Base Erosion and Profit Shifting (BEPS)

Comments Received on the Public Discussion Draft

BEPS ACTIONS 8 - 10

Financial transactions

Part I

14 September 2018
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September 1, 2018

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Centre for Tax Policy and Administration
2, Rue Andre Pascal
75775 Paris Cedex 16
France

Comments on the OECD discussion draft on financial transactions

Dear Messieurs & Mesdames,

We welcome this opportunity to express our comments on the discussion draft. Here below are our comments for your reference:

On C.2.2. Accurate delineation of cash pooling transactions:

On Paragraph 108:

The original text (parts related to comments are underlined):

A potential difficulty for tax administrations in analysing cash pooling arrangements is that the various entities in a cash pool may be resident across a number of jurisdictions, potentially making it difficult to access sufficient information to verify the position as set out by the taxpayer. It would be of assistance to tax authorities if MNE groups would provide information on the structuring of the pool and the returns to the cash pool leader and the members in the cash pool as part of their transfer pricing documentation. (See Annex I to Chapter V of the TPG about the information to be included in the master file).

Our comments:

Based on the various specific and implied information needed for transfer pricing analysis in section C.2. on cash pooling, we feel more information should be listed in a consolidated fashion to provide clarity, certainty and avoid unnecessary and unexpected information on the part of the taxpayers. This way, both the tax authorities and the taxpayers can have a quick general outline to assess the arm’s length nature of the pooling arrangement. They do not have to try to dig very hard from the paragraphs about what to look at for the analysis.

Our suggested wording (underlined parts are newly added):

A potential difficulty for tax administrations in analysing cash pooling arrangements is that the various entities in a cash pool may be resident across a number of jurisdictions, potentially making it difficult to access sufficient information to verify the position as set out by the taxpayer. It would be of assistance to tax authorities if MNE groups would provide information on:

- the structuring of the pool and
- the returns to the cash pool leader and the members in the cash pool
- what benefits are planned when setting up the cash pooling arrangements and what are actually achieved on a yearly basis
- what are the specific schemes to allocate the benefits among all members of the pool
- whether the cash pooling is intended and in fact a short-term arrangement
- what interest rates are applied for the borrowing and lending within the pool members
- what economically relevant factors are considered when setting up those interest rates
why the rates set make the cash pool members better off than their next best option (e.g. depositing funds with an external bank)

the existence of any bargaining power issues (net debtors vs. net depositors) for not participating to the pool

a description of the functions, risks and assets of the cash pool leader in the following aspects:
  - whether setting up the cash pool accounts, coordinating the pool and drafting the intercompany loan agreements are part of its responsibilities
  - extent of decision-making power on how to invest surplus funds or fund any shortfall
  - responsibility for setting the intra-group interest rates
  - extent of the undertaking of risk for any differences between the rates it sets with other group members and the rates at which it transacts with the independent lenders
  - whether it bears credit risk, liquidity risk and currency risk for intra-group finance
  - decisions on how or whether to hedge such risks
  - controlling the financial risks contractually allocated to it and has the financial capacity to bear those risks

reasons behind the methodology adopted to compensate the cash pool leader based on its functional and risk profile above.

as part of their transfer pricing documentation. (See Annex I to Chapter V of the TPG about the information to be included in the master file).

On C.2.3. Pricing of cash pooling transactions:

On Paragraph 111:

The original text (parts related to comments are underlined):
111. In general, a cash pool leader performs no more than a co-ordination or agency function with the master account being a centralised point for a series of book entries to meet the pre-determined target balances for the pool members. Given such a low level of functionality, the cash pool leader’s remuneration as a service provider will generally be similarly limited.

Our comments:

We feel the current underlined wording could be further expanded to provide more clarity for the notion of “limited” and its implications for taxpayers and tax administrations. For instance, referring to Chapter VII on intra-group services for more detailed guidance on compensations for a service provider in intercompany transactions.

And it would also be helpful to clarify whether this concept of “limited” can be interpreted as saying the cash pool leader is performing a low-value adding service as defined in Section D.1 of Chapter VII. Because in general, financial transactions are specifically excluded in Paragraph 7.47 of Chapter VII. But Paragraph 7.48 states that “the fact that an activity does not qualify for the simplified approach, …., should not be interpreted to mean that that activity generates high returns. That activity could still add low value….”. And more specifically, whether the simplified approach in Section D.2. of Chapter VII for determining arm’s length charges for low value-adding intra-group services, especially the 5% mark-up safe harbor, can be applicable to the cash pool leader in question here.

Our suggested wording (underlined parts are newly added):
111. In general, a cash pool leader performs no more than a co-ordination or agency function with the master account being a centralised point for a series of book entries to meet the pre-determined target balances for the pool members. Given such a low level of functionality, the cash pool leader’s remuneration as a service provider will generally be similarly limited. For more details on
determining the arm’s length arrangement for the services, refer to Chapter VII for guidance. Subject to further analysis of all the activities of the cash pool leader, the simplified approach in Section D.2. of Chapter VII for determining arm’s length charges for low value-adding intra-group services, and the 5% mark-up noted there, could be applied to the cash pool leader in question here. But this does not exclude other non-cost plus remuneration approach that may also be appropriate like providing a certain basis point spread for the cash pool leader.

On Paragraph 122:

The original text (parts related to comments are underlined):

Accordingly, T should be compensated for the functions it performs and the risks it assumes in accordance with the guidance in Section C.1. The lender’s and borrower’s perspectives of this guidance. This may include earning part or all of the spread between the borrowing and lending positions which it adopts.

Our comments:

It would be helpful to further elaborate on how to further determine the exact level of spread between borrowing and lending positions. How to allocate different weights to different functions and risks undertaken in the example in getting the level of the spread to compensate T? What parameters could be applied to quantify the different aspects of the functions and risks mentioned are as below?

- decisions on how to invest surplus funds or fund any shortfall
- setting the intra-group interest rates
- undertaking risk for any differences between the rates it sets with other group members and the rates at which it transacts with the independent lenders
- bearing credit risk, liquidity risk and currency risk for intra-group finance
- decisions on how or whether to hedge such risks
- controlling the financial risks contractually allocated to it and has the financial capacity to bear those risks

Our suggested wording (underlined parts are newly added):

Accordingly, T should be compensated for the functions it performs and the risks it assumes in accordance with the guidance in Section C.1. The lender’s and borrower’s perspectives of this guidance. This may include earning part or all of the spread between the borrowing and lending positions which it adopts. The arm’s level of the spread could be subject to an analysis of the possibility for profit split allocation using appropriate allocation keys.

On Paragraph 129:

The original text (parts related to comments are underlined):

129 In those situations where there is a genuine credit risk to the depositors, the interest rate benefit of pooling may be rateably allocated among the net depositors to the pool on the basis that the depositors have their capital at risk across all net borrowers from the pool members and so should be entitled to any benefit arising from the use of that capital.

Our comments:

The current discussion draft and the July 2017 version of the OECD TPG provide no definition for "a genuine credit risk” and what practical indicators could be deployed to measure the extent of the risk. Would the typical method employed by credit agencies or commercial tools to get the credit
rating be acceptable to tax authorities in assessing the level of credit risks? Would a standalone credit rating below a certain level imply a genuine credit risk? Or common sense should simply be applied or should more detailed guidance be added?

**Our suggested wording (underlined parts are newly added):**

129 In those situations where there is a genuine credit risk to the depositors, the interest rate benefit of pooling may be rateably allocated among the net depositors to the pool on the basis that the depositors have their capital at risk across all net borrowers from the pool members and so should be entitled to any benefit arising from the use of that capital.

A genuine credit risk can be broadly defined as a risk that a commercially independent bank or other lending or supervisory entity would believe to exist with at least a probability of over 50% based on the stand-alone creditworthiness of the borrower and the likelihood of its default over a specific time horizon on any potential borrowings.

Actionable Insights Advisory would be pleased to discuss those comments above in more detail.

Best regards,

Larry LI
Partner
Actionable Insights Advisory
To:
Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

By email to: TransferPricing@oecd.org

From:
Mr Alexander Kruglov

Dear Sirs,

Please find attached comments on the Public Discussion Draft “BEPS Actions 8-10. Financial Transactions” (hereinafter – the Public Draft).

Comment on Box C.1:
A decentralized treasury structure is possible in the following two cases:

1) For multinationals (“MNEs”) with multiple operating divisions which are independent from each other and operate in discrete industries with different cycles. A possible example is an MNE with four different divisions, such as power generation, industrial machinery equipment, software development and consulting.

2) For MNEs which have gone through a recent M&A process and represent distinct businesses under a common parent company. It is quite common that the acquired companies retain their separate treasury departments that continue running in parallel with the departments of the acquirer/parent company.

Comment on Box E.2
Actuarial analysis could be seen as one of the methods to support a primary economic analysis. In practice, it has certain limitations. Actuarial analysis considers purely the risk of failure based on technical assumptions and probabilities. However, it does not properly reflect market forces (e.g. supply and demand for insurance).

Another limitation is that an actuarial analysis does not consider two different underwriting philosophies pursued by independent insurance market participants which result in a very broad range of insurance rates on the open market. For instance, pure carriers (fully-fledged underwriters) use their own capacity to cover risks and do not reinsure them. Therefore, their interest is in being profitable over the long term. Being big players with numerous lines of business, they also normally focus more on long-term profitability rather than the revenue. On the other side of the spectrum there are managing general agencies (MGAs) that are usually specialized in one or a few lines of business. Their focus is more short
term as they are rather looking for premium volume as opposed to profitability so as to maximize their commissions.

Additional comments

On Paragraph 166:

It needs to be acknowledged that not all of the risks could be insured outside of MNEs. For instance, some risks could be either no longer insurable for a certain period of time or that insufficient capacity is available in the market for those risks. In those cases, a captive is an efficient vehicle to compensate for deficiencies of the insurance market. For instance, (1) the market for terrorism risks reduced after 2001, so it is likely that MNEs were using captives to insure those risks or (2) credit risk insurance almost disappeared from the market for several years after the 2008 financial crisis, so this is another class of risk which may have shifted to captives established by MNEs.

On Paragraph 176:

It needs to be acknowledged that in certain industries, statistical laws of averages that are used to apply and permit accuracy of modelling of the likelihood of claims may be of little relevance. For instance in the space industry where a limited number of launches takes place each year, a single insurance event may distort the results (unless the analysis is carried over an extremely long period of time). This is different, for instance, from the automotive industry where millions of cars are insured on an annual basis, and the results could be predicted with a high degree of accuracy.

Kind regards,

Alexander Kruglov
About Alternative Information & Development Center (AIDC):

AIDC was formed in 1996 in response to the democratic transition in South Africa and the new opportunities and challenges it brought those seeking greater social justice. Since then, AIDC has established itself as a leading source of research and information on themes of illicit financial flows, base erosion and profit shifting. AIDC has done extensive research on the issue of IFFs and BEPS. We have done case studies which exposes the transfer mispricing and BEPS practices of transnational corporations. For example AIDC provided evidence to the Farlam Commission of Inquiry that Lonmin PLC was shifting annually R250 million to a letterbox company in Bermuda.

Working with the Black Sash we have shown how Net1 uses software licensing fees charged to its subsidiary Cash Paymaster Services as a profit shifting tactic. We have also made a submission to the Davis Tax Committee and engaged multiple times with local and international tax experts to explore the best way to reform our broken tax system. We are doing work in relation to drafting legislation on a general anti-avoidance rule that can be adopted by government to halt illicit financial flows. We also recommend a move toward transparency: establishing a public database and registry for everyone to be able to know the beneficial ownership of every asset, land, trust and company in South Africa.

Introduction:

AIDC doesn't believe the arm-length principle is the most appropriate theoretical base to build our international tax system. It is a concept that deny the very specific essence of multinational companies by creating the fiction the trade relations within these entities should be accounted for in a similar way the trade between unrelated companies is accounted for. Multinational companies operates as groups. We can't assume that they don't and therefore ask them to entertain this fiction that their subdivision trade with each other in the same fashion as unrelated companies. The very essence of multinational company operational model is to build international value creation chains by linking resources, productive forces and markets internationally. Acknowledging that value creation is for these companies an international holistic process implies the international tax system has to cater for such complexity by evaluating value creation and profit making at an international level for tax purposes. Only then should this value and profits be apportioned between the different subdivision of multinational companies to allow national jurisdictions to tax their fair share of profits.
However, knowing it is currently through such problematic principle the current reforms of the international tax system has been designed, including the BEPS Action Plan, we will try to show how best to interpret these new rules and here the discussed guidelines on financial services to produce a fair and just outcome.

Our comments take as a given that in the same way international value chains build by multinational companies should be understood as a whole, the value created by financial services should be shared evenly amongst the members of a same multinational entity. We will therefore demonstrate how best to avoid the financial value created from being captured by specific entities within multinational groups while using intra-group loan, cash-pooling structures, financial guarantees and captive insurances.

Our comments will also have as a core principle that any tax rules must be kept as simple as possibly acceptable, even if it means the result of such rules distort slightly the outcome that is designed to mimic the theoretical outcome a market economy would have produced. To us, two main reasons justify such principle. First, simplicity provides certainty to economic actors and avoids lengthy and costly tax disputes. Obtaining a perfect arm-length price for a transaction can't justify that public finances be dilapidated in the process due to legal costs and payment delays. This is especially true for developing and emerging economies where tax authorities don’t always have the same capacities to deal with complex and lengthy tax disputes. Simplicity is therefore an important principle to ensure the new emerging international tax system will fit the need of all jurisdictions irrespective of their internal capacities, and not only those of OECD members. The second reason is a question of legitimacy: a good tax rule is a rule understandable by everyone. This ensures its legitimacy which is the core driver of tax compliance. The need for simple and accessible tax rules is therefore a pragmatic choice.

Lastly, it is important to note when reading these comments that the Alternative Information & Development Center has over the years accumulated a vast experience in dealing with illicit financial flows and transfer pricing related disputes. We therefore wants to emphasize that the following comments are designed to address one the main issue our case studies revealed: the disguise of dividend payments through the use financial service related payments in order to avoid both legitimate tax obligations, and social obligations in the countries where the core value creation activities take place. The following comments might therefore create debates and controversy since they don’t follow the current mainstream approach which privilege capital exporting countries in the designing of new international tax rules.

Risk-adjusted rate of return (Box B4)

While there is merit to add a premium on a comparable risk-free to determine a just interest rate for a financial transaction between related parties, such methodology has nevertheless an inherent flaw. It takes as a given the objective is to determine the interest rate that would have been chosen in an exactly similar transaction between two unrelated parties. However, the essence of related party transactions is that the two parties are related. This simple but fundamental fact means that informations hazards between the two parties are most likely non-existent. This absence of information asymmetry means that risks for the lenders of discovering malpractices, hidden informations, or even to witness the borrower taking harmful actions (i.e. contracting another loans and offer better securities to the second
loans) are nonexistent. The logical conclusion is that the premium associated with the risk embedded in the transaction will necessarily be lower than the premium attached to a similar transaction between independent parties. We therefore encourage the guidelines to reflect such information symmetry and its impact on determining a correct rate of return for a transaction.

Decentralized treasury structure (box C1)

As already underlined in the introduction, MNE value creation activities are by essence global and reflect these integrated international value chains. It means the treasury function of multinational economic actors is necessarily globalized in order to manage and answer best the financial needs in term of liquidity and investment occurring during the development operations such value chains require. If we don't deny there might be some exception to this rule, we believe there is value in inserting within the guideline a rebuttable assumption that the treasury function is centralized within these MNE.

The Lender's and borrower's perspective

It is important when trying to determine the relative position of both the lender and the borrower of an intra-group loan to take into account the assumed transparency of information between two related parties. It means that there is no hazard neither difficulty for the lender in determining the creditworthiness, credit risk and economic circumstances of the borrower. By being a related party to the borrower, the lender knows the kind of economic sectors it operates in, the economic opportunities it can reasonably expect, its strategy, as well as its comprehensive financial situation. This has an important impact both in lessening the cost occurred in evaluating the creditworthiness of the borrower, and in limiting the risk associated with the loans (impact on premium applied to a risk free rate).

Then this relation between related parties has another consequence: when such relation is build over substantial and common ownership links (i.e. parent companies), it means granting securities become irrelevant in determining the credit risk of the borrower.

We acknowledge the fact the guidelines include in §51 a reference to such securities, but we hope it will be redrafted to incorporate an assumed solidarity and implicit support between parent companies and therefore the irrelevance of securities in determining the risk. An even better assumption we encourage the OECD to adopt within the guidelines is to introduce an assumption that the whole assets of a borrower (or a percentage of them in case of partial control by the parent company) in a related party loan are a de facto security when evaluating the credit risk of the borrower.

Credit Ratings and the effect of group membership (box C2)

We strongly believe it is important to include in the guidelines the rebuttable presumption that an independently derived credit rating for a multinational group shall be considered as the credit rating for each group member. It should indeed always be the key component in determining the credit rating of a member. Multinational economic entities operates as a whole. It is therefore evident that an independant credit rating of the group should be the common basis on which to determine an appropriate rate of return for group members. Since the essence of multinational enterprises is to
maximize their profits, they will always aim at reducing to a minimum level the financing costs for the group as a whole. As a consequence, the only practical solution to determine an affiliate's creditworthiness is to use the group's credit rating since it is most likely to be a better credit rating than those given to its individual affiliated entities. Using the group's credit rating for all its members is therefore just acknowledging the fact that MNE will always try to rely on such a rating to reduce their funding costs and by there increase their profitability. Not only is it practical, but it will also save resources and costs both for multinational companies in determining the right financial price of a related parties transaction, and for national tax authorities by limiting the room for tax disputes. We also encourage the authors of the guidelines to make such presumption an irrebuttable one in the case the related entities are parent companies.

**Implicit Support (answer to box C3)**

As already expressed before, we believe the best way to determine the credit rating of a multinational group's individual entity is to use as a base the credit rating of the group as a whole since the cost of capital for any member of the group has to be equal to the one the group would pay as as whole. It is then up to the group to decide or not to invest such capital in risky activities or not, but that shall not influence the cost of capital for the affiliated member. We indeed believe there is a strong implicit support between the different entities of a group: a MNE always plans its economic strategy globally in order to maximize its return on investments globally. As a consequence, any of its assets shall be regarded equally as a potential profit making asset. The fact that certain assets might be less strategic to the core businesses and operations of the group is therefore not relevant in determining the interest rate of an inter-company loan.

**Covenants**

To price adequately an inter-company loan, we believe that the existence of automatic covenants between related parties is a given. Both party to the loans are part of the same MNE and therefore, the lender has no risk of seeing the borrower acting at its expenses unless this is beneficial for the MNE as a whole. Samely, by being part of the same MNE, there is no information asymmetry between the parties. It means there is no possibility to justify an higher interest rate in regards to the usual and inherent risk of being provided false or misleading information when the parties are unrelated. On the contrary, the fact that both parties are from the same MNE means that there is a automatic assumption information is transparent between the parties. It justifies then a lower interest rate for the borrower due to the absence of information hazard.

**Loan fees and charges**

We believe that such fees and charges, even when there is solid ground to justify any, can't be justified to the same extent that they might be for a transaction involving two unrelated parties. The mere fact that the parties to the transaction are associated enterprises automatically means the costs of raising capital and satisfying regulatory requirements will be lower due to the historical links between the two companies, the transparency of information between the two companies, and the automatic confidence that exist between related parties.
Determining a just interest rate for intra-group loans (box C.5, C.7)

In determining a just interest rate for an inter-company loans by using the 'Comparable Uncontrolled Price' method, the list of elements to take into account of §83 is a good first basis. However, we believe some of these elements shouldn't be in this list or should be dealt with cautiously in regards to the specific nature of the relation between the borrower and the lender in a inter-company loan.

First, as we already mentioned it, the absence of collateral must not lead to select a comparable more risky than the controlled transaction: the existence of collaterals are to be presumed due to the fact that both parties are related parties (see the section 'Collateral' of this document). This is true too for securities as we already expressed why we believe a implicit financial support exists between the members of the same MNE. In addition, the fact that both parties are related means that no harmful behavior from the borrower will take place without at least evaluating the impact of such action on the lender and more broadly on the whole multinational group. We therefore believe the guideline should reflect the extra-care needed when dealing with these specific elements in order not to overprice a loan by using inadequate comparable.

However, we believe that the 'Cost of funds' method can be a better approach since it better reflects the financing cost of the MNE than a comparable transaction. We nevertheless want to highlight that the risk-premium and the profit margin used in this method may be illegitimately inflated by not taking into account two elements. First, the necessary sharing of profit between the members of the same MNE which implies that any profit registered by the lender in the studied transaction will necessarily be lower than if the transaction took place between unrelated parties. The second danger is to overestimate the risks taken by the lender by not considering the implicit financial support that exist within an MNE, as well as the information transparency that exist between the related parties.

Cash Pooling (Answer to boxes C8, C9, C10,)

When using cash pooling arrangement, being it physical pooling or notional pooling, we believe the only profit a cash pooling leader company can expect shall be from benefiting of a small return on investment that reflects the real costs incurred in managing the transactions between the member of the pool, and the potential external lender and borrowers of the pool.

Coming to the financial benefits created or expected from the pooling arrangement, we believe there are not linked to any risk taken by the cash pooling leader and should not be attributed as such to the leader. On the contrary they are attributable to the capital invested by the different members of the pool who decided according the the unified cash management strategy of the group to maximize the financial gains (more interest received) or to diminish the financial costs (less interest paid) linked to cash management. The only reasonable way to allocate such gains or savings is therefore to reward all pool members evenly by attributing the gains and savings according to their relative capitalistic size by comparison to the capitalist size of the group. It might result in direct cash payments to the affiliates, or alternatively can translate into more beneficial interest rates given or charged to the affiliates, in accordance to the relative gains attributable to each member as described before.
In term of cash pooling guarantees, we believe such guarantee are pointless and should not lead to any payments. This is simply because in such cases, a financial solidarity exists between the member of the same MNE and implies there is an implicit support between the members of a pooling scheme. It thus cancels the need for any guarantee since these *de facto* cross-guarantees between the members already cover the potential risks.

**Financial Guarantees and implicit passive guarantees (answer to box D1)**

As argued already previously, we consider that an multinational group should have a single credit rating applicable for all its entities. Coming to the question of financial guarantees, we similarly believe the guidelines must include a rebuttable presumption that multinational groups provide financial support to their affiliated entities. Consequently, no extra cost neither fees can incur on the borrower due to absence of formal financial guarantee from another affiliate of the group or from another parent entity.

We don't dismiss the possibility of a loss for the guarantor, but we believe in the event of such a loss that it must be assimilated to a capital contribution, and not to a financial instrument from which payments could be derived. We further insist that such presumption should be made irrebuttable when the related entities are parent entities.

**Captive insurance (Answer to box E1)**

In regard to captive insurance, we believe that out of the list of criteria provided in §166, two major criteria are absolutely critical in order for a captive insurance provider to be able to legitimately claim any profit from such an activity.

First, there is a need for a sufficient pooling of activities to insure the risk mitigating activity indeed takes place by sufficiently diversifying the risks. If such sufficient diversification of the risk is not achieved, the logical conclusion that one shall draw is that the service provided is not an insurance service. In such a case, it is then likely the payments will be assimilated to a dividend payment and that it might lead to tax obligations associated with such kind of payments.

Then, the second important criterion to check for is the diversification of insurance activities outside of the MNE. This latter criterion is fundamental to us simply because without insurances being provided to external entities, the premium paid to a captive insurance will appear as illegitimate. In theory, the justification for a return on investment (beyond the covering of the expenses incurred in administering and issuing insurance policy) is linked to the risk taken by insuring an uncertain transaction or entity. But, in the case parties are related, the risk the captive insurance company takes (potential future losses to cover) is non-existent. From the perspective of the whole MNE, no loss mitigation is ever happening since the payment of a claim by a captive insurance company will only lead to transfer the loss from the 'insured' company to the captive insurance one. It will still constitute a net loss for the group as a whole. Since in such situation, there is no real possibility of mitigating the risk properly, it means then no return on capital can be expected from such an activity. The exception is therefore that real risk-taking activity is happening when issuing insurance policies to external and unrelated entities. The only possible remuneration for such a captive insurance company from its related customers would therefore be linked to the administrative fees and costs that might have occurred in the course of administering and ensuing insurance policies.
Coming to fronting schemes of captive insurance and schemes that allows group synergy, we acknowledge that a small profit might be expected in order to compensate the facilitation activity that took place. However, any extra profit linked to the reduction of costs due to the pooling and sharing of the multinational group insurance needs (internal diversification of the risk), must be redistributed between the affiliates of the MNE according their respective premium as a pro-rata of the group's total insurance needs. In other words, the group synergy's gains occurring due to the collective bargaining process facilitated by the captive insurer shall be entirely split between the affiliates of the group, set aside the cost of facilitating such process.
By email to: transferpricing@oecd.org

7 September 2018

BEPS Actions 8 - 10: Discussion draft on financial transactions

Dear Sir,

1. General Comments

Introduction

AFME1 welcomes the opportunity to respond to the OECD's discussion draft entitled “BEPS Actions 8 - 10: Public discussion draft on financial transactions” published on 3 July 2018. We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD's initial proposals.

We believe that the OECD should make clear in its final recommendations that the proposals contained in the discussion draft should not displace any existing transfer pricing rules which apply to financial institutions, for the following reasons:

1. The existing transfer pricing guidelines for banking and finance groups

The volume and complexity of activities undertaken by financial institutions mean that a transaction-by-transaction approach, which has been suggested in the discussion draft, is impractical for financial institutions and tax authorities. The OECD has already considered the allocation of risk and capital within financial institutions when developing the 22 July 2010 “Report on the attribution of profits to permanent establishments” (the 2010 report). The 2010 report recognises the importance of Key Entrepreneurial Risk Taking (KERT) functions in a bank or financial institution (i.e., the creation of financial assets and management of the risk associated with those assets). We believe that the 2010 report is widely regarded by both tax authorities and taxpayers as a reasonable and fair approach to taxing banking and finance businesses and should remain the principle source of guidance for the banking and financial services sector. We urge the OECD to make this clear in any further possible guidance.

2. The importance of regulatory requirements for the banking and financial services sector

The financial services sector is subject to extensive regulatory requirements, in particular with regard to capital, liquidity and leverage. Supervisory authorities have sought to ensure that the regulatory framework promotes financial stability, protects deposit holders and ensures the continuity of services to customers and businesses, in particular lending throughout the business cycle. This means that financial institutions are required to hold

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1 AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA), a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

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increased capital reserves against their assets and face limits on their ability to leverage\(^2\). We understand that financial institutions will typically seek to exceed rather than merely meet minimum regulatory requirements. The regulatory requirements limit the ability of financial institutions to engage in activity which may cause concern in relation to BEPS. This is an important feature of the financial services sector and distinguishes it from other sectors. We are pleased that this has been acknowledged by the OECD in several places in the discussion draft\(^3\), and we believe that the importance of regulatory requirements in determining the structure of financial transactions within financial institutions should be made clear in the OECD’s final recommendations.

2. Specific comments

In case helpful for the OECD, we share the following observations on the proposals contained in the discussion draft:

- In Paragraph 19, the OECD states that “when considering whether to enter into a particular financial transaction, independent enterprises will consider all other options realistically available to them”. The OECD gives some examples of market conditions which may act to restrict the ability of parties to lend. However, we note that market conditions may be such that they encourage greater lending. We believe that it would be more balanced to reflect that here.

- We note in Paragraph 34, that special consideration should be given to a company’s business strategy - in particular, where a company is involved in a merger or acquisition - when determining the comparability of transactions for transfer pricing purposes. We believe that this is an important factor and welcome the OECD’s approach here.

- In Paragraph 52, in relation to loans between a parent and subsidiary, the OECD states that “the parent already has control of and ownership of the assets of the subsidiary, which would make the granting of security less relevant to its risk analysis as a lender”. In the context of regulated financial institutions, we understand that this is not necessarily the case. For example, we note that recovery and resolution plans are required for systemically important banks which can mean that shareholders are deprived of advancing funds, as a result of the protection afforded to other creditors. This serves to highlight that the financial services sector differs from other sectors.

- In Paragraph 80, in relation to the pricing of loan fees and charges, the OECD states that “it must be borne in mind that independent lenders’ charges will in part reflect costs incurred in the process of raising capital and in satisfying regulatory requirements, which associated enterprises might not incur.” We welcome the acknowledgement here that there are costs associated with meeting regulatory requirements. As noted above, for the financial services sector, this is likely to be an important factor.

\(^2\) Another feature of regulatory requirements is that they may impact members of a regulated group that are not individually regulated.

\(^3\) For example, we note that in Paragraph 3, the OECD states that “in the absence of other influences such as legal or regulatory constraints, the balance of debt and equity funding between independent enterprises will be the result of various commercial considerations...Thus, in an intra-group situation, other considerations such as tax consequences may also be present”. Furthermore, in Paragraph 13, the OECD states that “the effect of government regulations” is acknowledged.
• In Paragraph 92, in relation to bank opinions, the OECD states that their use would “represent a departure from an arm’s length approach based on comparability since it is not based on comparison of actual transactions”. It is not clear why a bank may not undertake the necessary due diligence and provide a useful opinion and would suggest that the OECD provides further details.

• In Paragraph 100, in relation to the accurate delineation of cash pooling transactions, the OECD states that “As cash pooling is not undertaken regularly, if at all, by independent enterprises, the application of transfer pricing principles requires careful consideration”. We understand that it may still be possible to use information regarding the standard banking arrangements involving the cash pool leader as a comparator for intra-group cash pooling arrangements. This should be reflected in the OECD’s final recommendations.

• In Paragraph 111, the OECD states that “In general, a cash pool leader performs no more than a co-ordination or agency function”. We note that this statement is qualified in Paragraph 112 which states that “Where accurate delineation of the actual transactions determines that a cash pool leader is carrying on activities other than coordination or agency functions, the pricing of such transactions would follow the approaches included in other parts of this guidance, as appropriate”. In practice, we understand that cash pool leaders often perform activities other than coordination or agency functions (as is illustrated in the examples in Paragraphs 114 onwards) and therefore we suggest that this should be reflected in Paragraph 111 and in the OECD’s final recommendations.

Once again, we are grateful for the opportunity to share our comments with the OECD and would be pleased to answer any questions on the above comments.

Yours faithfully,

Adam Willman
Director, Tax Policy
Attn: Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

10 September 2018

Dear Tax Treaties, Transfer Pricing and Financial Transactions Division

DISCUSSION DRAFT ON OECD BEPS ACTION 8 – 10 FINANCIAL TRANSACTIONS: ABS Comments

The Association of Banks in Singapore (“ABS”) welcomes the opportunity to comment on the OECD BEPS Actions 8 – 10 Discussion Draft on Financial Transactions (“Discussion Draft”). We appreciate the OECD’s efforts to consider taxpayer’s views on the practical application of this guidance.

Background

ABS plays an active role in promoting and representing the interests of the banking community in Singapore and has a membership of 156 local and foreign banks/institutions and representative offices. ABS also works closely with the authorities in supporting their role in developing and maintaining a sound financial system in Singapore.

Established in 1973, ABS has over the past 40 years, brought its members together, establishing common grounds through benchmarking and setting banking guidelines as well as working on projects of mutual benefits to face the challenges of the financial and banking community in Singapore.

Overarching comments

In considering future revisions to the OECD TP Guidelines (or secondary guidance documents), it is important that any such revision is complimented by the experience of tax administrations and taxpayers in handling the practical challenges relating to intra-group financial transactions. To ensure that guidance provided within the Discussion Draft does not give rise to unwarranted dispute between taxpayers and tax administrations, we believe the final guidance on financial transactions should be limited to areas of consensus only. This will help to avoid tax disputes or double taxation arising from the application of this Discussion Draft.

We also note that the Discussion Draft is not specific to any industry sectors, and as such it does not seem to take into account the intrinsic differences in the nature of industries. For the financial services sector, consideration should be given to its role as key providers of debt financing; reliance on interest for profitability and liquidity; and the strict regulatory capital rules which apply.

In particular, regulatory requirements are an important consideration, as these typically determine the type of equity and debt allowable, their relative proportions, and the liquidity requirements of financial services entities. These regulatory factors significantly reduce the risk of Base Erosion and Profit Shifting (BEPS) risks posed by the financial sector.
Furthermore, it is vital that any rules introduced in relation to the transfer pricing of intercompany financial transactions within the financial services sector do not weaken the effectiveness of capital regulation in providing protection against future financial crises. Both of these points have been recognized by the OECD in the past, as part of the 2015 Report BEPS Action 4.

If the Discussion Draft is to be applied to the financial services sector, a clear statement should be featured stating the importance of the regulatory approach and regulatory considerations which govern intercompany financial transactions in this sector. Alternatively, it should be clarified that the Discussion Draft is not intended to apply to the non-financial services sector.

Taking account of the above over-arching points, we set out below our views on some of the areas of feedback sought, as organized based upon the OECD’s request for public comment.

**Specific comments on questions raised**

**B.1. Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention (“MTC”), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.**

We note that Paragraphs 8 to 10 of the Discussion Draft establish that accurate delineation is not the only approach to determining the appropriateness of a MNE’s capital structure. This guidance is helpful to clarify for countries the OECD approach of accurate delineation in relation to capital structures and interest deductibility, notwithstanding that countries maintain flexibility to adopt alternative approaches under domestic legislation. We would like to take this opportunity to suggest further possible additions which would strengthen this section.

While Paragraphs 13 – 15 allude to the requirement to take into account the relevant characteristics of the transaction, we would suggest a strengthening of the guidance on how financial services regulatory requirements may influence or limit a MNE’s capital structure. The financial services sector operates under strong supervision/regulation, and as a result, regulatory constraints are primary drivers for the structuring of financial transactions and determining the capital structure.

We would further propose that, due to the importance of interest to the intrinsic nature of the financial services sector, the Discussion Draft should explicitly address reference that suitable and specific rules on interest deductibility be developed for this sector. As an example, the 2015 Report on BEPS Action 4 recognized the need for specific rules that address the BEPS risks for financial institutions, and exemption from fixed ratio rules approaches were envisaged.

We recommend that the Discussion Draft indicate clearly what guidance is intended specifically for financial institutions, including identifying the regulatory considerations, potential exemptions or separate guidance which should be applied for financial institutions.

**B.2. Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.**

The example set out in Paragraph 17 of the Discussion Draft provides a single highly specific criterion to determine the total amount of debt permissible. As there are multiple possible mechanisms for conducting an assessment of a borrower’s ability to service its debt obligations (and other commercial considerations in addition to a pure financial projection approach), such
an example without additional explanatory details may create confusion and increase the chance of taxpayer-tax authority dispute. We would propose that additional explanations on possible methods to assess a borrower’s ability to service its debt obligations is required, as this would be critical to enable the majority of MNEs to take this guidance into consideration.

Furthermore, it is not clear what the order of preference would be in relation to a MNE servicing its debt. For example, if a MNE entity has a loan from a third party, a loan from its head office, and another loan from another related party, what is the order in which these instruments should be considered when assessing the ability for the MNE entity to service its related party debts.

From a financial services sector perspective, we believe it is critical for the Discussion Draft to first consider regulatory requirements as the primary consideration for a financial institution’s debt/equity structure. The risks of having excessive debt which BEPS have sought to tackle are addressed by the capital ratios and leverage ratios required under Basel regulatory frameworks. Assuming that the conclusions of the 2015 Report on BEPS Action 4 still hold (in relation to the primacy of regulatory considerations), it should be made clear that the debt and equity as established for regulatory purposes should not be subject to potential re-characterization.

With regard to the discussion on ‘options realistically available’ (“ORA”) in Paragraph 19, we believe that this statement may unduly cause discussions to focus on providing evidence that all ORA were considered prior to entering into a transaction. While fundamentally it is true that an independent enterprise would try to enter into the most attractive transaction to meet their commercial objectives, providing objective evidence that this has been done in a related party situation can be practically challenging and onerous to compile. This would be equivalent to suggesting that a MNE retain evidence that all possible funding mechanisms were considered (along with their respective pricing), to demonstrate that the resultant related party transaction is most cost effective.

Instead, it should be recognized that a MNE’s treasury function would try to fund the various entities and businesses at the lowest price possible, taking into consideration other factors (such as stability of funding sources, access to capital markets, and market reputation). These strategic aims of a MNE treasury function and their intention to fund the MNE as cheaply as possible should already be indicative that any ORA have been considered.

B.3. Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction. Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

We appreciate that the guidance outlines the characteristics, economic factors, business strategies, and risks which may be relevant in assessing financial transactions. While it is alluded to in Paragraphs 30 – 32, we would further highlight that the available liquidity of the lending currency be specifically mentioned and considered in conjunction with the other factors. For example, availability and accessibility of USD may be constrained in the onshore markets of certain countries and should be factored into when assessing the need for and pricing of financial transactions.

In addition, from a financial services sector perspective, it would also be appropriate to consider liquidity risk (defined as the risk of the financial institution being unable to meet its financial obligations) as a factor. In practice, financial services firms will consider the costs of maintaining liquidity pools, tenor transformation, and valuation of liquidity premiums when arranging financing. This type of risk has been referenced in previous OECD publications (e.g. 2017 OECD TP guidelines), and is critical consideration for financial service sector firms.
B.4. Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm’s length interest rate.

Risk-free rate of return

Box B.4 of the current Discussion Draft suggests that a risk-free rate of return be applied for transactions where the analysis shows that the funder lacks capability, or does not perform decision making to control the risks associated with a financial asset.

To reduce the likelihood of dispute between taxpayers and tax authorities, we would appreciate further guidance from the OECD with regard to appropriate base rates which can be considered to approximate a risk-free rate of return (e.g. government issued securities, Interbank Offered Rates, Secured Overnight Financing Rate etc), taking into account the debates currently ongoing between the Alternative Reference Rate Committee (“ARRC”) and similar bodies globally.

In addition, further clarity would be helpful in contrasting such a risk-free rate of return in relation to possible scenarios seen in practice. For example, if a MNE raises funds in a special purpose vehicle (“SPV”) through an issuance to the public, provides these funds to Entity A, but the control of the decision making functions and control of risks are undertaken by a central treasury function in Entity B. It is not clear how the difference between a risk-free rate and the arm’s length amount (rate issued to the public) should be treated.

Applicability of cost of funds approach

We note that the Discussion Draft presents an alternative approach to pricing based on the cost of funds approach (Paragraphs 89 – 91). Under the cost of funds approach, intra-group lending should be priced based on the cost of funds incurred, with a risk premium to reflect the inherent economic factors of the loan and a profit margin. However, it is not clear in the Discussion Draft how this cost of funds approach should be viewed in context of the risk-free rate of return approach (or vice versa). We would welcome further guidance from the OECD in relation to how these methods should be looked at in conjunction.

Taking into account the above, we would also like to caution that, for a financial institution, a cost of funds approach may not be possible to apply effectively in all circumstances. For a typical financial institution there may be a range of funding sources (and possibly managed as a pool of funds). Due to the fungibility of the funds, identifying the actual cost of funding for a specific transaction can be impractical. Furthermore, bearing in mind the objective of funding the group in the most cost effective manner, different entities could be involved in fund raising activities which adds to the complexity of accurately identifying actual funding costs.

While we are aware that there are countries with domestic legislation supporting a cost of funds type of approach (i.e. tax deduction is allowed only to the extent that cost of funds can be linked to an external issuance), this can be unduly onerous and fundamentally challenge the ability of financial institutions to raise funds in a competitive way. We would encourage any efforts by the OECD to issue guidance to help address such issues, in particular for the financial institutions.


C. Treasury function

C.1. Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

We note that the description of a treasury function in Paragraph 38 of the Discussion Draft provides some generic structures and has not considered the operation of a treasury function within a financial institution.

From financial services sector perspective, the treasury function tends to be complex, with commercial or regulatory reasons why activities need to be performed locally. For example, regulators in-country may insist on treasury activities being performed locally, segregated from the central team and taking into account local funding considerations.

We would recommend that any update to the Discussion Draft recognize the role of a corporate treasury function within a financial institution, or explicitly comment that the description of the treasury function is not applicable to the financial services sector.

C.2. Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

Commentators’ views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

We applaud and agree with the OECD that a rebuttable presumption relating to the use of group credit ratings (provided independently derived) across each group member would be helpful. In practice, a MNE would not normally obtain an independent credit rating to be derived for each group member. Credit ratings are used commercially as an indicator for investors, and do not serve an internal purpose for a MNE – hence it would be burdensome and unnecessary to require individual credit ratings to be assessed for each constituent entity of a MNE.

As part of the application of a group credit rating across a MNE group, consideration should also be given to the particular industry of the MNE. For example, within the financial services sector, where reputation holds a high significance, allowing a subsidiary to fail would lead to many concerns and possibly in an extreme scenario lead to a run on the bank (e.g. the sustained withdrawal of bank deposits). This further reinforces that each individual subsidiary should be viewed in the context of the group’s credit rating, as it is highly unlikely (even without an explicit guarantee) that a bank would allow a subsidiary to fail without fully settling its obligations.
However, the rebuttable presumption suggested by the OECD is helpful because in certain select situations (often arising from requirements for financial deals), individual entities within the group may obtain credit ratings determined by external rating agencies. In such situations, it may even be the case that the individual entities have better credit ratings than the Group.

Considering the above, we would recommend that the wording in Section C.1.3 of the Discussion Draft be strengthened to take account of these points. This would be highly likely to improve tax certainty and compliance in an area which many MNEs and tax authorities have found difficult to tackle.

C.3. Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

A stand-alone credit rating of an MNE is determined solely based upon its individual financial performance, without accounting for external factors. This definition should be clarified, since a standalone rating of a MNE group means without external support from its sovereign country (or other industry players), and the standalone rating of a subsidiary within a MNE group implies it is without support from its parent company (or other group entities).

We agree to the Discussion Draft that in certain situations, implicit support of a subsidiary within an MNE group can be substantial. However, it is impractical and onerous to quantitatively measure the effect of such implicit group support (this would be akin to MNEs attempting to do the work of a credit rating agency), and we would recommend that the guidance make clear that it should not be a requirement to quantify the impact of such implicit group support.

Instead, the Discussion Draft seems pointed in the right direction in considering the qualitative factors which would indicate the extent such implicit support is likely to be extended to constituents of a MNE group. For example, the qualitative factors involved in assessing implicit support would be based on actual market conditions and overall group strategy (e.g. new market expansion, reputational risks involved, significance of a group member, etc).

Where these factors indicate a high likelihood of implicit support for the constituent entity, the credit rating should be matched to that of the MNE group. If the OECD is of the opinion that there should be credit rating notching or adjustments based on different levels of implicit support, the mechanism for assessing and implementing this should be made clear in the guidance, since uncertainty in this area would give rise to significant tax uncertainty and tax disputes.

C.5. Commentators’ views are invited on:
- the role of credit default swaps (CDS) in pricing intra-group loans;
- the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

Credit default swaps (“CDS”)

CDS’ are typically used to transfer the credit exposure on instruments from one party to another. We can therefore understand the OECD’s interest in utilizing the pricing of such instruments as proxy for pricing certain components of intra-group loans. For example, CDS spreads for government issuances in a borrower’s country in theory are a possible proxy determining country risk / transfer and convertibility risks related to that country.
However, it should also be noted that as a traded instrument CDS pricing/spreads may be affected by multiple market-related factors (e.g. market demand and supply), and may be used for hedging purposes. These factors could reduce the reliability of its use in pricing intra-group loan. In addition, country risk / transfer and convertibility risk also hinge on non-financial factors, such as the country’s tolerance for deficit and the political will within country to pass capital control legislation. These non-financial factors are difficult to assess and quantify, and doing so requires specialist credit rating agency expertise.

Taking into account the above, we would recommend the OECD carefully consider all relevant factors and provide appropriate guidance with respect to the use of CDS’ in the pricing of intra-group loans.

Economic models in pricing intra-group loans

It cannot be disputed that economic modelling used by credit institutions form the basis for the pricing of third party loans. However, such economic models typically provide the starting point for third party loan pricing – in practice, market conditions or negotiation between parties could result in variations from these formula derived rates.

Even taking this into account, it would seem logical that such economic models (where available to a MNE) be used as a starting point in the pricing of intra-group loans. In effect, the economic model provides a basis for determining the intra-group loan pricing in line with a representative market price. Where additional qualitative factors apply which would impact the pricing of the loans (such as negotiating power or unmodeled considerations), these could be elaborated on and appropriate adjustments can then be made to try to improve the comparability to a third party loan situation.

C.6. Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.

In Paragraphs 92 – 93 of the Discussion Draft, we note that bank opinions and informal loan pricing are discussed. While the Discussion Draft does not officially seek comment on this topic, we would like to use this opportunity to share our opinions.

When a bank provides a pricing offer to a third party (particularly when it is in writing), such pricing will very likely have been produced through the same mechanisms as a formal offer. In most situations, the bank would have determined this pricing based on its internal financial and economic modelling – these are normally systematic taking account of the borrower’s credit rating and financial situation. Notwithstanding that a formal offer letter has not been issued, the pricing is representative of the market price, and the level of rigor in producing that quotation should not be pre-judged.

The OECD should also bear in mind that this conclusion on bank opinions or informal pricing offers will have an implied impact on other potential benchmarking references. For example, widely used market references such as the London Inter-bank Offered Rate (LIBOR), are themselves only indicative pricing determined by a pool of market participants. While the ARRC are looking at what benchmark rates should be applied in future, it is not inconceivable that many countries will continue to utilize similar Interbank Offered Rates even in the future.

We would therefore propose that the OECD re-assess whether such bank opinions should be considered as an acceptable pricing benchmark (assuming such pricing is derived in the same way as offers to other third parties).

We trust that the above comments are useful and will be taken into account in relation to this topic. Thank you.
Financial Transactions

A response to the
3 July
OECD Public Discussion Draft

by

The Association
of British Insurers
The Association of British Insurers

The Association of British Insurers (ABI) is the leading trade association for insurers and providers of long term savings. Our 230 members include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.9 trillion.

The ABI’s role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

Introduction

The ABI welcomes the opportunity to comment on the Public Discussion Draft on Financial Transactions. We have limited our comments to Section E - Captive Insurance.

Executive Summary

Reinsurance companies within regulated financial services groups should be explicitly excluded from Section E. Intra-group financial transactions of regulated financial services companies are not a major source of BEPS concern, as control by regulators in multiple jurisdictions significantly reduce any transfer pricing risk on such transactions to virtually zero.

We are not convinced that Section E is required for captive (re)insurers as the guidance already set out in the new Chapter I and other chapters of the OECD guidelines should be applied to captive (re)insurers in the same way as other companies. However, we have commented below on specific paragraphs contained in Section E.

Detailed Points

Section E – Captive Insurance

We believe there needs to be a clearer introduction to section E than that provided in Paragraph 163. This introduction should describe Captive Insurance and Captive Reinsurance transactions in more detail and differentiate them from other forms of (Re)Insurance between members of a regulated insurance group. In particular, there should be clarification that “Captive Insurance” as described in Section E is intended to refer to an enterprise providing insurance to related parties within a group whose primary focus is not that of (re)insurance.
It is our understanding that this section is intended to focus on situations where non-insurance MNE groups have a company within that group that provides (Re)Insurance to other group members. However, the entire section E and indeed the entire discussion draft refers to MNE groups and their members. Without further clarification, the captive section could apply equally to intra-group reinsurance between members of a regulated insurance group or intra-group retrocession in a regulated reinsurance group.

In our view, there should be a specific statement to clearly differentiate between the arrangements within an insurance group and arrangements within a non-insurance MNE for the following reasons:

- Within an insurance group the reinsurance will be undertaken between regulated entities. The regulated nature of this industry means that the risk of the arrangement not being arm's length is very low
- In a reinsurance arrangement, the original insurance involves third party risks outside the group. This means that the risks being reinsured are commercial risks
- There is a very real possibility of losses arising

There is also a suggestion in Paragraph 163, that a captive insurance company does not provide insurance but instead insurance-type services. We do not agree with this suggestion and recommend the wording is amended.

**Section E.1. Overview of Insurance**

The definition quoted in Paragraph 164 rightly identifies that insured events are outside the control of the insured. Paragraph 165 then talks about risks which the insured has some ability to influence and refers to product liability risk. We note that given there are many classes of business and risks that the insured has the ability to influence (by applying sensible loss control techniques) the specific reference to product liability risk alone may be misleading. We suggest the wording is amended to reflect this position.

We believe that the indicators of an independent insurer listed in paragraph 166 have the potential to cause confusion.

In particular, the comments on the economic capital position of the group misunderstand the nature of diversification; it is entirely possible for diversification to occur where only internal risks are (re)insured and those risks are retained within the group, provided a sufficient quantum and variety of risks are covered. In addition, the original insurance associated with these risks could involve third party risks from outside the group.

Paragraphs 169 -171 reiterate that “The principles of accurate delineation of the actual transactions and allocation of risk detailed in Chapter I of these guidelines apply to captive insurance scenarios in the same manner that they apply to any other intra-group transactions”. However, there is no mention of Part IV of the 2010 Report on Attribution of Profits to Permanent Establishments and the acceptance of risk at this point, despite clear reference to the importance of this report in footnote 1 to D.1.2.1 which includes paragraphs 1.61 and 1.65.
We recommend there should be a reference to Part IV of the 2010 Report on Attribution of Profits to Permanent Establishments in these paragraphs and that for regulated (re)insurance groups the Transfer Pricing Guidelines are to be applied consistent with the Part IV analysis.

**Section E.3. Existence of Insurance**

Paragraph 174 refers to insurance being defined above. It is unclear which paragraph this is referring too. We assume that it is a reference to Paragraph 164, but this should be made clearer. In particular, as Paragraph 166 actually states that “Prescriptive definitions of insurance are beyond the scope of this guidance.”

Paragraph 1.98 of Chapter 1 says that an entity must both exercise control of risk and have the financial capacity to assume that risk. The discussion draft focuses only on control of risk and there doesn’t seem to be any reference to financial capacity which is very important to insurance business and an explicit regulatory requirement.

**Section E.4. Reinsurance captives – Fronting**

We do not agree with the comment in Paragraph 178 that fronting arrangements involve a third party that is indifferent to the levels of the price of the insurance and re-insurance transactions. We consider that this paragraph should be clearer that the third party (re)insurer in such cases is receiving an arm’s length remuneration. In addition, the third party (re)insurer may well not be indifferent to the transaction pricing from a regulatory and / or credit risk perspective. Clearly if the (re)insurer is retaining a proportion of the risk, as is frequently the case, it would require an arm’s length price at least for its proportion of the risk.

It should also be noted that a fronting insurer is exposed to the risk of default by the reinsurer, in which case it is responsible for paying claims to policyholders without a compensating reinsurance recovery and would expect a remuneration to reward the bearing of that credit risk.

**Section E.5.1 and E5.2 Pricing of Premiums and combined ratio and return on capital**

In response to the question in Box E.2, we consider that actuarial analysis is likely to be an appropriate method of arriving at an arm’s length premium. However, such analysis should recognise the regulatory environment and valuation method actually employed by the captive. In addition, we note a concern that the technical actuarial skills required to perform such analysis are in short supply, in particular in jurisdictions, both onshore and offshore with a smaller insurance industry.

We do not agree that combined ratio can be used accurately to achieve a comparable uncontrolled price for annual premiums and underwriting profit. An analysis based on combined ratio, i.e. underwriting performance potentially across a number of transactions, appears to us to have more in common with a transactional net margin analysis than a typical “CUP” method, in particular investment performance is also included as is suggested by step (ii). Suggesting that a comparison of combined ratios can result in a genuine CUP is to us potentially misleading, in particular given the comments in paragraph 183 (with which we
agree) on the differing capital pressures and profiles applying to captive (re)insurers vs third party (re)insurers. Furthermore, much insurance is exposed to infrequent large and very large losses, which may be excluded from a combined ratio analysis if the timeframe is too narrow, yet commercially are priced into premiums for arm's-length (re)insurance and often form one of the key motives for the client to purchase such insurance.

If return on capital is to be used as a method of arriving at an arm’s length measure of arriving at total profit, it should be looked at separately.

Section E. 5.3 Group Synergy

Where the captive performs a genuine insurance function within the group, has the functions and capital to manage such risks, including retaining risks to provide a diversification benefit, we do not consider that the return on such activities should be allocated to other members of the group. This suggestion does not reflect the nature of (re)insurance. For example, when a claim occurs other entities do not have the financial capacity to settle claims which must be settled using reserves that are backed by investment assets purchased with premiums.

Legally and functionally these reserves and the investment assets backing them should be owned by the captive (albeit that non-KERT functions may be outsourced). Also, where there is a possibility of an insurance loss arising within the group (as opposed to being passed to an external reinsurer), as with all arm's-length insurance, the group synergy model would fall down.

For the avoidance of doubt, the above comments on 5.3 refer only to captive insurance within a non-insurance group. In our view given the regulatory and commercial constraints on (re)insurance groups as discussed above, we do not believe that a group synergy approach would ever be appropriate in the context of reinsurance within an insurance group.

Section E. 6. Agency Sales

The example in paragraphs 187 and 188 states that the insurance product sold is materially the same as that which any other insurer in the general market could provide. The example then makes two assumptions;

- that A could sell policies underwritten by another insurer and retain most of the profit for itself, and
- that the captive insurer B will earn a higher level of profit from the insurance than an independent third-party insurer would.

The example, however, does not provide any justification for these assumptions. The profit earned by B will equate to the difference between the premiums collected and the aggregate of claims paid, and expenses incurred in administering the policies. If the same insurance was purchased from an independent third party the only variables would be the level of premium and the costs of administering the policies. The unstated basis for the assumption seems to be that either the independent insurer would charge a lower premium or that its administration costs would be higher, both of which seem unlikely.
It is possible that an independent insurer might charge a lower premium, for example due to the greater diversification of risk that it can achieve compared to B. However, that is not relevant to the TP analysis of the transaction which should reflect the actual premium which the customer has paid for the insurance. If the independent insurer received the same premium, then it would make the same profit as B. A would also be fully remunerated for selling the insurance cover by the commission it receives from the independent insurer. An independent insurer would not share with A the insurance (underwriting) profit made on the insurance.
7 September 2018

BEPS Actions 8 – 10 discussion draft: transfer pricing aspects of financial transactions

AstraZeneca welcomes the opportunity to comment on the public discussion draft on the transfer pricing aspects of financial transactions. We recognize that there are a number of complex issues within financial transactions; however it is disappointing that the OECD are unable to come to a consensus view on this and this suggests that a public consultation on the issues raised in the discussion draft would be a necessary next step.

Multinationals operate across a wide range of jurisdictions with often differing views on acceptable capital structures and interpretations on how the OECD Transfer Pricing Guidelines should be applied to financial transactions. The differing approaches between tax administrations may result in tax disputes and double taxation which is a key concern for multinationals operating globally.

The current guidance contained within the 2017 OECD Transfer Pricing Guidelines offers limited explanation on the practical application of arranging financial transactions in accordance with the arm’s length principle and the documentation and evidence that taxpayers are expected to maintain.

The discussion draft sets out a broad framework to expand the existing guidance and to document practices in applying the OECD Guidelines. For the framework to be effective, it will require further explanation on how it should be applied in practice and consensus amongst OECD members.

To minimise the risk of tax disputes and double taxation, consensus on the guidelines amongst OECD member countries is required. This guidance should be supported by comprehensive examples on how they should be applied.

Section B – Interaction with the guidance in Section D.1 of Chapter I

- The discussion draft states that an MNE group has the discretion to decide upon the amount of debt and equity that will be used to fund any MNE within the group. Thus, in an intra-group situation, other considerations such as tax consequences may also be present. We do not consider that the assertion that a multinational will use tax as a key value driver to determine their capital structure.

- B.1: We are concerned that the proposal to allow tax authorities the ability to implement domestic rules to address capital structure and interest deductibility may result in differing and inconsistent approaches rather than a set of mutually agreed international principles. In the absence of international consensus, it highlights the importance of effective mechanisms to resolve and prevent double taxation as provided in Article 25 of the OECD Model Tax Convention with the provision for Mutual Agreement Procedure although entering into this process would inevitably challenge a multinationals internal resources.
• **B.2:** The framework at C.1.1 states that both the borrower’s and lender’s perspectives should be considered when pricing intra-group loans. From a practical perspective, there has been greater focus placed on the circumstances of the borrowers (e.g. credit worthiness) to determine the arm’s length pricing of intra-group debt. Whilst the increased focus on the lenders position is helpful for multinationals operating with a centralised treasury function, there needs to be further guidance on how this should be practically applied to avoid a mismatch of approaches taken by tax authorities.

Multinationals operate internal investment appraisal processes to decide whether to invest in a project or not. Commercially, a multinational will not undertake an investment if it is not forecasted to generate a positive net present value and ultimately create shareholder value. The structure of the financial instrument(s) used to fund the project is determined to match the risk and return associated with the investment.

We do not understand the proposition that where there is a difference between total funding requirements and the arm’s length amount, the full amount shall be deemed as equity and not a loan at all. It creates further scope for potential mismatches between treatments between tax authorities.

• **B.3:** We agree that the factors listed at B2 are all important considerations in determining the arm’s length nature of the transaction and that a functional analysis setting out the functions and risks of both parties to the transaction is important in delineating the transaction and arriving the arm’s length interest rate. The lender would be allocated risks in relation to an advance of funds within the MNE group on the same basis as if the arrangement were between two third parties.

The guidance on the economically relevant characteristics of actual financial transactions sets out the need to consider both the lender’s and borrower’s perspectives. This comment is helpful as lenders and borrowers will have different economic characteristics and motivations. In practice, more focus has been placed on the borrower to test its ability to service debt under relevant thin capitalisation rules and the applicable interest rate that the borrower would be able to access on an open market in reflection of its credit rating and risk profile. As clear emphasis is now placed on the lender’s perspective, further guidance will be required how this can be practically applied to reduce tax disputes and double taxation.

• **B.4:** We have included some comments on the application of the risk free rate of return where the functional analysis shows that the lender does not take control of the risk associated with lending to a subsidiary. This section contains a number of questions which we consider merits public consultation and consideration to achieve international consensus before the guidance can be applied.

  4. It may make sense to reference government securities denominated in domestic currency only as they would typically offer the lowest rate of return. It is not always possible to identify securities issued at the time of the controlled transaction as they are not issued on a daily basis. The closest bond to the inception of the controlled transaction could be used to reference the risk free rate of return.

  6. The duration of the comparable financial instrument should match the duration of the funding requirements. However it might not be possible to align this exactly with what is available on the open market and therefore the instrument with the most comparable economic characteristics should be considered.

  8. See comment on B.5.
- 10. See comment on B.6.


- 18. The guidance indicates that debt pricing in a comparable uncontrolled transaction where the lender assumes only the financial risk will consist of a risk-free rate of return plus a risk premium element to determine the arm’s length interest rate. The guidance is too theoretical and does not provide any real practical guidance as to how to determine the different elements of risk identified. Nor is it clear from the discussion draft how the outcome of the proposed risk-free and rate of return approach will differ from the approach applied by MNCs of determining arm’s length interest in reference to the interest attached to a comparable arrangement with similar economic circumstances.

- **B.5**: We consider that Government issued securities are the best approximation of risk-free rates of returns. If there are no relevant government issued securities available, issued AAA corporate debt may be the closest approximation to a risk free instrument assuming similar economic characteristics.

- **B.6**: It is not clear in what circumstances a funder would lack the capacity to control at least some of the financial risk associated with the provision of funding. There will always be some inherent financial risk of borrower default assumed by the lender. This may be economically reduced by explicit or implicit guarantees. It is not correct to state there is no financial risk involved.

The scenario set out in B.6 seems unusual in the context of a multinational. It is unlikely that the financial risk would be separated with the other risks associated with funding so that such an adjustment would be necessary. If this situation did arise, here are likely to be significant complexities surrounding recognition of the transaction and allocation of reward that could lead to tax disputes and double taxation. Any relief from double taxation under Article 25 OECD MTC, may face similar complexities.

For the controlling entity, there is also likely to be wider corporate tax issues such as potential withholding tax exposure and complexities surrounding domestic legislation for example interest restriction rules. From an accounting perspective, the controlling entity would be receiving interest income against no interest receivable on the balance sheet. There could also be unintended FX exposure.

Further guidance is required to show how the guidance should be practically applied and risks and rewards allocated in absence of an intercompany agreement between the controlling entity and the funder.

**Section C – Treasury function**

- **C.1**: AstraZeneca operates a fully centralised treasury function and has no comment on this point.

- **C.2**: Where a multinational group member seeks external finance, in most cases an external lender would consider the credit rating of the multinational group in first instance before determining the credit worthiness of the borrower. Typically, a group member would have a lower rating depending on the risk profile.

The approach of using the group credit rating as set out in C.2 is not aligned with the commercial considerations that external lenders will have when making a lending assessment. In first instance the credit worthiness of the borrower will be considered on a standalone basis. If the credit worthiness
does not satisfy the external lenders risk criteria, broader considerations such as parental credit rating are then considered to determine borrower eligibility.

Furthermore, neither of the suggested approaches are likely to achieve tax certainty or tax compliance without a further guidance and international consensus on how such proposals should be applied. The proposal for the taxpayer or the tax administrations to establish a different credit rating for an individual group member is unhelpful as it creates greater tax uncertainty for multinationals as tax administrations are likely to form differing views as to what is the arm’s length debt pricing for a transaction.

The definition of a multinational group credit rating could be ‘a relative measure of financial and non-financial strength of a group relative to other third parties’.

In the absence of publicly available data, a multinational group credit rating could be determined by the information or metrics used by external banks to determine credit ratings for lending decisions. This could be used as part of internal economic modelling (Also see C.5).

- **C.3:** International consensus through public consultation is required on a number of the issues highlighted in this section:
  - The definition of a stand alone credit rating requires consensus although clearly it would be a ‘credit rating that a multinational group member might reasonably expect to be assigned based on the financial and non-financial position and strength on a standalone basis’.
  
  - To assess the impact of implicit support is difficult from a practical perspective as tax administrations currently have differing views and approaches to assess the impact of implicit support on a credit rating of a group member with some taking it into account and others not. Paragraph 69 states that the level of group support will depend on the status and ‘relative importance of the entity’ to the group. This is a wide-sweeping statement as in reality the level of group support is likely to vary depending on the industry and other economic considerations.
  
  - a non-strategically important entity as detailed in paragraph 72, which is likely to be sold or soon to be dormant is not likely to subject to an intragroup financing transaction. Consensus as to whether implicit support is to be taken into account in assessing the arm’s length nature of the loan should be sought through public consultation.

- **C.4:** We do not agree with the proposition that the level of group support that an entity receives depends on the strategic importance of the entity to the overall strategy of the business and future success. In practice, most multinational groups will provide support to all wholly owned subsidiaries regardless of strategic position to ensure financial obligations are met. As mentioned in C.3 if a subsidiary is deemed to be of no strategic importance, the entity is likely to be sold and therefore no investment or intragroup borrowing would be made. The most important issue to resolve is whether implicit support should or should not be included in an analysis of the arm’s length interest rates paid by a multinational company intragroup.

- **C.5:** Credit Default Swaps (CDS) provide real time pricing of risk however practically are limited to larger or more established multinationals. Not all businesses have credit which is traded or priced on the open market therefore it is difficult to apply when pricing intra-group loans as CDS data would only cover a small proportion.
We would welcome an internationally agreed methodology for pricing intercompany loans and we consider that economic models could be used to arrive at a price for intercompany loans for an entity based on relevant or industry accepted financial metrics.

- **C.6:** It is the comparability of the critical terms and conditions and economic characteristics of the financial instrument that render it a proxy or a realistic alternative to intra-group loans. This means that bond issuances as identified in the discussion draft could be considered if appropriate.

- **C.7:** An internal CUP would be most appropriate where the borrower also has external debt on its balance sheet. This would be assuming comparable economic characteristics and borrowing terms to the original transaction. Any adjustment to the CUP is highly subjective and is likely to be open to differing interpretations by tax authorities and cause greater uncertainty.

In practical terms, it is likely that external debt will be sourced by a parent or treasury company within a multinational group before onward lending to the group entity that requires the funding if different. This is due to commercial reasons to access the preferential interest rates achieved by the group credit rating. Therefore, there may not be a directly comparable internal CUP available with the borrowing entity to the related party transaction. We do not agree with the proposal to come up with an average interest rate across external debt as what is important in determining whether a rate is arm’s length or not is to look for comparable terms and conditions and an averaging analysis will not achieve this.

- **C.8:** In a physical (or zero balance cash pool), the cash pool leader will assume risk when external borrowing is required to support the cash pool. The cash pool leader will enter into an external agreement with a third party lender based on the group credit rating. The onward lending from the cash pool leader and the cash pool participant(s) will take place via an intercompany arrangement. The interest margin set in relation to the intercompany agreement will be in line with the credit rating position of the cash pool participant. In this example, the cash pool leader will receive a higher interest rate on the intercompany loan then the interest it will pay on the external loan (assuming comparable economic characteristics). The difference could be an arm’s length return for the risks assumed by the cash pool leader.

Under a notional cash pool arrangement, risk is assumed by all participants under a cross guarantee structure. In practice, the allocation of risk may be onerous as the cash pool structure involves one lending rate and one borrowing rate for all participants. The individual credit ratings of the participants are not considered on an individual basis.

International consensus is required to determine on how to quantify the benefits before even considering the allocation between participants. We have the following comments on the practical application of the three approaches to allocation as set out in paragraphs 127 – 129:

- **Paragraph 127** – The size of the balance might not be necessarily indicative of creditworthiness.

- **Paragraph 128** – This simplified approach could have limited application as it practise it is unlikely that all cash pool participants have the same or similar credit profiles. Credit worthiness is also based the circumstances at a given point in time and credit profiles can change. This approach would be difficult to administer. Furthermore, using the same interest for depositors and borrowers is not aligned with the interest rates achievable on the open market as they are never the same.
- Paragraph 129 – This approach would be difficult to administer as it would involve adopting a complicated cash management structure.

- C.9: We do not think that the situation identified in this question whereby an entity within the MNC is compelled to join a cash pooling arrangement even though it is worse off by doing so would arise in practice. The interest conditions attached to a cash pool arrangement are generally driven or determined by market conditions and therefore participants are unlikely to be worse off. Benefits for participants to cash pooling arrangements are that it is administratively easier and reduces counterparty credit risk.

- C.10: Cross guarantees are required by external lenders in notional cash pooling arrangements as it can be the only recourse in the event of default. Where there is large number of cash pooling participants, the aggregate balance sits with the bank and therefore risk needs to be managed. Cross guarantees have the impact of making all participants to the cash pooling joint and severability liable.

- C.11: Where multinational groups operate an off-setting hedge position either via a contract instrument with a third party or a natural hedge, financial risk and control is transferred to the group treasury company managing the hedge. A group entity on an individual basis will not have the consolidated visibility that a group treasury company will have to identify a natural hedge or to seek a contract instrument if financial risk still presents itself at a group level.

The risk and reward of hedging does not sit with the group entity not directly party to the hedging arrangements, therefore there should be no impact on the entity’s P&L. The risk and reward should sit in the group treasury company.

Where the group treasury company has arranged a hedging contract on behalf of a group entity as per paragraph 135 of the discussion draft, the risk and reward remains with the group entity. The group treasury company should receive arm’s length compensation for providing the arrangement service. In these circumstances, only the group entity entering into the hedging contract is exposed to the risk and reward.

Where a group entity wants to de-risk and relies on the group policy to offset, the transfer pricing treatment of the underlying risks associated with the original exposure will depend on the operation of group policy. If it can be evidenced that a change in the liability position will continue to be supported by the off-set hedging arrangements of the group treasury company, the economic risks are with the group treasury company. Where this is not the case, the risks associated with the additional unhedged exposure will remain with the group entity. This is subjective and will depend on the facts and circumstances of the arrangement.

Section D – Guarantees

- D.1 A financial guarantee allows a borrower to obtain financing on terms that could not be achieved on a standalone basis. How a financial guarantee can be accurately delineated from a borrower’s perspective will depend on whether the borrowing entity would expect to receive a benefit from a guarantee on an independent basis. From the guarantor’s perspective, it will involve considering whether economic risk has been transferred from the borrower to the guarantor.

Where an explicit guarantee has been provided to a third party lender on behalf of a borrower, it is likely the guarantee will be a benefit to the borrower. The guarantor is assuming a proportion of the risk and therefore should be compensated for the assumption of risk. If the entity would be able to obtain funding on the same terms a standalone basis despite the guarantee then there is no benefit.
Where there is no benefit to the guarantee and no economic risk perceived beyond additional external financing within the multinational group, no guarantee fee should be payable between the borrower and the guarantor. For example, the guarantee may be implicit or non-legally binding with no recourse for the third-party lender. This will depend on the facts and circumstances.

Financial guarantees are likely to be insisted on by an independent lender when the credit worthiness of a company on a standalone basis is insufficient to borrow on the terms required e.g. duration or amount. This also includes circumstances where in absence of a financial guarantee, the credit worthiness of a company might render it unattractive or incapable of obtaining finance on the open market.

Section E – Captive Insurance

- **E.1:** Indicators that the policy issuer is actually assuming risks would include the following:
  - Risks assumed are in accordance with the MNE insurer license (and business plan)
  - Risks have been suitably underwritten by the MNE
  - The MNE group member has adequate financial resources to meet the expected liabilities, whether direct or via reinsurance
  - The MNE is reporting on risks assumed

The specific risks assumed by the policy issuer are determined by the type of insurer license held, if non-admitted policies are permissible and whether specific in country expertise is required (above what the captive can provide), and whether the risk forms part of the captive business plan (i.e. a core business risk).

If these conditions are met, then the risk can be transferred to the captive, earning premium. Risks are accepted on the basis that the Insured is managing operations in accordance with group policies and standards.

For risks to be considered assumed, a policy will be in force, with premiums paid by the relevant MNE. Examples are useful, but we would expect each MNE to operate differently.

It is essential that the “controlling mind” of the MNE insurance member has the ability to make decisions on opportunities and that it has the capability to respond. The underwriting function should have clear operating boundaries, that ultimately feed into the board of the company, and it is the MNE board which is ultimately accountable for the management of the MNE member.

Where activities are outsourced, the MNE member should have a clear risk management framework that govern the ongoing activity, such that there should not be any unexpected surprises on the income allocated to the MNE member.

Where there is a lack of control over risk, and direction, we would expect that the MNE group member loses oversight on these critical activities, leading to poor performance and ultimately failure of the captive.

- **E.2:** Premium pricing should be conducted using an actuarial analysis (in house or external) to arrive at a prudent sum which is reflective of the overall risk assumed by the MNE.
Investment income however is difficult for captive insurance companies to consider as part of the calculation. Investment income is a variable that can’t be reliably calculated at the start of the allocation process and whilst the income may be material in one year, the MNE could also suffer losses in excess of premiums charged.

The suggested approach is mainly relevant and can be readily applied where the MNE insurer has the data and expertise.

- **E.3:** In the example in paragraph 187, there is a relatively easy access to the general market leading to a larger number of sales compared to more knowledgeable customers seeking an equivalent policy. If B is earning profit above the level of insurers providing similar cover, yet A is receiving a commission in line with independent agents, it would suggest:

  1. Based on the portfolio of risks, the insurer risk is over-priced i.e. is the premium benchmarked?
  2. There are a relatively low number of claims, which in turn implies:

    - The sales team are being overly pushy, selling insurance where it is not really required and relying on the consumer being unaware, so a marketing advantage
    - The policy has stringent claims conditions, that are unfair to the consumer
    - The uneducated consumer doesn’t know their rights

The suggestion that the balance of profit be allocated to A would create additional incentive for A to continue its current selling practices. Instead, the MNE insurer should assess the pricing of the policies and adjust premium based upon actual and forecasted loss experience (and expenses). This then continues to reward A with commissions commensurate with the market, provides the consumer with a policy that is priced appropriately and provides the insurer with a reasonable level of profit.

If the premium per policy is similar to that available from external markets, the profit should remain with the insurer, and not the seller. The risk landscape can easily change, and it may be that the insurer at some point in time incurs higher losses. With retained capital, the MNE insurer could also look to introduce new policies – whereas if the profit is retained by the seller, opportunities are lost.

Yours faithfully

[Signature]

Catherine Harlow
Head of Transfer Pricing
To
OECD
Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
2 rue André-Pascal
75775, Paris, Cedex 16
France

General comments

German business as represented by the BDI thanks the OECD for the opportunity to comment on its Discussion Draft on BEPS Actions 8 – 10 Financial Transactions issued July 3rd 2018. BDI welcomes the draft. The explanations given in the draft discussion paper are basically appreciated and address the major topics of financial transactions within a MNE group. However, BDI would like to ask for some supplementary clarifications.

Specific comments

Ad Box B.4. and B.5.

The theoretical considerations given in B.4. that a funder lacking capability or is not performing the decision-making functions to control the risk associated with an investment should only earn a risk free return is reasonable. However, the draft concedes there is no investment with zero risk. It seems justified to assume government bonds are coming closest but BDI would welcome some clarifications.
When taking the return on government bonds as a proxy for the risk free return the draft does not distinguish between the issuing yield and the secondary market yield of government bonds. In our view no. 4 and 5 of Box B.4. can be interpreted in such a way that the draft aims exclusively at the issuing yield for the definition of the risk free return. Since the actual rate of return is derived by the combination of issuing yield and issuing price focussing on the issuing yield of government bonds alone can be insufficient. Further clarification would be welcomed.

According to the above the secondary market yield of government bonds could be a superior proxy. For almost all relevant currencies national central banks frequently publish the secondary market yield for almost all terms of maturity. But this yield can become negative as recent evidence showed. In consequence w would ask for a floor which excludes a negative risk free return.

Even when basically denying a default risk for government bonds it remains an issue. Additionally all government bonds capture an inflation premium since they are issued with a nominal not a real interest rate. However, in times of economic or financial crisis this premium is hardly noticeable since the return on government bonds mainly reflects other objectives of central bank’s monetary policy e.g. the prevention of government bankruptcy. Due to these considerations a country risk premium which is determined independently from the individual characteristics / situation of the borrower should be taken into account.

The example in Box B.4. no. 7 suggests to choose the lowest interest rate available when several countries issue bonds in the same currency. The situation of different issuers of government bonds in the same currency can occur in:

- Currency unions,
- Developing countries/emerging markets issuing public debt in an anchor currency,
- Federal states.

At first glance it seems reasonable to take the lowest interest rate as benchmark for the lowest risk associated with all countries issuing public debt in the same currency. However, opting straightforward for the lowest interest rate of all countries implies that this country is not necessarily involved in the actual transaction.

Therefore the choice of the lowest rate of return on public debt can be prone to conflict and subsequent dispute cases e.g. in a currency union. In our opinion it will be difficult to communicate to national tax authorities why the lower return on German government bonds shall serve as benchmark for the risk free investment when the lender e.g. is located in France and the borrower in Italy.
A similar argument holds for emerging markets. There could be the situation that a MNE is doing business in an emerging market and finances affiliates not in the national but in an anchor currency and the emerging market country also issues public debt in that anchor currency. Then it can be expected that the anchor country itself has got a lower rate of return on government bonds than the emerging market. Again it will be difficult to communicate to the tax authorities of the emerging market country that a lender located within their jurisdiction should receive that lower rate of return for a risk free investment when financing affiliates in the anchor currency.

In consequence of the considerations above the yield of government bonds that can be taken as benchmark for the risk free investment should be limited to those countries involved in the actual transaction.

In federal states normally the federal level absorbs the largest fraction of the public budget so the application of the federal rate of return should be the normal case. However, in extreme cases of federalism a subcentral level, e.g. all federal states together can, make up for the dominant part of the budget. If additionally there is a no-bailout clause between the jurisdictions a subcentral jurisdiction may have a lower rate of return than the federal one. Even though this can be expected to be a rare case clarification which rate to choose could be helpful.

Ad Box C.2.

Some jurisdictions take the view that a stand-alone rating of the borrower is required in order to determine intra-group financings in a MNE group. However, such an approach can hardly be put into practice and may not even be feasible for a MNE group with several hundred affiliates and a significant number and frequency of intra-group financings. Such a stand-alone rating approach would trigger an extended effort to treat every group company individually when administrating and controlling intra-group loans. In addition, the stand-alone rating approach may not sufficiently take into account the implicit support within the group for both affiliates and the ultimate parent company.

Therefore, alternative approaches need to be considered for a MNE group. For instance, the credit rating of the MNE group is used but adjusted on the basis of the general business and financial risk of the group’s companies (notching up or down from the MNE group credit rating. by using a matrix provided by rating agencies. In this respect, the group companies could be attributed to clusters with respect e.g. to their strategic importance within the MNE group. The credit ratings for each cluster would be an average of the affiliates captured in the cluster and this average would need to be verified frequently.
For example, the credit rating of the MNE group as a whole is assessed as being A (business risk: strong; financial risk: modest. whereas for the group’s companies it can be attributed to the clusters A (credit rating: BBB+; business risk: satisfactory; financial risk: modest. and B (credit rating: BBB-; business risk: fair; financial risk: modest. Such an approach would be a compromise between a stand-alone credit rating (lower rating. and a parent support rating (higher rating. In case of such an approach taken, the individual component of the creditworthiness is additionally given by the country risk premium.

Ad 135.

A clarification should be included whether such an approach also applies for internal (fx. hedges between the treasury company and an operating company, for which the treasury company passes on 1:1 via the hedge the conditions negotiated with an external.

Ad Box C.8.

For cash pooling functions we would like to ask for a more consistent approach in line with the application of the arms length principle (ALP) as the draft generally outlines for financial transactions within MNEs. We consider it somewhat contradictory that the rate of return basically shall depend on the business strategy and the risks associated but at the same time cash pooling is considered as being a low risk function for which the ALP can hardly be applied as described in no. 100. In our opinion also for cash pooling the rate of return shall depend on the functions carried out by the cash pool leader. These could be e.g. currency exchange services (associated with a currency risk) or a liquidity management (associated with a liquidity risk).

Ad Box C.11.

When a hedging contract is intermediated by the treasury company – meaning the group’s treasury unit concludes the contract with an external but the risk exposure lies within another group company which is then off-set on the group level – the participation of the treasury company in the hedge should not be regarded as a service of the treasury company to the other member of the group. In this situation the group company itself remains unhedged and the treasury company undertakes a proprietary position for its sole benefit and at its sole risk and therefore, the hedging of the treasury company does not meet the requirement of providing a benefit to the group company.
Via e-mail: TransferPricing@oecd.org

Private and Confidential

Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
2 rue André-Pascal
75775, Paris, Cedex 16
France

7 September 2018

Dear Sir or Madam

OECD discussion draft on financial transactions

BDO International thanks the OECD for the opportunity to provide comments on its discussion draft on the transfer pricing of financial transactions (‘the DD’) issued on 3 July 2018.

We consider this a very important area for transfer pricing practices, not least due to the relative fungibility of financing arrangements, and it is clear that a great deal of thought has been given to this wide-ranging and often complex area.

We set out a summary of our opinions and recommendations overleaf followed by more specific comments on particular matters.

Yours faithfully

Anton Hume
Transfer Pricing Partner
For and on behalf of BDO LLP
Representing BDO International
Overview of comments

The Discussion Draft helpfully highlights difficult and controversial areas, and sets out sensible approaches for certain aspects of the transfer pricing analysis of financial arrangements.

Guidance on this area should ideally lead to increased clarity on how both borrowing and lending parties, as well as any other relevant parties such as treasury teams, should be assessed for transfer pricing purposes. However, the current DD gives us some cause for concern that a range of subjective areas could potentially remain open for conflict due to potential differences in interpretation.

We note that the DD does not represent the consensus views of the CFA, and we understand that differences of opinion remain within Working Party 6 (“WP6”) in relation to certain aspects. We welcome the fact that the DD has been published in the spirit of obtaining wider input from MNEs and advisers to assist the move toward both a consensus view, and a more coherent position. BDO strongly supports the need for consensus, and we believe that, in its absence, the DD could encourage further controversy, MAP disputes and double taxation, and result in a failure to provide the tax certainty which businesses need.

The detail given to discussions on the pricing of loans is commendable, however little is covered in terms of how the quantum of loans should be assessed. For example, discussion could be included in relation to common metrics such as debt:EBITDA or interest cover, or other ratios for certain transaction types. The implications of guarantees should also be considered in relation to this area, instead of just in respect of loan pricing.

In addition, we feel that it would be appropriate to resist any temptation to turn transfer pricing interpretation into a counter for specific tax-planning scenarios where this approach has the potential to lead to a lack of clarity or potentially significant compliance burdens.

An example to highlight this is the general area of ‘risk-free returns’. There is a valid concern that groups are in some cases able to make an equity contribution to a subsidiary in a low-tax jurisdiction, and then lend funds via this entity to other group members, in order to shift profits. While we would not suggest that such arrangements should be specifically spared from the appropriate application of transfer pricing principles, attempts to prevent profits arising in such companies via transfer pricing could have much wider consequences.

It should not be overlooked that in many instances groups do not have complex financial management structures within each entity, and can often be run on a group-wide basis, leading in some cases to limited discretion or control over which entity will provide funding to each other. If MNEs are assessed against a theoretical ideal of a true lending business, where credit committees would operate and detailed monitoring and analysis of ongoing arrangements would be expected, then they would often fall short.

The risk-free return approach for MNEs with limited control over their lending arrangements would appear to potentially impact most intercompany lending within MNE groups. For example, a cash pooling or similarly automated arrangement could be expected to be treated in this way. At the extreme end of the spectrum, certain treasury management roles could be transferred to low-tax jurisdictions, potentially side-stepping the type of issue the rule appears to be seeking to address.

It may still be valid to incorporate appropriate returns for MNEs managing the financing arrangements of other group members, especially where the functions performed are
complex (similar to the management of a debt fund or other set of investments), but the approach taken appears poorly targeted.

Generally, more examples upon the lines of Chapter VI would be welcome to give greater clarity to the guidelines. We also believe that this will give greater clarity to WP6’s thinking in regard to the issues considered.

Our subsequent comments are selective and do not comprehensively cover every area addressed in the DD.
Specific areas

We set out below specific comments on the areas raised in the consultation.

Section B.1. - Identifying the commercial or financial relations

Assuming that it is intended that the guidance should apply to all types of business, including both regulated and unregulated Financial Services (“FS”) business, then the statement that, “An MNE group has the discretion to decide upon the amount debt... that will be used to fund any MNE within the group” (paragraph 3), will not necessarily be correct where regulatory constraints dictate otherwise.

We believe that the intention is that the guidance should apply to FS as well as other businesses, but some explicit statement to this effect, and some commentary in relation to FS business, including examples, would also be helpful.

Delineation and characterisation

The delineation of transactions is an appropriate step in any transfer pricing analysis, however as noted in paragraphs 8-10, there are often other tax rules that may be expected to address the characterisation of balances that may appear as debt, but have certain equity-like characteristics.

In applying the arm’s length principle, we consider it critical to determine the amount of debt, and other relevant terms that would have been agreed between unrelated parties. Many aspects discussed, such as the ability or willingness to make repayments, are relevant to this analysis.

The example in paragraph 17 is reasonable in this context, and we do not consider that the question of debt/equity characterisation under any transfer pricing analysis should be looked at with an ‘all or nothing’ approach.

We recommend that further clarity is provided to separate ‘quasi-equity’ type arguments that seek to determine whether in actual fact the balances appear to be in the nature of equity, from any analysis that focuses on the likely lending and borrowing capacity of parties dealing at arm’s length.

While separating out capital-like balances from any financing analysis may be a benevolent aim, it creates a somewhat paradoxical state of affairs where the alternative position assumed to take place between independent parties acting at arm’s length is considered to be the provision of equity.

Separate transfer pricing treatment could be considered, for instance not imputing interest income on these balances, but clarity over how this may take place would be appropriate.

On the other hand, the question as to whether a financing business acting at arm’s length would advance funds, and if so, on what terms, sits much more naturally within the principles applied elsewhere in transfer pricing.

If capital structure matters cannot be sufficiently addressed by reference to the arm’s length principle (clearly a conclusion of the OECD which motivated BES Action 4), then there may need to be a new mechanism available to MNEs to address the concern that current mechanisms do not efficiently prevent the problem of double taxation in relation to debt/equity matters. This might take the form of a revision to the OECD model treaty to
provide mechanisms for mutual agreement on such matters, and potential advanced mutual agreement measures and arbitration mechanisms to resolve potential disputes.

In relation to the amount of debt to be priced, BDO otherwise welcomes the DD’s advocacy of the alignment of the guidance with the approach to the accurate delineation of the actual transaction in accordance with Chapter I. However, the range of factors (and the level complexity, and compliance burden, this would suggest) that are advocated should be considered. In that context. The following areas give us cause for concern:

a) The requirement to consider how a group prioritises funding needs among different projects (para 14).

b) The requirement on the part of the entity that advances funds to consider other investment opportunities (para 19).

c) The absence of any specific reference to materiality when it comes to demonstrating that outcomes demonstrate compliance with the arm’s length principle.

In relation to b) above, it would seem appropriate to recognise that a lending entity in an MNE group is unlikely to consider broader market investment opportunities outside of the specific business objectives and core purpose of the wider group of which it is a part.

We would suggest that consideration should be given to the specific group factors relevant in determining what alternative investment opportunities a group company would need to consider when advancing funds to other members of the MNE group. Some specific and explicit recognition of entity versus group considerations, and the interplay between them would be helpful. So too should the ‘transaction’ in the context of its accurate delineation for these purposes and any ‘series of transactions’ of which it is a part.

These factors may also be relevant when considering the implicit support arising from passive association, and the external funding policies and practices of group management, informing the conditions under which a subsidiary would have borrowed from an independent lender etc. (see paras 35 and 67 where it is acknowledged that a consideration of the wider group dynamic is appropriate).

In relation to c) above, we have particular concerns about the potential compliance burden that such analysis may give rise to. We would advocate some guidance as to the circumstances where a lower standard of analysis (e.g. of hypothetical alternative lending/borrowing scenarios) might be justified.

BDO agrees that transactions need to be accurately delineated. However, the risk assessment guidance and functional characterisation should take into account financing transactions. General guidance cannot be applied. Example 3 (Chapter I, paragraph 1.85) in the 2017 OECD Transfer Pricing Guidelines is a good example (for cash box companies), as the contribution of the owner of the assets is limited to financing the acquisition.

It is impossible to apply the general guidance relating to risk management functions to financing transactions. Hence guidance on the delineation of financing transactions should give greater consideration to the key terms of the arrangement, and the commerciality of those in the market context, than any other factors.

Comparability Adjustments

The reference to comparability adjustments in the context of their improving the reliability of a comparable in para 20 would also benefit from more explicit and specific guidance. For
example, what are the nature of the adjustments that may be considered, and in what context?

Consideration should be given to the level of diligence to be applied in the making of comparability adjustments (which in many circumstances could be very exacting) and some specific guidance as to how the adjustments might be made.

Para 84 recognises that there is ‘unlikely’ to be a ‘single market rate at which a borrower could obtains funds or a lender could invest funds, but instead a range of rates would likely be available. This is implicit also in the accurate transfer pricing of related party lending terms more generally, and only emphasises the complexity with which MNEs and their advisers are faced in assessing comparability factors that might be made to lending criteria in practice. Such adjustments are rarely made in practice but subjective adjustments are often made on the basis of qualitative (as opposed to quantitative) criteria.

Section B.2 - economically relevant characteristics

While it is noted at paragraph 24 (and 51) that the functions performed by a lender within an MNE group may be less comprehensive than those that would be performed by an independent lending business, this fact does not appear to have been carefully considered in respect of all other sections in the DD, in particular Box B.4.

The remaining characteristics discussed are appropriate, although it would be helpful to emphasise the importance of the borrower’s financial strength and the nature of its business, as these are not fully dealt with through the functional analysis discussion, wider economic circumstances, or business strategy.

There are obvious parallels to the KERT analysis advocated by the OECD Report on the Attribution of Profits to PEs but no reference is made to that guidance. The footnote to Chapter I D.1.2.1. of the 2017 OECD Guidelines (Analysis of risks in commercial or financial relations), on the other hand, makes specific reference to the Report on the Attribution of Profits to PEs in the context of the approach to risk allocation for regulated entities, acknowledging that the guidance in D.1.2.1. “Is not specific to any particular industry sector.” More specific guidance as to risk evaluation would be helpful in the DD - See below.

Box B.4

A lending entity should be entitled to arm’s length remuneration for its assets, functions and risks. The financial capacity to bear the risk, rather than just functional capacity, should be taken into account. Hence, we cannot say that an entity that has financial capacity to bear risk is entitled to nothing but a risk free return.

Whilst there was a great deal of commentary in the DD regarding how to define a ‘risk free rate’ (which we believe there is a good argument to be made should be ‘zero’), a more important issue for MNEs is how to define a ‘risk adjusted rate’.

C. - Treasury function

The statement at para 43 that the treasury function - “Will usually be a support service to the main value creating operations” - might suggest that companies performing this role will usually act as a routine service provider. As such, these entities may potentially deserve a relatively low, cost plus reward commensurate with the above characterisation (rather than one justifying a margin on any borrowing and lending activities). This position is clearly at odds with other statements in the DD. For example, para 38 acknowledges that a centralised
treasury may have full control over the financial transactions of the group, and therefore may be engaged in potentially complex activity, employing skilled/qualified personnel. To what extent (if any) that this amounts to the controlling (and potential bearing) of complex risks (credit/FX/liquidity) is another consideration.

There is comparatively little commentary about risks related to treasury activity and the issue of evaluating where risk sits in the context of such activity, and the activity outcomes. Whilst para 44 acknowledges the importance of the identification and allocation or the economically significant risks regarding treasury activities ‘in accordance with Chapter I’ (and therefore draws upon the guidance provided in that chapter in regard to the accurate delineation of transactions and associated evaluation of risk, the latter, in D.1.2.1), there is little specific guidance in that Chapter, or in the DD, on its application to treasury-type functions.

An evaluation of factors relevant to a particular borrower, undertaken for the purposes of a lender making a decision whether to lend (and on what terms) (paras 49 and 50), may be very different in nature from the factors considered in a risk evaluation relating to other business activities.

As outlined above, the guidance in D.1.2.1. of the 2017 OECD Guidelines explicitly recognises that, “The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector.” It acknowledges too that - “While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed.”

Chapter 1.63 of the Guidelines recognises that, “risk management is not the same as assuming a risk”. 1.64 recognises that, “financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises.”

These considerations illustrate the necessity for very specific delineation of the factors pertinent to the analysis required of a treasury function in an MNE group. Examples illustrating this point would help draw out the factors pertinent to the analysis.

Box C.1

It is entirely possible that the MNE will not have a centralised treasury function, allowing each entity to make decisions affecting how costs of capital are optimised, and how investment returns are managed or maximised. In this context, it is highly likely that local operations would enjoy a higher degree of financial independence and control, and be able to access better deals due to familiarity with local customs and relationships, essentially providing increased flexibility.

This is particularly the case when operating in different systems, as what works in Europe may not be acceptable in Asia. This is likely to be an option for MNE groups who seek to establish more independent flow of business, and is likely to work better for MNE groups where different geographies or business units have little commonality of operations. Decentralisation of treasury functions is also more likely to occur in more entrepreneurial companies, where there is a need for agility.

In decentralised cases, treasury will usually be acting as a service provider. Where this is the case, depending on facts and circumstances, there will be services that require remuneration from other group members. That means that management of key treasury functions will be
located at local levels, and treasury function will be seen as more of a routine operation within the group.

The effect of implicit credit support in decentralised groups is also likely to be severely diminished.

C.1 - Intra-group loans

Para 52 suggests that, “The parent already has control of and ownership of the assets of the subsidiary”. We note that this does not always necessarily follow. Also, where a borrower has assets that are not already pledged as security elsewhere, it would not always be appropriate in all cases to deem them as available collateral for an otherwise unsecured loan (and therefore impact its resultant pricing). Many companies borrow without security even when they have assets which might otherwise act as collateral.

We note the reservations expressed in para 63 as to the limitations of commercial credit rating tools. However, they clearly benefit from some objectivity, and provide a publically available and reasonably transparent basis for an evaluation (certainly in so far as quantitative factors, as opposed to qualitative factors, which will be more subjective, are used in the determination).

Qualitative factors may nonetheless provide a more nuanced basis for credit scoring, and should not be dismissed out of hand (nor should in-house models used for credit scoring) in evaluating whether a taxpayer has made a reasonable attempt to support the pricing policies of its treasury function.

C.1.3 Effect of group membership

Stand-alone credit rating

The use of a stand-alone credit rating is a common tool used by lenders in assessing the credit risk of a single borrower, when making investment or financing decisions from a risk tolerance perspective. In other words, the stand-alone credit rating refers to the borrower’s creditworthiness, in the absence of extraordinary support or intervention from its parent or affiliated company. Extraordinary or implicit support is typically idiosyncratic in nature and is extended to prevent an issuer from becoming nonviable.

Each credit rating agency applies its own methodology in measuring creditworthiness and uses a specific rating scale to publish its ratings opinions. This corroborates the fact that the assignment of credit ratings is not an exact science.

Credit ratings constitute just one of many factors that the marketplace should consider when evaluating debt securities. Accordingly, a credit rating might be used as an indication of credit quality, but investors should consider a variety of factors that affect the credit quality of a borrower. Within the framework of assessing the creditworthiness of a single borrower, the borrower’s willingness and ability to repay its obligations in accordance with the terms of those obligations should primarily be evaluated.

More specifically, within the framework of a stand-alone credit rating analysis, among other quantitative factors (such as profitability, leverage, liquidity, etc.) and qualitative factors (such as industry characteristics, country risk, legal and regulatory environment, etc.), available current and historical financial information should be evaluated, and the potential impact of foreseeable future events should be assessed. In addition, the existence of external
support or credit enhancements (such as letters of credit, guarantees, insurance and collateral) and the existence of implicit support should be also evaluated.

The proposal that there should be a rebuttable presumption (C.1.3.) that each group member has the same rating as the group of which it is part is patently contrary to the proper application of the arm’s length principle. In the absence of explicit parental guarantees it cannot be contended (even where adjustments made for implicit support given the varying degrees of importance of different subsidiaries to the wider group) that any reasonable application of the arm’s length principle would result in the same credit rating for all group companies.

Furthermore, it is not clear as to whom could rebut any such presumption. Does this mean the taxpayer as well as the tax authority concerned? Does the ability to rebut a presumption help provide any more clarity as to the proper application of the analysis than without it?

**Implicit support**

The synergy effects of group membership have recently been getting more and more attention from tax authorities (and Courts on litigation) globally. More specifically, when analysing an intra-group debt from a transfer pricing perspective, the effects of the implicit support that arises from a subsidiary’s passive association with its MNE group should be also considered (among other quantitative and qualitative factors).

Despite the fact that, for the time being, no exact definition exists for “implicit support”, the most commonly used meaning is that it reflects the expectation that a parent company will step in to support its subsidiary in the event of financial difficulty and meet its debt obligations.

In addition to formal guarantees (i.e. explicit support), any transfer pricing analysis considering the arm’s length financing terms available to a borrower within an MNE group should also consider the potential impact of implicit support from affiliated companies. For this purpose, it is important to consider both the degree of strategic importance of the respective MNE within the group, and the parent company’s willingness and capacity to provide such implicit support.

In this respect, it is important to note that there is still a substantial difference between a formal guarantee (i.e. explicit support) and implicit support. Implicit support might be limited to the hope that the parent company will step in to provide support even though there is no contractual obligation to do so.

An assessment should be made, based on a number of factors, whether the parent company would provide implicit support to the MNE in case of financial difficulty. If so, the extent of such support should be also taken into consideration in a credit rating analysis.

While the practices followed by each of the major credit rating agencies may not be entirely consistent, each of their methodologies applies a “notching” approach whereby they may take into account the strategic relationship between a MNE and its parent company.

Once the overall quantitative and qualitative factors has been assessed, an MNE’s stand-alone credit rating might be adjusted upwards to the parent company’s rating to reflect the implicit credit support. Any analysis must also take into consideration the effects of the respective MNE’s strategic importance to the group’s ultimate parent company.
We do not favour automatic capping of the borrower’s rating to that of the group level as this approach does to reflect the arm’s length principle. There are many examples of subsidiaries with a higher credit rating than that of the MNE group of which they are a part.

BDO broadly, however, agree with the approach set out as reflecting the impact of the ‘halo’ effect. More implicit and prescriptive guidance would be helpful, with some examples illustrating its impact.

C.2. Cash Pooling

The DD insists that cash pooling is a short-term liquidity arrangement (albeit in practice balances often remain in place for significant periods of time), and that a functional analysis should be carried out in order to determine the functional profile of the cash pool leader (e.g. service provider, in house bank, or hybrid).

Regarding the benefits generated from a cash pool structure, an analysis should be conducted to determine whether those benefits result from group synergies caused by the concerted effort of the participants. If so, the benefit should be split between the cash pool participants after remunerating the cash pool leader with an arm’s length reward based on its functional profile.

The DD mentions that a cash pool leader will, in most cases, perform basic functions (e.g. coordination functions), and bear limited risks, resulting in a relatively low expected arm’s length return on these activities. However, the question of how the cash pool leader should be remunerated if the role of the cash pool leader is more complex (with functions beyond a simple coordination role e.g. bearing credit risks, performing treasury functions, investment manager, etc.) and is not addressed in the current draft.

Equity at risk

In cases where the cash pool leader performs functions and bear risks beyond those of a plain service provider, the cash pool leader should have the people, and the financial capacity to control and assume those risk. In addition the entity should have enough equity to assume the financial risk in case that risk materializes (equity at risk).

The DD is not clear on how to estimate the equity at risk, and what parameters should be considered. A common approach used in some countries is based on an estimation of the potential loss. In that case, using the borrower’s credit profile and historical and expected financial performance, it can be possible to estimate the probability of default. Using such a probability based approach could be a good way to estimate any expected loss, and consequently the expected equity at risk.

Allocation of group synergy benefits

Another important issue regarding cash pooling arrangements is the allocation of the resulting benefits. The DD emphasizes that the benefits should only be allocated to the participants if those entities have deliberately performed actions to earn the benefit, provided that the benefit is not a direct consequence of group synergies.

Before an MNE decides to participate in a cash pooling structure, a careful analysis should be performed to determine the particular benefits for that entity. An MNE acting at arm’s length would only be a member of the cash pool if it expected to obtain a tangible benefit from the arrangement, and that benefit must be better than the best possible available alternatives. In
any case, an MNE shouldn’t be obligated to be a member of the cash pool just because of group policy.

Another issue that should be clarified is whether an entry fee should be paid by new cash pool members that want to participate in an existing pooling arrangement that is already generating benefits for its participants. If so, further consideration must be given to how this entry fee could potentially be calculated?

C.3. Hedging

Delineation of transactions

In a situation where there are off-setting positions within an MNE group, the appropriate delineation of the actual transaction under Chapter I of the 2017 OECD Guidelines will be dependent upon a number of factors.

For example, what influence, input and risk management direction is provided by the MNE group entity booking the transaction, to the MNE group entity booking the risk? The entity booking centralised hedging transactions may have limited autonomy over risk management activities, and may simply act as a hub for booking hedging transactions so that risk can be better monitored, and hedging costs can be reduced through group synergies.

Also the terms of the actual transaction need to be clearly identified in order to determine the discretionary risk management activity undertaken by the hedging entity. For example:

   a) The terms of the actual transaction
   b) The quantum
   c) Other market risk exposures such as FX, interest rate and counterparty credit risk

Where transactions are simply hedged on a back to back basis the terms of the actual transaction will directly affect the profits and losses arising on the instrument hedging the underlying risk.

Offsetting group positions

Where a member of an MNE group has a risk exposure which it wishes to hedge, but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, the appropriate treatment will be largely dependent on the hedging policy adopted by the MNE, and the degree of risk management discretion exercised by the hedging entity.

A ‘split’ hedge will arise where the MNE assets/transactions being hedged are booked in a different group entity to the hedging activity. Group transfer pricing policy should address split hedge situations and seek to align the group’s arrangement with those that might be expected to be adopted between independent third parties. The most appropriate transfer pricing approach will be driven by the operating facts; including the actual booking of the transaction and the associated hedging activity.

Where ‘split’ hedging arises it is normally appropriate to allocate profits or losses arising from the hedge to the entity booking the actual primary transaction. This is on the assumption that the sole driver for the hedging transaction is the underlying transaction entered into by the unhedged group entity.
In arriving at the appropriate transfer pricing outcome for a split hedge, the connection between the underlying asset being hedged and the hedging transactions should be examined. Given that the hedging transaction is being entirely driven by the underlying asset, it would be reasonable to conclude that the significant people or KERT function originating the actual transaction should drive the attribution of the associated hedge. In the absence of the origination of the underlying asset no hedging transaction would be required.

Failure to attribute split hedging transactions to the location of the underlying asset would also result in losses/expenses in the hedging location with no expectation of achieving a profit. The hedging location would suffer the hedging costs without receiving any of the income from the associated underlying asset which is being hedged. This position is not commercial and clearly does not reflect arrangements that would be adopted between two independent third parties.

Unless the unhedged MNE exercises some direction over the underlying hedging activity, it is only reasonable to allocate hedging results associated with a notional value equivalent to the underlying transaction. Where proprietary positions are taken on hedges (i.e. the hedge does not match the terms and risk exposures of the underlying transactions) the profits and losses associated with these positions should reside with the hedging entity.

Where significant risk management discretion is exercised by the hedging entity then it may not be possible to easily delineate the profits and losses that should be allocated to the unhedged entity. In these circumstances an allocation will need to be made, applying appropriate allocation keys, which is commensurate with actual transactions booked by group entities. This is on the assumption that the main purpose of the Group hedging policy is to eliminate or reduce the exposures arising from actual transactions booked by group entities.

D. Guarantees

Delineation of financial guarantees

In order to delineate a financial guarantee, first it should be determined whether or not the borrower within the MNE group has obtained a benefit from being part of the group. For instance, has a lower interest rate been paid, or a higher loan amount obtained. In some cases a lender may not be willing to lend at all without the assurance of a guarantee. If a benefit has been identified, then there might be either an implicit guarantee for which no guarantee fee has to be paid, or an explicit guarantee for which a guarantee fee might have to be paid.

If the borrower has obtained a benefit via an explicit guarantee, the next step is to determine the nature of the benefit, specifically whether it is a benefit for which an independent party would be willing to pay. For instance not all third party lenders request that related party guarantees are put in place, as they may assume that financial support will already be received in case of a default by the borrower.

On the other hand sometimes an independent party requests an explicit related party guarantee only to increase the likelihood that a debt can be repaid. In that case there is no additional benefit derived for the borrower in respect of this explicit guarantee. If the benefit for the borrower is indeed a benefit for which an independent party would be willing to pay, a guarantee fee for the explicit could be considered appropriate.

It is also possible that a related party will provide a guarantee in the form of pledge on an asset. In that case the relevant asset will be sold in the event of default. This will be the case when the guarantor has insufficient liquid assets available itself to repay the outstanding
loan. This form of guarantee could affect any applicable guarantee fee, as there might be additional expenses incurred (e.g. transaction costs) in order to liquidate the asset.

However, overall the value of the guarantee mainly depends on the benefit it brings the borrower, as well as the strategic influence of the borrower within the MNE group.

Insisted guarantees

An independent party can request an explicit guarantee be put in place to increase the likelihood that a debt can be repaid. This may be the case where a borrower has a relatively low standalone credit rating due to a lack of sufficient assets. There are also independent lenders which, based on policy, will request an explicit guarantee when the loan provided exceeds a certain threshold.

Impact of insisted guarantees on credit rating and loan pricing

The overall credit rating of the MNE group will not be affected by the insisted guarantee as the rating of the borrower is indirectly included in the credit rating of the MNE group. However, an insisted guarantee provided by a related party to the borrower could affect the standalone credit rating of this guarantor. The effect of the guarantee on the standalone credit rating of the guarantor depends, among other things, on the risk that the guarantee will be invoked. If this risk is expected to be high, then this fact could influence the standalone credit rating of the guarantor. A guarantee provided to a borrower with a high risk of default will potentially influence the quantitative factors (such as profitability, leverage, liquidity etc.) considered by a credit rating analysis.

Other remarks

Paragraph 140 mentions two issues in the case where the effect of a guarantee will be to permit the borrower to borrow a greater amount of debt than that it could have otherwise borrowed in absence of the guarantee.

a) Whether a portion of the loan from the lender to the borrower is accurately delineated as the loan from the lender to the guarantor (followed by an equity contribution for the guarantor to the borrower); and

b) Whether the guarantee fee paid with respect to the portion of the loan that is respected as a loan from the lender to the borrower is arm’s length.

First of all we doubt whether it will be practically feasible to determine the part of the loan which could had been lent by the borrower on a standalone basis. A third party lender will always take into consideration the fact that the borrower is part of a MNE. Substantiation of an amount based on third party comparable data seems impossible. Secondly, there is the issue of how this should be processed in the borrower’s and guarantor’s accounts - There may be complex differences between tax and statutory accounts that may be of a temporary or permanent nature.

Anton Hume
Partner, BDO UK
anton.hume@bdo.co.uk
+44 20 7893 3920

Andrew Stewart
Associate Director, BDO UK
duncan.nott@bdo.co.uk
+44 20 7893 3389
The BEPS Monitoring Group

Comments on the Public Discussion Draft on
Additional Guidance on
BEPS Actions 8 – 10 – Financial Transactions

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organisations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with contributions and comments from Sol Picciotto and Veronica Grondona.

We appreciate the opportunity to provide these comments and are happy for them to be published. We would also be willing to speak at any public consultation that may be held on this topic.

September 2018

SUMMARY

‘The use of third party and related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning’. These are the opening words of the final report of 2015 on BEPS Action 4 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. Consequently, that report recommended a best practice approach for limiting interest deductions by combining a fixed cap with a group ratio rule that would allow exceptions in some cases for the cap to be exceeded. Although relatively easy to apply, the final recommendations in Action 4 would still allow excessive deductions for most MNEs in most industry sectors. Hence, many countries will also apply transfer pricing rules to the internal financial relationships of MNEs, and the present discussion draft (DD) aims to refine the advice on application of these rules.

Despite the importance of financial transactions and their pervasive use by MNEs for BEPS purposes, readers of this DD gain no sense of urgency, no sense that this is an issue that affects the vast majority of MNE structures. The DD should be expanded to explain the pervasiveness of tax-motivated financial transaction structuring and emphasise that such transactions require careful and continual tax authority attention and a strong sense of skepticism.

This DD is well thought out and clearly represents considerable time and effort to create a cohesive document to provide guidance to taxpayers and tax authorities alike. While an excellent
document in every sense of the word, its subtleties and attention to detail will be lost on the many undeveloped and even some developed countries that simply do not have the resources and skilled personnel necessary to apply these rules. In discussing the need for an accurate delineation of each financial transaction, the guidance makes clear that each situation must be examined on its own merits. This of course means that each financial transaction, of which there may be many within any MNE group and even within each MNE group member, must be separately examined on an ad hoc basis. This requires resources and specialist knowledge of each industry as well as of the complexities of corporate finance that is in short supply; for most tax authorities around the world, it is non-existent. The documentation of these rules is an expensive exercise for MNE taxpayers as well. Hence, what is sorely needed are simplified methods that are simple to apply and that provide results that are fair to both taxpayers and tax authorities alike. This DD is a chance for the OECD to be a leader in considering such methods and providing meaningful guidance that would be of tremendous utility to many countries.

A. GENERAL REMARKS

1. Making clear the pervasiveness of tax-motivated financial transaction structuring

We welcome the firm statement in paragraph 3 of the DD that:

In the absence of other influences such as legal or regulatory constraints, the balance of debt and equity funding between independent enterprises will be the result of various commercial considerations. In contrast, an MNE group has the discretion to decide upon the amount of debt and equity that will be used to fund any MNE within the group. Thus, in an intra-group situation, other considerations such as tax consequences may also be present. [Emphasis added.]

‘Other considerations such as tax consequences may also be present.’ This is an understatement of major proportions. As a very practical matter, with perhaps the exception of regulatory constraints that could potentially affect bank and some other regulated financial groups, there are typically no significant commercial or legal reasons for intercompany financial relationships (e.g. fundings, derivatives, etc.) to be structured in any particular manner. Usually, the prime reason for using intra-group debt is to enable deductible interest payments and to provide a more tax efficient means of returning untaxed earnings through repayment of debt rather than through post-tax dividends.

The funding of a new subsidiary’s planned operations may be structured through any one or a combination of the following arrangements between members of the same corporate group:

(i) share equity capital,
(ii) contribution to capital with no issuance of shares,
(iii) third-party seller financing or loan with or without group member guarantee,
(iv) on-demand open account facility or loan with or without interest,
(v) written loan agreement with fixed repayment with or without interest,
(vi) acquisition of tangible or intangible assets followed by a sale to the subsidiary in exchange for seller financing with or without interest and with open or fixed payment terms, and
(vii) acquisition of tangible or intangible assets followed by a lease or licence to the subsidiary with terms and lease or royalty levels at the discretion of the group.

With the exception of the first three, the MNE is typically free to decide on the currency in which to denominate the transaction. Each of these approaches may give rise to varying taxation consequences to the new subsidiary and the other group member. Most typically, tax is the major factor that determines the one or more transaction forms chosen.

The point of the above is that readers of the discussion draft as presently written gain no sense of urgency, no sense that this is an issue that affects the vast majority of MNE structures. We strongly suggest that this aspect of the discussion draft be expanded so as to explain and emphasize the reality that tax-motivated financial transaction structuring is pervasive. Such transactions are a major cause of BEPS and require careful and continual tax authority attention and a strong sense of skepticism.

2. The need for simplicity

a. In General

The final report of 2015 on BEPS Action 4 Limiting Base Erosion Involving Interest Deductions and Other Financial Payments recommended a best practice approach for limiting interest deductions by combining a fixed cap with a group ratio rule that would allow exceptions in some cases for the cap to be exceeded. This approach provides a limitation mechanism that many countries either have implemented or are expected to adopt and is relatively easy to apply. It should also be more effective than thin capitalisation rules, which can be avoided relatively easily, and the terms of which have varied considerably among the countries that had adopted them. While the new Action 4 approach is a significant improvement, the upper limit of the recommended cap of 30% of earnings before interest, tax and depreciation (EBITDA) is high for most MNEs in most sectors. Further, making the group ratio rule an alternative that can increase the interest deduction limit rather than the primary limitation method (as first proposed) greatly reduces the effectiveness of this method. Countries may still opt for a more stringent version of this new interest deduction limitation, such as a cap at 10%, the lower end of the recommended range, but may be reluctant to do so for fear of deterring inward investment. Consequently, tax authorities will continue to apply transfer pricing rules as their first line of defence against the BEPS financial structuring between members of MNE groups. This discussion draft aims at refining the guidance on application of those rules.

This discussion draft is very well thought out and clearly represents considerable time and effort to create a cohesive document to provide guidance to taxpayers and tax authorities alike. While an excellent document, its subtleties and attention to detail may only be appreciated by a small slice of its potential audience. This small slice primarily includes, of course, transfer pricing experts, the vast majority of whom are in the private sector either employed by or advising the large multinational groups (MNE groups) from law, accounting, and other advisory firms. This small slice includes only a relative few within tax authorities, and the majority of these few will be from a small number of developed countries.

The pricing of intra-group financial transactions affects all countries, including the most developed and the most undeveloped. With the greater relative dependence of undeveloped countries on corporation tax, it is of utmost importance that guidance be provided that is capable of being followed and that provides both a degree of certainty and fair results to both taxpayers
and tax authorities. While the care and theoretical correctness of the guidance within this discussion draft is to be applauded, the results create requirements to perform a highly subjective analysis that most tax authorities will have neither the resources nor the skills to make; most will not even be able to review for reasonableness analyses that MNE groups have prepared. Where a tax authority does have the resources and skills, the high level of subjectivity will simply produce more taxpayer/tax authority disputes. Further, where tax treaties are applicable, and the MAP process is therefore available, these increased disputes will further clog competent authorities’ backlog of cases.

What is sorely needed are simplified methods that are easy to apply and that provide results that are fair to both taxpayers and tax authorities alike. A sensible interpretation of article 9 of the model convention is needed to enable the formulation of simplified methods that are capable of being easily applied. Without such methods, the system is unworkable. Unless priority is given to adopting simplified methods, there will inevitably be an increase in disputes and increased adoption of varying individual national responses to a system that is just not administrable.

The BEPS Monitoring Group believes that in the mid- to long-term the currently respected separate entity principle should be replaced by a formulary approach that treats MNE groups as the unitary businesses that they are. The forces that will propel governments to abandon the separate entity principle in favour of a formulary approach include the current system’s collapsing due to its subjectivity, the inability of tax authorities to deal with it, the opportunities it creates for BEPS structuring, and the uncertainty and conflicts created for business. If the OECD wishes to prolong the current reign and defer a future adoption of a formulary approach, then it must seriously deal with complexity and subjectivity through the identification of simplified methods and guidance in their implementation.

Considering the above, we suggest that a section be added to this discussion draft that encourages and provides guidance to countries wishing to apply simplified approaches including sectoral or other safe harbours and a cost of funds approach. We also make herein some additional simplification suggestions.

b. Suggestions

In discussing the need for an accurate delineation of each financial transaction, the guidance makes clear that each situation must be examined on its own merits. This of course means that each financial transaction, of which there may be many within any MNE group and even within each MNE group member, must be separately examined on an ad hoc basis. This requires resources and specialist knowledge of each industry as well as of the complexities of corporate finance that are in short supply; for most tax authorities around the world, it is non-existent.

In the interest of working to achieve to the greatest extent possible meaningful simplification that provides fair results to both taxpayers and taxing authorities, we believe that sectoral safe harbours could be developed for many industry groups. The design of safe harbours for financial transactions should be viewed as a collective action problem. A properly designed safe harbour should be of general benefit to those taxpayers it covers, as well as the tax authority. We believe that appropriate safe harbours should be designed as applying presumptively, on an opt-out basis where a taxpayer can justify the opt-out. Opting-out should be the exception. A taxpayer would thus be allowed to rebut the presumptive safe harbour method, but only on grounds which should be strictly defined. This possibility is mentioned in the OECD Transfer Pricing Guidelines
(TPGs), which mention that ‘a rebuttable presumption might be established under which a mandatory pricing target would be established by a tax authority’ (para. 4.104).

We encourage individual countries or regional groupings of countries to develop such sectoral safe harbours. Even better, the Platform for Collaboration on Tax (or any of its component members) could develop sectoral safe harbours that could be adopted by individual countries for which those specific sectors are important.

Another potentially simplifying approach that the discussion draft guidance should include is for countries to allow taxpayers to justify their pricing (e.g. interest rate on an intercompany loan) based on the cost of funds to the group member lender. Paragraphs 89 – 91 of the discussion draft briefly discuss the ‘cost of funds’ approach.

We suggest that a section be added to this guidance that encourages countries wishing to apply simplified approaches to consider sectoral or other safe harbours as well as a cost of funds approach. We suggest that such an expanded section could include guidance on the various alternative approaches that is sufficient to help countries wishing to use such simplified approaches to decide on which approaches might be applicable to their national/industrial profile. If the OECD wants to take a leadership position that will help define and harmonise this area, then now is the time to provide such guidance.

We have also suggested within the below Specific Comments a number of additional suggestions that would result in simplification.

B. SPECIFIC COMMENTS

Box B.1. Question to commentators

Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention (“MTC”), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

Response:

Paragraph 3 of the DD (quoted in section A.1. above) accurately points out that the decision on the balance of debt and equity of an affiliate forming part of an MNE group is unlike that between independent enterprises. This squarely raises the central issue of interpretation of article 9 of the model tax conventions. The wording of article 9.1 clearly indicates that it was aimed at dealing with this problem. However, the article’s reference to ‘independent enterprises’ has been misinterpreted by some in a way which makes it contradictory. The article does not require that all relationships between associated enterprises should be evaluated by comparing them to those of similar independent enterprises. It simply states that the profits of associated enterprises may be adjusted to take account of the differences between the relationships of related and unrelated entities.

Hence, the DD is correct in our view to state in paragraph 9 that countries are free to apply their own preferred approach to ensuring that capital structures within MNE groups are not used for BEPS purposes. It is also correct in stating that the accurate delineation of transactions is not mandated by article 9, nor indeed does it mandate a focus on scrutiny of the transfer pricing of transactions. The Commentary on article 9 of the OECD model convention makes it clear that while the OECD’s report Transfer Pricing Guidelines for Multinational Enterprises and Tax
Administrations ‘represents internationally agreed principles’ for the application of the arm’s length principle, article 9 ‘remains the authoritative statement’ of that principle.

While the BEPS Action 4 limitations are applied to all interest expense on an aggregate basis, transfer pricing rules are applied to specific loans and other financial transactions. Hence, these two approaches may be considered to be complementary, with transfer pricing rules being applied first to determine the appropriate interest and other charges that apply to each individual financial transaction, and BEPS Action 4 limitations being applied thereafter to potentially restrict a taxpayer’s aggregate interest and other relevant charges.

Nevertheless, it is clearly important to provide, if possible, guidance on this interaction, especially on how to deal with possible conflicts which may arise if countries apply different approaches to determining what is debt or equity for tax purposes and consequently to what interest would be potentially deductible. We suggest the addition of examples of other methods used by some countries to make this ‘debt vs equity’ determination and guidance on how different methods might be reconciled. This could be particularly helpful to competent authorities attempting to deal with MAP cases under article 25. The OECD Commentary at present notes this issue as well as the issue of thin capitalisation rules in paragraph 3 of the Commentary to article 9, part of which is quoted in the DD.

It seems clear that this paragraph 3 should be updated in light of the report on BEPS Action 4, which recommends a best practice approach significantly different from typical thin capitalisation rules. This raises issues which go well beyond the scope of the current DD, and which will require considerable further work. Such work should include reconsideration of what is meant by the phrase ‘arm’s length profit’ in paragraph 3(c). It should not be used to preclude the use of simplified methods such as those we suggest in this submission, which would apply on a presumptive but opt-out basis. If the OECD continues to insist that determining an ‘arm’s length profit’ must always require scrutiny of individual transactions on an ad hoc basis, then opportunities for significant BEPS structuring and the inability of tax authorities to contain it will continue. The OECD must lead in adopting effective and workable approaches to the application of article 9.

Box B.2. Question to commentators

Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

Response:

Say that the example’s loan amount is €10 million and that the amount of supportable loan is €4 million, thus leaving €6 million that is inappropriately treated as loan. We strongly believe that the proper result for this example is that the full €10 million should not be treated as a loan; presumably in this case as equity. If the TPGs suggest that the loan should be split with only the €6 million treated as not being a loan, there is strong motivation for MNEs to push the envelope since they know that they will be no worse off than if they had initiated the funding with a €4 million loan and €6 million of equity. Knowing that the entire €10 million will not be treated as a loan if they are too aggressive in their profit shifting through excessive debt and loan interest,
then they will be conservative in their planning and transfer some amount as equity along with a loan in an amount that they truly believe that they can support as being legitimate.

Considering the above, we suggest that paragraph 17 be changed to the following:

17. For example, consider a situation in which Company B, a member of an MNE group, needs additional funding for its business activities. In this scenario, Company B receives an advance of funds in the amount of €10 million from related Company C which is documented in a loan agreement with a term of 10 years. Assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount. Based on these facts and circumstances, it can be concluded that an unrelated party would not be willing to provide such a loan to Company B. Rather, an unrelated party would only be willing to provide a loan of a portion of the loan amount, say €4 million. In these circumstances, the entire loan agreement, as accurately delineated, would not be recognised as a loan for the purposes of determining the amount of interest which Company B would have paid at arm’s length. Countries could consider treating only the €6 million as not being recognised as a loan. This would place Companies B and C in the same position they would have been in had they initially arranged €6 million of equity and €4 million of loan. As such, there is no downside to the MNE group from aggressively treating the full €10 million as debt. It is believed that applying the accurately delineated non-loan (i.e. equity) characterisation to the entire transaction is the only approach that will truly encourage taxpayers to make a serious effort before executing intercompany financial transactions to give them truly supportable amounts and terms. (See Section C.1.1 that requires analysis of both the lender’s and borrower’s perspectives.)

**Box B.3. Question to commentators**

Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

**Response:**

Overall, we believe that the breadth of factors covered is extensive and well stated. Perhaps our only concern with this section B.2. (‘The economically relevant characteristics of actual financial transactions’) is its implication for practical application by developing countries and, for that matter, many developed countries. The level of sophistication required of the tax authorities and the resources necessary to give justice to assessing a related-party financial relationship are so extensive that they would be beyond the capabilities of all but a relative few tax authorities. We believe that sectoral and other relevant safe harbour approaches are necessary in light of the tax motivation that underlies most intra-group financial transactions and as long as group members continue to be treated as separate entities that are acting with a fictional ‘independence’.

The discussion draft in Paragraph 78 fully recognises the ‘fictional’ nature of this ‘independence’. This paragraph reads, in part:

… Intra-group lenders may choose not to have covenants on loans to associated enterprises, partly because they are less likely to suffer information asymmetry and
because it is less likely that one part of a group would seek to take the same kind of action as an independent lender in the event of a covenant breach, nor would it usually seek to impose the same kind of restrictions. … [Emphasis added.]

The guidance overall is an excellent and comprehensive discussion, but frankly it simply ignores the elephant in the room that MNE groups structure many, if not most, intra-group financial arrangements based on tax minimisation goals. As noted above, the guidance should make crystal clear that intra-group financial transactions require careful and continual tax authority attention and a strong sense of skepticism.

Paragraph 22 includes the following:

… between associated enterprises the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and circumstances. It is therefore necessary to look to other documents, the actual conduct of the parties – notwithstanding that such consideration may ultimately result in the conclusion that the contractual form and actual conduct are in alignment – and the economic principles that generally govern relationships between independent enterprises in comparable circumstances in order to accurately delineate the actual transaction in accordance with Section D.1.1 of Chapter I. [Emphasis added.]

Paragraph 22 clearly and distinctly provides guidance for a tax authority to determine whether the actual conduct of the parties is consistent with the terms of intercompany agreements. The italicised additional comment, though, is not only unnecessary, it is inappropriate in that it almost invites tax authorities to refrain from bothering with this review procedure that may reveal no wrong-doing. Any tax audit procedure might reveal no wrong doing. There is no reason to be pointing this out for solely this procedure that is otherwise required under Chapter I. Frankly, we believe this comment is insulting to tax authorities from any country. We strongly suggest that this gratuitous comment be deleted from Paragraph 22.

Paragraph 24 and Section C.1.1. (‘The lender’s and borrower’s perspectives’) set out in clear fashion the sort of analysis that a lender should be expected to take in considering whether to advance a loan to a borrower. In related party situations, there will be analysis, but the focus of the analysis will almost certainly be on the risks and rewards with respect to the use of the funds by the borrower and not on the creditor risks which are implied in Paragraph 24.

Operating managements of MNE groups make economic investment decisions without regard to legal entity lines. They think and act along product, service, and divisional operating lines. While tax may be an important factor in an investment decision, it is only the tail…and the tail does not wag the dog. Following the basic decision to actually make some economic investment or conduct or expand some business, the group decides on the specific tax structuring that can include moving funds into the subsidiary to finance this activity. Such movement of funds may be via any of the mechanisms listed earlier in this submission (e.g. share equity, loan, acquisition of tangible assets by another group member with assets leased to the subsidiary, etc.). In contrast to Paragraph 24 and its focus on the analysis that a lender would conduct, Paragraph 25, along with Section C.1.1., notes the perspective of the borrower and its normal concerns.

In this light, although paragraphs 24 and 25 along with Section C.1.1. are excellent discussions, they are really theoretical in nature. Internal intra-group transactions such as financings are
structured based primarily on tax considerations (see earlier discussion on this aspect). Analysing and devising such intra-group structures are typically legal, tax, and treasury functions with little participation of operating management. This analysis normally follows the real substantive analyses conducted by product, service, or divisional operating line management to conduct some new business, expand an existing one, or make some other investment. As a result, it will be very likely that any ‘lender’ or ‘borrower’ documentation of analyses conducted for an intra-group financing structure will be prepared solely to support tax filings and not due to any operational need. Today, even in relatively decentralised MNEs, there will be central control and decision-making with respect to legal and tax structuring of finance. The discussion draft notes this typical central control and direction of the treasury function in Paragraph 45. Once the business decision to invest in an activity has been taken, there will virtually never be two separately managed group entities truly considering their respective positions as ‘lender’ and ‘borrower’. They would not make in any real sense the analyses that are described and contemplated within Paragraphs 24 and 25 along with Section C.1.1. (It may be noted that in some MNE groups, the directors of many operating group affiliates, particularly special purpose companies, will be personnel from legal, tax, and treasury functions rather than operating management personnel.)

Hence, we suggest that the discussion draft be amended to note more clearly this typical reality and the need for countries to consider the use of sectoral or other safe harbour approaches for determining the treatment of financial relationships as loans or equity and their pricing if they are determined to be loans.

**Box B.4. Question to commentators**

*Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm’s length interest rate.*

**Response:**

We believe this is excellent discussion and guidance that may be used by any country’s tax authority where the country’s rules require such analysis. As indicated elsewhere in this submission, we believe that the vast majority of countries have neither the resources nor the skilled personnel to be able to appropriately implement this guidance, especially for more complex financial transactions, many of which will involve foreign currency denomination with associated exchange rate risks. As a result, we again call for expanded guidance on alternative safe-harbour approaches that could be considered by those countries that desire to use them.

**Box B.5. Question to commentators**

*Commentators are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns.*

**Response:** None

**Box B.6. Question to commentators**

*Commentators’ views are invited on the practical implementation of the guidance included in paragraph 11 of this Box B.4, and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest expense up to an arm’s length amount, but the funder is*
entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.

Response:

While there will of course be exceptions, the bulk of situations such as here described where the funder is entitled to no more than a risk-free return will involve the residual interest being attributed to either the parent company or a group member in the home country of the MNE group. As many major MNEs are headquartered in highly developed home countries, the tax authorities within those home countries should have the capability to assess the appropriate group entity on the appropriate level of income and to deal with MAP issues. We therefore believe that for the bulk of situations, there should be no practical impediments to this guidance.

Box C.1. Question to commentators

Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

Response:

As we have pointed out, the treasury function of MNEs always entails centralized decision-making. Its borrowings are from globalised financial markets and are managed and directed on a group-wide basis. Although some functions of the treasury operations may be decentralized, these would virtually never involve transfers of credit risk to a local group member since locally performed functions would virtually always be defined by strict group-set parameters. (This is not to say that a local group member will not have local personnel controlling the risk in the extension of credit to customers and managing obligations to third-party vendors and other suppliers.) Further, an integrated MNE may take a decision to close down a business activity conducted within a local group member. In such a case, it will virtually always stand behind the debts of that member; the reputation and standing of the group simply transcend the financial cost of settling the member’s debt. In the rare case where an MNE chooses to let its member’s debt go unpaid, the MNE is consciously bearing a real reputational/business cost. Thus, the financial risk is controlled by the parent company with that risk being borne ultimately by the creditors of the parent company and, in the last analysis, its shareholders. As a further example, there have been instances in the past where a local country experiences a financial crisis with the initiation of chronic inflation of the local currency and devaluation of the local currency against hard currencies. In such cases, parent companies have quickly re-denominated intercompany loans so as to place the loss within the subsidiary. In summary, the risk of treasury operations cannot be considered to be transferred in any meaningful sense to an affiliate which may happen to have local personnel performing some treasury functions.

Box C.2. Question to commentators

Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
• a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

Commentators’ views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

Response:

We agree that the two suggested rebuttable presumptions would be simplifying moves that would be fair to both taxpayers and tax authorities.

Given the typical central management and integration of most MNEs today, we believe that the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE makes excellent sense as a simplifying measure that is fair to both taxpayers and tax authorities.

Box C.3. Question to commentators

Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

Response:

All of Section C.1.3., ‘Effect of group membership’, is excellent discussion of a complicated topic. Clearly, much thought and consideration has gone into it.

Having said this, though, we first note what is said in Paragraph 74 that very appropriately comments, in part:

The kind of information on which the group would base a decision of whether or not to provide support to a borrower in particular circumstances is usually not available to a tax administration. …

We have noted earlier the theoretical nature of the excellent discussion of factors that a borrower and lender should consider. We have also noted the difficulty that most tax authorities would have to make the analyses that are described throughout this discussion draft, using that difficulty as a reason to suggest that the guidance should encourage countries to consider relevant sectoral and other safe harbour approaches. Now, in this Section C.1.3., we see a further raising of the subjectivity bar to a new level. Rather than just applying the principles to a group member that is treated as being independent under the separate entity concept, there is direction to take into account the potential impact of passive association with the rest of the group on creditworthiness and other terms. We do not doubt the relevancy of this potential impact. Our only concern is our strong doubt that there are any tax authorities in this world who could, or would, attempt to dive into this morass of subjectivity. Any presentation to a tax authority by a taxpayer on this aspect of determining appropriate transfer pricing results will likely cause both
glazed eyes and a total inability to audit in any fashion the correctness, or even the reasonableness, of the taxpayer’s presentation and position.

Considering the above, we suggest that this Section C.1.3. be deleted from the discussion draft. It simply goes too far.

**Box C.4. Question to commentators**

Commentators’ views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

**Response:** See above response to Box C.3.

**Box C.5. Question to commentators**

Commentators’ views are invited on:

– the role of credit default swaps (CDS) in pricing intra-group loans;
– the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

**Response:** None

**Box C.6. Question to commentators**

Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.

**Response:**

The following is from the response provided above to Box B.1.

For example, the funding of a new subsidiary’s planned operations may be structured through any one or a combination of the following:

(i) share equity capital,
(ii) contribution to capital with no issuance of shares,
(iii) third-party seller financing or loan with or without group member guarantee,
(iv) group member on-demand open account or loan with or without interest,
(v) group member written loan agreement with fixed repayment with or without interest,
(vi) group member acquisition of tangible or intangible assets followed by a sale to the subsidiary in exchange for seller financing with or without interest and with open or fixed payment terms, and
(vii) group member acquisition of tangible or intangible assets followed by a lease or licence to the subsidiary with terms and lease or royalty levels at the discretion of the group.

**Box C.7. Question to commentators**

Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.
Response:

We believe that countries could reasonably choose to apply an average interest rate within any safe harbour mechanisms that they decide to implement. Since the goal is an easy-to-apply approach that provides results that are fair to both taxpayers and tax authorities, using an average interest rate should normally be a reasonably objective approach to determining such a rate.

In a manner of speaking, this question also relates to the ‘cost of funds’ discussion in Paragraphs 89-91. We believe that in many cases where one group member has borrowed funds from outside the group and then lends internally (either directly or indirectly) to the group member borrower that will use the funds in its locally conducted business, such third-party financing arrangements will have been decided upon centrally with the group member borrower being a passive participant, merely controlling its use of the funds within its business. This group member borrower takes what is given as equity investment, intra-group loans, or any other of the mechanisms listed in the response to the Box C.6. question above. The group member borrower simply executes what it is directed to do regarding the signing of documents and the accounting for the funds or other assets that are provided. Such a situation would suggest the use of either an average rate or a ‘cost of funds’ rate depending on the facts.

Box C.8. Question to commentators

With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular,

- are there circumstances in which one or another of the approaches would be most suitable?;
- does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?;
- whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

Response:

Regarding the first paragraph in Box C.8. that concerns the position of the cash pool leader, our response to Box B.3. commented, in part:

In related party situations, there will be analysis, but the focus of the analysis will almost certainly be on the risk and rewards with respect to the use of the funds by the borrower and not on the ‘creditor’ risks assumed by the group member lender …

Considering this reality, there should be few, if any, situations in which a cash pool leader has conducted any real ‘lender’ analysis and decision making that would allow it to be seen as carrying credit risk. Accordingly, we believe that cash pool leaders should only be remunerated
for providing services to cash pool participants. If the OECD is able to identify some rare exceptions where the leader does truly conduct these analyses and functions, perhaps this issue could be simplified with a rebuttable presumption that remuneration must only be for services rendered.

As a more general comment on Section C.2. and cash pooling arrangements, it is likely that many MNE groups that maintain cash pooling arrangements will assign a central leader role to a special purpose company group member organized in a zero- or low-tax country. In many such cases, the special purpose company might legally hold the pool’s funds and contract with other pool members and one or more banks or other financial institutions that provide services to the pool. Such a special purpose company might have no employees of its own. Rather, the group personnel managing the pool and the activities of the special purpose company will be located within the parent or another group member either in the home country of the MNE or in some regional management office. We suggest that the discussion draft mention this as a possible situation and note that any appropriate reward of the cash pool leader would flow to the group member whose personnel are in fact directing the special purpose company and who control the risks it undertakes. Example 2 (Paragraphs 119 – 123 of the discussion draft) could be expanded to consider this factual situation. (It may be noted that Paragraphs 168 and 171 concerning captive insurance arrangements notes the possibility that the group member captive might be managed by another group member.)

Where a special purpose company is used as a cash pool leader, and personnel in the parent company or another group company actually make operating decisions and run the business of the special purpose company, it may well be that there will be a permanent establishment of the special purpose company in the country where those personnel are located. We suggest that the potential for a permanent establishment within that country and the direct taxation of the special purpose company by that country be included within the guidance. In particular, this aspect could also be added as a further expansion of Example 2.

Box C.9. Question to commentators

In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

Response:

Given the strong nature of the centralised management within most MNEs and especially within functions that are almost always coordinated and managed centrally such as the treasury function, we cannot imagine a situation where a group member is not ‘forced’ to participate.

If it is decided to provide guidance on this point, we strongly suggest that there be a presumption of ‘forced’ participation wherever this aspect is important to the accurate delineation of the cash pooling arrangement. This presumption would only be rebutted where strong evidence is available.

Box C.10. Question to commentators

Commentators’ views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.
Commentators’ views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

Response: None

Box C.11. Question to commentators

In a situation where there are off-setting positions within an MNE group, commentators’ views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators’ views are invited on whether that risk should be treated as being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

Response:

We believe that simplicity should prevail. Thus, where an MNE has chosen not to execute any mechanism to legally offset gains and losses from natural hedges within different group members, the guidance should provide that each group entity will recognise its gain or loss with no offset being allowed within either group member.

Box D.1. Question to commentators

Commentators’ views are invited on

- how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);
- the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;
- where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and
- examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

Response: None

Box E.1. Question to commentators

Commentators’ views are invited on the following:

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;
• when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and

• whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;

• when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

Response:

We fully recognise and agree that captive insurance arrangements are a legitimate means for an MNE group to achieve non-tax objectives that include self-insuring, reducing its group-wide insurance costs through re-insurance, etc. (Such objectives are set out in Paragraphs 172 and 173.) Despite the legitimacy of such non-tax objectives, from the perspective of many countries, captive insurance arrangements represent a serious tax risk.

Unless an MNE group conducts an insurance business for unrelated parties as one of its principal business lines, we believe that the risk-sharing and other benefits that a captive provides are motivated by management’s desire for cost reduction and a well-managed worldwide operation. These are central activities that benefit the entire group and should be seen the same as any other management function that benefits all participating group members.

Hence, we recommend that guidance should provide that insurance costs should be shared amongst the participating group members and that there should be no use of comparable uncontrolled prices that might be available from arrangements between unrelated parties. The pricing of insurance should not reflect premium levels that allow the captive to earn profits from conducting an insurance business.

To recognise that some groups may, in fact, operate an insurance business for unrelated parties as one of its principal business lines, we suggest a rebuttable presumption approach. This would allow an MNE group that does have insurance as a principal business line to establish this fact and to charge its group members premiums that can be supported by uncontrolled prices.

Box E.2. Question to commentators

Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

Response: None

Box E.3. Question to commentators

Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.
Response:
We believe that the example is fine as is. We suggest no changes to it.
Comments on the OECD Discussion Draft on Financial Transactions

Working Party No. 6 — Tax Treaties, Transfer Pricing and Financial Transactions
Division, OECD/CTPA

To

BonelliErede — Valdani Vicari & Associati

From

Comments on the Discussion Draft on Financial Transactions

Reference

6 September 2018

Date

Dear Sirs/Madams

BE–VVA¹ would like to thank you for the work done in drafting the BEPS Action 8–10 Discussion Draft on Financial Transactions ("Draft") and are pleased to provide a preliminary set of comments and observations to contribute to the Draft’s implementation along with a brief introduction to the commented topics.

¹ BE–VVA is an exclusive alliance in the field of transfer pricing created by the law firm BonelliErede ("BE") and the economic consultancy firm Valdani Vicari & Associati ("VVA"). BE–VVA combines a team of tax experts who hold prestigious positions at major universities teaching taxation and transfer pricing and a team of fully dedicated economists focused on economic consultancy in the fields of valuation, transfer pricing and commercial litigation.
Introduction to our comments

BE-VVA would first like to thank the OECD for its commitment in trying to reduce tax uncertainty regarding transfer pricing matters. BE-VVA welcomes the Draft as a fundamental step towards providing guidance on a matter that is gaining increasing importance in the transfer pricing arena, as shown by landmark court cases.

Our comments refer to both selected boxes and selected paragraphs. When we do not cover all the queries mentioned in one box, we specify the query and argument addressed. When our comments relate to either more than one paragraph or boxes and paragraphs together, reference is made to the paragraphs or both the boxes and the paragraphs, respectively.

Executive summary

One of the most significant techniques in the international tax arena for shifting profits relates to financial transactions. The OECD has devoted a great deal of effort to trying to resolve the underlying issues (among others, by issuing BEPS Actions 4 and 8–10) and to set out fundamental principles to reduce profit shifting.

The recurrent theme of the OECD’s efforts can be seen in BEPS Actions 8–10, which clarify that funding companies should merely be entitled to a risk-adjusted rate of return.

The OECD principles are very much in line with landmark court cases and tax legislation interventions by the European Union (e.g., ATAD 1 and 2).

In light of this, and considering the importance of ensuring continuity and harmonisation in interventions on the matter, we structured our comments to follow the topics set out by the OECD, with particular focus on: (i) interaction with the guidance in Chapter 1, Section D.1 of the OECD Transfer Pricing Guidelines; (ii) intra-group loans; and (iii) cash pooling.

Interaction with the guidance in Chapter 1, Section D.1 of the OECD Transfer Pricing Guidelines

With regard to Chapter B of the Draft, we first analyse the interaction between the recharacterization of a transaction and Arts. 9 and 25 of the OECD MTC and
BEPS Action 4 (Box B.1). We raise our concern as to whether the Draft's recommended approach (willing to lend/willing to borrow) suffices to resolve the problems relating to double taxation.

Subsequently, we examine the example of para. 17 (Box B.2) and provide some hints on its possible implementation and the practical implications that could arise regarding the concept of “maximum amounts”.

We then analyse the concepts outlined in paras. 17, 19 and 34 on financial projections and the ability to service the loan. We focus on: (i) the connection with Chapter VI of the TPG; (ii) the relevant flows to be considered (whether cash or income, net or operating); (iii) the purpose of financial projections; and (iv) the concerns deriving from the possible absence of financial projections.

We then welcome the provisions on the factors to be taken into account in analysing financial transactions (Box B.3) and suggest some additional factors that could be included in the list. We also suggest to parameter the breadth of the analysis to the materiality of the transaction and the size of the multinational group.

Finally, we provide our view on the risk-free and risk-adjusted rate of return (Box B.4). With regard to the risk-free rate of return, we mention some key points relating to the financial instrument to be considered and the maturity of the risk-free investment. With regard to the risk-adjusted rate of return, we provide a non-exhaustive list of technical issues that could impact the calculation of the risk-adjusted rate of return.

**Intra-group loans**

With regard to Chapter C.1 of the Draft, we first focus on the concept introduced in para. 52 and raise our concerns regarding: (i) its compliance with the separate entity approach principle, and (ii) its possible practical implications in terms of burdening the taxpayer’s effort and tax certainty.

Moreover, we provide our viewpoint on the group credit rating (Box C.2), focusing on the benefits of tax compliance and consistency with the separate entity approach.
Cash pooling

With regard to Chapter C.2 of the Draft (Box C.8), we first provide a practical example of a cash pool leader acting as an entrepreneur and examine its functional profile. We then focus on the approaches for allocating cash pooling benefits and provide examples based on our experience. Subsequently we provide a possible three-step analysis to determine the remuneration of the cash pool members (both when the cash pool leader acts as an entrepreneur and when it does not).

We then analyse the transfer pricing consequences of a member being obliged to participate in a cash pool (Box C.9).

Finally, we examine the treatment of surpluses in a cash pooling arrangement (para. 106) and suggest some practical approaches to address the topic.

Box B.1. Commentator's views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report

One of the most relevant issues relating to intercompany transactions is understanding whether and to what extent a financial transaction exists as characterized by the taxpayer. This is of paramount importance given the implications that characterizing a debt into equity may have not only on transfer pricing but also on corporate income tax and the tax treatment of the related proceeds (as either interest or dividends).

The OECD initially partially addressed this matter in its 1979 report on “Transfer Pricing and Multinational Enterprises”, which described the different approaches adopted by countries to distinguish an equity contribution from a loan. The report recommended that countries adopted a flexible approach in which the special conditions of each individual case had to be evaluated. Afterwards, the OECD report on thin capitalisation addressed in more depth the applicability of the arm's length principle to characterize debt as equity.

The current Draft, in compliance with the principles stated in Chapter I of the OECD Transfer Pricing Guidelines ("TPG"), provides a list of economically relevant characteristics of financial transactions that should be taken into account to accurately characterize a transaction. We deem advisable that a more detailed guidance
should be provided on the useful indicators for establishing the nature of an advance of funds. Particularly, it should be explained how any indicator might suggest the nature of the transaction (e.g., whereas it is quite intuitive the potential relevance of the presence or absence of a fixed repayment date, the reference to “the source of the interest payments” or to the use of the funds “to acquire capital assets” is less clear; moreover, the “ability of the recipient of the funds to obtain loans from unrelated lending institutions” seems to partially overlap the criterion of “willing to lend” mentioned under para. 17).

We point out that also the Commentary to Art. 10 of the OECD MTC deals with the possibility to consider interest on loans as dividends “…insofar as the lender effectively shares the risks run by the company…” (in para. 25) (and provided, on the basis of Art. 10, para. 3, of the OECD MTC, that this income is treated as dividend by the domestic law of the State of residence of the payer). Whether this is the case must be determined on the basis of the several criteria listed by the Commentary (e.g., whether the repayment of the loan is subordinated to claims of other creditors, the absence of fixed repayment date). Some of these relevant factors resemble the economically relevant characteristics mentioned by the current Draft. It would be therefore advisable to clarify the interaction between the analysis to be carried to accurately delineate an advance of funds for transfer pricing purposes and the guidance provided by the Commentary to Art. 10 of the OECD with respect to loans whose proceeds falls in the scope of the definition of dividends provided by Article 10, para. 3, of the OECD MTC.

It is also worth mentioning that the TPG state (in para. 1.122) that the non-recognition of an actual transaction should be carefully applied as it can be contentious and a source of double taxation. This is particularly true in financial transactions as countries may have different approaches to characterizing a financial instrument as debt or equity. Indeed, some jurisdictions have a comprehensive definition of debt and equity, whereas others simply list specific types of transactions that can be treated as debt or equity.

Consequently, the risk of economic double taxation becomes extremely high and the conventional tools for limiting or avoiding its detrimental effects may not be sufficient in light of the high degree of judgmental criteria.

For transfer pricing purposes, tailored guidelines should therefore be provided to properly characterize intercompany debt, also taking into account that the high degree of integration of MNEs may prevent market comparable transactions from be-
ing identified. Given that this situation, as recognised by the OECD guidelines, does not exclude a transaction being at arm’s length, it should be evaluated whether the approach recommended in the Draft for establishing whether and to what extent a financial transaction should not be recognised (willing to lend/willing to borrow) suffices to solve the problem.

Box B.2. Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

As a general comment, we believe that additional elaboration of the example contained in para. 17 is required to provide practical guidelines to tax authorities and taxpayers. For instance, the example could better explain: (i) the relevant characteristics of both the companies involved and the loan, (ii) the considerations behind the conclusion that an unrelated party would not be willing to provide such a loan, (iii) the options realistically available to the parties involved, and (iv) the consequences of recharacterizing the loan as equity from an economic and tax perspective.

With regard to the amount that may not be recharacterized, we welcome the reference to the concept of maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow rather than recharacterizing the entire transaction. In this respect, the following two cases can be identified:

(i) only one of the “maximum amounts” (from either the lender’s or the borrower’s perspective) is lower than the debt amount: in this case, the portion of debt to be delineated as equity corresponds to the difference between the maximum amount (the one lower than the debt amount) and the debt amount; and

(ii) both the “maximum amounts” (from both the lender’s and the borrower’s perspective) are lower than the debt amount: in this case, the portion of
debt to be delineated as equity corresponds to the difference between the lowest of the maximum amounts and the debt amount.

If even only one of the two “maximum amounts” is equal to zero, the entire loan amount must be delineated as equity (the entire interest amount is not deductible).

In all other cases, the reduction of the loan amount is always partial, and, consequently, the reduction of interest deductibility.

We also wonder whether the “maximum amounts”, determined based on the analysis of both the lender’s and the borrower’s ORAs, could also be determined based on “cost of capital optimisation”, as there is always, at least theoretically, an optimum debt to equity ratio that minimises the cost of capital, rather than average industry ratios.

Finally, we wonder whether the “maximum amounts” should be determined based on pre-money or post-money scenarios, given that pre-money scenarios are based on balance sheets reflecting a historical state, whereas post-money scenarios are based on ad hoc financial projections that reflect an envisaged future condition.

Theoretically, post-money scenarios should be preferred to pre-money scenarios because this is exactly what a lender is interested in when evaluating the capacity to service the loan and the borrower’s creditworthiness.

Nonetheless, to reduce the burden for the taxpayer that needs to draw up ad hoc financial projections, a possible “short-cut” solution could be a “post-money scenario” based on the “alteration” of balance sheets (e.g., more debt matched with more tangible investments or cash, all else being equal).

The topic of pre- or post-money scenarios is indeed also an issue when dealing with the measurement of credit ratings (see Section C.1.2), particularly considering that analytical credit rating tools (e.g., Moody’s RiskCalc) are fed by balance sheet ratios, which are historical by nature.

Paras. 17, 19, 34. On financial projections and ability to service the loan

We deem it would be appropriate to provide guidance on the presumed “all good-faith financial projections” (see para. 17).
The first consideration regards the possible connections and the consequent combined interpretation with Chapter VI of the TPG on the reliability of projections in evaluation techniques.

Second, to properly assess the ability to service the debt in financial transactions, the relevant flows should be cash, rather than income flows, and they should refer to net, not operating flows.

This circumstance raises the burden of the analysis and the documentation to be provided, as it would demand the elaborations of additional projections and, hence, additional assumptions would be needed compared to those based on expected operating income flows, in terms of working capital requirements (i.e., expected development of payables, receivables and inventory), capital expenditures, repayments of outstanding debts and possible incurring of newly issued debts (both outside the debt under examination), and tax-related cash flows.

The third consideration regards the purpose of financial projections and the related determination of the ability to service a loan.

We understand that the goal is to support a possible ORA (e.g., the lender will not be willing to provide the loan if the borrower is unable to service it), but the question then becomes: if the borrower is able to service the loan, is the pay-back period relevant for determining the possible maturity (i.e., term of the loan) and, therefore, once again, influencing lenders’ ORAs?

In fact, at least theoretically, unless clear evidence exists that a borrower will be unable to service the loan at any time in the future, which should entail recharacterizing the entire loan amount as equity, the borrower can service the loan over a long period that could go far beyond the period the lender would be willing to accept.

The final consideration concerns the possible absence of financial projections.

In this case, can the absence of financial projections be assumed as evidence of genuine uncertainty surrounding the time horizon of the investment the borrower intends to make (which should actually constitute the reason for the loan request) through the funds the lender provides? Moreover, in the event of genuine uncertainty, can it further be assumed that the loan would be short term (e.g., one year), even though it might be renewed (e.g., every year)?
Box B.3. Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

With regard to the definition of the economically relevant characteristics of financial transactions, in general terms we recommend that the breadth of the analysis should always be commensurate with the materiality of the transaction and the size of the multinational group to maintain a fair balance between burden (for the taxpayer) and accuracy (for the benefit of tax authorities).

This very high-level consideration is all the more true considering: (i) the undeniable technicalities surrounding financial transactions; and, at least for companies that do not belong to financial sectors, (ii) the “core business” and the “sources of competitive advantage” (i.e., where the bulk of profits come from) loosely relate to financial transactions.

Conversely, with regard to material transactions, the correct and complete delineation of the factors in delineating financial transactions is crucial. Prices of financial transactions are, indeed, extremely sensitive to many different factors (e.g., date of issuance and seniority) and the analysis provided in paras. 22–36 in this regard is greatly appreciated and extremely helpful. An eventual minor implementation of the analysis of the factors could be including in para. 28: (i) the date of issuance of the loan, and (ii) the borrower’s industry. Both factors are, indeed, addressed in transactions between third parties and could significantly impact the pricing.

Box B.4. Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm’s length interest rate.

The first consideration concerns the possible connections and the consequent combined interpretation with Chapters VI and VIII of the TPG on risk-free and risk-adjusted rates of return.

On risk-free rate of return

Provided that the progression of returns, along the continuum from risk-free to risk-adjusted return, depends on the breadth of functions and risks of the funder,
and assuming we are addressing intercompany debts (including those recharacterized as equity), a loan remunerated with a risk-free rate of return could be argued to make no economic sense.

Unless a default-free borrower is introduced within the logical framework, no lender would be willing to incur default or credit risk without appropriate remuneration. If the argument holds, the transaction can then be assumed not to be a loan, but a risk-free investment, such as AAA-rated bonds.

The consequent consideration relates to the maturity of the financial instrument yielding a risk-free return. Assuming it cannot be considered a loan, its maturity should depend only on the functions and risks of the lender (or investor). This implies that possible financial obligations and constraints on the lender must then be considered (e.g., the lender cannot invest in the long term when it must repay its short-term debts).

Moreover, a long-term debt, be it a coupon-bearing bond or a loan with interim instalments, is not yet a “pure” risk-free investment to the extent it exposes interim cash flows to “reinvestment risk”.

One counterargument is that an investment in a risk-free zero-coupon bond neutralises the reinvestment risk, as interim coupons have no payments. Nonetheless, it can still be argued that determining the time-horizon of the risk-free security (i.e., maturity) cannot exclude from consideration the potential impact of economic circumstances.

In fact, if it is true that the propensity to hold cash increases in volatile economies to meet unspecified contingencies, it must then be concluded that a short-term investment (possibly renewed) should be preferred to long-term investment in that environment.

In this way, the return appears far more consistent with the definition of “pure” risk-free investment, as the possible divestment of long-term bonds in an unstable environment would expose the investor to price risk due to the fluctuation of interest rates that can alter a security’s market value.

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2 Issued by governments or companies, provided they are default-free (i.e., no credit risk).

3 In this respect, according to credited doctrine this is the ultimate reason behind the normally upward sloping term structure, empirically demonstrated by the average differential between long- and short-term returns on default-free bonds, which remunerates the investor with a “horizon premium”.
Conversely, despite the above arguments, if the transaction must be assumed as a loan, its maturity must be linked to the time-horizon of the investment the borrower intends to make. This conclusion, in turn, points back to the considerations on financial projections (see our comments to paras. 17, 19 and 34).

**On risk-adjusted rate of return**

The risk-adjusted rate of return varies significantly depending on the holders that provide the funds, namely debt holders or equity holders. The main difference lies in the claims, as debt holders’ claims are always preferential over those of equity holders.

This implies that, although the downside risk is possibly the same for both debt holders and equity holders (at worst, they can both lose all the invested capital, with the different seniority claims remaining equal), the upside risk is potentially unequal, as the debt holder can at best earn the “promised” return (i.e., cost of debt), whereas the equity holder can at best earn up to an infinite “generated” return, which is clearly higher than the “expected” return (i.e., cost of equity).

That said, when functional analysis suggests we are dealing with debt financing (in this case the funder should bear the financial risk only), the risk-adjusted rate of return should correspond to the return “promised” to debt holders (i.e., cost of debt).

However, this means that debt holders are in any case exposed to downside risk: borrowers can default. If this is true, the conclusion that the risk-adjusted rate of return (“promised” return, for debt holders) would remain unchanged if ex-post results were lower than those estimated ex-ante becomes highly debatable (see Box B.6, para. 14).

Moreover, consistently with the different risk profiles of the debt holders and equity holders, the conclusion becomes all the more debatable when functional analysis suggests we are dealing with equity financing. In this case, if the funder were to bear both the financial and the operational risk, the issue would then be determining the “expected” return, namely the cost of equity.

This makes it necessary to carefully delineate the characteristics of the equity, determine its underlying parameters and adopt a clear position as to whether it is levered (i.e., the funded entity is financed also with debt) or unlevered (i.e., the funded
entity is financed only with equity). This position is adopted based on historical or expected (i.e., implied from current stock prices) equity risk premiums, regardless of whether they are consistent with the perspective of an “optimally diversified investor” incurring only systematic or undiversifiable risk, and regardless of whether they are aligned with the returns generated by financial investors in relation to venture capital funds.

The above list is not exhaustive but includes some of the most relevant technical issues that could significantly impact the calculation of the risk-adjusted rate of return.

Para 52. On the considerations on the borrower’s assets in intercompany loans

Para. 52 of the Draft, systematically placed in Section C.1 on intra-group loans, deals with the treatment of the borrower’s assets and the possibility to consider them as collateral also in the absence of contractual rights arising from the intercompany loan.

The principle introduced in the paragraph: (i) appears to contradict the general principles of the TPG, and (ii) might have non-negligible practical implications in terms of both compliance burdens and tax (un)certainty.

The principle whereby the assets of the subsidiary, which is under the parent company’s control and ownership, might be considered collateral also in the absence of contractual rights appears to contradict the fundamental principle of the separate entity approach under Art. 9 of the OECD Model. Indeed, pledging an asset as a security is a concrete action that must comply with several legal provisions – which produce effects also on third parties – that are set out, among other things, to accurately delineate the security (e.g., grade of the security and timing factors) and provide certainty to lenders (both current and future). Pledging an asset as a security

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4 On the theoretical continuum, the cost of debt should be lower than the unlevered cost of equity, which, in turn, should be lower than the levered cost of equity.
5 This is one fundamental assumption of the Capital Asset Pricing Model, a model used frequently by practitioners.
6 According to the typical remuneration scheme of venture capital funds, the overall remuneration (comprising management fees and performance remuneration) for both investors and asset managers varies depending on actual performance. This is further evidence of the highly debatable position that a risk-adjusted rate of return is unaffected by differences between ex-post and ex-ante results.
therefore cannot be considered an incidental benefit – as defined by the TPG – of being part of an MNE.

With regard to the non-negligible practical implications, it has to be pointed out that in order to consider an asset to be collateral of the intercompany loan, the MNE should: (i) before any intercompany loans are issued, analyse all the borrower’s assets and consider whether they are truly free from any legal constraints (or, even worse, non-legal constraints but constraints due to the transfer pricing adjustment deriving from the application of the paragraph under examination); and (ii) during the entire life of the intercompany loan, monitor all the borrower’s assets and possibly re-determine the pricing of the loans in consideration of possible future pledges granted to other entities.

The practical implications might also increase tax uncertainty and thus increase the number of disputes with tax authorities.

In demonstration of the above, in our experience entities within an MNE are financed through both internal and external financing, and it is not unlikely that collateral is granted to loans received by third parties after those between associated parties (with all the practical implications mentioned above).

In light of the above, we recommend either: (i) rephrasing the paragraph to better explain the circumstances in which assets might be considered collateral even in the absence of contractual rights, or (ii) removing the paragraph.
Box. C.2. Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance: (i) a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member; (ii) a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member. Commentators' views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

In our view, the suggested approaches could provide a benefit in terms of tax compliance, but their impact in terms of tax certainty may be remote to the extent that tax authorities are still entitled to apply different solutions. In this respect, the final provision in both approaches (whereby the group credit rating might be subject to the right of tax authorities to establish a different credit rating for a particular member) provides no further certainty than other methods generally applied and accepted in credit rating assessments (e.g., the notching-up approach, that considers as a starting point of the analysis the legal entity on a standalone basis). Moreover, an analysis that assumes as a fundamental reference point the single legal entity appears to be more aligned with the separate entity approach and permits to evaluate the specificities of each member (e.g., geographic market and financial performances of the borrower).
Box C.8.

With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

The aim of physical cash pooling is to efficiently manage the “supply of money”, i.e., to provide resources when needed, at the right time and at a lower cost. Participants’ balances are swept into a central account owned by the cash pool leader (“CPL”) to be appropriately allocated based on the participants’ working capital needs. Given that the CPL holds the balances, it normally performs treasury activities relating to the cash pooling. The issue is understanding the situations in which a CPL performs these activities as an entrepreneur or as a service provider. In general terms, an appropriate value chain and functional analysis needs to be performed to understand the group’s business model and whether the CPL has “control over risks” and the “financial capacity to assume risks” (particularly credit risk). That said, in our experience when the parent company of an industrial group: (i) is the principal operational company with the most economic relevance (e.g., in terms of margins, assets and equity) within the group; (ii) performs core business and central support functions (whereas, by contrast, participants operate as low-risk distributors or contract/toll manufacturers); and (iii) acts as the CPL, the parent company usually performs (and assumes) all the functions (and risks) relating to the cash pooling. The “parent” CPL, thus, acts as an entrepreneur. In such a situation, particular care should be exercised if the “parent” CPL is classified as a service provider for the sole reason that, for example, the cash pooling agreements in force between group members stipulate that the credit risk of the cash pooling borrowing participants is shared among participants.
Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular, (i) are there circumstances in which one or another of the approaches would be most suitable?; (ii) does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?; (iii) whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

With regard to the three questions reported in the Draft – Box C.8 – second paragraph, we note the following:

(i) circumstances in which the approaches mentioned in paras. 127 (“enhancing the interest rate for all participants”) and 129 (“allocating the cash pool benefits to the depositors”) might be suitable will be separately addressed in a specific subsequent section for the sake of clarity. With regard to the approach mentioned in para. 128 (“applying the same interest rate for all participants”), assessing the similarity of participants’ credit profiles – a basic assumption to apply this approach as reported in the aforementioned paragraph – can be challenging given the subjectivity of this evaluation. It is therefore more appropriate to examine the specific characteristics of each participant (e.g., credit profile) and then allocate the benefits consistently;

(ii) the allocation of cash pooling benefits should be combined with the participants’ arm’s length standalone interest rates to arrive at an arm’s length remuneration for the participants; and

(iii) the main issue encountered in assessing the remuneration for the cash pooling participants is – in our experience – the definition of appropriate arm’s length standalone interest rates. The issue of “if and how” to allocate group synergies is generally difficult to address given: (a) the potential difficulty to collect pertinent information if the CPL is a foreign company; and (b) the absence of clear guidance on how to appropriately manage the cash pooling benefits.
Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

The economic analysis to determine the arm’s length remuneration of cash pool members should be based on the following three steps:

(i) **Definition of the arm’s length standalone positive and negative interest rates for each participant.** To manage the working capital requirements (payables and receivables over time), independent companies mainly use a bank account that normally provides: (a) a credit line (overdraft), which generates negative interest rates; and (b) the possibility for the company to have money available on demand (overnight deposit), which generates positive interest rates. The interest rates of this transaction are the comparable market references to be eventually adjusted given that the positive and negative interest rates of cash pooling participants are affected by the CPL’s functional profile and the participants’ creditworthiness, respectively.

(ii) **Calculation of the cash pooling benefits, namely netting and volume benefits (main benefits).** The netting benefit corresponds to the interest rate spread saving generated by pooling balances together. This benefit is a bank’s typical remuneration and is generated as long as positive (negative) balances “absorb” negative (positive) balances (see the brown cells in the table below). The volume benefit derives from more favourable interest rates negotiated with the cash pooling bank vis-à-vis arm’s length standalone interest rates. This benefit represents the “commercial bargaining power” (i.e., better conditions) of “stay-together” and is generated as long as balances increase (see the blue cells in the table below). An illustrative example of the calculation and the value trend of the netting and volume benefits is shown in the table below.

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(iii) **Allocation of the cash pooling benefit.** The allocation should be consistent with the role of the CPL (entrepreneur vs service provider) and the type of benefit (netting vs volume), as graphically summarised in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Who: CPL</th>
<th>Who: Participants</th>
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</thead>
<tbody>
<tr>
<td><strong>Netting benefit</strong></td>
<td>Who: CPL</td>
<td>How: equal split among positive and negative Participants, after the remuneration of the CPL</td>
</tr>
<tr>
<td><strong>Volume benefit</strong></td>
<td>Who: Participants</td>
<td>How: in proportion to the relative balances (absolute values)</td>
</tr>
<tr>
<td>CPL as Entrepreneur</td>
<td>Who: Participants</td>
<td>Who: Participants</td>
</tr>
<tr>
<td></td>
<td>How: in proportion to the relative balances (absolute values), after the remuneration of the CPL</td>
<td></td>
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</tbody>
</table>

When the CPL acts as an entrepreneur, both the CPL and the participants are entitled to earn as follows:

(i) **the CPL:** the netting benefit (i.e., the typical remuneration of a bank), considering that the CPL performs (assumes) the relevant functions (risks), similarly to a bank; and

(ii) **the participants:** the volume benefit, considering that participants (together) generate “commercial bargaining power” (i.e., better conditions) vis-à-vis the cash pooling bank. The volume benefit could be allocated among participants based on: (a) the actual volume benefit generated by each participant; (b) “all participants” balances size proportion (in line with the approach mentioned in para. 127); and (c) “lending participants” – balances size proportion (in line with the approach mentioned in para. 129). In our opinion, the second approach is generally more appropriate considering that the better conditions vis-à-vis the cash pooling bank are reached due to the “bargaining power” generated by all participants.
When the CPL acts as a service provider, both the CPL and the participants are entitled to earn as follows:

(i) **the CPL:** a fee based on full cost mark-up borne to operate the cash pool, considering that the CPL does not perform (assumes) the relevant functions (risks), similar to a typical service provider; and

(ii) **the participants:** (a) the netting benefit, whether one or more participants perform (assume) the relevant functions (risks). The netting benefit should be equally allocated among participants considering that, as reported above, it does not depend on the size of the balances. However, if lending participants actually assume the credit risk – e.g., when an explicit guarantee is required by a bank only from lending participants to cover possible negative pooled balances – the allocation of this benefit only to lending participants should be evaluated (in line with the approach mentioned in para. 129); and (b) the volume benefit (the same considerations reported above apply, i.e., those applicable when the CPL acts as an entrepreneur).

Box C.9. In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

Para. 102 of the Draft provides with a description of the ratio underlying cash pool transactions by referring to strategies in managing the MNE group’s liquidity.

The last sentence of para. 102 contains a general preliminary remark on members’ ORAs, stating as follows: “No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option”.

In this regard, the matter of a particular member of an MNE group being obliged to participate in a cash pooling arrangement by the group’s policy needs to be examined in relation to that member’s ORAs. Indeed, once the cash pooling transaction is accurately delineated, the transfer pricing consequences of participating in a cash pooling arrangement need to be analysed in relation to the participating members’ ORAs. If a clearly more attractive option than participating in a cash pooling ar-
rangement is realistically available, the remuneration of the member with the better option should be priced accordingly.

**Para 106 – on the treatment of surpluses**

The issue of group members that participate in cash pooling arrangements maintaining surpluses or borrowing positions that, rather than functioning as part of a short-term liquidity arrangement, become more long term, first entails addressing the issue of short-term vs long-term financing.

It is indisputable that the duration\(^7\) between assets (investments) and liabilities (funds) must match, just as it is indubitable that cash pooling structures should service short-term liquidity needs, namely working capital needs. Moreover, it seems similarly relevant that working capital investments are “revolving” by nature, whereas tangible investments are “wasting” by nature, as their economic utility lessens over time.

Before continuing, we deem it appropriate to include a dutiful parenthesis. As may have become clear, we are referring to only monetary and tangible assets and not also to intangible assets. This is intentional as at least two observations are worth mentioning.

The first, of a conceptual nature, concerns the useful lives of intangibles that, at certain conditions and unlike tangible assets, can last indefinitely, whereas considering intangibles to be short-term and revolving assets is questionable at least.

The second, more compelling and less theoretical, concerns the “loan-to-value” ratio of intangibles that represents the portion of value that could be financed by debt. It is quite acknowledged that the “loan to value” of intangibles is significantly lower than that of tangible assets, down to a limit of “zero loan-to-value” for goodwill. This because it represents something that cannot be isolated, and hence separately transferred, from the entire business combination\(^8\).

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\(^7\) Technically, the duration of debt can be shorter than its maturity as the former is affected by the weight of interim payments before the repayment of principal. As the weight of interim payments increases, the duration of debt shortens. Only with zero coupon bonds, with no interim payments, do duration and maturity coincide.

\(^8\) The definitions of goodwill differ depending on perspectives (accounting, IP law, strategic and transfer pricing, etc.). Nonetheless, it can represent a significant amount of the value of intangibles, hence a material portion of company profits, if the weight of intangibles on company value is taken into account.
That said, and returning to the issue of short-term versus long-term financing, companies that participate in cash pooling arrangements experience “excess cash” when short-term financing needs are lower than the cash contributed to a cash pool. This implies the presence of a durations mismatch and, therefore, an opportunity to invest in longer-term financial instruments to reap higher profits.

The issue then becomes how to practically determine the “excess cash”. One solution could be using average industry ratios used as proxies for operating cash (e.g., cash to company value, cash to total assets and cash to revenues). Any company that holds a (positive) cash balance greater than industry averages will therefore hold excess cash.

As to the different industry ratios, those carrying “company value” as the denominator are the ratios to be preferred, at least theoretically. It is also true, however, that it is more onerous due to the re-expression of the balance sheet values from carrying to recoverable amounts and the reclassification from financial to functional statement.

A more heuristic approach might therefore be adopted – an approach that remains reasonable and is sometimes used in the transfer pricing practice – based on the selection of upper limits of market ranges of short-term deposits or financing (namely, overnight or overdraft rates for zero or target cash pools with daily sweeps).

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Please do not hesitate to contact me or any of the individuals below if you require any clarification on these comments.

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9 See note 3 on “horizon premium”.
10 The reverse is also true: companies that participate in cash pooling arrangements experience “excess deficit” when short-term financing needs are lower than the cash absorbed into the cash pool that, indeed, at least in part, finances long-term investments. This implies the presence of durations mismatch and the need to switch, at least partially, from short-term to long-term financing, bearing the consequent higher cost. Once again, the issue then becomes how to practically determine the “excess deficit”. One possible solution could be using average industry ratios used as proxies for operating deficits (e.g., short-term debt to company value, short-term debt to total assets, and short-term debt to revenues). Any company that holds a (negative) cash balance greater than industry averages will therefore bear “excess deficit”.
11 Financial statements classify assets and liabilities as current or non-current, whereas functional statements classify assets depending on their destination, and sources of capital depending on the persons that provide the funds, namely debt holders and equity holders.
We look forward to discussing any questions you have on our comments or on other specific matters raised by other commentators on the Draft.

Yours sincerely

[Signature]

Stefano Simontacchi

Stefano.Simontacchi@belex.com

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<thead>
<tr>
<th>BE-VVA</th>
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<td>Marco Adda</td>
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Date: 07.09.2018

Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

By email to: TransferPricing@oecd.org

Dear Sir/Madam,

Comments on Public Discussion Draft on Financial Transactions-BEPS ACTION PLAN 8-10 [3 July – 7 September 2018]

B.1 Identifying the commercial or financial relations

Para B.1 provides guidance to accurately delineate financial transaction to determine whether a purported loan should be regarded as loan or some other kind of payment in particular a contribution to equity capital.

Para 10 mentions that the purpose of the section is to provide guidance for those countries that use the accurate delineation under Chapter 1 to determine whether a purported loan should be regarded as loan or not. However, in our view the guidelines should recommend that each country should accurately delineate the financial transaction applying principles laid down in as per BEPS Action Plan 8-10 read with guidelines issued on Financial transactions from time to time.

Box B.3

Para 16 lists few of the economically relevant characteristics that may be useful indicator to accurately delineate loan transaction. Further, Commentator’s views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

In our view, the most important factor that should be considered to be decisive factor while delineating the financial transaction is the creditworthiness and financial capability of the borrower at the time of entering into financial transaction. If basis creditworthiness of the borrower, no third party lender would have been willing to lend funds, then the entire amount of loan should be delineated as equity. Post above analysis the other factors like absence or presence of repayment date, tenure of loan, purpose of loan should not play a role in overturning the nature of financial transaction. This fact should be brought out specifically under guidelines with a mention that other factors as mentioned in para 15 and para 16 may add persuasive value to delineation of transaction if at all.
Even if the purpose is to use the funds for day to day operations, since no third party lender is willing to support the borrower, the parent company has ultimately in its capacity as a Shareholder has infused funds by way of interest free loan which in substance is equity looking into larger business interest for group as a whole. Further, once basis the creditworthiness of borrower, an interest free loan is delineated as equity, the tax authorities should not be concerned over the form used to infuse funds by the parent company as lot of factors like restrictions to infuse equity to safeguard minority interests, FDI restrictions, regulatory approvals can play a role to make investment by way of loan rather than equity which in substance is equity. Further, one of the major objectives of BEPS Action Plans was to look at substance rather than form and that has been aptly reiterated in para 12 of Discussion Draft also that particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis and that accurate delineation of the actual transaction under Chapter I will precede any pricing attempt. To add emphasis on this aspect, the guidelines should further bring out clearly that if in substance an accurate delineation, the financial transaction emerged as an equity contribution, the tax authorities of both borrower and lender jurisdiction should not be concerned with form [i.e. interest free loan] and disregard the form for tax purposes.

The above view further strengthens if provisions dealing with Thin Capitalization are looked into as dealt with under Article 9 of OECD Model Tax Convention also. If on one side for tax purposes, an interest payment is disallowed because the loan is regarded as equity contribution in essence, then on other side, principally applying same parameter, for transfer pricing purposes also, if loan is considered in essence as equity, no interest income should be imputed in hands of lender. The principles should be consistently followed by tax and transfer pricing purposes by both lender and borrower jurisdictions.

**Box B.2 Para 17**

Comments are invited on whether entire amount needs to be accurately delineated as equity in the event that amount that lender is willing to lend or that a borrower is willing to borrow is less than the total funding required for a particular investment. In our view, the complete amount should be considered to be equity contribution rather than bifurcating the amount into loan and equity basis willingness of third party lender or borrower. At a given point in time, basis financial position of the borrower, even if lender will be willing to lend say 10% of the total funding requirement, the borrower may not be willing to block the regular borrowing limits for funds that may be required by him for meeting working capital requirements by accepting 10% loan for a strategic project where funds are sought at the behest of shareholder or for a particular capex project.

Further, once a loan transaction is accurately delineated as equity contribution, at the time of analyzing other financial transactions subsequently, while determining creditworthiness and financial capability of the borrower, the initial transaction should be considered as equity contribution rather than going by the form. The guidelines should bring out this aspect for better clarity and to avoid contradictory approach adopted by different jurisdictions.
Box C.1.3. Effect of group membership

Commentators' views are invited on rebuttable presumption that an independently derived credit rating at the group level may be taken as a credit rating for each group member for the purposes of pricing the interest rate or not subject to the right of taxpayer or the tax administration to establish a different credit rating for a particular member.

We would welcome the approach mentioned above to determine credit rating of individual group member as the same would be useful for tax certainty and tax compliance without having undue litigation.

In fact most of credit rating agencies even though deriving stand alone credit rating of individual group members as a starting point but arrive at final credit rating after considering impact of group rating and recommends similar rating as that of group if ties between group and individual members are strong.

Para 92 & Para 93 Bank Opinions

It is mentioned that bank opinions would not be generally regarded as providing evidence of arm's length terms and conditions as before proceeding to make a loan, a commercial lender will undertake the relevant due diligence and approval processes that would precede a formal loan offer. In our view, the Banks with whom the borrower is regularly dealing for other financial transactions may not necessarily require to undertake due diligence process again while giving quotes to the borrower if sought for particular loan transaction that would have been entered with such bank. In our view, bank quotes/ opinions do give an opportunity to benchmark the transfer price when other external comparable are also not available in database and therefore should be acceptable while carrying out benchmarking analysis.

Box D.1- Financial Guarantees

Para 143 of the Discussion Draft mentions that even an explicit guarantee will not necessarily confer a benefit on the borrower. Circumstances may produce the practical result that group members are financially interdependent quite apart from any formal guarantee arrangement, such that the economic risk of the guarantor may not change materially on it giving an explicit guarantee. In other words, the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the borrower. In such circumstances, the guaranteed borrower is not benefitting beyond the level of credit enhancement attributable to implicit support of other group members and no guarantee fee would be due.

We would like to emphasize that in essence, irrespective of the guarantee transaction, the economic risk of the guarantor does not change who is in essence acting as a shareholder is responsible to protect the interest of the group as a whole at all times including the group member for which guarantee is sought. The moral obligations, the status of parent company [listed or not] and economic ties with group member anyways signifies a bigger responsibility on the shoulder of parent company as a shareholder to protect the group member in financial distress irrespective of
guarantee being given or not. Accordingly, in our view in essence for guarantee transaction [be it implicit or explicit], the guidelines should bring the same specifically within purview of shareholder activity for which no guarantee fee should be charged.

Without prejudice to above we welcome the approach mentioned to accurately delineate a guarantee transaction in a circumstance where provision of guarantee by a parent company in favour of third party lender with respect to loan advanced by such third party lender in favour of its overseas subsidiary company shows that in absence of such guarantee, the overseas subsidiary company having regard to its inferior financial position and credit rating namely even considering implicit support could never have been able to raise loans on its own, then such loan will be essence considered to be loan from third party lender to guarantor followed by equity contribution by the guarantor to borrower. This is essence signifies Shareholder Function not meriting an arm’s length guarantee commission and it will be helpful if this is explicitly mentioned in Guidelines as Shareholder function.

We further agree that anything less than legally binding commitment like letter of comfort or other lesser form of credit support involves no explicit assumption of risk and therefore no guarantee commission should be charged.

Yours Faithfully,

[Signature]

Manish Agarwal
Global Tax Head
Bharti Airtel Limited
William Morris
Chair, BIAC Tax Committee
13/15, Chaussée de la Muette, 75016 Paris
France

Jeff Van Hove
Head of the Tax Treaty, Transfer Pricing, and Financial Transactions Division
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

Submitted by email: TransferPricing@oecd.org

07 September 2018

DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS

Dear Mr. Van Hove,

Business at OECD (BIAC) thanks the OECD for the opportunity to provide comments on its Discussion Draft on Financial Transactions (“FT”) issued 03 July 2018 (the “DD”).

We welcome this initial effort in this very complex area and believe the DD is a helpful and balanced first step in seeking to address common issues related to intra-group FTs.

However, at this stage, we believe there is a bigger issue that still needs to be addressed, namely the question of whether, and to what extent, Transfer Pricing (“TP”) rules should be applied to intra-group funding. The BEPS project – as the name implies – was an anti-avoidance project. And base erosion through interest payments has already been addressed in some very significant ways: restrictions on interest deductibility (inter- and intra-group), revised TP guidance to ensure that transactions are accurately delineated (which even without specific guidance have significant influence on TP of FTs), and the anti-hybrid rules. These sets of measures have already been adopted by a significant number of countries (and the European Union) and more will follow.\(^1\)

It is unclear to us, except in a very narrow set of cases, what advantage will be gained by applying a further detailed set of rules to intra-group financial transactions (although the benefit of consistent application by Tax Administrations in such cases where it is appropriate would be advantageous). Guidance that applies too broadly will greatly complicate the daily funding activity of many multi-national enterprise (“MNE”) groups, adding compliance burdens for those businesses, and creating (more) information overload for governments. And this for a very uncertain gain over what is already gained by the interest deductibility, broader TP principles, and anti-hybrid rules (not to mention the mandatory reporting and exchange of tax avoidance planning under Action Item 12 and now being enacted in measures such as the EU’s DAC6).

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\(^1\) In addition, we believe those groups whose primary business is financial services should be explicitly excluded from the guidelines.
Clearer guidance in the areas that the DD covers may practically be required because of the uncertainty and double taxation risk that arises from the broad range of approaches that are currently being asserted by Tax Administrations in these complex areas. But at a tax policy level that is a reason to ask the question again of whether there is a genuine need for a different (and more burdensome) approach for all FTs. Business at OECD has always accepted the need for the BEPS project, and has participated constructively in that project. But we would ask for a reconsideration of the extent to which this project is required, and would recommend a clear consensus expression of the limitations on the necessity (and applicability) of new TP rules in this area.

In those, hopefully, quite limited areas where it is determined that complicated TP rules should apply to intercompany funding transactions (such as guarantee fees, cash-pooling, and captive insurance, as opposed to structural or short term operational loans which are more common and less complex), Business at OECD has been a consistent advocate of the arm’s length principle (“ALP”) and we would not support deviations from that standard. As noted in our detailed comments, we believe several aspects of the DD should be revised to avoid (either explicitly or implicitly) potentially undermining the ALP.

As with prior reports, we find detailed examples (numerical if possible, and particularly those that can help identify the key differences in scenarios that should lead to a different pricing outcome) provide helpful clarity. Clear examples are essential for all sections, and we have provided some illustrations in our detailed comments that we hope you will find useful in developing these.

For any (hopefully limited) framework to be effective, this effort will require further explanation on how such rules should be applied in practice by way of a final report representing a consensus amongst OECD members. Business at OECD would welcome a public consultation on these issues as a next step to helping the OECD members to come to consensus on these difficult issues.

Again, we thank you for the opportunity to comment on this vital guidance and stand ready to help further in any way that we can.

Sincerely,

Will Morris
Chair BIAC Tax Committee
General Comments

1. The DD is a helpful first step in identifying and seeking to address common issues in intra-group FTs. We believe the DD is generally balanced and covers a broad range of issues to which guidance would be welcomed. However, we are concerned that in its current form, the DD does not provide enough clear guidance with regard to some difficult issues, particularly the overarching question of whether determining the capital structure of a multi-national enterprise ("MNE") is something that should be tested using Transfer Pricing ("TP") (and specifically the Arm’s Length Principle ("ALP")) or whether this falls outside of TP altogether and is better addressed through domestic limitations. Within this also lies a tension between whether some transactions should be recharacterised (and re-priced accordingly) or dealt with through overarching anti-avoidance rules.

2. As discussed in more detail below, the DD seems to focus more on providing certainty around pricing certain transactions than about answering this question. We believe this is appropriate for a project looking specifically at the TP implications of FT under the ALP. However, it should be recognized that lacking clear guidance on these matters leaves open the opportunity for unilateral domestic action in addition to interdependent, but separate, TP and non-TP based rules that would impact the tax treatment of such transactions. It would be beneficial if additional guidance were provided on this point (either through a separate workstream or through agreement on high level principles on ordering and limitations within this workstream).

3. The DD should address certain comparable transactional conditions unique in the context of TP of FTs – e.g., implicit support. The current DD is unclear in this area and consequently presents mixed guidance, including delineation of the transaction, assessing the borrower’s credit rating and impact of implicit support. Clarity in these areas will be integral for successful implementation of the OECD’s guidance.

4. The spirit and main objectives of BEPS reports included clarity, certainty, and avoidance of unnecessary disputes. Lack of a consistent approach leaves the door open to drawn out discussions with Tax Administrations without resolution, while also potentially creating requirements for documentation and functional analysis far in excess of current requirements, given the volume of transactions that would be within scope. By requiring significant functional analyses and documentation, to the guidance may not accomplish its stated goal (i.e., to target tax avoidance through BEPS). If substantive support is required for all FT, the guidance will require significant additional resources, both in terms of internal management time and external advisory fees, resulting in voluminous documentation that Tax Administrations are unlikely to have the time to review, resulting in minimal, if any, additional certainty to Tax Authorities or taxpayers.

5. We believe that the guidance should aim to provide as much certainty as possible with a focus on limiting the compliance burden required, at least with regards to many common
and immaterial transactions that pose limited risk to tax bases (the volume of which our members believe significantly outweigh those more complex, high-risk transactions where a greater documentation and compliance obligation may be more appropriate). While our members have expressed concern about the use of safe-harbours since the European Council included using them as a hallmark for reportable transactions under the Sixth Directive on Administrative Cooperation, we would welcome guidance on simplified approaches for routine transactions that are unlikely to pose a material risk to Tax Administrations.

6. Related to this point, in some areas (as noted in detail below) while we would not support deviations from the ALP, we believe the analysis of FT may slightly differ from other types of transactions in the steps and analysis required to determine an appropriate transfer price that is consistent with the objectives of the ALP. We encourage a view that weighs the importance of functions, assets and risks relative to one another in the analysis. This approach should provide an ability to provide flexibility and simplification – still within the objective of the ALP. For example, it is possible that fewer people are required and fewer “activities” / functions needed to manage and control FTs when compared to, for example, the activities relevant to developing a new product, even where the value at risk of each type of transaction to a business is the same. This is already partially evidenced by the differences in detail provided in the DD on the functional activities of a lender or borrower on a loan compared with the significant focus given to the myriad “functions” relevant to a DEMPE analysis within the context of Chapter VI.

7. We have many, detailed comments in response to the DD regarding entity-level credit ratings, however, our thoughts can generally be summarized as follows:

- A bottom-up entity credit rating calculation, utilizing a rating agency methodology is the closest approach to a pure arm’s length method for the vast majority of lending institutions and should be the default method (and certainly used for material transactions).

- If a simplified method is sought to increase tax certainty, then we believe a taxpayer should have the right to use the group credit rating for individual entities within the

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2 Business at OECD continues to believe that the ALP properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to “real-world” economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated in guidance, and practical supporting rules are not provided, then we are concerned that we will see an acceleration in a worrying trend (already apparent in the TP audit practices of numerous countries), where a broad interpretation of “BEPS principles” is used to justify new unilateral rules and automatic application of non-arm’s length approaches in routine situations. As noted in our detailed comments, several aspects of the DD should be revised to not explicitly or implicitly undermine the validity of the ALP. Further, this guidance should remain consistent with existing guidance provided (e.g., the OECD’s 2010 report on the Attribution of Profits to Permanent Establishments).
group as a safe harbour similar to the group ratio test devised under BEPS Action Item 4. This approach is not in line with the arm's length principle, but (given group credit ratings will typically be stronger than individual entities) if such an approach is available at the behest of the taxpayer rather than the Tax Administration, this may reduce the compliance burden without posing BEPS risks.

- Lastly, we have concerns that starting with the group rating and notching the rating up/down could be an overly complex and subjective approach, which could substantially increase controversy and double taxation if not accompanied with clear guidance. If Tax Administrations are keen on such an approach, we strongly encourage the need for clear and objective guidance regarding how and when to apply this method to make it manageable and provide administrative ease for the taxpayer and the Tax Administration.

8. As with prior reports, we strongly believe in the inclusion of detailed examples (numerical if possible, and particularly those that can help identify the key differences in scenarios that should lead to a different pricing outcome). As currently drafted, there are only formal examples in 3 sections (Interaction with the guidance in Section D.1 of Chapter I, Treasury Function/Cash Pooling, and Guarantees). We would welcome clear examples be drafted for all sections, and provide some illustrations below in our detailed comments that we hope you will find useful in this regard.

9. The DD’s guidance is not well suited to the regulated financial services industry. The guidance implicitly views intra-group FT as ancillary to the activities of a taxpayer’s primary businesses, which is not the case for financial services firms whose primary business are FT. Although there is some limited acknowledgment to the relevance of non-tax regulatory mandates with respect to the accurate delineation of the transaction, in the financial services sector, non-tax regulatory mandates can dictate the structure and terms of intercompany financial dealings, and, in our view factual distinctions require a special approach.

10. Further, intercompany FTs of regulated financial service companies were not and are not a major source of BEPS concerns and intense scrutiny and control by regulators in multiple jurisdictions significantly reduce TP risk on such transactions. Accordingly, rather than adding another, potentially conflicting, set of rules atop an existing web of non-tax regulation, Business at OECD believes that the FT guidance should exempt regulated financial service company’s intra-group FTs. If an exemption is not provided, we believe the guidance should adopt a strong presumption that such transactions are consistent with the ALP.

11. Outside the technical merits, we also found the format of the DD to be distracting in parts. For example, the first substantive section focuses on accurate delineation of FT, also including guidance with regards to pricing some FT. Then, in the subsequent sections, relevant issues are identified along with pricing guidance – although certain sections
continue to revert back to whether each respective FT is properly delineated. We would welcome a restructuring of the paper, so the pricing guidance (and transaction delineation guidance) is clearly recognized. One such solution may be to organize the DD along the following lines (either within, or with, subsections for different types of transaction within scope): (1) accurate delineation guidance, (2) pricing options, and (3) related issues and considerations. A more clear structure would distinguish between what items are relevant considerations and academic insight versus practical guidance to be used by both taxpayer and Tax Administration, as the TPG are intended.

12. The DD sets out a broad framework to expand the existing guidance and to document practices in applying the TPG. For the framework to be effective, this effort will require further explanation on how such rules should be applied in practice by way of a final report representing a consensus amongst OECD members. The OECD is a leader in multilateral rulemaking, seeking to bring consensus to a very divergent global environment. Thus, it is crucial that any clarifications provided, especially in such an important area such as TP, have the backing of as many stakeholders as possible. We see a risk that if such a document is published in a final form, without a large consensus, it will create the opposite effect. Namely, it would create more uncertainty (rather than clarity) on the taxation of intra-group FTs. Business at OECD would welcome a public consultation on these issues as a next step to help the OECD members to come to consensus on these difficult issues.

Specific Comments

B. Interaction with the guidance in Section D.1 of Chapter I

Reponses to Questions

Box B.1: Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention (“MTC”), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

13. As a general matter, we believe that the accurate delineation of FT should not be subjected to higher scrutiny than other intra-group transactions, and, as such, we would expect reclassification of FT to be rare in tax audits.

14. We believe the approach in paragraphs 8-10 is counterproductive as currently drafted as it undermines priority of OECD guidance by suggesting that if countries already have measures to restrict/re-characterise FT that this OECD guidance may not be helpful. It seems unusual for the OECD to resign itself to a) not being able to provide consensus guidance on FTs (although we have, of course, seen several other non-consensus DDs), or b) accepting that unilateral measures (implemented domestically) will trump the application of the ALP to FTs. In our view, it would be helpful (in an ideal world) for governments to agree to a “problem statement” of sorts before providing complex
guidance that will impact on many thousands of related party transactions. This statement could explore things like:

- What are the problems that we are trying to solve?
- What unilateral measures have countries adopted and how do they compare in their effectiveness to the ALP?

15. Alternatively, if the OECD would like to move forward with delineation guidance, it is our view that it should be taken as the primary guidance. If not viewed as the primary, consensus, guidance, we run the risk of proposing new rules without bringing in line existing regimes or providing a boundary of rules for unilateral actions.

16. If the DD is going to defer to domestic rules, related guidance should be provided to ensure that these rules have a degree of consistency and do not result in double taxation. For instance, if a domestic rule is implemented to reduce the interest expense deduction this should be consistent with both BEPS Action 4 and the TPG to minimise double taxation and facilitate MAP. Further, measures to avoid double taxation should be encouraged (e.g., if an Action 4 rule is applied domestically to a borrower, then the lending entity should be able to make a corresponding adjustment to reduce the interest income attached to prevent double taxation). Also, measures that lead to the greatest risk of double taxation (e.g., statutory limits on interest rates) should be strongly discouraged, while other measures more in line with OECD guidance (e.g., the Final Action 4 Report) should be supported. This is a common issue in practice where regulatory requirements prevent the common and intended classification – e.g., characterising a deposit as a short-term loan. These domestic divergences require pricing the FT in one way, against the underlying economics, which may result in double taxation or conflict.

17. If the guidance is going to allow/acknowledge divergences in domestic approaches, then more attention should be given to what should be done in those situations as several common issues are implicated. FTs always have at least two parties, and often the lender side will face double taxation if the borrower-side country imposes a non-ALP domestic restriction. We encourage the OECD to consider those situations in the context of its mission to remove double taxation (and to promote cross-border activity). On this question, should the lender jurisdiction accept the impact of domestic rules implemented overseas? Would a taxpayer have penalty protection if it has filed in the lender jurisdiction based on specific restrictions faced by the borrower (and what if those restrictions have a regulatory rather than tax focus)? Guidance related to these difficult questions would be helpful.

**Box B.2:** Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire
amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

18. If the accurate delineation exercise indicates that the transaction is, for all intents and purposes, a loan but where the amount is more than otherwise available in the market, and where the borrower’s realistic alternative would be to borrow up to a certain level, a key question is whether (i) the entire transaction is recharacterised, (ii) a portion is recharacterised, or (iii) this should be dealt with by other (e.g. domestic) measures in place of recharacterisation. This is particularly important given there will be instances where the appropriate amount of debt is unclear or subject to dispute between businesses and Tax Administrations.

19. While all of our members were agreed that it would not be appropriate to recharacterise the entire transaction, their views were not aligned on whether it would be preferable to deal with the unintended consequences of doing so against those that would arise from partial recharacterisation or special measures. Withholding tax implications must also be considered, especially the practical implications around filing, payment, refunds and deadlines. We believe that consistency in approach and mechanisms to relieve double taxation are paramount in the guidance. For example, regardless of the characterization, the lender should be treated as the funding party and not as a conduit.

20. If the OECD decides to cover capital structure under the TPG, we would welcome additional examples of where debt may be treated as equity for tax purposes as well as examples where recasting the transaction would not be appropriate. Useful examples would include where normal debt levels are permissibly increased to fund a large asset purchase or M&A activity, or due to (temporary) liquidity issues. Once additional, realistic examples are added, we would welcome the opportunity to more clearly comment on the theoretical as well as practical issues at play, including the interaction with other areas of the guidance (e.g., impact of implicit support).

21. It is implied in paragraph 18 that funding would not be granted to Company B if it was unable to service a loan of such an amount. We would welcome additional clarification as to whether the expression “amount” refers to interest only or to capital and interest together. If the latter, this view may not be in line with what anecdotal evidence suggests. We understand that there are several instances in the open market where both Governments and corporations borrow funds where the principal itself is not expected to be reimbursed at maturity from cash flows generated throughout the funding period, so the principal is refinanced or rolled over subsequent terms/transactions. In the context of business, this is often the case where they seek to lower their cost of capital. For avoidance of doubt it would be preferable for the meaning of amount to be clarified and by referring to it as interest only.
22. In our view, considering the potential for cascading effects, the Tax Administrations should bear the burden of proof if they are trying to change the treatment of a loan to equity.

23. Finally, it would also be advisable for the DD to acknowledge and address corresponding consequences of any recharacterisation in the guidance – e.g., withholding tax (“WHT”) on dividends versus interest, whether domestic law would provide for a reclassification, corresponding TP adjustments required in future years, springing (and disappearing) partnerships that may cause corporate groups to deconsolidate, etc. – and thus why recharacterisation or special measures should be rare.

Box B.3: Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

24. To start, we find it very helpful that the DD points to relevant economic circumstances and acknowledges that differing pricing may be possible (e.g., in the instance of a merger or acquisition). This approach suggests that a less formulistic approach and instead one based on the facts is preferred. To this end, the DD provides that the circumstances are likely to be different across industry. We would support extending the sentence to also acknowledge economic differences at the product and market level. Similarly, where discussing the difference between independent FT and intra-group FT, the DD fails to mention that taxation will also be considered by the independent enterprises when pricing the FT.

25. Further, we strongly agree that the pricing should strive for temporal proximity with regard to the transaction to be priced. Paragraph 31 suggests that precise timing of the issue of a financial instrument in the primary market or the selection of data in the secondary market are significant […] and that it is not likely that multiple year data on loan issuances will provide useful comparables. Our view is that this may be especially the case for years that show significant spikes (e.g., the credit crunch in 2008/2009).

26. In our view, rather than the starting point of a loan or bond, the yield to maturity of instruments with similar remaining maturity (or other comparable data points) should be used as the tested transaction (provided similar risk profiles, currency and seniority). The market pricing of such instruments should ensure comparable pricing, such that the period in which these instruments were originally issued would be less relevant.

27. As requested, we have provided a list below of certain commercial drivers that may incentivise an MNE group to fund with debt or equity based on our experience:

   - **Flexibility of the funding mix:** loan funding can be easily repaid as part of a sale or dilution, or even to absorb positive working capital movements. Capital is less flexible. Decapitalisation is generally even more difficult in countries where court approval is required (i.e., is not a private process);
Currency exposure: An equity injection may have to be in local currency; lending in a different currency (e.g., USD) can avoid volatility in value of the subsidiary and may provide MNE groups flexibility to manage economic exposures. Furthermore, equity injections need to be purchased outright, but loans can be swapped - equity therefore leads to a long-term currency exposure, which can be costly if the entity plans to repatriate cash in the near future;

JV requirements: In joint ventures where proportionate funding is a requirement, funding is a cooperative process where both equity and debt funding have to be consistent, and shared, amongst venture partners;

Cash extraction: Capital intensive industries may be heavily loss-making in opening years and repayment of debt / interest avoids in-country cash build-up (dividend distribution usually not possible). Also, currency controls and other similar local restrictions may limit the ability to repay equity and/or debt;

Commercial considerations: Interest might be recoverable from 3rd parties and lead to a net economic benefit (local and group);

Withholding/Other Taxes: Gross-based WHT are likely to apply to interest payments, incentivizing the use of equity which may be subject to a preferential taxation regime;

Matching cost and income: For example, in case of a business that heavily depends on loans or leases to acquire assets; and

Liquidity matching: The parent may seek to recover its own cost of funding to ensure liquidity matching.

Regulatory requirements: In certain industries, such as the insurance industry, there are regulatory requirements that establish a minimum amount of capital per legal entity. In such industries, it is common practice that part of the capital provided is subordinated debt, which is cheaper to raise than equity. The regulatory rules will also typically limit the amount of debt that can be counted for regulatory capital purposes.

Box B.3 (cont’d): Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

Box B.4: Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section. C.1.7 Pricing approaches to determining an arm’s length interest rate.

28. Theoretical considerations given in B.4. that a funder that lacks the capability or is not performing the decision-making functions to control the risk associated with an investment should only earn a risk-free return is not without merit. However, the DD rightfully concedes that there is no investment with zero risk.
29. When taking the return on government bonds as a proxy for the risk-free return, the draft does not distinguish between the issuing yield and the secondary market yield of government bonds. Since the actual rate of return is derived by the combination of issuing yield and issuing price focusing on the issuing yield of government bonds alone can be insufficient. Further clarification would be welcomed, but if one was chosen, we would expect the secondary market yield of government bonds to be a superior proxy. For almost all relevant currencies national central banks frequently publish the secondary market yield for almost all terms of maturity.

30. Even when default risk for government bonds is ignored, it remains an issue. Additionally, most government bonds capture an inflation premium since they are issued with a nominal, not a real, interest rate. However, in times of economic or financial crisis this premium is hardly noticeable since the return on government bonds mainly reflects other objectives of central bank’s monetary policy, e.g., the prevention of government bankruptcy. Due to these considerations a country risk premium which is determined independently from the individual characteristics / situation of the borrower should be taken into account.

31. The example in paragraph 7 of Box B.4. suggests that choosing the lowest interest rate available when several countries issue bonds in the same currency would be required. The issue of different issuers of government bonds in the same currency can arise in currency unions, developing countries/emerging markets issuing public debt in an anchor currency, and federal states. At first glance it seems reasonable to take the lowest interest rate as benchmark for the lowest risk associated with all countries issuing public debt in the same currency. However, opting straightforward for the lowest interest rate of all countries implies that this country is not necessarily involved in the actual transaction.

32. Therefore, the choice of the lowest rate of return on public debt (e.g., in a currency union) can be prone to conflict and subsequent dispute cases. In our opinion it will be difficult to communicate to national Tax Administrations why the lower return (e.g., on German government bonds) shall serve as benchmark for the risk-free investment when the lender and borrower are located in different countries (e.g., France and Italy).

33. A similar argument holds for emerging markets. There could be the situation that a MNE is doing business in an emerging market and finances affiliates not in the national but in an anchor currency and the emerging market issues public debt in the anchor currency. Then it can be expected that the anchor country itself has got a lower rate of return on government bonds than the emerging market. Again, it will be difficult to communicate to the Tax Administrations of the emerging market country that a lender located within their jurisdiction should receive that lower rate of return for a risk-free investment when financing affiliates in the anchor currency.

34. Similarly (but more broadly), it is critical to recognise that even in so called “low risk” lending scenarios, there is ultimately a risk that the funds will not be repaid such that the
lender would “write-off” the loan. While it is a legitimate concern that in such instances within groups, the MNE may effectively have a choice as to where to recognise the loss (which is clearly not true for external funding providers), guidance on such scenarios (and confirmation that in such scenarios the “risk-free” return should be assumed to continue with the true risk-bearer suffering the loss) would be welcomed. Further, explicit guidance regarding how one should classify such transactions (e.g., where the write-off is transferred for accounting purposes and how it should be characterized for tax purposes) would be helpful.

Box B.5: Commentators are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns.

35. We generally agree that Government issued securities are likely the best reference for a “risk-free” return. However, we would also like to suggest using the LIBOR/EURIBOR/NIBOR rates, as the reference index used between financial entities may, depending on the circumstances, be a proper measure of a low/no risk financing. For loans with a duration of greater than 1-year, we would like to give consideration to using the mid-swap rates of the interest rate swaps (USD, EUR, etc.) as a possible measure.

36. As noted above and in the DD, there is no investment with zero risk. As such, the chapter seems to aim for the closest available proxy. Further work should be done on this front to make clear when “closest available” is sufficient to constitute a comparable, particularly in relation to the suggestion of government-issued securities as low-risk proxies. The example suggests that facts and circumstances lead to the selection of an AA-rated government security – but it is not clear why, in this instance, AA is sufficiently comparable to riskless.

Box B.6: Commentators’ views are invited on the practical implementation of this guidance included in paragraph 11 of this Box B.4, and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest expense up to an arm’s length amount, but the funder is entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.

37. Regarding the interaction between OECD Model Tax Convention (“MTC”) Art. 25 and Art. 9 Para. 1 and 2, we believe that the OECD should promote conclusion of double tax treaties (“DTT”) with Art. 9, Para. 2 of the OECD MTC (corresponding adjustment) during the implementation phase of BEPS measures. In our experience, the corresponding adjustment provision presents a much quicker remedy from (economic) double taxation than the mutual agreement procedure (“MAP”). However, we do remain strong supporters of MAP, in such alternative situations without Art. 9 Para. 2.

38. The TPG define in paragraph 1.65 that “[c]ontrol over risk involves the first two elements of risk management [...] (i) the capability to make decision to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making
function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.” We have doubts as to whether the compensation due to the related party exercising control over the risk (in the hypothetical scenario where it is not the same legal entity as the actual lender) will be treated as interest or alternatively as some other form of income (e.g., service fee). This can lead to different WHT treatment and may be of particular difficulty should the different jurisdictions not share a similar interpretation. Also, in the hypothetical scenario – where the funder’s income is required to be adjusted via a TP adjustment to a risk-free rate – taxpayers may find constraints should the funder be located in a jurisdiction where the rules only permit upward adjustments (e.g., UK).

39. Further, and on a more elementary level, the interaction of the risk-free rate of return with other section(s) of the DD raise additional questions. A particular point is on what exactly constitutes decision making in the context of a FT for exercising control over the risk. Paragraph 43 reads “[a]s such, the treasury function will usually be a support service to the main value-creating operation” and Paragraph 45 states that “[a]ccordingly, the approach of the treasury to risk will depend on the group policy where certain objectives may be specified, such as targeted levels of investment return (e.g., the yield must exceed the cost of capital), reduced cash flow volatility, or targeted balance sheet ratios (e.g., assets to liabilities). Therefore, it is important to note that usually the higher strategic decisions will generally be the result of policy set at group level rather than determined by the treasury itself.”

40. For further clarity, we suggest the DD incorporate examples of potential scenarios where a separate legal entity is to be compensated for exercising control over the risk. We have drafted an example below to demonstrate the potential complexity with regards to a common operating structure:

- Many MNEs have complex inter-company financing structures with several funding entities (some of which face the market), often for local regulatory reasons or regional purposes. In addition, the treasury activities of the funding entities are often isolated in a small number of shared service centre entities, which supplement senior Treasury personnel in the HQ. Lastly, responsible directors are located in each respective funding entity (who are expected to act in the interests of those companies). Most of the substantive activities in relation to related party FTs may be undertaken by the shared service centre entities and the relevant borrowing entity (if looking at a traditional loan).

- One way of interpreting the DD would be to give an arm’s length interest deduction to the borrower, a risk-free return to the lender (funding entity with the capital) and then the balance, in theory, going to the treasury function (or to the small handful of senior treasury personnel in the HQ)?
Such an approach raises several related questions:

- What is the impact if more than one shared service centre entity has provided treasury services in relation to one loan?
- How do we determine what exactly is the risk-taking function at what point in time, and can this change over the life of the FT (i.e., could the residual be “allocated” to a different entity year by year)?
- What is this excess payment from a legal perspective – is it still interest or something else?
- What is the WHT analysis and what treaties would apply if all entities are in different territories?

Accordingly, we are of the view that it should be a very rare occurrence to re-characterize the risk premium component of the arm’s length return from the actual lender to another entity deemed to bear the financial risk, unless answers are provided to the questions outlined above.

However, reading further into the DD, the OECD seems to be suggesting that treasury activities are actually a “service” (that we assume might be compensated on something similar to a cost-plus basis). Thus, with this approach, if the service fee is less than the total, we question whether the residual should go to the funding/financing company. For example, in a cash pool scenario, would the funding/financing company actually be the pool depositors? Clarity and guidance on this point would be welcomed, as we have serious concerns as to the practical implication of such measures (e.g., any characterization that would result in cash pooling becoming an internal syndicated funding would be effectively impossible to administer from both the standpoint of the Tax Authority and the taxpayer).

As understood, this guidance – providing simply a risk-free return when the funder lacks the capability, or does not perform the decision-making functions to control the risk with investing in a financial asset – is intended to target entities known as “cash boxes” (i.e., shell legal entities that simply provide capital without the sufficient corresponding functions, assets, and ability to bear risk that the comparables relied upon do.) However, we are cautious as to whether this is the best way to address this deemed abuse, as the guidance is general and would apply regardless of the underlying circumstances. For example, this guidance will be applied to groups that have financing companies in relatively high-tax jurisdictions, which have not centralised their treasury activities for tax avoidance purposes. We believe that where a traditional arm’s length result does not result in an allocation of profits that causes policy concerns, it should be respected. Further, any option to allocate remuneration above the risk-free return to different,
related entities must be objective, manageable and consensual among countries. If not, such will create more issues and double taxation than the existing system.

43. For these reasons, we would encourage a threshold to be introduced to determine the scenarios where that approach would be applicable, so it only targets cash box entities and the deemed abuse. We believe a very clear definition of what constitutes a “cash box” is required or else this approach may lead to distortions and abnormal outcomes.

44. On a separate, more specific point, the DD does not make it explicit that where looking at a multi-sided TP analysis, the lender’s underlying cost of funds should be taken into account when determining the risk-free rate of return. For example, if an entity borrows cash on a 5-year loan a fixed interest rate of 3%, this amount should be includable within the interest rate charged to the affiliate. To continue the example, if the risk-free rate is determined to be 1%, the respective interest rate charged should be 4% (i.e., 3% cost of capital plus the 1% risk-free return). We acknowledge that such may be implied, but we would strongly prefer such is explicitly stated to avoid any potential confusion.

45. The DD makes reference to the example stated in Paragraph 1.85 of the OECD TPG. Although, we are not entirely convinced of its merits in the specific context of FT, the concept of an investor not being entitled to more than a risk-free return where it lacks the capability to control the risk associated with investing in a financial asset is perhaps contradictory with many examples that exist in the market. The role of investment advisors or asset managers, who have the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity and the capability to make decisions on whether and how to respond to the risks associated with the opportunity together with the actual performance of that decision-making function provide a good contra-example. This does not translate to the investor only being entitled to a risk-free return, in many cases quite the opposite. We again suggest that the DD should incorporate examples of the hypothetical scenarios involving FT for which this approach is targeted.

Additional Comments

46. Generally, regarding the accurate delineation of the transaction, we have concerns about how the status of the funder helps to accurately delineate an advance of funds. If the OECD believes such is the case, we recommend outlining reasons for such (as the historical approach has been to focus on the borrower alone). At the least, such guidance could limit the volume of routine transactions that would be subject to more complex TP analysis and documentation (see below).

47. We also encourage the OECD to bear in mind the economic and legal realities under which MNEs are operating. Each legal entity is going to be subject to certain rules and regulations – thus, even though the company is part of a global group, such does not mean that they are able to ignore existing legal regimes and practices. For example, company directors have legal, fiduciary duties which would prevent them from
deliberately taking action that is not in the interest of the company (e.g., deliberately making loss making loans). This provides one general example of the issue of diverging from the traditional norm of the separate entity approach.

48. The DD implies that a full functional analysis and documentation exercise is required for all intra-group FTs. We believe that this requirement would be overly burdensome and ineffective. If the goal is to target tax avoidance through BEPS, this approach does not seem to accomplish it as it simply creates additional analyses and documentation – which would likely result in additional work for advisory groups, Tax Administrations and taxpayers without any necessarily corresponding impact on tax avoidance. Considering many transactions are very small and/or have minor risk, we strongly suggest that proportionality is considered and applied in the guidance. To this end, thresholds and safe harbours can be valuable tools to limit time incurred by both business and Tax Administrations where the underlying exposure or risk is minimal (although our members do have concerns regarding the additional administrative burden that would arise for them under the EU’s Sixth Directive on Administrative Cooperation that would arise through utilisation of safe harbours, so simplified approaches may also be beneficial). Further, new ideas should be considered that may be within the aim of a functional analysis but do not require such substantive documentation and analysis.

- In our view, it is likely that the functional analysis of one FT will be relatively consistent across the category of transactions, i.e., meaning you could prepare a single functional analysis for intra-group transactions as an appendix to each FT (or at the very least, a single function analysis for the treasury function per defined categories of FT). In our view, undertaking a full functional analysis for both sides of all FTs is not likely to yield new, important information. Alternatively, a global functional analysis, which provides the basis for all global FT of a certain category, will provide helpful support as well as documentation of consistency in approach FT to FT.

49. As with other sections, we strongly suggest safe harbours, simplified approaches and other de minimis rules in this context to avoid costly analyses. For example, a safe harbour could be applied where the subsidiary borrows on the same terms, conditions and leverage as the group as a whole. Further, de minimis exemptions can be provided for minor or immaterial FT amounts.

50. When pricing the transaction paragraph 19 endorses a two-sided analysis for FT which is quite a departure from the historical approach where the majority of the analysis has been on the borrower (this is also mentioned and expanded in the functional analysis in paragraphs 24 and 47). While our members do report that Tax Administrations are increasingly looking at multi-sided analyses in any event, we remain concerned of OECD endorsement of an approach that increases the required level of analysis and consequential documentation trail that would need to be completed for all (or more) FTs
without any corresponding benefit to Tax Administrations or taxpayers. This additional focus on the lender’s perspective will require additional guidance on how this can be practically applied.

51. Paragraph 19 provides that independent enterprises “will consider all other options realistically available to them, and will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity…” “All other options realistically available” is very broad, and consequently this threshold could be impractical to manage in many cases. We would welcome additional guidance on how this analysis is expected to be performed, and how taxpayers can be comfortable that their analysis of “all options” is sufficient.

52. Additionally, the language could provide avenues for Tax Administrations to use hindsight to choose other options that are advantageous to their positions using ex post facts. We would welcome strong guidance against such an approach.

C. Treasury function

Responses to Questions

Box C.1: Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

53. Our members note that such arrangements are not overly common in MNE structures.

Box C.2: Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

54. As a general matter, we welcome the OECD seeking to provide simplification measures to provide tax certainty. However, if such a rule is to be endorsed, we would strongly suggest such be a safe harbour

3 Alternatively, if safe harbours are not provided, we would still prefer additional tax certainty with a presumption rule provided such is generally in line with the ALP and has objective parameters – e.g., the
Authorities – versus simply a rebuttable presumption. Further, we welcome the introduction of a materiality threshold where for less material transactions these approaches could be followed (similar to the existing guidance on intra-group services, i.e., low-value added services). For example, FT only exceeding USD 10 million would need to be comprehensibly documented, and any transactions below the threshold would be considered as priced at arm’s length.

55. As outlined below in response to Box C.3, we believe the ALP is best applied by using a stand-alone credit rating adjusted to take account of implicit support of the group, and a method that starts with the group credit rating and then allows for “notching” based on highly subjective criteria (e.g., importance of the enterprise to the group and likelihood of parental support), may or may not be appropriate in all cases.

56. Therefore, if the OECD does not wish to mandate the use of adjustments to a group credit rating, then it should provide additional guidance in this matter to avoid controversy. Alternatively, considering that adjustments to (group or standalone) ratings are likely to remain specific to facts and circumstances and hard to define through a common ground rule, the OECD should consider additional guidance as to the circumstances that give rise to the appropriate use of either an adjusted group rating or adjusted stand-alone rating.

Box C.2 (cont’d): Commentators’ views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

57. See comments above.

Box C.2 (cont’d): Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

58. In the absence of a publicly available credit rating, an approach for MNEs to determine the group credit rating could be to establish it by reference to credit rating methodologies published by credit rating agencies. For example, Moody’s publishes multiple credit rating methodologies that are specific to sectors/industries. Each methodology paper usually provides general guidance as to Moody’s approach and aims to assist different economic agents in better understanding how quantitative and qualitative risk characteristics affect rating outcomes across different industries. Consequently, albeit not an exhaustive articulation of an end-to-end methodology, these rating methodology papers could be endorsed as an acceptable option. Another potential alternative could be for a credit rating to be inferred by reference to the credit rating assigned to Corporate Bonds offering terms and conditions similar to the average external cost of funding of the MNE Group.

government can only rebut if the credit rating would vary by a “significant” amount and the loan is “material” (with definitions of a significant variation and materiality).
Box C.3: Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

59. S&P, Moody’s, Fitch, etc. do not always give subsidiaries the same rating as their parent and nor do they rate all subsidiaries by taking the parent’s credit rating and adjusting down. Our concern is, if the lender uses an individual credit rating and the borrower uses a group-level one, such may result in double taxation. Therefore, we believe the ALP is best applied by using a stand-alone credit rating adjusted to take account of implicit support of the group. The adjustment for implicit support should consider the approach taken by commercial lenders first, and official credit rating agencies second, as appropriate.

60. However, we do have concerns around such an approach being mandatory for all transactions, as it may not be feasible for a MNE group with several hundred affiliates and a significant number and frequency of intra-group financings. Such a stand-alone rating approach would trigger an extended effort to treat every group company individually when administrating and controlling intra-group loans.

61. We would therefore recommend that alternative approaches be considered in addition. For example, the group companies could be attributed to clusters with respect (for example) to their strategic importance within the MNE group. The credit ratings for each cluster would be an average of the affiliates captured in the cluster and this average would need to be verified frequently.

62. International consensus (potentially through public consultation with all stakeholders) on the definition of stand-alone credit rating would be helpful and welcomed by our members.

Box C.3 (cont’d): Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

63. We agree with some of the concepts of implicit support, and that an MNE’s stand-alone creditworthiness may be related to the group’s, depending on facts and circumstances. Where an MNE’s ties to the group are strong and strategic in nature, we feel it may be more appropriate to apply an adjusted group rating as third-party financiers would do so. Where a group company stands on its own with a likelihood of being replaced, divested or diluted at some point in time, a “bottom up” stand-alone rating, possibly adjusted for implicit support, may be more appropriate (externally rated joint ventures being the clearest example).

64. Implicit support is a widely recognised consideration, used in practice by external rating agencies, but with little evidence in transactions that may be used as comparables. Two to three notches seems to have developed into an industry-wide norm, based on rating agencies’ credit reports. Moody’s in particular is quite transparent in how it applies the concept of strategic importance and implicit support in its rating framework.
65. Current wording for applying implicit support seems to be quite subjective and “a matter of judgement” (paragraph 70). Thus, additional guidance and clear, practical examples would be welcomed. In our view, a key outcome of this consultation process would be to provide clarity and international consensus on this issue, as currently many Tax Administrations hold differing views and approaches in this area.

**Box C.4:** Commentators’ views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

66. We agree that a group member with a higher degree of integration and importance will be more likely to be supported by the group. Therefore, the higher the credit rating the entity is likely to have. However, there would still typically be a difference in the parent and rating and that of the subsidiary (e.g. due to diversification risk). Further, in certain industries, separate legal entities are used to isolate risky activities or functions with significant exposure (e.g., chemicals, power/utilities, etc.). These specific circumstances and divergences across industries, products and markets should be considered when addressing implicit support.

**Box C.5:** Commentators’ views are invited on:

- The role of credit default swaps (CDS) in pricing intra-group loans;
- The role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

67. CDS can corroborate the pricing of a loan. We think it is possible to work out the risk premium demanded by unrelated investors which, together with a risk-free rate of return can be used to price debt. However, we note that CDS are unlikely to be a CUP for advances. Alternatively, the use of internal comparables when available, otherwise, commercial database can prove useful – including a mix of both.

**Box C.6:** Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.

68. We support the use of bond data. It is more widely available than other data and has a more active/liquid secondary market and so should not be ignored. However, bond yields do not take account of up-front fees and also tend to be priced lower than loans (perhaps because bond markets are more liquid), so adjustments would need to be made to bond yields to price a loan. Another alternative is the use of interest rate swaps. This represents a contractual obligation between willing parties, agreeing to exchange interest payments for a defined period of time based on an underlying notional amount.

**Box C.7:** Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.

69. It is highly unlikely that an internal CUP will be available to price intra-group transactions as so many key characteristics (credit rating, maturity, size of loan, currency etc.) will vary
materially between the members of the group versus the group as a whole. Therefore, a MNE group’s average interest rate paid on its external debt should not be considered as an internal CUP.

Box C.8: With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

70. We believe that a cash pool leader can act as an entrepreneur and service provider. Therefore, the allocation of group synergies very much depends on the allocation of functions and risks. Again, this flows back to our overarching view that the OECD should support the ALP when pricing FT.

71. Additional guidelines on how to remunerate full centralized treasury activities (full or significant control over the FTs of the group) would be very helpful. We believe these rules could follow the Chapter VII of the TPG as starting point.

72. The types of services which could be provide by an entrepreneur cash pool leader could include, but would not be limited to, the following:

- Provision of “on-call” liquidity.
- Cost-efficient settlement of intergroup balances and external payments.
- Investing excess group cash in an external portfolio of financial instruments and managing that portfolio to optimize returns while balancing the need to ensure liquidity.
- Foreign exchange services, including internal netting and external FX trading, which allow participants to reduce currency exposure and trading costs.
- Managing liquidity risk, where a cash pool has structural surplus or deficit in deposit positions, potentially requiring external borrowing facilities or other arrangements.
- Back office services, such as bank account management, cash flow forecasting, calculating interest rate calculation, and accounting services.

73. The cash pool leader may also manage and bear financial risks, which should be considered when establishing the arm’s length return. The cash pool leader will bear financial risks where depositor balances and interest payments are protected with no cross-guarantees. In this case the cash pool leader will assume market risk and black-swan event risk on external investments, credit risk on lending, liquidity risk if investments are in fixed-rate instruments versus the floating rate paid to depositors, and potentially foreign exchange risk if multiple currencies are invested in the pool.
74. In this context, it may be appropriate to consider a service-based return for back-office activities, but with additional return required for the other activities / management and assumption of risks. For the services element, a service fee CUP could be established by reviewing the service fees/annual fees charged by third-party lenders for back-office tasks, which are intended to cover the cost of arranging a loan and any related transaction fees and account maintenance costs. These are often expressed as an additional basis point spread on the loan balance in the loan agreement. In no event should this result in a recharacterisation of the cash pool leader as not lending to the borrower.

Box C.8 (cont’d): Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular,

- Are there circumstances in which one or another of the approaches would be most suitable?
- Does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?
- Whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

75. Generally, we do not agree with the general assumption that the cash pool leader performs no more than a coordination function (even though such may be the case in certain notional pooling arrangements). Rather, this should always depend on the functional analysis and especially the allocation of risk as mentioned above. Although, where cash pooling results in economic benefits which would not otherwise be available to members, then it may be appropriate to share these benefits with the members. However, in practice this sharing could be difficult to execute and requires further guidance. Analysis regarding the allocation of benefits to the cash pool members may be simplified by first calculating the reward/remuneration for the cash pool leader. After determining the pricing to the cash pool leader, the remaining, residual benefits could then be allocated among the other participants, but it is not clear what the legal characterization of such sharing would be.

76. The amount shared should represent the net profit of the cash pooling enterprise after (i) the deduction of all expenses associated with running the cash pool and (ii) an appropriate arm’s length return is given to the cash pool leader commensurate with its particular functions, assets, and risks.

77. This residual “benefit” amount could be distributed amongst all members. However, it may be more appropriate to only share with depositors if the residual benefit was primarily driven by the investment of the cash they made available to the cash pool (e.g., by lending to affiliates or investing in external financial instruments). Again, this would depend on the facts and circumstances and it would be beneficial for the OECD to include commentary on the salient factors in this regard.
78. Specifically, the OECD should provide guidance on the appropriate mechanism for sharing the residual benefit with members. This could be through a lump sum payment at the end of the year once the actual cash pool results are calculated, for example. If so, guidance is required on the character of this payment (e.g. interest). Alternatively, an additional interest spread could be added to the rate paid to depositors throughout the year. If so, guidance on how this spread would be established would be beneficial (e.g. whether accurate forecasts, which are difficult in a dynamic interest rate environment, would be required).

Box C.8 (cont’d): Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

79. See comments above.

Box C.9: In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

80. We would find it useful if the OECD provided additional examples regarding the options realistically available to the participants of the cash pool taking into account their financing and working capital strategy. For example, cash pool members making deposits yet needing short term access to funds would not be considered longer-term loans to other businesses under the same facts.

81. At arm’s length a depositor/borrower may be prepared to accept a less advantageous headline interest rate than is available externally in order to access the multiple benefits from membership of the cash pool, which could include the following:

- Access to a permanent source of financing without large facility or arrangement fees payable to third party banks or the requirement to provide covenants (e.g., access to overdrafts without punitive overdraft rates and penalties).
- Access to liquidity that may not otherwise have been available from the local external banks, with the funds being available immediately for use.
- Reduced exposure to external bank counterparty credit risks, particularly in markets with limited access to highly-rated financial institutions.
- Access to foreign exchange, treasury and banking expertise and global treasury management systems, which would be inefficient to procure individually.
- Access to a more diverse portfolio of external investments and economies of scale on transaction costs and management costs which would not be available to the individual entity.
- More cost effective / reliable access to external debt.
82. In paragraph 111, a cash pool leader performs no more than a co-ordination or agency function and the DD implies that by considering a low level of functionality their remuneration as a service provider will generally be limited. The DD then includes Example 1 to illustrate such a scenario. However, we believe that this scenario (and others) may raise other tax questions and/or challenges.

**Box C.10**: Commentators’ views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

83. We do not believe that a physical cash pool requires cross-guarantees if it is truly short-term lending. For example, no cross-guarantees are provided in cash pools where the cash pool leader acts as an entrepreneur and bears and manages the financial risk.

**Box C.10 (cont’d)**: Commentators’ views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

84. N/A – see above.

**Box C.11**: In a situation where there are off-setting positions within an MNE group, commentators’ views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators’ views are invited on whether that risk should be treated as being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

85. We believe that understanding the purpose of the hedging transactions is paramount to pricing. For example, the treasury function may be hedging the earnings of a foreign subsidiary on behalf of an investing entity, in which case the credit/debit caused by the hedge should be transferred to the investing entity which (directly or indirectly) owns the subsidiary and reports in a different currency. Any service fee payable to treasury should come from the investing entity, with the exposure being hedged. This also applies in the case where the treasury function uses a central entity to hedge externally a MNE group member’s risk/exposure (e.g., paying staff/suppliers in EUR but having revenues in GBP) and then transfers the credit/debit result of the hedge to the entity with that exposure.

86. Alternatively, treasury may be hedging an internal risk. In this case, treasury may hedge an exposure of a MNE group member internally (e.g., treasury uses a central entity to enter into hedging transactions with the MNE group members holding two equal and opposite positions). This would only work however in the situation where the amount, currency pair and timing of exposures of multiple MNE group members are (perhaps in combination) similar enough as to hedge the material amount of the risk(s). In our view,
any service fee payable to the treasury function should come from the entities with the exposure.

87. On the question of how to address offsetting positions that occur in different entities in the group, we consider that in general, hedging should result in balanced books at entity level. For example, if there are natural offsetting positions within a group (FX in an operating entity versus a hedge in a separate treasury entity), we believe, generally, that the group would maintain its natural hedge from an accounting perspective. However, from a tax perspective, (assuming an accurate delineation and arm’s length terms) each entity should be respected and should recognize its own respective gain or loss (if any).

Additional Comments

88. In our view, the description of treasury functions in the current version is over simplified and does not truly account for the complexity and range of functions of many MNE treasury functions. In addition, we believe there should be more recognition that a group treasury company is not the same as an external lender. Clearly the extent to which they differ will depend on the enterprise, but if a taxpayer assumes that they are borrowing from a bank, then the bank will have a larger and more diverse loan book than an intra-group financing company. This fact seems to be ignored. More confusingly, the lenders cost of capital (or cost of borrowing) is also ignored, focusing only on their assessment of the borrowers’ creditworthiness.

89. It would be helpful for the OECD to describe the typical functions exercised by third party lenders (especially in relation to the assumption of risk). Lending between unrelated parties is typically subject to only a periodic review which does not require a large number of staff, and we would welcome if the OECD could confirm this fact. We are of the opinion that the evaluation of, decision to take on, and management of credit risk can be performed by relatively few people in a relatively short time, as demonstrated in the industry. We do not believe that this undercuts the allocation of returns if an accurate delineation of the transaction is undertaken.

90. Paragraph 52 states that parent “already has control of the assets of the subsidiary” so it is important to consider that the “absence of contractual right over the assets of the borrowing company does not necessarily reflect the economic reality of the risk inherent in the loan.” However, we disagree with this statement as a matter of legal fact. The subsidiary owns those assets, not the parent. If the subsidiary is liquidated, creditors will have first claim on any asset. The subsidiary, which may have independent directors and/or minority interests, can only distribute up assets as allowed by corporate law and its own memorandum and articles of association. As such, we caution against broad and over-generalised statements and believe determination of control of the assets for tax purposes should be made based on the facts and circumstances. Further, simply ascribing control of the subsidiary’s assets directly to the parent could create unintended Permanent Establishment consequences.
91. We agree with the comment in paragraph 54 that borrowers seek to optimise their WACC for the chosen business strategy whilst having the right funding, and that some borrowers will pledge collateral to reduce their cost of finance. However, whether to pledge collateral can also depend on other factors (some underlying assets are unsuitable to be used as collateral as cannot be used or sold on by the lender). The fact that there are many third-party loans lent without collateral should inform any arm’s-length analysis.

92. In paragraph 56, the DD suggests that borrowers should consider the possibility to renegotiate loans prior to scheduled maturity to obtain better conditions. However, in the absence of a provision allowing such a renegotiation in the loan agreement (e.g., a formal put/call option), it is not reasonable to expect that parties acting at arm’s length will be able to renegotiate loan terms whenever market conditions change. This is because both parties must agree and only one is likely to benefit from the process. Tax Administrations might reject a renegotiation as a violation of the ALP because one party is likely to be worse off and that party would have had the realistic alternative of rejecting the renegotiated terms. In addition, it is not practical to continually (or very frequently) review all loan relationships. Therefore, provided that initial terms were reasonable in the context of contemporaneous market conditions, there should not be an expectation of renegotiation.

93. As briefly mentioned above, and relevant for paragraph 61, we believe uncontrolled transactions indicate that loans tend to have higher interest rates than bonds. This is because bonds are more liquid and require upfront bond issuance costs which are not apparent in bond yield data. Confirmation of such in this section would be helpful.

94. In our view, paragraphs 63-66 appear to provide a preference for official credit ratings. If such is the case, we disagree as in practice commercial lenders assume the real credit default risk and would therefore be more likely to conduct a “far more rigorous analysis.” Further, in paragraphs 64 and 65, the OECD considers the use of financial tools, such as Moody’s risk calc., as not appropriate. However, the results obtained by using these tools are based on actual figures (financial statements), that in majority of cases have been signed and audited by external parties (external auditors). And thus, in our view, this information will be, in many cases, more reliable than internal (or Tax Administration) forecasts, projections or expectations.

95. Paragraph 67 states that “in particular, an MNE group’s external funding policy is seen as a guide for informing the conditions under which an MNE would have borrowed externally.” This statement is an over generalization that does not recognise that external borrowing and intra-group funding may not be directly related. An external funding policy may consider investor expectations and group-wide considerations as opposed to individual investment needs.

96. It would be extremely helpful should the guidance also incorporate a reference as to whether Central Bank data is (or not) encouraged/dismissed as suitable for TP purposes.
Our members have experienced this type of data being brought into discussions inconsistently (in particular in transactions involving developing countries or markets where more common sources of information do not include specific data on either loans or bonds for that specific market). In light of existing OECD guidance our view is that this data should not be endorsed as a feasible option and having that reference in the paper would assist in mitigating disputes. We are thinking for example where the OECD TPG note that “in no event can unadjusted industry average returns themselves establish arm’s length prices.” This data source often cannot be subject to meaningful adjustments. Therefore, the OECD commenting and/or providing guidance as to its (non) appropriateness would be welcomed.

97. In paragraphs 92-93, the DD finds that bank opinions are a departure from the ALP as such are “not based on comparison of actual transactions” and such letters “do not constitute an actual offer to lend.” However, in practice, our members find that it is very difficult for a bank to withdraw from its previously stated intentions. As such, these opinions are not given without consequence, and therefore such opinions could provide useful corroborative evidence – especially where they make reference to comparable loans they have considered in the market place. However, as noted above, such may not be necessary as other reasonable and proper methods may/likely exist.

98. In addition to the pricing approaches outlines in section C.1.7, we outline an additional approach below we believe follows the ALP, while also accounting for the unique scenario of intra-group lending.

- This approach would start with a Base Rate (relevant currency-adjusted, tenor-adjusted LIBOR/swap rate) and then add an Entity Credit Risk Premium and/or a Country Risk Premium as needed based on market data.

- The Entity Credit Risk Premium is calculated by assessing the credit rating of the borrowing entity (e.g., Moody’s quantitative rating factors applied to the entity’s actual financial results) and then using the Bloomberg Yield Curve database to define an appropriate risk premium (above LIBOR/swap rate) to apply to borrowing by an entity with that credit rating. Entity Credit Risk Premium is calculated for each instance of intercompany borrowing based on contemporaneous data.

- Country Risk Premium is based on assessment of the applicable country’s sovereign debt yields and CDS rates.

99. As mentioned above, DD fails to provide clear guidance with regard to some difficult issues. In addition to the overarching question of whether determining the capital structure of a MNE should be tested using TP and the ALP or whether this falls outside of TP, other controversial topics, albeit mentioned in the DD, also do not provide clear guidance. A specific example is the discussion of whether a cash pooling balance is short or long term in nature. This topic is referenced in Paragraph 107 where it is stated that
that “one of the practical difficulties in such situations will be deciding how long a balance should be treated as part of the cash pool before potentially being treated as something else, for example a term loan.” The DD acknowledges the practical difficulties of the subject yet fails to provide further insight as to what should constitute short term vs. long term from a TP perspective.

100. Another common challenge is when a short-term balance “becomes” long-term and how it should be priced (i.e., either as a long-term deposit or an intra-group loan). The DD only makes reference to a term loan which, at least, places it over and above a (long) term deposit. Additional guidance in relation to this topic would be welcomed and would (hopefully) minimise what our members have experienced as common disputes between Tax Administrations and taxpayers as to this matter(s). As it is known, cash pooling arrangements have already been subject to well-known court cases (e.g., Denmark and Norway) and anecdotal evidence suggests that many other disputes between taxpayers and Tax Administrations on this topic have occurred albeit not reaching the public domain. Clear guidance on a topic that has proven to be of controversy would therefore be welcomed.

101. Paragraph 108 states that it would be of assistance to Tax Administrations if MNE groups provide information on the structuring of the pool and the returns to the cash pool leader and the members in the cash pool as part of their TP documentation. This information does not seem to be contemplated in the items listed under MNE’s intercompany financial activities (Annex I to Chapter V), following BEPS Action 13. If the intention is to add additional items to the Master File, we believe such guidance should not be addressed in this paper.

D. Guarantees

Reponses to Questions

Box D.1: Commentators’ views are invited on

- How a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);
- The circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;
- Where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and
- Examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.
102. There are different forms of guarantees, ranging from license-to-operate performance guarantees, to access to backup funding, to formally improving a group company’s creditworthiness to attract 3rd party funding. In our view, the DD focuses on the latter—the guarantee is explicit support to support the already available implicit support. These guarantees are effectively part of the funding structure, and hence, pricing should be based on the respective loan pricing principles applied; and the same concerns apply as well (e.g., if the total range of ratings between group and entity is split between a guarantee and implicit support, an inability to value implicit support makes it difficult to value the guarantee).

103. In paragraph 140, if the Tax Administration of the guarantor does not respect the analysis, there is a significant risk of double taxation (i.e., the interest/guarantee income being fully taxable without a full deduction by the borrower). As such, we would strongly advise removing this position, unless guidance around this point is clarified.

104. Our members are not sure how relevant cost is in paragraph 141, because (as mentioned above) most pricing of intra-group FTs rely on CUP methods. Also, we would request evidence to prove that the costs incurred in an independent context (e.g., a bank) are greater than a related party lender. Our speculation is that such costs may be higher in total but are actually lower on a transaction-by-transaction basis and certainly per-dollar-lent/guaranteed.

105. In developing countries, where the local third party bank does not know the MNE group member or the MNE, the local third party bank may insist on a guarantee from an independent guarantor (e.g., a large, well-known bank) to ensure the borrowing of the MNE group member. In these situations, the independent guarantor charges a guarantee fee that reflects the likelihood that the MNE group member would default and the local bank calls on the guarantor. We believe this guarantee does not change the credit default risk of the borrower and thus would also not affect the interest rate on the loan charged by the local bank to the MNE group member.

106. In paragraph 142, we believe that the risk of default in the original loan still exists if the loan is guaranteed. Rather, an element has passed to the guarantor from the lender. All else being equal therefore, the interest paid plus the guarantee fee together should be an amount very similar to the interest on the original loan. Thus, in our view, the yield method appears to be the best method for pricing guarantee fees.

107. The strong language in paragraph 143 may lead to the conclusion that guarantee fee is never appropriate in the intra-group context, which does not appear intentional. As such, would recommend softening the language, where possible.
Additional Comments

108. Further, this section, similar to cash pooling, could be improved by describing more instances where these pricing methodologies may be appropriate depending on the circumstances, specifically noting the salient facts that might make this the case.

109. Also, our members would welcome additional guidance on when a service is deemed to be provided and how the benefit generated in the guaranteed entity can be proved – with special consideration paid to situations which usually do not take place between independent parties (e.g., unlimited / undetermined guarantees). We would also welcome guidance on the remuneration of non-financial guarantees (i.e., operational guarantees).

E. Captive Insurance

Responses to Questions

Box E.1: Commentators’ views are invited on the following:

- When an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;
- When an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and
- Whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;
- When an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

110. If the aim of this DD is to target only industrial captives, such should be explicitly stated. On the other hand, if the intention is to include (re)insurance groups, then significant work is required to address regulatory, capital and other matters that impact insurers. In our view, (re)insurance groups should be excluded from these rules (see our general comment above regarding the regulated financial services industry) as both parties to the (re)insurance will be subject to regularly supervision. In addition, given that similar regulation applies to industrial captive insurers, we question the benefit of applying special tax rules.
111. As mentioned several times above, Business at OECD strongly supports the ALP and such should be applied if the facts and circumstances allow. In this context, a full functional analysis may be required to properly allocate the risk. Guidance that is too prescriptive in the captive insurance section could result in pricing not in accordance with the ALP.

112. Paragraph 166 sets out six indicators that would be expected to exist in independent insurers and would be relevant to reinsuring both group and non-group risks. The second bullet notes that there is the need to insure/reinsure both group risks and non-group risks to show a real economic impact for the group as a whole as a result of diversification. However, many reinsurers in an insurance group have arrangements where only group risks are insured and maintained within the group. The original insurance associated with these risks would however involve third party risks from outside the group. The fact that there are only group risks being insured or reinsured would not mean that there is no real economic impact and diversification benefit arising.

113. Paragraph also 166 suggests that, as evidence the real economic impact, the captive either includes a significant portfolio of non-group risks or reinsures a significant proportion of the risks outside of the MNE group. Another possibility would be if the breadth and depth of the MNE group would be sufficient to diversify risks without an external party. As such, we recommend a minor change stating that this is but one example.

114. In addition, bullet 5 of paragraph 166 states that the captive should have the requisite skills and experience at its disposal including employees with senior underwriting experience. In our view, the expertise of the employees should be in line with the tasks at hand – i.e., sufficient to accept the risk and determine arm’s length pricing.

115. The fact that it is not possible to get insurance/reinsurance overage for certain risks externally should not, in itself, question the commercial rationality of such an arrangement.

116. We believe that there are instances where MNEs identify real commercial risks that they wish to insure. Third-party insurers may choose not to issue policies if they do not have the appetite for the corresponding risk. However, this should not lead to the conclusion that such an arrangement is not commercial. Even though it may be the case that general insurers have no appetite for the risk, a specialist (e.g., a captive) might be willing to take on such risk. Similarly, during an “incubation” period, an MNE may wish to self-insure to build up a track record, with a view to externally insuring the risk once the insurance market becomes comfortable.

117. In paragraph 171, the DD states “that risk will be controlled by either the insurer or (more likely in a captive insurer scenario) another entity within the group.” However, insurance companies do not and cannot “control” risk. It is the nature of the insurance industry to take on risks that cannot be controlled (if they could, the industry would not exist in its current form). Insurers can manage (or mitigate) risk by reinsuring and by setting up
reserves to cover future claims. However, they do not control the risk, thus in the context of captive insurers control of risk is not relevant. To be consistent with Part IV of the OECD 2010 report, mentioned above, it is the decision to take on risk which is key.

118. We would welcome thresholds for and examples of when “an MNE may lack the scale to achieve significant risk diversification and may lack sufficient reserves to meet additional risks represented by the relatively less diversified portfolio of the MNE group” as noted in paragraph 176.

119. In paragraph 178, the DD states that the third party is “indifferent to the levels of pricing” when acting as a fronting insurer for a captive. However, in fronting arrangements, the fronting company normally retains a portion of the risk (e.g., 5%) and therefore is not “indifferent” to the pricing.

Box E.2: Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

120. It is our understanding that actuarial analysis as described in paragraph 181 may calculate a “technical” rate which could differ from the market rate for a particular risk. Therefore, we would welcome more description (including examples) of how this might be adjusted to produce an arm’s-length rate. We believe that the actuarial analysis can provide an effective, last resort pricing option, while remaining in line with the ALP and industry practices. In addition, the DD does not consider the use of broker quotes, a very common method of establishing arm’s length pricing for captives. Brokers will quote by looking at the range of commercial rates available in the market, rather than a pure “technical” rate determined by actuarial analysis. Our members are of the view that actuarial analysis, brokers’ quotes, or a combination of both can be adopted to establish arm’s length prices for premiums.

121. We disagree that a combined ratio and return on capital can produce a CUP as stated in paragraph 182. Specifically, it does not take into account many other commercial factors that an insurer needs to assess when determining its pricing. If the captive is assuming significant underwriting risks, it needs to generate sufficient capital reserves to satisfy its claims and remain solvent (in addition to meeting the regulatory requirements).

122. From experience, our members disagree with the conclusion in paragraph 183 that the capital requirements of a captive are likely to be “considerably lower” than an insurer writing policies for unrelated parties (or that insurance regulators frequently set lower regulatory capital requirements for captives), as any regulated insurer will be required to hold adequate capital for its position.

123. Paragraph 185 concludes that “[t]he synergy benefit arises from the collective purchasing arrangement, not from value added by the captive.” However, a functional analysis may show that without the functions and activities of the captive, it is unlikely that MNEs could
achieve the same level of benefit, which is something an insurer would be compensated for in an uncontrolled transaction. The captive is the vehicle which allows the “collective purchasing arrangement” to be realised.

Box E.3: Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

124. The example provided makes two assumptions:

- That the product sold is materially the same as that which any other insurer in the general market could provide; and
- That A could sell policies underwritten by another insurer and retain most of the profit for itself.

125. However, once a detailed functional analysis is considered it will often be the case that there are material differences between insurance products. It cannot simply be assumed that the retailer in the example should retain most of the profit for itself without undertaking a detailed analysis of the relevant transaction.

126. The example appears to assume that the captive insurer B will earn a higher level of profit from the insurance than an independent third party insurer would and also that an independent third party insurer might share the insurance (underwriting) profit with an independent agent selling the insurance cover. The example, however, does not provide any justification for these assumptions.

127. The profit earned by B will equate to the difference between the premiums collected and the aggregate of claims paid and expenses incurred in administering the policies. If the same insurance was purchased from an independent third party the only variables would be the level of premium and the costs of administering the policies. The unstated basis for the assumption seems to be that either the independent insurer would charge a lower premium or that its administration costs would be higher, both of which seem unlikely.

128. It is entirely possible that an independent insurer might charge a lower premium, for example due to the greater diversification of risk that it can achieve compared to B. However, that is not relevant to the TP analysis of the transaction which must reflect the actual premium which the customer has paid for the insurance. If the independent insurer received the same premium then it would make the same profit as B. A is also fully remunerated for selling the insurance cover by the commission it receives from the independent insurer. An independent insurer would not share with A the insurance (underwriting) profit made on the insurance.
OECD
Tax Treaties, Transfer Pricing and
Financial Transactions Division
2, rue André Pascal
75775 PARIS Cedex 16

Submitted by email: transferpricing@oecd.org

6 September 2018

REQUEST FOR AN INPUT ON DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS
ACTION 8-10 OF BEPS

Dear Madam, Dear Sir,

The tax department of Bignon Lebray (French independent law firm) and DBA (accounting,
audit and consulting group) welcomes the opportunity to provide input on the draft
discussions on financial transactions (action 8-10 of BEPS).

We have focused our answers on the questions in part C of the draft papers.

***

C.1. INTRA-GROUP LOANS

Box C.2.

We believe that the first rebuttable presumption proposed in the draft papers i.e. assuming
the credit rating of the group applies to each of its subsidiaries should be selected for the
three following reasons:

(i) This assumption covers most of the situations that we see in practice and
simplifies the analyses to be conducted. Indeed, in many situations it would be
possible to apply the rates obtained by the group from third parties to “mirror”
loans made to subsidiaries;

(ii) This assumption would limit the number of credit rating analyses to be performed
by the group. Actually stand-alone credit rating analyses may need to be
performed only in specific circumstances (when the functional and risk analyses
indicates that such analyses need to be carried out). This would reduce the
associated compliance costs for the MNEs and the risk of discussions with the tax
authorities on the modalities used to perform such credit rating analyses (see our
development below);
As the assumption is rebuttable, taxpayers, or the tax authorities, will have the possibility (if the circumstances require based on the functional and risk analyses) to propose an individual rating for the borrowing entity.

We consider that the second presumption proposed in the drafts would create an unnecessary burden on the MNEs as it implies that:

(i) the group credit rating (which, for smaller MNEs, is not performed by the international credit rating agencies) should be a "starting point" from which adjustments should be made;

(ii) many credit rating analyses on a stand-alone basis would need to be performed (even though not required by the circumstances), creating many unnecessary costs for the MNEs as the outcome of such analyses may, in many situations, be criticized by tax authorities for the reasons below.

In general, concerning the use of credit rating analyses, we would like to emphasize that this should not be the sole method identified in the draft to benchmark rates applied to intragroup loans, but one amongst others.

We believe that it may be appropriate to use the group's credit rating to determine a subsidiary's credit rating for both practical and substantive reasons.

The credit rating is generally the reference point used to establish the rate, but it is also customary to take into consideration the guarantees of the borrower. Indeed, an entity belonging to a group benefits from an implicit guarantee ("halo effect") as discussed in the comments below, which has the effect of improving or deteriorating its rating as compared to the group's rating. The most complex point remains the qualitative factors of these analyses.

Regarding the rating of a group ("independent shadow rating") in the absence of a credit rating by the main rating agency, conducting a credit rating analysis requires obtaining a satisfactory level of objectivity in the rating. This is a rather complex analysis consisting in developing a rating model able to interpolate with traditional ratings so as to give a spread (setting up of quantitative and qualitative criteria, correlation tests with S&P/Moody’s/Fitch, work on a significant sample of companies, back testing over several years of the tool for entities benefiting from public rating).

In this respect, it seems inappropriate to produce a case-by-case ex-nihilo rating for a company that does not have a group rating.

For long term loans, it seems to be more realistic to use a group Weighted Average Cost of Capital (WACC) adjusted as the case may be for country, currency and illiquidity risks. This approach would be appropriate for a group with unlisted financing. This would apply to loans with a defined long-term maturity or, in absence of defined terms, loans for which uses are predominantly long-term assets (tangible or intangibles).

It seems to us that alternative methods to the sole credit rating analyses should be proposed as valid methods. In this respect, we often see in practice that other referentials are used as for instance indexes (Euribor etc…) plus a mark-up. These indexes are easily available and, for "simple transactions" (i.e. when it can be assumed that the credit ratings of the entities are aligned) the use of these indexes increased by a few basis points may be proposed as an alternative.
As a general comment in all situations it would be relevant to adjust the rates identified under the different methods discussed when the borrowing and lending companies are located in different States and have a significantly different country risk premium.

In such situations, a premium should be factored in when the borrower is located in a country with a higher risk. Similarly, for loans in local currencies, adjustments should be made to reflect the currency risk if it was not contractually covered.

Indeed, it may be necessary to take into account in the applicable rate, the differential between the country risk premium of the borrower and that of the lender. This risk premium has not been addressed in the current draft on financial transactions.

Similarly, it might be interesting to take into account the differences in the legal regimes applicable in the States parties to the transaction, particularly with regard to the risk of repossession when assets are pledged as collateral.

**Box C.3.**

A stand-alone credit rating of a company belonging to a MNE, is a complex analyses as discussed above in box C.2. We consider that two main scenario should be considered:

- the individual credit rating of a member of the group is the one of the group. The parent company can apply the same rate obtained from external sources on similar intragroup loans. If no internal CUP is available, the parent company can search for comparable loans (maturity, etc…) made to borrowers with a credit rating similar to the one of the group

- a "stand-alone" credit rating of the borrower is conducted and comparable loans are identified in available databases. Such stand-alone credit rating analyses should be conducted only when the circumstances require it. When the borrowing entity has real autonomy and the functional and risk analyses implies that its own credit rating deviates from the one of the group.

**Box C. 4.**

We are in agreement with the analyses developed in the discussion drafts.

**Box C.7.**

An interest rate paid on its external debt by a group of multinational enterprises may be considered as internal CUP if:

- The circumstances can be deemed comparable as they met the comparability criteria defined in the OECD Guidelines to identify external comparables. If the circumstances are not strictly comparable, adjustments may be proposed provided they are duly supported.

- It is also possible to consider adjustments if it appears that the mere fact of belonging to the same group creates synergies / interactions between members of the group, and according to the role and functions assumed by the different entities in relation to the group (cf. Box C.4.)
Such interaction may have a positive or negative effect on the amount of the rate to be applied, as set out in §1.157 of the Transfer Pricing Guidelines.

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C.2. CASH POOLING

Box C.8

Cash pooling agreements may cover different situations, mainly depending on the functional profile of the cash pool leader. As set out in the Public Discussion Draft, two different generic profiles may be found in practice:

- **Cash pooling services provider profile**: under this situation, the cash pool leader mainly administrates and organizes the cash positions of the participants (deposits/loans and corresponding remunerations/accrued interest), as the case may be by contracting with a third-party financial services provider (bank). The cash pool leader does not bear any credit risk, except pro rata to the cash borrowed from banks up to its negative net cash position. The remuneration of the cash pool leaders corresponding to this profile is generally computed based on a cost plus method by reference to its operating costs (excluding the financial interest due to the third-party bank or the lending participants). This remuneration it to be covered by the net cash income generated by the cash pool, the surplus (excess cash of the cash pool leader on a considered period) being reallocated between the participants pro rata to their positive contribution (see comments below);

- **Bank profile** according to which the cash pool leader carries out a more fully-fledged financing activity, including, for instance, participation in the definition of the financing strategy of the group and the assumption of a credit risk on the loans granted to the group’s entities. The monies funded by the cash pool leader may be of a longer term than those of usual cash pooling organizations, subject to a specific and more in-depth analyses of each borrower’s profile to set the loans’ financial terms and conditions.

Our comments will only concern the first cash pooling mechanism (whereas the “bank” cash pools might be subject to transfer pricing rules similar to the ones applicable to standard intercompany loans).

In practice, cash pools are usually structured with zero-balanced bank accounts of the participant companies; a minimum threshold of cash might also be defined to allow more flexibility at the participants’ level. The average net cash position of each participant is computed on a yearly basis, after set-off, or not, of the positive and negative cash positions booked during the period (if no set-off is made, a participant might be considered as both a depositor and a “borrowing” entity for said period). Should a participant be continuously depositor or borrower for a medium to long term period (i.e., for a period of one year to two years at least), its participation in the cash pool might be disqualified by the tax authorities which could consider that it should be deemed to evidence a standard intragroup loan which shall thus be subject to the specific financial conditions discussed above.
Based on our experience, the allocation amongst the participants of the cash pooling benefits is generally made on a yearly basis as an adjustment to the interest computed on the positive or negative yearly positions of each participant. For sake of simplicity, the cash pool benefits shall be assessed after deduction of the cash pool leader’s compensation.

As a general principle, the remuneration of each participant shall be computed on an arm’s length basis. Yet, since independent parties rarely enter into cash pooling agreements, the direct reference to uncontrolled transactions might prove difficult, thus obliging to consider each underlying controlled transaction of the cash pooling separately, i.e., (i) the deposits made by the excess-cash companies, (ii) the short term “loans” borrowed by the companies that end up cash-short on an average and yearly basis and (iii) the services of the cash pool leader.

When it comes to the deposits, the commonly admitted position in France is that the remuneration of the depositors should not be lower than the remuneration they could get from unrelated banks for deposits with the same characteristics (amount, term, currency, etc.). This potentially enables the cash pool leader to mark up on these funds either by depositing them in a third-party bank at a higher placement rate or by lending them at a higher interest rate to cash-short participants.

The conditions of the loans deemed to be granted by the cash pooling entity to the cash-short participants are usually not set by consideration of the credit rating of each borrowing participants and thus based on a CUP rationale, as for standard intragroup loans. Indeed, this does not exactly fit with the short term nature of the facilities. Additionally, it would lead to various rates depending on the participants’ profile, which rates may, furthermore, vary as time elapses. Moreover, if the cash pool benefits are reallocated between the participants, the interest rate applied to such loans will be automatically adjusted afterwards (see comments below).

Therefore, for sake of simplicity, groups generally elect for a unique rate to apply to all the cash-short companies, as the case may be equal to rate that would be agreed between the cash pool leader and an independent lender plus a spread aimed at compensating the cash pool leader. For even more simplicity, when the cash pool’s benefits are reallocated between the participants, groups generally apply one single rate to both deposits and loans, considering that, whatever the rates we may apply for deposits and loans beforehand, the final adjustment of the rates resulting from the allocation of the cash pool’s benefits will lead to the same result in terms of deposit rate, on the one hand, and loan rate, on the other hand (see comments below).

Considering the functional profile of the cash pool leader of a day-to-day cash pooling, our view is that its compensation shall be calculated based on a margin computed on its direct and indirect operating expenses. This cost plus method might be combined with a spread on bank rates pro rata to the loans subscribed by the cash pool leader from third-party lenders, in the case where the cash pool is cash-short. In that case, the spread shall be computed on the interest rate applied by independent banks on the loans or short term facilities granted to the cash pool leader. In any case, the compensation of the cash pool leader shall be withheld from the cash pool’s benefits, which benefits generally include the net cash position of the cash pool leader (structurally positive, by assumption).

After closing of a given financial year, the cash benefits of the cash pooling agreement might be computed by comparing, for that financial year, the consolidated cash of the participants (including the cash pool leader) with the situation where no cash pool would have been implemented, it being understood that, as already mentioned, the benefits of the
cash pool shall be computed after deduction of the cash pool leader’s remuneration. The consolidated benefit shall generally correspond to (i) the mitigation of the financial costs charged by third-party banks (interest, penalties, commissions), considering the reduction of the amounts of the loans to be subscribed from third parties and of the interest rates applied by banks, and (ii) the increase of the deposits income derived from third-party banks (volume effect).

These consolidated benefits might be shared amongst the participants pro rata to their positive contribution to the cash pool (OECD, Actions 8-10, §1.162). Considering the positive impact of the excess-cash participants on the overall cash position of the group, we are of the view that the benefits should be shared only amongst them. The reallocation of the net benefits of the cash pool would generally result in an increase of the interest rates applied to both depositors and cash-short participants.

Box C.9

We agree with the assertion that “No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option”. However, in practice, it might happen that controlled entities have no choice but to enter into a cash pooling agreement with potential drawbacks for them, notably if they are deprived of the cash they would expect to use or they would need for their own investments. Moreover, the cash pool shall not result, at the end of the day, in any illiquidity or financial difficulty for the participant companies. Finally, some prohibited loans (financial assistance, for instance) might be an obstacle to the entry of a newly acquired company into the cash pool.

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On behalf of Bignon Lebray and DBA, we respectfully thank you again for this opportunity and hope that our comments will contribute to the further discussion. We would be pleased to discuss or clarify our comments, if necessary.

Yours sincerely,

Cyril Maucour
Partner – Bignon Lebray
cmaucour@bignonlebray.com

Pierre-Emmanuel Sherrer
Partner – Bignon Lebray
psherrer@bignonlebray.com

In association with:

François Bianco
Partner–DBA
françois.bianco@fr-dba.com
Via Email: TransferPricing@oecd.org

Centre for Tax Policy and Administration
OECD
2, rue André Pascal
75016 PARIS
France

Milan, September 4, 2018

Public comments on the “BEPS 8-10. Discussion Draft on Financial Transactions”

Executive summary

Dear Sirs,

Borioli & Colombo Associati, an Italian tax consultancy firm, independent Member of BKR International (one of the top 10 global accounting associations), appreciate the work the OECD continues to undertake in the revision of the transfer pricing guidance following the BEPS project.

The need for specific guidance relative to financial transactions has always been felt as extremely relevant from a tax perspective and not only for TP issues. The Discussion Draft (Draft) has to be appreciate because of its effort of analyzing several features of these kinds of transactions.
For what it concerns the identification of the transactions (part B of the Draft) a lot of clarification has been provided. Nonetheless, some further efforts seem necessary to reach a deeper elucidation of the different kinds of financial instruments and agreements to be considered. In this industry, sophistication produces an ever growing number of new type of contracts whose legal and economic (and tax) effects should be duly matched.

Similar conclusions hold true also for the analysis at part C of the Draft. Further, notwithstanding, treasury functions are increasingly complex and integrated in cross-border agreements and transactions, some of them could assume the nature of a routine service provided by an ad hoc entity of the MNE group to the other associated enterprises. In this respect, some room might be introduced for considering them as an “intra-group service” to be dealt with according to guidance at Chapter VII, OECD Transfer Pricing Guidelines, notwithstanding par. 7.47 affirms that “financial transactions” “would not qualify for the simplified approach” for intra-group low value added services.

Finally, some more advice should be provided for identifying the rationale for captive financial entities and insurers. In fact, paragraphs 172-173 of the Draft should be extended for considering the relations between the OECD “separate entity approach” with the economic logic of setting up a captive entity providing financial and insurance service at lower cost, where “lower cost” reflect an entrepreneurial logic as robust as the arm’s length principle.

****

Kind regards.

Borioli & Colombo Associati
Transfer Pricing Team
Giorgio Borioli
Public comments on the “BEPS Actions 8-10. Discussion Draft on Financial Transactions”

Dear Sirs,

Borioli & Colombo Associati, an Italian tax consultancy firm, independent Member of BKR International (one of the top 10 global accounting associations), greatly appreciate the work the OECD continues to undertake in the revision of the transfer pricing guidance following the BEPS project.

For what it especially concerns financial transactions, these have always been considered a very specific issue presenting peculiarities that make them different from the transactions of the other industries. This makes this Discussion Draft on the transfer pricing issues related to financial transactions very appreciate. In this respect, we provide hereinafter our comments and observations on the Draft1.

1 If not differently specified, reference to “paragraph” in the text is to be intended as made to the paragraphs of the Discussion Draft. The OECD Transfer Pricing Guidelines, 2017 version, are indicated as “OECD TPG, while the OECD Model Tax Convention, 2017 version, is indicated as OECD MTC.
**Box B.1. Question to commentators**

Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention (“MTC”), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

Guidance at Chapter I, OECD TPG provides reference for pricing transactions according to the arm’s length principle when they occur between associated parties assuming that this principle is the most suitable for attributing income and tax burden to each party in respect of any effective transaction between them. This approach should hold true also for financial transactions because that principle aims at granting that commercial and financial relations between associated enterprises would be determined only by business reasons. The same concept is made clear at paragraph 1.2, OECD TPG, where it is stated that “When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way [as independent enterprises], although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other”. To correct any distortion due to the association to an MNE group, article 9 OECD MTC introduces proper corrections in the form of adjustments to prices of MNE group transactions and when tax assessments give rise to a double taxation situation, mutual agreement procedure are at disposal to limit as far as possible any negative effect.

If this is generally true, financial transactions in an MNE group may reveal the further issue consisting in the possibility of locating both the origin of the debt and the relative deduction of interest free from any effective commercial ground but greatly influenced by tax rules only. As a consequence, almost any Country adopt specific rules limiting interest deduction and also the BEPS project dedicated a specific Action to such issue (i.e., Action 4).

That said, TP rules basically aims at granting not only arm’s length remuneration to any enterprise of an MNE group but also, from a different perspective, a fair distribution of income and tax bases among Countries. From this viewpoint, notwithstanding TP rules intersect BEPS issues, as BEPS Action 4 shows, different is the logic of the two perspectives.

If limiting interest deduction responds to a BEPS logic, arm’s length remuneration of risk assumed and functions performed points to “align Transfer Pricing outcomes with value creation”, i.e. to remunerate correctly the economic activity really put in place by an enterprise. Characterization of an economic transaction may lead to different results if the viewpoint changes. In this situation the problem may arise of disregarding interest deduction by entity A in country A when entity B in Country B has really assumed relevant risks and performed relevant functions consequently deserving an equally relevant fair remuneration. Whether a functional analysis demonstrates the authenticity of the controlled transaction, i.e., the authenticity of the functions performed, the risks assumed and the asset used, both in respect of their existence and dimensions, the better solutions should be to admit the arm’s length amount of interest deductible notwithstanding it may exceed any limitation due to a “limitation of interest deduction rule”. In fact, any different approach would give rise to a situation of double taxation, that should be avoided not only according to article 25 OECD MTC but also to the Preamble itself of any Tax Convention.
Because of interaction of BEPS Action 4 rules, domestic limitations of interest deductions and the arm’s length principle of article 9 OECD MTC, some specific guidance should be provided, for example, by explicitly introducing a sort of derogative rule admitting higher interest deduction when the effective nature of the transaction is ascertained.

From a formal perspective, this remedy should not be strictly necessary because of the existence of article 9 and 25 OECD MTC that affirm the general principle and aims of tax conventions (i.e., avoiding double taxation). But, because of the bad practices examined in the BEPS Action 4 Report, a paragraph in the OECD TPG could be introduced to fulfil that purpose adequately having regard only to the soundness of the transaction as structured by the associated parties, i.e., only establishing if it has an effective economic rationale. Besides, it is worth noting that this verification should also give comfort in verifying the nature of the transaction in terms of debt rather equity contribution provided to the “borrower”.

Box B.2. Question to commentators

Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

The example apparently takes into consideration a situation excessively “extreme” as far as it considers a borrower “that it is clear that would be unable to service a loan of such an amount”. Under these conditions it is consequently apparent that no arm’s length loan would have been granted by any lender with the immediate effect of re-characterized the loan from the related party as an equity contribution, with all the relevant outcomes.

In light of the guidance aimed at by this Consultation, it could be much more worthwhile building an example where the borrower would be able to service the loan received by the related party but its financing conditions appear to be comparable to the market’s ones except for the insertion of some “subordination clauses” granting objective advantages to the borrower. Such example might be built in the following terms:

- Company B, member of the MNE group, needs funding for some relevant capital assets investment.
- Company B considers the different options realistically available to it either due to its association to the MNE group or to resort to financial transactions available in the market with external counterparties.
- The relevant amount of the investment and the uncertain regional (but not worldwide) perspectives of the industry of B makes lenders requiring interest at x%.
- Associated Company C, the head treasury entity and cash pooler of the group, decides to provide finance to related Company A, sole shareholder of B, at x-α%. Company C can take advantage of a cost of funding of x-γ%, with γ>α, because of its own excellent credit rating.
In turn, Company A advances funds to B at $x-\beta\%$, with $\alpha > \beta$, together with some subordination clauses relative to the reimbursement conditions and without weighed the risks of the regional industry conditions and perspectives.

These clauses thus become extremely relevant in evaluating *in concreto* the transaction. In fact, they may render the finance provision extremely advantageous because they can grant Company B the possibility, for example, of freezing some payment of interest to A (e.g., depending on the level of some Company B’s internal financial index, RoS, EBIT, EBITDA, or other) or subordinating the interest payment to Company A after the payments of other B’s lenders or capital repayment to A when the investment made would grant a certain rate of return.

Alternatively, it may be considered the possibility of hedging the transaction with a credit default swap (CDS) underwritten between Company A and Company C with C hedging in turn with another CDS at arm’s length conditions with external financial institutions.

Under these conditions, characterization of the amounts borrowed by Company B becomes more realistic and more problematic. Probably, under the facts and circumstances of the case, Company A’s provision of funding to Company B could reasonably be re-characterized as an equity contribution or a subordinated loan equivalent to an equity contribution (with the same effects on interest deductibility). Such conclusion might also be reinforced by considering the partly different perspective that the assumption of risk by Company A (or even Company C) could be seen as an ordinary shareholder activity in its own interest due to the different evaluations of the industry regional perspective.

Finally, from the last perspective, the problem of characterizing the effective amount provided to Company B would change a bit its significance being linked not so much to the amount provided but essentially to the conditions of its provision.

**Box B.3. Question to commentators**

*Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.*

At first glance, guidance provided at Chapter I, sec. D, OECD TPG results surely relevant also for the comparability analysis of financial transactions. Reference to concepts such as contractual terms, functional analysis, (financial) products provided and the economic circumstances and business strategies continues to be held valid also in respect of such transactions.

However, if this is generally true, financial transactions differ from other transactions because of some specific features that make them different from other services or products provided in non-financial transactions.

For example, the relevance of borrower’s credit rating has a large impact on the loans conditions, both from a stand-alone perspective or when group guaranties are conceded. This feature does not appear in any transaction of other industries.
Also, the large and continuing changing variety of financial instruments deserves specific attention because the same result, i.e., providing funds, may be obtained through several (combination of) different instruments and contracts.

Finally, because of the special regulations often provided for this kind of transactions in any Country, it happens that the same financial facility may be characterized differently in the different Countries involved giving rise to hybrid situations (already dealt with under the Action 2 of the BEPS Project).

Probably some more specific guidance would be needed, especially for transactions with derivative instruments and their combinations, for example how pricing an instrument embedding a financial derivative.

It is a common experience that Tax Administrations’ perspective and reasonings differ from the perspective of financial operators with the effect that the same transaction is attribute different rationales and characterizations depending on which perspective is adopted. In case of a TP comparability analysis, largely inspired by economic factors, such differences cannot be ignored. Further, in the finance industry even risk becomes a sort of item that can be bought or sold. By modification of a contractual clause or by the adoption of a hedging instrument, any risk may be hedged or reduced, so modifying also the nature itself of the financial transaction. Also, these outcomes should be adequately evaluated coherently with guidance at Chapter I, section D.1.2.1.2. Step 2: Contractual assumption of risk, OECD TPG.

All that considered, it would be largely helpful to extend the guidance at paragraph B.2.3 “Characteristics of financial products or services” of the Draft with some evaluation of the above peculiarities.

Box B.3. Question to commentators
Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

From a lender’s viewpoint, providing funds requires the most complete and comprehensive knowledge of the borrower’s situation and its prospective business developments. This knowledge should help determining the credit risk and the interest to be paid in a sufficiently informed way and awareness.

In a transfer pricing context, i.e., in case of transactions between associated enterprises, it may happen that (some of) the information necessary to assume such informed decisions could not be provided exhaustively, even for reason of “confidentiality” in respect of the MNE group’s policy. Of course, when the advance of funds is due to significative investments or to acquisition of a new business the MNE group as whole may be impacted by the consequences of such transactions. In these situations, borrower’s creditworthiness would be influenced, at least at some degree, by the creditworthiness of the MNE group itself. This situation introduces effects of indirect or implied guarantees that may favour both the borrower and the lender. Together with these effects of
reciprocal internal guarantees there should also be considered the effects of potential set-off positions.

As further discussed, internal financing or captive financial entities may consent the assumption of risks that could be more fitting than market’s ones.

All these issues reflect to the lender’s contractual position and the arm’s length remuneration due for its services.

Briefly, provision of funds to MNE group requires the lender to considered not only a thorough examination of the business to be financed in the group context but also the whole relations existing among the entities of the group (e.g., in terms of implicit guarantees, strategic importance of the borrower in respect of the group strategy, etc.). Such analysis will obviously concur to the consequent determination of the interest to be paid to the lender.

Somehow, this perspective may challenge the “traditional” stand-alone approach endorsed by the OECD. If this is true, some deeper analysis would become unavoidable.

Box B.4. Question to commentators

Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm’s length interest rate.

Guidance in the Box is surely very helpful in view of introducing in the OECD TPG some key concepts for assessing financial transactions in a comparability analysis. However, because at the heart of such an analysis there is the comparison between the controlled and the uncontrolled transaction, some further specific guidance on how pricing alternatives financial transactions could be very useful in light of the distinctive characteristics of such transactions in respect to the others considered at Chapter I, Section D, OECD TPG.

From this perspective, apart from the opportunity to introduce some further examples (e.g., about situations where a funder entity maintains the capability of effectively controlling the risk associated with investments in financial transactions), some more attention could be devoted to the “actual delineation” of financial deals, especially in case of combination of more than one “simple” financial instrument or contract. In fact, market practice gives extensive evidence of the use of such “combos”2 whose “practical” effect, for example, may be as equal as a “traditional” purchase agreement but whose financial and legal outcome are definitely not. As these issues are already dealt with by existing accounting standards, even though with different purposes and only partially, in a TP analysis it could be useful to understand how the aggregation of this kind of transactions should be coped with, in particular if the analysis can give rise to result not aligned with the guidance of Chapter III, section A.3.1, par. 3.9, OECD TPG.

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2 A very common “combo” is a combination of a put option with a call option with identical underlying asset, strike price and terms that has the same effect of selling/buying that asset.
Further, also the definition of “control over risk” in a financial transaction should be more deeply investigate. Reference made at paragraph 10 of the Draft to the example at paragraph 1.85, OECD TPG does not appear to be completely satisfactory, at least because that example mainly handles with investing in an asset, no matter if tangible or intangible.

The same need for deeper clearance seems to emerge in the analysis of the difference between financial and operational risks at paragraph 13.

Also the analysis at paragraph 14 should be a little more extensive, for example by making clearer the (if any) differences between failing to develop the investment for which the loan transaction has been entered to and the “market failure” due to the unsuccessful exploitation of the financed investment.

Box B.5. Question to commentators
Commentators are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns.

Investments in any form of financial products, other than a bank deposit at the risk-free interest rate, involve some sort of risk due to the volatility of the economy and the actual conditions of the issuer.

As it has been made clear by OECD TPG (paragraphs 1.85 and 6.60) risk-free rate of return is a relevant approximation to estimate the arm’s length remuneration for an investor that has not control over the risk associated with investing in a financial asset. If Government securities are usually used as a benchmark for this kind of pricing, it is however necessary to exactly identify the effective nature of the securities that are dealt with. In fact, not any Government security can appropriately be used as such a benchmark. Parenthetically, it is a common experience that any Countries may experience very striking downgrading of its credit rating with the result of becoming a high-risk issuer. Consequently, it could be useful to provide firstly some guidance also for identifying appropriate risk-free Government securities.

Further to this remark, it becomes evident that the level of risk and its potential transferability is the authentic issue to deal with. At this regard, it is easy to observe that financial industry has long been provided instruments for transferring or hedging risks, e.g., through credit derivatives, with the effect that pricing financial instruments becomes relatively “simple” after having priced the appropriate credit derivative. Credit default swap (CDS) market already offers an opportunity to gauge market views on a firm or bond issuer’s credit risk.

A still further evident consequence of this approach is that, by definition, the underlying security of a CDS becomes devoid of any risk because of the credit risk protection granted by the “protection seller” in the credit derivative transaction. From this viewpoint, it follows that pricing a security and calculating it arm’s length remuneration may reasonably be done having regard to prices and commissions paid for the correct credit derivative.
Entering a CDS transaction is similar to buying insurance against default or similar credit events. It is also analogous to swapping the payments from a risky security for the payments of a risk-free security in exchange for a contingent payment in case the risky security defaults. Therefore, the default swap spread reflects the credit risk of the underlying asset (i.e., the reference entity) and hence, the premium is usually quoted in basis points over a reference rate such as LIBOR or the swap rate.

An investor who owns a risky bond can protect himself against default (credit) risk by buying the corresponding CDS. Ruling out arbitrage, this strategy requires that CDS and bond spreads are the same. This assumption may be illustrated as follows. Suppose we buy a risky bond (e.g., corporate bond) that pays a risk-free rate plus a constant spread. Suppose we also buy a CDS on this risky bond to insure against possible default. This transaction would yield a return equal to the risk-free rate plus the CDS and bond spread differential, or default swap basis. However, since these two transactions are equivalent to holding a risk-free bond (e.g., treasury), they should yield a return that is equal to the risk-free rate. Therefore, there should be no spread differential between CDSs and bonds. Economists has long formalized this argument and explained what specialized assumptions are needed for it to hold true. In terms of price dynamics, theory suggests that there should be one-to-one changes between CDS and bond spreads\(^3\). Others formalize the relationship between bond and equity prices using option-pricing theory arguing that equity is analogous to a call option when the firm is also financed by debt\(^4\).

Accordingly, for an accurate comparability analysis attention should be put in contractually delineating the characteristics of the financial transaction to hedge. Because of the novelty of the issue some guidance or examples may be useful.

**Box B.6. Question to commentators**

Commentators’ views are invited on the practical implementation of the guidance included in paragraph 11 of this Box B.4, and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest expense up to an arm’s length amount, but the funder is entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.

Situation depicted at par. 11 of Box B.4 seems to represent a triangular case where, for example, the funder A is resident in Country A and the borrower B in Country B while a third entity C, that effectively controls the risk associated with the transactions, may be resident of Country A or Country B or another third Country C.

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Even if this situation involves the potential presence of up to three Countries tax laws, it does not seem that it can disallow deduction of interest by B when the interest to be paid has been determined correctly under TP guidance, i.e. when its amount is at arm’s length. In this case, Country B will apply its taxation rules that should be in accordance with the provisions of the relevant Tax Convention between Country A and Country B (article 11, Interest, OECD MTC).

For what it regards the transaction between A and C, this could be more or less explicitly priced according to the relevant TP rules, whether the two entities are part of the same MNE group (and in this case article 9, Associated Enterprises, OECD MTC will be applicable).

Differently, if A and C are not part of the same group, it is reasonable to assume that the transfer of risk control from A to C (e.g., by way of a credit default swap or another “explicit” agreement) would have been already priced at arm’s length, i.e. according to the ordinary commercial (financial) practice.

Under such circumstances it becomes hard to say that B could suffer a double taxation on its interest deducted, in particular if payment from B to A have been fixed according to Article 9, OECD MTC, i.e. according to TP rules. In respect of B and Country B’s Tax Authority, no relevance should have the presence of C because the A-C transaction is completely irrelevant for B, that could even ignore it.

For A and Country A’s Tax Authority, the situation will be different because firstly it should be assessed if the risk has been actually transferred to C and secondly at what price. If A and C are related parties the dispute between Country A’s and Country C’s Tax Authorities should be coped with reference to Article 9, OECD MTC and TP rules, and probably having recourse to Article 25 OECD MTC procedures.

Differently, if A and C are not related parties, risk control transfer should have been quite surely priced at arm’s length with no possibility of double taxation against A.

Box C.1. Question to commentators
Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

Paragraph 38 describes a situation where each MNE maintains full independence in managing its treasury function. This is the case of a fully decentralised treasury group model. However, such a situation does not seem to be implementable as fully as the exemplification suggests at least for two reasons.

The first one is that full autonomy and independence do not mean that the individual MNE has a corresponding stand-alone credit rating sufficient to make possible any financing decision. On the contrary, the simple belonging to a group determines some kind of implicit guarantee that favourably modifies the financing opportunity of the MNE so that such autonomy and independence risk to be more formal that effective. This holds especially true for financing needs.
other than the day-to-day necessities. In these last cases, MNEs are usually dealing with significant amount of cash justified by and destined to important and permanent investments, at least as a general rule. In such circumstances, it appears quite difficult to admit the possibility of the pretended full independence of the controlled MNE when closing such financial agreements, especially if the amount is not negligible.

Secondly, in an MNE group business strategies implementation is, in any event, under a constant monitoring and co-ordinating surveillance by a group holding entity, whose main activity is to assure that all the entities of the group would act coherently with the group strategies, even for what it regards financial management. In these conditions, a treasury structure notwithstanding its possible level of independence will always be under the co-ordinating power of the holding entity, especially for financing expenditure different from the day-to-day ones.

Such considerations are partly evoked also at paragraph 40, even if the paragraph aims at a different purpose.

Conclusively, in a TP context, being part of a group of several entities creates a sort of reciprocal effects and constraints, either explicit or implicit, on the measurement and assessment of the borrower’s creditworthiness, in general terms and with respect to any particular debt or financial obligation.

**Box C.2. Question to commentators**

Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;

- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

The hypothesized approaches start, even though with different perspectives (presumptions), from the “group level” credit rating with the aim of “extending” it somehow to the “individual member level”.

As regards the item of the “rebuttable presumptions”, it is common experience that tax assessment is often grounded and empowered by this kind of presumptions. Actually, the critical point of the above hypotheses seems just to be the assumption that the “group level” is or may be considered the best approximation for the credit rating of each group member.
According to some researches, even if the so called “parent-subsidiary link” or “group link” give undoubtedly some evidence of the parent/holding member of the group providing credible guarantee to its subsidiaries indebtedness, this link may not be promptly traduced in any effective supportive measure because of the absence of liability the parent entity could truly be willing to assume.

The key point of these assumptions seems to be the value to attribute to the default costs the parent entity should be available or willing to assume or to afford in respect of the subsidiary debt. This point may be seen as a sort of trade-off between bankruptcy costs at the group level and tax advantage of debt treatment at the subsidiary level.

Finally, these issues are evidently connected to others as the significance of comfort letters or credit default swaps underwritten by the parent entity.

Following this reasoning, the first hypothesis does not appear the most effective approach because it lacks of any supportive evidence that the group rating may represent a suitable comparable of the individual rating. Moreover, it also seems that it would depart from the general assumption that the controlled transaction be accurately delineated because it is hardly possible to characterized the transaction as a “group transaction” unless the usual “OECD strand-alone approach” is abandoned.

As a consequence, for the same motives, the most suitable approach seems to admit a rebuttable presumption relative to use of the group credit rating as a “starting point”, from which appropriate adjustments are made. Of course, in this case, some guidance should be provided for identifying such “adjustments”.

Box C.2. Question to commentators

Commentators’ views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

For what we are going to observe also in the following paragraph, using “group’s credit rating” may help tax certainty only as far as appropriate guidance is provided to outline the necessary definitions and to help finding the necessary adjustments.

For example, the individual MNE risk profile credit rating should at best take account of the markets in which the business entity runs its trade, that is normally different from entity to entity, the characteristics of its industry and market, the country risks of those markets and the competitive position of the entity. Also, the individual financial situation introduces differences among the subsidiaries complicating the determination of a “group financial situation”. The individual financial risk profile depends on also management decisions about seeking funding for the company, cash flows the enterprise can achieve and its financial obligations towards external lenders. Finally, a further element to be counted for is that the group credit risk analysis can only begin starting from the analysis of individual member positions, from their shareholding ownership, the presence of captive finance subsidiaries acting as funds providers for all the group
members, their financial prospective needs for increasing fixed and intangibles assets (prospected investments), etc.

Conclusively, because of the reasons above, it may be said that the simple belonging of a company to a group is not a sufficient condition for assimilating its overall risk profile and credit rating to those of the “sum” of the other companies belonging to the same group or to a synthetic “group credit rating”. This result could be achieved only on the condition that appropriate adjustment be made. In view of adopting this approach, an in depth and extensive guidance on all the mentioned issues is needed.

**Box C.2. Question to commentators**

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

A possible definition of “MNE group credit rating” could be as follow: “The lender’s estimate of the creditworthiness of an MNE group as such, based on past history of borrowing and repayment, explicit and implicit guaranties granted by the ultimate parent entity”.

Starting from such a definition, there emerges also the factors that should be taken in consideration when elaborating a “measure” of the group rating. Consequently, calculation of such credit rating will have to be supported at least by the analytical foundation of a “constructive group entity”, i.e. the simulation of having to do with only a single legal entity instead of the actual several group entities.

Even though such definition appears quite coherent and consistent with its scope, it requires a deep analysis starting from the definition of the concept itself of “group”. For the purposes of these analysis, in fact, the terms “group” and “group members” refer to the parent or ultimate parent, and all the entities over which a parent or ultimate parent has direct or indirect control, where “control” should generally refer to the ability to dictate a group member’s strategy and cash flow plans and may be present even if ownership is less than 50% plus one share/unit.

Also the “importance” of the subsidiaries is relevant. As paragraphs 70 e 71 suggest, subsidiary’s status may be relevant in respect of the willingness of support being provided by the group.

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5 Effects of this definition become clear when analysing joint venture structure with 50% capital participation of both the investors.

6 For example, Standard & Poor’s Ratings Services, Group Rating Methodology, November 2013, propose this classification:
   - Core,
   - Highly strategic,
   - Strategically important,
   - Moderately strategic, or
   - Non strategic.
The proposed definition appears to be quite “objective” once an appropriate mandatory guidance will be provided for weighing its different constitutive elements. It also seems sufficiently independent from the evaluation and assessment made by any credit rating agency because it should rely only on quantitative elements derived by the ultimate parent entity’s past behaviour, in turn linked to any single MNE’s behaviour (i.e., the financial obligations assumed in the past, as resulting from balance sheets), together with macroeconomics conditions elaborated by central statistics authorities. Equally independent from credit rating agencies seems to be the statistical tools required for the analysis of these data because it should assume only such internal information and public economic forecast.

The definition seems equally reliable as far as it can be any internal comparable used in a TP comparability analysis. In fact, past behaviour in term of assumption of credit risk as a consequence of the support provided to subsidiaries can be easily and independently detected in the financial accounts and balance sheets of the entity while economic data are not (at least, as a general assumption) influenced by the MNE group ultimate parent entity attitude.

Box C.3. Question to commentators
Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

“Stand-alone credit rating of an MNE” might be defined as “The lender’s estimate of the creditworthiness of an MNE, based on its past history of borrowing and repayment, isolated from any effect of its membership in an MNE group and/or from the supportive effect of explicit and implicit guarantees provided by any other member of the same MNE group”.

Box C.3. Question to commentators
Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

The issue of the “implicit support” has long troubled TP analyses of financial transactions and the potential relative guarantee fees, as recent case law is keeping on showing. Considerations at paragraphs 68 to 74 satisfactorily summarize much of the relevant conclusions, notwithstanding in some points it is not completely clear what kind of support they are dealing with (e.g., at par. 71 e 72). In fact, according to the definition provided at par. 68, “implicit support” is “the benefit that may arise from passive association”, while at par. 69 it seems that “implicit” support is not exactly the same as “passive” support when it is said that “group members are considered to be more, or less, likely to receive group support according to the relative importance of the entity to the group” so suggesting an action or “active involvement” of some group member, consequently giving the impression of a conceivable “active implicit support”. Clarification on this point appear to be necessary.

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7 For different regulatory purposes, a sort of the same mandatory approach has already been adopted by banks regulators and financial watchdogs.
8 See, India, case Everest Kanto Cylinder, ITA No.542/Mum/2012; Canada, General Electric Capital Canada Inc. vs. The Queen, 2010 FCA 344; ECI, Case C-382/16, Hornbach.
Having said that, for what it concerns *implicit support*, and assuming that it comes from the mere “passive” association to an MNE group, it should not be counted for in calculating the creditworthiness of MNE entities, because of the absence of any positive (explicit) obligation of any specific entity of the group. This conclusion perfectly parallels the conclusion at par. 1.158, TPG, according to which “an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group”.

However, it is equally undoubted that an MNE entity, acting as a borrower, will gain some benefit from its association to the group also in case of an “informal” involvement by a group member, i.e., not legally binding or actionable before a court. In these situations, notwithstanding any “active” behaviour is realized, an effect in front of the lenders is certainly recognizable. Admitting such benefit should probably entail an obligation of recognizing some form of remuneration to the “guarantor”.

The immediate critical point is that the benefit originates just because of having grouped several valuable entities without the material possibility of attributing to one or another of them any special recognition or specific assumption of responsibility.

Conversely, as any form of support typically increases the (at least potential) risk of losses to the “support provider” some form of monitoring should be introduced and evidenced in the provider’s legal or accounting statements. From this perspective, introducing some kind of remuneration should not sound so controversial being a sort of effect of the potential risk the “support provider” is going to assume or, at least, is dispose to assume.

A further point relates to the “importance” of the implicitly supported entity. Considerations at paragraph 729 could have some “practical” ground but they can hardly be perceived by external lenders. Admittedly, defining the strategic importance to the group of any of its entity is an extremely sensitive task and probably it requires undisclosed information not easily accessible from outside.

Moreover, in the absence of mandatory rules concerning the disclosure of the group’s strategies any kind of support, either implicit or explicit, might be judged unfairly remunerated with the effect that, in light of the approach suggested at that paragraph, there will be an increased risk of disputes between MNEs and Tax Administrations. Parenthetically, while this hypothesis looks remote and quite unfeasible, the same conclusion seems to be reached at paragraph 74, according to which “The kind of information on which the group would base a decision of whether or not to provide support to a borrower in particular circumstances is usually not available to a tax administration”.

For what it concerns measures of the implicit support effect, it does not seem controversial that an implicit guarantee cannot have the same value as an explicit arrangement from another group entity, at least in the absence of any legally enforceable obligation. Besides, as the value of a guarantee depends on the probability of the guarantee being triggered and the extent of the shortfall

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9 Paragraph 72: “In the case of an entity which is of no strategic importance to the group and has only weak linkage it might be appropriate on the prevailing facts and circumstances to consider the entity on the basis of its own stand-alone rating only”.

between the amount guaranteed and the debtor’s available own resources, in case of implicit guarantee no “trigger event” can formally be deducted in a comfort letter or in any similar agreement.

In these situations, supposing that support is due only by the parent entity, consideration may be put to the percentage of ownership, management control or the shared name of the group. With regard to elements relative to the borrower, importance can be attributed to its strategic importance in the group structure, its country of residence (and if the same of the parent entity or not) or its financial condition (amount of its own capital, its sources of capital, financial capacity or nature of the investment for which financing is required).

Because the support provided is not legally binding, the support provider may choose a sort of “selective default hypothesis” of its subsidiary, i.e. to let the subsidiary going default, only when a certain threshold of cash flow reveals it insufficient for effectively supporting it. More analytically, a “marginal default probability” of the borrower and of the group should be estimated, under the assumption of an optimal debt level of the parent or MNE group.

**Box C.4. Question to commentators**

Commentators’ views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

The structure of paragraph 70 seems to show some inconsistency as far as its first part deals with explicit support while the second describes hypotheses of implicit support without any apparent meaningful linkage.

Assuming the point of view of the analysis in the draft, i.e. admitting a sort of weighted comparison between “qualified” entities of the Group, whose relative weight is due to their links and strategic importance in respect of the Group strategy, the different effects of implicit and explicit support become relevant. Firstly, from an external lender’s viewpoint, it is quite difficult to estimate the level of “strategic importance” of any entity of the Group. This is more and more evident in case of highly integrated MNE group. This situation may give rise to a sort of “adverse selection” effect that might penalize the most “strategic” entities of the Group, whose creditworthiness risks to be estimated at the (presumably inferior) level of the less strategic ones. Only by giving evidence of an explicit support by the MNE group such effect of adverse selection could be overcome.

Differently, if no such distinction is introduced, with the effect of putting on an equal footing all the entities of the group, the relevance of the implicit support is able to have some positive effect on the credit rating of the borrower MNE. Without being compelled to analyse the “strategic” structures and objectives of the MNE group, the lender will assume the credit rating of the Group (or, at least, of the ultimate parent entity) as a consequence of a reasonable expectation that group support be granted to the single borrower.

Conclusively, the analysis at paragraph 70, even if it introduces some objectively important feature that the group financial managers should assess, it should be similarly further deepen to lead to the
introduction of some more effective definitions and guidance for the analysis from a lender’s viewpoint.

**Box C.5. Question to commentators**

*Commentators’ views are invited on:*

- the role of credit default swaps (CDS) in pricing intra-group loans;
- the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

According to literature and commentators, CDS spreads are better measures of default risk than bond spreads for a number of reasons. Roughly speaking, mainly because: the corporate CDS market is more liquid than the corresponding bond market; it is difficult to construct bond spreads in practice (for example in terms of maturity matching); it is well known that the CDS market plays a leading role in the price discovery process. Evidence from data shows that loan spreads have become significantly more responsive to the price of risk in the CDS market. For all these reasons it is quite comfortable saying that CDSs play a fundamental role in pricing loans in general. Such conclusions hold surely true also for “external” loans where the group treasury manager enters financial agreements with third party financial institutions. In these situations, pricing the loans is made according to the ordinary market’s procedure (at arm’s length).

In case of pricing intra-group loans, the situation might appear slightly different because of the effect of the group relations. In fact, if it is assumed that the shareholder of the borrower would take on (at least, partly) the risk of default of the controlled entity, this component would impact on the loan pricing. But this effect should only be relevant for pricing the external provision of cash that market lenders know to be univocally destined to a controlled group entity different from the group treasury manager that enters the loan agreement. In this case, the group creditworthiness may play a role in the pricing process.

In intra-group loans these effects should be neutralized for determining the arm’s length interest rate. The problem at this stage is to determine the stand-alone credit rating of the intra-group borrower. In this case, a CDS quotation could surely be considered a suitable comparable also for intra-group loans as far as it is able to express the creditworthiness of the group borrower as a stand-alone borrower and the consequent interest rate applicable to its request for financial resources.

**Box C.6. Question to commentators**

*Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.*

Loans are perhaps the most common and simplest channel for providing financial resources to business. However, market’s practice gives evidence of other channels as suitable as loans for

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providing such resources and depending on the specific necessities and characteristics of the borrower and its purposes. These alternatives, however, present some differences depending both on their legal and economic structures which have effects on the TP comparability analysis.

As a start, a short list of suitable financial agreements and instruments (giving rise to interest deductions) have already been enumerated at Chapter 2, par. 36, of the Action 4 2015 Final Report – “Limiting Base Erosion Involving Interest Deductions and Other Financial Payments”. It includes:

✓ profit participating loans
✓ instruments such as convertible bonds and zero-coupon bonds
✓ alternative financing arrangements, such as Islamic finance
✓ finance leasing agreements
✓ derivative instruments or hedging arrangements related to entity’s borrowings.

Even though financial payments related to such financing agreements present the common feature of giving rise to deductible expenses and the consequently TP issues, their specific characteristics make them hardly comparable from the viewpoint of risks assumed and functions performed to a “simple” loan agreement.

Starting from this remark, one distinction may be drawn with reference to the destination of the cash needed by the borrower, in particular if the cash provided is to be destined to investment for the acquisition of machinery or other technical equipment rather than the mere ordinary functioning of the enterprise.

According to such a distinction, leasing agreements, for example, are valid alternatives to loans. In fact, if the loan has been entered into for obtaining the resources to acquire technical equipment, such a loan and an operative lease agreement seems to be a comparable “realistic alternative” in respect of the business rationale behind the controlled transaction and the risks attached to it.

Following the same reasoning, repurchasing agreements (“repo” transactions) cannot be considered similar to a loan entered into for the same reason as before. However, a repo or a combination of derivative contracts might be assumed as comparable to a loan if the whole set of provisions regulated the transaction give sufficient evidence that its risk profile and economic effects are substantially equivalent to a loan. If this happens, also these kinds of transactions might be considered a realistic alternative to a loan.
Conclusively, if the previous considerations may be held generally true from a financial perspective, the problem could arise when assessing the comparability of loans and any of the mentioned (financial) alternative having regards to the “five comparability factors” od the OECD TP Guidelines\(^\text{11}\).

**Box C.7. Question to commentators**

**Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.**

With reference to the issue of whether an MNE group’s average (external) interest rate can be considered an internal CUP, primarily it seems necessary to identify exactly all the elements of the definition before engaging in such an analysis.

According to the OECD TPG, an “internal comparable” is a comparable transaction between one party to the controlled transaction and an independent party while an “external comparable” transaction occurs between two independent parties, neither of which is a party to the controlled transaction.

As regards this definition, par. 2.16 states that “It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price. For example, a minor difference in the property transferred in the controlled and uncontrolled transactions could materially affect the price even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin”.

So clarified the perimeter of the analysis, some problems may arise in respect of the concept itself of “MNE group’s average interest rate”. Basically, to postulate a “group’s average interest rate” to be used as a comparable for measuring the arm’s length interest rate of a specific individual loan granted to a specific group entity seems to contradict the principles on which the comparability analysis is grounded. In fact, the OECD TPG contemplates several factors and limitations to make the results of such an analysis acceptable and the basic principle is that the controlled transaction and the uncontrolled one be “similar”. As a consequence, assuming a group’s “average” seems to contradict blatantly those principles notwithstanding all the reciprocal influences that group membership may determine on the credit rating of an individual borrower, in term of explicit or implicit support from other entities of the group.

\(^\text{11}\) Reference is made to the economically relevant characteristics that need to be identified in the commercial or financial relations between associated enterprises in order to accurately delineate the actual transaction:

1) The contractual terms of the transaction
2) The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices
3) The characteristics of property transferred or services provided
4) The economic circumstances of the parties and of the market in which the parties operate
5) The business strategies pursued by the parties
Neither seems it acceptable to admit and introduce some kind of correction factors. Indeed, no such a factor can correct the initial assumption of pooling different no comparable transactions. On this issue, some guidance is provided by the OECD TPG (par. 2.17), according to which where differences exist between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. However, although the TPG themselves suggest that practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods and every effort should be made to adjust the data so that it may be used appropriately in a CUP method, pooling different financial transactions realized by different entities of the MNE group seems going quite too far from the accurate delineation of the transaction to be priced in light of the comparability factors usually adopted since the beginning of the comparability analysis.

**Box C.8. Question to commentators**

With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

Because cash pooling agreements are aimed at achieving the most efficient possible cash management, a physical pooling option may determine the cash pool leader to assume risks with respect to direct lending to MNE borrowers. Considering the mechanics of this kind of cash pooling alternative, such event seems to be quite far from being remote.

In a physical cash pooling, participants agree to move their excess cash on a periodic basis to an entity within the corporate group called “cash pool leader”. The cash pool leader concentrates excess cash from participating business units and uses those funds for the benefit of the participants. Cash pool participants with a cash deficit can receive an intercompany loan from the cash pool leader and pay interest to the cash pool leader. Participants that contribute excess cash to the pool receive interest on the funds they make available. Funds advanced to the cash pool leader appear as an asset on the balance sheet in the form of intercompany loans. Similarly, funds borrowed from the cash pool leader appear as a liability, classified as intercompany loans incurred. All these features imply that in the case of physical pooling, the cash pool participant with excess cash is explicitly lending funds to the cash pool leader, and cash pool participants with cash deficits are incurring an intercompany obligation to repay funds to the cash pool leader while the bank administering the accounts has no direct economic exposure.

In the event of an enterprise distress, or a problem with a specific cash pool participant, the obligations arising from the cash pooling agreement would create mutual and enforceable legal obligations between the cash pool leader and each cash pool participant. The cash pool leader would be under legal obligation with each separate cash pool participant. This means that a cash pool participant that is unpaid by an insolvent cash pool leader can look only to the cash pool leader for recovery while if an MNE borrower that has received funds from the cash pool becomes distressed, the cash pool leader may proceed only against the particular cash pool participant to which it has advanced those funds. As a consequence, the group leader should be granted an appropriate remuneration beyond the one granted for the services provided as cash pool manager.
Besides, in these situations, it becomes crucial to estimate the credit rating of the Group borrowers and the consequent interest rate applicable to them even though being members of the same Group implies that some guarantees or fees upon the borrower could be (partly) avoided or reduced because the lender may be a sort of lender and guarantor at the same time. Such positive effect of the implicit or explicit support that may be attributed to the Group membership should be reflected in the conditions of the loan agreement, i.e., the cash pooling clauses, for reducing the cost of lending and also these conditions should undergo a TP comparability analysis.

Box C.8. Question to commentators

Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular,

- are there circumstances in which one or another of the approaches would be most suitable?;
- does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?;
- whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

Because the main benefit in entering a cash pooling agreement is a more effective liquidity management reducing the cost for external borrowing, allocation of such benefit should firstly take in consideration the provision of net cash balances by any pooler. In fact, absent this provision the cash pooling structure would not be able to deliver any benefit to the poolers. If this is true, the obvious, and perfectly coherent with the TP approach, consequence is that the entities providing positive cash surplus should obtain some compensation at least considering their loss of opportunity in term of a free risk investment in the financial markets (cost-opportunity approach). Secondly, on the other side, also poolers with cash deficit balance should receive some benefit in entering such agreements that should be at least equal to the difference between market interest rates and the charges due to their deficit position. In fact, these poolers when entering the agreement should be better off than not entering otherwise there would be no reason for participating in the pooling.

If these are the limits that characterize the two different possible situations of the poolers, the approaches envisaged at paragraphs 126 and ff. should be mitigated as far as those positions need to be equally considered. Thus, “enhancing the interest rate for all participants” (the option at paragraph 127) or “applying the same interest rate for all participants regardless of whether they are depositors to or borrowers from the pool” (option at paragraph 128) it seems to ignore the different options that the market offers in an arm’s length equivalent transactions. Also, the third option at paragraph 129 does not recognize the same market’s opportunity in favour of the “net borrowers” in terms of being better off outside the pool.
Actually, cash pooling arrangements (as captive financial institutions) represent a solution aimed primarily at overcoming the higher costs of borrowing at market’s rates. Consequently, in the balance of interest between net borrowers and net lenders of the same MNE group, the economic rationale of the agreements should give some preference to the greater benefit at hand in setting up the pooling, i.e., a reduced interest rate for the net borrower MNEs. Only secondly, the cost-opportunity remuneration for the cash surplus providers should be taken in consideration as a sort of unintentional effect of the agreement. Moreover, in this evaluation some weight should be attribute also to the potential cost of the financial recovery of those MNEs in case of their default. From a practical viewpoint, an arm’s length free risk interest rate conveniently adjusted for the net position respectively assumed in the cash pooling (i.e., depending on the effective debit or credit position assumed) could represent the best option for gauging the two opposite positions of the poolers. In point of fact, it must finally be admitted that cash pooling structures (as captive financial institutions or other group services providers) have been devised with the (almost) exclusively aims of avoiding the external sourced cost of borrowing realizing internal economy of scale or internal cost savings that hardly can be replicated in the markets.

Box C.9. Question to commentators

In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

In the conditions described at par. 102, it appears evident that if an MNE would have not be willing to participate in the cash pooling agreement but, because of the connection with the other members and in view of the overall Group strategy, it had to do it, this obligation should be priced and a remuneration be granted to it.

This result seems to be coherent with the usual TP approach to the extent that if the MNE worsens its position to befit the other members of the Group (i.e., by reducing interest payment to external lenders or increasing the credit rating of the MNE group “as a whole”) it is legitimate to ask for an appropriate indemnification.

This particular situation should probably be given evidence in the TP documentation describing the cash pooling agreement because of such negative effect that the group membership determines on the individual MNE. While it is worth observing that from the viewpoint of the Tax Administration this situation might be hardly identified, the “damaged” MNE is nevertheless exposed to the risk of a tax assessment and, probably, also this risk should be priced and indemnified.
Box C.10. Question to commentators

Commentators’ views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

Commentators’ views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

Because of the risks previously considered, it is common practice for cash pool participants being required to enter agreement aimed at granting others debit balance by bank lenders because of their treasury function.

These agreements are often coupled with parallel internal agreements aimed at recovering the potential losses against the default of one of the other MNEs member of the cash pooling (“contribution and indemnity agreements”). Such agreements should provide that, to the extent that the bank asserts any right of offset or guaranty claim against one cash pool participant in respect of a default of a sister company, the cash pool participant may recover its losses against the defaulting sister company.

While contractual structures may be influenced by the differences in the relative applicable laws and other legal and regulatory requirements (e.g., insolvency rules), the common feature of such “cross guarantees” is to (apparently) reinforce the lender in case of an MNE group member’s insolvency. Actually, this issue seems to present further implications beyond strict TP issues. In fact, while some Countries consider this practice as a good way for smaller MNE groups to obtain bank funding, others are evaluating the greater risks of default and debit crunch, with larger effects on the industry, because of the increased difficult of controlling the chains of guarantors, especially when they are residents in several Countries and their credit rating is not officially recognized or recognizable.

Because of such different implications of this issue, a specific analysis should follow up either from a TP, and a more general taxation, viewpoint (e.g., if these agreements may be qualified for the application of local thin capitalization rules or withholding taxes), and from a wider (banking and insolvency) laws and regulatory perspectives.

While the Final Report on Action 4, Limiting Base Erosion Involving Interest Deductions and Other Financial payments, has already dealt with some of these issues, the specific problems “cross guarantees” are arising, even before some Courts, should probably deserve ad hoc considerations wider than those at paragraphs 130 and 131 of the Draft.

Box C.11. Question to commentators

In a situation where there are off-setting positions within an MNE group, commentators’ views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

As it is made clear by the TPG itself, “A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated
enterprises” (par. 1.56, TPG). Consequently, the asserted exposure to risks should determine, for TP purposes, that the MNE bearing such risks has the capability of responding to them also from the financial point of view (adequate capital endowment or some form of guarantees). Having said that, it follows that to offset two or more positions requires that the entity must currently have a right of set-off that cannot simply be contingent on a future event but must be legally enforceable in the normal course of business or in an event of default or insolvency of the entity or any of its counterparties.

Under these conditions, that are relevant also for accounting purposes, it results that the only profits and losses that can be booked by the entity are those deriving by those enforceable rights and obligations.

In a different context, an off-setting effect could emerge only in case of participation to a consolidation regime of the profit and loss accounts of all the entities of the group but this result cannot obviously be envisaged under a TP perspective.

Box C.11. Question to commentators
Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators’ views are invited on whether that risk should be treated as being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

In the proposed scenario, it seems that the unhedged MNE is assuming a larger than arm’s length risk because of the group policy that is imposed upon it. If this is the situation it can hardly be admitted that the full risk, and the relative costs, should be upheld only by that entity. This conclusion seems coherent with the definitions proposed by the TPG, according to which “control over risk involves (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function” (par. 1.65). Where these conditions are not verified, “the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk” (par. 1.98).

Conclusively, obeying to the group policy determines that the unhedged MNE will have the right to claim an indemnification for the larger risks and costs it has to assume.
Box D.1. Question to commentators

Commentators’ views are invited on

• how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);

• the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;

• where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and

• examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

Financial guarantees maybe considered as twofold (explicit or implicit) agreements with different effects if looked at from the viewpoint of the borrower or the lender but with the almost unique aim of facilitating cash provision to the borrower by the assumption of some obligations by the guarantor.

From this first “definition” it follows that the accurately description of the guarantee granted to a related party by an MNE should start making it clear if such guarantee is implicit or explicit because very different are the effects of the two forms of guarantee.

In fact, usually, an implicit guarantee (e.g., a letter of comfort) does not create any legally enforceable obligation on the part of the (related party) issuer with regard to the credit exposure. However, it can give evidence to the lender that the borrower is part of the MNE group to which the implicit guarantor also participates. This condition give rise to the issues already discussed at Chapter I, section D.8-MNE group synergies of the OECD TPG. In particular, if the borrower is enjoying only incidental benefits attributable solely to its being part of a larger MNE group because of the absence of any legally enforceable obligation.

As par. 1.158 OECD TPG makes it clear the term “incidental” refers to benefits arising solely by virtue of group affiliation and “in the absence of deliberate concerted actions or transactions” leading to that benefit, as depicted in the example 1 at par. 1.164. Consequently, in case of the issuance of a comfort letter is hardly deniable that a “deliberate concerted action” has been taken so excluding the hypothesis of being in a situation of simple “passive association” to the MNE group. But, the absence of any legally enforceable obligation seems equally to exclude also the case exemplified at par. 1.167, where the parent company “P agrees to guarantee the loan from Bank A in order to induce Bank A to lend”, as this example deals with an explicit guarantee.

Similar conclusions are illustrated at par. 7.13 OECD TPG where it is stated that “no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from deliberate concerted action involving global marketing and public relations campaigns”.

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The central points of this analysis lead to the conclusion that some further guidance on the effect of implicit guarantees should be provided. This necessity becomes more and more evident also because of not uniform case law in different Countries. In fact, while the “GE Capital Case”\textsuperscript{12} gives evidence of the Canadian Court’s opinion about the arm’s length fee payable because of the granting of implicit support that should not be ignored as it is an economically relevant characteristic of the transaction and should be taken into account, the European Court of Justice, in “Hornbach Case”\textsuperscript{13}, recognizes that “there may be commercial reasons for a parent company to agree to provide capital on non-arm’s length terms”, i.e., without any payment for interest.

The further question as to what circumstances a guarantee is insisted upon by an independent lender, may find an answer when it is considered that lenders have the necessity to be reasonably certain that the borrower (or the guarantor) would comply with its obligation. From their perspective the best choice would probably be a legally binding guarantee actionable in front of a Court. But under certain circumstance also an implicit guarantee might satisfy the same need, e.g. when the implicit guarantor put special attention to reputational risks.

Finally, the effect on the cost of borrowing will be surely positive when a guarantee is provided because of the amelioration of expectations by lenders (and credit rating agencies) that legal obligations due to credit facilities will be somehow respected. Of course, the exact measure of such amelioration will depend on the specific clauses of the guarantee agreement. The larger and more comprehensive are the risks covered by the guarantor, the higher will be the reduction of the interest rate required by the borrower (and reasonable consented by the lender) and the increase of the credit rating of the borrower.

Box E.1. Question to commentators

Commentators’ views are invited on the following:

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;

- when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and

- whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;
• when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

From a general point of view, an insurance policy represents the obligation of the insurer to assume a certain risk instead of the original debtor. Following the general OECD TPG definition, “control over risk involves ... (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function” (par. 1.65, OECD TPG). This implies that the insurer is accepting the material effect of the obligation of letting indemnified the insured in respect of the payment of a certain premium.

Apart from the hypothesis that the transaction is not genuine, from this definition it emerges that for recognising not only the existence but also the transfer of the risk (deriving from an original transaction/obligation) to the insurer a legal approach should take in account the effectiveness of such transfer of the original obligation.

This implies that it should be verified if the original creditor is granted effective actions for having access to administrative authority or to a court to see its rights duly recognized and indemnified by the insurer.

If this right exists it can be said that the insurer has actually assumed the risk covered by the policy issued. It further follows from this approach that any indicators will be unnecessary as far as the only effective measure for verifying the effective assumption of the insured risk by the insurer remains the actionability of the right by the original creditor. If this actionability lacks, any “external” indicator could appear, and actually becomes, only a mere formal “declaration of intent” of the policy issuer.

The first consequence of the effective assumption of the insured risks by the MNE policy issuer is the equally effective assumption of the risk of suffering losses for payments due at the verification of the event covered by the policy. The indemnification of the insured or the satisfaction of the original creditor’s claim will give rise to losses equal to the payment due or to costs equal to a reinsurance policy underwritten with another (professional) reinsurer.

Another consequence of the actual assumption of risks and the performance of the related control functions in respect of such risks, is that the MNE group member that issued the policy should be recognized an appropriate return. Because underwriting policies deals with the selection of risks and rating insured risks deals with the pricing system applicable to the risks accepted, useful reference for pricing an arm’s length premium may obviously be found if looking at the current practice of the insurance market and commercial database (e.g., actuarial analysis or credit derivative contracts).
Results of the previous analysis seems to maintain their soundness also in case of outsourcing underwriting functions. Usually, “insurance underwriting” consists of analysing and evaluating risks to be insured through technical and actuarial analysis that provides the insurer with in-depth opinion on a certain issue or risk in view of fixing the premium for it being assured, having regard to the potential exposure and the likelihood of losses to be incurred by the insurer. However, notwithstanding this core function, it does not seem that the final decision of assuming a risk may reside only upon the “insurance underwriter” with the effect of transferring upon him the risks at hands. Differently, it is always the insurer that accept or not the risks and correspondingly requires an appropriate premium. If this conclusion may be accepted, the “control over risk requirement” seems to be satisfied even if the supportive function considered has been outsourced. In any case, some examples may surely be useful for clarifying a so delicate industry practice.

Following the same reasoning, not satisfying the “control over risk requirement” implies that insurance arm’s length premia due for the policies issued cannot be attributed to the captive company. So, the latter could claim the recognition only of a “free risk remuneration” at maximum not having to face any substantial risk. In this case, premia paid should be attributed to the entity (the reinsurer) that is going to substantially assume the risks insured, leaving to the policy issuer only a commission fee for having provided the placement service.

Box E.2. Question to commentators
Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

Paragraph 181 briefly proposes to adopt an approach based on actuarial analysis for pricing captive insurance premia as an acceptable alternative to internal comparable.

Firstly, it is worth noting that, as general experience, captive insurers hardly have “external” transactions to be relied on for an internal comparability analysis. Notwithstanding this circumstance, comparability analysis under the usual OECD approach may in any event be performed according to one of the other methods different from the “CUP method” enumerated at Chapter II of the OECD Guidelines. In fact, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case “[taking] account of the respective strengths and weaknesses of the OECD recognised methods” (par. 2.2 OECD TPG). Having recourse to one of those methods seems always possible even though it is to remember that captive companies have been set up almost exclusively to minimize the costs of the provision of services from external economy, i.e., from entities outside the “MNE group” itself.

Besides, in the insurance industry, commercial insurance premia are padded to cover the insurance company’s own profit margins and overhead costs while captives’ premia tend to be lower because those companies are not attempting to make greater profit but provide insurance policies (insurance services) at lower cost than the ordinary market’s ones. Effectively, the key difference between a commercial insurance and a captive company seems only to be that the owner of the captive assumes both the role of the insurer and the insured. Further, captive insurers are generally designed to “complement” and not wholly replace an external company’s commercial insurance by addressing only certain kind of risks more efficiently. This reflects also on the capital adequacy
requirements, as noted at paragraph 183. Under these conditions, the usual comparability methods might be inadequate if not adjusted for taking account of this peculiar feature of such service providing entities. Yet, these differences should not be emphasised too much considering that “when associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way” (par. 1.2, OECD TPG) as it happens between independent entities.

Consequently, to avoid transfer pricing disputes with Tax Authorities the “usual” (independent entities) OECD approach is thought to maintain fully its usefulness and the comparability methods duly adapted to this industry continue to supply adequate basis for the analysis. In this case, reference might be made to the cost of a re-insurance policy covering the risks assumed.

Nevertheless, an “actuarial approach” leaded by actuarial analysis could also be adopted. These analyses require to take account for the specific risks assumed (e.g., market risks, operational risks, credit risks, environmental risks, etc.), the performance history of the insured entity, the potential losses, etc. The difference between the two approaches may be attributed to a figurative commission of the captive company, having also regards to the capital requirements imposed by industry regulators.

Finally, also credit derivatives commissions could be helpful for such pricing and comparability analysis. While differences exist between insurance policy and credit derivatives, they are instruments for leveraging credit risks and, as such, may be assumed in the comparability efforts required by transfer pricing analysis.

**Box E.3. Question to commentators**

*Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.*

The example deals with the situation where a Company A performs both goods selling functions and insurance policies reselling functions. Those functions are relative to goods produced and policies emitted by other entities of the same Company A’s group.

The example is good at describing a situation where the “unique” contribution to the transactions comes from the commercial organisation of the business (the business model) and the role played by the retailer that maintains and safeguards the profitable relations with the final customer/clients (the “value chain”).

In a sense, it seems a good case for a residual profit split analysis where Company A’s routine functions, i.e., selling consumer goods, is followed by the non-routine supply of insurance policies. If this conclusion is true, the example would not appear to be the most appropriate example of an “agency situation” as that considered at paragraph 186 because it does depict a transaction where selling policies is only accidental and secondary to the main activity of the seller so that it can hardly be defined as an insurer agent whose main or core activity is, of course, “arranging” such supplies. Actually, if the example fits well for illustrating the application of the profit split method, it seems more unclear in providing some guidance for a “selling agency” situation.
Instead, what it emerges clearly from the example is that Company A enjoys a strategic (but incidental) competitive advantage due to the direct contact with the buyers of those products that are incidentally covered by the insurance policies provided by Company A’s MNE group. Of course, notwithstanding this competitive advantage be incidental, it should be adequately compensated.

Quite differently should it be the guidance for determining the arm’s length remuneration of a “sale agent” working as paragraph 186 seems to suggest. As any other “agent” attention should be devoted to the risks it assumes, functions performed and assets used. The case in the example seems to be excessively peculiar and does not give exhaustive guidance for “agency sales”.

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Kind regards.

Borioli & Colombo Associati
Transfer Pricing Team
Giorgio Borioli
September 7, 2018

Tax Treaties, Transfer Pricing and Financial Transactions Division
Center for Tax Policy and Administration (CTPA)
Organisation for Economic Co-operation and Development (OECD)

(delivered via email)

**BEPS Actions 8-10—Financial Transactions (3 July – 7 September 2018), Public Discussion Draft, Base Erosion and Profit Shifting (BEPS) project**, (hereinafter, the “draft”)

**Comments by Pat Breslin**

Dear members of the OECD/CTPA and working parties:

Breslin Consulting would like to thank the OECD including the Tax Treaties, Transfer Pricing and Financial Transactions Division, and the Center for Tax Policy and Administration (CTPA) for the opportunity to provide input on this very important project.¹

As with previous input and comments on OECD international tax projects, I preface by noting extensive experience in areas directly relevant to the discussion draft and this project. This includes experience as a business executive negotiating financial transactions and other arm’s length transactions; managing finances as CEO of an independent high-tech enterprise; and in other areas on which the draft focuses. Furthermore, I have extensive experience as an economist and expert on matters involving international tax and transfer pricing including issues relevant to the draft.

**Executive Summary**

The comments can be summarised as follows. The introduction includes general background of relevance to the draft and my comments in particular. General background on transfer pricing and the context in which the draft was issued is provided—portions of which may seem quite familiar to those experienced in transfer pricing. However, it was felt that this initial background provides extra context for other audiences that may have interest in such issues, while it helps establish context for the main thesis of the comments, as discussed below.

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¹ Hereinafter, these comments in response to the draft will be referred to as “the comments.”
The thesis of the comments is as follows: The draft guidance on financial transactions focuses heavily on MNE group-focused attributes in analysing related party transactions. This contrasts with wider application of the arm’s length principle in other contexts—including with respect to many other transaction types, as well as financial transactions in different tax jurisdictions and contexts.

In other OECD guidance and in practice, the arm’s length principle focuses on a party-specific approach that analyses specific facts, circumstances, functions, assets and risks of each transacting party in relation to the transaction and each other. It then compares these relevant factors with independent parties and their transaction. The analysis posits the specific related parties as if they were unrelated (the “independence hypothesis”) in order to eliminate the price-distorting effects imposed by their related conditions. In some respects, a focus on group attributes as appears in the draft may risk undermining the independence hypothesis. Further, it can be conceptually at odds with an arm’s length approach that seeks to determine outcomes that would occur, but for related party conditions including group attributes.

This general theme is combined with a number of other invited comments (as posited by the draft’s “box” request items). Specific box and section areas addressed include those listed under Contents below.

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I. Introduction

Transfer pricing analysis is inherently party-specific. It analyses related party prices and profits in relation to comparable transactions between independent parties. Comparable independent party transactions provide an objective basis for comparisons because independent parties are unaffected by conditions imposed when transacting parties are related—i.e. related conditions.

Here, a transfer price emanates from any transaction between related parties—such as affiliated companies in a multinational group. Because they are related parties, multinational affiliates would have potentially unlimited discretion in setting transfer prices with each other.

Thus, Affiliate A in Country A (a low tax jurisdiction) could over-charge when it sells to its related Affiliate B in Country B (a high tax jurisdiction). The effect of this higher transfer price would be to shift taxable profits from Country B to Country A—lowering B’s profits and taxes, while lowering tax liability for the multinational group overall.

However, if B were independent of A and other group companies—instead of their related party—B would naturally be opposed a higher price that reduces its profits. Further, B would likely be indifferent to lowering taxes for unrelated parties and their group. Acting independently, B would shop around for the best price and, if A wanted B as a customer, competition would discipline A’s pricing approach. Independently negotiated prices, and competitive prices under market conditions, are considered arm’s length prices.

Related conditions and price-distorting effects

Absent any legal or regulatory constraints, the price-distorting effects of improper transfer prices have detrimental effects on the world economy—depriving governments of taxes due and exacerbating fiscal concerns worldwide. Increasingly, governments (individually and collectively) scrutinise whether and how transfer pricing schemes undermine effective taxation. Regulators are also concerned the effects are anti-competitive, giving MNE groups unfair advantages and discriminating against other companies and countries—in addition to taxpayers globally.

For decades, the arm’s length principle has been an antidote to improper transfer pricing. It is in use by tax authorities and multilateral institutions worldwide. The arm’s length principle holds that, for tax purposes, transfer prices must reflect arm’s length prices—that is, prices consistent with what independent parties would willingly agree to pay (or receive)—given the same or a similar transaction under comparable facts and circumstances.

A party-specific versus a group-focused approach to transfer pricing analysis

As discussed in comments below, among the author’s main observations is the degree to which the draft appears to depart from, or at least relax, the OECD’s long adherence to core tenets of applying the arm’s length principle. Often the draft appropriately references and describes these core tenets. But, perhaps unintentionally, other aspects of the guidance do not seem to fully support arm’s length concepts.

The author is concerned that this could potentially undermine application of the arm’s length principle both in the context of the draft and more broadly in other contexts. This could also be detrimental to guidance in other areas where use of the arm’s length standard relies on different interpretations than

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those appearing in the draft.

Principle among the author’s concerns is the tendency for the draft to rely on analysing related conditions among MNE affiliates as a basis for determining an arm’s length result—rather than adhering more strictly to the existing OECD guidance on identifying arm’s length conditions experienced by independent parties, for example.

In particular, the draft appears to rely heavily on MNE group attributes as factors impacting its conclusions about appropriate pricing. Relative to other guidance, the draft appears to intermingle facts and circumstances that pertain more to the MNE group as a whole, and less to the specific related parties to the transaction and other specific relevant parties.

This concerns the author because MNE group attributes are themselves related conditions and arguably are among those price-distorting conditions that an arm’s length analysis seeks to avoid by observing independent party transactions.

Thus, the comments below examine the guidance in the draft with particular attention to some key questions:

1. To what extent does certain guidance depend on comparisons that rely on group attributes rather than the specific facts and circumstances of the transacting parties, and any other (specific) parties of importance or relevance to the transaction?

2. To the extent the draft does weigh group attributes and, more generally, related party conditions more heavily than other guidance, what are the implications for the draft itself and for other guidance? What potential impact does this have on our understanding of the arm’s length principle?

As an expert and proponent of proper application of the arm’s length principle, the author offers a few parameters in examining the questions above:

The author sees arm’s length analysis as necessarily and primarily party-specific in the sense that its focus must be on the attributes of the individual parties to the transaction. This sometimes tends toward a focus on how the parties are different in terms of what perspectives they would have were they independent parties to a negotiation, rather than related parties under common ownership and control, for example.

In contrast, a focus on group attributes, when present, tends toward seeing the related parties in the same or similar light—with respect to a given attribute—even though one may acknowledge that they are not the same in all respects.

Thus, while the group focus may recognize related parties as having some differences, such as with respect to their functions, assets and risks, it will also tend to attribute aspects of these key characteristics to the group and therefore bypass the critical “independence hypothesis” on which the arm’s length principle depends.

One example of this is in the draft’s conclusions about implicit credit support, which it assumes as widely available to any MNE group affiliate that:

- seeks to obtain a better credit rating and corresponding interest rate, and/or
• encounters any risk of defaulting on its debt.

The draft treats this implicit support as an uncompensated benefit available to all in the group—without any clear limit and without identifying and delineating any specific related parties that (in whole or in part) actually assume that risk without any compensation.

Here, transfer prices (such as interest expenses on related party loans) are heavily influenced by related party conditions—as opposed to arm’s length conditions faced by independent lenders and borrowers.

The author’s comments in such areas may not always be conclusive—and it is acknowledged that the complex subject matter in the draft necessarily confronts challenging issues that may not be amenable to simple or straightforward alternatives. Potential solutions to these issues also may not (as yet) be as evident in these comments, given this early stage in the draft guidance.

Recognising this draft and consultation period as part of a process, the author thus offers the comments with all due respect and commends the drafters and working group members for offering a very thoughtful draft in order to tackle BEPS in this critical area.

II. Box B.1 comments regarding paragraphs 8, 9 and 10

It is an interesting coincidence—not without irony—that the number sequence of paragraphs 8-10 in the draft matches that of BEPS Actions 8-10. This is not only because the draft itself falls within BEPS Actions 8-10, as discussed below.

The irony stems from the fact that—unlike most output from Actions 8-10—draft paragraphs 8-10 seem to place the arm’s length principle in a secondary role. It appears to be merely an optional tool for governments in enforcing transfer prices—here, the intra-group financial transactions subject to the draft.

In contrast, most output from Actions 8-10 has emphasised applying the arm’s length principle as the primary approach to transfer pricing analysis, while adding guidance to improve upon its use. Such guidance applies to different transaction types than the draft; but it comprises almost all transactions not covered in the draft—including tangible goods, services and intangible property transactions, for example.

The BEPS release of Actions 8-10: 2015 Final Reports were collectively entitled Aligning Transfer Pricing Outcomes with Value Creation. This multi-report document begins with the section “Guidance for Applying the Arm’s Length Principle” and embodies revisions to Section D of Chapter I of the Transfer Pricing Guidelines ("OECD guidelines").

Chapter I emphasises an approach that accurately delineates the actual (related party) transaction as a necessary step in determining whether such transfer prices are arm’s length—i.e., consistent with prices that independent parties would willingly agree to pay (or receive) in similar transactions and circumstances.

Correspondingly, Section B of the current draft guidance is entitled Interaction with the guidance in Section D.1 of Chapter I. But where financial transactions guidance is concerned, the importance of using a Chapter I approach seems reduced by a range of competing alternative approaches—some recognised here in the draft, for example, and others which were set forth as best practices by other BEPS guidance.
such as BEPS Action 4, *(Limiting Base Erosion Involving Interest Deductions and Other Financial Payments)*.\(^2\)

To be fair, the draft does not disregard the arm’s length principle—in fact, it describes aspects of it very well and adheres to it at least in part. Section C.1 on pricing intra-group loans is a case in point.

Meanwhile, paragraph 8 of the draft notes that the draft guidance in paragraphs 3 to 7 of Section B.1 is consistent with the (revised) Chapter I of the OECD guidelines as well. Paragraph 8 states,

*Although* this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I of these Guidelines to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the capital structure under domestic legislation before pricing the interest on the debt so determined. (emphasis added)

Paragraph 8 thus mentions Chapter I. But taken in context, it almost seems to imply that the preceding portion of the draft was consistent with Chapter I by coincidence. Here, the arm’s length approach of Chapter I is described as optional—*i.e.* one among other approaches governments may choose to apply (as many actually do). Meanwhile, taken alone most such other approaches need not necessarily attempt to yield arm’s length results. They may or may not be likely to—perhaps by coincidence?

Perhaps the author reads too much into the use of the word “although” in the paragraph 8 reference to paragraphs 3 to 7. But no doubt, it espouses other approaches—including approaches that emerge in domestic legislation—that “may be taken to address the issue of the capital structure” of related parties in regard to financial transactions.

Given the ambiguity, it is worthwhile to examine how the paragraphs preceding paragraph 8 are “in accordance with Chapter I.” In the author’s view, this portion of the draft does seem consistent, as do other sections intended to focus on the arm’s length principle.

In draft paragraph 4, for example, some will recognise that comparing related party capital structures to those of independent parties is in itself a form of an arm’s length test—or at least a useful step in such a test. Indeed, independent lenders analyse prospective borrowers using measures like debt to equity ratios in comparing them to actual independent borrowers—in order to determine a loan amount (if any) the potential borrower might be qualified to receive. Use of such measures is so common at arm’s length that it seems natural to consider such questions in regard to related party debt and borrowers.\(^3\)

Paragraph 4 also considers the connection between related party interest payments and taxable profits—while paragraph 5 addresses the necessary connection between the amount of such interest and the amount of debt on which it is assessed.

Thus overall, this draft section on capital structure is a useful illustration. It highlights that an arm’s length interest rate alone will not necessarily yield an arm’s length amount of interest payments in absolute terms. Instead, the bigger transfer pricing question may be whether a related party loan itself—


\(^3\) See for example, https://hbr.org/2015/07/a-refresher-on-debt-to-equity-ratio
that is, the base on which the interest rate is computed—qualifies as debt (or not). This may be seen as part and parcel to Chapter I guidance on the accurate delineation of a transaction.

Still, paragraph 8 seems to provide a caveat to those who believe their intercompany financial transactions are in keeping with Chapter I and the arm’s length principle—according to their own interpretation. Interpretations of the arm’s length principle can vary dramatically, as the author has noted frequently. Thus, the draft notes that, in practice, governments will feel free to move past debating this potentially complex question in financial transactions contexts. And many already do—using other approaches.

In conjunction with the Action 4 Report, this new guidance envisions governments’ further use of formulaic measures that may require much less analysis and discussion than that required in applying the arm’s length principle—especially where more complex financial transactions are concerned.

For example, paragraph 9 states

Accordingly, this guidance is not intended to prevent countries from implementing approaches to address capital structure and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I as the only approach for determining whether purported debt should be respected as debt.

So, the draft has no intention to “prevent countries” from using approaches other than Chapter I, and will not mandate accurate delineation of financial transactions under Chapter I to assess purported debt. As discussed below, in practice such departures from traditional arm’s length analysis raise concerns for the author.

Paragraph 10 serves to reminds us that the arm’s length principle still plays an important role regarding financial transactions—just as it clearly does with respect to other transaction types. The draft reinforces that Chapter I will continue to be used by some countries—whether as a primary approach or in conjunction with other tests. It also acknowledges that there is less consensus on interpretations of Article 9 in the context of capital structure—and that this draft section serves to provide guidance to countries wishing to use a Chapter I approach.

It is worth asking why this departure from the primacy of the arm’s length principle under Actions 8-10 at this juncture? After all, other major BEPS guidance has just recently succeeded in reinforcing its primary role in objectively determining appropriate transfer prices.

In the author’s view, it may be the excessive amount, proliferation, and highly problematic nature, of intercompany debt that informs the draft’s seeming departure (in part) from the arm’s length principle where financial transactions are concerned. Measures like approaches from Action 4 reflect urgency—like expedient stop-gap measures intended to reverse course rapidly against perceived abuses.

The draft recognises that the magnitude of the problem already has countries making their own rules. Collectively, these create an almost “all hands-on deck” worldwide view towards approaches to tackle the problems.

One needs to look no further than the first sentence of the Action 4 report, which largely reflects the global consensus view, including not only from OECD and G20 countries but numerous other countries worldwide.
The Action 4 report’s introduction begins with a section, *Use of interest and payments economically equivalent to interest for base erosion and profit shifting*. It observes that abuses related to intra-group debt may come all too easily. Action 4 states,

The use of third party and related party interest is perhaps **one of the most simple of the profit-shifting techniques** available in international tax planning. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity.

(emphasis added)

The Action 4 report further elaborates on a range of issues that have made the scale and magnitude of BEPS in the intercompany debt and interest context almost intractable. Below are quotes from the text:

[U]se of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. (paragraph 1)

[S]ubsidiary entities may be heavily debt financed, using excessive deductions on intragroup loans to shelter local profits from tax.

Base erosion and profit shifting can arise from arrangements using third party debt (e.g. where one entity or country bears an excessive proportion of the group’s total net third party interest expense) and intragroup debt (e.g. where a group uses intragroup interest expense to shift taxable income from high tax to low tax countries).

In particular, countries have experience of groups structuring intragroup debt with equity like features to justify interest payments significantly in excess of those the group actually incurs on its third-party debt.

**III. Box B.2 and Paragraph 17**

Box B.2 invites comments that relate to prior questions in Box B.1—which itself addressed potential differences between the *de facto* capital structures of related parties compared to those of independent parties, as a general matter. Box B.1 also addressed whether related party capital structures can be arm’s length when they demonstrate such significant imbalances.

Here, Box B.2 considers debt versus equity financing alternatives in determining the form of an investment transaction. In referencing paragraph 17, Box B.2 invites particular comments that can be considered in two parts (shown below as quoted excerpts):

1. the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or

2. whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

(emphases and numbering added)

Notably, the two items above appear to be presented in the draft as an “either or” pair of alternatives—*i.e.* an all debt or all equity investment. However, paragraph 17 discusses one among potential alternative
approaches to item 2—i.e. a combination of debt (up to a maximum amount) and equity investment (to cover the balance of funds needed by the borrower).

Regarding the “relevance of the maximum amounts” of debt from the perspectives of each of the parties to a financing transaction (item 1), such limits are highly relevant in pricing any transaction consistent with arm’s length conditions.

These limitations are often defined by the “options realistically available” to the transacting parties—who, at arm’s length, would seek better prices or deals that inform their maximum amounts in any case such as this. Such references to Chapter I could perhaps be cited here; but the draft incorporates helpful related guidance in paragraphs 18 and 19.

Paragraph 17 highlights draft section C.1.1 in reference to item 1 above—i.e. The lender’s and borrower’s perspectives in a loan transaction. To the author, arm’s length analysis must consider perspectives of the parties in conjunction with considering their options realistically available (again, see paragraph 19). In keeping with the main theme of these comments, these two major prongs of arm’s length analysis are highly party-specific, according to the parties’ individual facts and circumstances.

From the author’s perspective, a third prong—analysing the transacting parties’ functions, assets and risks in relations to the transaction and each other—completes a necessary three-prong approach to applying the arm’s length principle. All three prongs are inherently party-specific—and they are interrelated.

To counter paragraph 17 at item 2 above, available alternative forms of investment would include convertible debt and other potential types that combine elements of debt and equity. These might also variably include other terms and conditions that are quite common in arm’s length funding transactions. Such terms might deal more directly with the parties’ specific operational and financing concerns and address associated risks.

Convertible debt issues rights to the funder that include elements of debt funding and equity, as well as options to convert debt into equity. This common example has played a role for some high-profile technology companies en route to their initial public offerings. But convertible debt is nothing exceptional—it is a long-standing investment alternative which the author has used in funding transactions—outside of a consulting context.

Corporate finance texts cite numerous other types of debt-related instruments, many of which selectively vary and combine terms and other transactional features that defy traditional notions of pure debt and pure equity as completely separate concepts.

It is in this light that one must regard the Box B.2 items above. In the author’s view, it is not the case that relevance of maximum debt levels acceptable to counterparties (item 1), yields any single “or” alternative such as it appears item 2. As discussed below, paragraph 17 itself demonstrates at least one alternative to item 2 when the conditions in item 1 are considered.

In general, paragraph 17 concludes by describing a total investment comprising 1) a loan amount up to the maximum acceptable to either party, and 2) equity to cover the remaining funds required by the borrower’s business.

Paragraph 17 also progresses the discussion from one of the draft’s earlier points, as it reveals that overall capital structures of MNE affiliates can become way out of balance. Such cases exhibit relatively more debt than independent parties would, or even could, assume at arm’s length—that is, a) from the
perspectives of independent lenders and other investors and, b) as a consequence of a, from the perspectives of independent borrowers and other investees themselves.

There are some clarifying points the author suggests with respect to paragraph 17, in particular with respect to the second and third sentences. Thus, the first three sentences are quoted below in a short numbered list for convenient reference:

1. For example, consider a situation in which Company B, a member of an MNE group, needs additional funding for its business activities.

2. In this scenario, Company B receives an advance of funds from related Company C which is denominated as a loan with a term of 10 years.

3. Assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount.

To the author, sentences 2 and 3 seem potentially out of context and out of sequence in relation to each other. Of course, the author acknowledges that the example concerns MNE affiliates that may, in reality, have more discretion and flexibility in how they conduct their actual dealings with each other—as a practical matter.

Indeed, differences in how MNEs might act, or “do things,” compared to independent parties should not affect determination of an arm’s length result. An arm’s result would be an outcome—such as a loan amount or other transfer price—that is consistent with an outcome that would have been realised if the related parties were independent parties—unaffected by related conditions.

To elaborate, an arm’s length result does not mean the related parties act (or do things) in exactly the way independent parties would—such as by engaging in fist-pounding negotiations, or comparing quotes from competing suppliers that are not members of MNE group whose products an MNE must sell. As a matter of fact, related parties may not act like independent parties in this regard.

However, as long as their transactions reflect arm’s length outcomes consistent with those that would be realized by independent parties engaging in comparable transactions under the same or similar circumstances, the arm’s length principle is upheld.

With that lengthy caveat in mind—sequentially, the analysis of Company B financial projections in sentence 3 would really come before sentence 2 in paragraph 17, under normal circumstances. Of course, given what those projections reveal, under arm’s length conditions, one would ask how the funds advanced in sentence 2 (as written) would occur at all?

The existing ordering of facts in the draft paragraph 17 may be inadvertent. In any event, the author provides comments below on paragraph 17 as it is currently written. However, to the author it may be important to clarify or revise in a future draft.4

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4 Some of the subsequent comments may expound on aspects of the example beyond what may have been intended for comment in Box B.2. But such expanded comments will be quite relevant to other facets of the draft—as the author finds the example serves a useful and broader purpose in this respect.
For the sake of illustration, at arm’s length, Company C could be seen as derelict as a lender, to first advance funds to B in the form of a 10-year loan (sentence 2) and then learn that B’s “good faith projections” make it clear that B cannot service a loan in the amount advanced over the 10-year term.

Here, the author will use vernacular he sometimes employs to illustrate Chapter I concepts like the accurate delineation of the transaction and analysing the functions, assets and risks (i.e. “functional analysis”) of the relevant parties:

In paragraph 17, Who does what, where and when? And, when risk is assumed, a key question is, When?

Here it would be critical to know, who really assumes the risks associated with advancing the funds as a loan? Who has the functional and financial capacity to make such a decision—based on what information—and to bear the consequences of a negative outcome? These types of questions relate to the accurate delineation of the transaction under Chapter I, in particular where allocation of risks—e.g. financial and operational risks—are concerned.

IV. Section C.1.3 and Box C.2 regarding effects of group membership

The author questions whether the rebuttable presumption approaches described in Box C.2 go too far in their emphases on group attributes and related conditions—while they potentially disregard party-specific facts and circumstances that inform key elements of an arm’s length analysis.

Under the first approach in Box C.2—absent a taxpayer’s rebuttal—the default credit rating for each MNE group member would be an independent credit rating at the total MNE group level. In effect, this treats each member affiliate as if it were the same in relation to the group and each other—at least with respect to creditworthiness. (Approach 1)

The second approach (Approach 2) uses the group credit rating as a “starting point from which appropriate adjustments are made.” This is potentially an improvement—at least incrementally—but only to the extent valid adjustments are made that make the entity-specific credit rating more consistent with that party’s actual facts and circumstances.

Thus, if Approach 2 requires adjustments derived from the relevant related party’s facts and functional analysis—why not begin by analysing this information and rather than start with a group credit rating that may not reflect this specific MNE affiliate’s creditworthiness at all?

That is, these two approaches introduce further potential to overlook more relevant party-specific attributes essential to applying the key elements of arm’s length analysis. Such party-specific attributes include the different contributions each party makes to the transaction in terms of its specific functions, assets, risks, perspectives and available options.

Other potential questions arise, such as whether one can “accurately delineate a transaction” between two parties when they are seen as the same in such a key aspect of the transaction. Of course, an independent lender and borrower could have the same credit rating—but never for a reason such as this. If such a state arose in reality, it would more likely be by coincidence.

Another issue is raised in paragraph 65 that is not coincidental but rather might be expected in examining credit ratings for members of a related group. Paragraph 65 highlights that credit rating analysis metrics
“may be influenced by controlled transactions” and using them is “likely to be unreliable without proper comparability adjustments.”

This appears to reflect a compounding or circular effect that can arise from reliance on related conditions as a basis for—or as part of—an arm’s length analysis. A focus on such group-related attributes can distort transfer pricing outcomes and frustrate the purpose of the independence hypothesis and the arm’s length approach.

To the author, it does not seem that group-focused elements of approaches proposed in the draft are consistent with key elements of arm’s length analysis as discussed elsewhere in the OECD guidelines—and in these comments.

V. Box C.3 regarding implicit support and paragraphs 68-74

Box C.3 requests comments on “the effect of implicit support as discussed in paragraphs 68 to 74, of the discussion draft, and how that effect can be measured.”

As noted here and elsewhere, the draft appears to make a clear conceptual distinction between implicit *versus* explicit credit support—such as through a written financial guarantee. It further suggests that these two types of credit support can be separately measured in a clear and distinct way and asks for comments on this question.

One immediate observation is that the concept of implicit credit support reflects related conditions and would be less likely to have any clear analog under wholly arm’s length conditions.

Of course, the draft correctly considers that, for example, a third-party lender may consider a borrower that is part of a related group as having the implicit support of one or more of its MNE group members. But even in that case, while the loan itself may be arm’s length, it does not seem that the intra-group provision or receipt of implicit support can be seen as such.

Thus, in the author’s view, implicit support is reflective of related conditions—no matter what its effect (if any) on the terms of a third-party lending arrangement. After all, implicit support does not exist but for a relationship between related parties. In contrast, explicit credit guarantees can be seen as existing under either related or arm’s length conditions.

Now to the question in Box C.3: Before we can measure implicit support, we must properly distinguish it. Here, the author is concerned that the draft’s implicit *versus* explicit support distinction may be open to inconsistent interpretations, especially when taken together with the revised Chapter I of the guidelines.

The draft rightfully suggests that different facts and circumstances may produce different outcomes, depending on the case. But it also seems to set forth a dividing line between implicit and explicit support that, from a Chapter I perspective, may not be so well-defined.

For example, the draft appears to provide that a related party borrower should not have to compensate implicit support, while seeming to recognise that implicit support may have the same (or nearly the same) effect as a formal guarantee—such as in providing potential benefits to both the borrower and the lender.
The draft could also be seen as inconsistent with Chapter I when it states that only a “legally binding commitment” can define a compensable “guarantee” that is worthy of payment from the borrowing entity. (see paragraphs 138 and 142)

In contrast, according to the revised Chapter I, the accurate delineation of the transaction must consider any formal contract terms in conjunction with the conduct of the transacting parties. Where there are inconsistencies between the conduct and the contract itself—and/or when the contract is silent regarding particular conduct or a factor affecting price—both the contract and the conduct must be considered together.

Chapter I is thus explicit in noting that a mere contractual allocation of risks (or a lack thereof) is not determinative without ascertaining how such risks are assumed in practice by the actual parties, according to their conduct. If the contract is not consistent with the conduct, the allocation of risks will be the actual assumption of risks based on the conduct.

Paragraph 68, describes implicit support as follows:

Implicit support is the benefit that may arise from passive association when, for example, an MNE attains a better credit rating and correspondingly reduced interest rate from an independent lender due to its membership of the MNE group of which it is a part and where there is no contractual obligation of any group member to provide support.

In paragraph 68, the draft is clear in regarding group-related implicit support as producing a benefit to a related party borrower. But according to the draft, unlike Chapter I, a lack of a contractual provision negates the need for any compensation—despite the cited benefits, and regardless of the conduct of the parties.

Discounting implicit support for greater uncertainty?

The draft asserts a degree of certainty regarding the availability of implicit credit support to a borrowing MNE entity. It sees implicit support as “assumed” (i.e. expected) in the view of independent credit raters (see paragraph 151). It also states it that implicit support is “usually” expected by independent lenders (at paragraph 68).

Thus, the draft seems to assume implicit support as a given—a near certainty. However, it also appears to note that legally binding explicit support, such as through a guarantee, provides lenders with greater certainty than implicit support. 5

Given this greater uncertainty, one might then assume that implicit support, when present, should be discounted relative to contractual credit support like a guarantee under otherwise comparable circumstances. Perhaps such a discount might seem moot when implicit support—while usually assumed—is never compensated, according to the draft.

However, measuring implicit support remains important in other parts of the draft—and perhaps it is in these contexts that a notional discount relative to an explicit guarantee might be contemplated, at least in

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5 Further, as discussed in Chapter I, a guarantee reflects “deliberate action” on the part of related counterparties that augments the assertion that it should be compensated. This as opposed to “passive association.”
concept.

For example, in paragraph 141, the draft notes that in pricing a guarantee, one must measure post-guarantee borrowing costs against the “non-guaranteed cost of borrowing, as adjusted for any implicit support.”

Section D.1.2. on “Determining the arm’s length price of guarantees” also notes that, in order to price explicit support like a guarantee, the starting point is to take the non-guaranteed interest rate (or borrowing cost) and adjust it “taking into account the impact of implicit support as a result of group membership.” (see paragraph 149 under Yield approach.)

Paragraph 150 describes the same process in more detail while it notes,

In determining the extent of the benefit provided by the guarantee, it is important to distinguish the impact of an explicit guarantee from the effects of any implicit support as a result of group membership. See example 1 at 1.167 [of Chapter I of the OECD Transfer Pricing Guidelines]. (emphases added)

Thus, according to the draft, it does not seem possible to measure—and, therefore, properly compensate—an explicit guarantee without measuring implicit support; ironically, while not compensating the latter.

Other relevant and specific parties

Difficulties in measuring the benefits of implicit support also may need to be weighed in relation to any potential costs and risks of providing the benefits—and who bears them.

The draft leans heavily on “status” as a member of the MNE group (see paragraph 142)—a related condition—as qualifying one to receive implicit support. This implies that the beneficiaries of such support could become numerous within the group—notwithstanding whether or not such parties in fact borrow. However, the draft is much less clear about who bears the associated costs and risks.

The draft addresses some potential fact patterns that involve pervasive cross-flows of cross-guarantees among many parties within the MNE group—some playing implicit guarantor to others while at the same being supported by potentially numerous others. This group-wide dispersion of allocated risks, costs and benefits could become “impossible” to cope with, according to the draft. (see paragraph 144).

In the author’s view, inferring that such pervasive exchanges of support may occur across the entire MNE group may reflect an over-reliance on group-related attributes and related conditions.

Thus, the author wonders whether, within some MNE groups, it in fact would be smaller set of specific group members that may effectively provide benefit—and bear associated risks—by way of implicitly supporting other affiliates.

Perhaps a more strict and expanded adherence to accurately delineating the transaction would assist in identifying such parties. One might consider specific attributes and connections between the transacting parties and other relevant specific parties of importance in this regard. This might reduce dependence on less clear group-related conditions.

Paragraph 69 introduces a concept of a hierarchy of “relative importance” of different types of entities
within an MNE group—an analysis approach that is further described in paragraphs 70-74 and discussed in greater detail below.

VI. Box C.4 and paragraph 70 regarding likely group support criteria

The author questions the relevance of the analysis in paragraph 70 and whether it could introduce an approach that is inconsistent with the Chapter I guidance on applying the arm’s length principle. It also raises questions regarding draft Section D on guarantees.

For example, Chapter I focuses on the specific related parties to a transaction as if they were independent—concentrating on the functions, assets and risks of each party in relation to the transaction and each other.

In contrast, paragraph 70 proposes a group-focused analysis that considers transacting entities primarily in relation to i) their entire MNE group, and ii) individual group members that are neither parties to the transaction nor necessarily relevant to it.

By focusing on MNEs in connection with their membership in a controlled group of companies, paragraph 70 risks departing from the independence hypothesis on which Chapter I is based.

The group-focus of the approach naturally would influence a determination of loan terms and interest—through its effect on a borrowing entity’s credit ratings—but from a non-arm’s length context.

Paragraph 70 lays out criteria for likely group support of a group member entity based whether that entity:

1. has “stronger links,”
2. “is integral to the group’s identity or”
3. is “important to [the group’s] future strategy,”
4. is “typically operating in the group’s core business.”

In the author’s view, these appear to be highly subjective criteria open to wide-ranging interpretations. It is also unclear, for example, what the draft means by “links” when it refers to “stronger” and “weaker” links. One might ask, ‘links to whom or what?’ Use of the term “integral” is similarly unclear.

Here and in subsequent paragraphs (i.e. 71-74), the draft asserts that items 1-4 above are “indicators” in support of a critical assumption—that is, when they are present “it may be reasonable to assume that a group entity would be likely to receive support from the rest of the group.”

But consider the indicators regarding “stronger links” and being “integral” to the group’s identity. To the author, by definition an MNE group integrates its underlying MNE affiliates; they are “linked” or “integrated” by common ownership, for example. At least in this sense, it is unclear exactly how such a link would be stronger or weaker. The draft also seems to refer to operational “linkages” without much clarity.

At the end of paragraph 70, it states,

The impact of an assessment of implicit support is a matter of judgement but depending on the particular facts and circumstances it may be appropriate to treat those entities most likely to receive group support as having a credit rating more closely linked to the group rating.
Here, it is probably helpful to clarify who is making this judgement—for example, is it a tax authority’s judgement, a taxpayer, or both?

In the quote above, the draft refers to an entity’s credit rating as more closely linked to the group rating. This added context does not necessarily lend greater clarity, however. For example, it remains unclear whether the earlier reference to “stronger links” pertains to this linkage between entity-specific and group credit ratings.

The draft appears to note an implied relationship between the notion of a “stand-alone” credit rating for the affiliate—if such a stand-alone credit rating exists—and an MNE group level credit rating. But when the entity-specific and group ratings are “closely linked,” does it mean that they are correlated—e.g. moving in the same direction under specific changes in circumstances? The draft is unclear on the point.

Of course, one might expect that a major change in the group credit rating would potentially affect stand-alone credit ratings (whether actual or notional) for many and perhaps all entities within the group. But the entity-specific credit rating and its relationship to a group level credit rating—when “linked”—is directionally unclear. Perhaps in some cases it is foreseeable that certain risks pertain specifically to an affiliate independently—e.g. in its facing country specific and/or market-related risks—while the group as a whole is more diversified and thereby insulated from such entity-specific risks?

These questions hearken back to the rebuttable presumptions that all MNE entities would have the same credit rating as the group level credit rating (Box C.3). The variety of credit profiles discussed in paragraphs 70-74 belie the proposition that group entities with such profiles should be assumed to have the same credit ratings.

The paragraph 70 approach also appears inconsistent with Section D (“Guarantees”) of the draft. For example, it would attempt to “assess” when it might be reasonable to “assume” that “the group would be likely to support a particular entity,” in the event of it defaulting a loan or in providing an implicit guarantee to its prospective lenders.

But, as paragraph 151 indicates, “If the [related party] borrower has its own independent credit rating from a commercial credit rater, this will usually reflect its membership of the group and so ordinarily no adjustment would be needed to this credit to reflect implicit support.”

This leads one to ask whether, in such a case, the mindset of an unrelated lender would also reflect anticipated group support—based either on such an independent credit rating for the borrowing entity, or on the lender’s independent perspective and analysis. To the extent the lender assumes implicit support, the analysis introduced in paragraph 70 would appear to be unnecessary.

It seems worth noting here that, if pricing a guarantee requires netting out the benefit of implicit support—measuring this benefit would be further complicated if it were already embedded in available independent credit ratings, as paragraph 151 suggests.

VII. Box E.3, Agency sales of insurance, and other relevant parties
The draft invites comments on Paragraphs 187 and 188, which include a stylized example of an intercompany agency relationship between Company A (“a high street retailer of high value new technology consumer goods”) and Company B (“an insurer which part of the same MNE group as A”). The tested transaction is A’s compensation for sales of 3-year insurance policies (for accidental damage and theft) that are sold to third party consumers in its retail location.

In this case, the transaction as established by the taxpayer is analysed in light of certain of the functions of companies A and B. These include A’s retailer role—which also entails its point-of-sale offering of B’s insurance policy “product.” A receives a commission based upon benchmarks that include independent agency commissions selling similar insurance policies.

Paragraph 188 appears to conclude that A is undercompensated with such a commission while B inappropriately realises all “profit” after the commission—at profit levels exceeding the levels of independent insurers selling comparable policies.

However, the author would question the conclusions in the draft when presented with a few additional (and quite plausible) facts in such a case. Indeed, the conclusions in the draft may be questionable even with the exact same fact pattern given in the draft without more detail.

One obvious omission in the facts is whether or not the “high value new technology consumer goods” (hereinafter, “devices”) are developed and made by MNE affiliates of A and B, whether they are sourced from independent suppliers, or some combination of such sources. For the moment, these comments assume that the devices themselves are developed, produced and supported by related parties.

Questions the author would see as important in applying Chapter I in such a case include the following:

1. What is the nature of the “high value new technology consumer goods” (i.e., “devices”) to which the insurance policies apply? (i.e. what exactly is B insuring against damage or theft?)
2. What is the nature of the coverage under the insurance policies? Are claims usually resolved monetarily or through replacement devices?
3. What parties within the MNE are capable of providing replacement devices? Are new devices, or refurbished devices (or both) provided to resolve claims?
4. Who gathers, maintains, and analyses device-related data regarding patterns of common accidents and issues relating to potential claims? Also, who tracks device performance and obsolescence over time, including in relation to consumer habits when using devices?
5. Who analyses develops and implements necessary device fixes? Who puts programs in place to repair, refurbish or replace devices? Where does this occur?
6. Do integrated services and/or consumer data survive accidental damage to the device, or its theft? How and when? (e.g. cloud services, backup software, locking systems or services, etc.)? Who provides such support, software and data services? Where, and using what resources and capabilities?
7. Who develops the device technology? (Presumably it is neither A nor B, or the example should
state as such.) Where and when was this technology developed? What is the track record of the relevant technology development team(s)?

8. Who is responsible for the continuing development of technology and devices and where?

9. Who manufactures the devices, and where does this occur? How are manufacturing costs and processes managed and by whom?

In the author’s view, these are the types of questions conducive to addressing the main points in paragraph 188, which states,

“[i]n considering how the conditions of the transaction between A and B differ from those which would be made between independent enterprises, it is important to consider how the high level of profitability of the insurance policies is achieved and the contributions of each of the parties to that value creation.” (emphases added)

From the draft’s perspective, it is A’s special advantage in its consumer facing role at the point of sale of the devices that explains the high level of profitability the combined parties generate through sales of insurance policies. The basis for this conclusion seems rather cursory, however.

From another perspective, depending on the case, it may be asserted that insurance policies do not drive the sale of products—but products often drive the sale of insurance policies. Thus here, contributions related to the devices and their development, production and related support services could be weighed.

Without probing questions like items 1 to 9 above, including understanding the nature of the insured products and potential claims, it would remain unclear how and where value is created in this transaction and by which parties.

This example also provides context to elaborate on the idea of other specific parties that are relevant and important to the transaction. These may not be limited to parties A and B in the example. Given additional facts assumed above, one can envision valuable contributions from other parties that better explain the sources of higher profit levels on the insurance policies.

Generally, profits from insurance derive from premiums collected net of claims paid and operating costs—with additional investment income on positive balances of funds from collected premiums over time.

In this light, A’s point of customer contact may contribute to premiums by increasing the volume of policies purchased by customers at the source. But profits would also depend on the size and number of claims relative to collections of premiums, and price competition from other insurers, for example, as noted in the draft.

However, in the extended fact pattern above, the A-B group develops and manufactures its products giving it substantial capability to satisfy claims cost-effectively. This may be due, though indirectly, to contributions of other relevant specific parties, such as Company X (R&D, engineering affiliate), Company Y (customer and technical support affiliate), and Company Z (manufacturing affiliate).

Thus, for instance, under the insurance policies, Z could be the ultimate supplier within the group for
replacement devices. The group—through such affiliates using arm’s length transfer prices—could provide replacement devices at cost (or nearly so). Satisfying claims with refurbished devices (that are recovered in exchange for customer product upgrades) could further reduce costs. However, a third-party insurer without these related party contributions might face replacement claims costs at or close to the market value of new devices. They also would not have access to low cost refurbished devices—without their having any product upgrade role or capability in the market.

Additionally, for example, valuable aspects of performing the actuarial role in estimating expected losses from claims are naturally present within the A-B group. This would be because the policy insures products for which the group already conducts deep product research—yielding robust data conducive to analysing and estimating potential claims in-house.

In short, the high profit levels in the example could derive from advantages and efficiencies within the A-B group that have the effect of lowering claims costs on the insurance policies—as opposed to customer facing advantages.

Also in this case, the available in-house insurance-related functions leverage existing expertise and resources naturally within the group—as it maintains such capabilities by virtue of making the same products that it insures while constantly performing deep product research. Such a fact pattern would seem plausible in other captive insurance contexts as well.

Once again, I greatly appreciate the opportunity to offer comments on the draft and look forward to continuing to assist the OECD’s efforts on this and related subjects.

Sincerely,

Pat Breslin
Washington, DC
September 7, 2018

(Delivered via email)
Comments on the Public Discussion Draft
BEPS Action 8-10 – Financial Transactions

On 3 July 2018, Working Party No. 6 ("WP6") published the “Public Discussion Draft – BEPS Actions 8-10 – Financial transactions” ("Discussion Draft"), containing proposed additional guidance on the transfer pricing guidance aspects of financial transactions. This additional guidance is intended to expand on the respective guidance provided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("TPG") and public comments on the Discussion Draft were invited by WP6.

I would like to thank WP6 for the work done so far on the Discussion Draft and the kind invitation to comments from the public. My following comments represent personal views and have not been prepared on behalf of any other individual or organization.

Intra-group financial transactions have long been a focal point of anti-tax avoidance measures in general and transfer pricing regulations specifically. Intra-group financial transactions provide a relatively easy to implement measure if MNE groups want to shift profits from one tax jurisdiction to another. At the same time, the determination of arm’s-length conditions and prices for such transactions is highly complex from a technical perspective.

This makes it difficult for tax administrations that want to evaluate intra-group financing from the viewpoint of the arm’s-length principle as well as for MNE groups that want to structure their intra-group financial relationships in a tax efficient manner that is not aggressive. Therefore, further guidance on this topic is highly needed and welcome.

In the following, I provide my comments on certain topics in Sections B and C of the Discussion Draft as well as general comments on it.

1  Interaction with the guidance in Section D.1 of Chapter 1

1.1  Important contents of Section B

Section B of the Discussion Draft is aimed at elaborating on the guidance on the application of the arm’s-length principle provided in Section D.1 of Chapter I of the TPG. This is done in two subsections which deal with the identification of the commercial and financial relations and the economically relevant characteristics of financial transactions respectively.

The Discussion Draft effectively tries to emphasize that multinational enterprise ("MNE") groups have more freedom to decide about the capital structure of their individual MNEs, leading to possibility of differences to capital structures under arm’s-length conditions. It also acknowledges that while in determining the arm’s-length conditions of financial transactions the same principles as for other controlled transactions apply, jurisdictions are free in implementing further measures to regulate the capital structure of MNEs. The determination of debt for tax purposes can therefore be subject to other, parallel regulations.

Furthermore, the Discussion drafts enumerate the comparability factors laid down in paragraph 1.36 of the TPG as also relevant for financial transactions: contractual terms, functional analysis, characteristics of financial products or services, economic circumstances, and business strategies. These comparability factors are illustrated using their application to intra-group loans as example.
1.2 Box B.1 on Other Approaches to Regulate Capital Structures

WP6 invites comments on the guidance included in paragraphs 8 to 10 of the discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the Model Tax Convention, and the BEPS Action 4 Report.

Paragraphs 8 to 10 deal with the relationship between transfer pricing aspects and possible other approaches of tax jurisdictions to regulate the capital structure of MNEs. Accordingly, local tax jurisdictions may implement other measures to regulate the capital structure and interest deductibility.

Article 25 of the MTC opens taxpayers the way to the mutual agreement procedure in cases where it does not consider the taxation in line with the respective tax convention between two jurisdictions. While the competent authorities of both jurisdictions are encouraged to resolve the issue by mutual agreement, the MTC foresees arbitration in cases where such agreement cannot be reached within two years.

Paragraphs 1 and 2 of Article 9 of the MTC provide the basis of taxing MNEs based on the determined arm’s-length results as well as mandating corresponding adjustments in the other relevant jurisdictions for cases in which one jurisdiction has adjusted the results of a taxpayer from a controlled transaction.

The BEPS Action 4 Report as updated 2016,\textsuperscript{1} deals specifically with the possible tax issues arising from intra-group financing. It recommends local jurisdictions the implementation of a “fixed ratio rule” as well as a “group ratio rule” to limit the deductibility of net interest payments.\textsuperscript{2} These limitations are irrespective of the status of the recipient as related party or non-related party.

Regarding the relation to the BEPS Action 4 Report, the following applies:

- As the measures under BEPS Action 4 limit the deductibility of net interest payments for tax purposes based on a so called “benchmark fixed ratio” tax administrations may interpret this in a way that related-party net interest payments exceeding the fixed ratio (or the group ratio) should not be considered interest payments for transfer pricing purposes.

- Considering that non-deductible net interest payments can be rolled forward and deducted in future taxable periods up to the fixed ratio or group ratio, this may put taxpayers in unfavorable positions due to the loss of such future deductibility and, possibly, higher withholding tax rates for payments such a dividend payment. MNE groups that prefer such a qualification are free to reclassify the respective debt as equity at any time, if they consider this more appropriate.

- A forceful reclassification of such net interest payments may also not in line with the arm’s-length principle as shown by the study whose results are cited in paragraph 96 of the BEPS Action 4 Report. If factual reasons exist to doubt the nature of related-party net interest payments, tax administrations still can use comparability analyses to examine this possibility.

- Therefore, WP6 may consider including in the Discussion Draft an explicit statement that


\textsuperscript{2} The “fixed ratio rule” limits the net interest expenses to a benchmarked percentage – from 10 to 30 percent – of earnings before interest, tax, depreciation, and amortization (“EBITDA”); the “group ratio rule” is optional for tax jurisdictions and, where implemented, allows taxpayers to deduct net interest expenses of up to the group ratio of net interest expenses over EBITDA where this is higher than the benchmarked percentage for the fixed ratio rule.
exceeding the fixed ratio or the group ratio under BEPS Action 4 does not provide evidence that parts of the related-party debt of the taxpayer should not be classified as debt for transfer pricing purposes. For clarity, this statement should explicitly refer to paragraph 96 of the BEPS Action 4 Report which shows that a material proportion of MNE groups incur net interest payments in excess of the recommended amounts of the fixed ratio rule.

1.3 Box B.2 on the Reclassification of Debt

WP6 invites comments on the example contained in paragraph 17 of the discussion draft, in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the amounts are less than the total funding required for the particular investment.

The example in paragraph 17 of the Discussion Draft illustrates a situation in which a part of the funding provided to an MNE from related parties exceeds the amount that unrelated parties are deemed to be willing to provide in the form of debt. Basis for this finding is that the financial projections of the MNE show that it would not be able to service the full amount of the funding.

Under perfect conditions, it would be appropriate in the described situation to reclassify the amount exceeding the arm’s-length debt amount as equity and still recognize the remainder as debt. However, in typical situations, this will prove difficult, as such calculations will be complex and require a large amount of technical competence and data. Especially tax administrations will therefore depend to a large amount on the preparations done by the taxpayer.

Regarding such reclassification of debt, the following applies:

- The existing wording of the example should, in essence, be retained.
- WP6 may consider adding a clarification that the recognition of debt in similar situations for tax purposes may rely on the appropriate analysis and documentation of the economic substance of the transactions and that in cases of doubt it may be justified that tax administrations reclassify the whole amount.

1.4 Box B.3 on Comparability Factors

WP6 invites comments on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction. Furthermore, comments are invited in the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

This question seems to aim at obtaining input on the economically relevant characteristics of actual financial transactions, guidance which is contained in paragraphs 22 through 26 of the Discussion Draft based on the general conception of comparability factors of the TPG.

In general, the specific factors influencing the pricing of a given financial transaction depend on the given type of this transaction. As financial instruments and services are of a wide variety, such specific comparability factors, too, are very much depending on the specific transaction.

Regarding the economically relevant characteristics of actual financial transactions, the following applies:

- In many functional analyses of financial transactions between related parties, it can be observed that general functions, assets, and risks of the parties are elaborated on. Accordingly, WP6 may consider rewording the second sentence of paragraph 23 to
clarify that functions, assets, and risks with direct relation to the specific financial transaction are relevant, for example: “This analysis seeks to identify the functions performed, the assets used, and the risks assumed by the parties to the controlled financial transaction with regard to this transaction.”

- Instead of clarifying general principles, which should be relevant to Section B of the Discussion Draft, paragraphs 24 through 26, 28, 31, and 34 are specific to loans. Accordingly, WP6 may consider relocating them to Section C.1.

1.5 **Box B.4 on Risk-Free Rates of Return**

WP6 invites comments on the guidance contained in the box and its interaction with other sections of the discussion draft, in particular “Section C.1.7 Pricing approaches” to determining an arm’s-length interest rate.

Box B.4 contains guidance on determining risk-free rates of return and risk-adjusted rates of return, the latter of which containing containing as one component a risk-free rate of return on which then a risk premium is added. The risk-free rate of return is defined as “the hypothetical return which would be expected on an investment with no risk of loss”. For risk-adjusted rates of return, additionally to the approach of constructing it out of a risk-free rate and a risk premium, the box mentions as possible approaches the return of realistic alternative investments or the cost of funds.

Section C.1.7 – paragraphs 81 through 93 – of the Discussion Draft describe guidance on three specific approaches to determining arm’s-length interest rates: comparable uncontrolled prices, cost of funds, and bank opinions. Regarding comparable uncontrolled prices, this guidance reconfirms certain economic factors to consider for external as well as internal comparable transactions as well as possible realistic alternatives for comparable loans, such as bonds. Regarding the cost of fund approach, the section states that the lender adds its relevant expenses for arranging and servicing the loan and a risk premium on top of its cost of funds, considering its relative costs to other lenders operating in the market. Bank opinions are rejected, mainly with the argument that they do not represent actual transactions.

Regarding the interaction between the guidance in Box B.4 and Section C.1.7, the following applies:

- While paragraph 93 explicitly rejects approaches that are not based on comparison of actual transactions, the guidance on Box B.4 requires the determination of a hypothetical “risk-free rate of return” which cannot be found in data directly derived from actual transactions. Without further elaboration by WP6 this seems to be a structural internal inconsistency of the Discussion Draft. (Nevertheless, in this point this seems to be rather an issue of paragraph 93, as explained below.)

1.6 **Box B.5 on Alternatives to Approximate Risk-Free Rates**

WP6 invites comments to describe financial transactions that may be considered realistic alternatives to government issued securities to approximate risk-free rate of returns.

In its academic sense, “risk free” means that the actual returns from an investment always have to be exactly the same as the expected returns; there can be no variance in return, as otherwise deviations between actual and expected returns would be possible and the investment would contain risk. Therefore, to be considered “risk free”, an investment must fulfil two conditions: Firstly, there cannot be a chance of default. Secondly, all return from the investment must be realized at the end of the investment horizon.

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3 This definition diverges significantly from economic definitions of “risk” and poses a serious problem for practitioners. This is explained in more detail as part of the Other Comments on Section B, below.
The first condition is obvious, as the chance of default will result in a possible deviation of the actual from the expected return. This means that only investments in governments that can control the issuance of their currency can have a chance of being risk free investments. However, even where governments theoretically have the possibility of issuing money to make payments to investors, there may still be doubt about their willingness to do so, for example due to political reasons. Therefore, even such investments will contain at least minor risk and can therefore only be used to reasonably approximate a risk-free rate of return.

The second condition adds on this, as any investment, such as government bonds, that contains payments to the investor during the term of the investment will result in risk on the reinvestment of such payments. This will arise due to the risk of market changes over time. Even a reinvestment of the payments in the same default-free investment will therefore involve risk. Together with the practically unavoidable risk from the first condition, this means that any investment opportunity available in reality will contain at least minor risk and will only allow for approximation, not for determination of a risk-free rate of return.

This makes the need for practicable means of estimating a risk-free rate of return even more pressing as it still will be necessary for the application of the respective approach of the TPG. Alternative ways that tax administrations and taxpayers may come up with include inflation rates and interest rates on retail bank accounts.

A rational in using inflation rates may be seen in the argument that a risk-free investment would at least guarantee that the purchase power of the invested amount remains the same over the investment term. However, inflation rates are typically determined by the increases of consumer price indices. In many cases, these will not be relevant for a specific related-party transaction and possibly more relevant price indices may show materially different rates of increase or decrease.

Other, potential issues with inflation rates are that the price changes may partially be due to changes in the quality of the measured goods or services. This will especially be relevant in cases where certain goods are subject to rapid technological developments. Such price changes would then not reflect the maintenance of purchasing power and require additional, complex and possibly unreliable, analyses for their exclusion.

For retail bank accounts, a possible argument may be that – depending on the banking regulations of the specific tax jurisdiction – they are guaranteed up to a certain amount by deposit insurance. Therefore, such deposits would bear extremely reduced risk and the respective interest relatively near to the risk-free rate. However, such deposit insurance will not be available for many currencies. Additionally, the amounts insured under deposit insurance schemes are typically very limited, raising the question if they can suffice the comparability requirements relevant for typical intra-group transactions.

In all cases, the use of alternatives to government bonds for approximating risk-free rates of return seems to be connected with substantial conceptual problems and would likely result in additional tax insecurity and causes for dispute between tax administrations and taxpayers.

To these aspects, the following comments apply:

- For the given reasons, WP6 may consider to explicitly limit the use of other financial transactions besides government issued securities to specific cases in which such securities are not available and the data from other government securities cannot be reliable adjusted.
- Additionally, as this concerns a core topic of the TPG, the OECD may consider more...
excessive theoretical and empirical research to substantiate methods for approximating risk-free rates of return for transfer pricing purposes.

1.7 Box B.6 on Information Exchange between Jurisdictions in Cases of Recharacterization

WP6 invites comments in the practical implementations of the guidance included in paragraph 11 of Box B.4, and its interaction with Article 25 of the OECD Model Tax Convention in a situation where more than two jurisdictions are involved (for instance in situations where a funded party is entitled to deduct interest expense up to an arm’s-length amount, but the funder is entitled to no more than a risk-free rate of return under the guidance of Chapter I, and the residual interest would be allocable to a different related party exercising control over the risk.).

Paragraph 11 of Box B.4 determines that a funded party is entitled to a tax deduction up to an arm’s-length amount even in cases where the funding party is only entitled to a risk-free rate of return, because it lacks the capability to control the risk connected with the funding. The remainder would be attributed to the party that controls the risk.

The proposed guidance in paragraph 11 of Box B.4 of the Discussion Draft effectively mandates a recharacterization of the transactions of the MNE group in the described situation. This will require the cooperation of the tax administrations in all three relevant jurisdictions to implement the form indicated by the Discussion Draft.

As mentioned in the comments to Box B.1 above, Article 25 of the MTC opens taxpayers the way to the mutual agreement procedure in cases where it does not consider the taxation in line with the respective tax convention between two jurisdictions. In the given example, only a recharacterization of the transaction by the tax administration of the jurisdiction in which the party controlling the risk is located provides a strong external incentive for MNE groups to initiate a mutual agreement procedure.

To these aspects, the following comments apply:

- In cases where tax administrations recharacterize transactions as described in the example in paragraph 11 of Box B.4 of the Discussion Draft, the mutual agreement procedure under Article 25 of the MTC alone may not be sufficient to ensure that the transaction will be treated according to its economic substance by all relevant MNEs.

- WP6 may consider including additional guidance proposing that in cases as in the given example of the Discussion Draft, the tax administration reminds its local MNE to also inform the other relevant parties of its MNE group about the recharacterization. Furthermore, this additional guidance should include reference to spontaneous exchange of information under Article 26 MTC and other applicable legal sources, where such exist, to encourage tax administrations to proactively share information about the recharacterization with the tax administrations of the other parties to the transaction.

1.8 Other comments on Section B

- In paragraph 3, sentence 1, the wording “…the balance of debt and equity funding between independent enterprises…” should be corrected to “…of independent enterprises…” due to semantic reasons.

- Paragraph 18 seems redundant, as it only repeats general guidance already contained in the TPG – especially in paragraph 1.35. As paragraph 11 already clarifies that the general guidance of the TPG is also applicable to financial transactions, WP6 may consider deleting paragraph 18.

- Contrary to the BEPS Action 4 Report, which consistently uses the term “financial
**2 Treasury function**

**2.1 Important contents**

Section C deals with the treasury function, specifically intra-group loans, cash pooling, and hedging. Parts of the proposed guidance on intra-group loans deal with credit ratings, covenants, guarantees, and different pricing approaches to intra-group loans. In the sub-section of cash pooling, the Discussion Draft comments on physical and notional pooling, the delineation of the cash pooling transactions, and the arm’s-length rewards for the leader and the members of the cash pool. Finally, a brief sub-section on hedging transaction is included.

**2.2 Box C.1 on Decentralized Treasury Functions**

WP6 invites comments on describing situations where, under a decentralized treasury structure, each affiliate within an MNE group has full autonomy over its financial transactions, as described in paragraph 38 of the discussion draft.

Paragraph 38 of the Discussion Draft explains that the organization of the treasury function in an MNE group can vary between a completely centralized structure, under which the individual MNEs have no responsibilities in financial matters, and a completely decentralized structure in which each MNE has full autonomy over its financial transactions.

Situations in which the individual MNEs have full autonomy in financial matters will be a rare exemption. Even in newly formed MNE groups whose members were originally independent and then acquired, internal coordination about financial matters arises typically quickly to increase financial efficiency. Situations in which the headquarters of an MNE groups leaves its subunits with autonomy about their financial matters may especially exist in the case of an investment fund, but even in such situations, typically most of the sub-units will be MNE groups – rather than individual, local entities – with some amount of financial centralization.

Therefore, to such decentralized treasury functions, the following comments apply:

- MNE groups in which the affiliates have full autonomy about their financial transactions are likely to be only a hypothetical construct than an actual possibility; even in decentralized MNE groups, there will likely be at least some amount of informal central...
authority over the financial matters of the individual MNEs, especially in significant cases.

- However, this should not be understood in the way that in each case the transfer pricing analysis needs to assume the existence of a central treasury function that requires separate remuneration. Rather, in many cases of decentralized treasury, the individual MNEs will have the full capability to deal with their financial matters autonomously. If, in such a situation, the central coordination of the financial transactions is limited, it may still be appropriate to analyze the financial relationships within the group under the assumption of full autonomy of the individual MNEs.

2.3 Box C.2 on the Rebuttable Presumption of a Credit Rating

WP6 invites comments on the usefulness of the following two approaches for tax certainty and tax compliance:

- A rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

- A rebuttable presumption that tax administrations may consider using the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for setting the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

Furthermore, comments are invited on the use of an MNE group credit rating for tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Finally, comments are invited on a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

A group credit rating will typically not provide a reliable approximation of a stand-alone credit rating of individual members of that group. Unrelated lenders of particular MNEs of that group may still base their interest rates either on the group credit rating as such or as a starting point. Therefore, it will give many situations in which the group credit rating can be helpful for the transfer pricing analysis of intra-group lending. However, this will depend on the facts and circumstances of the specific case.

To a rebuttable presumption that allows using an independently derived credit rating directly or as starting point, the following comments apply:

- Such a rebuttable presumption will bear the tendency that tax administrations, rather than examining all relevant facts and circumstances of a case, refrain from the efforts to appropriately analyze intra-group lending transactions. In cases where the results of such examinations are not in line with arm's-length results, this will result in additional effort for taxpayers to justify their transfer pricing, burdening them with internal and external costs and increased risk of economic double taxation.

- WP6 may consider an explicit statement that such rebuttable presumptions are not in line with the arm's-length principle.

2.4 Box C.4 on Group Support

WP6 invites comments on the relevance of the analysis included in paragraph 70 of the discussion draft.

Paragraph 70 comments on the likelihood that an MNE group will support a group affiliate in situations of financial distress. Here, the Discussion Draft mentions that it may be more
appropriate to link the credit rating of entities with a close link to the MNE group’s core business more closely related to the group-credit rating. However, it also mentions that this will be a matter of judgement, depending on the facts and circumstances.

Generally, the possibility that a group of companies will not support a group member in a case of default on its financial obligations. In certain cases, subsidiaries are specifically incorporated for the purpose to shield the rest of the group from specific financial risks. As the proposed guidance already indicates, determining such considerations from the outside will be highly subjective. In fact, this is much more difficult than determining if the entity is closely connected to the core business, as even – often especially – the financial risks connected with the core business will be separated from the group by means of a separate legal entity. Any such analysis will therefore be highly unreliable.

To this, the following comments apply:

- As the analysis to determine if a specific group affiliate will receive financial support by the group is highly unreliable, WP6 may consider to either delete the proposed guidance completely or replacing it with a clarification, that such analyses should typically not be relied on in transfer pricing analyses.

2.5 Other comments on Section C

- High-level explanation of how a credit rating may be derived should be included, to improve the understanding of this tool by tax administrations and multinationals.

- The Section lacks guidance on the intra-group sale and purchase of external receivables, thus factoring transactions. As for many industries, factoring is an important measure of cash management and credit risk management and respective intra-group transactions are well established, WP6 may consider including such guidance.

Bank Opinions

- Regarding using bank opinions in pricing intra-group loans, paragraph 93 of the Draft states that “[s]uch an approach would represent a departure from an arm’s length approach based on comparability since it is not based on comparison of actual transactions.” In this strict form, this statement may be misleading. The implementation of the arm’s-length principle does not necessarily require comparable actual transactions; even where such transactions are available, they only represent a more or less accurate estimator for the purely hypothetical behavior that unrelated parties in place of the related parties would demonstrate.

- The current wording may especially wrongly imply that contribution or residual profit splits are no longer considered arm’s-length transfer pricing methods.

- While bank opinions indeed are of limited reliability compared to actual transactions, they can provide a valuable contribution to a thorough arm’s-length analysis by providing starting points or potential reasonability checks.

- Additionally, in cases where the volume of the controlled transaction does not justify the effort necessary for a thorough search for comparable transactions, they can serve as a practicable estimator of arm’s-length pricing. This is especially relevant for smaller MNEs, which often engage in the intra-group provision of relatively small amounts of loans and for which the expenses, connected with, for example, a database search may pose a significant burden.

- Finally, they can also be helpful for the tax administrations of smaller countries whose budgets may not allow for unlimited database accesses. These would often rely on bank opinions to confirm the reasonableness of taxpayer’s analyses.

- Therefore, WP6 may consider clarifying the wording of paragraph 93 to appropriately
reflect the above aspects explicitly.

**Rewarding the cash pool leader (para. 109 to 112)**

- Para. 109 seems redundant with basic guidance on the ALP given in the TPG and may be removed from the Draft; para. 110 similarly repeats basic aspects of the ALP but may be retained for clarification, for example at an earlier point of the Draft, as its current wording applies to all financial transaction, not only a cash pool or a cash pool leader.

- Para. 111 speaks of the remuneration for the “cash pool leader”. WP6 may consider to rewording this and the subheading of the section to speak of remuneration of or rewarding the cash pool leader function. This is because in a given cash pool, the entity performing the role of the cash pool leader may, as mentioned in para. 112, have other roles that may require separate remuneration.

### 3 General Comments on the Discussion Draft

- The Discussion Draft completely lacks a bibliography of economic literature that was used to provide background on its formulations. This may give the impression that the guidance provided by WP6 is discretionary and not based on economic principles and/or empirically observed behavior of third parties. It also makes it more difficult for interested readers to gain more insights in the background of the guidance provided. WP6 may therefore consider including a respective bibliography.

- The proposed guidance of the Discussion Draft on specific financial transactions in Sections C to D still seems to require further consideration and more examples. WP6 may consider elaborating on those in a second draft for discussion at a future point in time.
Response to Discussion Draft on BEPS Actions 8-10 regarding Financial Transactions

September 7, 2018

Submission to Organization of Economic Cooperation and Development (OECD)
Introduction

The Canadian Bankers Association (CBA) welcomes the opportunity to respond to the Discussion Draft on financial transactions that Working Party No. 6 has produced under the Organization of Economic Cooperation and Development (OECD) mandate of the Report on Actions 8-10 of the BEPS Action Plan. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in satisfying their financial goals while obtaining banking products and services through existing and evolving channels.

Need to differentiate between banks and non-financial services entities

The CBA believes that the Discussion Draft, as written, does not recognize that regulated banks are unique and different from non-financial services entities. Banks are in the business of managing risk and capital. Unlike non-financial services entities, risk and capital are core components of banks, which are subject to unique, complex and rigorous government and industry oversight and regulation.

Accordingly, the Discussion Draft should explicitly exclude the regulated banking sector from its scope of coverage, given that:

- The banking sector is operationally different from the non-financial services sector; and,
- The capital structure and operations of banks are heavily regulated at the regional and supra-regional levels.

As a result of the differences between banks and non-financial services sectors, the Discussion Draft provides guidance that may yield non-arm’s length results for banks. In addition to providing comments on the scope of the Discussion Draft, the CBA has also included in an attached appendix certain examples contained in the Discussion Draft that are not applicable to the regulated banking sector. We encourage the OECD to propose specific financial services sector guidance in draft form at a later time, and that comments on this draft be solicited thereafter.
Role of bank treasury departments

The roles of bank treasury departments are different from those of non-financial services treasury departments. Bank treasury departments serve a highly complex and vital operational role. They are primarily responsible for sourcing different types of funds that are available to a bank on behalf of its business units. In turn, these business units use these funds to purchase or create assets, such as loans, for the purpose of earning revenues and profits. In most cases, the treasury department manages a variety of different types of risks (e.g. duration, funding, liquidity, interest rate, among other market risks) between the bank’s sources of funds and the use of funds in the creation of assets in the ordinary course of funding the bank’s core businesses. Bank treasury departments are also responsible for the management of the bank’s overall asset and liability mismatch and the ensuing risks.

Banks use several different funding sources. Generally, these include:

- Short-term debt funding - This refers to a short-term related party transaction where one entity may obtain short-term funds from other members of the group or in the open market through vehicles such as commercial paper markets to cover short-term need and cash requirements.
- Retail and institutional/wholesale deposits - For regulated banks, deposits (liabilities to a bank) provide a relatively inexpensive source of funds for the bank. These funds are subsequently employed throughout the bank and its different businesses.
- Secured debt funding - Secured funding is often sourced by banks through reverse repurchase and repo transactions. Such funding is relatively inexpensive and used to fund operations.
- Senior unsecured debt lending - Committed and uncommitted revolving facilities are often used by banks to fund their operational cash flow requirements and to manage liquidity from a centralized perspective for multiple group entities.
- Equity - Although expensive for banks and not the primary source of funding for operations, equity is an important source of funding primarily for regulatory, solvency, and for the maintenance of a strong credit rating.

As highlighted above, the bank’s treasury department is central and core to the management of a bank’s inventory (funds) that are used to create and purchase assets in the ordinary course of its day-to-day business. By contrast, treasury departments of non-financial services companies operate with a different
mandate; they are primarily only focused on funding their operations which consist of producing tangible goods or providing services, where funds are not considered core inventory.

Furthermore, the OECD has already recognized the unique nature of the financial services sector, through the guidance that it has provided in its 2010 report on Permanent Establishments. This prior recognition is not reflected or noted in the OECD’s Discussion Draft. As a result, the CBA believes that guidance for the banking sector, recognizing its unique nature of operations and regulatory oversight, already exists for the purpose of analyzing such transactions from an arm’s length perspective. The CBA does note, of course, that some changes may be required to account for the difference of operating in multiple legal entities as opposed to the single legal entity context analyzed by the 2010 report.

Finally, it should also be noted that funding transactions along with the management of risk are heavily regulated and monitored for the banking sector (which is not the case for the non-financial services sector).

**Regulatory approval should be taken as evidence that a financial transaction is compliant with the arm’s length principle**

The CBA is of the view that the unique characteristics of banks and the substantial regulatory requirements imposed on them should, taken together, provide sufficient assurance to the OECD and tax authorities that intercompany financial transactions are entered into at arm’s length.

Regulatory requirements are imposed on banks that not only focus on capital and assets but also on the transfer of capital and risk to their subsidiaries. Such regulatory restrictions are in most cases applied to both sides of a transaction by two different and independent regulators.

There are several examples of how regulators oversee the cross-border activities of firms operating in the banking sector, including:

- Most banking regulatory bodies closely monitor and affirm, either through direct approvals or through indirect confirmation, the capital structure of banks as well as the use of intercompany debt. Such regulatory oversight imposes restrictions and constraints on the use of intercompany debt. The imposition of additional tax driven requirements is not only difficult but will likely create conflicts and non-arm’s length results.

- Even in situations where one of the counterparties to a transaction has no regulatory oversight, in most cases the regulatory body of the other counterparty has broad authority to
monitor and to impose restrictions on intercompany transactions.

- At the core of their operating models, banks require strong credit ratings in order to access relatively inexpensive funds and to qualify as strong counterparties for various financial transactions. In addition, third party lenders are sensitive to intercompany debt and in many cases have explicit and restrictive covenants within their loan agreements on the use of related-party debt by the borrower.

As noted in the above examples, banks face significant oversight and restrictive rules on the assumption of risk and the use of intercompany lending transactions. The OECD should recognize that regulatory oversight imposes an analysis that is comparable to the arm’s length principle for intercompany debt transactions and whether an enterprise is, as a result, thinly capitalized. This analysis is significantly more rigorous and more appropriate than the proposed analysis in the Discussion Draft. As a result, the CBA is of the view that the OECD should exclude banks from the Discussion Draft and recognize that additional analysis and requirements are not helpful and can only lead to an additional administrative burden and non-arm’s length results.

**Conclusion**

Overall, the Discussion Draft does not adequately acknowledge that banks are operationally unique and highly regulated. While treasury departments in the non-financial services sector focus primarily on funding operations that consist mainly of service provision or tangible goods production, bank treasury departments manage risk in order to source the requisite funds needed to create or purchase assets (such as loans) to generate revenues and earn profits. In addition, banks are subject to regulatory oversight, with respect to their capital structure and use of intercompany debt, as compared to non-financial services firms.

The regulation of risk assumption and intercompany debt across the banking sector is rigorous, and in and of itself leads to arm’s length results. As a result, an additional overlay of analysis is not helpful and can only lead to non-arm’s length results.

The CBA recommends that the Discussion Draft explicitly exclude banks from its coverage. We encourage the OECD to propose specific financial services sector guidance in draft form at a later time, and solicit comments on the draft thereafter.
Appendix

Comments on various examples

It should also be noted that the examples used throughout the Discussion Draft are non-financial services specific and are not relevant for the banking sector.

Examples include the following:

- **Paragraph 17** – This example presents a fact pattern that questions the extension of a loan in a situation where the financial projections of the borrowing entity do not support the servicing of the 10-year loan by the borrower. The CBA is of the view that the example is too simple and unrealistic, and does not account for the supervisory and regulatory oversight of banks. As a result, advice that may stem from this example may lead to non-arm’s length analysis and results.

- **Box B.3.** – This example seeks comments on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction and on the situation where the lender would be allocated risks as a result for the advancement of funds within a multinational enterprise (MNE) group. It is precisely this section of the Discussion Draft where paragraphs 22 – 28 do not recognize that banks operate in a regulated environment facing constraints that impose guidelines and limits on the assumption of risk and use of intercompany debt. This example highlights that an additional set of rules covering financial transactions for regulated companies in the banking sector is duplicative and may lead to an unnecessary complication and non-arm’s length outcomes.

- **Box E.3.** – This example seeks comments on paragraphs 187 – 188 of the Discussion Draft. It neglects the fact that banks operate in a regulated environment. Also, as currently written, it seems to suggest that the assumption of risk is routine, and that the only driver of profits within the example is the point-of-sale (POS) advantage. This may be the case, for example, where the fact pattern is similar to the fact pattern established in the United Kingdom transfer pricing case DSG Retail v HMRC. However, the guidance should make it explicitly clear that a proper delineation of the transaction, followed by a detailed functional and risk analysis, is required to establish that the POS advantage exists before categorizing the assumption of risk as routine. When seeking to price intra-group captive insurance transactions, and subsequently apportion profits, all facts and circumstances of the transaction should be considered, including a potential POS advantage. It must be first established and demonstrated that a POS advantage exists, and that it is the most significant determinant of the excess profits among all possible determinants.
Even if a POS advantage exists, it may be one of many factors that contribute to overall profits for an insurance product. Alternatively, it may not constitute an intangible as it may not create a lock-in advantage for the seller of the insurance if the purchaser has other options available to it in the insurance market. The underlying risks borne by the insurers must also be thoroughly analyzed, given that they may be complex and highly conducive to high yields and returns. The determination of the profit drivers of the transaction in question, and whether potential intangibles such as POS are relevant to driving profit, will differ across different business and insurance products. Accordingly, the CBA recommends that this example be excluded from the final draft of this document.

As illustrated by the Discussion Draft paragraphs addressed above, certain examples throughout the Discussion Draft neither consider nor reflect the unique operations of the banking sector and the fact that this sector is regulated. At a minimum, then, it should be made explicit that the examples within the Discussion Draft are not applicable to banks.
7 September 2018

Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
The Organization of Economic Cooperation and Development
By email

The Capital Markets Tax Committee of Asia – Transfer Pricing Sub-Committee’s Submission with regard to the Discussion Draft on Financial Transactions

Dear Sir/Madam

The Capital Markets Tax Committee of Asia – Transfer Pricing Sub-Committee ("we" or "CMTC") refer to the invitation for public comments by the OECD on the OECD BEPS Actions 8 to 10 Discussion Draft on Financial Transactions (the "Discussion Draft"), and enclose our submission regarding our views and comments on the contents of the Discussion Draft.

CMTC is a financial services industry body consisting of 42 financial institutions operating in Asia which are represented through their regional tax directors. CMTC’s membership comprises of major commercial banks, investments banks, securities houses, insurance companies, and asset managers with a presence in Asia.

We welcome the opportunity to submit our comments on the Discussion Draft and appreciate the OECD's efforts in addressing the practical challenges that are faced by tax administrations and taxpayers in the development of guidance for the treatment of financial transactions.

In addition to providing our views on the specific issues related to the practical challenges in the Discussion Draft, we would also recommend that additional guidance be provided to minimize uncertainties and interpretational conflicts amongst taxpayers and tax administrations.

Should you have any questions about this submission, please do not hesitate to contact Ms. Suet Ping Liu or Mr. Sachin Agarwal, representatives of the Capital Markets Tax Committee of Asia – Transfer Pricing Sub-Committee, at +852 3413 4337 or +852 3604 3311 respectively.

Yours faithfully,

Ms. Ping Fan
Chair person, Capital Markets Tax Committee of Asia

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The Capital Markets Tax Committee of Asia – Transfer Pricing Sub-Committee with regard to the Financial Transactions Discussion Draft

Introduction

The Capital Markets Tax Committee of Asia – Transfer Pricing Sub-Committee ("we" or "CMTC") welcomes the opportunity to submit our comments on the OECD BEPS Actions 8 to 10 Discussion Draft on Financial Transactions (the "Discussion Draft") and we commend the OECD on the release of the Discussion Draft.

The Discussion Draft is an important milestone in global transfer pricing as it represents the first, detailed global discussion on the application of the arm's length standard to select types of financial transactions and is an important accomplishment in line with the objectives of the OECD's BEPS project.

The types of financial transactions addressed in the Discussion Draft are particularly important to CMTC members, whom enter into such transactions with third parties and related parties on a day-to-day basis through the course of their ordinary business. As such the CMTC appreciates the opportunity to comment on the Discussion Draft.

Our comments can be categorized into two areas, firstly comments which are overarching and apply to the entire Discussion Draft, and secondly comments in direct response to the questions raised by the Discussion Draft. The CMTC's comments are focused on considerations for the banking and insurance sectors (together the "financial services sector") and where appropriate draw on the existing OECD transfer pricing and international tax guidance for these regulated sectors.

We hope our comments contribute to the final guidance on transfer pricing for the select financial transactions.

Executive summary

As the CMTC members operate within the financial services sector, the Discussion Draft is of significant importance, as members will enter into these types of transactions on a daily basis with both third parties and related parties. Our key recommendations and comments are as follows:

- The Discussion Draft has been issued as a non-consensus document. It is our view that the final guidance on the select financial transactions should be limited only to areas of consensus to limit the basis for tax disputes and double taxation; and to better facilitate the resolution of double taxation cases.

- The Discussion Draft does not specify the sectors to which it is applicable, and does not include any comments that explain how third party and intercompany financial transactions are intrinsic to the profit earning capacity of financial services firms in a way that differs from other industries. Given the lack of consideration for the intrinsic nature of the financial services sector, the Discussion Draft appears more suitable for the non-financial services sector and we recommend that the Discussion Draft clearly state this.

- As the OECD has previously provided clear guidance specific to the financial services sector, outlining a clear basis for tax administrations to understand or frame the industry appropriately, we recommend any guidance on the transfer

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pricing of financial transactions include clarifications that the guidance is not applicable to the financial services sector. Alternatively, we recommend that specific industry considerations and concerns be included for the financial services sector.

- Regulatory requirements are an important feature requiring special consideration for the financial services sector, and the OECD has previously made references to how regulatory factors should be taken into account, and reference be made to specific financial services sector transfer pricing guidance. If the Discussion Draft is to be applicable to the financial services sector, sufficient guidance should be given regarding the importance and priority of the regulatory approach when considering risk allocation and the arm's length standard for intercompany financial transactions in the financial services sector.

- For banks and financial institutions, the Cost of Funds approach is often used as a basis for calculating intercompany lending rates applicable within the group. However, the cost of funds comments in the Discussion Draft do not appropriately consider the needs of the financial services sector, which will have numerous and varying funding sources and manage funding on a portfolio basis. We recommend that the cost of funds method in the Discussion Draft be modified to include a pooled cost of funding approach (akin to a fungible approach) for intercompany lending in the financial services sector.

- The Discussion Draft makes no distinction between a captive insurance company which a group uses to essentially 'self-insure' against risks, as compared to intra-group reinsurance of third party risks to a single regulated reinsurance provider. As the differences between these types of captives are significant, each type of captive should be considered separately for transfer pricing purposes. The Discussion Draft should clarify which types of entities that the comments apply to, and note that the comments do not apply to regulated reinsurance providers.

Our detailed comments applicable to the entire draft, along with specific responses to the OECD's questions are set out below.

**Comments applicable to the entire Discussion Draft**

As a non-consensus document it is unclear whether the guidance contained in the Discussion Draft will be incorporated into the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD TP Guidelines"). Even if the guidance is not ultimately incorporated into the OECD TP Guidelines there is the practical reality that tax administrations may take advantage of the guidance in examination of taxpayers. Accordingly, it is our view that the final guidance on the select financial transactions should be limited only to areas of consensus to limit the basis for tax disputes and double taxation; and to better facilitate the resolution of double taxation cases.

Consistent with many other OECD documents, the Discussion Draft does not specify the sectors to which it is applicable. It also does not acknowledge that third party and intercompany financial transactions are intrinsic to the profit earning capacity of financial services firms in a way that differs from other industries. To earn profits, financial services firms take interest rate, foreign exchange and financial
securities/derivatives market risk when facilitating, intermediating or principally entering into various types of financial transactions (including many types that are not covered in the Discussion Draft). Financial services firms also facilitate credit, maturity, and liquidity transformation in a way that other industries do not. Given the lack of consideration for the intrinsic nature of the financial services sector, the Discussion Draft appears more suitable for the non-financial services sector and we recommend that the Discussion Draft clearly state this.

The OECD has previously provided clear guidance with respect to the financial services sector, outlining a clear basis for tax administrations to understand or frame the industry appropriately, such as in the OECD documents, "The Taxation of Global Trading of Financial Instruments: A Discussion Draft, OECD, reprinted 1998" and "The OECD Report on Attribution of Income to Permanent Establishments, 2010". The OECD chose to address the financial services industry explicitly in this previous guidance because it was deemed necessary to ensure a consistent level of understanding across MNEs and tax administrations about the intrinsic nature of financial services. We recommend any guidance on the transfer pricing of financial transactions include clarifications that the guidance is not applicable to the financial services sector. Alternatively, we recommend that specific industry considerations and concerns be included for the financial services sector and identification of where the application of the arm's length standard may diverge for financial services and non-financial services industries.

Regulatory requirements are an important feature requiring special consideration for the financial services sector. Applicable regulatory requirements determine the type of equity and debt capital allowable, the proportion of debt capital allowable, the liquidity requirements under which related party and third party regulated entities must operate, and the amount of business which may be undertaken. In this regard, regulators can dictate the manner in which debt is provided to subsidiaries in a regulated group. For example, in the context of total loss absorbing capital ("TLAC") some regulators require capital to be raised through a particular issuance vehicle, the proceeds from which are then able to be lent to related parties through the issuance of internal or intercompany TLAC.

We note that the Discussion Draft does not make specific references to the regulatory frameworks of the financial services sector. However, the first footnote of the OECD Guidelines notes the following.

"While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognized, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the Report on the Attribution of Profits to Permanent Establishments (OECD, 2010)." ¹

The importance of the footnote noted above cannot be understated. Multinational enterprises ("MNE") in the financial services sector seek to align tax and regulatory positions. The above footnote is an important precursor to the transfer pricing analysis, method selection, and method application put forward by MNEs in the

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¹ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, p 53.
financial services sector. If the Discussion Draft is to be applicable to the financial services sector a clear statement or footnote similar to that above is an essential starting point for acknowledging the importance and priority the regulatory approach to risk allocation should be given when applying the arm’s length standard to intercompany financial transactions in the financial services sectors.

The Discussion Draft explicitly addresses the treatment of captive insurance companies. While paragraph 164 of the Discussion Draft refers to *Part IV of the 2010 Report on the Attribution of Profits to Permanent Establishments* to outline the general scheme of insurance, the definition and operation of a captive insurance company is not discussed or defined. In particular, no distinction is made between a captive insurance company which a group uses to essentially 'self-insure' against risks ("Unregulated Captives"), as compared to intra-group reinsurance of third party risks to a single regulated reinsurance provider ("Regulated Captives"). The differences between Unregulated Captives and Regulated Captives are significant and each type of captive must be considered separately for transfer pricing purposes. We understand the intention of the Discussion Draft is to apply to Unregulated Captives only and this appears to be the case based on the examples and language used throughout, however we suggest that this is clarified. Many insurance and reinsurance companies operate Regulated Captives as core parts of their business and derive significant commercial and regulatory benefits from doing so. There is concern that the current use of the term 'captive insurance' may lead jurisdictions to seek to apply guidelines which have been drafted for Unregulated Captives, to Regulated Captives, notwithstanding it would be inappropriate to do so.

Accordingly, we recommend that it be clarified that the Discussion Draft is intended only to apply to the non-financial services sectors and it is not intended to apply to the financial services sector, and that the principles included in the Discussion Draft should not be 'read across' when considering the financial services sectors. We would also recommend that it be noted that additional separate guidance may be drafted to cover the financial services sector in due course.

To the extent our comments above are unable to be reflected in the Discussion Draft, we recommend that the Discussion Draft be revised to include specific references to the regulatory approach to risk allocation as it relates to the capital structure and funding of regulated entities operating in the financial service sectors. These revisions should acknowledge that the regulatory framework governs actual arm’s length financial transactions of regulated entities and as such provides a transparent, consistent starting point for transfer pricing of the selected financial transactions involving regulated related parties.

**Specific responses to questions raised in the Discussion Draft**

To the extent it is not possible to clearly state the Discussion Draft is not applicable to the financial services sector, we recommend that significant additional guidance be provided which is relevant and applicable to the financial services sector.

To that end, we have included our responses to the Questions and 'Requests for Comments' raised in the Discussion Draft. Our responses are specific to the financial services sector. Accordingly, we would emphasize the importance of separately considering, consulting with and providing guidance for the financial services sector.
Box B.1. Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

Paragraphs 8 to 10 of the Discussion Draft acknowledge that approaches other than the accurate delineation of the actual transaction may be adopted in order to determine the amount of debt that should be priced and to address the issue of capital structure. There are references to other approaches (e.g. a multi-factor analysis) and references to domestic legislation to manage capital structure and interest deductibility. Paragraph 10 of the Discussion Draft concludes by establishing that the purpose of Section B is to provide guidance for those countries that choose to use the accurate delineation of the actual transaction to determine whether an instrument should be regarded as a loan for tax purposes.

We recommend that Section B should also specifically refer to the widely accepted, and transparent financial services regulatory requirements governing the financial services sector, in particular with regard to capital, liquidity and funding. Section B should acknowledge that, structuring financial transactions in a particular manner and the determination of a company’s capital structure, may be as a result of regulatory requirements or limitations. Emphasis should be given to regulatory factors, as in many scenarios it would be reasonable to conclude that regulatory concerns operate as a primary driver in determining at least some element of how a financial transaction is conducted. These regulatory requirements also apply to related parties and third parties in equal measure, which is indicative of arm’s length requirements for all parties.

With respect to the financial services sector, the BEPS Action 4 Report noted “there is a need to develop suitable and specific rules that address BEPS risk in these sectors”.² This is because the intrinsic nature of the financial services sectors warrants different consideration from other industries with respect to interest deductibility given the particulars of debt funding in these highly regulated sectors and the nature of their third party profit and loss earning businesses. It is our view that the Discussion Draft should explicitly include a reference similar to that in the BEPS Action 4 Report i.e. there is a need to develop suitable and specific rules that address the intercompany financial transactions of the (financial services) sector.

The commentary to Article 9 of the OECD Model Income and Capital Tax Convention November 2017 (“the OECD Model Convention”) notes that Article 9 is relevant for prima facie determining whether a loan can be regarded as a loan or should be regarded as some other form of payment such as equity capital.

For the clear interpretation and application of Article 9 of the OECD Model Convention and the associated commentary, we recommend that only the portions of the Discussion Draft for which there is a consensus be considered for inclusion in the OECD TP Guidelines. Accordingly, if there is no consensus on the Discussion Draft recommendation of how to determine the arm’s length amount of intercompany debt capital this particular portion of the Discussion Draft should not be included in the OECD TP Guidelines and should not be applicable for Article 9 purposes.


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If there is a consensus on the Discussion Draft recommendation of how to determine the arm’s length amount of intercompany debt capital, and this portion of the Discussion Draft is incorporated into the OECD TP Guidelines, we recommend that the commentary to Article 9 be modified to reflect the important principles upon which debt capital may be re-characterized and provide clarity with respect to the scenario where a portion of the debt is considered *bona fide* debt and a portion of the debt is re-characterized as equity.

**Box B.2. Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.**

We recommend that special consideration should be given to the financial services sector with particular emphasis given to the impact of the regulatory frameworks in which they operate. We request that it be clarified that the scenario outlined by paragraph 17 be specified as relating to an MNE operating in the non-financial services sector.

If the regulatory approach to risk allocation is applied in a banking example, it is arguable that all debt accepted as debt for regulatory purposes should not be at risk of re-characterization. This may involve a standard amount allowable under regulations and may include a firm or entity specific buffer allowable under regulations, but involving some level of discretion of the related party under consideration.

As a general transfer pricing observation, applicable to all sectors, in our view, provided that both a comparable third party borrower and lender would be willing to borrow and lend the amount of debt respectively, it does not appear to be appropriate to consider that the entire amount of funding actually advanced should be accurately delineated as equity. Provided that third parties would be willing to borrow and lend a certain amount of debt, this amount of debt would appear to create a floor, below which a debt transaction could not be re-characterised as equity through an accurate delineation of the actual transaction approach.

Paragraph 19 outlines that either the borrower or lender may consider the 'options realistically available ("ORA") to them' when considering whether to enter into a financial transaction. The ORA fails to recognize the common strategic aims of a financial service MNEs’ treasury function i.e. to fund the various related parties and businesses at the lowest price possible; and to fund a diverse portfolio of businesses and related parties in line with the MNE group’s overall business strategy. We suggest that it be clarified that the regulatory framework and broader objectives of the group are considered as a factor when considering the options realistically available.

In practice, it may be difficult for taxpayers and tax authorities to prove options which may be realistically available to the taxpayer and further consideration and guidance should be provided to how such an approach could be implemented in practice without significantly increasing controversy, particularly with aggressive tax authorities.

**Box B.3 Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate**
delineation of the actual transaction. Commentators' views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

We note that paragraph 13 of the Discussion Draft states "Because differences exist among industry sectors, factors such as the particular point of any industry in its life cycle, the effect of government regulations, or the availability of financial resources in a given industry are relevant features that have to be considered to accurately delineate the controlled transaction." We recommend that this sentence be modified to make specific reference to financial services regulations and we recommend that an additional sentence be added acknowledging that where financial regulations constrain related parties and third parties in a similar way with respect to capital structure, this should be considered indicative of an arm’s length capital structure.

We recommend including liquidity risk as a key factor when delineating the financial transactions of MNEs in the financial services sector. In practice, when determining the amount of equity and debt in their capital structure, companies in the financial services sector will consider the cost of maintaining liquidity pools, tenor transformation and how to value liquidity premiums when arranging financing from related parties. Financial risks (such as those described above) are already referred to in the 2017 OECD TP Guidelines (Chapter 1, p51, 1.72 paragraph (c)). This type of risk is very prominent for companies in the financial service sectors, and will be a consideration for lenders.

Of the economically relevant characteristics that are outlined in section B.2. the “Characteristics of financial products or services” is the most critical, as the underlying nature of the instrument will underpin the contractual terms and the pricing.

**Box B.4. Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm’s length interest rate.**

We have responded to the comments on risk-free and risk adjusted returns below. Comments in respect of cost of funds are discussed at C.1.7:

**Risk-free rate of return/risk-adjusted rate of return**

Box B.4. includes a discussion regarding situations where the accurate delineation of the transaction shows that a funder lacks the capability, or otherwise does not perform the decision-making functions to control the risk of investing in a financial asset. In these cases the Discussion Draft considers that the funder should not be entitled to more than a risk free return as its profit.

One scenario where more clarity is needed, is the situation where a group entity which does not have the capability or perform the decision making functions to control the risks has borrowed money from third parties to make an investment, and accordingly has a cost of funds. It is not entirely clear from the guidance how the cost of funds should be treated when determining the return that the entity should receive.

This could be a practical issue for the financial services sector which may set up special purpose vehicles to issue debt to the public with a different credit rating to the overall group, or where a group financing company provides a loan to a group subsidiary where the people controlling the risk are employed by another group
subsidiary (i.e. the regulated operating bank entity). Given that the special purpose vehicle or group financing entity in this example would have a cost of funds, if inadequate income was earned by the entity on its investment then it could end up in a permanent loss. This situation can be distinguished from the example in Paragraph 1.85 of the OECD TP Guidelines, due to the cost of funds of the funding entity, which is not addressed in Paragraph 1.85.

Accordingly, we recommend that the Discussion Draft should address whether the funding entity would earn a total profit equal to the risk free rate (i.e. net profit equal to the risk free rate), or whether the income retained by the entity would be limited to the risk free rate (i.e. gross profit equal to the risk free rate), irrespective of the cost of funds.

Similarly, there are situations where a bank headquarter raises funds from third parties, and lends them to a related party special purpose vehicle in a second country, which is then managed from a related party fund manager in a third country. In this situation it would be important that the bank raising funds from third parties can earn sufficient profit on its borrowing, but it is unclear based on the example provided exactly how the profits should be split. Again, additional examples of how the profits should be split would help address these types of cases.

Additionally we recommend that the risk free rate reference point not be limited to the government security with the lowest rate of return. Differences in the rate of return might not be limited to differences in risk between issuers. Differences may arise due to volume and liquidity of the government security and potentially other factors.

We recommend that the guidance on the application of the risk free rate state that where a tax assessor’s transfer pricing adjustment attributes the return above a risk free rate to a particular taxpayer, an attribution of an notional amount of interest expense must also follow (in fact that attribution of interest expense due to commercial, legal, and regulatory reasons should only be notional).

Section C – Treasury function

We observe that the comments in paragraphs 37 to 46 are not applicable to how banks and financial institutions usually operate their treasury functions.

Paragraph 38 of the Discussion Draft states “the organization of the treasury will depend on the structure of a given MNE group and the complexity of its operations”. As a general rule the treasury function of banks and other financial services firms tend to be very complex encompassing a wide range of activities.

While it might be possible for a non-financial services sector MNE to centralize a significant component of its treasury function, an MNE bank or securities trading firm will centralize certain key aspects of its treasury but will not be able to centralize activities that must be performed locally for commercial and/or regulatory reasons.

This section makes reference to liquidity, however it fails to acknowledge the particular importance of liquidity risk management and in doing so misses a very important point, that for many financial services firms, liquidity transformation occurs not only on a third party basis but also on an intercompany basis as part of the treasury remit.
Accordingly, we recommend that the Discussion Draft include an explicit comment that the activities described in paragraphs 37 to 46 are not representative of the complexity of financial services sector treasury functions. To the extent that comments reflecting the functions of the financial services sector is desirable, the CMTT would be happy to provide more information on the treasury function for financial services sector MNEs.

Box C.1. Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

For the financial services sector, it would be rare to see a fully centralized treasury structure, due to regulatory restrictions requiring that local business units meet their own local capital and solvency requirements. Similarly, there may be requirements to ring-fence funds for different types of investments. Therefore banks and financial institutions will generally operate decentralized treasury structures, with a high degree of autonomy over their own transactions to meet regulatory requirements.

Section C – Bank Opinions - paragraphs 92 to 93

Paragraphs 92 to 93 reinforce a position that a simple "bank opinion" (referred to in the Discussion Draft as a "bankability" opinion) are not considered to be proof of arm's length conditions.

In addition to the existing guidance, we recommend that the OECD should distinguish between a simple "bank opinion", which is essentially a black box with no comparable data, and a more complex bank analysis of market information to establish an arm's length rate – particularly for internal use within a financial institution. Such an internal analysis may not specifically relate to a single comparable transaction, but would leverage a financial institution's core competency of analyzing market information (interest rate/yield curve analyses, credit rating analysis, etc.). An analysis prepared in this way, while still being a "bank opinion" of the applicable rate should be acceptable to support an arm's length rate of interest.

Furthermore, we recommend that the paragraphs clearly explain that market reference rates (such as LIBOR, TIBOR, etc.) should be permitted for use in establish arm's length rates, even though they may not be "actual transactions".

Box C.2. Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.
Commentators' views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

For the financial services sector, the first rebuttable presumption (i.e. that an independently derived credit rating for the group may be taken as a credit rating for each group member – a uniform group rating) would be useful and appropriate for most cases. This approach to determining a credit rating reflects the practice of many bank treasury centers to establish funding rates for the group, which are then applied uniformly across the bank, with variances between bank and non-bank funding, short versus long term funding, currency differences, etc. As such, banks will generally not adjust the pricing for related party lending on an entity by entity basis, as such an approach would be onerous given the volume of transactions.

It is important that the presumption is rebuttable and that tax authorities will accept evidence to rebut the position, as there are circumstances where banks may establish a different interest rate. For example, some bank or insurance subsidiaries could have a higher credit rating than the group, such as a subsidiary that is established specifically for the purpose of raising external funds. In this example, the bank/insurer would likely arrange for an independent credit rating for the fund raising vehicle to be prepared. Accordingly, we recommend that guidance be included to clarify that where a public credit rating is available for a group subsidiary, the public credit rating should be used in place of a group rating, and could be used as evidence to rebut either of the presumptions in Box C.2.

In determining credit ratings, consideration should also be given to particular industry conditions or circumstances which would indicate similar credit ratings across a group. For example, in the financial services sector reputation is critical, and allowing a subsidiary to fail would possibly invite a run on an institution (for example the sustained removal of bank deposits). Therefore, even without an explicit intercompany arrangement it would be highly likely that banks and insurers would support their subsidiaries and ensure that debts are settled.

The request for comment with respect to the rebuttal presumptions raises an important question that is not addressed in the Discussion Draft. To the degree related parties' credit ratings are based on (adjusted or not) the group rating, should the cost of achieving credit ratings objectives (e.g. certain administrative, employee, and other liquidity costs in achieving the rating) and maintaining certain credit ratings be factored into the transfer pricing of financial transactions? It would be useful for the OECD to provide clarity on this point in line with the increasing reliance on the group rating and/or the influence of implicit support.

Additionally, with respect to the rebuttal presumption of using the group rating, it is important that the OECD clarify the value of any financial guarantees which typically are viewed as credit enhancing and may be priced on this basis. OECD guidance in this respect would be appreciated.

Box C.3. Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.
Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

A stand-alone credit rating may be the result of the financial strength of an entity, but within a group where a specific related party obtains a rating, that external credit rating may also be part of an explicit effort of the group to support and obtain a rating for a specific related party for specific purposes (i.e. swap trading, medium term note issuing entities, etc.).

In respect of the question around implicit support, this should not be taken into account when a borrowing entity has its own public credit rating, as any support is likely to have already been taken into account. Further, when evaluating the likelihood and effectiveness of implicit support, the particular industry conditions/commercial circumstances should be taken into account. For example, as noted above, for a bank or insurer allowing a subsidiary to fail would have a significant reputational effect globally. Accordingly, an argument could be made that there is significant implicit support.

Despite the above comments on implicit support, in the financial services sector, third parties may still require explicit guarantees – although not necessarily being financial or credit enhancement guarantees. There are situations where explicit guarantees involving related parties have been demanded by third party counterparties in financial services sector transactions (e.g. settlement guarantees, or performance guarantees). These types of guarantees (which are a form of explicit support) are not currently addressed in the Discussion Draft in terms of implicit support, or the comments on Guarantee Fees at Section D - Guarantees. We would recommend that explicit guidance should be provided in respect of other types of important guarantees which are linked to financial transactions. This further demonstrates our broader point that the variety of commercial considerations and variations on transactions involved in the financial services sector require more specific guidance or caveats on the limitation of the Discussion Draft as it applies to the financial services sectors.

Additionally, the reference in this question to how the effect of implicit support can be measured implies that a formulaic approach to pricing implicit support is being considered, or that it may be desirable. Such a formulaic approach may restrict discretion and de-emphasize the specific facts of each taxpayer and entity within a group. As such the current approach indicated in the Discussion Draft is more appropriate.
Box C.5. Commentators’ views are invited on:

- the role of credit default swaps (CDS) in pricing intra-group loans;
- the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

In respect of the role of credit default swaps ("CDS") in pricing intra-group loans we have the following observations:

'CDS' and CDS spreads may be considered as a possible mechanism to measure the pricing in relation to the "country risk" and "transfer and convertibility risk" of borrowing entities. For example, in the absence of any other reliable measure, CDS spreads for the government / leading banks / leading insurers in the borrower country could be used as a possible proxy for the pricing of "country risk" and "transfer and convertibility risk".

However, it should also be noted that CDS may not always represent a "pure" pricing instrument for the country / transfer and convertibility risk, as the pricing may at times be influenced by multiple market related factors (e.g. supply and demand of traded CDS'); may not reflect accurately the country's ability to pay; and the subjective assessment of a country's political will to pass capital control legislation. These factors would also need to be considered when assessing if CDS should be applied to the pricing of intra-group loans.

Taking the above into account, we recommend that OECD to provide appropriate guidance on CDS after factoring in all relevant considerations.

In respect of the use of economic models for pricing loans, although the "cost of funds" approach is more applicable for the financial services sector and banks in particular, we have the following general observation regarding the use of economic models for pricing intra-group loans. As economic modelling will be used to determine the pricing of loans to third parties, it is appropriate that such models could be used for pricing related party debt. The economic model's qualitative data could also be adjusted with reference to quantitative information (i.e. negotiating power) to establish loan pricing.

Box C.7. Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.

For banks and financial institutions, the Cost of Funds approach is often used as a basis for calculating intercompany lending rates applicable within the group.

However, the cost of funds comments in the Discussion Draft do not appropriately consider the needs of the financial services sector, which will have numerous and varying funding sources and manage funding on a portfolio basis. Additionally a variety of different sources may be involved in fund raising, adding complexity to the problem of identifying the cost of funds. Funding is managed in this manner as part of deliberate liquidity risk management strategies that seek to ensure a variety of funding at various tenors which can then be lent on an intercompany basis (often facilitating liquidity and tenor transformation for the intercompany borrower).

Detailed guidance is required for the "cost of funds" approach, which is commonly referred to as "liquidity transfer pricing" predominately in the financial regulatory and
management reporting context of banks. Liquidity transfer pricing is a component of the funds transfer pricing framework, and determines both the time period for which a particular asset requires funding, and the appropriate cost (i.e. "Liquidity Premium") of funding consumed by the asset. The Liquidity Premium may be based on the observed average cost of funding and the availability of balance sheet capacity (after factoring in the routine borrowing from debt issuance, deposits placed by customers, investments in risk free securities, issuance of loss absorbing securities, etc).

Accordingly, this makes it difficult to follow a 'one for one' approach to applying a mark-up to cost of funds (as contemplated in the Discussion Draft, Box B.4., paragraph 21).

Given the above, the one for one approach (akin to a traceable approach) alluded to in the Discussion Draft is practically not applicable to banks and financial institutions, and does not reflect the funding and liquidity and regulatory environment that financial services firms (banks and securities brokers in particular) operate within. Accordingly, we recommend that the cost of funds method in the Discussion Draft be modified to include pooled cost of funding approach (akin to a fungible approach) for intercompany lending in the financial services sector.

Failure to consider a broader definition of the cost of funds particularly in the financial services sector would result in failure to acknowledge one of the major operational, strategic, and regulatory realities of many banking treasury organizations.

**Box E.1. Commentators’ views are invited on:**

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognizing that the policy issuer is actually assuming the risks that it is contractually assuming;

- when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and

- whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;

- when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

We request it be clarified that, reinsurance arrangements of third party risk between a regulated insurer and a regulated captive insurer, are excluded from the Discussion Draft. On the basis that the regulatory framework and oversight which regulated companies are subject to, in of itself, should provide appropriate scrutiny to ensure that risk transfer takes place. This should obviate the need for a separate set of
criteria to prove that risk transfer takes place solely for the purposes of determining appropriate transfer pricing.

Regulatory oversight is a unique feature to regulated entities and is generally considered burdensome and expensive to comply with, but is considered necessary for policyholder protection. Accordingly, when considering whether risk is transferred in the non-financial services sector it may not be appropriate to look directly to the regulatory regime applied to insurance companies, but instead may be appropriate to look towards other factors. For example, we consider that it may be more helpful to look towards the factors alluded to in these questions, such as whether the captive can satisfy the control over the risk requirements, whether it has financial capacity to assume such a risk and perhaps more practically, whether a claim has ever been made against the captive. However, it should be emphasized that in a regulated insurance company, a consideration of these factors should not be relevant as the effect of the regulatory regime ensures risk transfer.

In considering the appropriate outsourcing of an underwriting function we consider that sections 1.65 - 1.67 of the OECD TP Guidelines may be made reference to which specifies that while the day-to-day risk mitigation activities may be outsourced, a person must have the expertise and capacity to determine whether such risk mitigation activities are being appropriately performed by the outsource provider and must have the expertise to adapt or terminate the outsourcing contract. Therefore, while it is not necessary for day-to-day risk management activities to be undertaken by the captive, sufficient underwriting expertise should be housed in the captive in order to make appropriate decisions with regard to the management of insurance risk. We consider that an example would be helpful in clarifying the appropriate level of expertise that a captive should employ.

Where an MNE group member which issues insurance policies does not satisfy the control of risk requirements of Chapter I, arguably premiums received / returned and insurance claims should not be wholly allocable to that MNE group member and instead that should be put in the position of earning a risk free return in respect of capital held.

Box E.3. Commentators' views are invited on the example described in paragraph 187 and 188 of this discussion draft.

As discussed earlier in this response document, a distinction should be made between the scenario where an MNE group seeks to 'self-insure' through the use of an Unregulated Captive and the scenario where third party risk is reinsured on an intra-group basis by a regulated insurance company, which we have defined as a Regulated Captive. The scenario described by paragraph 187 and 188 involves the reinsurance of genuine third party risk, and so is closer to the Regulated Captive scenario. Whereas the focus of this Discussion Draft, including the Fronting section in paragraph 177\(^3\) has largely been Unregulated Captives.

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\(^3\) Paragraph 177 appears to focus on the interaction between the fronter and the MNE group rather than the regulated insurer
Appendix 1 – List of members of The Capital Markets Tax Committee of Asia

1. AIA
2. Allianz
3. American Express
4. ANZ
5. AXA Asia
6. Bank of America Merrill Lynch
7. Bank of China
8. Barclays
10. BlackRock
11. BNP Paribas
12. Citigroup
13. CLSA
14. Credit Agricole CIB
15. Credit Suisse
16. Daiwa Capital Markets Hong Kong Limited
17. DBS
18. Deutsche Bank
19. Eastspring Investments (Singapore) Ltd.
20. Fidelity Investments (HK) Ltd
21. First Abu Dhabi Bank
22. Goldman Sachs
23. Hang Seng Bank
24. HSBC
25. ICBC Standard Bank
26. ING
27. JPMorgan Chase Bank, NA
28. Macquarie Bank
29. Manulife
30. Morgan Stanley
31. National Australia Bank
32. Natixis
33. Nomura
34. Prudential Corporation Asia
35. Rabobank International
36. Royal Bank of Canada Capital Markets
37. Royal Bank of Scotland
38. Societe Generale
39. Standard Chartered Bank
40. Swiss Reinsurance Company Limited
41. UBS
42. Westpac
September 6, 2018

Tax Treaties, Transfer Pricing and Financial Transactions Division
Organization for Economic Cooperation and Development
Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Subject: Base Erosion and Profit Shifting (BEPS) Action 8 – 10 Financial Transactions

Dear Sirs and Madams:

We are responding to the invitation to send our comments on the discussion draft Report 8-10 of the BEPS Action Plan (“Aligning Transfer Outcomes with Value Creation”), Working Party No. 6 (“WP6”). Our comment starts with some general remarks, followed by arguments responding to the specific questions included in the boxes.

The Captive Insurance Companies Association (CICA) is a multi-national, domicile-neutral captive insurance association. CICA’s approximately 400 members are from a cross-section of domiciles, captive/risk retention groups and service providers from 27 countries around the world. For over forty-five years, CICA has been working to protect the captive industry.

CICA is committed to providing the best source of unbiased information, knowledge, and leadership for captive insurance decision makers. By monitoring emerging issues and regulatory changes in the U.S. and around the world, CICA and its advocacy partners can respond proactively to help mold laws and regulations affecting the captive industry. Our member representatives in partnership with the European Captive Insurers and Reinsurers Owners Association (ECIROA) have reviewed the OECD’s report and welcome this opportunity to share our input.

Also attached is CICA’s Guidance for Captive Owners and Managers, addressing the 2013 OECD Action Plan on Base Erosion and Profit Shifting, which explains in detail how the captive industry is prepared for the requirements formulated in the BEPS Papers. This has been previously submitted to the OECD.
General Remarks:
CICA supports the targets of OECD which have been preformulated by the G-20.

It is imperative that the OECD should ensure that any new guidance relating to captive insurance companies should not contradict certain fundamental accounting and insurance regulations already in place and adhered to by multinational companies. In this regard, we believe that the arm’s length principles of any transfer pricing arrangements involving a captive insurance company should firstly be treated as a genuine insurance transaction satisfying the conditions of IFRS 17 and secondly it must fall within the specific categories of insurance classes laid down by the insurance regulations for which the captive is authorized to conduct in the jurisdiction. Currently, the draft discussion paper includes certain comments and examples which could potentially give rise to unnecessary uncertainty and time-consuming administrative burden for both MNEs and tax authorities.

Box E.1. Question to commentators
Commentators’ views are invited on the following:
• 1 - when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognizing that the policy issuer is actually assuming the risks that it is contractually assuming;
• 2 - when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and
• 3 - whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;
• 4 - when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

Comments:

Ad 1
   - Both, direct captive and reinsurance captive are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer
and appropriate capital levels. To align the requirements, IAIS (International Association of Insurance Supervisors) has issued the “APPLICATION PAPER ON THE REGULATION AND SUPERVISION OF CAPTIVE INSURERS, November 2015”. (Link: https://www.iaisweb.org/page/supervisory-material/application-papers/file/58019/application-paper-on-the-regulation-and-supervision-of-captive-insurers-
)

- There is pooling of risk in the captive insurer, carrying a diversity of risk spread within the group’s scope of activity,
- Captives have the requisite skills and experience at their disposal in accordance with the supervisory requirements (such as Solvency II or IAIS paper) to third party service providers acknowledged and/or registered by the local supervisor. All required functions - identical with those for all other insurance companies - have to be exercised and approved. No lighter regulatory regime for insurance of group risks is existing.
- Note: in some regulatory regimes captives are granted some simplification due to the application of the Proportionality Principle
- Outsourced functions such as premium collection and claims handling are appropriately remunerated according to the service they provide based on contracts or service level agreements which are transparent and following the arm’s length principles (and which are under pressure of a strong competitive market).
- The commercial rationale to establish the captive is determined by the risk management concept of the owner to carry part of the insurable risk within the group to save cost and administrative burden. The use of the term “mitigation” may mislead the reader due to the fact that the captive is assuming the insured risk within the limits of their policy (contract) and protects itself via reinsurance in the market (e.g. stop-loss cover).
- Risk in excess of the capacity which the captive can pay for, based on equity, premium and reserves, usually is insured in the insurance market outside the group.
- The captive has a real possibility of suffering losses, i.e. to pay in accordance with the policy underwritten up to the limits of these policies and in the annual aggregate.
- A properly managed and regulated captive will have sufficient reserves to meet its liabilities. The extent of risk diversification is relevant only to the likely level of reserves that may be required.
- A properly managed captive will have risks presented to it. The captive board will decide whether to accept the risk, and if so, on what terms. This decision is not taken elsewhere in the group.
- OECD should not try to introduce new definitions of insurance and insurance contract but rather refer to IFRS 17 and IAIS definitions of “genuine insurance transaction”
- In a Solvency II environment for instance this would be demonstrated by the ORSA report
It is unnecessary to create another set of indicators to evaluate whether the captive is actually assuming risk. There are currently well understood and applied principles in this regard that tax authorities could rely upon such as IFRS 17 and the insurance regulations. They generally follow the standards laid down by the European Union directives and/or the International Association of Insurance Supervisors. Creating another set of “indicators” is likely to create confusion, uncertainty, and inconsistency between accounting, insurance, and tax regulation.

Captives are required to apply for insurance / reinsurance licenses from regulators and test the ability for the entity to act as an insurance risk bearing vehicle. The application process will evaluate the risk that the captive is proposing to take, which will be clearly outlined in the proposed insurance contract that is required to contain certain minimum standards, such as appropriate risk triggers, consistent with the principles of insurance set by the IAIS and IFRS 17.

Regulators will stipulate the financial conditions required by insurance / reinsurance entities to accommodate the levels of risk proposed.

Regulators will also test the governance and oversight arrangements of the proposed operation, requiring certain standards.

Only when these areas have been scrutinized and evaluated against the requirements as set for the jurisdiction in question, will insurance / reinsurance license be granted.

With these comprehensive measures in place, we suggest that the OECD acknowledge the measures already in place by insurance regulators to determine the legitimacy of insurance for individual captives as further tests will undermine the insurance regulatory processes, create duplication and will be unlikely to strengthen the tests of insurance already in place.

Ad 2

The commercial reasons for an MNE group to use a captive insurer normally include some or all of the following: a. stabilizing premiums paid by MNEs within the MNE group; b. gaining access to reinsurance markets; c. reducing the cost of risk because the group considers that retaining the risk within the group is more cost effective; d. providing coverage when the commercial insurance market makes it difficult or too expensive to get insurance coverage for certain risks; e. centralizing the MNE’s insurance data and costs - but f. definitely not to benefit from tax and regulatory arbitrage.

Where such difficult to insure risks are insured by a captive insurer this will be on an arm’s length price calculated on the risk assessment of insurance experts experienced in bundling a variety of risks which allow to place these risks in the reinsurance market with a high attachment point (always due to approval of the local supervisor).

For any risks for which market comparability is difficult, the OECD should bear in mind that this does not mean the risk in ‘ uninsurable’, but that either the market is insufficiently informed on the risk or has only a developing appetite for the risk.
- Captives, supported by appropriate data and robust transfer pricing techniques, can also legitimately accept risks, subject to the overriding insurance regulatory framework requirements.
- Captives issue an insurance policy based on a lot of criteria/parameters, similar to the traditional market: a. loss ratio (of insured) compared to market, b. experience based, c. premium adjustment due to loss/claim development, d. risk mitigation tools of insured, loss prevention i.e. technical standards or legal provisions
- Captives are used to insure previously uninsured risks as an incubator for new products. The captive gathers loss information to enable the product and pricing to be refined.
- The OECD still questions whether putting difficult to insure risk (i.e. insurance too expensive in the commercial market) is a valid transaction. It absolutely is: while it may be a crucial risk, it is still a risk to the company who has a captive, thus they need to account for it in some way to protect themselves, and a captive is a great way of doing that. – Examples: Where companies have incubated risk in their captive to build up a risk profile, or where the commercial market is undeveloped, and actually transferred this into the commercial market after a few years (cyber or supply chain risk are examples of this).
- In relation to the OECD’s suggestion that tax arbitrage is a driver for captive utilization, it should be highlighted that, through the use of a captive, the MNE is attracting additional indirect taxes such as Insurance Premium Tax and equivalent tax charges, which, on a consolidated view, can result in higher tax liability position for the MNE.

Ad 3
- As in all relationships between insurer and insured there is a learning aspect for the risk management function of the insured group. Captives assume risk. The responsibility for risk in the group is assigned to the Board level of the group. The control and daily management of risks within the group is delegated to a separate function. Either a risk management or an insurance department takes care for the risk transfer – this is done usually in the insurance market. Part of this risk can also be presented to a captive, but the captive Board has in its own responsibility to decide whether to accept these risks and, if so, on what terms. The captive has to secure that the financing of the notified claims and losses is guaranteed.
- The performance of outsourced functions is based on a contract/service level agreement which determines precisely what the service provider has to do. The work is remunerated in accordance with his performance and can be compared with the prices of competitors.
- Outsourced underwriting for the direct captive is based on the criteria/parameters mentioned above. The service has the same effect on the captive as if the underwriter would be an employee of the captive.
- A properly managed captive will have risks presented to it. The captive Board will decide whether to accept the risk, and if so, on what terms. This decision is not taken elsewhere in the group.
- Decision-making always remains with the captive’s Board of Directors or Underwriting Committee. This includes decisions about which risks to underwrite or not, under what terms and conditions, as well as which reinsurance protection should be purchased or not.
- The captive should be able to demonstrate access to the appropriate skills, expertise and depth of resources to undertake its activities. These need not be employees as long as the remit under which they operate is clear and defined. Where the resources are provided by a service provider then appropriate outsourcing/consultancy contracts should be in place, and where the functions are provided by other employees of the MNE there should be clear segregation of duties.
- Generally, the current insurance regulations are extremely stringent about the various functions of the captive such as underwriting and outsourcing etc. That would not require further layer of regulations by the OECD. There is a risk that any additional requirements issued by the OECD could potentially create unwarranted confusion, ambiguity, uncertainty and in the end lot of administration for MNEs as well the corresponding tax authorities. OECD need to respect and acknowledge the standards, rules and regulations set out by the International Accounting Standards, the European Union, International Association of Insurance Supervisors and the respective insurance supervisory regimes.
- The captive Board is responsible for all decisions relating to the operation of the captive. All risk decisions must be considered in relation to the Board approved underwriting policy, which will comprehensively outline the nature, type and quantum of risk that the captive can assume. The underwriting policy of the captive, as with all the Board approved policies, are subject to Regulatory approval and ongoing audit scrutiny.
- This process is buttressed by numerous control functions, internal procedures and oversight measures, including the presence of an underwriting function, whose primary function is to oversee the correct application of the underwriting policy and apply expert judgement on the performance of risk assumed by the captive.
- It is important for the OECD to appreciate the highly regulated environment in which captives operate and the high standard of expertise required and expected to satisfy regulatory requirements.

Ad 4
- As an insurance company the captive has to follow the requirements of the regulation. It cannot be influenced by other parties in the MNE group how to act or react. The only ultimate control over the captive is given on the Board level of the captive based on a delegation of responsibility (from MNE Group Board level) which is a requirement of Corporate Law and Corporate Governance Guidelines.
- Fronting: Captives can apply for the license to underwrite all lines of risk. The supervisor has to approve it. Fronting insurers are necessary to issue local policies in numerous countries to structure a compliant IIP. The direct captive cannot issue local policies in other (third) countries without a license. Only in Europe, based on the Freedom of Services Rule the direct captive can issue
policies. Fronting insurers provide the service for the entire group of insurers which carry part of the risk – in a quasi-syndication. The fronting carrier is reinsuring the lower part of the programme (with an expected higher frequency) to the captive. The premium includes the cost of doing (ceding commission), i.e. the entire policy issuing, money transfers and claims handling, beside the price for carrying the risk.

- There are two different approaches, gross and net structures of the IIP. In a gross structure the entire premium is running through the captive and the captive has to pay for reinsurance in excess of the risk which it assumes on its account; the premium share is appropriate and sufficient to cover to the two parts of the risk (i.e. for captive and reinsurer). The reinsurers invoice the appropriate part of the premium to the captive. In a net structure the captive receives based on the fronting policy only the premium which is necessary to cover the assumed risk. This leads to the question of the calculation of this premium which has to be arm’s length.

- A situation where the Board of Directors of the captive would not have any say in the underwriting strategy of the captive and would not have the possibility to decline underwriting would not be possible under insurance regulations

- But even in such case, if there is still actual risk transfer to the captive and the captive does provide risk bearing capital, the captive would still be entitled to the risk premium. The question from a transfer pricing perspective is more around the appropriate remuneration of those functions through service level agreements.

- And if the captive has so little substance that its mind and management is not deemed to be within its domicile at all, then this situation is already addressed within existing Controlled Foreign Companies (“CFC”) legislation and the entire profit would be reallocated to the parent country, and/or premiums would not be deductible and claims could not be paid. The local regulator could also cancel the captive’s license for lack of local governance.

- The insured third party (which is the owner of the captive) is not indifferent to the levels of the price of insurance - Why would the transaction not be genuine insurance? The captive needs to ensure that it collects sufficient premium to cover its risk. The insured wishes to keep the premium to a minimum to reduce premium taxes and ceding commission

Box E.2. Question to commentators
Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

Comment on the entire Chapter E.5. - Determining the arm´s length price of captives:

- The calculation of an arm’s length premium is in the best interest of all involved parties. The criteria and parameters to determine and calculate the “correct” rate is not an exercise of one method (in comparison to other methods). It is the combination of all mentioned so-called methods under para. E.5 (Determining the arm’s length price of captives).
- Before establishing a captive, the MNE group has insurance experience and price expectations having placed their insurance policy in the market without captive. Once, the captive starts underwriting part of the MNE’s risks, the comparison with the former premium is one of the factors to find the risk adjusted premium for the two parts of the insurance cover, a. for the captive and b. for the insurance market which is still carrying most of the risk, especially the higher sums insured (e.g. in a layered insurance programme). Before a MNE will agree on and accept an offer from the insurance market, the MNE has received different submissions from various insurers at a market price. The captive now has to calculate how much of the total risk of an insurance policy (or programme) it can underwrite (based on the signed capital and expected premium income) and parallel, the premium can only be part of the total market premium, appropriate to run this type of risk over a midterm period.

- There is always the opportunity for a back-testing in the market whether a premium rate would be too high or low. Submissions are done regularly or frequently to receive from the market comparable quotations.

- The premium always includes cost of administration of the captive, the fronting fee (or ceding commission) for the fronting insurer, for claims handling, investment management and the service providers which take over some functions described as necessity in the IAIS paper or in Solvency II and/or for broker services as part of the value creating chain.

- Abuse can easily be identified when some of the parameters and charges are beyond the market standard and also offending common sense evaluation based on a diligent observation.

- The insured third party (which is the owner of the captive) is not indifferent to the levels of the price of insurance - Why would the transaction not be genuine insurance? The captive needs to ensure that it collects sufficient premium to cover its risk. The insured wishes to keep the premium to a minimum to reduce premium taxes and ceding commission

- The actuarial analysis presented under para 181 is an alternative which is comparable to the combined approach mentioned in the para above. Why? Because all data and experience which is used, applied and integrated in the process to determine the rate of line (premium as above) is used also as the basis for the actuarial quantification.

- The application of actuarial science is a requirement in all (or most of) the regulatory regimes for the respective portfolio; this has to be applied for all captive lines of business as well.

- Actuarial pricing is indeed a widespread pricing methodology for the entire commercial insurance market

- Actuarial pricing is similar to Cost Plus transfer pricing method. The cost element is made of expected losses and the margin element comprises a risk margin for volatility, a compensation for running costs (distribution, underwriting, claims), and a profit margin.

- Actuarial analysis is indeed a widespread pricing methodology in the insurance market and we welcome the approach described in paragraph 181. This approach is in line with international supervisory standards such as the Solvency
II Directive. As well as providing a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and provide robust support to the risk retention / transfer decision.

- It is our view that actuarial techniques represent an exceedingly reliable pricing approach, where the exposure data, loss history and other relevant factors are developed into a bespoke model to forecast losses which enables the determination of an appropriate technical premium for the risk in question.

- However, a matrix ‘approach should be appropriate, with option for market comparability or actuarial approaches, dependent on the individual circumstances involved. The nature, scale and complexity of the risk in question should be considered in the determination of the appropriate transfer pricing approach, i.e. a stable property portfolio with 10 years loss data and accurate exposure data may require triennial actuarial review with underwriting oversight in intervening periods. Less stable or more complex risk types requiring more frequent assessment.

- Synergy benefit comes from three elements: synergy between group entities, risk transfer, and risk bearing capital. Only the captive can provide risk and capital as a licensed insurance or reinsurance entity. Entities would not be able to achieve same level of benefit without the captive. So, the captive does provide added value in the transaction and should be duly remunerated for that. The captive should be recognized as a substitute for another commercial insurer, being subject to approval of supervisors.

- We follow the description of the group synergy effect with one additional comment: the synergy benefit arises from the collective purchasing arrangement which include a multiple of legal entities in a multiple of countries and has to be monitored in such a way that for the big insurance entity (i.e. the captive). The captive has the opportunity to buffer the payout for claims and losses based on the regulatory requirement to set aside reserves for the future events. These reserves are assessed under the regulatory regime as capital beside the equity. This explains why the captive is adding real value to the MNE group’s activity.

**Box E.3. Question to commentators**

Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion drafts.

**Comment:**

- Depending on the line of business a captive is underwriting and who is the insured customer (and/or beneficiary), the business may be direct underwriting with third parties and consequently not a captive business, its pure traditional insurance.

- The Dixon’s case is in our view definitely no captive arrangement and we agree that this type of business should be run as traditional insurance. The main issue of this case has been alleged circumvention of tax payment. We never advice MNEs to structure such a SPV for tax reasons.
The paragraphs 187 and 188 are not an example to discuss captive business. In this world there are lots of SPVs using the financial markets which try to avoid or circumvent tax or to mislead customers, supervisors, taxmen and the public. They may generally present non-transparent and non-conclusive numbers, are not regulated and not approved by supervisory authorities.

Captive insurance is a risk financing tool that is essential for stable business operations, not tax avoidance. Captives are highly regulated entities by the authorities where they are registered.

Thank you again for this opportunity to submit comments.

Respectfully submitted,

Daniel D. Towle, President
Captive Insurance Companies Association
4248 Park Glen Road
Minneapolis, MN 55416
USA
dtowle@cicaworld.com
www.CICAworld.com
BEPS Actions 8-10 – Financial Transactions: Public Discussion Draft
Response by the Chartered Institute of Taxation

1 Introduction

1.1 We refer to the Public Discussion Draft published on 3 July 2018 on BEPS Actions 8-10 – Financial Transactions. We welcome the OECD’s time and effort in this very difficult area and are pleased to provide the comments below.

1.2 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers and tax authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

1.3 In our view, objectives for the tax system should include greater simplicity and clarity, and also greater certainty, so businesses can plan ahead and make investment decisions with confidence.

1.4 The discussion draft provides a lot of background information and raises some key questions that are a useful starting point to develop guidance in this area that should benefit taxpayers and tax administrations in pricing specific transactions that have historically posed challenges. The discussion draft is generally well balanced, constructive and informative, and we welcome it, and the opportunity to comment on it.

1.5 The discussion draft sets out a broad framework to expand the existing guidance and to document practices in applying the OECD Guidelines. For the framework to be effective, we suggest that it will require further explanation on how it should be applied in practice and consensus amongst OECD members. The fact that the OECD is at the moment unable to come to a consensus view on this, suggests that a public consultation on the issues raised in the discussion draft would be a useful next step.
1.6 With this in mind, we set out below some areas, where we think it would be helpful for the OECD to consider as it develops the guidance further.

2 Compliance and administration

2.1 The discussion draft implies that a full functional analysis and documentation exercise is required for all intra-group financial transactions. This is overly burdensome. MNEs undertake a significant volume of intra-group transactions, including many transactions that are small (either in relation to the group, the funded activities, or the size of the economy of the country receiving or providing the funding). Treasury functions are set up (in part) to reduce the administrative burden of dealing with such large volumes of transactions.

2.2 By requiring significant functional analysis and documentation for all transactions, the stated goal of the project, which is to target tax avoidance through BEPS, seems to be overlooked. Accordingly, proportionality must be considered and promoted in guidance, and we believe that the majority of the guidance would also benefit from being restricted to ‘high risk’ transactions; if the focus were more clearly on how to address complex and high risk transactions, this could be a more targeted discussion.

2.3 Thresholds and safe harbours can be valuable tools to limit the time incurred by both taxpayers and tax administrations where the underlying exposure or risk is minimal. While relying on safe-harbours would create an additional compliance burden for EU based entities (due to the recent amendments to the Directive on Administrative Cooperation requiring all such cases to be reported), optional safe-harbours (which are not ‘relied upon’) and thresholds would be welcomed by taxpayers and would, presumably, be useful to tax administrations’ objectives to focus on high risk transactions.

2.4 To the extent that treasury functions are set up to reduce the administrative burden of dealing with significant volumes of similar transactions, it may be worthwhile exploring whether the facts and circumstances in some cases suggest returns could be simplified by looking to functions rather than transactions.

2.5 Cash pooling by treasury functions is an area where the use of thresholds/safe harbours may be particularly appropriate. Unless a treasury function is located in an unusually lowly taxed jurisdiction, any profits it makes, including “cash pooling synergies” will be subject to tax; and the reallocation of synergies is thus only reallocating taxing rights. Such reallocations are likely to be complex to perform, and to audit/review by tax authorities. Except in very large Groups they are unlikely to result in a significant reallocation of tax between territories. Accordingly, in the interests of cost-efficient tax administration for both taxpayers and tax authorities, we suggest that a threshold be determined, below which no reallocation of synergies should be made. In the case of a below threshold treasury function set up in a tax haven, CFC rules would be a better approach to ensuring the synergy benefit did not go untaxed, rather than a reallocation of benefit.

3 Purpose of the Guidelines and interaction with domestic laws

3.1 Increasingly, countries are introducing tax rules that impact cross border transactions that are not strictly aligned with the arm’s length principle. These are generally
focused on tackling potential abuse, and it is generally understood that departures from the arm’s length principle can be appropriate in such circumstances.

3.2 Some of these rules (for example the interest restriction rules agreed under BEPS Action 2, or controlled foreign company rules in accordance with BEPS Action 3) have benefitted greatly from multilateral agreement at the OECD on a framework that guarantees (at least a degree of) comparability and cross-compatibility between different countries’ rules. This allows taxpayers to structure their affairs in ways that give them greater certainty and are aligned with the many governments’ objectives of ensuring tax is levied where value is created and eliminating double-taxation and non-taxation.

3.3 However, other unilateral measures have been introduced (for example recharacterisation of transactions or interest limitation rules that are not aligned with the BEPS Action 4 recommendations) that depart from the arm’s length principle (albeit - in some cases - with the same objectives) in ways that have not been agreed multilaterally. Such unilateral action poses significant challenges for taxpayers in ensuring that they are not subject to double taxation.

3.4 With regards to financial transactions, we believe that the BEPS Action 4 recommendations have relieved the pressure in situations where there is a difference in view between countries (or between taxpayer and tax administration) about the appropriate amount of leverage that a company can bear. However, the discussion draft confirms that the pricing issues it seeks to address does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation, presumably in addition to the approach agreed under BEPS Action 4.

3.5 Appropriately, the discussion draft focuses more on providing certainty around appropriately delineating and pricing certain transactions, than on answering broader questions around whether the actual capital structure of groups should be respected for tax purposes. However, we believe it would be helpful for the guidance to recognise that unilateral restrictions on capital structures, in addition to interdependent, but separate, transfer pricing and non-transfer pricing based rules, necessarily weakens the importance of finding the appropriate transfer price of a financial transaction: in many cases, absent global agreement on a different approach, the result is double taxation.

3.6 Where such domestic restrictions will override any detailed analysis of the appropriate transfer price in any event, it would be helpful if this were recognised in discussions of the level of work (and documentation) that taxpayers should be expected to prepare.

4 Understanding of (and interaction with) the arm’s length principle

4.1 Notwithstanding our agreement that the focus of the guidance should be on the accurate delineation and pricing of transactions (rather than the appropriateness of capital structures within a group), there are elements where it will be essential to explore further the interaction between the two areas, specifically in relation to:

- whether the ‘options realistically available’ test (when applied to a borrower) implicitly asks questions around capital structure;
• reallocation (and corresponding / future year adjustments, including the impact on sourcing for withholding tax purposes) where the appropriate delineation results in the legal funder being awarded only a risk free return;
• expected substance requirements for relevant financing and treasury functions; and
• the circumstances requiring multi-sided analyses, and the interplay with the single entity principle (which is particularly challenging when looking at credit ratings).

4.2 More broadly, there remains areas of discussion among practitioners (which was common to the profit splits and hard to value intangibles projects) whether the purpose of the guidance is to identify the arm’s length price for transactions based on what third parties actually do, or rather whether the objective is to identify what third parties placed in similar situations would do.

4.3 It has been broadly understood that where similar transactions are entered into between third parties (based on the accurate delineation of the transaction), then pricing should be applied in accordance with those actual prices, but that where transactions are (by their nature) transactions which unrelated parties would not undertake with each other, it is more appropriate to look at what (if they had) they might have done (which may be based on a review of realistic alternatives).

4.4 It may be useful to spell this distinction out more clearly, and to which transactions each approach should be adopted. For example, cash pooling transactions are unlikely to be entered into between groups of unrelated entities, while long term structural loans are more likely to be so. There are, however, reasonable comparables for deposit rates on the open market to demonstrate the costs/returns of realistic alternatives for each party if the intra-group cash pool was not available. Drawing out this distinction on the underlying economics (and potential reasons for diverging from an approach of seeking third party comparables), may be a useful starting point in reaching consensus on which transactions (or which transactions under what circumstances) should be viewed through these different lenses.

5 Section B: Interaction with the guidance in Section D.1 of Chapter 1

5.1 We suggest that, as it stands, the guidance on risk free and risk adjusted rate of return is too theoretical and does not provide any real practical assistance as to how to determine the different elements of risk identified. It would be helpful if the guidance could be made more practical. It is also not clear from the discussion draft how the outcome of the proposed risk-free and rate of return approach will differ from the approach applied by MNEs of determining arm’s length interest in reference to the interest attached to a comparable arrangement with similar economic circumstances.

5.2 The discussion draft refers to situations where a funder lacks the capability to control the risk associated with investing in a financial asset (paragraph 11 under the Box B.6.). We are not clear in what circumstances a funder would lack the capacity to control at least some of the financial risk associated with the provision of funding. Consequently, we cannot envisage any circumstances in which the suggestion that risks can be separated and allocated to a party not involved in the intercompany arrangement could be applicable. It would be helpful if the OECD could revisit the points being made.
Section C: Treasury functions

6.1 The discussion draft includes an explicit statement (in paragraph 47 under section C.1.1.) that both the lender’s and borrower’s perspectives should be taken into account when determining the delineation of a financing transaction. From a practical perspective, historically there has been greater focus placed on the circumstances of the borrower (for example its credit worthiness) to determine the arm’s length pricing of intra-group debt. This does not mean the lender’s perspective has previously been ignored but as a result of the position historically, we suggest that further guidance is required to understand how both the lender’s and borrower’s perspectives should be taken into account when applying the statements contained in the discussion draft. It is likely that the parties will have different considerations that may result in differing views as to what is the arm’s length interest rate.

6.2 As they currently stand, we do not think that either of the suggested approaches in terms of using the group credit rating as a proxy for local entity credit rating would achieve tax certainty or easily enable tax compliance by MNEs and suggest that further detailed guidance is required as how such proposals should be applied. Furthermore, the approaches are not aligned with the commercial considerations that external lenders will have when making a lending assessment.

6.3 Assessing the impact of implicit support on credit worthiness is difficult from a practical perspective as tax administrations currently have differing views and approaches to assessing the impact of implicit support on a credit rating of a group member, with some taking it into account and others not. This highlights just one area where international consensus would provide clarity and, we suggest, that the OECD should be working towards this being a key outcome of this consultation. Paragraph 69 states that the level of group support will depend on the status and ‘relative importance of the entity’ to the group. This is a wide-sweeping statement as, in reality, the level of group support is likely to vary depending on the industry and other economic considerations.

6.4 Other particular aspects on which international consensus through this public consultation process would be welcomed to provide clarify are:

- an internationally agreed methodology for pricing intercompany loans and we consider that economic models could be used to arrive at a price for intercompany loans for an entity based on relevant or industry accepted financial metrics; and
- the definition of a stand-alone credit rating.

Examples

7.1 We welcome the inclusion of examples in three sections of the discussion draft. It would be similarly welcome and useful to have examples in the remaining sections.

7.2 In addition, as with all OECD guidance, the closer that several examples can be to demonstrating the salient features that would lead to the appropriateness of different approaches (or demonstrate the BEPS risk that the OECD seeks to address) would be most welcome.
8 Acknowledgement of submission

8.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

9 The Chartered Institute of Taxation

9.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 18,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.
Comments on OECD Discussion Draft on the Transfer Pricing aspects of Financial Transactions
SECTION B - Interaction with the Guidance in Section D.1 of Chapter I

This section of the discussion draft discusses how the concepts of Chapter I of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘OECD Guidelines’) in particular the accurate delineation of the actual transaction under Identifying the commercial or financial relations (as described in Section D.1 of the OECD Guidelines Chapter I), may relate to the capital structure of the entity within an MNE Group.

Box B.1. Question to commentators:
Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention (“MTC”), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

Recommendation:
Para 10 mentions that the purpose of the section is to provide guidance for those countries that use the accurate delineation under Chapter I to determine whether a purported loan should be regarded as loan or not. However, in our view the guidelines should recommend that each country should accurately delineate the financial transaction applying principles laid down in as per BEPS Action Plan 8-10 read with guidelines issued on Financial transactions from time to time.

Box B.2. Question to commentators:
Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

Recommendation:
The complete amount should be considered to be equity contribution rather than bifurcating the amount into loan and equity basis willingness of third party lender or borrower. At a given point in time, basis financial position of the borrower, even if lender will be willing to lend say 10% of the total funding requirement, the borrower may not be willing to block the regular borrowing limits for funds that may be required by him for meeting working capital
requirements by accepting 10% loan for a strategic project where funds are sought at the behest of shareholder or for a particular capex project.

Further, once a loan transaction is accurately delineated as equity contribution, at the time of analysing other financial transactions subsequently, while determining creditworthiness and financial capability of the borrower, the initial transaction should be considered as equity contribution rather than going by the form. The guidelines should bring out this aspect for better clarity and to avoid contradictory approach adopted by different jurisdictions.

Box B.3. Question to commentators:
(i) Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.
(ii) Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

Recommendation:
The most important factor that should be considered to be decisive factor while delineating the financial transaction is the creditworthiness and financial capability of the borrower at the time of entering into financial transaction. If basis creditworthiness of the borrower, no third party lender would have been willing to lend funds, then the entire amount of loan should be delineated as equity. Post above analysis the other factors like absence or presence of repayment date, tenure of loan, purpose of loan should not play a role in overturning the nature of financial transaction. This fact should be brought out specifically under guidelines with a mention that other factors as mentioned in para 15 and para 16 may add persuasive value to delineation of transaction if at all.

Even if the purpose is to use the funds for day to day operations, since no third party lender is willing to support the borrower, the parent company has ultimately in its capacity as a Shareholder has infused funds by way of interest free loan which in substance is equity looking into larger business interest for group as a whole. Further, once basis the creditworthiness of borrower, an interest free loan is delineated as equity, the tax authorities should not be concerned over the form used to infuse funds by the parent company as lot of factors like restrictions to infuse equity to safeguard minority interests, FDI restrictions, regulatory approvals can play a role to make investment by way of loan rather than equity which in substance is equity. Further, one of the major objectives of BEPS Action Plans was to look at substance rather than form and that has been aptly reiterated in para 12 of Discussion Draft also that particular labels or descriptions assigned to financial transactions do not constrain the transfer pricing analysis and that accurate delineation of the actual transaction under Chapter I will precede any pricing attempt. To add emphasis on this aspect, the guidelines should further bring out clearly that if in substance on accurate delineation, the
financial transaction emerged as an equity contribution, the tax authorities of both borrower and lender jurisdiction should not be concerned with form [i.e. interest free loan] and disregard the form for tax purposes.

The above view further strengthens if provisions dealing with Thin Capitalization are looked into as dealt with under Article 9 of OECD Model Tax Convention also. If on one side for tax purposes, an interest payment is disallowed because the loan is regarded as equity contribution in essence, then on other side, principally applying same parameter, for transfer pricing purposes also, if loan is considered in essence as equity, no interest income should be imputed in hands of lender. The principles should be consistently followed by tax and transfer pricing purposes by both lender and borrower jurisdictions.

**Box B.4. Question to commentators:**
Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 pricing approaches to determining an arm’s length interest rate.

**Recommendation:**
We agree with views outlined by OECD.

**Box B.5. Question to commentators:**
Commentators’ are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns.

**Recommendation:**
Realistic alternatives to government issued bonds include nationalized bank fixed deposits. Fixed deposits generally include a lock-in period with a fixed rate of interest.

Further next best alternative may be securities issued by AAA listed corporates or its equivalent which are publicly available and are considered by some countries at par with government issued bonds. AAA is the highest credit rating awarded by international credit rating agencies like Moody’s, Standard & Poor and Fitch. It represents that these companies are the most stable players in the industry and investors’ money in such companies can be realistically assumed to be safe.
Box B.6. Question to commentators:
Commentators’ views are invited on the practical implementation of the guidance included in paragraph 11 of Box B.4 and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved.

Recommendation:

OECD suggests that interest paid be broken down into two parts. The first part comprising of risk free interest payment should be made to the lender who does not control the risk whereas the risk adjusted premium amount should be paid to the lender who is assuming the risk. However, the foremost practical difficulty in this approach is in respect of reporting requirements.

For example A asked B to advance funds to C. A has full control of the risk. C is paying interest at the rate of 15%, of which the risk free rate is 10% and 5% is the adjusted risk premium. Now, the question here arises as to whether C breaks the payment in two parts and repatriates’ separate payments to the two parties or C pays the entire interest to B and B further passes on A’s share. Further guidance is required on the role-play of the different related party (i.e. neither the borrower nor immediate lender).
SECTION C - Treasury Function

This section highlights how the management of group financing commonly known as the ‘Treasury Function’ is important for a MNE group and potentially complex activity where influential factors such as business strategy, place in the business cycle, industry sector, operational currency etc. have a critical role-play.

This section has the following sub-sections:

**Intra-group loans:** Describes the importance of acknowledging the perspectives of lender and borrower for considering the commercial and financial relations between the associated enterprises. In doing so the discussion draft highlights primarily various factors that affect pricing of financial transactions such as credit ratings, effect of group membership, involvement of covenants, loan fees and charges. It further discusses the possible pricing approaches such as Comparable uncontrolled price method for determination of arm’s length interest rate.

**Cash Pooling:** Details the set up and working of cash pool arrangement within MNE groups and describes various types of pooling such as physical pooling, notional pooling etc. This sub section also discusses in detail how cash pooling transactions should be delineated and thereon priced. Also lays down few suggestions for rewarding the cash pool members.

**Hedging:** Role play of hedging in a MNE set-up for mitigating exposure to risk arising due to exchange difference. Also suggest possible mechanisms by which MNE groups may centralize the hedging of risk.

**Box C.2. Question to commentators:**
Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.
Commentators’ views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE. Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

**Recommendation:**

We would welcome the approach mentioned above to determine credit rating of individual group member as the same would be useful for tax certainty and tax compliance without having undue litigation.

In fact most of credit rating agencies even though deriving stand alone credit rating of individual group members as a starting point but arrive at final credit rating after considering impact of group rating and recommends similar rating as that of group if ties between group and individual members are strong.

**Box C.4. Question to commentators:**
Commentators’ views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

**Recommendation:**

Though in substance we agree with the view of OECD, however one cannot overlook the subjectivity involved, i.e. the importance of an entity may change over time or it may not be as strategically important to the group as outside parties may assume.

It further states that entities who have a credit rating closer to the group credit rating are likely to receive more support. That may not be the case always. For example: capital-intensive industries require a lot of capital inflow in its initial years and it does not start earning until it starts production. During those lee years the credit rating may be low, however owing to its importance the group may be willing to support it in case of requirement or relevance.

**Box C.6. Question to commentators:**
Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.
**Recommendation:**

Optionally convertible debentures may be considered as an alternative to intra-group loans. However, comparability adjustments may be required for factors such as quantum, term period, security issued as collateral, currency of issue and ultimate use.

**Box C.7. Question to commentators:**

Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.

**Recommendation:**

For average interest rate to be considered as an internal CUP, the foremost criteria should be that the debt pertains to common currency. It may not be advisable that third party borrowing in LIBOR be used as an internal CUP for loans advanced in INR owing to the economic circumstances. Interest paid on third party debt in INR may be considered as comparable for debts issued in INR only.

Another issue which may arise in this context is regarding the nature of loans issued. Adjustments need to be made for differences in the nature of long term short term, secured unsecured before the same can be used as an internal CUP. However, adequate guidance is sought on the factors and mechanism that may be used to carry out comparability adjustments.

**Box C.9. Question to commentators:**

In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

**Recommendation:**

Considering a situation wherein, a captive service provider is remunerated at cost + fixed mark-up or margin. Over the years it has accumulated cash but it does not use it to advance loans given management’s intention to maintain its functional characterization of low risk entity. Under this circumstance, such an entity may be obliged to deposit its surplus cash in the cash pool.
Box C.10. Question to commentators:
Commentators’ views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples. Commentators’ views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

Recommendation:

Cross guarantees exist only within related parties and are not prevalent in independent party situations. OECD recommends that cross guarantees could be considered akin to implicit support and hence contribution made in case of default should be regarded as a capital contribution.

We are of the opinion that cross guarantees may be required in case the entire cash pool is in deficit. Where few accounts are in deficit but ultimately the net balance is in surplus, cross guarantees may not be required as any interest due is already adjusted by the banks. However, where the entire account is in deficit it may insist cross guarantees.

Box C.11. Question to commentators:
In a situation where there are off-setting positions within an MNE group, commentators’ views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.
Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators’ views are invited on whether that risk should be treated as being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

Recommendation:

Where an entity has a risk exposure it wants to hedge, but is unable to do so due to group policy, the entity which has implemented such policy shall be the one bearing the risk of any loss as it restricts the entity from taking any prudent action to mitigate potential losses. Similarly, if the entity benefits from not hedging, the gain should also be transferred to the entity in charge of controlling entity/policy maker. However, guidance is required on the amount of loss/gain that maybe transferred.

For example: Company A is to receive 2000 Japanese yen after 3 months. However, due to off-setting within the group Company A could not enter into hedging contract. The day the
Para 92 and 93 on Bank Opinions:

92. In some circumstances taxpayers may seek to evidence the arm’s length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a “bankability” opinion, stating what interest rate the bank would apply were it to make a comparable loan to that particular enterprise.

93. Such an approach would represent a departure from an arm’s length approach based on comparability since it is not based on comparison of actual transactions. Furthermore, it is also important to bear in mind the fact that such letters do not constitute an actual offer to lend. Before proceeding to make a loan, a commercial lender will undertake the relevant due diligence and approval processes that would precede a formal loan offer. Such letters would not therefore generally be regarded as providing evidence of arm’s length terms and conditions.

Recommendation:

The Banks with whom the borrower is regularly dealing for other financial transactions may not necessarily require undertaking due diligence process again while giving quotes to the borrower if sought for particular loan transaction that would have been entered with such bank. In our view, bank quotes/ opinions do give an opportunity to benchmark the transfer price when other external comparable are also not available in database and therefore should be acceptable while carrying out benchmarking analysis.
SECTION D - Guarantees

This section considers consequence of financial guarantees on certain intra-group transactions and evaluates how to understand the said consequence it is vital to understand the nature and extent of obligations after delineating the concerned transaction in line with guidance in Section D.1 of the OECD Guidelines.

It talks about different types of guarantees such as explicit guarantees, implicit guarantees and cross guarantees and how these should be priced at arm’s length. It suggests various approaches such as using CUP method, yield approach, cost approach, valuation of expected loss approach and capital support method.

Box D.1. Question to commentators:

Commentators’ views are invited on

- how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);
- the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;
- where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and
- examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

Recommendation:

Circumstances may produce the practical result that group members are financially interdependent quite apart from any formal guarantee arrangement, such that the economic risk of the guarantor may not change materially on it giving an explicit guarantee. In other words, the formal guarantee may represent nothing more than an acknowledgement that it would be detrimental to the interests of the group not to support the performance of the borrower. In such circumstances, the guaranteed borrower is not benefitting beyond the level of credit enhancement attributable to implicit support of other group members and no guarantee fee would be due.
We would like to emphasize that in essence, irrespective of the guarantee transaction, the economic risk of the guarantor does not change who is in essence acting as a shareholder is responsible to protect the interest of the group as a whole at all times including the group member for which guarantee is sought. The moral obligations, the status of parent company [listed or not] and economic ties with group member anyways signifies a bigger responsibility on the shoulder of parent company as a shareholder to protect the group member in financial distress irrespective of guarantee being given or not. Accordingly, in our view in essence for guarantee transaction [be it implicit or explicit], the guidelines should bring the same specifically within purview of shareholder activity for which no guarantee fee should be charged.

Without prejudice to above we welcome the approach mentioned to accurately delineate a guarantee transaction in a circumstance where provision of guarantee by a parent company in favour of third party lender with respect to loan advanced by such third party lender in favour of its overseas subsidiary company shows that in absence of such guarantee, the overseas subsidiary company having regard to its inferior financial position and credit rating namely even considering implicit support could never have been able to raise loans on its own, then such loan will be essence considered to be loan from third party lender to guarantor followed by equity contribution by the guarantor to borrower. This is essence signifies Shareholder Function not meriting an arm’s length guarantee commission and it will be helpful if this is explicitly mentioned in Guidelines as Shareholder function.

We further agree that anything less than legally binding commitment like letter of comfort or other lesser form of credit support involves no explicit assumption of risk and therefore no guarantee commission should be charged.
SECTION E - Captive Insurance

This section introduces the concept and gives an overview of Captive Insurance providers in a MNE set-up. Explains the rationale for use of captive insurer by MNE groups and further explains the effect of existence of such an insurer while pricing an intra-group financial transaction.

This section moves on to describe the arrangement of fronting reinsurance captives. Also discusses the possible approaches such as pricing of premiums, combined ratio and return on capital and Group synergy for determination of ALP of captive insurers. The concluding subsection also briefly talks about the agency sales under this Section where an insurance contract is not sold directly from insurer to insured.

**Box E.2. Question to commentators:**
Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

**Recommendation:**
We are in consensus with recommendations proposed by OECD regarding use of actuarial valuation to arrive at the quantum of premium to be charged.

**Box E.3. Question to commentators:**
Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

**Recommendation:**
We concur with the recommendations proposed by OECD. On accurate delineation of the transaction, it was observed that company A was performing the critical function of intervening at the point of sale to sell insurance policies of Company B. Company B was leveraging on Company A’s customer base to sell more policies. Accordingly, Company A is required to earn higher returns in line with critical functions performed.

Therefore, Company B should be remunerated similar to other insurance providers and balance profits should be transferred to Company A.
Copenhagen Economics welcomes the opportunity to comment on the OECD’s Discussion Draft on BEPS 8 - 10, Financial transactions, issued on 3 July 2018.

Copenhagen Economics supports the OECD’s efforts to develop rules to prevent base erosion and profit shifting by engaging in financial transactions.

Copenhagen Economics believes that additional clarifications on the proposed guidance and examples will help both the taxpayer and the tax administration in addressing the practical challenges concerning intercompany financial transactions.

It is our opinion that clear and pragmatic guidance on intercompany financial transactions would represent a further step in the proper allocation of profits based on economic substance.

We present our comments and feedback to the discussion draft below.
1 BACKGROUND

The 2015 report on BEPS Actions 8-10 mandated follow-up work on the transfer pricing aspects of financial transactions. Under that mandate, the discussion draft, which does not yet represent a consensus position of the Committee on Fiscal Affairs or its subsidiary bodies, aims to clarify the application of the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines. This particularly pertains to the accurate delineation analysis under Chapter I to financial transactions. The work also addresses specific issues related to the pricing of financial transactions as well as the remuneration of parties potentially involved in the transaction (e.g. centralized treasury functions) such as:

- Intra-group loans;
- Cash pooling;
- Hedging;
- Guarantees; and
- Captive insurance.

Given this purpose, the OECD released a discussion draft (the “Discussion Draft”) on 3 July 2018 with the aim to clarify, improve and strengthen the guidance on intercompany financial transactions.
2 OUR COMMENTS TO THE DISCUSSION DRAFT

2.1 Accurate delineation of the transaction

As indicated in the OECD Guidelines (para 1.33), the accurate delineation of the actual transaction represents the very first step in any comparability analysis concerning one or more controlled transactions between entities, which are part of the same multinational enterprise ("MNE"). The accurate delineation of the controlled transaction(s) consists of identifying "the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated".

We believe that the reference to “other approaches to address the capital structure” made in the Discussion Draft (para 8-10), and the relationship between these “other approaches” and the accurate delineation of the transaction, is not completely clear.

It is our opinion that the accurate delineation of the controlled transactions, for financial as well as other types of controlled transactions, is a key element of the comparability analysis and does not prevent domestic legislations to address the issue of the capital structure.

It is our opinion, indeed, that an in-depth analysis of (among others) the economic circumstances and the business strategies is key in 1) delineating the profile of the financial transaction and 2) determining whether the transaction is to be considered – for transfer pricing purposes – as a loan or as a capital contribution.

In particular, when dealing with external financial institutions, the main elements that are considered include, among others:

- A description of the main purpose related to the financial transaction (i.e. strategic acquisitions, investment in capital expenditures, working capital financing, etc.);
- An analysis of the balance between the level of debt (prior entering the financial transaction) and the amount of owned assets or capital;
- An analysis of the creditworthiness of the borrower;
- An analysis of the cash flows related to past and future periods at the company or project level;
- An industry analysis including e.g. cash flow generation/absorption and capital structure.

These features are value drivers analysed in the course of a third party financial procedure. Hence, they should also be taken into consideration in the course of a transfer pricing analysis, in order to accurately delineate the controlled transaction(s). Therefore, it is our opinion that the accurate delineation of the controlled transaction(s) is key to determine whether the transaction has to be considered (fully or partially) a loan or a capital contribution for transfer pricing purposes.

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2.2 Risk-free rate of return: general considerations

As indicated in the Discussion Draft (Box B.4, para 1) "Where [...] the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain".

The risk-free rate of return is defined in the Discussion Draft (Box B.4, para 2) as "the hypothetical return which would be expected on an investment with no risk of loss".

In our view, even in the situation where the funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, the remuneration should be proportionate to the financial risks linked to the profile of the asset. Where the analysis of the contractual terms and the functional analysis provide evidence that the funder is actually exposed to financial risks, a risk-free rate of return is likely to underestimate the arm’s length remuneration to the funder.

It is important to delineate the transactions as stipulated in para 1.33 and mentioned above. First, the arm’s length remuneration to the funder is to be determined based on the financial risks linked to the borrower’s profile (i.e. creditworthiness) and to the riskiness of the asset (e.g. secured vs. unsecured loan). Second, any support provided by any other related party (e.g. a group entity hosting the central treasury function) in the management of decision-making functions and in the control of risks related to the provision of funds is to be considered in the transfer pricing analysis, given the delineation of the transactions indicated above.

Assume that a company A, part of a MNE group, provides to company B, part of the same MNE group, a loan for a specified amount, under the guidance and supervision of the central treasury function at company C, also part of the MNE group. Based on the facts and circumstances of the case, company A presents a limited functional profile and does not perform the decision-making functions to control the risk associated with investing in a financial asset. Nonetheless, based on the analysis of contractual terms and the actual conduct of the parties, company A is to some extent exposed to financial risks related to the granted loan.

Assume then that the arm’s length remuneration for comparable loans provided on the free market is found to be around 5.0% and that the risk-free rate of return is found to be around 2.0% (see Figure 1 below).

Based on the argumentations reported in the Discussion Draft, the funder is to receive a 2% risk-free remuneration.

In our opinion, the funder (company A) is to be remunerated with 1) the risk-free interest rate (2.0% in the example); and 2) a portion of the difference between the market interest rate and risk-free interest rate (3.0% in the example), based on the risks actually incurred. The remaining part of this difference is to be attributed by company A to the central treasury for the support received in the management and risk-control of the loan.
2.3 Risk-free rate of return: determination

The Discussion Draft specifies the determination of the risk-free interest rate as follows (Box B.4, para 3): “An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk”.

The Discussion Draft (Box B.4, para 4) suggests with specific regards to currency factor that: “To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the investor’s cash flows, i.e. the functional currency of the investor rather than its country of domicile. When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return”.

We identify two different issues, as indicated below:

1. The risk-free interest rate should be based on security issued in the functional currency of the investor rather than its country of domicile. The Discussion Draft does not consider the possibility of a loan extended in a currency (e.g. US Dollar) differing from both the currency of the country of domicile (e.g. Swedish Krona) and the functional currency (e.g. Euro).

2. The Discussion Draft indicates that in the case of “multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return”. We see a potential deviation from the arm’s
length principle as then the risk-free rate is not based on the most appropriate return on securities, but arbitrarily on the on the lowest level.

2.4 **Risk-adjusted rate of return: mark-up on costs**

As indicated in the Discussion Draft (Box B.6, para 21), a cost approach may be used to determine the risk-adjusted rate of return in controlled financial transactions “*where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk*”.

Based on this approach: “[…] the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower”.

In our view, the described cost approach does not necessarily reflect the time-value of the anticipated funds from the perspective of both, the lender and the borrower. Indeed, the cost approach may well be suitable to determine the remuneration related to the centralized support services concerning intercompany financing (see Discussion Draft para 39-41). However, it hardly reflects the benefit to the borrower stemming from the funds received and the potential return to the lender.

In addition, we believe that a guidance on how to determine the profit mark-up should be provided in the Discussion Draft for the computation of the risk-adjusted rate of return.

2.5 **Pricing approaches to determining the arm's length interest rate of intercompany loans: internal CUPs**

The Discussion Draft indicates that (para 88) “[…] it may be possible to identify potential comparable loans within the borrower’s or its MNE group’s financing with an independent lender as the counterparty”.

Given an exemplary intercompany provision of funds granted by the parent company P to a related company A (the controlled transaction), here below we describe four examples of internal CUPs, ordered according to their degree of comparability (see also Figure 2).

- **External transaction no. 1**: loan provided to company A by an external lender L. In this situation, we consider the comparability to be the highest, given the same borrowing entity with the same creditworthiness.

- **External transaction no. 2**: loan provided to an external borrower B by the parent company P. In this situation, B serves as a comparable borrower to company A, assuming that its profile (i.e. credit rating) is sufficiently similar.

- **External transaction no. 3**: loan provided to an associated company C (part of the same MNE group) by an external lender L. In this situation, the transaction can be considered as an internal CUP, assuming that the profiles of the borrowers (company A and company C) are sufficiently similar, although none of the related companies involved in the intercompany financial transaction is part of the independent one.2

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2 Although this transaction cannot be strictly considered as an internal comparable uncontrolled transaction, following the wording included in the Glossary of the OECD Guidelines (Page 24), it may represent a valid reference to compare the controlled transaction, since one of the parties to the independent transaction (company C) is part of the same MNE Group.
• **External transaction no. 4**: “pass-through” loan provided to the parent company P by an external lender L. This situation is considered to be less comparable, as the parent company’s profile is unlikely to be sufficiently comparable to company A’s profile.

**Figure 2**  
**Exemplary internal CUPs**

Referring to the question in Box C.7 of the Discussion Draft, in our opinion the MNE group’s average interest rates paid on external debt may be considered as a proxy of internal CUP when the characteristics of the external loans (in terms of amount, maturity, currency, etc.) are sufficiently comparable to the controlled transaction under analysis.

For clarification of any aspect of our responses presented above please contact:

- Hendrik Fügemann  
  Partner  
  hef@copenhageneconomics.com
- Vincenzo Zurzolo  
  Senior Economist  
  viz@copenhageneconomics.com
- Charlotta Zienau  
  Economist  
  chz@copenhageneconomics.com
Dear Tomas

**BEPS Actions 8-10: Discussion Draft on Financial Transactions**

Thank you for the opportunity to comment on the non-consensus Discussion Draft issued on 3 July 2018 (the ‘Discussion Draft’) on the application of the OECD’s *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the ‘Guidelines’ or ‘the OECD Guidelines’) to financial transactions. The comments within this letter have been written from the perspective of the UK with input from other countries.

There is a lack of detailed specific guidance for financial transactions in the current version of the OECD Guidelines and a new chapter, collating financial transaction-related guidance in one place and providing illustrative examples, would be a helpful addition. International consensus on their application will also be welcomed.

It is important that guidance in relation to the treatment of financial transactions is as clear and unambiguous as possible. Any new guidance should, as a primary objective, seek to minimise the number of disputes and disagreements that will arise. It is therefore important that a single international framework is established through detailed guidance and examples, in order to minimise disputes and double taxation that will require time and resources from businesses and tax authorities to resolve.

This will be of particular importance in respect of the draft guidance within Box B.4 on situations where, owing to a lack of capability to control the risk associated with investing in a financial asset, amounts of residual interest income are potentially allocable to different related parties within a multinational group. The draft guidance in this area requires significant expansion and the inclusion of supporting examples, in order to clearly illustrate the circumstances where such a reallocation is and is not required, and to facilitate multilateral agreement both on the identity of the parties entitled to residual interest income, and on the amounts of their shares. Introduction of unclear guidance on this matter poses a significant risk of material and complex disputes arising involving many different jurisdictions. This area should be explored in further detail in subsequent Discussion Drafts and/or relevant public consultation meetings. Consideration should be given whether the BEPS concerns of jurisdictions here may be better addressed through widespread adoption of controlled foreign company rules in line with BEPS Action 3.

The draft guidance in relation to how implicit support affects the pricing of intragroup loans and of guarantee fees is in general consistent with existing transfer pricing practice, which in turn draws upon the practices and guidance issued by credit rating agencies. This is a practical and well established
practice in the pricing of debt, but it will nevertheless be helpful to have these approaches set out in detail and supported by examples.

The proposal for OECD guidance on cash pooling is helpful, particularly in respect of practical approaches to measuring the overall benefit achieved from cash pooling arrangements. This has been an area of increasing dispute between businesses and tax authorities, and between tax authorities, in recent years.

Statements providing clarity on approaches to guarantee pricing, methodologies for performing benchmarking analyses, and the importance of documenting the features and attributes of transactions, are also useful.

Further comments in relation to the matters raised in the Discussion Draft are set out in the attached appendix.

If you would like to discuss any of the points raised in this letter or the Appendix, please do not hesitate to contact me (alobb@deloitte.co.uk) or Stephen Weston (sgweston@deloitte.co.uk).

We would be happy to speak on this topic at any future Public Consultation meeting if it would be helpful.

Yours sincerely

Alison Lobb

Deloitte LLP
APPENDIX

Section B - Interaction with the guidance in Section D.1 of Chapter I

Box B.1: Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention (‘MTC’), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

The draft guidance in paragraphs 8 to 10 confirms that jurisdictions are not prevented from implementing domestic provisions to address capital structure and interest deductibility. Such domestic measures (including measures to implement BEPS Action 4 and ‘thin capitalisation’ rules) are not based on the arm’s length principle and are not relevant in determining the accurate delineation of intragroup loans or the arm’s length amount of interest under Article 9 of the Model Tax Convention. References to non-arm’s-length-based measures within the Guidelines should continue to be limited, to avoid any inference that whether a result is or is not arm’s length will depend on the existence of domestic measures.

It would be helpful if the Guidelines were to address situations where it is clear to a business that it would suffer a disallowance of interest under domestic rules (i.e. where the determination of a precise arm’s length price becomes academic). To reduce unnecessary administrative burdens, businesses should not be required to perform full transfer pricing analyses in respect of such transactions.

Box B.2: Commentators’ views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

In the example, the delineation of the ‘entire amount’ as equity is not in accordance with the arm’s length principle and is therefore not appropriate. The delineation of the whole amount as equity leads to cliff-edge situations where the transfer pricing outcome can be significantly different in cases where there are substantially similar economic and commercial outcomes. For example, a loan of £999,999 could be respected in full but a loan of £1,000,000 could be recharacterised as equity. In practice, groups would be likely to issue tranches of smaller, perhaps subordinated, loans in order to ensure that an arm’s length amount of debt is not recharacterised. The approach in paragraph 17 which determines that only the excess should be recharacterised as equity is appropriate.

To the extent that the accurate delineation of a loan results in an amount which is not recognised as debt, this excess should be treated, for transfer pricing purposes, as a contribution to equity. The total amount of value transferred from lender to borrower is usually not in doubt and the full consequences of the delineation should be respected – including any benefits arising from an enhanced level of equity. This should be explicitly stated in the draft guidance.

‘Options realistically available’ (Paragraph 19)

The Discussion Draft refers to the consideration of ‘options realistically available’. The options available to a subsidiary are heavily influenced by its ultimate parent and the benefit to the group as a whole. In practice the subsidiary is often faced with a binary choice of realistic options: (i) accept additional funding from the group, on the understanding it will put the funding to the use the group intended (subject to evaluation of the commerciality of such an arrangement and negotiating the terms of the debt) or (ii) refusing the additional funding. It would not be a realistic proposition for the subsidiary to proceed with other options for investing the funds offered: such as lending the money out on the markets, or lending the money to subsidiaries in other groups, notwithstanding the possibility that these options could result in a slightly higher return on investment. In many cases, the most likely
realistic option would be for a company to put money on deposit with a bank. It would be helpful if the Discussion Draft could expand on the meaning of ‘realistically’, acknowledging the limitations in the context of group companies.

In circumstances where there is a wider range of other realistic options, an independent party would make best effort to evaluate many different realistic options, but would stop once they are confident they have a sufficient understanding of the range of potential outcomes. It would be inappropriate if the draft guidance gave rise to an onerous requirement to consider and document all other realistic options – reasonable endeavour to evaluate the range of options should be sufficient.

Box B.3: Commentators’ views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction. Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

Functional analysis (Paragraphs 24 and 25)

Requiring connected party lenders to perform the same level of activity as an independent bank, such as creating a financial model to estimate default risks, would be inappropriate (as set out in paragraph 24). However, further guidance and examples are needed to determine the level of work that should be undertaken, and the extent to which this varies depending on the nature of the company’s business e.g. for financing companies with limited or no day-to-day activities as compared to treasury companies.

Paragraph 25 suggests that the availability of funds to repay amounts of principal and interest due to the lender is usually a relevant function of a borrower. Many borrowers, especially large borrowers, can be highly confident of their ability to refinance debts on the open market as and when they approach maturity (and thus operate without the liquid funds to repay the debt). Third parties can and do lend on this basis. Whilst in a connected party situation transfer pricing documentation might be required to support an underlying assumption that a future refinancing is feasible, this should be an acceptable alternative to demonstrating the availability of funds.

Characteristics of financial products or services (Paragraph 28)

Other characteristics of a loan include clauses relating to:

- optionality: e.g. whether there are provisions allowing for early redemption or termination, or for the lender to transfer the debt to another lender. Whilst options for earlier redemption (and redemption fees) are clearly important in the context of fixed-rate loans, these are also terms which a floating-rate borrower would take into account; and

- the governing law under which the contract is drawn.

Economic circumstances (Paragraphs 29 to 32)

A common source of dispute is whether the date of a comparable falls close enough in time to be acceptable. Paragraph 31 comments upon the importance of timing but further practical guidance and examples would be helpful given the inherent subjectivity.

Guidance is also needed for obtaining comparables for debt with less common characteristics, i.e. where comparable transactions occur more infrequently on the open market. In these cases, it may be preferable to consider comparables over an extended timeframe to obtain an appropriate and statistically significant sample. The volatility of the markets is also important - if prices can be shown to be stable in the period, a broader timeframe should be acceptable for illiquid markets.

The importance of geographic location should not be given undue prominence in the draft guidance. The largest multinational groups are not restricted to raising debt from local markets and will raise
finance across different global markets. A comparable which closely matches the intra-group debt in economic circumstances other than location should not therefore be excluded.

In practice, some factors are more important than others and guidance is needed to help users evaluate the impact each factor is likely to have on interest rates. For example, credit ratings are generally homogenous with respect to industry, and an independent lender would be expected to offer similar interest rates to a company with a B rating in the automotive sector, and a company with a B rating in the housing market. Whilst the currency of a bond has a significant effect on rates, this can be adjusted to provide a useful comparable.

**Box B.4:** Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular Section C.1.7 Pricing approaches to determining an arm’s length interest rate.

**Box B.5:** Commentators are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns.

**Box B.6.** Commentators’ views are invited on the practical implementation of the guidance included in paragraph 11 of this Box B.4, and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest expense up to an arm’s length amount, but the funder is entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.

**Risk free rate of return**

Although there is no truly risk free investment, the use of appropriate government-issued securities as a reference point is widespread practice and straightforward to apply. The draft guidance in paragraphs 1 to 8, on the risk free rate of return, is therefore helpful. In particular, the reference within paragraph 6 to matching the duration of the instrument with the duration of the financial instrument is important.

Situations where sovereign debt rates become negative, for example in the case of certain maturities of German government debt in recent years, also need to be considered.

**Treatment of the funded party**

Paragraph 11 is very helpful in respect of clarifying the treatment of the funded party. The funded party should always be entitled, for transfer pricing purposes, to a deduction up to an arm’s length amount in respect of the funding - the quantum of interest deductible does not depend on allocation of risk control functions on the funder's side. Examples to illustrate this principle would be welcomed.

The tax authority of the funded party’s jurisdiction remains entitled to challenge whether, based on the terms of the loan, the amount of interest charged is arm’s length in nature. It would be helpful if the Guidance were to set out how such disputes would be agreed through MAP, and that the parties to MAP would likely include those jurisdictions allocated residual interest amounts, as well as the jurisdictions of the funded party and potentially the jurisdiction of the funder.

**Treatment of the funder**

Without significant expansion of the draft guidance within paragraph 11, disputes between businesses and tax authorities, and between tax authorities, are likely with the potential for double taxation. In particular more clarity is needed to address:

- **a)** how to determine whether a funder lacks ‘capability to control the risk associated with investing in a financial asset’ to such an extent that the residual return over the risk-free return is re-allocable. Consideration should be given as to differences in the level of functions
expected from a company entering into a one-off transaction, and a fully-operational treasury company which enters into financial transactions on a day-to-day basis.

b) how to determine precisely which related party/parties exercise ‘control over the investment risk in accordance with the guidance in Chapter I’; and

c) how to numerically divide the residual return between the relevant parties.

Examples

Specific examples of paragraph 11 applying to financial transactions are needed, setting out the full functional analysis of the parties involved in the funding in line with Chapter I, along with commentary on the types of functions and activities undertaken. The following example illustrates key issues in respect of the application of the guidance to a financing company with limited or no day-to-day activities:

- Company B is resident in jurisdiction B. It is adequately capitalised and has both local management and a fully functioning board of directors working and resident in jurisdiction B.
- Company B is offered an amount of equity funding from its parent company, Company A, resident in jurisdiction A.
- The amount of equity funding provided by Company A is equal to an amount required by Company C, a subsidiary of Company A, resident in jurisdiction C. Company C needs this amount to purchase land and machinery for its manufacturing business.
- Company A requests that Company B lends money to Company C to fund Company C’s purchase.
- The board of directors of Company B is responsible for detailed consideration of the proposal, reviewing and raising questions on: the terms of the proposed loan; Company C’s financial position, forecasts, and creditworthiness; and whether it is in the best interest of Company B to proceed.
- After the board concludes it is in Company B’s best interest to proceed, Company B agrees to the loan, receiving interest from Company C, and a return of the principal when the loan term expires.

Without expanded guidance, there is a risk of dispute between the tax authorities of jurisdictions A and B over whether Company B should be allocated the full return or whether the threshold for reallocation of residual interest over the risk-free return has been met.

In many cases, the facts will be more complicated:

- The group’s headquarters are based in jurisdiction A, but it has additional regional headquarters with partial strategic responsibility over Company B in jurisdiction B, and Company C in jurisdiction C.
- The group may have a main treasury company in jurisdiction M, and regional treasury companies in jurisdictions N and O.
- Company C is part of the manufacturing division. The decision that Company C needed to acquire more equipment was made by the management of the manufacturing division in jurisdiction X.

All of the various parties may have been involved to some extent in the transactions. However, without clear guidance on which activities and functions are relevant, double taxation may arise if the aggregate return taxed across the various jurisdictions exceeds the total deduction available to the funded party.

It would be helpful to see examples demonstrating a spectrum of outcomes, linking in the remainder of Chapter B, showing the functional circumstances where the funder retains the full return, the funder receives the risk free return only, and where the accurate delineation is such that no debt is recognised.
Risk control functions

Detailed guidance and examples illustrating risk control functions are needed. Consideration should also be given to the possibility that, in practice, certain groups may perform limited control functions in respect of intragroup debt. It is unclear how paragraph 11 would operate in these circumstances.

The key entrepreneurial risk-taking functions involved in creating and subsequently managing a loan described in Part II of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments could be considered as a useful starting point, but would need to be adapted to reflect the comments in paragraph 24 that the functions associated with an intragroup financial transaction would not be as extensive as those of regulated entities covered by the 2010 report.

It would be helpful to understand the extent to which the location of control of the risks associated with intragroup financial transactions is linked to location of control of the underlying capital. Multinational groups will typically have made a decision on the specific employees or directors who have the authority to make decisions in respect of investing capital. Provided such persons have the competence to match their authority this could be a good indicator of where key risks are controlled.

Dispute resolution

An increased application of the approach set out in paragraph 11, with its inherent uncertainties, could lead to an increase in disputes, audits, and double taxation, particularly where multiple jurisdictions are involved. It is therefore essential that full mutual agreement procedures are available, including binding arbitration where double tax treaties have committed to it. Joint audits should be available to help resolve issues as efficiently as possible, with any adjustments agreed automatically rolled-over into MAP.

Impact of statutory tax rates

It is important that new guidance in this area is consistent with the primary purpose of the Guidelines: to evaluate whether transactions comply with the arm’s length principle. This would require businesses and tax authorities to apply new guidance arising from Box B.4 irrespective of the statutory tax rates of the parties involved. Transfer pricing measures should not be used as a substitute for controlled foreign company rules and this should be made clear in the Discussion Draft.

Domestic law limitations

Although domestic legislation may address the need to replace an actual price with an arm’s length price for transfer pricing purposes, it may not satisfactorily allow for a company to recognise income on a loan it is not legally a party to. The OECD should consider recommending amendments to domestic law to impute taxable income where residual interest is allocated in this way.

General comments on Section B

Application to the financial sector

Whilst the Discussion Draft has been drafted to provide guidance on the transfer pricing of financial transactions in general, it would be helpful if the Discussion Draft briefly commented on the applicability of any new guidance to groups who operate businesses within the regulated financial sector (e.g. banking groups and insurance companies).

As recognised by the footnote to D.1.2.1 in Chapter I of the OECD Guidelines, the regulatory approach to risk allocation to regulated entities in this sector should be taken into account. Businesses and tax authorities are required to make reference to the guidance within Parts II, III and IV of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (on banks, enterprises trading financial instruments, and insurance companies respectively) where appropriate.
Whilst the fundamental principles within the Discussion Draft will also be of use to a group with regulated entities, long-standing approaches supported by the footnote should remain valid. For the avoidance of doubt, it would be helpful if a consistent footnote or paragraph were also included within the introduction to any new chapter on financial transactions.

**Difficulties with determining accurate delineation of quantum of debt**

In respect of the sale of goods and services, a range of prices would typically be agreeable to both the seller and buyer as independent parties, with economics pushing parties towards the middle ground. However, there is often not one ‘correct’ answer to the question of what amounts ‘would’ have been agreed between borrowers and lenders and thus accurately delineating the amount of debt to be priced is a difficult area. Loans of any amount in between the minimum amount that the borrower would borrow, and the maximum amount that the lender would lend, could be consistent with both the lender and the borrower’s standalone positions and considered commercially rational to all.

It is important to note that in a third party situation, once it has been established that proposed loan amounts are sustainable and in line with a bank’s lending policies, the eventual amount borrowed by the business (and the balancing amount left to be raised through other means), is broadly at the total control of the party to be funded – not the lender. Consequentially, references within the Discussion Draft to considering the perspectives of both the borrower and the lender are less appropriate when delineating the quantum of debt. The focus here should remain on the perspective of the borrower. (The perspectives of both parties would more likely be taken into account when determining the arm’s length price of an accurately delineated loan, per section C.1.1 of the Discussion Draft). In the interest of certainty, recharacterisation of the quantum of debt could only be required by exception, and the practical focus of applying the arm’s length approach to debt should be on the accurate delineation of the other terms of the debt, and consequently determining the arm’s length amount of interest payable in line with those terms.

If not, then the Discussion Draft will need to be made much clearer on how the factors affecting the delineation of quantum should be determined in practice, supported by detailed examples. The amount the borrower ‘would’ have borrowed will vary depending on many factors including the ownership structure of the group. A key issue therefore is the extent to which the preferences of the wider group and/or its shareholders should be taken into account. It would be instructive to consider any draft guidance in the context of its consistency with the following arm’s length transaction which can be seen in practice: a publically-listed group is acquired by a private equity fund, and immediately afterwards de-listed. The acquired group – whose underlying businesses and financial prospects have not changed – will have had a low level of external debt before the transaction, reflecting a lower appetite for high-leverage found within listed groups. However, immediately following the transaction, the amount of ‘arm’s length’ debt pushed down onto its balance sheet may have increased by many multiples, becoming highly-leveraged.

The amount that the borrowers ‘would’ borrow will also vary depending on where a business is in its life cycle e.g. businesses are likely to borrow more on an acquisition in a new market than to finance organic growth in a domestic market.

Paragraph 16 of the Discussion Draft, which sets out indicators to consider when accurately delineating an advance of funds, would be more helpful if it were expanded, with examples, describing in more detail how exactly each indicator should be interpreted.

**Accurate delineation of the terms of debt**

Further guidance is needed, along with detailed examples, on the situations in which, as part of the accurate delineation of the transactions, specific terms within the debt agreement are to be disregarded or imputed.

Where the group is able to demonstrate existing or historical funding was available from third parties on similar terms (either to that borrower, or to similar group members), it would be inappropriate to
impute additional terms (e.g. collateral clauses) as part of the delineation of connected party loans contracted on a similar basis. Comparable transactions should be permitted to support not only the pricing of interest, but the appropriateness of the other terms of the debt.

Section C- Treasury function

Box C.1. Commentators are invited to describe situations where, under a decentralised treasury structure, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

A wide range of treasury structures exist in practice, ranging from one centralised head office treasury department to different degrees of decentralisation. Decentralised structures are often a feature of conglomerates and groups which have grown by acquisition in cases where each subgroup is of a sufficient size to manage its own external funding. For example, it is common for groups who require 24 hour access to capital markets to establish geographic hubs, e.g. three treasury teams in New York, London and Hong Kong covering the Americas, EMEA and Asia-Pacific respectively.

The legal structure of decentralised treasury structures can also vary. Some groups establish separate local entities which employ the treasury personnel resident in that jurisdiction, but the use of branches is also common. In other cases, treasury personnel may be employed by the local operating company or intragroup service provider entities. Such personnel may not necessarily have 'treasury' within their job titles, or in the names of their operating units, but they may none the less have the equivalent roles and abilities of treasury personnel found in other groups.

Differences also exist in groups’ strategies relating to corporate financial management, including how costs of capital are optimised, and investment returns are managed or maximised. Activities undertaken by the treasury function may, depending on facts and circumstances, be services that require remuneration from other group members.

It is possible for some routine treasury activities to be outsourced from one part of the group to another. However, provided the outsourcing arrangements ensure that the original party has the authority and ability to make the strategic treasury decisions, and to review outsourced work, this would have limited bearing on the accurate delineation of a treasury structure.

In summary, there is a wide variety of commercial ways in which groups structure their treasury functions. These differences mean that businesses and tax authorities must always consider the facts and circumstances specific to the group under examination. It is not possible to apply generic conclusions on accurate delineation derived from other multinational groups or Discussion Draft examples, as they may result from a significantly different division of treasury risks, functions and assets across the group.

Box C.2. Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;

- a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.
Commentators’ views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

The introduction of a rebuttable presumption that the group credit rating should be used is a departure from the arm’s length principle. Any benefits of simplification will only be realised to the extent that the rebuttable presumption is not challenged by tax authorities – i.e. that it is not rebutted. The tax compliance savings and other benefits would be limited unless it was clear that penalties and interest would not be applied to any challenge. It would also be helpful if the OECD were to consider situations where the presumption is challenged by some tax authorities but not all, leading to inconsistencies of pricing approach. It would also be important to determine the outcome under MAP, and whether the presumption or the arm’s length principle should prevail. There is a significant risk of double taxation if these principles are not expressly set out in the Guidelines.

It would be possible to introduce a ‘safe harbour’, where the group rating is applied to all group members, to allow for compliance and administrative savings. This would not be a rebuttable presumption. To realise such savings this would need to be applied consistently and would not follow the arm’s length principle. If such an approach were to be introduced, it may be appropriate to restrict its use to groups of less than a clearly defined size.

The second rebuttable presumption approach bears a closer resemblance to third party approaches adopted by credit rating agencies, and is more consistent with the draft guidance set out within paragraphs 68 to 74 of the Discussion Draft. Guidance is produced by credit rating agencies to describe the approach taken, including Standard & Poors’ group rating methodology. The credit rating of the group is ‘notched down’ to obtain ratings for the most integral members of groups, typically those classified as ‘core’ and ‘highly strategic’. However, for less integral group members, the typical approach adopted by the credit agency would be to start with the stand-alone credit rating and ‘notch up’. More detail is therefore needed on how ‘notch down’ adjustments should be made for the less integral group entities. Without a widely accepted methodology for determining the adjustments required under the second rebuttable approach, there are unlikely to be significant compliance savings or an increase in tax certainty.

Examples should also be provided as to when the presumption should be rebutted e.g. a different credit rating would be needed if an asset rich subsidiary could borrow more cheaply than the wider group.

Short term balances

The rebuttable presumption approaches may be more suitable for the pricing of shorter term intra-group loans, especially in respect of very short term loans for which comparative market data is often unavailable. When evaluating the effects of passive association on short term loans, a third party lender may conclude that a group has sufficient backup liquidity to provide any support needed to prevent its subsidiaries from defaulting in the near future, with the effect of narrowing perceived differences in short-term creditworthiness across the group, bringing the effective credit rating of subsidiaries closer to that of the group. This effect can also be seen in the practices of credit rating agencies: the highest of the specialised credit ratings given to short-term loans (e.g. Standard & Poors’ A-1+, A-1 ratings) are typically fewer in number and broader in range of applicable companies when compared to the equivalent ratings given to longer term debt.

1 See https://www.spratings.com/scenario-builder-portlet/pdfs/ICSB_Group_Rating_Methodology.pdf
Group ratings

Ratings determined through the use of economic models provided by credit rating agencies, are not as reliable as commissioning a rating from the agencies themselves, but are an adequate, unbiased and cost-effective manner of estimating the credit rating for a group, and their continued usage should be supported. Such economic models are particularly valuable in determining stand-alone credit ratings.

Box C.3: Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

Guidance is provided by external credit ratings in respect of the approach taken to determine stand-alone credit ratings, for example the methodology used by Moody’s here.

Box C.4: Commentators’ views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

The adoption of this guidance requiring implicit support to be taken into account would be helpful. It is consistent with existing limited guidance on this topic, including Examples 1 and 2 in paragraph 1.164 of the OECD Guidelines.

The beneficial effects of passive association between a group member and its wider group should be reflected in an assessment of its creditworthiness, in line with the guidance published by and approach used by credit rating agencies. Paragraphs 68 to 74 are consistent with credit rating agency guidance and practices. However an explicit reference supporting the use of published credit rating agency guidance would increase certainty. Alternatively, existing credit rating guidance should be incorporated into the Discussion Draft. Without further detailed guidance, or the use of credit rating agency guidance, key questions raised by paragraph 70 such as ‘is this particular subsidiary operating in the group’s core business?’ would be highly subjective and lead to an increase in disputes.

Interaction with domestic law

The OECD should recommend the removal from domestic law of any restrictions inconsistent with the revised Guidelines. For example, United Kingdom domestic legislation\(^2\) may prevent the taking into account of passive association/implicit support when determining the arm’s length pricing of intragroup loans.

Covenants

Maintenance covenants are not provided on the issuance of bonds and should not be required between related parties. There should not be any consequential effect on the pricing of the loan.

Lending from a parent to a subsidiary

It would be helpful for guidance to address the specific issues which can arise when applying the Guidelines to the lending of funds from a parent company to its direct subsidiary. There is a risk that the introduction of guidance requiring that the effects of implicit support be taken into account could unintentionally lend support to non-arm’s length arguments which do not recognise the distinctions between the activities the funding party performs in its capacity as a lender, and those it performs in its capacity as a parent company.

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\(^2\) Section 153 Taxation (International and Other Provisions) Act 2010
The correct application of the arm’s length principle would involve considering what a third party would take into account if it were acting as the lender but not also acting as the parent company – i.e. the loan is delineated as if the functions, risks and assets relating to the lending capacity and to the parent-company capacity are accurately separated between two different economic entities. The lending entity would still factor in the effects of group membership in determining the arm’s length interest rate, however this would be through new guidance on implicit support and passive association. Advantages solely available to a parent company, such as enhanced information on and control over the subsidiary, and the ability to call upon the subsidiary’s net assets, would not be of advantage to a third party lender, and cannot be directly factored into an accurate delineation or pricing.

Box C.5: Commentators’ views are invited on:
- the role of credit default swaps (CDS) in pricing intra-group loans;
- the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

An approach based on benchmarking against publically available bond data is nearly always appropriate for pricing debt, and consideration of credit default swaps should not in general be required.

However, if the intra-group loans have economic characteristics uncommonly seen on the bond markets (for example, if the borrower has an unusually low credit rating not commonly seen from public bond issuers), it may prove difficult to collate a statistically sufficient level of bond data to form a reliable price from bonds alone. In these limited circumstances, use of credit default swap data, or other less common approaches, may provide additional useful pricing data, or could be used as a corroborative tool, provided it is possible to support the appropriateness of the approach.

Box C.6: Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.

It is not necessary for a financial transaction (or indeed other types of transaction) to be, in each and every circumstance, a perfectly comparable transaction and/or a realistic alternative to an intragroup loan in order to be reliably used for the determination of arm’s length interest rates. It is only necessary that financial transactions are sufficiently comparable to provide arm’s length interest rate ranges consistent with the most realistic alternatives (e.g. bank loans).

The use of publically available corporate bond data is commonly used to verify the arm’s length interest rates for intragroup loans. Corporate bonds have a different legal form to traditional loans but still fundamentally represent the lending of money by a lender to a borrower. The use of corporate bonds is therefore in line with the pragmatic approach to identifying comparable transactions set out in section 3.38 of the OECD Guidelines.

Money market fund transactions, term deposits, commercial paper, and other similarly short-term commercial instruments may also be considered as realistic alternatives to very short-term intra-group loans, especially if market data on such bonds is limited.

Box C.7: Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.

For larger and more complex groups, use of a single internal CUP for all of the group members would appear to be inconsistent with the comments elsewhere in this section on the effects of passive association.

It would not be in line with the arm’s length standard to perform a simple average of the interest rates payable on different external debts if the economic characteristics of the external debts varied to a significant extent – in particular if the debts had different maturities or were denominated in different currencies. To the extent that an average is used, then it should be based on the average credit
margin (rather than interest rate) in order to remove the impact of differences in currency and maturity dates.

However, if for example a parent company were to borrow from a third party lender, and if that parent company were to on-lend a similar amount intra-group on similar terms, the interest payable on the external debt could be a useful starting point for determining the arm’s length pricing of the intra-group loan. The key factor to consider is how closely comparable the risk profiles of the loan to the parent company and the intra-group loan to subsidiary are. Provided any differences are minor, or if the economic effects of any differences are well understood, the appropriate comparability adjustments to approximate an internal CUP from an external interest rate could, in these circumstances, be calculated.

**Bank opinions (Paragraphs 92 and 93)**

As set out in these paragraphs, opinions from banks fall short of fulfilling the requirements to be considered a source of comparable uncontrolled prices in their own right. However, robust bank opinions have potential as a source of supporting evidence that a pricing obtained through another transfer pricing method is appropriate.

It would be instructive to consider how in general a court adjudicating a transfer pricing dispute would treat evidence from banks. Judges are capable of accepting the submissions of bank personnel as a form of expert evidence, provided they are satisfied with the quality and reliability of the bankers’ evidence.

Provided evidence can be provided to demonstrate that a bank providing an opinion has received all the relevant financial data, and that it subjected the data, in an objective manner, to the typical procedures it applies to its own customers, its opinions should be taken into account.

Nonetheless, it is not realistic, nor appropriate, to suggest that all intra-group loans should be supported by an external bank opinion.

**Box C.8:** With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular,

- are there circumstances in which one or another of the approaches would be most suitable?
- does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?
- whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

Overall, the proposed guidance on cash pools is consistent with the arm’s length framework and recent case law. However, groups will always need to take into account the facts and underlying functionalities of their cash pool arrangements. The circumstances of individual members of the pool –
to the extent that they are atypical of other cash pool members – may need to be taken into account when determining that member’s particular returns.

A group member with a large amount of depositable cash would be expected to receive a more favourable interest rate from a bank, compared with a group member with much smaller amounts of cash, or group members that temporarily have net positive cash amounts but fluctuate between positive and negative positions in the medium term. The more favourable rate is owed to the first party (a) to reflect the preference of banks to reward large deposits over small deposits (i.e. a volume discount) and (b) to reflect that the party would be more comfortable depositing, at least a proportion of its free cash, on longer maturity terms.

In practice, banks typically apply lower interest rates to deposits than they do to overdrafts and therefore an approach that applied the same rate would not be on an arm’s length basis.

**Notional pooling**

It would be helpful, for example in the context of the three approaches to rewarding cash pool members, if an example showed how an approach would be applied to a group using notional pooling.

**Box C.9:** In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy.

As stated in paragraph 102, a result which left a group member worse off (whether in actuality, or as a result of proposed adjustments under transfer pricing rules) should not be considered an arm’s length result. The results of any such group member should be adjusted accordingly to restore it to a position no worse than its stand-alone position.

**Box C.10:** Commentators’ views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

Commentators’ views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

Irrespective of whether cross-guarantees are present in cash pool arrangements (either contractually or substantively in effect), in most cases it would be impractical to require businesses to factor the effect of each and every cross-guarantee into the transfer pricing analysis. It is not clear that the overall effect of pricing in such guarantees would have anything more than a de minimis effect on the allocation of profits around a group and the administrative burden would be disproportionate. In some cases, guarantees from a parent company may be the exception and should then be adjusted for accordingly.

The effect of cross-guarantees should be ignored in the transfer pricing of cash pooling arrangements, with further work required only to the extent that the specific fact pattern would be expected to result in more than a de minimis impact on profits.

**Box C.11:** In a situation where there are off-setting positions within an MNE group, commentators’ views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators’ views are invited on whether that risk should be treated as
being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

It is unclear whether there are significant tax collection risks arising from the scenarios described within the Discussion Draft, or significant numbers of disputes on these matters, and therefore guidance may not be needed on this area.

The question of determining whether entities, on a stand-alone basis, would choose to enter into hedges would be extremely subjective as approaches vary between groups.

Introducing a potential requirement to hypothesise the existence of additional intragroup derivatives and calculate the profit and loss effects would exacerbate the already complex tax and accounting treatment of hedging. Determining the terms and affected amounts of the hypothetical derivatives would not be straightforward; the resulting administrative burden would be significant for businesses and may not be matched by any significant benefit for tax authorities.

Any requirements in respect of hedging would need to be significantly expanded to include detailed guidance and examples of the complexities. For example, the requirement for ‘compensation on arm’s length terms’ included in paragraph 135 is vague. The interaction with domestic legislation also needs to be considered, recognising problems some jurisdictions may have applying transfer pricing adjustments to hypothetical transactions parties are not legally a party to, and to ensure that double taxation does not arise e.g. to ensure that a counterparty is able to obtain tax relief for the corresponding cost where income has been imputed in another jurisdiction.

Section D - Guarantees

Box D.1: Commentators’ views are invited on:

- how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the Guidelines (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);
- the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;
- where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and
- examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

Recognition of the principle that the effects of implicit support and the benefit of passive association should be taken into account when pricing guarantee fees is welcomed. It is also helpful to have different approaches to pricing guarantee fees detailed within the Discussion Draft. Some of the approaches, in particular the yield approach, are simpler to apply than others, preferred by businesses and tax authorities and more commonly seen in current practice. In most cases use of simpler approaches should be considered sufficient, and groups should not be expected to also perform more complex approaches, which have a more theoretical basis, unless warranted by unusual circumstances.

The Discussion Draft needs to address cases where there is a wide range between the maximum and minimum determined as an acceptable fee for the arm’s length price under different approaches. In
the absence of evidence to the contrary, a group should be able to use an actual fee if it lies within this range.

Additional and more complex examples would be helpful to illustrate each of the approaches in the Discussion Draft more fully, including setting out circumstances where each approach may be of greatest relevance.

Example 1 should be expanded to provide more details of the accurate delineation process that established that passive association raised Company D’s credit rating from BBB to A. Paragraph 159 should also explicitly confirm that the rate an independent lender would have lent to a borrower with a BBB rating (i.e. the standalone rating) is irrelevant for the purposes of pricing the guarantee fee.

In respect of Example 2, further details are needed in Paragraph 160 as to how the group uses a CUP approach to determine that 1% to 1.5% is the correct range of arm’s length prices.

Independent guarantors

Commentary on the possible use of independent parties to provide guarantees would also be useful. Smaller companies, typically in the context of export companies and/or those making one-off purchases of valuable machinery, may request letters of credits from banks in exchange for a fee, and the fees payable may be an appropriate source of comparable data in some cases. Consideration of how long a letter of credit is valid for, and how this compares with the term of the guarantee to be priced, would be required, with comparability adjustments included where necessary.

Monoline insurance companies also exist as independent financial guarantors. In exchange for a fee, a monoline can extend a guarantee to its issuer, allowing it to borrow from the market with a higher effective credit rating. Data derived from transactions with monoline insurance companies could be a source of comparable transactions, although only in respect of the limited types of borrower typically covered by monolines in the marketplace.

General comments on Section D

Cross guarantees

The comments in paragraph 144 on cross-guarantees are very useful. We agree with the statement that “evaluating the effect of a cross-guarantee arrangement is difficult and as the number of parties involved increases, may be practically impossible.” This is commonly seen in practice; including examples involving up to 20-30 guarantors, and therefore resulting in hundreds of cross guarantee relationships.

Section E - Captive Insurance

General comments on Section E

Nature of captive insurance

Whereas the Discussion Draft has a subsection titled ‘Overview of insurance’ (E.1.), a similar introductory section providing an overview of captive insurance would also be helpful. This could also incorporate the existing draft comments on rationales for captives (E.2.) and on fronting (E.4.).

There are two different types of captive insurance company (hereafter ‘captive’) seen in practice:

1. A specialised member of a multinational group - a group which predominately operates non-insurance businesses - which operates an insurance business, and which mainly enters into insurance transactions insuring the risks of other members of its group. The key transfer
pricing issue in respect of this type of captive, is the pricing of premiums and claims between the captive and the other group members.

2. A specialised member of a multinational group - a group which predominately operates non-insurance businesses - which operates an insurance business, but mainly enters into insurance transactions with third party customers of other members of the group. Examples of groups that make common use of such captives include domestic appliance retailers (where the captive provides product liability insurance), car hire groups (motor insurance), and groups in the tourism sector (travel insurance). The key transfer pricing issue in respect of this type of captive, is the arm’s length division of insurance profits between the captive and the customer-facing members of the group.

Both types of captive can optionally involve the additional use of a third party re-insurer if it wishes to reduce the group’s overall level of exposure to risks.

Parts of draft guidance apply to one type of captive more than the other – for example subsection E.6. (‘Agency sales’) applies more directly to the second type of captive. It would be helpful if the Discussion Draft made this clear.

It would also be helpful if the Discussion Draft were to make a clear distinction between captive arrangements, as described above, and the transactions seen between members of a diversified multinational insurance group, i.e. a regulated group whose overall business is the commercial provision of insurance services. This is similar to the guidance in Chapter VII of the Guidelines that distinguishes between low value-adding back office services, and those of a core business. It would be helpful if the guidance explicitly set out that the facts and circumstances of the business will be of importance.

It may also be useful to cross-reference the existing guidance within the footnote to D.1.2.1 in Chapter I of the OECD Guidelines, requiring that the regulatory approach to the allocation of risk to regulated entities within the insurance sector should also be taken into account.

Group synergy (paragraphs 184 and 185)

Through entering into captive insurance arrangements, a group may reduce the level of premiums payable to external insurers/re-insurers, such that the group obtain an overall benefit from synergies, for example from the markets willing to accept a proportionately lower premium in respect of a larger, more diversified pool of risks.

Any result will depend on the specific facts and circumstances of the group. However, we note that, in contrast to cash pooling arrangements, where the day-to-day activity of a cash pool leader can be highly automated, a captive insurance company is still required to evaluate the risks and pricing of each intragroup contract it enters into. The captive insurer will also face the financial consequences of settling intragroup claims. It would therefore be inappropriate to reward captive insurers on a cost-plus basis. They should be entitled to a share of synergy benefits, based on the valuable functions they perform, just as an intra-group reinsurance vehicle within a wholly insurance group would be entitled to retain similar synergy benefits.
Box E.1:  Commentators’ views are invited on the following:

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;

Indicators that a company is an insurer (paragraph 166)

Before addressing the issue of whether insurance risk is actually assumed, it is necessary to confirm that the transaction in question involves the transfer of insurance risk.

The Discussion Draft suggests determining this through consideration of the indicators set out in paragraph 166. However, unlike in many other sectors, insurers are usually subject to rigorous regulatory regimes. As a result, one of the most reliable indicators, and the one easiest to test, should be the regulatory treatment of the captive. This should be considered in conjunction with the accounting treatment of the policies in the hands of the captive (as the relevant standards typically consider whether there has been a transfer of a risk from a policyholder to the insurer), and the legal treatment of its transactions. Except in the most unusual circumstances, where a company is treated as an insurer under these standards it should be taken as sufficient evidence of the existence of an insurance transaction for transfer pricing purposes, and a consideration of further individual factors would usually be unnecessary.

- Specific comments in respect of the draft indicators currently set out in paragraph 166: It is possible for a captive to exclusively insure group risks without it also seeking to reinsure a 'significant proportion of the risks' outside of the group. Such an insurer would satisfy neither (i) nor (ii), but still carries out recognisable insurance functions. (Second bullet).
- It is unclear why the regulatory regimes of an insurer and any reinsurer would need to be 'broadly similar' (Third bullet).
- There are examples of risks for which, when arising in an individual company, it can be very difficult to obtain third party insurance. Such market failures can, for example, be seen in respect of flood risk. However, following the aggregation of risks via a captive, it can be possible to obtain third party re-insurance from the market (Fourth bullet).

Indicators that risks are being assumed

The key indicators that a captive is actually assuming risks relate primarily to the functional capability of the policy issuer to assume and manage the risk. The policy issuer should have access to the appropriate resources and people, with sufficient underwriting experience and expertise, to competently and independently perform the following functions:

- Reviewing the work undertaken by third party outsourcing providers and having the ability to question the analysis and assumptions where appropriate, e.g. captive managers arranging the insurance cover, actuarial modelling of the expected losses etc;
- Evaluating the pricing of the proposed insurance policies proposed by the fronting companies and being able to question the assumptions underpinning the pricing before making a final decision; and
- Reviewing and negotiating the terms of the insurance cover with third party brokers and/or fronting companies and independently coming to a decision that it is in the best interest of the captive to enter into the contract.

Tax authorities may require captives to demonstrate that these functions are happening in practice, through the retention of appropriate evidence such as email correspondence, board minutes and underwriting memos.
As above, it would also be useful to cross-reference the existing guidance within the footnote to D.1.2.1 in Chapter I of the OECD Guidelines, which for businesses within the insurance sector would link to the principles in Chapter IV of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments, including its comments on the regulatory approach to the allocation of risk for regulated entities, and on the key entrepreneurial risk-taking functions of an insurance business.

**Assuming risk (paragraph 171)**

Paragraph 171 states that "The insurer is carrying out a risk mitigation function in respect of the insured party’s risk but not actually assuming that risk. It is assuming the risk of insuring (i.e. mitigating) the insured party’s risk.” However, paragraph 175 states “Insurance requires the assumption of risk by the insurer.” For clarity and consistency with paragraph 171, it would be helpful if reference to ‘risk’ in paragraph 175 was replaced with ‘insurance risk’.

**Rational for a captive (paragraphs 172 and 173)**

A further rationale for a captive is to centralise insurance within a single entity in line with the group’s risk management strategy.

Non-recognition of an intragroup insurance transaction should not be required under paragraph 173 solely due to a lack of observation of similar transactions between independent parties. (Such a conclusion would be inconsistent with the principles established in paragraphs 1.122-1.127 of the OECD Guidelines).

The existing example within paragraph 1.126 of the OECD Guidelines, which relates to insurance transactions, provides a clear example of where a transaction is not recognised due to lack of commercial rationality.

A counterexample of a transaction which possesses commercial rationality but is uncommonly seen in the marketplace would be welcome. Specialist insurance in respect of 'low frequency, high severity' risk (e.g. the risk of a major oil spill for an offshore energy company, or the risk of a product liability failure for a pharmaceutical company) may be more common in captive situations as a reflection of the group’s own understanding of these less frequent risks, rather than due to a lack of commercial rationality.

- **when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, [...]**

The main risk a policy issuer needs to assume is the 'insurance risk', which requires capital to back it. The 'insurance risk' is the risk that the circumstances which the group members insured against actually arise and therefore that the captive policy issuer is required to pay out on those claims. The captive must have a real possibility of suffering losses, as referenced in paragraph 166.

- **[...] what control functions would be required for these risks to be considered to have been assumed;**

The captive needs to have the control functions in place to enable it to fully consider and answer the question of whether it is likely in the best interest of the policy issuer to enter into any proposed intragroup insurance contract. This includes personnel with a sufficient level of experience and expertise for the lines of business covered to adequately evaluate the terms of the proposed insurance contracts. Even where activities are outsourced to third parties, the captive should be able to demonstrate that it has the requisite experience and expertise to analyse the insurance contract pricing work undertaken and independently come to a final view on the pricing. Please see below for further details.
• whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;

Third parties may be used to assist with some of these control functions – for example, commissioning a third party captive manager to perform contractual underwriting work, or a third party expert to conduct actuarial analyses and recommend appropriate pricing for premiums. This should not affect the analysis of whether insurance risk has been assumed, so long as the policy issuer retains the ability to, and in practice does, critically evaluate the work performed on its behalf by third parties (e.g. by raising appropriate questions on the assumptions and calculations upon which recommendations are based) and provided that the ultimate decision to proceed is taken by the management of the captive.

• when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

Given the high levels of regulation faced by insurance providers, such an occurrence would be very rare in practice. A company with inadequate controls over risk would likely be in violation of its regulatory requirements.

However, if the key decisions over control of risk of an insurance company were made by personnel located in another jurisdiction, the likely outcome would be an exposure of that company to the regulatory environment of the other jurisdiction, and the creation of a permanent establishment or other form of taxable presence there.

Irrespective of how and where exactly risk is controlled on the captive’s side of the transaction, the group member/insured party paying the premiums should remain entitled to an arm’s length deduction for its insurance costs.

Box E.2: Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

The actuarial approach referred to in paragraph 181 is highly relevant and its explicit recognition within the Discussion Draft is helpful. Actuarial approaches are commonly seen in practice, and are particularly useful in respect of larger, more complex captives.

In part this is because of the limited data available on comparable uncontrolled transactions. The most comparable transactions typically occur between the captive insurance companies and other members of those same groups – with the results that they do not constitute ‘uncontrolled’ transactions. Limited data is publically available on the premiums paid by independent insurance companies for similar risks.

A common actuarial approach is the use of frequency and severity curves to estimate the expected losses on the risks insured. A key challenge is obtaining reliable claims data given the ‘low frequency’ and ‘high severity’ of the risks insured by the captives.

Combined ratio and return on capital (paragraphs 182 to 184)

If section E.5. were to be expanded, it would be sensible to expect paragraphs 182 and 184 in particular. Additional discussion on the following practical difficulties commonly experienced would be useful:

• Determining the appropriate period to perform return on capital benchmarking exercises, especially in the context of insuring risks that are ‘low frequency and high severity’ in nature – i.e. risks where the probability of a claim occurrence is remote but when a claim materialises it
can potentially erode the capital base of the captive significantly (e.g. product liability risk, offshore property, environmental disaster).

It would be inappropriate to compare the combined ratio and return on capital of captives insuring such risk on a year-by-year basis, particularly in years when there is no claim. The profitability of companies insuring these risks is volatile, and any comparisons should be made over longer, multi-year periods to counter the ‘peaks’ and ‘troughs’ of the insurance cycle.

- The effect of differences in the capital adequacy requirements of a captive insurer and of an independent insurer. These differences typically arise for two reasons:
  - The regulatory regime of common insurance jurisdictions often set higher minimum capital requirements for independent insurers, compared to captive insurers (on public policy grounds that failure of the former has the potential to affect many different parties, whereas the failure of the latter would typically affect one group only).
  - The formulas used to calculate the capital requirements of captives may be less sophisticated than those used for independent insurers in respect of recognising the beneficial effect of diversification of risk from both a line of business and geographical perspective.

A return on capital benchmarking using standard reinsurance companies as comparable transactions may not be sufficiently comparable if the effects of diversification cannot be adjusted for reliably or with a degree of accuracy. From a practical perspective, this typically proves challenging and may require the use of rating agency models.

Use of opinions

One practice of supporting premium prices is to obtain the expert opinions of third parties (e.g. independent insurance companies or insurance brokers which would have access to a wide range of data) of how they would price the relevant insurance premiums to the extent that they write similar risks.

As discussed above (in respect of the use of bank opinions to price debt), in many cases the opinion of third parties falls short of the arm’s length standard, but opinions could still constitute supporting evidence, provided their robustness can be evidenced.

Box E.3: Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

It would be helpful if the example were expanded with further detail. In particular, it would be useful to understand how the existence of the following related key facts would be established in practice:

- that the insurance product sold to the third party is ‘substantially the same’ as that which any other insurer in the general market could provide;
- that Company A could sell policies underwritten by another insurer and retain most of the profits itself;
- that the opportunity to earn a high level of profit is attributable to the advantage of intervening at the point of sale.

Under such circumstances, a transfer pricing outcome resulting in additional profits recognised in Company A would be broadly in line with the application of the arm’s length principle, reflecting the valuable contribution Company A makes to the overall business. Each case would need to be considered on its facts.

In certain years an overall annual loss could arise as a result of a low frequency/high-severity event occurring, such as the discovery of a systematic product fault. The suitability of any proposed
mechanism to share excess profits between Company A and Company B, or to attribute all these profits to Company A, must therefore be considered for loss-making years too. A simplistic mechanism which would result in an automatic attribution of insurance losses to Company A would likely be inappropriate – Company A’s day-to-day activities are those of a sales agent and it is unlikely to have the capital to bear significant insurance losses, nor would it have been expected by regulators to maintain such capital. Company B holds the capital, and would be expected to bear most of the loss in a loss-making year. When determining an appropriate mechanism for sharing the profits, consideration should also be given as to how Company B would be compensated for any loss-making years, perhaps by recognising a right to claw back profits from Company A arising in subsequent profit-making periods.

Depending on the facts and circumstances and the division of risks, functions and assets between the parties, the underwriting performed by Company B may also be considered a valuable profit driving function of the overall business, with an arm’s length outcome being a split of the excess profits (i.e. the profits after rewarding Company A with a commission for its sales activities) between Company A and Company B. It would be helpful if the example would apply or refer to the framework set out in the 2018 OECD report Revised Guidance on the Application of the Transactional Profit Split Method.
To:

Tomas Balco,
Head of the Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development

Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

By email: TransferPricing@oecd.org

7 September 2018

Dear Tomas,

Sub: Comments on the Discussion Draft on Financial Transactions issued under the mandate of Report on Actions 8-10 of the BEPS Action Plan

Thank you for the opportunity to comment on the discussion draft on financial transactions issued under the mandate of Report on Actions 8-10 of the BEPS Action Plan (hereinafter referred to as “Discussion Draft FT”).

We note that significant efforts have been made to bring out this discussion draft paper, on financial transactions which is aimed to be included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017. It was anticipated that the taxpayers and tax authorities would arrive at a consensus for dealing with transfer pricing issues of financial transactions as this is a highly contentious issue. Our comments on the discussion draft have been provided below and aim to share insight on how independent parties interact and characterise the financial arrangements and pricing, which would bring further clarity to the taxpayers and the tax Authorities.

More detailed comments with respect to Discussion Draft FT are presented below. If you have any comments or questions, please feel free to contact any of the following:

<table>
<thead>
<tr>
<th>Name</th>
<th>Email</th>
<th>Contact Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dinesh Kanabar</td>
<td><a href="mailto:dinesh.kanabar@dhruvaadvisors.com">dinesh.kanabar@dhruvaadvisors.com</a></td>
<td>+91 22 6108 1010</td>
</tr>
<tr>
<td>Rahul Mitra</td>
<td><a href="mailto:rahul.mitra@dhruvaadvisors.com">rahul.mitra@dhruvaadvisors.com</a></td>
<td>+91 124 668 7010</td>
</tr>
<tr>
<td>Aditya Hans</td>
<td><a href="mailto:aditya.hans@dhruvaadvisors.com">aditya.hans@dhruvaadvisors.com</a></td>
<td>+91 22 6108 1901</td>
</tr>
</tbody>
</table>

We look forward to participating in further discussions on finalization of Discussion Draft FT.

Yours sincerely,

Rahul Mitra
Dhruva Advisors LLP
Executive Summary

The Discussion Draft FT has been broadly categorized in four sections. These include:

I. Interaction with the guidance in Section D.1 of Chapter 1 of OECD TP Guidelines

II. Treasury Function
   a. Intra-group loans
   b. Cash pooling
   c. Hedging

III. Guarantees

IV. Captive Insurance

Section I focuses on accurate delineation of financial transactions and critical factors that need to be analysed, while undertaking the functional analysis for a financial transaction. As per the requirement, we have attempted to cover in our response the facts and circumstances that should to be analysed to determine the characteristics of the financial transaction, factors to be considered while allocating risks to lending entities and the use of risk free rate of return along with its practical application.

We have explained the affirmative role of para 1 and 2 of Article 9 of the OECD MTC, in determining the arm’s length debt amount and its practical application in the context of Article 25 and BEPS Action 4.

With the objective of accurate delineation of financial transaction been addressed in Section I on the basis of contractual terms, group’s capital structure, borrower’s ability to raise funds, industry practice etc., our response also addresses practical application of arm’s length principle in determining the arm’s length interest rate in case of intra-group loans and arm’s length remuneration in case of cash pooling and hedging arrangements.

Intra-group loans are most commonly observed financial transactions among MNEs and determining credit rating is the foremost step to evaluate arm’s length interest rate. The issue of applying of group’s credit rating to member’s credit rating and the effect of implicit support in determining member’s standalone rating have been elaborately discussed by us in response to respective questions.

Cash pool arrangements and intra-group hedging arrangements typically exist in large MNEs and one needs to first undertake a detailed functional analysis to determine the characteristic of the cash pool leader or entity providing hedging contracts to other members of the group. The remuneration to a cash pool leader or treasury center hedging contracts is significantly dependent on the functions performed. For instance, if you find a cash pool leader or treasury center (hedging contracts) who assumes the financial risks but the functions to control those risks are undertaken by a separate entity, the cash pool leader or treasury center remuneration would be limited to risk free rate of return and return for coordination and facilitation functions. In cases where they undertake functions in controlling those risks coupled with the financial capacity to bear those risks, the remuneration would be based on market prices charged by independent financial institutions undertaking cash pooling and hedging arrangements.

Section III relates to financial guarantees and its impact on borrowing capability, capacity and interest costs under an MNE structure. The functional analysis of the transaction and parties involved becomes crucial to determine whether the provision of guarantee is a chargeable financial service, shareholder service, sale of financial asset or a simply a treasury function. While determining guarantee to be a shareholder service, one should analyse the borrowing capacity of the borrower and willingness of the lender to provide loan in absence of a guarantee.
Apart from enabling borrowing capability and increasing borrowing capacity of the borrower, guarantee also helps in improving the credit rating of borrower which consequently results in reduction of borrowing cost. Charge on guarantee needs to be accompanied by an analysis of guarantee providing economic and commercial benefit to borrower, say by reduction of borrowing cost. Further, the principle which has existed for long and continues to exist in the OECD TP Guidelines, 2017, for there being no charge where the member of the group is benefited by mere association to the group or due to some incidental activity of the group, the same analogy would apply for financial transactions in case of an implicit support. A charge should arise for an explicit guarantee where it can be determined that the benefit of guarantee is over and above the implicit support.

The last section of the Discussion Draft FT deals with Captive Insurance. One of the crucial aspects while undertaking transfer pricing analysis for captive insurance companies is to undertake a thorough review of insurance risks contracted and the corresponding control functions being performed to manage those risks. Captive insurance companies performing the limited function of underwriting and not satisfying the control of risks requirement would not retain the insurance return.

The thoughts shared by us in the above paras are only a summary of our detailed responses provided subsequently. For ease of reference, we have also provided an index in the next page which guides one to relevant pages for specific comments.

We have been supported by our following team members in drafting the detailed comments.

Ashish Jain, Meera Kohli, Sourav Toshniwal and Komal Mehta employees at Dhruva Advisors LLP.
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Comments on specific questions of Discussion Draft FT

I. Interaction with guidance in Section D.1 of Chapter 1 - (accurate delineation of financial transaction)

Box B.1 Commentators’ views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the OECD MTC, as well as the BEPS Action 4 Report

Para 8 to 10 states:

8. Although this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I of these Guidelines to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the capital structure under domestic legislation before pricing the interest on the debt so determined. These approaches may include a multi-factor analysis of the characteristics of the instrument.

9. Accordingly, this guidance is not intended to prevent countries from implementing approaches to address capital structure and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I as the only approach for determining whether purported debt should be respected as debt.

10. Although countries may have different views on the application of Article 9 to determine the capital structure of an entity within an MNE group, the purpose of this section is to provide guidance for those countries that use the accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, in particular a contribution to equity capital).

In cases involving intra-group debt, arm’s length principle needs to be applied as a two-fold exercise. First, we would need to determine the “amount of debt” that would be considered a debt in an independent scenario, and second, we would need to determine the “terms and conditions” that would be agreed upon in an independent scenario.

The two-fold exercise stems from Article 9 itself, which states in para(1), “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises”.

“Conditions” typically implies the debt transaction in the first place, along with its attached terms on which associated enterprises agree to transact. As for independent parties, the primary question would be to determine the amount of debt that would be transacted between them and thereafter the question of pricing comes in.

Further, in para (2), Article 9 states, “any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions have not so accrued” to be “included in the profits of that enterprise and taxed accordingly”

It needs to be appreciated that, in the spirit of Article 9, “conditions” are responsible for profits being appropriately or inappropriately accrued to associated enterprises. Thus, determination of arm’s length debt amount is an inherent feature of applying arm’s length principle under Article 9 of OECD MTC.

The issue of appropriate capital structure has been an eternal debate between tax administrators and taxpayers. The issue was first acknowledged in 1979 Report on “Transfer Pricing and Multinational Enterprises”. However, it did not provide any concrete methodology on how the issue could be addressed; it only pointed out that different treatments in different jurisdictions to address the issue of capital structure might result in economic double taxation.
In 1986, the OECD issued a Report on “Thin Capitalisation” by its “Committee on Fiscal Affairs”, which deliberated on the issue of capital structure within the ambit of Article 9.

Para 48 of the 1986 Report explicitly stated that Article 9 is relevant to determine both arm’s length interest rate on debt and whether the debt can be considered as debt, whether in part or in full.

The 1986 Report also states that jurisdiction could provide in their local laws fixed ratio of debt to equity that would address the issue of capital structuring on thin capitalisation and warrant recharacterisation of debt to equity or vice-versa. However, para 49 of the Report specifically points out that recharacterisation under domestic thin capitalisation rules needs to conform to arm’s length principle under Article 9.

With respect to the operation of Article 25, in cases where one jurisdiction has opted for recharacterisation of debt to equity basis, its domestic thin capitalisation rules which go beyond the requirement of Article 9, the 1986 Report states in para 50 that:

“in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit, that this principle should be followed in applying existing tax treaties, in particular in the operation of the mutual agreement procedure under the equivalent of Article 25 of the Model, and that it should also be followed in the negotiation of bilateral treaties in the future”

Thus, there should not be any doubt on the fact that, under Article 25 jurisdictions, there is the need to respect the operations of Article 9 while determining the arm’s length debt amount irrespective of their domestic thin capitalisation rules.

The next question arises in cases where the domestic thin capitalisation rules does not exist, i.e. in India, does one still need to analyse amount of debt that would be considered a debt in an independent scenario? Our view is in the affirmative, as the issue of capital structure or thin capitalisation stems from Article 9 itself, as explained above. In this regard, one should also consider the commentary to Article 9 in para 3(b), which states that:

(b) Article [9] is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm’s length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;

BEPS Action 4 Report aims to limit base erosion via interest deductions and other financial payments. It makes recommendations for best practices in the design of rules to address base erosion and profit shifting using interest and payments economically equivalent to interest, by aligning interest deductions with taxable economic activity. BEPS Action 4 focuses on the use of third party, related party, and intragroup debt to achieve excessive interest deductions or to finance the production of exempt or deferred income. Action 4 recommends restricting interest payments even on third party debts which have no third-party involvement and therefore could be alleged of taking any tax benefit at a group level.

This raises questions such as how one entity may be restricted on taking up third-party debt or restricted in claiming tax deduction on third-party interest payment. Interestingly, in para 12 of BEPS Action 4, it states that the rule-based approach is more feasible than an arm’s length test to consider base erosion and profit shifting as the latter resource is intensive and time-consuming. With respect to the administrative convenience of introducing rule-based deduction, it should be noted that rules should be framed with the effort of aligning with the arm’s length principle. Further, when it is determined that the domestic rules are prejudiced to an entity when compared to scenario under arm’s length principle, it should be mandated that jurisdiction would adhere to arm’s
length principle under Article 25 of Convention to resolve disputes and reduce economic double taxation.

Further, the para 12 also states that arm’s length principle fails to test base erosion under the following circumstances:

- where group’s structure debt with equity-like features to justify interest payments significantly more than the group incurs on its third-party debt
- claiming a deduction for interest expense which is used to fund investments in non-taxable assets or income streams e.g. dividend

It should be noted that capital structuring is a business call. One might use the option of debt over equity or vice versa when considering the various factors involved. The following should be analysed when evaluating whether MNEs are indulged to take taxation benefit: (1) whether the debt-equity ratio is in line with independent scenario and (2) the terms attached to the debt instrument would be acceptable in third party scenario.

There should not be any adjustments/disallowances under domestic rule-based laws when the parties’ approach to resolve the matter under Article 25 following these two factors.

**Box B.2.** Views are invited on the example contained in paragraph 17 of this discussion draft; in particular, on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

Para 17 of the Discussion Draft FT states:

17. For example, consider a situation in which Company B, a member of an MNE group, needs additional funding for its business activities. In this scenario, Company B receives an advance of funds from related Company C which is denominated as a loan with a term of 10 years. Assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount. Based on these facts and circumstances, it can be concluded that an unrelated party would not be willing to provide such a loan to Company B. Accordingly, the accurately delineated amount of Company C’s loan to Company B for transfer pricing purposes would be a function of the maximum amount that an unrelated lender would have been prepared to advance to Company B; and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C. (See Section C.1.1 The lender’s and borrower’s perspectives). Consequently, the remainder of Company C’s advance to Company B would not be recognised as a loan for the purposes of determining the amount of interest which Company B would have paid at arm’s length.

Para 17 explains a scenario between related parties where the transaction pertains to that of a loan but considering the factual circumstances the unrelated lender would not have been willing to grant the loan considering the financial standing of the borrower.

We provide certain illustrations for a better understanding of the stakeholder as to when it could be considered that the lender would not have been willing to grant the loan (either in full or in part) or the borrower would not have been willing to borrow the said amount (in full or in part). These are:

- In cases where the creditworthiness of the borrower does not support the borrowing of a loan from any third party. This could typically happen in a situation of a newly set up entity with no operations and minimal equity funding, or a special purpose vehicle (SPV) has been set up for
acquiring some targeted assets / entities as per the group strategy. It should be noted that in the second instance, the SPV itself would not have been willing to borrow the funds in the first place as the acquisition was the parent’s objective.

- A lender would also not be willing to grant a loan when the amount of the proposed loan is beyond the borrowing capacity of the borrower. The borrowing capacity is directly proportionate to debt servicing capacity and the same could be evaluated considering the existing profitability, cash flows, future cash flows, projections over a period of loan, etc.

- Another instance where the lender would not have been willing to lend additional funds or continue with the existing funding, where the borrower’s financial condition has deteriorated since the loan was borrowed and the risk profile has increased significantly, to the extent that an independent lender would not be willing to assume such risk. Under these circumstances, the independent lender would have negotiated the voting rights, management rights etc., from the borrower for the continuation of the loan arrangement.

- Apart from the financial factors pertinent to a borrower and its Group, independent lenders also analyse the purpose of loan funding e.g. a loan required to undertake oil exploration activities. Exploration of natural resources is considered one of the riskier forms of business operation as the exploration may not be profitable and the cost of the exploration will have to be written off. Financing for these kinds of arrangements are generally undertaken through consortium of financing institutions as they want to limit their exposure of default. Thus, an independent lender will not be willing to lend the entire financing even when the profitability, cash flows, future cash flows, projections over period of loan etc. are satisfying and indicative to generate the entire funding.

Thus, the analysis of determining the amount of loan that would have existed in an independent scenario is a complex process; one should not only analyse the ability of borrower to generate loan funds, but also understand the limiting factors of an independent lender, while providing the loan. This stems from the fact that where an independent lender is hesitant to assume significant risk of funding a project, a related party lender would easily provide loans owing to its relationship. The limiting factors are generally relevant to analyse in the case of term loan financing vis-à-vis working capital financing as repayment of term loan is more dependent from the sustainability of the project.

The factors to be analysed to understand the maximum amount that the lender would be willing to borrow could be taken from Taxation Ruling 92/11 issued by Australian Taxation Office in relation to the application of transfer pricing principles to loan arrangements. Some of the relevant points are:

(a) The legal effect of the transaction

A loan would ordinarily create the legal relationship of creditor and debtor. In the case of the rights and obligations of the provider of funds being similar to the rights and obligations of a shareholder, this will be taken as a factor indicating that the contribution might be akin to the supply of equity capital. For example, the lender may have, in relation to the loan, voting rights, a return dependent upon profits, or other rights that usually attach to ownership.

(b) Repayment of principal

A loan repayable on demand or within a short period of time will not be considered as equivalent to equity unless other facts associated with the "loan" demonstrate conclusively that the "loan" is equivalent to a contribution to equity. Conditions regarding repayment of the loan that are not consistent with an equity investment would be a factor indicating that the loan is not equivalent to equity.
Similarly, where the contributor’s claim to repayment of the contribution is not effectively subordinated to the claims of other creditors, this is a factor indicating that the contribution is not the equivalent of equity.

(c) Purpose of the contribution

The use of the funds by the borrower for investment in fixed assets of a long-term nature for use as core assets of the business of the borrower may be a factor that might indicate that the funds are the equivalent of equity. This could be the case, for example, if it is customary in a particular industry or in the country in which the investment is made to use equity capital for the investments.

(d) Debt equity ratio

Where the ratio of debt to equity is very high compared to the average for an industry or in the country in which the investment is made, this would be one of the factors that might indicate that a part of the debt may be the equivalent of a contribution of capital.

(e) Factors affecting the form of investment in a country

An investor may have a need to maintain flexibility of investment having regard to the investment regulations applicable in a country e.g. the existence of barriers to repatriation of equity in the country of residence of the recipient of funds, or where a country imposes a minimum shareholding requirement by domestic investors. In these cases, some contributions that are the equivalent of equity may be made in the form of loans to ensure that the percentage of the shareholding of domestic investors is not diluted.

(g) Ability to obtain finance from an unrelated third-party

Representations have been made that interest should not be attributed in the case of a loan if the circumstances of the borrower were such that an independent lender would not have provided credit to that borrower.

Thus, it is certain that in an independent scenario, the lender would analyse the borrower’s obligation to fulfil the financial obligations under the loan arrangement by analysing the operational, financial, and market scenario affecting the borrower. Based on such robust analysis, the lender will make the decision of lending a particular amount to the borrower. The independent lender might not be willing to lend the entire amount the borrower seeks based on the former’s analysis; however, it may be willing to lend part of the requisite amount.

All relevant factors that could make the loan arrangement viable for an independent lender should be considered when analysing the maximum amount that a borrower could borrow. These may include increasing the rate of interest to cover for additional risks, provision of additional security through mortgage of assets, etc. External market data could also be considered when evaluating the maximum amount of debt that a company could have borrowed, e.g. we should evaluate the key financial ratios of similar companies in the industry to understand the level of EBITDA to debt service ratio and EBITDA to interest coverage ratio which would provide an indication to the borrowing capacity of the borrower in an independent basis.

The consideration of re-characterising the debt into equity for transfer pricing should arise only where considering all possible adjustments, the loan transaction would have been undertaken by the independent lender.
Box B.3. (a) Views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction

The Discussion Draft FT has listed the following economically relevant characteristics of actual financial transactions (i) contractual terms (ii) functional analysis (iii) characteristics of financial products or services (iv) economic circumstances, and (v) business strategies. The following additional factors need to be considered when these characteristics are read in conjunction with Section D.1.1 of Chapter I:

- **Contractual terms:** Although the Discussion Draft FT mentions the relevance on contractual terms, we wish to further emphasise this point, especially given that the contractual agreements are the starting point for any financial transaction. Given that the agreements are legally binding, it is imperative that they are clearly defined, including that they have suitable covenants and have closed-ended terms. It is observed that related party financing contacts fail to include these important factors, thus questioning the veracity of the actual transaction. Thus, detail functional and risk analysis inherent for the loan, commitment of the investment by the lender, determining the terms of the loan will be necessary to accurately describe the actual financial transaction.

- **Capital structure of the group:** The concepts of “group and fixed ratio” have been discussed in detail under the BEPS Action Plan 4. In our view, while performing the functional analysis of a financial transaction, due consideration should also be provided to the capital structure of an MNE group, as it is reflective of the overall business strategy. This is especially true in a scenario where the business of the subsidiary is highly integrated or akin to an extension of the parent MNE, albeit in a different legal entity.

- **Debt Funding as equity:** While providing comments to B.2 above, we have highlighted debt funding as equity; thus, the purpose of funding, decision-making, and control of funding are important aspects which would need to be studied as part of accurate delineation of the transaction.

- **Change in contractual terms could lead to debt restructuring:** As an example, consider if Company A obtains a loan from a third-party lender (a bank or a non-banking financial institution) but is unable to service the loan owing to trading difficulties. Assume that the lender in this case opts to release part of its debt obligation in consideration for equity shares of a company in the anticipation of future increase in share value for reducing the interest cost of Company A. Owing to this participation in equity, there is a possibility that the third-party lender, although transacting at an arm’s length basis, may fall under the definition of a related party. Assuming there is no significant change in the covenants of the agreement, it would be appropriate to treat the balance debt at arm’s length, without subjecting Company A to further scrutiny in terms of its shareholding relationship with the lender. In our view, the Discussion Draft should focus to consider such other scenarios and provide explicit guidelines thereon.

**Tax implications in the source and residence country on the return on capital, treatment under treasury regulations, and accounting treatment of the two countries:** Apart from analysing the characteristics pertinent to loan instrument, transacting parties etc., one should also analyse the tax implications in the source and residence country, treatment under treasury regulations, and accounting treatment of the two countries. This is particularly relevant as independent parties gives due credence when determining the nature of the financial instrument and pricing thereof. For example, if a lender would be interested in the net rate of interest that it would receive, the cost of tax withholding, typically where tax credit cannot be availed in lender’s jurisdiction, is required to be assumed by the borrower. Similarly, when analysing the source of funding, a borrower also analyses the net cost that would be incurred by it, including the gross-up costs, if any.

Similarly, the accounting treatment would also play a role in determining the type of financial instrument, i.e. where the accounting treatment is driven by substance over form principle, then it makes sense to align the treatment of instrument for tax and transfer pricing purposes in line with the accounting treatment. However, there remains the possible scenario where even when the
instrument is loan under accounting treatment, it needs to be considered otherwise for transfer pricing purposes. Similarly, where accounting is more driven by legal form, it is pertinent to analyse the actual substance of the transaction for transfer pricing purposes.

- **Inter-company outstanding receivables**: MNEs are less stringent to follow-ups on outstanding balances when it comes under related party scenario as the risk of default is less compared to third party debtor. However, at times, the outstanding balances are deliberately not cleared with the objective of providing financial support to related parties. A careful analysis of facts and circumstances of outstanding balances should be undertaken to understand whether the receivables have achieved features of a loan thereby requiring a separate compensation in the form of interest on such receivables.

While analysing such cases, credence must be given to normal levels of debt turnover ratio and debt lead time in that industry, practice followed by the entity in the case of third party receivables being overdue, any dispute existing on the balance outstanding, rate of interest charged in case of external receivable balance, repayment capacity of the creditor, status of other creditors of the entity concerned, etc.

- **Operational risks and control over such risks**: In light of the guidance provided on risks in TP Guidelines in section D.1.2.1, care needs to be taken to analyse whether the entity assuming the operational risks of a business also performs the relevant people function to control and manage such risks and has the financial capability to assume such operational risks. At times, MNEs tend to indulge in consolidation of operational risks to one entity for varied objectives. However, an analysis of the aforesaid people function would only determine whether such entity is also entitled to earn non-routine operational profits associated with the operational risks. In cases where it is determined that people function in relation to control and management of risks is not being performed by such entity, then one needs to conclude that the risk assuming entity is only assuming financial risk and should only be entitled to financial returns associated with such financial risk (in case of loan/guarantee etc.) instead of non-routine operational profits associated with the operational risks.

**Box B.3 (b)** Commentators’ views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group

The OECD guidelines and the Discussion Draft FT acknowledge that within an MNE group, risks should be allocated to the contracting party responsible for decision-making and controlling utilisation of such advances. Generally, in transactions involving an advance of funds, the lender faces the risk of default of the borrower, which may be insulated by way of collateral or guarantee. However, in financial transactions between associated enterprises, lenders are usually allocated risks, without any insulation. We have identified a few scenarios where the lender would be allocated complete risks with respect to an advance of funds:

- **Inconsistency between conduct and contractual arrangements**: The lender may be exposed to allocated risks in cases where the contractual terms of an agreement are not consistent with the actual conduct of the borrowing party. However, inconsistency in conduct and contractual arrangements may be more perceptible in cases where the control and management for the borrower company lies entirely in the hands of the local management and not the lender company (assuming it is the parent company).

- **Business strategy**: If an advance is extended by a lender (parent) to meet a specific business strategy of the Group, such as an acquisition of a company, introduction of a new product line, creation of a brand. In such cases, the lender is typically responsible for taking the strategic decisions to acquire, expand, and introduce a new product, while the borrower, the subsidiary, merely executes such decisions. Since the decision-making and control of executing business strategies is in the hands of the lender, the risk allocation would also lie with it. Contrast this with a case where the lending occurs by another group entity, but the decision-making and control relating to such business strategies lies with the parent company. In such a case, the lender, a group entity, will not be allocated the risk and would be entitled to only a risk-free return.
**Treasury functions associated loan:** Treasury departments can function either as a cost center or profit center; however, the roles and responsibilities in each case would be different. In cases where the Treasury of an MNE Group is just facilitating the financial requirements of other members of the Group through external bank/financial institute without assuming any financial or commercial risks, then the treasury department needs to be considered a cost-center.

On the other hand, where the Treasury department is operating as financial institution for members of the MNE Group and assuming financial or commercial risks in this regard, then it needs to be considered a profit center.

The treatment of financial loan provided by Treasury Center needs to be analysed in the light of functions performed and risks assumed by the treasury center:

- **Treasury department as “cost center”:** While operating as a cost-center, it is unlikely that the treasury department would bear the risks associated with providing loan, i.e. risks in case of loan default. The treasury department would generally arrange for a loan either through internal or external sources, while keeping itself as the front-end. In such circumstances, the treasury department should be entitled to routine returns associated with facilitating activities.

- **Treasury department as “profit center”:** A treasury department that operates in a fashion comparable to a real in-house financial institution takes proprietary positions and assume risks which will require the relevant functional and financial substance in to properly control them (reference is made to paragraph 1.63 of the OECD Guidelines). In these cases, the treasury department should price all intercompany transactions, including financial loans, “at market rates”.

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**B.4. Commentators’ views are invited on the guidance contained in this Box and its interaction with other sections of the discussion draft, in particular on Section C.1.7 Pricing approaches to determining an arm’s length interest rate.**

This section of the Discussion Draft FT discusses the concept of risk-free and risk adjusted rate of return in detail and how it ought to be applied alongside the concepts of control and decision-making.

**Risk-free rate of return**

The risk-free rate of return is defined as a hypothetical return, which is expected on an investment with no risk of loss. In section 1, the Discussion Draft FT encourages a two-sided approach, keeping in view the perspectives of both the transaction’s borrower and lender, while at the same time focusing on the options realistically available to them, before deciding on a financial transaction.

The Discussion Draft FT outlines the importance of selecting an appropriate reference rate that matches the characteristics of the transaction, such as functional currency, maturity, and issue date. Though government security serves as a reference point for risk-free rate, it is relevant to highlight that yield on such securities varies significantly between countries due to difference in sovereign, economic, social and political climate, functional currency, and tenure.

The table below provides the 10-year government bond yield, which varies from 0.17% in Switzerland to as high as 12.23% in Brazil. The differences in yields could be a factor of growth rates, inflation rates, exchange rate differences in currencies, which may result in a difference in prices for the same instrument in different countries. The difference in interest rates encourage MNEs to scope for cheaper sources of borrowing, not limiting themselves to the domestic lending market.

<table>
<thead>
<tr>
<th>Country</th>
<th>10 Year Bond Yield (in per cent)</th>
<th>1 Year Bond Yield (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>2.705</td>
<td>1.843</td>
</tr>
<tr>
<td>Brazil</td>
<td>10.389</td>
<td>6.972</td>
</tr>
<tr>
<td>Germany</td>
<td>0.464</td>
<td>-0.661</td>
</tr>
</tbody>
</table>

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1 Source: Bloomberg
### Table 1

<table>
<thead>
<tr>
<th>Country</th>
<th>10 Year Bond Yield (in per cent)</th>
<th>1 Year Bond Yield (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>7.410</td>
<td>6.637</td>
</tr>
<tr>
<td>Japan</td>
<td>0.56</td>
<td>-0.145</td>
</tr>
<tr>
<td>Mexico</td>
<td>7.505</td>
<td>7.689</td>
</tr>
<tr>
<td>Singapore</td>
<td>2.306</td>
<td>1.546</td>
</tr>
<tr>
<td>Switzerland</td>
<td>-0.826</td>
<td>-0.16</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.349</td>
<td>0.561</td>
</tr>
<tr>
<td>United States</td>
<td>2.679</td>
<td>1.9317</td>
</tr>
</tbody>
</table>

The table reinforces the expectation theory, which states that the rate of return is impacted basis the tenor.

Further, in reference to the example mentioned in the discussion draft in paragraph 7 (page 11 and 12), a member of an MNE group would consider security issued by the highest credit rated country as a reference for the risk-free rate of return, while advancing funds. This could only be relevant for a country with common currency such as the Euro. In our view, the illustration is of limited applicability and could raise contentious issues with the tax administrators of the borrowing countries, especially when its own interest rates are lower than those of the funding country.

The difference in rates is also reflected in the safe harbor rates or applicable federal rates issued in various countries on loan transactions. Thus, OCED, by way of its guidelines, may provide clarifications and allowable thresholds to arrive at the rate of risk-free return, and other alternatives based on prevailing facts and circumstances.

Further, there could be scenarios where the financial transaction is between related parties across countries with a third different operational currency. In estimating an arm’s length interest rate in such cases, economic adjustments such as currency swaps may need to be carried out for levelling out the currency differences existing between comparable agreements and the loan transaction. The guidelines should include such scenarios and provide insights on such adjustments.

**Risk-adjusted rate of return**

While dealing with the issue on risk premium, the Discussion Draft FT suggests that the entity exercising control over the financial risk and control over any other specific risk on the funding, will be entitled to a risk-adjusted rate of return. The Discussion Draft FT also suggests various approaches towards determining the risk-adjusted rate of return, which include considering comparable uncontrolled transactions and realistically available alternative instruments (such as bond issuances or loans with uncontrolled transactions) with the same risk profile and comparable economic characteristics or the cost of funds approach.

Even though using comparable uncontrolled transaction agreements is a more direct method, it will have underlying terms and conditions that may not be similar to those of the controlled transaction. Such differences in characteristics and contractual terms of external loan agreements will weaken the economic analysis and economic adjustments (tenure, security, interest rate type, currency, etc.) and would be required to be undertaken to reduce the differences. The issue becomes more complicated when there are multiple entities involved in the transaction. In our experience, loan agreements involving multiple parties with unrelated parties typically have unique characteristics that may not allow for comparison. Such multiple party agreements are either witnessed in the case of consortium funding or loan syndication, where the projects and contractual arrangements are complex and the characteristics to such agreements are diverse. Aside from this, while the Discussion Draft FT deals only with a three-party structure, there is the possibility that there could be more than a single entity entitled to a risk-adjusted return.

While performing an economic analysis and having adopted the uncontrolled price method, uncontrolled agreements may not explicitly mention the composition of risk-free and risk adjusted rate of return. In an uncontrolled scenario, the lender may have allocated a higher cost towards the advance and hence it would be entitled to a higher return over and above a risk-free rate.
As mentioned in Section C.1.7, the loan could be priced based on the cost of funds\(^2\) incurred by the lender in raising the funds to lend. Also, the cost of funds approach can be practically applied in a case where the funds have been raised by a member of the group from a third-party lender and thereafter disbursed to the borrower wherein along with the third-party lending costs, the group lender will charge a spread/premium as its profit margin. In cases when there is a company with an internal cash surplus, the opportunity cost of such funds (equated with deposits) could serve as the minimum rate expected from a loan.

B.5. Views are invited to describe financial transactions that may be considered as realistic alternatives to government issued securities to approximate risk-free rate of returns

In our view, while there are no perfect substitutes that may be considered realistic alternatives to approximate risk-free rate of return, in a funding transaction one may look at financial products which would reward the lender with the minimum return it could expect in a similar situation. Theoretically, financial products such as risk-free bond repay the interest and principal with certainty. In such cases, the rate of return to an investor would be the risk-free rate which is paid irrespective of the state of the economy. In practice, other than government issued security, instruments which are issued, managed, or backed by the government, such as retirement benefits funds, etc. could be a closer substitute. Although they carry a credit risk, the risk could be considered negligible. The next best alternative could be the highest-rated (AAA) corporate bond issued which has the least risk and the issuer can easily meet its financial commitment. Another alternative is the rate borrowed by a commercial bank from a Central Bank for the countries wherein the government bond market is not developed.

Box B.6 Views are invited on the practical implementation of the guidance included in paragraph 11 of this Box B.4 and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest expense up to an arm’s length amount, but the funder is entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.

Para 1.85 of Chapter 1 of OECD Guidelines, referred to in the question, deals with the situation where the lender lacks the capability to control the risk associated with investing in a financial asset. In this case, the lender should be entitled to no more than a risk-free rate of return, and the residual difference between the arm’s length rate and the risk-free rate of return would be allocable to the party exercising control over the investment risk. The same situation is re-iterated in Para 11 of discussion draft. The discussion point here is how the transaction would be priced between the parties involved and in case jurisdiction of one party imputes adjustment on that party, the practical resolution to be achieved by the parties involved within Article 25 of OECD MTC.

Considering the guidance as provided in para 11, let us consider that within an MNE, three parties are involved, say A, B and C, where A is the parent entity exercising control over the investment risk in accordance with guidance in Chapter 1 of OECD TP Guidelines, B is provider of funds, and C is the borrower. Based on benchmarking analysis, it is determined that C should be paying LIBOR plus 400 bps for the loan availed, wherein LIBOR plus 200 bps is the risk-free rate and 200 bps is for credit risk.

Basis para 11, C would claim an interest charge of LIBOR plus 400 bps, B would be entitled to LIBOR plus 200 bps, and A would be entitled to a balance of 200 bps for exercising control over the investment risk.

The transaction could be arranged in either of the following ways:

1. Where A, B, & C enters into a tri-party loan agreement and C pays B LIBOR plus 200 for providing the loan and 200 bps to C for exercising the risk control functions in relation to the loan

\(^2\) Includes expense for arranging the loan, costs in servicing the loan and a risk premium or profit margin
2. However, there is considerable jurisdiction with exchange control regulations which do not allow cross-border payments to parties without any receipt of tangible or intangible goods/services. In these cases, C shall pay entire LIBOR plus 400 to B, and B pays 200 bps to A for exercising the risk control functions for the loan provided by B to C.

Now, let us analyse the practical implementation of Article 25 under both scenarios. In the first case, where a tri-party loan agreement is entered into and C enters into transaction with both A and B, suppose B faces an adjustment under the allegation that a risk-free rate of return should be LIBOR plus 300 bps instead of LIBOR plus 200 bps. The adjustment results in economic double taxation for the MNE group. In the case of allegation of jurisdiction B being justified, and it is determined that LIBOR plus 300 bps should have been risk-free rate of return, B should file MAP with both A and C to reduce the double taxation and allocate the appropriate share of taxes between all jurisdictions. In the tri-party MAP process, it should be resolved as C’s payout of LIBOR plus 400 should be reallocated with B getting LIBOR plus 300 bps vis-à-vis LIBOR plus 200 bps, and A getting instead 100 bps vis-à-vis 200 bps. Further, A should re-compute its income from 200 bps to 100 bps.

Under the second scenario, where C pays entire LIBOR plus 400 to B and B pays 200 bps to A for exercising the risk control functions for the loan provided by B to C, an adjustment is inflicted in the jurisdiction of C alleging arm’s length interest rate to be LIBOR plus 300 bps instead of LIBOR plus 400 bps. The MAP is filed between B and C, and the jurisdiction of B is unable to convince the jurisdiction of C that arm’s length interest rate is LIBOR plus 400 instead of LIBOR plus 300 bps, then jurisdiction of B should file a MAP with jurisdiction of A to claim reduction in the 200 bps so paid to 100 bps out of alleged LIBOR plus 300 bps that it would receive.
II (a). Treasury Function - Intra-group loan

Box C.1. Commentators are invited to describe situations where, under a decentralised treasury function, each MNE within the MNE group has full autonomy over its financial transactions, as described in paragraph 38 of this discussion draft.

Para 38 states:

38. The organisation of the treasury will depend on the structure of a given MNE group and the complexity of its operations. Different treasury structures involve different degrees of centralisation. In the most decentralised form, each MNE within the MNE group has full autonomy over its financial transactions. At the opposite end of the scale, a centralised treasury has full control over the financial transactions of the group, with individual group members responsible for operational but not financial matters.

The treasury function in an MNE could either be centralised or decentralised. A centralised treasury center is typically responsible for a wide array of activities involving long-term funding strategy, foreign exchange risk management, short-term and long-term funding, policy making, management, etc.

In a decentralised treasury structure, most of the functions with respect to financial strategy is undertaken by respective entities. A decentralised treasury function would exist in the following scenarios:

Decentralised operations – In a decentralised operation structure, it is most likely that the treasury function could also be decentralised as it is administratively convenient for the respective entities to manage their own treasury activities along with their operational activities. Typically, these can be observed in a licensed manufacturer / distributor set-up.

However, there might be situations where a decentralised operational set-up has a centralised treasury function in a jurisdiction which is treasury-friendly. This could exist where the business model warrants significant banking transactions by way of hedging, export credits, LCs, etc., say, for example, in an MNE engaged in the trading of commodities.

Centralised operations – A centralised operational structure would normally have a centralised treasury function. However, there may be instances where a centralised operational structure has a decentralised treasury function. Typically, the scenario would include where the operational activities are more significant in comparison, and the treasury function has an insignificant role to play in the entire operations, e.g. a business operation where procurement is centralised and different operating entities take on-the-spot decisions with respect to financing activities. In this case, a centralised operational might also have a decentralised treasury.

Box C.2 (a): Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

• a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;

• a rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

Box C.2 (b): We invite commentators’ views on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.
The Discussion Draft FT defines credit ratings as a form of relative ranking of the creditworthiness of a company. Determination of creditworthiness is the most crucial aspect in pricing loan arrangements. Accordingly, it becomes pertinent to adopt the correct approach in evaluating the credit worthiness and assigning credit rating, so that the arm’s length interest can be determined.

Regarding the first rebuttal presumption, we are of the considerate view that the credit rating at group level could be considered to determine the credit rating of members of the group in specific circumstances. These may be:

- When a member company is an integral part of the group’s core business operation and it would not be in the group’s interest to allow the member entity to default as it would impact the core business operation and market reputation. Say, for instance, the group’s core business comprises manufacture and sale of household electronic items and a captive entity provides asset financing and insurance contracts to the customers of group. For providing asset financing, the member company borrows a loan from a third party. It is pertinent to mention here that the independent lender would rate the member company at par with the group as the member’s business is integral to group’s core business operation and it is highly likely that the group would bail out the member company in the event of default. It should also be noted whether it is a captive service provider or captive distributor/contract manufacturer, as the captive entity will derive its credit rating from the group’s rating.

- When the group company is heavily reliant on the member company for either the supply of a raw-material, intellectual property, or intangible goods, and the absence of which could cause disruptions in the supply chain of the group company and other member companies. Under such scenarios, the parent company, owing to economic interest, will be willing to bail out the member company, prompting an adoption of the group credit-rating.

- When the group’s business is highly integrated with the member’s business, as would be the case of a telecom service provider, where either side is dependent on the other for completing the last mile. In such cases, given the inter-linkages and high dependency, a group credit rating will be applicable.

- In case of debt-leveraged acquisitions where a SPV is floated as 100% subsidiary to acquire the target assets based on external debt funding, it is quite unlikely that the parent would allow the SPV to default on its external debt borrowed for purpose of acquisition. The independent lender would consider the group’s rating while providing the funds; however, they may require an explicit guarantee from the parent to meet its internal risk management.

- Where the loan in unconditionally guaranteed by the parent/group, the credit rating of the borrower would be considered at the level of group rating

The above scenarios need to be evaluated on a case-by-case basis to decide whether the Group’s rating should be considered for evaluating the credit rating of the borrower.

We would like to express some apprehension regarding the second rebuttal presumption, which provides a top-down approach to evaluate the credit rating of the borrower. The top-down approach requires one to undertake appropriate adjustments to the credit rating of the parent company to arrive at a credit rating of the member company. However, such appropriate adjustments would be highly subjective and shall remain a matter of contention between the taxpayer and tax authorities.

Instead of a top-down approach, based on our research on this topic, we understand that credit rating agencies typically follow a “bottom-up” approach, where the credit rating of the borrower is determined on a standalone basis and notching-up/down the credit rating is undertaken on the basis of the parent and groups’ financial credibility.
MNE group credit rating implies evaluation of the group’s creditworthiness based on quantitative (consolidated financial statements, including financial projections of the group) and qualitative (management profile, size and scale of MNE’s operation, industry in which group operates, macro-economic factors in which the group operate, etc.) parameters. Typically, accredited rating agencies assign ratings to MNE groups after undertaking a comprehensive study of both quantitative and qualitative factors.

The group’s credit rating may not be publicly available. In this scenario, the following options could be considered:

1. **Exercise could be conducted using renowned credit rating agencies’ published papers/guidelines** – It is observed that leading credit rating agencies issue analytical frameworks which they use to assign ratings. This is done by considering key qualitative and quantitative inputs that are usually most important for assessing credit risk in a sector/industry. The analytical frameworks issued are either sector, industry, or region specific. The rating methodology in these analytical frameworks provides general guidance that helps companies, investors, and other interested market participants understand how qualitative and quantitative risk characteristics are likely to affect the rating outcomes for companies in a particular industry. Though it does not include an exhaustive treatment of all factors, it helps to understand the qualitative considerations and financial information and ratios that are usually important for estimating credit rating. This is done through a detailed scorecard for the factors and sub-factors by assigning weights to each factor. The scorecard used for this methodology reflects a decision to favour a relatively simple and transparent presentation, rather than a more complex scorecard that would map scorecard-indicated ratings more closely to actual ratings.

2. **Publicly available credit rating tools** - Credit rating agencies have also introduced web-based products through which one can undertake credit rating analysis. Moody’s RiskCalc software, for example, is a simple web-based analytical tool which provides the credit rating of entities on the basis of certain quantitative (financial information) and qualitative factors (region, sector, industry, functional currency, etc.). The white paper on this tool states that the tool could be used effectively in evaluating the credit rating of small and medium sized private enterprises. It should be appreciated that inter-company loan transactions often involve closely held entities of the MNE group as one of the parties to the transaction and accordingly, these tools can be effectively used to evaluate credit rating for the purpose of benchmarking the price of loan. Further, commercial tools developed by private companies such as Oracle, SAP, and SunGard, are also available which use default models to assess the loss or exposure in case of defaults and thus assess the creditworthiness of companies.

It is an undisputed fact that credit ratings are the function of quantitative and qualitative parameters. While one can automate the consideration of quantitative parameters and certain level of qualitative parameters like currency, industry etc., in a software / analytical tool, the consideration of qualitative parameters for evaluating the credit rating is still an expert’s forte and is best undertaken by accredited credit rating agencies. It needs to be appreciated that the services of accredited credit rating agencies are expensive, and it may not be possible for all size of MNEs to avail their services for each inter-company loan transaction. The best alternative may be to evaluate credit rating through commercial credit rating tools which determines the credit rating considering all possible quantitative criteria and certain qualitative criteria.

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3 [https://www.moodys.com/researchandratings/methodology](https://www.moodys.com/researchandratings/methodology)

Careful consideration should be given for size of MNEs and size of loan transactions to warrant a credit rating exercise from accredited rating agencies. MNEs with consolidated turnover of less than €750 mn, for example, could rely on commercial credit rating tools to evaluate credit rating, providing that the loan size is also small, e.g. around €50 mn. Larger MNEs and larger loans imply larger stakes involved and accordingly, stringent compliance might be warranted by way of credit rating exercises by accredited rating agencies for determination of arm’s length interest rate.

Box C.3. Commentators are invited to provide a definition of the stand-alone credit rating of an MNE.

Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

Box C.4. Commentators’ on the relevance of the analysis included in paragraph 70 of this discussion draft.

As the two questions have overlapping sections of the Discussion Draft FT, we have addressed the two together. To address the first query, in our view, the stand-alone credit rating of an MNE can be defined at the relative measure of creditworthiness of the member company considering its stand-alone financial statements, without accounting/adjusting for any external factors or group support. Standalone ratings reflect the credit profile of the non-financial corporate issuer/entity, without sponsor support, whether implicit or contractual explicit support.

The Discussion Draft FT appreciates that the implicit support of an entity depends on various factors, such as strategic importance, percentage of ownership, management control, shared name, common industry group, domiciled in same country, historical support, etc. Implicit support can be defined as the benefit of passive association a member company receives. Such benefits can be witnessed in the form of receiving funding from a financial institution or obtaining a reduced interest rate or other favourable terms of lending, which would otherwise not be the case. The implicit support of passive association is only an expectation and not legally or contractually binding on the parent company. It is for this reason that such support may need to be analysed on a case-by-case basis. The Discussion Draft FT covers various factors where the implicit support will be of relevance but there could be scenarios where the parent company might not support the member companies.

In cases where a joint venture has been set up by two equal partners, there exists the possibility of a dispute between the two partners which may lead to a questionable positive implicit support. Also, in cases where the member company is largely independent with local control and decision-making in the hands of its local management, venturing into high risk projects, especially involving EPC contracts, construction, and real estate, there may be other scenarios where the effect of implicit support should be applied with discretion. One other scenario where the effect of implicit support may be limited is in the case of special purpose vehicles (“SPVs”), which are typically set-up for meeting a limited objective. Such SPVs are inherently risky owing to the nature of their projects and the effect of implicit support may need to be applied considering the risk quotient and underlying agreement terms with the group company. However, in cases where the credit rating of a parent company can be applied to a member company, the discussion of implicit support becomes redundant.

The concepts laid down in the Discussion Draft FT have been practically applied in the case of General Electric Capital Canada case relating to the validity of the payment of a guarantee fee by a Canadian subsidiary to a US parent, where the Tax Court of Canada in effect decided to apply both the concept of a standalone approach and the concept of implicit support by the parent company to arrive at an appropriate credit rating for the Canadian subsidiary of General Electric Capital. In fact, the ruling appreciates the existence of implicit support and does not allow a separate charge for it as it does not require the efforts of the parent company. Although the concept of implicit support is peculiar to a parent subsidiary relationship, it can be adopted and applied without violating the arm’s length

https://www.fitchratings.com/.../RatingDefinitions

principles. The courts in this ruling have appreciated that implicit support is an economic factor, which ought to be considered when determining the arm’s length transfer price.

Credit rating agencies, including some of the major credit rating agencies, such as S&P and Moody and Fitch, adopt different models to quantify the implicit support available to a member company. For example, S&P Capital IQ\(^7\) has its own framework, which assesses a subsidiary credit rating after considering the group company support. S&P Capital IQ classifies member companies into three groups, which include core subsidiaries, strategically important subsidiaries, and non-strategic subsidiaries. Each category of subsidiary may receive different levels of support from its parent company, ranging from minimum to maximum. The support overlay quantifies such support and provides appropriate adjustments to the standalone results of the credit worthiness of a company.

The framework treats the credit risk assessment of a core subsidiary in line with that of the parent model score, whereas the credit risk assessment of a strategically important subsidiary is generally three notches higher than its standalone model score (subject to a cap of one notch below the parent company model score) and the credit risk assessment of a non-strategic subsidiary is at the level of the subsidiary's standalone model score.

The frameworks adopted by the credit rating agencies clearly lays down the strategic importance of the member company in the group operations and its linkages with the parent company. Thus, when there is a strong implicit support, the credit rating of the MNE borrower would be more closely linked to the group rating. In cases where the borrower is of limited or no strategic importance to the group and has weak linkage, it might be appropriate to consider its own stand-alone credit rating.

In India, we have researched the framework of CRISIL, which considers the implicit support of the group company for notching up or notching down the individual credit rating of the subsidiary company. CRISIL adopts its criteria framework, which include the following factors, and assigns weights to each of these factors depending on its criticality for the relevant case under consideration:

- Economic rationale: The economic rationale focusses on the strategic importance of the subsidiary to the parent;
- Moral obligations: The moral obligations include factors such as the extent of management control, shared name, domiciliary status, and stated posture of the management; and
- Corporate status of the parent: The corporate status of the parent includes listing status and propensity to raise funds from capital markets

The final determination of rating for the subsidiary company is based on the linkages between the parent company and the subsidiary company, which could be a low, medium, or high linkage.

<table>
<thead>
<tr>
<th>Box C.5. Commentators’ views are invited on:</th>
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<tbody>
<tr>
<td>– the role of credit default swaps (CDS) in pricing intra-group loans;</td>
</tr>
<tr>
<td>– the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).</td>
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</tbody>
</table>

- **Credit default swaps**

While CUP is the most widely used method for benchmarking loan transactions, there are other options, such as credit default swaps, price quotations, insurance pricing models, standby letters of credit etc., which could be used for benchmarking.

CDS is a derivative financial instrument between two parties, whereby the buyer makes a payment to the seller for the right to a payoff in the event of default of either a loan/bond, a trade receivable, or other type of liability. The spread in case of a CDS is reflective of the risk associated with the default, and so the riskier the debt, the higher the premium. As such, the premium on a CDS is reflective of the credit risk premium, which is one of the factors in the pricing of intra-group loan transaction.

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\(^7\) Refer: Support does matter in credit, S&P Capital IQ
CDS price is only a function of default risk, while loan pricing is a function of several terms of the loan instrument, such as amount of loan, tenure of loan, security attached, currency of loan, terms of repayment, credit risk etc. Further, the market for CDS is regulated and limited to certain industries. Considering the aforesaid factors, CDS may not be very helpful in pricing intra-group loans.

- **Role of economic model in pricing intra-group loan**

Financial institutions and banks adopt economic models to price loans, depending on the nature of industry and other qualitative and quantitative criteria that are required to be satisfied. The economic models incorporate loan risks, position of the borrowers, and strategy of the credit institutions/bank strategy to ensure that loan transactions are priced in a fair manner. Further, such models incorporate not only the likelihood of payment default, but also estimate the quantum of loss in the event that a borrower fails to fulfill financial obligations.

In our view, results of such economic models, if publicly available, can serve as a good reference point or be adopted as potential comparable uncontrolled prices for determining the interest rates on intra-group loans. However, these models are the result of groups of transactions and represent a market indicator but not necessarily actual transactions between unrelated parties. Further, appropriate economic adjustments may need to be performed to such reference points to arrive at a suitable arm’s length price.

**Box C.6. Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.**

In our view, there are no perfect substitutes for intra-group loans to determine the arm’s length price. However, financial instruments, like bonds, debentures, intra-group deposits etc., with similar terms and economic characteristics to intra-group loans may be considered alternatives if third party loan transactions are not available for determining arm’s length interest rate on loans.

**Box C.7. Commentators are invited to describe situations in which an MNE group’s average interest rate paid on its external debt can be considered as an internal CUP.**

The Group’s average interest rate on debt cannot be considered as internal CUP to determine the arm’s length price of a member’s intra-group loan as the Group’s average interest rate would be a function of group’s credit rating, nature of financing arrangements, the group's debt serving ability, scale of operations, diversified business operations, etc.
II (b).  Treasury Function - Cash pooling

Box C.8 (a) With respect to the operation of a physical cash pool, commentators’ views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

In our view, any scenario where a cash pool leader (“CPL”) is responsible for the control and decision-making in relation to the treasury functions, will lead to a situation where it would be allocated risks. These could include investing and financing decisions relating to the group and/or member company.

i. In a scenario, where a CPL operates as an entrepreneur entity (such to an in-house bank), wherein it carries out all relevant functions, assumes risk and employs assets relating to investing or financing activities. In the instant case, the CPL acts as a counterparty to the transactions and assumes the risks associated with such activities; and

ii. In any scenario, where the decision-making in relation to the advance and allocation of funds is decided by the CPL, exercising material functions and risks instead of the parent/m member company, will lead to the former bearing the risk allocation.

Box C.8(b) Commentators’ views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular:

- are there circumstances in which one or another of the approaches would be most suitable?
- does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?; and
- whether, in commentators’ experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

Addressing the next part of this question, which deals with allocating the cash pooling benefits to the participating members:

- Enhancing the interest rates for all participants

   The benefit of enhancing the interest rates for all participants will be more applicable in a scenario where the CPL does not perform any substantial functions or risks (i.e. operates as an intermediary), thus being entitled to a service or agency fee. In such cases, the CPL should not be entitled to any synergistic benefit or investment return arising from such an arrangement and any excess returns arriving from the cash pool activities should be allocated to the members basis the respective contribution by cash pool member.

- Applying the same interest rate for all participants

   The same interest rate will be more applicable in a scenario where the credit profile and balances of the participants are similar on a stand-alone basis (adjusting for implicit support). Such an approach will be more relevant to a sub-set of participants rather than all participants contributing to the cash pool, e.g. in a scenario where the participants come together for a long-term integrated project, with each party performing a certain strategic function. In this case, irrespective of whether one cash pool participant has a debit or credit balance, the same interest rate may be applied across participants, until the completion of the joint project.

   Such an approach cannot be uniformly applied to any situation and will need to be analysed on a case-by-case basis. If the same interest rate is applied uniformly, it could lead to an extreme situation of profit or loss at the hand of CPL and hence the approach is not fully viable.
- Allocating the cash pooling benefits to the depositors

As suggested in the discussion draft, this would be more applicable in a scenario where there is a capital risk arising for the depository participants. Apart from this scenario, it will also be relevant for participants who consistently have a positive balance. Such participants would typically include low risk contract manufacturers and service providers, who are exposed to low business and operational risks and are therefore capable of maintaining a positive balance.

- Allocation of group synergy benefits suffice to arrive at an arm’s length remuneration and practical experience and adoption

The OECD transfer pricing guidelines 2017 has mentioned that synergistic benefits or burdens may arise depending on the deliberate concerted actions of the group. Such concerted actions may lead to either structural advantages or disadvantages, which should be shared by the members in proportion to their contribution. However, this approach must meet the necessary arm’s length principles laid down in the guidelines. In our view, allocation of group synergy benefits is adopted by large multinational companies and is also an accepted view by certain tax authorities in cases of notional cash pool arrangements.

Box C.9 In the context of the last sentence of paragraph 102, commentators’ views are invited on a situation where an MNE, which would have not participated in a cash pool arrangement given the particular conditions facing it, is obliged to participate in it by the MNE group’s policy

In our view, it is unlikely that a member company would participate in a cash pool arrangement if such an arrangement would make it worse-off than the next-best option that would be realistically available. Following the concept of game theory, a member would expect to participate if it is in a better position, or at least at the same position. However, scenarios where participation to a cash pool would lead to higher transactions costs or increased interest rates than on a stand-alone basis would question the very basis of participation. This would be relevant in a case where the stand-alone entity is independently financially stronger than the rest of the group. In such peculiar situations, the member company’s participation is merely owing to its contractual obligation to be following the group policy.

However, in cases where the participants have taken commercially objective decisions to invest in a cash-pool in anticipation of futuristic benefits, the tax authorities should not be questioning the commercial or business decision of the member company.

Box C.10. Commentators’ views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

Commentators’ views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

Cash pooling arrangements are typically implemented by large multinational companies with numerous subsidiaries and group companies. To obtain the full benefit of a cash pool, it is commercially viable for all group companies to participate in the cash pool. However, it may be relevant to highlight that although there exists a common holding, the concept of separate entity approach distinguishes each company from its parent and other subsidiaries.

In our view, given the concept of the separate entity approach, irrespective of the cash pool belonging to a common group, there is a need for cross-guarantees in cash pooling arrangements. This requirement becomes even more critical when there exists a notional cash pool, as a bank may not

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8 Portuguese Arbitration Tax Court Rules on Notional Cash Pooling Arrangements, Tax Notes Intl. (3 June 2013)11’
agree to extend a loan or an advance on its own risk given the absence of physical existence of cash, thus necessitating the need for a cross-guarantee.

A good reference to a practical cross-guarantee is witnessed in the case of Portuguese Arbitration Tax Court Rules on Notional Cash Pooling Arrangements, Tax Notes Intl. (3 June 2013)11', wherein pursuant to the notional cash pool arrangement, the parent and the subsidiary provided cross-guarantee to each other for their respective account balances. Although this case does not discuss implementation of the notional cash pool, we thought it would be relevant international guidance on this topic. In this case, the Portuguese taxpayer had a good financial standing and higher credit rating in comparison to its parent. The tax authorities argued that due to a higher rating of subsidiary, the parent was able to obtain better interest rates, thus demanding a guarantee fee. However, after analysing the facts and circumstances, the Portuguese Court held that the arrangement was a contract of mixed nature and hence the terms and conditions of the cash pool arrangement should be analysed in detail before concluding the need for a separate guarantee fee.

We wish to illustrate the practical implementation of the cash pool savings with an example. The arm’s length guarantee fee should be the difference between the stand-alone interest rate the subsidiary pays on the basis of its individual rating (say 6% with BBB rating), as adjusted for implicit group support (say 4% with A rating). If a cross-guarantee was introduced to this arrangement, by either the parent or a member of the cash pool, the subsidiary could possibly obtain a further reduced interest rate (say cent 2% representative of AAA rating). Subsequently, the benefits or the interest savings of 2% (in the range of 0-2%), should be split between the guarantor and participants based on their bargaining power/respective contributions. Further, in our view, an implicit cross-guarantee is present in effect and substance in cash-pool arrangements; however, to obtain the benefit of further reduced interest rates from 0-2%, an explicit cross-guarantee by a parent or cash pool participant will be required.

It is relevant to highlight that the setting-up and implementation of a cash pool creates several legal, tax, accounting, and regulatory issues. Some countries either prohibit or have highly regulated guidelines surrounding cash-pool arrangements with a need to disclose such arrangements in their books of accounts under contingent liability. Other factors include: the type of cash pool, either physical or notional; single country or cross-border pooling; single or multiple currency, etc. As an example, notional cash pool is not permissible for a country like India, where the functional currency is not fully convertible. Also, there are restrictions in terms of setting up a domestic physical cash pool as the group must comply with regulatory sanctions. This includes the compliance from Companies Act, 2013, Income tax Act, 1961, deemed division provisions, etc.
II(c). Treasury Function - Hedging

C. 11(a) In a situation where there are off-setting positions within an MNE group, commentators' views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

Hedging, in general, is an investment position intended to offset potential losses or gains that may be incurred by an adverse price movement in an asset such as financial derivatives.

In the above situation, it has been explained that there exists off-setting positions within an MNE group and thereby creates a position of natural hedge for the group with no formal hedging contracts entered among the members of an MNE group.

In such a scenario, it needs to be observed whether the decision of not entering into any formal hedging contracts either within the group or with third parties has been made by a respective entity of the MNE group or has been directed by a central treasury team of the MNE group. In the case of the former scenario, the respective entities would be responsible for the profit or loss that they would earn or incur owing to their unhedged position. In the case of the latter, the appropriate treatment is explained in the next question.

C. 11(b) Regarding scenarios where a member of an MNE group has a risk exposure which it wishes to hedge but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, commentators' views are invited on whether that risk should be treated as being assumed by the unhedged MNE or by the entity which sets the group policy. If the latter, what would be the resulting treatment under the Transfer Pricing Guidelines?

Suppose a member of an MNE (domiciled in United States), which is in the business of trading, has some receivables in EUR currency. Due to foreign currency fluctuations, the member of an MNE is interested to hedge its Forex position. In general, the subsidiaries, inform the group treasury about their future cash flows (payables and receivables). However, there is an off-setting position elsewhere in the group and, because of the group policy, the Group’s treasury center prevents the member MNE to hedge its exposure.

In our view, following a functional analysis under the OECD TP Guidelines, the Group’s treasury shall assume the risks on account of the unhedged position of that particular MNE. Accordingly, any positive or negative outcome due to the unhedged position of that particular entity should be borne by the Group treasury. In a way, it should be considered that the Group treasury center has hedged the position of the respective entities by putting an estoppel to those entities for not seeking hedge outside market.

Thus, the group treasury should be obliged to settle the positions with respective MNE entities by a reimbursement / recovery of the loss / profit amount (less any savings from hedging cost) created with the risk exposure of the MNE entity. An example has been provided below in this regard: The situation of two Indian entities of an MNE group with respect to USD:

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Exposure</th>
<th>Current rate</th>
<th>Forward Rate</th>
<th>Forward premium</th>
<th>USD rate on 30th day</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary A</td>
<td>Receive $ 10,000 in 30 days</td>
<td>65</td>
<td>68</td>
<td>0.10</td>
<td>68.5</td>
</tr>
<tr>
<td>Subsidiary B</td>
<td>Pay $ 10,000 in 30 days</td>
<td>65</td>
<td>68</td>
<td>0.10</td>
<td>68.5</td>
</tr>
</tbody>
</table>

Subsidiary A wishes to hedge and secure its receivable @ Rs. 68/ $ by paying a premium of Rs 0.10 / $.

Similarly, Subsidiary B also wishes to hedge its liability @ Rs. 68/ $ by paying a premium of Rs. 0.10/ $.
However, considering the position of both the subsidiaries, there is an off-setting position within the Group and Group Treasury Center that restricts both the entities from entering into separate hedging contracts with the banker.

As on the 30th day, the subsidiaries end-up in following loss/ gain position due to their unhedged positions:

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Transaction size</th>
<th>Transaction Rate (USD rate on 30th day)</th>
<th>Rate Forgone (Forward Rate)</th>
<th>Gain / (Loss)</th>
<th>Premium saved</th>
<th>Net gain / (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary A</td>
<td>Received $ 10,000</td>
<td>68.5</td>
<td>68</td>
<td>$ 5,000</td>
<td>$ 500</td>
<td>$ 5,500</td>
</tr>
<tr>
<td>Subsidiary B</td>
<td>Paid $ 10,000</td>
<td>68.5</td>
<td>68</td>
<td>($ 5,000)</td>
<td>($ 500)</td>
<td>($ 4,500)</td>
</tr>
</tbody>
</table>

Based on the above explanation, the Group Treasury Center should recover the net gain of $5500 from subsidiary A and reimburse $4500 to Subsidiary B. It needs to be appreciated that whatever net gain/ loss assumed by Group Treasury Center, i.e. $1000 in the instant case, is the remuneration for providing hedging by estoppel to MNE entities.

It may also happen that the entity setting the Group policy, i.e. Group Treasury Center of an MNE, is just a coordinating entity and the decision-making lies with some other entity. In such cases, the gain / loss occurring out of the unhedged position of individual entities is to be borne by the entity with whom the decision-making lies.

Another scenario might also occur in a decentralised MNE, where individual entities undertaking independent economic activities and assuming the capacity to bear the outcomes of decision-making have agreed in consensus that when off-setting position will exist within the group, the respective entities would not undertake external hedge from the market. The consensus policy decision undertaken might be given to Group Treasury Center to oversee implementation of the policy. Under such scenario, the gain / loss occurring out of unhedged position of individual entities is to be borne by the respective entities.
III. Guarantees

Box D.1. Question to commentators

a) How a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset, or as a simple treasury service associated with a loan)?

The revised guidance provided in Chapter 1 of OECD TPG has extrapolated the arm’s length principle to assess the actual behavior (i.e. conduct) of the parties to a transaction against what is provided in the written contract. Thus, each situation must be examined on its own merits and accurate delineation of the actual transaction will precede any pricing attempt.

The Discussion Draft FT highlights the importance of conducting a debt capacity analysis of the borrower in the case of related party financial transactions. This includes a review of the MNE group’s financing policy, consideration of specific industry factors, and options realistically available to both parties (the borrower and the lender), so that entering into a transaction should not result in either of the parties to the transaction being worse off. In a related party financial guarantee, accurate delineation would mean to analyse how the related party financial guarantee is to be characterised and, thereafter, risks and rewards borne by each entity in the arrangement.

Provision of related party financial guarantees could result in the following:

- Credit enhancement of the guaranteed thereby reducing the borrowing costs; or
- Enable the guaranteed to avail loan from third party which was not viable for the guaranteed in the first place; or
- Increase the borrowing capacity of the guaranteed; or
- No commercial or economic benefit is derived by the guaranteed.

Thus, in order to accurately characterise the guarantee transaction, the foremost step is to consider the impact of financial guarantee on the guaranteed.

Generally, the result of the guarantee is that the credit rating of the guarantor is passed down to the debtor, thereby decreasing the risks assumed by the credit provider and ultimately resulting in more beneficial terms and conditions for the loan, including a lower interest rate. By issuing a loan guarantee, the guarantor in theory not only assumes the credit / default risk related to the loan, but also provides the related party with a benefit (i.e. through lowering of interest rates on the loan).

However, the guarantee is typically provided by the parent for its subsidiary in a related party scenario, and the consequence is that it enables or increases the borrowing capacity of the subsidiary, e.g., it is frequently observed in cases of cross-border acquisitions that an investment entity is formed as a Special Purpose Vehicle (SPV) for the purpose of Group’s / parent acquisition. The SPVs are incorporated with nominal level of equity capital (say $ 10,000) in comparison to the amount required for purposes of acquisition (say $10 million). The balance amount (i.e. $99 million) required is either funded by an internal loan or external loan on the basis of the parent’s financial guarantee to the external lender.

The provision of guarantee in this particular case enables the SPV to borrow the loan of $ 9.9 million, where in an independent scenario no external party would have agreed to fund the SPV on a standalone basis considering its minimal capital and negligible operating cash flows. Thus, in the instant scenario, the guarantee should be considered a substitute to equity capital by the parent entity and be regarded as a shareholder service warranting no charge.

One might argue, in the above scenario, that the external party may still agree to provide funding to SPV on a standalone basis considering the operations of company(ies) proposed to be acquired through the funds received. However, even in those circumstances, it needs to be seen that the
maximum amount that the SPV would have been able to borrow is based on the target companies’ financial status. Any amount of funding over and above the maximum amount that could have been borrowed by the SPV should be considered a substitution to the capital and shareholder service and warranting no charge.

Further, as per para 143 of the Discussion Draft FT, where it discusses a scenario in which a guarantee does not provide any economic or commercial benefit to the guaranteed entity and therefore should not warrant a charge for the same, there could be situations where the group members are financially so interdependent that the economic risk of a guarantor does not change materially on giving an explicit guarantee. In such cases, the guaranteed borrower may not be benefitting beyond the level of credit enhancement attributable to the implicit support of the Group/Parent entity and thus the guarantee does not warrant a charge.

Thus, one needs to appropriately analyse the role of financial guarantee on the guarantor and the guaranteed entity to accurately delineate the related party financial transaction and accordingly proceed to determine the arm’s length price.

- **Provision of financial services (whether chargeable service or shareholder service):**

  Provision of financial guarantees are normally considered a financial service. The moot point is whether the service is a chargeable service or non-chargeable (shareholder) service. Under the arm’s length principle, the question whether an intragroup service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house. (Para 7.6 of the OECD TP Guidelines).

  The OECD TP Guidelines (para 1.164 to 1.167) has well acknowledged the distinction of implicit and explicit support in the case of financial guarantees and appropriate treatment about the same. It has been provided that no service fee is warranted for implicit support by the parent to subsidiary; however, a service fee needs to be determined if the guarantee is explicitly provided and has resulted in a credit enhancement and reduction of borrowing cost.

  An implicit support could either be attributed to passive association of the guaranteed entity with the MNE group or can be regarded as incidental benefits drawn by the guaranteed due to primary activities of the parent which were not performed with the intention of providing any benefits to the guaranteed entity. The scenario of passive association has been deliberated in the Guidelines in para 1.164 to 1.166. The incidental benefits could be drawn where the parent has been able to build and maintain a strong banking relationship with the bankers through its regular commercial transactions and interactions. The relationship built with those bankers might result in favourable banking terms to the subsidiary. The subsidiary could be considered to draw incidental benefits and not direct benefits, thus warranting no charge.

  The guarantee could be considered a chargeable financial service only when it is established that:

  - the guaranteed entity would have been able to draw funds in its independent capacity; and
  - the guarantee has resulted in economic or commercial benefit in terms of lower borrowing cost

- **Treasury services associated with guarantee:**

  Treasury departments can function either as a cost center or profit center; however, the roles and responsibilities in each case would be different. The treasury department needs to be considered a cost-center in the case that the Treasury of an MNE Group is just facilitating the financial requirements of other members of the Group through external bank/financial institute without assuming any financial or commercial risks.
On the other hand, if the Treasury department is operating as financial institution for members of the MNE Group and assuming financial or commercial risks in this regard, then it needs to be considered a profit center.

The treatment of financial guarantee provided by Treasury Center needs to be analysed in the light of functions performed and risks assumed by the treasury center:

- **Treasury department as “cost center”:** While operating as a cost-center, it is unlikely that the treasury department would bear the risks associated with providing guarantee i.e. risks in case of default. The treasury department would arrange for a guarantee either externally or internally while keeping itself at front-end in providing guarantee. In such circumstances, the treasury department should be entitled to routine returns associated with facilitating activities.

- **Treasury department as “profit center”:** Treasury department that operates in a fashion comparable to a real in-house financial institution takes proprietary positions and assumes risks (which will require the relevant functional and financial substance in order to properly control them; reference is made to paragraph 1.63 of the OECD Guidelines). In these cases, the treasury should price all intercompany transactions, including financial guarantees, “at market rates”.

- **Sale of Financial asset:**

  Provision of financial guarantee gives rise to financial asset for the guarantor. Until the guarantor has rights to earn commission from the guaranteed, it is the owner of the financial asset so created. It may happen that the guarantor may transfer the guarantee to some other entity, along with the associated rights of earning commission, risks, and liabilities in the event of default. The transaction would be considered a sale of financial asset in this situation.

### b) The circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group

We have provided few examples below where an independent lender would insist upon guarantee while granting a loan to a member of an MNE group:

- Where the creditworthiness of the borrower does not support the borrowing of a loan from any third party. This could typically happen in a situation of a newly set up entity with no operations and minimal equity funding or if a special purpose vehicle (SPV) has been set up for acquiring some targeted assets / entities in line with parent’s or group’s policy. It should be noted that in the second instance, the SPV itself would not be willing to borrow the funds in first place as the acquisition was not its objective but driven by the parent company.

- A lender would also not be willing to grant a loan when the amount of proposed loan is beyond the borrowing capacity of the borrower, which the borrower could have realistically availed. The borrowing capacity is directly proportionate to debt servicing capacity and the same could be evaluated considering the existing profitability, cash flows, future cash flows, projections over period of loan, etc. The borrower can avail a loan from an independent third party on the basis of the guarantee provided by the Parent/ Group entity up to certain limit and beyond that part of the loan to be treated as substitute to equity capital and guarantee a shareholder service, since under independent scenario no lender would have lent such loan to the borrower. The concept of sub-division of loan as part equity and part debt is also stated in Para 140 of the discussion draft, which is also provided in the UK Transfer Pricing Guidelines issued by HMRC in the form of International Tax Manuals (INTM).

- Another instance where the lender would not be willing to provide additional funds or continue with the existing loans is where the borrower’s financial condition has deteriorated since the loan was borrowed and it has reached a stage of significant increase in risk profile where an independent lender would not have been willing to assume such high risk of default.
Guarantee would also be insisted in cases where the borrower desires a lower rate of interest and, based on its standalone credit rating, the lender is not willing to lend at such lower rate of interest. In this scenario, the guarantee of parent / group entity would lower the credit risk to lender, owing to the guarantor's financial standing and accordingly, lower the rate of interest originally proposed to the borrower.

c) Where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing;

d) Examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

It can be instructive to examine how the rating agencies view ratings for affiliated groups in the presence or absence of guarantees World-leading credit rating agencies like Standard & Poor’s, Moody's, and Fitch note that the association of an affiliate to a group (i.e. implicit guarantee and no explicit guarantee) is one of the many factors considered in establishing credit ratings, which would impact interest rates. The rating agencies analyses (i) the existence of legally enforceable loan agreements between the parent and subsidiary disclosed to the rating agencies and other third-party creditors, (ii) strategic importance of the affiliate within the group (to understand the weightage of implicit support), (iii) economic costs including legal, financial, operational, political, or reputation costs, (iv) structure and terms of intercompany support mechanisms, if such mechanisms exist, and (v) any other relevant facts and circumstances.

When compared to a quantitative rating of the subsidiary, the rating agencies generally ascribe qualitative adjustments that result in higher ratings for subsidiaries that are financially, strategically, and operationally integrated with better rated parents. S&P notes that affiliation is a consideration in assessing the credit rating of affiliated entities; affiliation between a stronger and a weaker entity will in most cases affect the credit quality of both, unless the relative size of one is insignificant.

The transfer pricing of guarantees is challenging. Relying on the intention the OECD Guidelines, the methods developed to benchmark guarantee fees usually assesses their arm’s length nature by trying to determine how third parties would price the transaction as a measure of the benefit conferred under the guarantee.

Explicit guarantees are agreed by the parties in written agreements and are therefore legally enforceable. One of the simplest cases of an intercompany guarantee is one in which a guarantee agreement is “valid, unconditional, and irrevocable, and provided that it requires prompt payments to the creditor in full before pursuit of remedies.” In these cases, when the related-party guarantor has a stronger credit rating than its affiliate, the guarantee “provides full credit substitution” for the issuing affiliate because the guarantee agreement is binding.

Implicit guarantees are not formal guarantees and not legally enforceable. Implicit guarantees refer to an assumption that, for borrowings, a borrower’s affiliate (typically its parent) would provide financial backing to the borrower in case it defaults. Unlike explicit guarantees, implicit guarantees are assumed to exist but are seldom laid out in legal arrangements.

From a transfer pricing perspective, an analysis of implicit parent company guarantees usually arises when tax authorities try to determine the stand-alone credit rating of an affiliated subsidiary. It is important to note that, from a technical perspective, consideration of such implicit guarantees may be challenged if one is pricing an explicit financial guarantee from that same parent to the subsidiary (versus in a case where such member of group or implicit guarantee elements are being considered in evaluating the credit rating for purposes of pricing stand-alone debt). The effects of implicit guarantees are assessed based on the quality of the guarantee, the strength of the guarantor, and the nature of the credit arrangement.

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10 Moody’s-Core-Principles-of-Guarantees-for-Credit-Substitution.pdf
guarantees on credit ratings are challenging to determine because implicit guarantees have no legally defined terms. Fundamentally, the effects of implicit guarantees depend on the parent’s willingness and ability to support the subsidiary. The scenario where the impact of implicit guarantee could be on par with explicit guarantee has been discussed in our comments to Box C2 where the group rating can be considered the member’s rating.

Summarising the above, we hold the following views (assuming that the loan availed on the basis of guarantee is to be considered as loan applying the principles of accurate delineation of transaction discussed above):

1. **Explicit Guarantee exists** – The independent lender would decide the terms and conditions of the loan arrangement considering the credit standing of the guarantor instead of borrower. Thus, the borrower’s rating is evaluated at BBB and the credit spread offered on a rating of 300 bps, whereas the guarantor could be rated as A and attract a credit spread of 250 bps. Thus, the guarantee could construe to have benefited the borrower by 50 bps as, in all possibility, the loan would be priced at a credit spread of 250 bps.

2. **Implicit Guarantee** – The first and foremost step is to analyse the impact of implicit support on borrower’s credit standing. For the scenarios in response to Box C2, where group rating would be considered as member’s rating, the impact of implicit support would be equivalent to explicit support. However, following the Guidance as per Chapter 1 of OECD Guidelines, no charge is warranted for implicit guarantee as the same is a result of synergy benefits or passive association of the member with the Group.

Thus, the starting point of quantifying the savings in interest cost through explicit guarantee is to compare the rate of interest under explicit guarantee with the rate of interest considering the standalone financials of the borrower and factoring the implicit support.
IV. Captive Insurance

Box E.1. Commentators’ views are invited on the following:

a) when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;

Our views on the above question stem from the guidance provided in OECD TP Guidelines, 2017. In this respect, the steps as provided in para 1.60 of the Guidelines to be analysed:

1) In typical captive insurance contracts, economically significant risks would need to be specified. Primarily, the risks for an insurer relates to compensating the insured for unexpected loss in the future due to the occurrence of contingent events. Based on the contractual terms, the insured risks need to be identified as a first step.

2) Based on the contractual terms and conduct of the parties involved in an insurance arrangement, one needs to analyse the role of associated enterprises in relation to “assumption and management of the insured risks”, and, in particular, the following should be given due credence:

- which enterprise or enterprises “perform” the risk control functions and risk mitigation functions with respect to insured risks;
- which enterprise or enterprises “bear the outcomes” of such insured risks getting materialised; and
- which enterprise or enterprises have the “financial capacity” to assume such insured risk.

It needs to be seen that the entity assuming risks also performs the risk management functions and have the capacity to bear the risk outcomes. The Guidelines in para 1.61 of Chapter I provides three elements that are relevant for risk management, which are:

(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function,

(ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and

(iii) the capability to mitigate risk i.e. the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

Thus, the possible indicators to arrive at a conclusion that the policy issuer is actually assuming the risks that it is contractually assuming are:

- whether the insurer has the capability to perform functions in relation to take on, lay off, or decline a risk-bearing opportunity, together with actually performing such risk control functions and risk mitigation functions;
- whether the insurer has the capability to make decisions in relation to risk mitigation activities, together with actual performance of such decisions and also “bear the outcome” of such insured risks when materialised; and
- whether the insurer has the “financial capacity” to assume such insured risk.
b) when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed; and

An independent insurance company typically performs a range of functions and assumes associated risks while earning an insurance-related return. Routine functions and associated risks in the nature of underwriting contracts and settling claims fetch routine returns; however, it is the assumption of economically significant insurance risks along with related functions (as explained above) which entitles them to earn non-routine insurance returns. Thus, one needs to understand what “specific risks” and “control functions” the captive entity needs to be able to perform to enable it to earn an insurance return.

The “specific risks” of a captive insurance company is the risk of compensating the insurer in the event of any contingent event occurring. It should be noted that the occurrence of the contingent event needs to be realistic, ideally, the risks for which one can get an insurance in an uncontrolled market. One would also need to be mindful of several operational risks like the risk of not complying with applicable regulatory requirements for captive insurance activities. Risks of resources (employees, contract employees) not possessing appropriate skills like underwriting, investment, valuing the premium, etc.

The control functions that the captive needs to perform in relation to the aforesaid specific risks includes:

- functions relating to diversification and pooling of risks assumed through insurance contracts issued to related entities;

- functions resulting in improvement in economic capital position of the group as a result of diversification either through: (i) insuring a significant proportion of non-group risks within its portfolio, or (ii) reinsuring a significant proportion of the risks it insures outside of the MNE group;

- functions of hiring and contracting resources with appropriate skills like underwriting, investment, valuing the premium, etc.

c) whether an MNE group member that issues insurance policies to other MNE group members can satisfy the control over risk requirements of Chapter I, in particular in the context of paragraph 1.65, in situations where it outsources its underwriting function. Comments are also invited on whether an example would be helpful to illustrate the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues insurance policies;

As touched upon earlier, when an independent insurance company undertakes insurance activities and charges premium in lieu of providing insurance, the insurance premium collected is a return for two activities:

1) Routine - Undertaking underwriting activities including but not limited to issuing policy documents, collecting premiums, paying claims, preparing reports, and compliance with regulatory laws. The aforesaid activities could be considered routine in nature and warranting not more than routine profits associated with insurance activities.

2) Non-routine - Assuming the specified insurance risks like the risk of compensating the insurer in the event of any contingent event occurring, operational risks like the risk of not complying with the applicable regulatory requirements for captive insurance activities. Risks of resources (employees, contract employees) not possessing appropriate skills like underwriting, investment, valuing the premium etc., and performing management and control functions in relation to such risks.
Thus, the entity performing functions limited to underwriting activities should retain routine return and the entity performing control functions and assuming insurance risks to retain non-routine return portion of the insurance premium.

However, it should be noted that in an independent scenario, the underwriter, apart from the aforesaid activities has to undertake the significant marketing activity of attracting clients to get themselves insured from the insurance company. Accordingly, it happens that they end up creating significant marketing intangibles. Thus, depending on appropriate analysis of the case, a portion of non-routine return for creating such marketing intangibles to be apportioned for underwriting function. However, in a captive insurance scenario, the underwriter does not have to perform the function of marketing the policy to get business. By virtue of being member of the MNE, the insurance contracts by default flow to the captive entity. Accordingly, in a captive insurance scenario, the returns to an underwriter should be limited to routine return for undertaking routine functions unless they assume insurance specific risks in part or in full.

d) when an MNE group member that issues insurance policies does not satisfy the control of risk requirements of Chapter I, what would be the effect of this on the allocation of insurance claims, premiums paid and return on premiums invested by that MNE group member.

In the scenario where the captive insurance entity does not satisfy the control of risk requirements, the allocation of insurance premium should be undertaken in accordance with appropriate delineation of functions performed and risks assumed among the entities of MNE group. As explained above, the premiums earned on insurance contracts relate for routine activities (like underwriting) and non-routine activities (assuming significant risks and performing control functions in relation to assumption and management of those risks).

Thus, what remains to be done is identification of the entity or entities undertaking routine or non-routine functions. If it does not satisfy the control of risks requirement then the captive entity would be entitled to earn the routine returns associated with the underwriting function.

Box E.2. Question to commentators

Commentators’ views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

Para 181 reads as:

181. Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm’s length for insurance of a particular risk. In setting prices for an insurance premium, an insurer will seek to cover its expected losses on claims, its costs associated with writing and administering policies and dealing with claims, plus a profit to provide a return on capital, taking into account any investment income it expects to receive on the excess of premiums received less claims and expenses paid.

Determination of insurance premium is a function of risks contracted and the likelihood of it to materialise in future. It needs to be appreciated that there is a huge gap between annual insurance premium vis-à-vis the amount of claim made by the party on the insurer. In cases where the claim is not made than the entire premium so received, less operating expenses, which results in profit for the insurer. However, when a claim is made by the insured, the insurer ends up paying significant excess over the premium received. Thus, the geniuses lies in predicting the number of claims to be filed and estimated cash outflow vis-à-vis number of insurance policy the company would be able to sell to arrive at a premium amount.
Calculation of expected claims is an exercise that is to be undertaken by an expert. Normally, actuarial analysis performed by experts provides the insurance companies with the appropriate amount of premium to be charged. In cases of transfer pricing analysis, reliance could be placed on comparable uncontrolled transaction data with appropriate adjustments to arrive at the amount of premium to be charged.

The next alternative would be to determine the insurance premium applying the risk of loss measure. In this approach, the expected amount of claim under insurance and loss of return on the claim is determined using economic models. This shall give the amount to be charged for assuming insurance risks. To arrive at insurance premium, recovery of costs along with return on such costs should be added on the amount for insurance risks.

The actuarial analysis by an independent expert should be undertaken as the next best alternative for determining the arm’s length insurance premium.

**Box E.3. Question to commentators**

Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

Para 187 and 188 states:

187. For example Company A is a high street retailer of high value new technology consumer goods. At the point of sale, A offers insurance policies to third party customers which provide accidental damage and theft cover for a 3-year period. The policies are insured by B, an insurer which is part of the same MNE group as A. A receives a commission with substantially all of the profit on the insurance contract going to B. A full factual and functional analysis shows that the insurance contracts are very profitable and that there is an active market for insurance and reinsurance of the type of risks covered by the policies. Benchmarking studies show that the commission paid to A is in line with independent agents selling similar cover as a standalone product. The profit B earns is above the level of insurers providing similar cover.

188. In considering how the conditions of the transaction between A and B differ from those which would be made between independent enterprises, it is important to consider how the high level of profitability of the insurance policies is achieved and the contributions of each of the parties to that value creation. The product sold to the third party is an insurance policy substantially the same as that which any other insurer in the general market could provide. The sales agent has the advantage of offering the insurance policy to its customer alongside the sale of the goods to be insured. It is the advantage of intervening at the point of this sale which provides the opportunity to earn a high level of profit. A could sell policies underwritten by another insurer and retain most of the profit for itself. B could not find another agent that has the advantage of point of sale contact with the customer. The ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer contact at the point of sale. The arm's length remuneration for B would be in line with the benchmarked return for insurers insuring similar risks and the balance of the profit should be allocated to A.

Our views are in the affirmative with the approach provided in the above paras. In the case of third party insurers, they need to undertake significant marketing and sale efforts to sell the insurance policies. The cost of such marketing efforts is in-built in the premium price. Further, it should also be noted that an independent insured entity might pay a higher premium to a well-known insurer as it builds over a reputation of honoring claims etc. Thus, the return for such marketing intangibles are built-in the premium price.

In the example discussed in para 187 & 188, Company B, the captive insurer does not have to undertake any significant marketing efforts to get insurance contracts and is able to attract consumers through marketing and sale efforts by Company A for its electronic goods. Further, in spite of being captive (unknown name in the insurance industry), it is able to charge a similar rate of premium that is...
being charged in market for similar types of insurance services. It would be obvious that the consumers are willing to pay the similar rate of premium charge on the goodwill of high street retailer i.e. Company A.

Therefore, a profit split analysis would be more appropriate in the above scenario, where the profits from insurance contracts are split between A and B on the basis of contribution made by both of them in generating such profits. Where B’s contribution is limited to assuming specific insurance risks and performing control functions for those risks, A contributes through marketing efforts and intangibles generated by it over the years.