Comments Received on the Public Discussion Draft

BEPS ACTIONS 8 - 10

Financial transactions

Part II

14 September 2018
# Table of contents (Part II)

<table>
<thead>
<tr>
<th>Organization</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTEK Energy</td>
<td>3</td>
</tr>
<tr>
<td>Duff &amp; Phelps</td>
<td>4</td>
</tr>
<tr>
<td>EBIT</td>
<td>22</td>
</tr>
<tr>
<td>Embridge Economics B.V</td>
<td>32</td>
</tr>
<tr>
<td>Erste Group Bank AG</td>
<td>37</td>
</tr>
<tr>
<td>European Banking Federation</td>
<td>42</td>
</tr>
<tr>
<td>European Captive Insurance and Reinsurance Owners` Association</td>
<td>53</td>
</tr>
<tr>
<td>Eversheds Sutherland</td>
<td>61</td>
</tr>
<tr>
<td>EY</td>
<td>66</td>
</tr>
<tr>
<td>Fantozzi &amp; Associati - Studio Legale Tributario</td>
<td>96</td>
</tr>
<tr>
<td>Federation of European Risk Management Associations</td>
<td>115</td>
</tr>
<tr>
<td>Federazione Nazionale Imprese Elettrotecniche ed Elettroniche (ANIE)</td>
<td>138</td>
</tr>
<tr>
<td>FTI Consulting</td>
<td>146</td>
</tr>
<tr>
<td>Grant Thornton International</td>
<td>150</td>
</tr>
<tr>
<td>Hardeep Singh Chawla</td>
<td>165</td>
</tr>
<tr>
<td>International Chamber of Commerce (ICC)</td>
<td>170</td>
</tr>
<tr>
<td>Insurance Company Working Group on BEPS</td>
<td>182</td>
</tr>
<tr>
<td>Insurance Europe</td>
<td>193</td>
</tr>
<tr>
<td>International Fiscal Association (Mexican Branch) Transfer Pricing Committee</td>
<td>196</td>
</tr>
<tr>
<td>Japan Foreign Trade Council</td>
<td>201</td>
</tr>
<tr>
<td>KPMG</td>
<td>209</td>
</tr>
</tbody>
</table>
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7 September 2018

Dear Sir / Madam,

Please find below our comments on the questions in Boxes «Question to commentators» and the content of the provisions of Discussion draft on financial transactions (BEPS actions 8-10)

If there are restrictions on external lending in the country of the Borrower, such as maximum lending rate, these restrictions apply to both transactions between related parties and transactions between independent companies. At the same time, if there is no alternative, more profitable way of lending to the Borrower with similar risks and on similar conditions in another market, an independent Lender may agree to issue a loan to a country with maximum lending rates restrictions if it will bring profit to it.

It is proposed to add a new paragraph or modify paragraph 32 of Chapter I to include the following provision:

"If local laws and regulations in the country of the Borrower impose restrictions on external lending conditions (maximum lending rates) and the loan was issued with this limitation, such restrictions may be recognized as market conditions in the country of the Lender as well if actually conducted transactions do not lead to losses for the Lender or such losses are a temporary measure as part of the long-term Business strategy."

Yours faithfully,

Nikolay Matyukha, Head of Tax Department
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<tbody>
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</tr>
</tbody>
</table>
Response to Invitation for Public Comments on the BEPS Discussion Draft on Financial Transactions

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Executive Summary

Duff & Phelps welcomes the opportunity to comment on the Organization for Economic Cooperation and Development's (the OECD) discussion draft titled BEPS Actions 8-10, Financial Transactions, 3 July – 7 September 2018 (referred to herein as the “Discussion Draft”). We commend the OECD on its efforts to raise and address some of the most difficult questions surrounding intercompany financing transactions as guidance on the topic of intercompany financing has been highly anticipated by taxpayers, advisors, and authorities alike.

As the OECD works to finalize its guidance on this topic, we encourage the OECD to balance the desire of countries to combat earnings stripping with the arm’s length principle. Proposed guidance that excessively deviates from the arm’s-length principle may have other pitfalls, which the OECD should thoughtfully weigh. This Executive Summary will summarize specific areas in the Discussion Draft that we consider potentially problematic, noting that these viewpoints are expanded upon in our commentary. The remainder of our commentary is dedicated to clarifying technical points and responding to the Discussion Draft’s specific questions to commentators.

First, with respect to the accurate delineation of transactions, we recommend that guidance avoid creating a framework for tax authorities to recharacterize loans simply because the...

1 The opinions and views expressed in this letter are those of the authors and not necessarily those of Duff & Phelps or its clients.
issuance could be seen as relatively risky or speculative. We note that there exist many highly levered, unsecured, high yielding debt issuances in the market. As such, riskier characteristics (e.g., unsecured, subordinate) should not be a means for automatic recharacterization. Instead, as in market practice, risk should be assessed in the context of the lender’s availability of funds and appetite for the risk associated with the deployment of these funds and the borrower’s intent and ability to meet the debt obligations arising from such an issuance. Further, risk should be adequately reflected in arm’s-length compensation (e.g., interest).

Also on this topic, we recognize the perceived merits of the OECD’s proposed approach of bifurcating intercompany financing instruments into part debt and part equity (as opposed to an “all-or-nothing” approach), but we also urge the OECD to consider the potential repercussions of loose guidance on this topic that may arise when countries attempt to implement it.

Second, with respect to risk free returns, we urge the OECD to reconsider and clarify its guidance with respect to situations in which it is found that a funder lacks the capability to perform decision-making functions and therefore cannot earn more than a risk-free rate as it applies to intercompany loans (and any return that a funder would earn in excess of the risk-free rate would be allocable to the entities that do perform decision making functions). Unlike prior guidance on Action Items 8 to 10 wherein the framework prescribed by the OECD removed potentially unlimited equity returns from what it called “cash boxes”, this guidance could remove fixed, contractual and readily benchmarkable returns from funding entities and overly compensate decision-making entities for what could be a relatively routine function in assessing and arranging lending opportunities. As such it is important that the OECD clarify this guidance in the context of intercompany loans, particularly with respect to defining decision making and control.

Finally, the Discussion Draft discusses the impact that the MNE group credit rating should have on the credit rating of a particular MNE within the MNE group. We have not opined on the appropriateness of considering the MNE group rating versus a stand-alone credit rating, but recommend that the OECD’s final guidance have a more clearly defined and objective framework. Group and stand-alone credit ratings are often different from one another, which would likely lead economic analyses to result in different arm’s-length interest rates. As such, introducing these different approaches for determining a MNE’s credit rating and potential rebuttable presumptions could lead to double taxation risk if countries interpret and implement this guidance differently.
Section B. Interaction with the guidance in Section D.1 of Chapter I

Discussion of Accurate Delineation

Firms operating at arm’s-length (both as lenders and as borrowers) have flexibility in deciding how to invest and capitalize. With respect to investing, a risk versus return framework, often depicted as a diagonal upward sloping line (shown below) is commonly referenced. Based on all available information at a given point in time, all investments on the line are considered by the market to provide adequate expected return for the level of assumed risk.

Increased risk corresponds with movement to the right along the X axis. Increased risk, does not in and of itself dissuade a reasonable investor, so long as the increased risk is in turn met with commensurate increased return. In the context of the graph, this would correspond with movement up the Y axis, increasing compensation in order for the investment to be considered adequately priced given its level of risk (i.e., moving from point A to point B).

Reasonable investors would not consider investments falling below the line as there are theoretically alternatives that either offer greater return for the same level of risk or the same return for less risk. However, when faced with multiple investment opportunities that are adequately priced (i.e., on the line, for example points A and B, among others), investors’ choices then come down to preferences, one of which may be risk appetite.

Many of the attributes of an instrument that are highlighted in the Discussion Draft (e.g., credit rating, collateralization, etc.) impact the risk associated with the investment. In considering the lender’s perspective when determining the accurate delineation of the transaction, transactions that generally have the characteristics of debt and are priced at arm’s-length (which is to say it carries an interest rate that would make it an attractive investment given its level of risk) should not be recharacterized strictly due to relatively risky characteristics. For
example, all else equal, investment B should not automatically be recharacterized solely because the investment could have been structured as investment A. This is true even for riskier, speculative debt, and in loans that have untraditional characteristics as there exists active high-yield and distressed lending markets where issuances command relatively high returns. In some cases, lenders with an appetite and capacity for some risk may be actively looking to take on additional risk for additional return.

The Discussion Draft also raises questions of accurate delineation from the perspective of the borrower, noting that a borrower should enter into the most attractive opportunity available to it taking into account its ability to service its debt, the funds it actually needs to satisfy funding requirements, and the fact that, although it may have the capacity to borrow and service additional debt, it may choose not to do so to avoid potential negative pressure on its credit rating and jeopardizing its reputation and access to capital markets. In the context of this section of the Discussion Draft, it is important to consider the flexibility firms have in determining their capital structure. While independent enterprises typically make borrowing in a way that seeks to optimize their weighted average cost of capital, there are instances where they may need to weigh factors that could compete with this consideration, or that may work towards this consideration in a manner which is not immediately clear. For example, an entity may elect to issue additional debt despite the potential for negative pressure on its credit rating in order to take advantage of a low interest rate environment in which such financing is relatively inexpensive. Alternatively, an entity may choose not to refinance an existing loan in a low-interest rate environment for a number of reasons such as costs associated with refinancing, reputational risk, and/or expectations that rates will continue to decline (which may or may not materialize). Ultimately, decisions are typically the result of a holistic assessment of potentially competing factors, viewpoints, and preferences made based on information available at the time (i.e., ex-ante information), and as such, guidance should caution countries to exercise restraint when making an ex-post assessment of what an MNE operating at arm’s length would have done.

**Discussion of Paragraphs 8 to 10**

The guidance in paragraphs 8 to 10 of the Discussion Draft acknowledges that countries may employ approaches with respect to capital structure and interest deductibility, which may be different from the general approach espoused in the Discussion Draft. More specifically, the Discussion Draft states that it does not intend to “prevent” countries from taking these approaches or to “mandate” countries to take an approach consistent with the “accurate delineation of the actual transaction” in accordance with Chapter 1 of the OECD Guidelines, which is espoused in the Discussion Draft. The Discussion Draft does not detail what these approaches may be, but does, in the Question to commentators in Box B.1., make reference the BEPS Action 4 Report, which detailed both a ‘fixed ratio rule’ and a ‘group ratio rule’ which act as mechanisms for capping interest deductions. These mechanisms are forms of thin capitalization rules that have been unilaterally implemented by certain countries.

Within the US, the recent revisions of Section 163(j) which place restrictions on the amount of interest that can be deducted for tax purposes are but one example of a unilateral
implementation of a version of an Action 4 recommendation. In previous commentary on the Action 4 Discussion Draft, we outlined the potential implications of one-sided, non-arm’s-length approaches to interest deductibility. These concerns continue to persist, as the guidance covered by this Discussion Draft continues to leave room for non-arm’s-length approaches to capital structure and interest deductibility.

The Question to commentators in Box B.1. of the Discussion Draft cites to specific articles within the Model Tax Convention (MTC) aimed at preventing double taxation and the resolution of such situations when they do arise. This is seemingly consistent with concerns presented in the updated version of the BEPS Action 4 Report (December 22, 2016) around an inconsistent implementation of Action 4 recommendations, in which the OECD notes the “importance of a consistent approach in providing protection to countries.” It is our general view that the arm’s-length principle should be espoused by the OECD as the recommended approach to addressing capital structure and interest deductibility associated with financial transactions in much the same way as it is for other intercompany transactions between associated enterprises. To the extent countries take unilateral non-arm’s-length approaches, opportunity for double taxation may arise. As such, to mitigate this risk, it is understandable that the OECD might espouse a consistent means for implementing non-arm’s-length approaches. That said, it is our opinion that the guidance should be clear that consistent non-arm’s-length approaches are secondary to espousing an arm’s-length approach.

**Bifurcation**

The example outlined in paragraph 17 of the Discussion Draft supports the concept of bifurcation with respect to debt/equity classification. Specifically, with regards to accurately delineating the transaction between Company B (the borrower) and Company C (the lender), the transaction would be bifurcated such that a portion of the advance would be respected as debt and the residual would be treated as equity for transfer pricing purposes.

A similar concept of bifurcation was included in the Proposed Regulations under Section 385 issued April 4, 2016\(^2\) (with a similar example), but ultimately removed as the IRS agreed to continue to study this issue. Comments submitted to the U.S. Treasury and IRS between the April 4th release and the October 13th finalization raised concerns around the discretion allotted to the taxing authority, the specificity of the proposed bifurcation rule, and the practical implications associated with administration of such a rule. Specific concerns included the absence of a detailed methodology for implementing bifurcation when it was deemed to be appropriate under the guidance, the lack of a detailed methodology for the determining bifurcation (and challenging bifurcation applied by the taxing authority), how the associated payments would be made (e.g., debt first, equity first, proportionately), and how these payments would be treated for tax purposes post-bifurcation. We would encourage the OECD to consider this as a case study before finalizing its recommendations on bifurcation.

\(^2\) The Section 385 Regulations are regulations within the US creating minimum standards for related party financing to be characterized as debt.
If the OECD recommends and/or countries implement clear, understandable parameters by which an instrument could be analyzed and bifurcated in a consistent manner with limited discretion and subjectivity on the part of the taxing authority, it would mitigate potential abuses of tax authority discretion that could result in significant tax uncertainty for taxpayers. In the Discussion Draft, the OECD recommends relying upon the maximum amount of debt the borrowing MNE would be able to service, the maximum amount that the lending MNE would have been prepared to advance, or the maximum amount that an unrelated borrower would have been willing to borrow. To employ any of these approaches, a subjective assessment that would be difficult to verify would be required. For example, it is unclear from the Discussion Draft what the most appropriate approach demonstrating the borrower's ability to service intercompany debt. One example might be a cash flow analysis of the borrowing MNE. Employing such a method would create additional questions around which cash flows to use (e.g., management projections, base case, upside and/or downside scenario) and how much of a cash or equity cushion should be accounted for.

Inconsistent characterization by the taxing authorities in the lender and borrower country may result in double taxation. The additional discretionary element of bifurcation, applied inconsistently, could in practice exacerbate the likelihood of this undesirable outcome.

**Risk-Free Rates of Return**

Boxes B.4., B.5., and B.6. discuss a framework in which MNEs that serve as lenders in related party financial transactions but that do not perform the decision-making and control functions are entitled to no more than a risk-free return. Our understanding of this section is that the OECD is applying to financial transactions the framework introduced in the 2015 Final Reports on Actions 8-10 in which “cash boxes” (capital-rich entities without relevant economic activities) are entitled to no more than a risk-free return. While we disagree with the cash box framework introduced in the 2015 Final Reports on Actions 8-10, we think that this proposed framework is even less appropriate given that the return being allocated away from the MNE’s in intercompany loans are not an unlimited equity return but rather a fixed, contractual return that can be measured based on arm’s-length benchmarks.

The OECD’s proposed guidance is especially problematic when one considers the application. Box B.6. asks commenters to discuss Paragraph 11, which states that when the lender does not earn more than a risk-free rate of return, the borrower can still deduct the full amount of the interest, and the difference between that interest and the loan is allocable to the entity that actually makes the financing decisions. Assuming that the risk-free return framework were to be implemented, we agree with the first part of that approach regarding the full amount of the loan being deductible; any alternative approach (e.g., only allowing the borrower to deduct up to the risk-free rate of return) would unfairly penalize the borrower for reasonably choosing to use funds from its multinational group rather than a third-party lender by treating the associated interest expense differently for tax purposes.

However, the second part of that approach is where the proposed guidance in the Discussion Draft seems less reasonable. Interest rates are primarily compensation to the lender for the
risk it will bear, not solely compensation for performing the functions needed to put the debt into place. The approach that the OECD is describing would lead to material compensation for risk bearing going to entities that are not bearing risk and are instead performing a potentially routine function in coordinating internal financing arrangements.

In the market an individual investor may deploy its capital in fixed income investments by engaging a third-party investment manager to make decisions on their behalf. In such circumstances, returns generated from the investing activities are primarily retained by the investor with the investment manager earning some compensation for its functions (usually a variable, two-pronged calculation where the manager earns a percentage of assets under management plus a percentage of return). The investor bears the financial risk and earns most of the return. The return for the financial risk borne by the investor is readily benchmarkable and determined by the market (reference the risk versus return framework discussed above). In this example, would the investor be seen as exercising decision-making and control functions solely for engaging the third-party manager?

We urge the OECD to clarify what needs to take place for a funding entity to be considered to have capability to control its own risks. For instance, would an MNE still only be entitled to a risk-free rate if they employed personnel that had final say on whether to engage in a loan, but had outsourced certain functions within the lending process (e.g., due diligence, legal) to a separate MNE (possibly the MNE where the MNE group’s internal tax and/or treasury departments sit)? Without further clarification, guidance that we believe is intended to limit the return earned by lending MNEs with zero employees and no functions could result in most of the return from intercompany loans flowing to the MNE that employs the management (e.g., the MNE group’s tax and/or treasury department) unless the loans are negotiated directly between MNE’s with no centralized coordination. The latter would clearly diverge from the arm’s-length principle. The lending MNE would not earn an arm’s-length return for the financial risk borne – a return that is observable in the market and the MNE with the management would potentially be over compensated relative to third-party investment managers.

**Miscellaneous Commentary on Section B**

- Box B.2. asks a question on the issue of bifurcation but frames the issue in the context of “the total funding required for the particular investment.” This seems to imply an expectation that a loan be tied to a specific investment, such as capital expenditure or acquisitions. We disagree with this premise as we have frequently observed third-party borrowers issuing debt for other purposes such as day-to-day working capital needs, refinancing, or simply a preferred capital structure. We recommend the OECD revise this language.

- Please clarify the extent to which Paragraph 31 was intended to refer to accurate delineation as well as loan pricing. Further, it would be useful if the OECD provided guidance on whether the standards on timing are the same for both components (e.g., if lender preferences on adequate capitalization are less likely to change over the span of a few months than interest rates are, perhaps there is less rigidity of
timing as a criterion for accurate delineation). Finally, it would be helpful if the OECD provided guidance as to whether metrics such as yield to maturity or yield to worst, which provide contemporaneous repricing of financial instruments to account for market interest rate movements (among other variables), would be appropriate and would allow taxpayers and practitioners to rely on a broader set of benchmarks.

- Please clarify with respect to Section B.2. (i.e., the “economically relevant characteristics of actual financial transactions”) whether the loan characteristics presented are intended to be considered for questions of accurate delineation, arm’s-length pricing, or both. Different standards may need to be considered to address accurate delineation versus pricing, even if there is overlap in their respective criteria.

- Box B.5. asks commentators to discuss alternatives to government issued securities as approximate risk-free rates of returns. To this point, we would first note that not all government debt is risk-free. We would also note that a highly rated corporate bond within the geographic location being considered could be a reasonable proxy for a risk-free rate, especially if it is an industry that would be expected to correlate with that of the local economy. Finally, as we describe later, the difference between a bond yield and a credit default swap (CDS) spread can serve as a proxy for a risk-free rate.

Section C. Treasury Function

Discussion of Treasury Function

A treasury department in many instances provides specific services with an observable benefit to related parties, and these should clearly be charged out at arm’s-length. There are also treasury functions that do not provide any benefit to a particular subsidiary, such as so-called “shareholder” activities, and these are not chargeable. However, this evaluation gets considerably more complicated when the intent of treasury’s service is to manage risk globally and provide the best outcome for the overall MNE group.

Foreign exchange risk management is an example of a centralized treasury activity that may result in intercompany policies that are only partially beneficial to, or wholly detrimental to, an individual MNE. Companies often manage foreign exchange risk by purchasing forward contracts from banks. Meanwhile, companies operating in multiple currencies, such as large MNE groups, can also manage foreign exchange risk using natural hedges based on cash flows in and out of the business in different currencies. Many MNE groups will use a combination of forward contracts and natural hedges. This global view of foreign exchange risk, in particular when managed through natural hedges, can leave specific MNEs exposed to stand-alone currency risk for the benefit of the MNE group.

It is here that the accurate delineation of the transaction becomes especially important. If the centralized treasury group enters into forward contracts to manage currency risk for a MNE and does so to manage that risk from the perspective of that MNE only, without regard to the global risk of the MNE group, it is a beneficial service that should be charged. However, if a subsidiary is forced to bear currency risk on behalf of the larger MNE group, it should be
compensated for its risk. It may be appropriate, for instance, to pool the MNE group’s overall currency risk and the resulting gain or loss, and then share the gain/loss across the subsidiaries that bore risk under the direction of the centralized treasury group. The shares of gain/loss should also be apportioned in a manner that generates an arm’s-length result, for example, based on the share of that risk incurred by each impacted MNE.

It should be noted the impact this type of analysis would have on standard headquarters cost allocation studies. It is often the case that global or regional headquarters will house centralized services, and the resulting transfer pricing analysis is often one of determining benefits across the MNE group and allocating costs accordingly. These analyses often include treasury costs of the parent. Under the above proposed approach of pooling globally managed risks, such as currency risk, one would most likely need to allocate the centralized cost of managing these risks among the participating MNEs. That is, since the gains/losses will be realized in proportion to the risks borne, so too should the operational costs of managing these risks. Notably, it would be incorrect to characterize these as shareholder costs of the parent, because upside and downside of the risk will be borne across the MNE group.

Credit Ratings

Impact of Status within a Group on Credit Rating

Section C.1.3. and Boxes C.2., C.3., and C.4. relate to the effect of group membership on an MNE’s credit rating (noting that this is different than the issuance specific credit rating, which is a separate but related consideration).

There are four possible outcomes to an evaluation of the effect of group membership:

1. Applying the group credit rating as is, with no adjustment for MNE-specific characteristics;
2. Using the group credit rating as a starting point with notching adjustments as appropriate;
3. Using the MNE’s stand-alone credit rating as a starting point with notching adjustments as appropriate (e.g., implicit support); and
4. Applying the MNE’s stand-alone credit rating as is, with no adjustment for group membership.

Box C.2. invites commentators to consider whether setting variations of either option 1 or 2 above as a rebuttable presumption would be useful for tax certainty and tax compliance. In the context of this question, it is important to note that these are rebuttable presumptions as opposed to taxpayer elective methods or safe havens. It is our experience that rebutting a presumption for tax purposes can require significant time and resources and those efforts (combined with the uncertainty of the success of the rebuttal) can yield higher compliance costs without any associated benefits of increased certainty. Rebuttable presumptions can yield double taxation unless they are implemented and applied consistently and multilaterally.
Further, we note that the proposed rebuttable presumptions are only for the credit rating of the MNE, which is but one step in a typical process of assessing the arm's-length pricing of a debt instrument. One would still need to consider the credit risk profile (e.g., credit rating) associated with the specific issuance, the appropriate reference rate (e.g., internal and/or external pricing), and applicable comparability adjustments, as warranted.

The concerns regarding rebuttable presumptions may be exacerbated when one country accepts the rebuttable presumption (i.e. option 1 or 2 above) and another performs an analysis that starts with the stand-alone credit rating of the MNE (i.e. option 3 or 4 above). As mentioned previously, all four options are put forth in the Discussion Draft.

If the OECD decides to include these different approaches in its final guidance, it should recommend that use of the MNE group versus MNE stand-alone credit rating and the magnitude of adjustments from those starting credit ratings be evaluated on a case-by-case basis. Further, a well-defined and objective framework that considers certain characteristics of the MNE and uses those characteristics to determine the most appropriate approach (i.e., whether to consider the unadjusted group or stand-alone credit rating or whether and by how much to adjust from those reference points) could be useful. The framework could include consideration of:

- The size of the entity relative to the overall group;
- If applicable, the MNE group/the parent’s history in supporting MNEs that are struggling to meet debt obligations;
- The extent to which the MNE’s operations are integrated with and integral to the overall MNE group; and
- The extent to which the MNE is branded in the same/similar manner to the parent.

**Consideration for Collateralization**

The discussion in Paragraph 52 around the consideration for collateralization in an intercompany loan from a parent of an MNE group to a subsidiary appears important, but additional clarity is required to ensure it is being interpreted correctly. We interpret this paragraph to suggest that there may be de facto security between the borrower/subsidiary and the lender/parent in such cases (and when assets are not explicitly pledged elsewhere), and that as such, the intercompany loan should be treated as secured regardless of whether such security is formally pledged. However, in a case where the borrower/subsidiary has pledged its assets elsewhere, the intercompany loan may be treated as unsecured. Please confirm that this interpretation is correct.

**Miscellaneous Commentary on Credit Ratings**

- The Discussion Draft notes that the use of multi-year credit ratings would be warranted for companies such as start-ups, special purpose vehicles, or that have recently been part of a merger/restructuring. In these cases, it is presumed that an independent lender would use multi-year projections to perform a credit rating analysis. We suggest further clarification from the OECD on weighting the value of
multi-year credit ratings against the uncertainty embedded in projections. Further, we request clarification on whether the OECD would consider multi-year or single-year credit ratings to be the “default” scenario and whether documentation of arm’s-length analyses should proactively defend the choice to use one or another.

- Paragraph 66 of the Discussion Draft discusses the extent to which the MNE’s sector should be taken into account when considering how financial ratios should be interpreted for purposes of transfer pricing. We believe that caution should be taken when implementing this recommendation. Specifically, we have the following comments:
  - The use of sectors can lead to pitfalls because certain sectors can have many sub-sectors with radically different characteristics. We consider fixed asset intensity, capital expenditure needs, research & development needs, prevalence of financial leverage, and operating margins to be examples of financial information that would impact the evaluation of a borrower (relative to a sector group or otherwise). If one considers healthcare (specifically given by OECD as an example of a sector), this could include anything from healthcare service providers, to medical equipment, to owners and operators of hospitals. It may be inaccurate, for example, to draw conclusions on the financial health of a healthcare service provider because it has fewer fixed assets than a real estate company that owns hospitals.
  - Please clarify if the assignment of a sector should be that of the MNE group or if it should be in line with the functions of the particular MNE. To the extent that the borrowing MNE exists to provide a single intercompany service (e.g., a distribution entity for a global electronic equipment manufacturer), does it make sense to rely upon the MNE group’s sector or a sector that more aligns with the specific service that the borrower MNE provides? The former would ensure results are aligned with the business cycle of the borrower MNE’s group, whereas the latter would lead to comparable issuances from borrowers that are similar financially (e.g., similar fixed asset intensity);
  - We note that most third-party credit rating tools include sector as an input and therefore if such tools are used, further adjusting for sector when considering comparable issuances could over-emphasize this factor.

- Box C.3 invites commentators to provide a definition of the stand-alone credit rating of a MNE. When considering the stand-alone credit rating of a MNE, a taxing authority and taxpayer alike should consider the credit risk profile of that MNE assuming all intercompany transactions are occurring at arm’s length (or adjusting for non-arm’s-length results) and without consideration of the MNE’s group affiliation other than the MNE’s ownership in subsidiaries. Specifically, when employing a credit tool to estimate the credit risk profile in the form of a credit rating, the MNE’s subsidiaries should be considered based on relevant accounting practices for investments (e.g., under IFRS equity method for ownership less than 50%, acquisition method for ownership greater than 50%). Consideration may need to be given to the other obligations of the subsidiaries that may take priority (e.g., with respect to capital structure and repayment) over the MNE’s rights to the subsidiaries’
assets and the impact these obligations would have on the available cash flow with which to meet the debt-related obligations of the MNE as a borrower, and more generally its credit risk profile. A stand-alone rating should consider the credit risk profile of the MNE before any consideration, if appropriate, for implicit support is made. And further, it is important to distinguish that the credit risk profile of the MNE is not necessarily synonymous with the credit risk profile of a specific issuance made by the MNE. The credit risk profile of specific issuances may vary depending on the features of the specific issuance and its rank within the capital structure of the MNE.

- The Discussion Draft cautions that, while commercial credit rating tools and internally developed models can be useful in performing interest rate benchmarking analyses, it is important to consider potential issues associated with the use of these tools. While we agree with many of the concerns raised by the OECD, we note that performing sensitivity analyses both with respect to the tools used and the parameters inputted into the tools (e.g., downside scenarios for projected financial data) can improve the reliability of the analysis that leverages output from these tools. Therefore, although there are potential drawbacks to consider in using commercial tools to determine a borrower’s credit rating, we contend that there are ways to mitigate the impact of such drawbacks.

**Intercompany Loans**

**Use of Credit Default Swaps (“CDS”) in Pricing Intercompany Loans**

In response to the Discussion Draft’s request to commentators on the use of CDS to benchmark intragroup loan interest rates in Box C.5., we start by defining a CDS contract and then discuss how it is priced. Lastly, we explain how CDS can be relied upon in a transfer pricing context.

A CDS is a common product of the credit derivatives market, which is analogous to an insurance contract against credit risk. CDS are available on sovereigns, quasi-sovereigns and large corporates, with the main players in the CDS markets being hedge funds, institutional investors on the sell side and commercial banks, on both buy and sell sides.

The structure of a CDS agreement involves the following three entities.

- A “protection buyer” (or “lender”) which is the owner of the underlying bond instrument;
- A “bond issuer” (or “borrower”), referred as the reference entity (the “reference entity”), which pays the investor periodic coupon payments and has committed to repay the principal due at maturity; and
- A “protection seller”, which is typically an insurance company or a securities company.

Since bonds can have lengthy terms to maturity, the bond owner cannot ascertain for the issuer’s financially sound position until maturity. By buying a CDS, the bond holder makes
periodic premium payments, called the “CDS spread”, to the protection seller in return for compensation on all losses if a “credit event” occurs during the CDS maturity.

Credit event is a standardised definition for the reference borrower’s default. It may take the form of reference entity’s bankruptcy, insolvency or inability to make payment of principal or interest, restructuring, and repudiation or moratorium. If no credit event occurs prior to maturity, the protection seller does not make a payment to the buyer.

The compensation can be either cash or physical. In a cash settlement, the protection buyer will receive from the protection seller the notional amount of the bond less its market value just after default, whereas in a physical settlement, the protection buyer sells the reference bond to the protection seller at its nominal value (the “Face Value”).

The aforementioned structure is briefly illustrated in the chart below.

The premium paid by the protection buyer is known as the CDS spread. This spread is quoted in basis points per annum and determined based on the nominal value of the CDS contract. For example, an investor holds a bond with a nominal value of $1.0 million and wants to buy a CDS to hedge the risk associated with this bond. If the CDS spread amounts to 50 basis points, then the investor would have to pay $5,000 on an ongoing annual basis.

The total value of the CDS to the buyer is computed by deducting the present value of the payments to the protection seller by the expected payoff to the protection buyer.

As illustrated by the formula below, the CDS spread is determined by setting the present value of the sum of all premium payments (1) equal to the present value of the expected payoff from the CDS at maturity or at the time when a credit event occurs (2). In other words, since the initial net payment is zero, the spread is first set for the value of the CDS to be 0 for both parties:
\[ \sum D_t p_t S d + \sum D_t (p_{t-1} - p_t) d \frac{d}{2} = (1 - R) \sum D_t (p_{t-1} - p_t) \]

\[ (1) \]

(2)

Where:

- \( D_t \) the discount factor for date \( t \);
- \( p_t \) the survival probability at time \( t \);
- \( S \) the annual CDS spread;
- \( d \) the accrual days; and
- \( R \) the expected recovery rate.

The CDS spread is then derived as:

\[ S = \frac{(1 - R) \sum D_t (p_{t-1} - p_t)}{\sum D_t p_t d + \sum D_t (p_{t-1} - p_t) d \frac{d}{2}} \]

Attention should be paid to factor \( p_t \), as the quoted CDS rate is closely connected to the survival probability of the underlying reference entity. This probability can be obtained by means of the credit rating of the entity.

In the end, CDS spreads are functions of demand and supply and can give a flavour of the market's perception about the default risk in the reference entity at a point in time. This point will be discussed in the following section.

CDS and bonds have both a predominant role in pricing credit risk. CDS provide an opportunity to trade and manage credit risk for the players in the financial sector while bond investors seek to gain interest income above the risk-free rate by investing in relatively riskier issuers and the level of interest reflects the premium offsetting the credit risk exposure.

**Bond yield / spread definition**

A bond's YTM is defined as the annual return an investor would receive if he or she held a particular bond until maturity. YTM is a calculation of a bond’s return that can help investors compare bonds with different maturities and coupons.

Empirically, a bond's YTM is defined as the percentage rate that will make the present value of the bond’s cash flows equal to today’s selling price.
\[ P = \sum_{t=1}^{n} \frac{C}{(1 + YTM)^t} + \frac{F}{(1 + YTM)^n} \]

Where:
- \( P \) the price of the bond;
- \( n \) number of periods;
- \( C \) coupon payment;
- \( YTM \) the Yield to Maturity;
- \( F \) the Face Value; and
- \( t \) the time period when payment is to be received

Bonds can be priced at a discount, at par, or at a premium. As we can see from the above formula, when the bond is priced at par, the bond’s yield is equal to its coupon rate. A bond priced above par, has a coupon rate which is higher than the yield, while a bond priced below par has a coupon rate lower than the yield.

As recognized by the OECD in Paragraph 86 of the Discussion Draft, yields of comparable bonds can be used to benchmark an all-in interest rate of an intragroup loan. To benchmark an intragroup interest margin (i.e. the credit margin above the base rate), a set of comparable bond spreads should be instead relied upon. A bond spread is the difference between YTM and a base rate / risk-free rate.

**Estimating the risk-free rate based on CDS spread**

Both bond and CDS spreads measure an entity’s credit risk and, in any efficient market, both compensate the investor’s loss if the borrower defaults. Therefore, a portfolio made up of a long position in a bond and a CDS is theoretically risk-free since if the bond issuer defaults, the CDS will cover for any loss sustained to the investor. Hence, the return on the portfolio should be equivalent to that of the matching par risk-free bond.

The following formula and graph explain the relationship between bond yields and CDS spread.

\[ S = y - r_f \]

Where:
- \( S \) is the CDS spread;
- \( y \) the yield of the bond of the same entity and with the same maturity with the CDS; and
- \( r_f \) the risk-free rate.
As an example, the graph above illustrates the evolution of both a CDS and its corresponding bond issued by Morgan Stanley. The above graph highlights the similar trend that both CDS spread and bond spread follow. However, in practice, the bond yield-CDS spread formula does not always hold true and consequently arbitrage opportunities may arise. This difference is called ‘basis’ and is calculated by subtracting the bond spread from the matched maturity CDS spread. Precisely, when $S$ is higher than $y - r_f$, an arbitrage opportunity would be to sell the CDS and short the bond and buy the riskless bond to earn a risk-free return. Conversely, when $S$ is lower than $y - r_f$, an investor should prefer to buy the CDS, buy the bond and short the risk-free bond.

However, arbitrage opportunities are not always pure. Factors explaining why empirical observations are not perfectly in line with the theory can be summarized as follows:

- While a bond investment should be funded, with principal payment at the start, periodic interest payments and repayment at maturity, a CDS is an unfunded contract, i.e. a swap. Therefore, CDS can be viewed as cheaper than bonds.

- Bonds are more prone to market technical distortions.

- The bond market lacks liquidity compared to the CDS market.

From a practical transfer pricing point of view, following a full functional profile analysis, a comparable CDS search can be performed to identify a set of internal or external CUPs, which can be used to determine an arm’s length interest margin. After selecting the

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3 Source: Bloomberg L.P.
appropriate comparable CDS spreads, then the interquartile range can be used as the arm’s length range of the tested transaction’s interest margin. This method can be an alternative to a loan or bond comparable interest search in a situation or market in which no direct loan or bond comparables are available.

**Internal CUPs and Using an MNE Group’s Average Interest Rate to Price Intercompany Loans**

Paragraphs 87 and 88 discuss the use of internal CUPs and Box C.7 requests commentary on use of the MNE group’s average interest rate in pricing intra-group loans as an internal CUP. The average interest can be defined as the average of all the different financing rates linked to the various debt instruments that exist in a company’s capital structure. For all internal CUPs including the MNE group’s average interest rate, it is our experience that they often cannot be used for purposes of pricing an intercompany loan without adjustments because the financing rate of each debt instrument is unique and dependent upon a range of economic and commercial factors.

For internal CUPs, it may be possible to make adjustments for these differences but doing so may not be possible for an MNE group’s average interest rate because there may not be one set of identifiable criteria from which to make adjustments. For example, if an internal CUP was issued in a geographic location that would call for an additional premium over the geographic location of the issuance under review, but was otherwise comparable, it might be possible to make an adjustment and back out that premium. However, an MNE group’s average interest rate could be the result of many issuances in different geographic locations such that it is not feasible to adjust for all the different country-risk premia captured in that average. Therefore, in most cases, the individual instances underlying the MNE group average interest rate will be more appropriate as CUPs than the average will be.

Specific adjustments that can be made to increase the reliability of CUPs (internal and external) include (but are not limited to):

- **Origination Date Adjustment**: when the internal CUP has been issued at a different date than the transaction under review, an adjustment could be performed to ensure the benchmark reflects the current market rate condition.

- **Liquidity Adjustment**: When the comparable benchmarks are liquid, such as bonds that are freely traded in the bond market, while the intra-group loan is illiquid and consequently subject to a lack of marketability, this potential difference could be addressed by a liquidity adjustment.

- **Geography Adjustment**: A geography adjustment could be performed when the comparables are issued by companies based in countries other than those in which the group members involved in the intra-group loan perform their business activities. It should be noted that geography could already be captured in a credit rating, so an additional adjustment may not be warranted.
- **Currency Adjustment:** A currency adjustment could be performed when the comparables and the intra-group loans are denominated in different currencies. It can be made through a currency interest rate swap, (i.e. an agreement that involves exchanging principal and interest payments in one currency for principal and interest payments in another, based on the maturity of the debt instrument).

While we agree that internal CUPs should be considered, it is also important to note that it may be the case that an external CUP may ultimately be more comparable to the tested transaction with respect to the terms and characteristics, including those listed above.
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Brussels, 7 September 2018

EBIT’s Members\(^1\) are grateful for the opportunity to provide comments on the OECD’s public consultation running from 3 July – 7 September 2018 with regard to the OECD’s Public Discussion Draft (“Discussion Draft”) on BEPS Actions 8-10 Financial Transactions. Below are a number of issues that EBIT believes are key for Working Party no. 6 of the OECD on the Taxation of Multinational Enterprises to do further work on.

**Accurate delineation of the actual transaction**

*Application of the approach of accurate delineation of the actual transaction*

In Chapter I of the Transfer Pricing Guidelines 2017, the OECD introduced the approach of accurate delineation of the actual transaction as one of the key aspects of a comparability analysis. The Discussion Draft in paragraphs 9-10 aims to provide guidance to countries that use the accurate delineation of Chapter I to determine whether a purported loan must be considered as a loan for tax purposes, in the context of the application of Article 9 of the OECD Model Tax Convention. The OECD does not however consider accurate delineation under Chapter I as the only approach for determining whether purported debt should be treated as debt, but rather explicitly allows application of other approaches.

EBIT notes that a cross-border misalignment on applicable approaches may result in double taxation. Such misalignment could ensue if the countries in which the transaction partners are located have different views on the debt recognised and subsequently the arm’s length interest rate due to different approaches applied. It would therefore be useful if the OECD provided guidance on the appropriateness of other methods and how misalignment on debt recognition is to be treated from a tax perspective. In any event, in case of such misalignment between countries, the recharacterisation of the loan should remain eligible for a mutual agreement procedure and not be considered as unilateral anti-abuse measure. It would however be preferable if the OECD would stipulate that countries should implement the approach of accurate delineation of the actual transaction as the only approach. As a range of these proposals could have substantial implications for withholding taxes applied to debt interest, or to dividend payments (i.e. secondary transactions following recharacterisation), We would welcome acknowledgement of this and clarification of how treaties must be analysed to prevent inadvertent penalisation of taxpayers.

*Practical simplification*

While the approach of accurate delineation of the actual transactions provides a sophisticated framework for the estimation of arm’s length practices, EBIT sees room for simplification in the area of financial transactions in particular with regard to the arm’s length debt leverage level assessment and the determination of the safe harbour interest rates. Concerning the debt leverage EBIT would welcome two types of escape rules. First, we believe that a fixed ratio rule (e.g. debt to equity ratio) would be useful. Second, we suggest applying a group escape clause: if the leverage level of the entity is lower than the group leverage on the consolidated basis, one should consider that there is no abuse of debt structure.

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\(^1\) EBIT membership information is available on: www.ebit-businesstax.com; EBIT Member companies include: Airbus Group, BP, Caterpillar, C-Brands, Deutsche Lufthansa, Diageo, GSK, Informa Group, International Paper, Johnson & Johnson, JTI, Naspers, PepsiCo, Pfizer, P&G, RELX, Schroders, SHV Group, Tupperware, UTC.
As far as the interest rates are concerned, EBIT notes that some countries have their own safe harbour rules for interest rate determination. It would also be helpful if the OECD clarified how local safe harbour rules could be applied in a cross-border context (i.e. considered as at arm’s length in the lender’s country). EBIT Members would welcome safe harbour rules at OECD level for different types of loans (e.g. M.o.U. on low risk activities).

**Debt servicing**

EBIT is concerned about the prescriptive language used in paragraph 17 of the Discussion Draft, by which, if an entity is unable to service a loan it can be concluded that an unrelated party would not be willing to provide such a loan to the entity, and thus, such loan received from a related entity would be not recognised as debt. We would appreciate further clarification of the term “servicing of debt” as used in this paragraph. “Servicing of debt” in general describes the payment of the interest on the debt acquired as well as the subsequent repayment of the debt amount. However, from our experience, it is perfectly feasible for an entity to hold a structural amount of debt, which it cannot repay in full without a further raise of capital. The fact that an appropriate level of debt is an important part of an efficient capital structure is acknowledged by rating agencies by giving target net debt/EBITDA and leverage ratios for each rating notch. The capability of immediate repayment of the principal amount of a loan on maturity should not be a necessary requirement for receiving such loans.

**Tax treatment of non-recognized amount of debt**

With reference to the example in paragraph 17 of the Discussion Draft and the specific invitation for comment, EBIT understands that only the remainder of such an advance – over and above the maximum amount that an unrelated lender would have been prepared to advance or the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow, would not be recognised as a loan. Can the OECD confirm that our understanding is correct? Where a portion of the lender’s advance to the borrower is not recognised as a loan, specific guidance on the tax consequences of the non-recognition and the potential use of secondary transactions and their consequences is necessary.

EBIT considers that recasting debt as equity would be unnecessarily complicated to implement and would have many unintended consequences. We strongly believe that recategorisations should take place only in very limited circumstances. The revised guidance should clearly define and limit the circumstances when this approach may be applied. EBIT would prefer guidance with practical examples on how to execute and reconcile conforming adjustments across jurisdictions if debt is recast as equity. To minimize unintended consequences, recasting the entire amount of debt (rather than simply a portion) at the time of the testing event can sometimes be more practical e.g.: determining the portion of indebtedness to be recharacterised as equity likely would result in significant disputes, not only between a taxpayer and a particular jurisdiction, but involving multiple jurisdictions as to the amount of such recharacterised equity. Additional equity could result in the purported lender becoming an equity holder subject to the direct tax consequences attendant to an equity holder, such as distribution withholding taxes and possible capital gains on the disposition of such interest, which would arise at the time the purported portion of the debt is retired. To be sure, EBIT considers that there are potentially serious knock-on consequences of debt being recast as equity and this should therefore only be done in extreme circumstances.

**The economically relevant characteristics of actual financial transactions**

**Contractual terms**

EBIT considers that between associated enterprises the contractual arrangements may not always provide all detailed information that tax administrations might wish to obtain in practice. The OECD suggests consultation of “other documents” in order to identify the actual
conditions of contractual arrangements between associated enterprises. EBIT however would prefer guidance on how to document intercompany loan agreements and specific examples of other documents that should be considered in the delineation process.

**Functional analysis**

EBIT Members would welcome clearer guidance regarding the consideration of the full range of activities performed by one party to the transaction (specifically when involving a group treasury company/function) when delineating the transaction. This is a point alluded to in Example 2 in paragraphs 119-123 in the context of cash pool pricing and the allocation of spread between borrowing and lending positions, but must also be a consideration for other types of transactions.

**Practical applicability of characteristics of actual financial transactions in data comparability**

Commercial databases are generally used for identifying uncontrolled financial transactions for benchmarking purposes in the context of Transfer Pricing analyses. Such commercial databases contain extensive, albeit ultimately limited, information on financial transactions and its characteristics. In particular, the information available may be limited to transactions having specific characteristics (e.g. country of origin). In practice, it is often not possible to obtain a sufficient number of comparable transactions if strict selection criteria are applied. In addition, in terms of transaction purpose, the information available is often limited or aggregated in such a manner that does not allow assessing whether the initial intent of the transaction is comparable with the tested transaction. EBIT is therefore concerned about the prescriptive language with regard to the economically relevant characteristics of financial transactions to be considered in the pricing process. We would welcome if the OECD acknowledges practical restrictions on the benchmarking process and allows for (reasonable) flexibility, acceptable to all parties concerned, with regard to the selection of comparables. The revised guidance should acknowledge and reiterate that if “perfect” comparable uncontrolled transactions are unavailable, it is often possible to make reliable adjustments to imperfect comparables and such adjusted comparables may be the most reliable means available to benchmark a tested transaction.

**Timing of the comparable transaction**

EBIT is concerned that in particular the timing of issuance of potentially comparable transactions, such as bonds, is not necessarily decisive for the assessment of the comparability of such transactions as long as the timing of the Transfer Pricing analysis is in line with the tested transaction characteristics. For example, in the case of bond transactions, the yield to maturity of otherwise comparable bonds derived at the timing of the issuance of the tested transaction provides indicators for arm’s length interest rates applicable to the tested transaction. In fact, a liquid secondary bond market is likely to provide a better comparable than a new public debt issuance due to the new issue premium (i.e. additional return demanded by investors to compensate them for the dilution of that company’s debt) included in the interest rate on a new issuance.

**Risk free return**

**Risk free return rate**

The risk-free rate of return is a purely hypothetical concept where the risk-free rate is generally approximated by the reference to the interest rate on certain government issued securities. OECD guidance stipulates that where 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 is entitled only to a risk-free return. In such circumstances, the risk is allocated to the enterprise which has control over the risk and the financial capacity to
assume the risk associated with the financial asset. Although EBIT Members believe that there are mechanisms more suitable to address situations in which a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, such as CFC rules, a risk-free return approach requires more guidance on how to allocate the return in excess of a risk-free rate. A risk-free return should not be applicable in cases in which the funder retains ultimate oversight of the portfolio even though it transfers day-to-day risk mitigation to others.²

The OECD specifically invited comments on financial transactions that may be considered as realistic alternatives to government-issued securities to approximate risk-free rate of returns. Assuming that the risk-free rate is appropriately limited, as noted above, EBIT Members believe that Interbank Offered Rate (e.g. Euribor, Libor or their successors such as SOFR and SONIA) could be considered as a realistic alternative to approximate a risk-free rate of returns on short-term transactions. Alternatively, for long-term transactions the swap curves may be preferable as the market’s forecast of what Interbank Offered Rates will be in the future could be considered. EBIT believes that this represents a reasonably practical approach also in terms of documentation process as evidence can be easily obtained. However, one should consider that while Interbank Offered Rates/Swap Curves are less exposed to the sovereign risk it is exposed to risks associated with a banking crisis (an exposure which the transition to SONIA/SOFR aims to mitigate). Thus, the choice should depend on the relevant market conditions. EBIT Members would also welcome the possibility to use a unique (i.e. fixed reference/maturity) safe-harbour risk free rate of return per currency in order to avoid practical difficulties in the determination thereof. Lastly, we would prefer additional guidance concerning the computation basis of the risk-free remuneration (i.e. to what exact basis should the risk-free rate be applied?).

 Allocation of the risk-free rate of return

EBIT Members would welcome additional guidance from the OECD on how the risk-free rate of returns should be split between affiliated entities in case different entities have the control over the risks and the financial capacity to bear the risks.

 Risk-adjusted rate of return

The OECD indicates that, under an approach based on the cost of funds, the controlled transactions would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower and that this mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in paragraphs 89 to 91. EBIT Members would welcome further clarification on how this mark-up should be computed in practice, as this is an issue groups are very frequently faced with. In particular, we would like to understand how leverage and credit risk considerations should be factored into the mark-up analysis. This is particularly relevant and applicable to the common situation where a group issues bonds through a financing company set up for the purpose, and that company on-lends the funds to elsewhere in the group. The bond issuing company is raising debt on behalf of the group, and should be remunerated only by a small turn reflecting functions performed. Though gross debt is high, the company has zero net debt, and can reply on the implicit or explicit support of the group to know that the on-lending will be repaid in order for the bond to be repaid on maturity.

We understand that the IRS has precedent for seeking to argue that the presence of a guarantee of the bond issue (required by the market for public debt issues) means the external bond debt should be recharacterised as an equity investment by the guarantor in the issuing company, simply because of the level of gross debt exceeds what could be borrowed without the guarantee – despite the fact that the net debt is zero. EBIT disagrees with the

view that guarantees of subsidiaries that are used to facilitate the passing of third-party borrowings to group members should be viewed narrowly from the perspective of the gross amount of debt on the books of the subsidiary borrower merely because such debt is guaranteed when the subsidiary has offsetting positions with other related affiliates. In such a case, the subsidiary’s net debt is the more appropriate position to be analysed”.

**Maturity of the financial instruments**

Referring to paragraph 6 in Box B.4., a short-term loan that is consistently replaced with a new instrument may, in some circumstances, be accurately delineated as a long-term instrument. However, there may be situations when the use of short-term instruments over a longer period of time represents a reasonable management decisions that should not be recharacterised. However, EBIT believes that a long-term loan with a “periodic break” clause, which allows the borrower and lender to renegotiate the terms of the borrowing or terminate the agreement at set anniversaries, may provide a more appropriate recharacterisation basis compared to a straight long-term loan, which would be priced differently.

**Treasury function**

**Centralized treasury centres operating as profit centres**

The Discussion Draft states that different treasury structures involve different degrees of centralisation, where in the most decentralised form, each entity within the group has full autonomy over their financial transactions and, at the opposite end of the scale, a centralised treasury has full control over the financial transactions of the group. EBIT Members would welcome additional guidance on how such differences could affect the remuneration of the treasury function in practice.

**Lender’s and borrower’s perspectives**

**Borrower preferences**

Borrowers on the capital market generally have access to both fixed and floating rate debt and choose the financing instruments based on their preference regarding financing risk exposure. If the business model and strategy of a borrower resulted in a loan taken on fixed rate without a break clause, it indicates that the borrower has consciously chosen not to expose himself to such risk. (Even if there is a break clause, a borrower can choose to not renegotiate / refinance its loans because they may receive services or other benefits from the lender. Especially for entities with a large loan portfolio, the constant interest rate monitoring will lead to administrative burden). Consequently, such borrower should not benefit from the favourable changes of market conditions. The wording of paragraph 56 of the Discussion Draft however implies that borrowers should seek to renegotiate existing loans if market interest rates change. Borrowers have the ability to choose a mix of fixed and floating rate debt, balancing certainty versus the ability to benefit from reduced rates. If the business model and strategy of a borrower means they have taken on fixed rate debt, and not paid for a break clause, they have consciously chosen not to retain this flexibility. EBIT believes that changes in macro-economic circumstances should not automatically lead to the recharacterisation of transactions if such options are not part of the transaction characteristics due to reasons explained above.

EBIT is concerned about the prescriptive language used in paragraph 54 of the Discussion Draft, by which, the borrower would generally seek secured funding ahead of unsecured funding in case the business has suitable collateral to offer. From our experience, while it may be cheaper, secured funding may result in the imposition of potentially significant restrictions and control over the conduct of the company. Many companies, particularly higher rated ones, would actively seek unsecured lending in priority. EBIT also has concerns with some of the language in paragraph 52. We suggest deleting the following sentence in the proposed
EBIT Comments on OECD’s Public Discussion Draft on BEPS Actions 8-10 Financial Transactions

guidance: “If the assets of the business are not already pledged as security elsewhere, it will be appropriate to consider ... whether those assets are available to act as collateral for the otherwise unsecured loan and the consequential impact upon the pricing of the loan.”

The preferences of borrowers with regard to characteristics of financing transactions in terms of interest rate structure and granting of security are both a result of the borrower’s business decisions. A particular concern of EBIT is that the current wording of the Discussion Draft dismisses alternative business considerations, which can result in reclassification of such transactions by tax authorities. EBIT wants to emphasize that choosing deviating business strategies/preferences must at all times remain the prerogative of businesses themselves.

**Documentation of the options realistically available**

The Discussion Draft stipulates that independent enterprises, when considering whether to enter into a particular financial transaction, consider all other options realistically available, and only enter into the transaction in absence of alternative that offers a clearly more attractive opportunity to meet their commercial objectives. Documenting that such rationales were considered is complicated due to sheer number of opportunities theoretically available to enterprises. EBIT would therefore prefer more extensive, detailed guidance and examples. The guidance should clarify that a taxpayer cannot reasonably be expected to identify and rebut in advance every alternative that a tax authority may subsequently identify as something which could have been a “realistic” commercial option. Stated differently, the mere fact that a tax authority proposes an alternative is an insufficient basis for recasting a taxpayer’s otherwise reasonable transaction if it has been priced appropriately.

In our opinion, a particularly reasonable method of the demonstration that other realistically available options of a financing transaction were considered would be quotes from unrelated banks, or consideration of typical deposit rates when analysing short-term intra-group facilities with comparable risk profiles (e.g. market yield curves publicly available). We request that the language in paragraph 49 be modified to eliminate this requirement that would be imposed on lenders, as it would allow tax authorities to raise additional questions such as why an entity made a deposit (with the central treasury), why it didn’t deposit less (or more), which would lead to prolonged audits and increased compliance burden. The guidance should reflect proper deference to the commercial decisions of a company’s management, as many factors are taken into account by the board of directors and management in operating the company’s business, including a financial capital perspective. While the board and managers take the shareholders’ perspective into account in making business decisions, good business governance practices and corporate fiduciary duties and responsibilities also dictate that the company operate in a commercial reasonable manner and not solely at the behest of a shareholder.

**Ownership of subsidiaries**

According to the Discussion Draft, in the case of a loan from the parent entity of an MNE group to a subsidiary, the parent already has ownership of the assets of the subsidiary and therefore, in evaluating the pricing of a loan between related parties it is important to consider the option where those assets are available to act as collateral for the otherwise unsecured loan and its impact upon the pricing of the loan (if the assets of the business are not already pledged as security elsewhere). EBIT urges the OECD to provide additional guidance on the treatment of the assets in the context of group ownership. In particular, it is unclear when or whether assets should be considered as pledged and find such reflection in the benchmarking process. For example, if the lender has to assume that the transaction is secured while he might not actually have the luxury of assuming that the assets can be used as security (e.g. in case of Joint Venture structures), it could lead to value leakage to 3rd party shareholders, which would not respect the arm’s length principle.
As previously stated, we strongly believe that tax authorities should not interfere with business decisions. Further guidance is required on those situations for which taxpayers would need to document why a loan was pledged or not. We think such guidance should be rooted in market practices, such as the application of underlying assets as pledged in the case of financing a real estate transaction, in order to provide a clear message and eliminate uncertainty. Further guidance and standards are also required with respect to different local treatment of the “ownership concept”. For example, countries may apply different shareholding thresholds when defining “ownership”, resulting in different assessment of a shareholder relationship between parent entity and its subsidiary. In a loan from the parent entity to a subsidiary, the assets would be considered as pledged from the perspective of one country and disregarded from the perspective of other country, ultimately resulting in an assessment of different interest rates to be at arm’s length.

Credit rating

In-house modelling Use of credit ratings

In practice, lenders often use in-house models or commercial tools to estimate the credit rating of a borrower. According to the Discussion Draft, where a reasonably reliable rating for a debt borrowing can be arrived at using such tools or models, these could be applied. However, the OECD questions the credit rating methodology used in commercial tools, as those use only a limited sample of quantitative data to determine a credit rating. EBIT Members consider that it would be helpful if the OECD would provide additional guidance on the input parameters necessary for the models to derive “reasonably reliable ratings”. Moreover, credit rating methodologies used in commercial tools released by rating agencies closely follow the agencies’ internal methodologies. In certain cases, such commercial models are only tools applicable with a reasonable effort. Thus, EBIT suggest that a reasonable degree of flexibility acceptable to all parties concerned should be allowed with regard to the application of in-house models or commercial tools. However, the guidance should also recognize the distinction between financial businesses and large companies that have the resources to employ in-house financial models and other businesses that do not have these resources or who determine that given the number of financial transactions decide not to allocate significant resources to in-house financial models.

Implicit support

Contrary to the considerations set out in paragraphs 69-74 of the Discussion Draft, none of EBIT’s Members can think of a scenario in practice where they would allow a subsidiary to default on third party debt. Parent company guarantees may be required by lenders – but sometimes this is because it allows them to do their due diligence on a listed and rated entity.

The Discussion Draft acknowledges the potential impact of passive association with the group on creditworthiness of a lender. EBIT Members have concerns with the potential for misapplication of group support as an integral part of the Transfer Pricing analysis because the benefit of passive association often is overstated and consideration of passive association tends to detract from the normative stand-alone principle. We would welcome additional guidance on the concrete application on how such association would be taken into account in the credit rating determination. While we understand that this could be done on the basis of credit rating agency methodology papers, we would also welcome simplified approaches (e.g. notching-down from parent company rating (top-down approach)), as groups are normally also using those, while stand-alone ratings (bottom-up approach) could also be the starting point of the analysis according to some rating agency methodologies). EBIT Members welcome the clarification by the OECD that no guarantee fee is due in the absence of a formal / legal guarantee, i.e. in the case of a “letter of comfort”.

Credit rating update
In the financial markets, financial transactions with a prolonged maturity period may often be subject to regular reviews and reassessments of the credit rating estimation. Certain instruments such as pricing grids on syndicated loan facilities are typically applied. EBIT would welcome additional confirmation by the OECD on the appropriateness of such assessments and specific guidance regarding critical maturities and assessment intervals.

**Interrelation between implicit support and financial guarantees**

EBIT Members would like to get confirmation that implicit guarantees should usually not lead to any remuneration and would also like to understand better in what specific circumstances such remuneration might be required. More generally, additional guidance on the interactions between implicit support and explicit guarantees would be welcome.

**Cash Pooling**

**Rewarding the cash pool leader**

Paragraphs 119-123 of the Discussion Draft describe an example of a group treasury company acting as cash pool leader. Specifically, it cites its ability to control financial risks contractually allocated to it, and its financial capacity to bear those risks, as potentially supporting – under functional analysis – such company “earning part or all of the spread between the borrowing and lending positions which it adopts”. In keeping with the language of the rest of the section, it may make sense to state explicitly that given such functionality, compensation for the cash pool leader may include part or all of the “netting benefit”, as referred to in paragraph 125.

**Cash pooling benefits**

In the Discussion Draft, the amount of the group synergy benefit is to be calculated by reference to the results that the cash pool participants would have obtained had they dealt solely with independent enterprises. While the idea of synergy benefits has some intuitive appeal, from a practical standpoint EBIT Members have concerns. Identifying, measuring and apportioning synergy benefits will be difficult to execute, and subject to considerable discretion and disagreement. We are concerned that the cost and complexity of compliance will increase substantially because of tax authorities perceiving synergy benefits where no such benefits exist. To the extent there are synergy benefits, errors in measurement may exceed the synergies themselves. Traditional pricing based on comparable third-party transactions will in many cases produce more reliable outcomes with less dispute and uncertainty than complex exercises intended to apportion synergies. Unless the treasury function is located in a low tax jurisdiction, cash pooling is not a high-risk BEPS issue but a low risk allocation of taxing rights issue. Further guidance should balance the theoretical value of “absolutely correct” taxation estimation against the administrative burden placed on taxpayers and the likelihood of low value disputes and MAP issues.

We ask the OECD to provide guidance and examples of the computation of synergy benefits, with appropriate consideration of the practicalities of conducting such a calculation, in order to better understand under what circumstances and based on what criteria one approach should be preferred over the other ones. We also want to stress that, in practice, many cash pools have significant functionality above and beyond pooling of liquidity (e.g. payment on behalf of participants structures). Under such structures, the cash pool header will operate as a payment and receipts hub for the cash pool participants and will perform more than a coordination or agency function with the master account. EBIT would prefer less prescriptive wording regarding the limitation of cash pool leader’s functions.

**Rewarding the cash pool members**
Given that cash pools are not operated between independent third parties and hence direct comparables for rewarding netting benefits to cash pool participants are not available, there is a need for a practical, pragmatic solution for taxpayers. EBIT would welcome acknowledgement by the OECD of the difficulty in calculating netting benefits and finding arm’s length methodologies for allocating to participants, and clearer acknowledgement that offering participants a more favourable interest rate (on both borrowings and deposits) than they may otherwise earn (bearing in mind options realistically available and the risk profile of the tested transaction) does reflect an appropriate solution. EBIT would welcome practical guidance on how the netting benefit should be shared, given that the calculations and pricing can be very challenging.

**Distinction between long-term and short-term debt**

The nature of a financing transaction in terms of the loan maturity may be subject to uncertainties in advance. Companies utilize different durations of debt to ensure adequate financing of their operations over fixed time frames. EBIT Members believe however, that acceptable accounting principles could be used to determine whether a financial transaction is short or long term, and the term to maturity should be respected so long as the decision relating to loan to maturity has been made in a reasonable way based on information available to the taxpayer at the time. Hence, EBIT would like to better understand how the OECD views specific duration thresholds for the distinction between long-term and short-term debt, as well as detailed guidance under which circumstances the short-term debt, should be reclassified as long-term debt. We would welcome a discussion including on the consideration of fluctuating balances on the characterisation of the transaction as being short or long term in nature. Further, different scenarios should find consideration in such guidance. For example, typically, balances on a cash pool will build up through the year and then reduce on the payment of an annual dividend. Any delay or restriction in paying out a dividend could lead to deposit balances remaining at a significant level for prolonged period of time, potentially exceeding the short-term duration thresholds. EBIT recommends that such balances should not be subject to long term recharacterisation. Flexibility should be allowed based on specific facts and circumstances, which can be documented.

EBIT Members would like to highlight that how to deal with early repayment when accurately delineating the actual transaction is important in practice. We would like to better understand how this can be factored into the analysis (i.e. breakage fees or option valuation reflected in the interest rate). In the case of reclassification, it should be limited to cases of clear abuse and not to situations in which taxpayers have exercised sound business judgment to ensure adequate working capital. In addition, with respect to financing transactions subject to reclassification, the guidance should reflect the business judgment of the company in assessing the impact of the relevant commercial and economic environment, including prevailing interest rates, foreign currency exchange rates and currency controls, on the chosen duration for the financing transaction under review.

**Hedging**

**General comments**

Generally, EBIT believes that insufficient guidance on hedging transaction is provided by the OECD in the Discussion Draft. In particular, EBIT would appreciate guidance on back-to-back hedging instruments and on offsetting positions within the group as well as specific guidance on the computation of the remuneration of the centrally performed hedging activities for the individual group entities. In addition, it would be useful to understand, with examples, how foreign exchange rate changes appear on financial statements when transactions are appropriately hedged. Foreign exchange losses, in particular, should be carefully explained; losses are an inevitable consequence of an effective hedge when the functional currency appreciates relative to a non-functional currency. It is often the case that tax auditors see only one side of the hedging transaction, invariably the loss side, and miss the
offsetting item otherwise hidden in the company's accounts, i.e., to the tax auditor, it appears as if the company has a one-sided foreign currency loss. Many times, this is due to timing issues that make it difficult to "unwind" the offsetting transaction and identify the offsetting gains and losses on a profit and loss statement. Therefore, it would be more appropriate to require that taxpayers have appropriate policies for executing hedge transactions, and that these policies are consistently applied.

**Financial guarantees**

*Cross-guarantees in the context of cash pooling arrangements*

A financial guarantee may aim to increase the borrowing capacity of a borrower – i.e. permit a borrower to borrow a greater amount of debt that it could in the absence of the guarantee. In such case, OECD suggests that a portion of the loan from the lender to the borrower, in excess of the borrowing capacity of a borrower, should be accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower). EBIT would welcome further guidance regarding the estimation of the loan amount to be delineated as a loan from the lender to the guarantor – i.e. the loan portion in excess of the borrowing capacity of a borrower. In particular, it should be clarified whether the recharacterized loan amount should equal the exact difference between the borrowing capacity of the borrower in absence of a guarantee and the situation in which a guarantee is provided by the guarantor, which also impacts the borrowing capacity. In some cases, it may be more appropriate to recharacterize an excessive loan by deeming it to be tranched, with amounts in excess of the identified borrowing capacity carrying a “junk” interest rate. These amounts could then be disallowed for tax purposes as not reflecting arm’s length behaviour, but they are at least still being characterised as payments of interest on debt. Safe harbour rules are helpful as a means to provide such guidance, especially because the portion subject to recharacterised needs to be limited to the nominal borrower’s greater borrowing capacity and not the improved interest rate resulting from the guarantee. In addition, the timing of any potential recharacterisation of a guarantee needs to be limited to certain testing periods, such as the time the guarantee is first extended or substantially modified. Having said this, a reiterated on page 2 of this paper, in EBIT’s view there are potentially serious knock-on consequences of debt being recharacterised as equity and this should only be done in extreme circumstances.

**Captive insurance**

Generally, we consider that captive insurance deserves a separate paper as it is a highly specific activity and not a type of financial transaction *per se*. We also wish to note that captive (re)insurance structures respond to sound economic and financial rationale and that they should therefore not be earmarked.

EBIT Members trust that the above comments are helpful and will be taken into account.

Yours sincerely,

European Business Initiative on Taxation – September 2018

For further information on EBIT, please contact EBIT’s Secretariat via Bob van der Made, Telephone: + 31 6 130 96 296; Email: bob.vandermade@pwc.com).

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September 7, 2018

Subject: Comments on discussion draft on financial transactions

Dear Sirs,

Embridge Economics (“Embridge”) is pleased to accept OECD’s invitation to share our views on the discussion draft on financial transactions of the OECD Transfer Pricing Guidelines issued on 3 July 2018 (“Discussion Draft”).

Embridge supports the OECD’s decision to release a discussion draft on financial transactions as current transfer pricing guidance on this topic is limited. Also, Embridge believe this topic is especially suitable for public consultation as complexity surrounding this topic can vary per jurisdiction and per industry. Public consultation may raise (unexpected) insight from various angles.

Our submission focuses on providing comments on specific questions included in the Discussion Draft. Comments are grouped per questions and further described below.

Box B.2
When looking at the fixed income market, a tranche approach is typically used, i.e. a loan has various risk tranches with corresponding interest rates. Based on the tranche approach, disqualifying a complete loan amount should be exceptional. However, the accurate determination of a maximum amounts an unrelated lender/borrower would be willing to lend/borrow can be challenging and depends on the loan purpose. Loan purposes include:

1. Acquisition of an asset;
2. Business development / future growth;
3. Business acquisition; and

For loans used to purchase of an asset, a loan-to-value benchmark approach is typically. When a loan is used to finance future growth or a business acquisition, the forecasted interest-to-operating-income ratio benchmark can be used. For working capital loans, a debt-to-equity ratio can be benchmarked.

Recharacterisation of an IC transaction is drastic and should be used in extreme cases only as a last resort and based upon in depth analysis and fact finding.

Box B.6

Guidance on “control over risk” in the context of financial transactions is currently limited. In contrary to transactions such as goods, services and intangible assets, little functions are performed in the context of financial transactions. Once a loan transaction is setup, the functions performed are typically of administrative nature with the exception of risk management. The time consumption of risk management is relatively low and the potential actions a lender can take in the event (credit) risk materialises is limited and typically predefined in an agreement.

Discussions on "control over risk" in the context of financial transactions may be controversial. For example, an entity may be setup for intra-group financing purposes whereby the directors manage the intercompany transactions. The directors of the entity may be aware of the risk profile of the borrower and have sufficient information to setup the loan agreement on behalf of the entity. Also, during the term of the loan, other related entities may monitor the credit risk and inform/advise the directors in the event risk materialises. Without further guidance on “control over risk”, disputes may easily arise with regard to who has the capability to control risk.
In the absence of a sound “control over risk” framework, an allocation of interest among entities involved may be challenging. If the lender has no capacity to control risk, who has? Although the treasury department is typically equipped to control risk, it often has a advisory role towards the CFO, controller, and/or management. Therefore, who has “control over risk” may not be that straight forward to answer, let alone the allocation of interest among entities involved.

Box C.2
We support the view that the credit rating of a borrowing entity (when it cannot be determined as a stand-alone entity) can be derived from the credit rating of the group as a whole. Nevertheless adjustments should be considered. Useful guidance with regard to the adjustments that can be considered is provided by S&P, which groups the entities within a multinational based on their importance in the following categories:

- Core entities: Same credit rating with the group as a whole;
- Highly Strategic entities: 1 notch adjustment downwards; and
- Strategically important entities: 3 notch adjustment downwards

The segmentation in the above categories can be performed based on an in depth functional analysis and discussions with management.

Box C.4
In order to assess the extent to which a borrowing group member will be supported by other group members, the incentive for support, which is related to the importance of the member within the group business and strategy, should be first examined. However, there are other relevant factors that could affect the relationship between the borrowing company and the affiliated entities such as:

1. Financial capacity/ability for providing support;
2. Domicile in the same country;
3. Percentage ownership;
4. The nature of other owners;
5. Common source of capital;
6. Significance of amount of investment;
7. Investment relative to amount of debt;
8. Management control;
9. The track record of the parent company in similar circumstances;
10. Shared name; and
11. The nature of potential risks.

Some of these factors can be determined relatively easily, including domicile, ownership, source of capital, and the (relative) size of the parent’s investment. Also, the level of parental management control of the subsidiary and its track record of supporting subsidiaries in financial difficulty can be determined based on historic behaviour.

Box C.7
Embridge is not in favour of using an MNE group’s (average) interest rate paid on its external debt as an internal CUP unless comparability between the external loans with the internal loan agreement can be guaranteed. In order for the interest rate paid on external debt to be considered as an internal CUP for a controlled transaction, the contractual terms as well as the characteristics of the financial products and the prevailing economic conditions should be examined. Example: the table below illustrates an actual example of an internal CUP analysis:

<table>
<thead>
<tr>
<th>Item/clause</th>
<th>IC loan agreements</th>
<th>External loan 1 (RCF) agreement</th>
<th>External loan 2 (PP) agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender:</td>
<td>XYZ BV</td>
<td>3rd party banks</td>
<td>3rd party bank</td>
</tr>
<tr>
<td>Borrower:</td>
<td>XYZ Group companies</td>
<td>XYZ BV</td>
<td>XYZ BV</td>
</tr>
<tr>
<td>Loan Instrument:</td>
<td>Revolving facility</td>
<td>Revolving facility</td>
<td>Term loan facility</td>
</tr>
<tr>
<td>Seniority:</td>
<td>Senior</td>
<td>Senior</td>
<td>Senior</td>
</tr>
<tr>
<td>Currency:</td>
<td>USD</td>
<td>USD</td>
<td>EUR</td>
</tr>
<tr>
<td>Interest type:</td>
<td>Variable</td>
<td>Variable</td>
<td>Fixed</td>
</tr>
<tr>
<td>Interest:</td>
<td>Tbd</td>
<td>Libor+1.10%</td>
<td>3.164%</td>
</tr>
<tr>
<td>Term:</td>
<td>1 year</td>
<td>From 1 till 12 months</td>
<td>7 years</td>
</tr>
<tr>
<td>Early repayment:</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

In the above table, the nature of the RCF agreement is very similar to the IC loan agreements, with regard to the main contractual terms and characteristics. On the other hand, the key terms and conditions of the PP agreement, such as the loan instrument, the denomination currency, the term of the loan, differ from the ones of the IC agreements. Therefore, in order to determine an appropriate spread for the IC loans, the PP agreement was rejected. As a result, the RCF agreement as an internal CUP transaction.
Embridge Economics will be pleased to contribute to the further development of the Discussion Draft and other relevant sections of the OECD Guidelines with respect to financial transactions.

Yours sincerely,

Roderick Veldhuizen
On behalf of Embridge Economics
Discussion draft on the transfer pricing aspects of financial transactions 7.9.2018

Dear Tomas

Erste Group Bank AG appreciates the opportunity to comment on the latest discussion draft relating to transfer pricing of financial transactions.

We recognize and appreciate OECD’s effort to clarify and unite as much as possible, the approaches applied in cross-border situations from a tax perspective as being crucial for doing business in the current environment, in order to protect both the tax payers and the tax authorities.

We have limited our comments to selected topics and kept them relatively brief. However, we would be more than happy to provide additional details or discuss further most of the topics covered in the discussion draft. As a bank, we obviously have substantial experience in financial transactions and as a third party option to intragroup (IG) funding, we can provide valuable insight in to many of the topics covered in the OECD BEPS discussion draft.

We would like to point out that our comments are purely meant for transfer pricing purposes and provides a simplified perspective into the corporate rating and pricing of financing.

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

An alternative to government issued securities to approximate risk-free rate of returns, would be interest rate swap rates, especially overnight index swap rates. The credit risk inherent in overnight money market rates, like SONIA (Sterling Overnight Interbank Average) or EONIA (EUR Overnight Interbank Average) can be considered to be close to zero. Currently there are efforts around the globe defining new risk-free reference rates, e.g. in the EU it is the new Benchmark Regulation which requires the market to establish a new risk-free reference rate. E.g. for Sterling the proposed risk-free rate is the SONIA, for JPY the TONAR (Tokyo Overnight Average Rate) and for Euro there was recently a consultation process on the successor of the EONIA (result is expected in autumn 2018).
In addition to the overnight interbank rates that are considered to be risk-free, in developed financial markets there is quite often a derivatives market for such rates as well. Hence, a yield curve can be obtained via quotations/executed trades from the derivatives market (interest rate swap market). The yield curve obtained can then be considered to be a risk-free curve.

**Box C.2. Question to commentators**

MNE group credit rating – how it could be determined and the use of it.

Group credit rating is usually based on the consolidated financial statements of the group. And together with the country ceiling, it usually represents one of the ceilings – i.e. limitations to the individual credit rating of an entity that is part of a group. But, unless you have an in-house rating model, what are the options to determine credit rating (group or individual). Some of the options are:

1. Develop own rating model – as a base one could use publicly available information, such as documents on credit rating published by one of the rating agencies;
2. Use third party funding provided to the group members to determine/estimate credit rating of the borrowers (individual entities) by using publicly available information such as bonds issued by entities that have official credit rating; or
3. Combination of the above.

Using group credit rating as proxy for each of the individual group members is a substantial simplification of pricing of IG transactions which would certainly bring less administration, and more tax certainty for both the tax payers and the tax authorities. However, this approach is far away from potentially comparable third party transactions. One may however consider, using group credit rating as a starting point to determine the individual members’ credit rating. One could for example assume that unless a group member is clearly in (or about to) default, the individual credit rating cannot be worse than a certain number of notches. However, again, would that reflect reality of comparable transactions such as funding provided by a bank? Not really, but this does not mean it cannot be used as a simplification, equivalent of a safe harbour rule if agreed upon by OECD members.

**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 68-74 of the discussion draft, and how that effect can be measured.

Stand-alone credit rating is a rating that is based on the financial data of the individual entity only. In addition to the financial data (hard facts), soft facts are also to be considered. Parts of the soft facts are miscellaneous elements such as risks (FX risk, ownership risk, management risk, reputational risk etc), market situation, negative information as well as influence of the group. Soft facts can have in principle either a positive or negative influence on the rating of an MNE.

Implicit support simply put, is an assumption that even without an existence of legal obligation such as guarantee (explicit support), other group member, usually the parent company, would provide (financial) support in case the
borrower would be in need. As the word “assumption” suggests, this in a way is an expert opinion, however, there are certain elements that can indicate the strength of implicit support such as:

- Industry – for example the implicit support within banking industry (i.e. within a banking group) is to be assumed to be one of the strongest. This is due to the fact that financial difficulties of one banking entity would have material damaging effect on the overall banking group such as good reputation and ability to raise funds which is absolutely crucial in banking industry;
- Size of a group entity – potential support usually rises with the importance of such entity for the whole group;
- Shared name – it may indicate importance of such entity for the overall group; and
- Other consideration such as history of support, operational integration etc.

Again, there is public information available from most of the rating agencies providing further details on which elements and to what extent can be considered as implicit support. The improvement of the stand-alone credit rating is usually limited to 2-3 notches. In addition, the group credit rating is usually used as an overall ceiling, such as country rating.

As already suggested above, it is also helpful to work with already existing third party financing that may help to determine the credit rating as perceived from an independent party. Such third parties would already consider all of the above mentioned elements such as implicit support or any existing ceilings to the rating.

Paragraph 73 discusses the situation where a stand-alone rating is higher than the credit rating of the group. In such cases, it is common that the group rating represents a ceiling and, thus, a negative influence on the stand-alone rating. This is due to the fact that the group (parent company) may undermine the rating of the entity by its actions, such as extracting available funds or restructuring the entity.

Discussing credit rating would not be complete without mentioning the explicit support and its influence on the stand-alone rating. Explicit support can have different strengths. The strongest form of support is the binding letter of comfort covering all liabilities of the borrower. It is important to differentiate between support for an individual transaction and for all liabilities. In the case of the latter, the usual outcome is that the credit rating of the group member is increased to the rating of the guarantor.

| Box C.5. Question to commentators |

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

In case economic models are non-existent, CDS may play an important role in estimating a proper arm’s length price for intra-group loans. CDS market is usually sufficiently liquid and, hence, representative of the pricing for sovereigns and large, well-known, consolidated global companies.

Sovereign CDS might not be applied one to one for the pricing of intra-group loans, but they can serve as a very good source for pricing the sovereign risk component in case no CDS is traded on the borrowing company itself. Hence, when pricing cross border loans, sovereign CDS spreads, can be applied to assess the sovereign risk component which needs to be taken into account. Depending on the risk class of the borrower, adjustments shall be made in order to reflect the individual credit risk as well as the economic conditions and terms of the specific funding in the pricing.
Box C.6. Question to commentators
Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intragroup loans.

The below answers are provided from the point of view of optimizing working capital and raising liquidity, but not considering the different ways of pricing of the given product. Choosing among the available alternatives of intragroup loan is based on the respective MNE’s business situation and economic consideration, i.e. whether it obtains liquidity through intragroup transaction (e.g. loan, equity injection) or turns to an external party (e.g. lender, investors).

Realistic alternatives of intragroup loans:
- Loan from a third party lender (i.e. not intragroup loan)
  o Under certain conditions (e.g. a complex financing product offered to a strategically important group client) a loan from a third party lender might be more attractive than an intragroup loan
- Factoring; various types of factoring is available at the market.
- Bond issuance:
  o Public issuance: under fulfillment of respective regulations, publicity, prospectus, minimum number of investros. Usual minimum size around 50mnEUR
  o Private placement: a bond issue addressed to selected number of investors (usually market sounding in an early stage of the transaction)
- IPO (initial public offering):
  o Raising capital through stepping out to the stock exchange and offering shares to investors. Similar to bond issuance, it requires also detailed market analysis, investors roadshow etc in order to determine the right amount of shares and their price. Hard underwriting would secure fix payment to the issuer, however, it is rather rare
- Equity injection by the parent company

Box D.1. Question to commentators
Commentators are invited to describe 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

Our comment:

Guarantees can be insisted by a bank as independent lender if the credit quality of the client does not meet its risk requirements (i.e. following credit risk policies), or if the lender doesn’t know the client well enough (i.e. no credit history is available).

Bank guarantees may be applied also, if the loan structure or funding requirements would give an advantage.
• where guarantees are insisted upon by an independent lender who grants loan to a member of an MNE group, how and why guarantees affect the credit rating and loan pricing

Our comment:

In cases, where the whole exposure of a client is guaranteed, the bank could apply a rating transfer of the guarantor, meaning the credit rating of the borrower would be made equal to the credit rating of the guarantor (see also our answer above).

If the credit rating improves, this means automatically that the pricing of the loan improves. However, one needs to keep in mind that it is not only the credit rating, but also many other elements that influence the pricing of a loan. And after all elements (currency, maturity, country risk, collaterals, etc.) are considered, it is also the competitive environment that plays an important role. Each bank will of course aim to cover its cost plus earn a certain profit. However, sometimes it is market relevant and sound business reasons exist, to provide the loan without any profit or even below cost.

• Examples of the most frequent cases where borrower obtains guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at

Our comment:

In Erste Bank, any guarantee can be provided to clients which relates to the client’s business itself, e.g.:  
- bid bonds - to allow the client to participate in a tender, usually to confirm financial standing of the client and to give confidence to the tenderer, that the client is able to perform/deliver if they win the tender;
- down-payment guarantees – these are common in projects (e.g. project finance, construction projects in energy sector, long term projects), usually clients may be asked for down- or advance payments, for which they are asked to submit a bank guarantee. The purpose is to guarantee that once the down-payment is received, the construction company will deliver/perform;
- performance bonds - bank guarantee covers the risk, that the client may run into difficulties during the respective project (delay, non-fulfillment etc); or
- retention bonds - a type of guarantee that is usually submitted at the end of a project in order to secure the risk of deficiencies, which may become obvious only after the finalization and final payment of the project.

A guarantee provided by Bank A for a regular bank loan provided by Bank B are quite unusual, but could occur in certain specific constellations, for example, in case of differences in funding costs or access to certain funds. E.g the bank doesn’t have the liquidity in the desired currency to provide the loan to the client, it is cheaper/easier to provide a guarantee than to raise funds. However, this happens very rarely.

As mentioned above, we would be more than happy to provide further information or details.

Best regards

Andrea Lee  
Head of Group Cost and Project Controlling and TP

Ildiko Toth/Enrico Gallo  
Transfer Pricing Specialists
EBF comments on the OECD Discussion Draft on BEPS Actions 8-10 regarding Financial Transactions

Preliminary remarks

The European Banking Federation (EBF), which is the voice of European banks, welcomes the opportunity to provide comments on the OECD Discussion Draft on BEPS Actions 8-10 regarding Financial Transactions.

Banks undertake intra-group financial transactions with the aim to segregate and manage risks and fulfil their regulatory obligations. The EBF would welcome that the Discussion Draft explicitly mentions that it focuses only on financial transactions between related parties according to Art. 9 Para. 1 OECD Model Convention (MC). Consequently, all financial transactions between third parties (e.g. from a bank to its clients) are out of scope of the Discussion Draft. The main purpose should be about improving the standard of non-banks treatment of financial transactions, and therefore the Discussion Draft should not replace or conflict with the OECD 2010 Report on the attribution of profits to permanent establishments of banks.

The banking sector is subject to extensive regulation, for instance, capital, liquidity and leverage requirements, ability to transact with particular customers and reporting. Seeking to protect customers and ensure financial stability, regulation actively and constantly shapes and controls how banking business is undertaken. The EBF welcomes the acknowledgment of the importance of regulation and risk management in the Discussion Draft. In this respect, the EBF would also appreciate that the Discussion Draft mentions that flexibility should be given to Multinational Entreprises (MNEs) as far as the application of the separate entity approach for the risk assumption is concerned.

Banks undertake financial transactions in huge numbers and volumes. Financial transactions are effectively the stock in trade of banking businesses. Therefore, the EBF believes that the accurate delineation of financial transactions should not be subjected to higher scrutiny than other intra-group transactions. We refer in particular to
our comments to Boxes B.1, B.2 and B.3 below. In this respect, the transaction-by-
transaction approach suggested in the Discussion Draft would be impractical for both
banks and tax authorities.

For example, the issues of association and implicit support in a banking group are more
complex than in non-banking groups. This is because banking groups generally will not
wish (reputation) and may not be allowed (regulation) to let their banking subsidiaries go
bankrupt, which implies that banking subsidiaries will generally be able to fully rely on
their banking parent’s capital and liquidity support in any event. Furthermore, banking
parents are actively engaged in steering and controlling their subsidiaries’ risks, making
their position very different from third party lenders that do not have the means to steer
and control their borrower’s risk. However, the regulator of a separately regulated
subsidiary will require the subsidiary to be adequately and appropriately capitalised in its
own right and to comply with its own capital requirements, independent of the parent’s.
Concerning systemically important banks, recovery and resolution plans are required,
which will significantly influence the relationship between parent and subsidiaries in this
regard. Great care is required in considering whether one may derive from this that the
credit worthiness of subsidiaries of a banking group can generally be assimilated with that
of the parent company and whether, as far as credit worthiness is concerned, the position
of banking subsidiaries will generally be very similar to that of foreign permanent
establishments of banking parents.

The volume of activities, the extensive regulation and the international nature of
banking operations produced a number of pressing and interesting transfer pricing
questions. This led to the creation of the OECD 2010 Report on the attribution of profits
to permanent establishment addressing the allocation of risk and capital within banking
Bank groups are usually organised in the form of a legal entity with several dependent
permanent establishments (PEs) – unlike industrial or services-sector groups with several
independent subsidiaries. The reason for this is regulatory/supervisory requirements for
their business activities. These concern the capital structure in particular. The Report takes
into account the treatment of PEs as hypothetical separate and independent enterprises,
particularly for banks and global trading in financial instruments (Parts II and III). The
findings of the Report have been incorporated into the current version of Article 7 of the
OECD Model Convention.

The 2010 Report is well-researched, thoroughly considering the manner in which such
banking businesses are conducted. The 2010 Report considered all aspects of banking
business including regulation and is respected by both banks and we believe tax
authorities, addressing the transfer pricing challenges presented by cross-border banking
businesses. We would urge that it be made clear that the Discussion Draft is not intended
to override the existing transfer pricing rules applicable to banks in the profit allocation
between a branch and its head office, nor the 2010 Report.

Where, in addition to PEs, bank groups operate subsidiaries that mostly conduct similar
business activities under the same or similar conditions in the host jurisdiction, we would
recommend that, in line with the AOA principles, financial transactions with affiliated
subsidiaries should be treated equally for tax purposes with respect to their delineation
and pricing. These principles are appropriate and transferrable.
Reasons for such reference to the AOA principles, elaborated for the banking sector, for bank PEs are:

- same regulatory/supervisory requirements for a bank group, no matter whether it is organised as an undertaking with dependent PEs and/or as a parent undertaking with subsidiaries;
- the hypothetical independence to be applied under the AOA to PEs, as well as the specificities of the business activities of PEs acknowledged thereunder;
- the comparability of the AOA requirements for, on the one hand, the banking sector in particular and, on the other hand, for financial transactions in general;
- the transferability of the reasons that led to the AOA principles for intra-bank loans (Part II);
- practical considerations, bearing in mind overall bank management that should enable banks to determine arm’s length transfer pricing of financial transactions at reasonable effort (implementation as “best practices”).

The proposed guidance should make clear that it first of all intends to target base erosion and profit shifting further to transfer pricing approaches regarding intra-group financial transactions, excluding regular regulated banking operations within banking groups that support commercial banking business. Such operations are not BEPS-driven, they should be excluded and are already subject to well-established transfer pricing approaches applicable to the trading activities. Banking groups fulfil an essential role as funding providers to the economy, which is an absolute key condition to enable economic growth. Banking groups and their activities are subject to extensive regulation to ensure the protection of customers and to protect financial stability. It is critical that regulation is not contradicted by taxation. For instance, if inconsistent and too stringent rules would be imposed to the pricing of intra-group financial transactions in the context of a banking group, this could directly affect the pricing of financial products to non-affiliated banking clients. Hence the importance to confirm that regular regulated banking operations in the context of a banking group are not targeted by the new guidance, but remain subject to the existing extensive and thoughtful work of the OECD so as to avoid that any new OECD transfer pricing guidance applicable to intra-group financial transactions has an adverse impact on the real economy.

Specific comments

**B.1. Identifying the commercial or financial relations**

**General comments re boxes B.1, B.2 and B.3**

As a general matter, we believe that the accurate delineation of financial transactions should not be subjected to higher scrutiny than other intra-group transactions. Opening up in this way for increased reclassification will likely lead to increased uncertainty and likely extensive tax audits. Due to the fact that the capital structure of banks is mostly determined by regulation, we generally do not see any potential debt/equity characterisation issues involving banks that could be relevant in the field of transfer pricing related BEPS risks: in other words, capital structure does not represent a decisive aspect to determine whether a financial transaction is priced at arm’s length Consequently, any
reclassification of financial transactions (e.g. from debt to equity) should be a rare exception in tax audits. Please note however that debt/equity characterisation could be a concern to banks where mismatches arise between different country practices that give rise to double taxation; at present, this issue has always been left to the individual countries discretion and has not actually been dealt with in any official OECD guidance. More generally, it is not yet fully clear how the proposed guidance on the transfer pricing of intra-group financial transactions, which proposes an OECD acknowledged approach for debt/equity characterization for transfer pricing purposes only, would precisely interact with debt-equity characterization approaches in the context of hybrid mismatch and interest deduction measures, where possible approaches appear to have been left to the discretion of individual jurisdictions.

It should be ensured that the accurate delineation of financial transactions does not contradict current banking regulatory legislation (capital requirements etc.). The tax treatment of transactions should remain in line with the existing regulatory requirements.

Comment re box B.1
Regarding the interaction between Art. 25 OECD MC and Art. 9 Para. 1 and 2 OECD MC, we believe that the OECD should promote conclusion of double taxation treaties (DTTs) with Art. 9 Para. 2 OECD MC (Corresponding adjustment) during the implementation phase of BEPS measures. In our experience, corresponding adjustment presents a much faster remedy from (economic) double taxation than the mutual agreement procedure. However, we do acknowledge the value of a Mutual Agreement Procedure (MAP) if a DTT does not contain Art. 9 Para. 2.

B.2. The economically relevant characteristics or actual financial transactions

B.2.1. We welcome it that accurate delineation of financial transactions should be in line with Chapter I, Section D.1 of the general OECD Transfer Pricing Guidelines. This means that contractual terms, functions exercised, assets used, risks assumed and characteristics of financial products or services should reflect the economic circumstances of the parties and the markets as well as the business strategies of the parties.

However, if the parent undertaking and the subsidiary of a bank group act within the limits of the regulatory requirements, there is no reason, bearing in mind the existing freedom of contract, to assess the contractual form differently for tax purposes. It should be made clear that the burden of proof lies with the tax authorities if they challenge the contractual form.

B.2.2. Where bank groups are concerned, reference should accordingly be made as regards the function and risk profile, particularly the functions of the lender and the key characteristics of loan transactions, to the (detailed) Part II of the 2010 OECD Report.
B.2.4.
If, in the case of bank groups, an external comparison with bank lending rates to third parties and/or with similar or other benchmarks is to be taken as an economically relevant characteristic, it should be noted that, in view of the functional and risk analysis required and the cash pooling by banks for the entire group, a blanket transfer of external price comparisons to intra-group loans (without any adjusted calculation) is basically inappropriate.

Overall bank management is based on the bank group’s overall leverage, not on a bank lending rate to third parties. If individual bank lending rates to third parties were taken as the basis, considerable adjustments would be needed to obtain a satisfactory price comparison for a bank group with affiliated subsidiaries.

B.2.4./B.2.5.
Generally speaking, an adjustment of the arm’s length principle in terms of economic circumstances or business strategy is appropriate if an arm’s length-based financial reorganisation measure is involved (see e.g. German Federal Fiscal Court (BFH) ruling of 9.6.1997, Grand Senate 1/94, Federal Tax Gazette II 1998, 307, by which the BFH rejects the tax classification of the waiver of a claim under financial reorganisation arrangements as a deposit). This applies particularly to the financial reorganisation of a bank subsidiary since, because of its business model as an intermediary, a bank group has to consider its reputation and cannot generally afford not to rescue a subsidiary and allow it become insolvent.

Over and above arm’s length-based financial reorganisation measures, an adjustment of the arm’s length principle appears called for in view of the overriding aspect of the parent undertaking’s own economic interest in the commercial success of the subsidiary and its duty to assume a certain degree of responsibility as stakeholder for funding the subsidiary (see in this respect, European Court of Justice ruling of 11.5.2018, case C-382/16, Hornbach Baumarkt AG).

Box B4
Box B4 creates some confusion. Reference is made in this context to what we mentioned in the introduction, i.e. only related party financial transactions should be covered by the Discussion Draft

a. For example, does section 10 and 11 imply that a third country may be involved, if so this may lead to confusion.

b. Section 13 and 14 are bundling the funding transaction with development of an intangible, which also leads to confusion, when separating the two types of transactions and pricing both in accordance with the arm’s length principle would be appropriate.

c. Please also see comment 3 above regarding country risk.

Ren° 4
A look at banking practice, where there is generally no risk-free finance, shows that taking government bonds as an example of (relatively) risk-free finance for price comparisons appears generally questionable. In addition, we regard such a benchmark as appropriate only for long-term finance in capital market business, but not for short-term finance in
money market business. Bearing in mind the adjustments needed, further explanation of these benchmarks is required.

Re no. 6
We take a critical view of maturity transformation. The example of reclassification of the subsequent replacement of a short-term financial instrument with another (short-term?) financial instrument as a long-term financial instrument is, in our view, at odds with the arm’s length principle (key term: risk analysis) and also appears too general.

Box B.5.
Realistic alternatives should be explained with the help of (further) examples.

Re no. 9
Given events on the ground in the eurozone, we oppose the idea of the tax administration of one country considering government bonds issued by a higher-rated country a basis for risk-free financing if both countries belong to the same currency zone (take, for instance, Greek vs. German government bonds).

Box B.6
Same remark as under Box B.1

C.1. Intra-group loans

Box C.1
In a bank group, the treasury function is highly important for the liquidity management of the bank as a whole. Depending on the business model of the group, this function can take (sometimes very) different forms, from highly centralised to more decentralised structures. As a result, treasury functions will be of varying importance with regard to function and risk analysis.

In view of this, we consider the distinction between a subsidiary with “full autonomy over its financial transactions” and a subsidiary where this is not the case to be inappropriate and too blunt. Further explanations are needed and, in particular, criteria for classification.

In any event, we would recommend making reference to the guidance on functional analysis in parts II and III of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (so called “Authorised OECD Approach”, or AOA).

We agree that the treasury function should be regarded as a service.

Box C.2
Goes against the arm’s length principle and this simplification will lead to more confusion. The process of trying to get an as right credit rating as possible (which is the current best practice) is aligned with the arm’s length principle and how third parties would act. The suggestions in Box C2 will likely lead to more confusion also as tax authorities from two different sides may have different views.

If a subsidiary has a stand-alone rating, the option of using it should be provided for because this is consistent with the arm’s length principle.
It would however always be appropriate, in the interests of practicability, legal certainty and with bank-wide risk management in mind, to use the group rating of a bank group as a basis when considering each individual subsidiary, even if the subsidiary has a rating assigned by a rating agency on a stand-alone basis, if this simplified approach is offered with no ability to rebut or adjust.

**Boxes C.2/C.3**

We agree that both perspectives should be taken into account when considering the economic and financial relations and analysing the economically relevant characteristics of transactions between associated borrowers and lenders.

It should nevertheless be borne in mind that intra-group loans in bank groups differ from those in industrial or service-sector groups when it comes to the management of business processes and, in particular, the treasury function in general. It is therefore open to question whether processes can be compared at all.

**Boxes C.2 to C.6**

In a financial institution with a centralized treasury function, one possible model for the parent company’s pricing of long term loans towards its international branches and subsidiaries which could be suitable for some groups is to split the price into two components: (i) a charge equal to the short term interbank rate (reference rate) calculated on the actual loan amounts and (ii) a liquidity premium. The liquidity premium should reflect the cost related to the need for the long term funding at group level that is created by the branch/subsidiary. For such purpose, the liquidity premium should be computed based on the net assets of the receiving branch/subsidiary, defined as the receiving entity’s outstanding loans to third party customers less the entity’s weighted deposits from third party customers.

Under this pricing model the need for long term funding created by the branch/subsidiary may deviate from the funding actually received by the branch/subsidiary. This is due to the fact that the contribution to the overall need for long term funding may deviate from the liquidity because the composition of outstanding loans to customers vs. weighted customer deposits in the branch/subsidiary may create a higher need for obtaining long term funding on a group level in order to stand behind the branch/subsidiary than what is actually needed for the branch/subsidiary to receive in terms of liquidity transactions in order to serve it’s day-to-day obligations.

We welcome that WP6 presents in the subchapter C.1.7 pricing approaches to determine an arm’s length interest rate that are widely spread in the practice. Due to the lack of Comparable Uncontrolled Prices (“CUPs”) in practice and complexity of other pricing models, we would welcome, if safe harbours in the form of transaction volumes would be used. We would appreciate, if e.g. only financial transactions exceeding USD 50'000 p.a. would have to be comprehensively documented. Any transactions below the threshold should be considered as priced at arm’s length.

As regards the pricing of intra-group financial transactions, transfer pricing rules must give sufficient regard to the essential role of regulated banks to the economy as highlighted above. As a necessary consequence, it must be clear that intra-group fund transfer pricing (and the pricing of any other financial transactions that support commercial banking business) should be consistent with regulatory policy and may not inadvertently affect the pricing to external, non-affiliated counterparts. This e.g. means that it must be possible
for banks to choose the funding base rate of intra-group funding transactions from any appropriate and justifiable pricing curve, be it a publicly available or implied curve, as long as such curve appropriately reflects the specific features (tenor, creditor status, ...) of each particular intra-group loan. In addition, as banks derive their funding from many different sources and do not usually attract funding to fund their subsidiaries on a 1 to 1 basis, transfer pricing approaches must allow that the pricing may be established taking into account the marginal average cost of funding.

It should also be clear from this that for bank groups, a blanket transfer (of pricing) of financial transactions with third parties to intra-group loans (without any adjusted calculation) is inappropriate. Overall bank management is based on the bank group’s overall leverage, not on a bank lending rate to third parties. If individual bank lending rates to third parties were taken as the basis, considerable adjustments would be needed to obtain a satisfactory price comparison for a bank group with affiliated subsidiaries.

It should be noted that in some cases the price of country risk is in some cases higher than differentiating the credit worthiness and will in such cases have a high impact on price. See comment 3 above.

**Box C.5**
Credit default swaps (CDSs):

CDs can be a valuable means of determining a (comparable) interest rate for a loan.

Since the draft does not discuss the role of CDSs in more detail, we would welcome further explanation, especially in the form of examples.

**Box C.6**
Internal CUPs - Banks do not only have internal CUPs (inbound) from a borrowers point of view, but banks have external (outbound) CUPs as lenders, i.e. banks have extensive CUPs and also internal models for calculating the price for customers, which should be deemed relevant also when pricing loans to associated parties.

**Box C.7**
In bank groups, the approach of taking account of a premium when determining funding costs is one (general) method which, though it departs further from the concept of the arm’s length principle, is nevertheless practicable.

We would recommend in this context that the guidance on bank groups should make reference to the corresponding guidance on capital resources in part II of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (so-called “Authorised OECD Approach”, or AOA).

**Par. 63/64 – Credit rating methodology**
The internal rating models used by bank groups have to comply with prudential and regulatory requirements. The use of internal rating models for determining ratings should therefore be permitted in the banking sector.

German tax courts have differing views on the effects of implicit support, such as financial support by the parent company (judgement of Münster Fiscal Court of 7 December 2016, 13 K 4037/13 K, F, appeal to the German Federal Fiscal Court ref. I R 4/17 vs. Cologne Fiscal Court of 29 June 2017, 10 K 771/16, appeal to the German Federal Fiscal Court ref. I R 62/17). The effect of such support with respect to the arm’s length principle is
frequently overestimated, in our view, since third parties will not normally rely on support from the group without explicit guarantees.

We believe it can be inferred from the OECD Transfer Pricing Guidelines that support from the group can only be regarded as reducing interest rates if third parties in a comparable situation, i.e. in the absence of an explicit guarantee, lend to group companies on more favourable terms simply because they belong to a group. Empirical evidence shows that this is not normally the case. Implicit support should therefore not normally have to be regarded as reducing interest rates.

In addition, we would recommend that the guidelines on intra-group loans should make reference to the corresponding guidance in parts II and III of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (so-called “Authorised OECD Approach”, or AOA).

Par. 73 – Stand-alone rating vs. group rating
If a bank group is involved, we do not agree that it may sometimes be appropriate to depart from the general approach and cap the stand-alone rating of a subsidiary at the level of the group rating. This is because the subsidiary’s stand-alone rating will be based either on the findings of an external credit-rating agency or on criteria recognised by banking supervisors and regulators. There is therefore no reason to assume the existence of abuse or of anything that could “undermine” this rating.

Please also see our comments above on stand-alone ratings and boxes C 2./3.

Par. 75 - Covenants
Covenants are not a criterion when it comes to intra-group loans because of the lack of a comparable situation when lending to a third party. Our comments above on relevant economic reasons in the form of a restructuring measure or in the lender’s own economic interests (see comments on Box B.3.) apply here too. The non-application, or lack, of covenants in intra-group loans justifies a departure from the arm’s length principle and does not have the effect of increasing interest rates.

Par. 79 - Guarantees
Unlike implicit support within a group, which is discussed above, guarantees should be seen as reducing interest rates with respect to the arm’s length principle (see our comments above on boxes C2./3.).

Par. 92/93 – Bank opinions
The draft guidance distinguishes between bank opinions and formal loan offers. The former are thought generally not to be indicative of arm’s length conditions, while the latter are not explicitly said to provide evidence of arm’s length conditions.

A bank’s documents relating to the formal offer of a loan are rooted in the arm’s length principle and should be explicitly recognised as evidence of arm’s length terms and conditions.

In principle, the same goes for bank opinions, provided that they go beyond mere “letters”. We reject any claim that a bank would issue such “letters” simply as a courtesy. Bank opinions are also firmly rooted in the arm’s length principle, especially given that adjustments may be made in response to new interest rates or maturity adjustments.
Par. 132-136 - Hedging
In this context, too, we recommend that the guidance on bank groups should make reference to the corresponding guidance in parts II and III of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (so-called authorised OECD approach, or AOA).

D.1 – Financial guarantees
Reference is made to comments to Boxes C.2 to C.6 above. It is welcomed that the same reasoning is explicitly expressed under the Section on guarantees where the guidance states that “it is recognized that even an explicit guarantee by a related party may not provide the borrower any additional benefit beyond an acknowledgement that the group as a whole may suffer negative consequences by not supporting the borrower in honouring its debt” and that in such circumstances “no guarantee fee would be expected to be paid.” We would recommend to explicitly emphasize in the guidance that this lack of additional benefits further to an explicit guarantee will commonly occur in the context of a banking group where strong regulatory requirements and high reputational care entail the highest degree of implicit support.

Guarantees – 141: a bank entity providing a guarantee to another entity will increase its risk weighed assets and will as such increase its cost for holding capital, which needs to be considered when pricing guarantees, which to some extent differs from other MNEs.

Guarantees 140 (same comment as 1): Will likely lead to increased uncertainty and likely extensive tax audits.
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About the EBF
The European Banking Federation is the voice of the European banking sector, bringing together 32 national banking associations in Europe that together represent a significant majority of all banking assets in Europe, with 3,500 banks - large and small, wholesale and retail, local and international - while employing approximately two million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that reliably handle more than 400 million payment transactions per day. Launched in 1960, the EBF is committed to a single market for financial services in the European Union and to supporting policies that foster economic growth.

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ECIROA is a registered Association in the EC Transparency Register with the ID No. 12749675101-70
This comment has been prepared by Guenter Droese, Executive Manager of ECIROA
September, 3rd 2018

ECIROA responds on the invitation to send a comment 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 a general introductory remark of ECIROA, followed by arguments responding to the specific questions raised in the blue boxes.

We attach a paper, the CICA 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 to fulfil the requirements formulated in the BEPS Papers.

ECIROA_GD_03.09.2018
E. Captive insurance

General introductory remark of ECIROA: ECIROA supports and appreciates the target to avoid profit shifting and the willful activity to circumvent tax payments to achieve as much transparency and clarity of a corporation’s operations and performance. ECIROA has invited OECD to join forces in our initiative and discussion with IAIS (International Association of Insurance Supervisors) to try our best to make it possible for all MNEs to allocate the appropriate share of premium as part of an International Insurance Programme (IIP) to all MNE group members in whatsoever country they are active to assign in accordance with the Transfer Pricing Principle the insurance cost=premium to the insured MNE entity/branch. ECIROA is strongly convinced that MNEs with or without captives are paying an arm’s length premium, well knowing that no underwriter can state the “100% correct” premium. In hindsight some adjustments are almost always needed.

Captives are implemented to carry risk as insurance companies for MNEs. The insurance policies are usually IIPs which provide cover around the globe with a predetermined protection for all MNE group members. Such IIPs include smaller risk exposure (potential frequency losses/claims) and huge or catastrophic exposures (with a very low frequency/probability). To purchase the same cover in each and every country of activity would be cost prohibitive.

The total premium= adding up all local premiums would be much higher as in an IIP or it wouldn’t be possible at all to purchase such a structure due to the fact that the insurance market cannot provide high sums insured as a multiple for one MNE group because of the huge capacity per MNE which would need huge locally assigned capital (invested by the insurers) following the local regulatory requirements.

Captives usually are carrying risks of the smaller risk exposure (frequency part) of the insurance programme.

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 recognising 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.

Comment:

Ad 1

- Both, direct captives and reinsurance captives 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-1 )

- 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 principle (and which are additionally 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 take and 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 refrain from introducing new definitions of insurance and insurance contract but rather refer to IFRS 17 and IAIS definitions of “genuine insurance transaction”

- Paragraph 1.63 and 1.64 of Chapter I state the following: “Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises.” And “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.”

- To demonstrate a captive company actually assumes the risk, there should therefore be a real possibility for the captive to have an underwriting loss, and the captive’s capitalisation should be commensurate with the risks underwritten (i.e. it should have sufficient asset base - liquid or contingent - to be able to pay the maximum foreseeable loss under a policy plus predictable claim payments)

- In a Solvency II environment for instance this would be demonstrated by the ORSA report

- There is no need to consider any specific “indicators” to assess whether the captive is actually assuming any risk. The accounting guidelines (IFRS) usually accepted by tax authorities and the insurance regulatory principles overseeing captive operations already ensure that aspect. Creating another set of “indicators” is likely to create confusion, uncertainty, and inconsistency between accounting, insurance, and tax regulation.

- 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 authorised 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.

ECIROA_GD_03.09.2018
- It is unnecessary to create another set of indicators to evaluate whether the captive is actually assuming risk given that 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 that generally follow the standards laid down by the European Union directives and/or the International Association of Insurance Supervisors.

- Captives are required to apply for insurance / reinsurance licenses from regulators and demonstrate / prove 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 licenses be granted.

- The ongoing adherence to these requirements is monitored by regulatory authorities and subject to audit and scrutinized by the internal defense systems of the captive, most notably in the form of a compliance officer, who will typically be a control function subjected to regulatory approvals.

- 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 would undermine the insurance regulatory processes, create duplication and will be unlikely to strengthen the tests of insurance already in place.

- Note: Captives which underwrite non-group risks in some jurisdictions may be considered as market insurer.

- Note: Due to accounting/IFRS requirements the set aside of funds in reserve or the pre-fund of potential future losses are not allowed (only for claims or losses which have definitely been made/occurred) – IFRS 37 does not allow to set aside reserves for unknown potential losses

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 ( - discovery of abuse would be the audit challenge for tax authorities).

- 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 is ‘ uninsurable’, but that either the market is insufficiently informed on the risk or has only a limited appetite for the risk.

- It is important that the OECD does not use market comparability as a test for whether a risk is appropriate to insure or not. The tests outlined previously as the principles outlined by IAIS should hold regardless of whether the market participates in the risk or not, as commercial drivers can distort the insurance market. Such comparability tests, if used and applied consistently to all licensed insurers would inhibit the development of insurance market - reducing the ability for insurers to innovate and allow mitigation against new and emerging risk types.
- Captives, supported by appropriate data and robust transfer pricing techniques, can also legitimatly 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 taking 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 risks are examples of this).
- Under the existing Solvency II regulation we cannot find any exemption for captives.
- Note: as above: in some regulatory regimes captives are granted some simplification due to the application of the Proportionality Principle.
- Again, the captive should provide “risk” and “capital” to be entitled to an insurance return.
- So same concept as above, there should be a real possibility for the captive to have an underwriting loss, and the captive’s capitalisation should be commensurate with the risks underwritten.
- 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

- Between the insured group and their decision maker and the performance of the captive as an insurance company to follow the policy wording and to exercise precisely the commitment of this policy is a big (Chinese) wall. 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. Regular or frequent submissions are state-of-the-art.
- 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. The final decision is taken by the Board of Directors 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.
- Paragraph 1.65 of Chapter I states the following: “Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (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.”

- 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.

- This governance is already required by insurance regulations from captive (re)insurance companies.

- 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 unnecessary 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 responsible for all decisions relating to the operation of the captive. All risks 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 fronter 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

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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 an arm’s length perspective is whether the service providers are paid the appropriate remuneration of those functions documented in the service level agreements.
- The insured third par ty (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 sums insured the MNE gets access to the reinsurance market which is possible only with an 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 draft.

- 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, which is obviously referred to here, 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 approved by supervisory authorities.
SUBJECT: Public comments on Discussion Draft on financial transactions, which deals with follow-up work in relation to Actions 8-10 ("Assure that transfer pricing outcomes are in line with value creation") of the BEPS Action Plan.

Dear Mr. Tomas Balco,

We are pleased to submit our comments on the Discussion Draft in order to contribute to clarify the application of the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines.

1. 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.

1.1 The guidance provided in the section B of the Discussion Draft is substantially aimed at determining whether a purported loan – or more generically a financial transaction - should be regarded as a loan for tax purposes or as some other kind of payment (i.e., contribution to equity capital), on the basis of the economically relevant characteristics of the transaction, defined in accordance with the indications provided for by Chapter I of the OECD Transfer Pricing Guidelines.

1.2 It appears that such guidance addresses financial transactions carried out within a MNE group performing commercial activity, not taking into consideration particular situations deriving from i) the nature of the lender and ii) the structured operation underlying the financial transaction.

1.3 In this regard, in defining the economically relevant characteristics to identify a financial transaction, a specific kind
of operation usually involving MNE groups carrying out financial activities - e.g. through investment funds - should be considered, in view of the requalifying power held by the Tax Authorities.

1.4 Specifically, we refer to the case of an investment fund resident in Country A which set up several special purpose vehicles ("SPVs") in Country B, to purchase real estate and subsequently rent it to operating companies, by funding the SPVs through dedicated loans (together with banks which provide part of the funding through loans guaranteed by the purchased real estate and by other guarantees).

1.5 The intra-group loan is repaid to the investment fund through the cash flows generated at the SPVs’ level by the rental fees received.

1.6 In application of the guidance at stake and of the relevant elements set forth in order to accurately delineate a financial transaction, it would be possible that the Tax Authorities of Country B may requalify the loan granted by the fund as a capital contribution, disregarding the transaction with the main aim to challenge the deductibility of interest expenses for the SPVs.

1.7 In this case, it should be taken into consideration that the interest paid by the SPVs may not be taxed at the fund’s level in Country A – as a fiscally transparent entity - and therefore no issue in the context of Article 25 of the OECD Model Tax Convention should arise.

1.8 In such scenario, the requalification of the loan and the consequent non-deductibility of interest expenses may negatively impact on the transactions at stake, since the interest expenses repaid by the SPVs become - at the fund level - proceeds to be paid to the investors (whose investments would decrease in value).

1.9 Moreover, it must be considered that domestic rules regarding the interest expenses deduction in force in several OECD countries – such as Italy – have already superseded the concept behind the thin capitalization rule (aimed at limiting the shareholder’s loan) by introducing interest expenses deduction rules, regardless of the shareholder qualification of the lender (accordingly to the provisions of Article 4 of the Directive 2016/1164 "Anti-tax Avoidance Directive").

1.10 In light of the above, it could be advisable to clarify that also for transfer pricing purposes such kind of financial transaction should not be challenged in terms of requalification of debt in equity (but only on the basis of the arm’s length applicable interest rate).
2. **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.

2.1 The amount granted to the MNE by a related party may be higher than the maximum amount that an unrelated party (e.g. a bank) would have been willing to provide to it; in such a case, the exceeding part of the loan may be requalified in contribution to equity capital.

2.2 We believe that it would be advisable to provide guidance on criteria to assess whether an unrelated party would have been willing to finance the MNE. To this end, the Debt Service Coverage Ratio ("DSCR") may help the taxpayer to identify the maximum amount of the loan (comparing the cash flow to the financial commitments assumed in terms of principal and interest subject to repayment during the duration of the loan: a DSCR lower than 1 (i.e., the operating cash flow generated is lower than the financial commitments servicing the debt during the period considered), highlights situations of financial tension with possible difficulties in repaying the debt. If this is the case, the loan may be requalified as contribution to equity capital and consequently, the deduction of the interest may be challenged.

3. **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.

3.1 Due to the general reduction of interest rates in the capital market, situations where there are elements to affirm that a MNE would have not participated in a cash pool arrangement are becoming quiet frequent, because both i) it does not receive any advantage from the cash pool arrangement (e.g. MNE has always been in a surplus position), and/or ii) it has a disadvantage compared to other available financial operations (e.g. MNE is able to obtain better interest rates on the local capital market).

3.2 *Prima facie* such financial transaction in the case at stake may be included in those operations which are carried out in the interest of the MNE group and not in the interest of each MNE;
however, it should be considered that an assessment regarding the benefit obtained in entering in a cash pool arrangement usually involves several aspects which are not taken into consideration during a tax inspection.

3.3 In fact, during a tax inspection regarding a MNE group cash pool arrangement, the main focus is almost always the interest rate applied; however, we consider appropriate that an analysis should be extended to further relevant aspects, as *inter alia* centralization of treasury function, mitigation of country risk of default, immediate availability of funds in case of necessity etc., which may certainly lead to different conclusions.

3.4 Due to the specific nature of a cash pool arrangement, an adequate delineation of the reasons behind entering in such an arrangement should be carried out before considering that a MNE would have not participated in it; we mainly refer to the fact that often an *ex post* evaluation is carried out by the tax inspectors, from which it can be simply concluded that MNE does not have any interest in entering in the cash pool arrangement, while this kind of evaluation are usually performed by the MNE *ex ante*, when no one is able to predict with certainty the trends of its cash flow; e.g., Company A participates in a cash pool arrangement having always a surplus position within the cash pooling from 2010 to 2016; however, in 2017 the reference market suffered a sudden contractions of orders and, consequently, Company A faced with a huge liquidity crisis.

3.5 In this case, it is clear that an audit carried out in 2016 regarding previous years would lead to different conclusion on the interest in entering into the cash pool arrangement, in respect to that reached in case of audit carried out in 2018 regarding 2017.

3.6 We consider that the above mentioned aspects must be considered within a delineation of a cash pool arrangement, since it is clear that such an arrangement cannot be simply compared to other financial transactions, in determining the interest of a MNE to participate in it.

3.7 It must be also noted that, due to the general reduction of the interest rates in the market capital, in some cases MNE group signed agreements with banks generating so called "negative active interest" (e.g. when the bank and the MNE agree a negative spread on a financial index which decreased close to zero): although in such a case, neither the MNE group nor the MNE seem to have any interest in maintaining the cash pool arrangement, it is the evident that further factors (see par. 3.3 above) drive the MNE group and MNE decisions.

* * *
Please feel free to contact us if you have any queries about this letter.

Eversheds Sutherland

Mr. Marco Melisse

Mr. Sebastiano Sciliberto
Dear Sir / Madam,

By means of this letter, we would like to share our comments on the public discussion draft on “BEPS Action 8-10: Financial transactions” (the discussion draft) as released by the OECD on 3 July 2018.

We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions regarding the discussion draft. Our comments in this letter are structured as follows:

- An executive summary of our detailed views and comments.
- A section outlining our general observations, where we strongly encourage the OECD to explicitly exclude MNE groups operating in regulated financial services industries from the guidance contained in the discussion draft. We also discuss the implications of double taxation that may arise, and urge the OECD to address such impact of double taxation for taxpayers. Finally, we address the most fundamental aspects of applying the arm's length principle to test to financial transactions.
- Sections containing our general comments on each section of the discussion draft, as well as provide our specific responses and observations to the various comment boxes found throughout the discussion draft.

This letter presents the collective view of EY’s global international tax network. If you have comments or questions, please feel free to contact any of the persons listed in the Appendix.

Yours Sincerely,

On behalf of EY

Ronald van den Brekel Tom Tsiopoulos
Executive summary

General comments

• We strongly believe that the guidance in the discussion draft should not be intended for MNE groups operating in the financial services industry given the presence of extensive regulatory restrictions that restrict the ability of MNE groups in the financial industry to enter into non-arm’s length transactions, as well as the very different nature of their business models, value chains, and operating activities.

• There needs to be a new, alternative, or supplementary mechanism available to MNE groups, such as a form of arbitration, to resolve disputes in cases where there could be substantial double taxation, especially if all countries cannot accept that capital structures can be addressed under tax treaties and by reference to the arm’s length principle.

• We are also concerned about members of the inclusive framework not reaching a consensus position on the contents of the discussion draft. It would be extremely helpful, for both taxpayers and tax administrations alike, if country observations and positions on the various topics be included in future draft guidance, if the guidance is non-consensus. Ultimate consensus on the final guidance, however, remains critical.

• The discussion draft unnecessarily shifts the main focus from determining an arm’s length price, given the respective form and terms and conditions of a financial transaction, to a delineation exercise, which in the case of financial transactions is likely to result in intensified controversy.

• Tax administrations tend to often deny the deductibility of losses, arising due to the materialization of financial risks assumed. Under the arm’s length principle, such losses should not be disregarded by tax administrations.

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

• We had hoped that the OECD would leave issues of capital structure and the definition of debt and equity to the helpful guidance already contained in the BEPS Action 4 report, and to the more appropriate domain of domestic anti-abuse provisions such as thin capitalization. We do not believe that the arm’s length principle is the appropriate framework for this.

Section C – Treasury function

• It is not entirely clear whether the guidance is primarily aimed at the corporate treasury function on its own, or should be also directly applicable to treasury companies, which usually record profit & loss statements similar to those for financial services companies. MNE groups often deploy a treasury setup with a separate treasury company, whose operations are supported by a corporate treasury team located elsewhere. Even if the treasury function could be characterized as providing a support service to the main value creating operation, this does not mean that an MNE group’s treasury company should be entitled to a stable but routine remuneration. Such separate treasury companies would be often entitled to a risk-related reward.

Section C.1 – Intra-group loans

• The guidance regarding the two-sided perspective and commercial rationality may be too burdensome and open to interpretation, which is likely to result in intensified controversy.

• The evaluation of options realistically available (ORA) should not be intended to create a requirement for taxpayers to document all possible hypothetical ORAs. We recommend the OECD to
reiterate that decisions of the parties should be respected, as long as they are sufficiently documented.

- EY recommends acknowledging that, in the event a borrower defaults on an intra-group loan, if that loan was properly delineated and priced, the lender should be able to deduct the credit loss under the arm's length principle.
- We strongly disagree with the suggestion contained in the discussion draft that quantitative credit rating models do not produce reliable results because they may be subjective.
- Unless adopted as a safe harbor, EY strongly recommends against any requirement for taxpayers to apply the MNE group credit rating, or for taxpayers being required to reconcile group member credit ratings to the MNE group’s credit rating.

Section C.2 - Cash pooling

- We strongly recommend the OECD to acknowledge that access to liquidity should not be considered a free service.
- The guidance should reflect that “netting benefit” is associated with the assets and liabilities mismatch, and that the corresponding liquidity risk arising out of this mismatch, as opposed to a presumption that the “netting benefit” is simply derived from offsetting debit and credit positions.
- Guidance regarding the characterization of netting benefits is welcomed, when allocated to cash pool members and/or other parties, including whether these could be seen as additional payments of interest, guarantee fees, or as having some other character.
- There needs to be symmetric treatment between the allocation of netting benefits and the assumption of losses that may arise upon the materialization of risks assumed.
- We recommend to emphasize that cash pool arrangements can be set-up in different ways; the use of “one-size-fits-all” approaches when analyzing cash pool transactions should be discouraged.
- The suggested approach to transfer pricing documentation will create undue and unnecessary administrative burden on taxpayers

Section C.3 - Hedging

- To the extent that as part of the delineation exercise it is determined that the group treasury company has control over and the financial capacity to bear the respective risks, then the centralized hedging function should be viewed as providing more than merely an intra-group service.

Section D - Financial guarantees

- We believe that the realistic alternatives standard requirement as outlined in the discussion draft may be unnecessarily cumbersome for taxpayers, increasing administrative burden. Instead, we believe that it may be more appropriate to select the most appropriate method based on the facts and circumstances of the transaction.

Section E - Captive insurance

- The draft contains six hallmarks of what can be expected of an independent insurer. Some of these hallmarks describe intra-group reinsurance in the insurance industry and not all of the hallmarks are relevant to the accurate delineation of captive insurance arrangements. In our view the hallmarks need to be significantly reworked to be relevant to captive insurance.
- The guidance should define “control” in the context of the assumption of insurance risk.
1. General comments to the discussion draft

OECD should make it explicit that the guidance is intended to target MNE groups operating in non-financial services industries

We strongly believe that the guidance in the discussion draft should not be intended for MNE groups operating in the financial services industry given the presence of extensive regulatory restrictions that restrict the ability of MNE groups in the financial industry to enter into non-arm's length transactions, as well as the very different nature of their business models, value chains, and operating activities, where the majority of profits are primarily derived from financial transactions. We encourage the OECD to explicitly exclude MNE groups operating in the financial services industry from the guidance contained in the discussion draft, and subsequent discussion drafts and final guidance on this topic that will be issued. Attempting applying the guidance contained in the discussion draft to MNE groups operating in the financial services industry would lead to non-arm's length results in many cases, unresolvable disputes, and would create conflicts with existing regulatory restrictions. Key observations underscoring the need to exclude MNE groups operating in the financial services industry include:

- The financial services industry is subject to significant regulation on acceptable capital structures, and may not have the flexibility to conform to additional restrictions for tax purposes. Regulators already require financial services companies to maintain adequate capitalization at a legal entity level and have clear guidance on various forms of debt, equity and other funding that can be relied upon. Applying the guidance in the discussion draft would result in conflicts between non-tax and tax rules, increasing the administrative burden on MNE groups in this industry.

- Regulators impose requirements for sufficient substance (both capital as well as mind and management) and local control of risks. A further layer of requirements for tax purposes would be at best redundant and at worst contradictory. Regulators are unlikely to accept retroactive changes to the income of regulated entities based on tax authority challenges to the substance of transactions that were respected by regulators.

- The discussion draft implicitly suggest that assuming financial risks such as credit risk, foreign exchange risk, liquidity risks, interest rate risks, etc. are ancillary to an MNE’s business and can be separated from an MNE’s core operations. For financial services companies, this is not true; the primary business of a financial services company is to assume, manage and invest in such risks. Attempting to apply the guidance in the discussion draft to financial services companies would lead to non-arm's length results in areas concerning the remuneration of these core risks

- Implicit support in the context of MNE groups operating in the financial services industry is materially different from other industries, and has very different considerations. Financial services companies have significant restrictions on their ability to “bail out” other group members under regulatory restrictions, e.g., regulations preventing a bank from bailing out a failing bank holding company and resolution plans that force a particular path to insolvency. Financial services companies have a very strong incentive to bail out affiliates if it can be accomplished within the bounds of regulation, because the reputational damage to a financial services company of allowing any affiliate to become insolvent could easily trigger a group-wide insolvency.
The elimination of double taxation

We are greatly concerned on the overarching implications of the guidance in the discussion draft and the lack of consensus as it relates to double taxation. Transfer pricing for financial transactions is a very important topic that is relevant for almost all MNEs. Currently, many diverging country practices in relation to such transfer pricing are observed.

Our detailed comments on the application of the arm’s length principle as it relates to capital structures are outlined further in Section B. However, we are concerned that if all countries cannot accept that capital structure can be addressed under tax treaties, and by reference to the arm’s length principle, then there needs to be a new, alternative, or supplementary mechanism available to MNE groups, such as a form of arbitration, to resolve disputes in cases where there could be substantial double taxation. This may require broader attention from the OECD, including the involvement of OECD Working Party No. 1.

Building on this, we are also concerned on members of the inclusive framework not reaching a consensus position on the contents of the discussion draft. This relates both to the guidance on capital structure and to the other guidance in the discussion draft. It would be extremely helpful, for both taxpayers and tax administrations alike, if country observations and positions on the various topics be included in future draft guidance, if the guidance is non-consensus. As long as no consensus has been reached, for transactions between two inclusive framework countries, one might consider respecting the transfer pricing as applied by the taxpayer, as long as it fulfills the requirement of one of the two countries. Ultimate consensus on the final guidance, however, remains critical.

Finally, to avoid any double taxation due to timing inconsistencies of when countries may adopt any ultimate guidance contained on this subject, we encourage the OECD to allow taxpayers a reasonable grace period to adapt their policies, if necessary, especially considering that taxpayers have multiple stakeholders that need to be consulted, and finally approve, of any change in policy relating treasury, financing, and capital structures. On this topic, we also strongly encourage the OECD to provide clear instruction on the entry into force of any new OECD guidance, and to advise against the retroactive application of any such ultimate guidance on this topic.

Respecting the form and terms and conditions of a financial transaction

The BEPS Action 4 report\(^1\) states that an arm’s length test “…can be resource intensive and time consuming for both taxpayers and tax administrations to apply…” and that its outcomes “…can be uncertain”. However, the guidance included in the discussion draft on the accurate delineation of financial transactions, including the identification of commercial and financial relations between the parties, as well as analyzing the terms and conditions of financial transactions, appear to be even more burdensome and open to interpretation. In our view, the discussion draft unnecessarily shifts the main focus from determining an arm’s length price, given the respective form and terms and conditions of a financial transaction, to a delineation exercise, which in the case of financial transactions is likely to result in intensified controversy.

In particular, there are vast possibilities as to how to structure respective types of financial transactions. The proposals contained in the discussion draft regarding delineation of financial transactions list too many areas for hypothetical exploration with little practical applicability. Instead, EY recommends respecting the contractual terms of a financial transaction for transfer pricing purposes, as long as an arm’s length price can be established using reliable comparable transactions.

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\(^1\) Paragraph 12 of the BEPS Action 4 report
and the decisions of the related parties are sufficiently documented, and only allowing the re-characterization of financial transactions in exceptional and rare cases.

**Accepting losses arising due to materialization of financial risks**

Based on our experience, tax administrations tend to often deny the deductibility of losses, which may arise due to financial risks materializing (especially credit and foreign exchange risk, as well as liquidity risk). In our view, it would be relevant to explicitly recognize that parties, when acting under arm’s length conditions, are found to be entitled to (ex-ante) risk-related returns, that they may also suffer actual (ex-post) losses arising as a result of the materialization of financial risks. Subsequently, under the arm’s length principle, such losses should not be disregarded by tax administrations.
2. Section B - Interaction with the guidance in Section D.1 of Chapter I

General comments:

- We had hoped that the OECD would leave issues of capital structure and the definition of debt and equity to the helpful guidance already contained in the BEPS Action 4 report, and to the more appropriate domain of domestic anti-abuse provisions such as thin capitalization. Notwithstanding the Article 9 commentary of the OECD Model Tax Convention (the OECD MTC) language mentioned in paragraph 5, the arm’s length principle as an analytical framework does not really provide useful insights on this matter, as discussed below. In addition, and for the same reason, we do not think that this will prove to be an area of consensus, nor should it. We were concerned to read that “the concepts of Chapter I, in particular the accurate delineation of the actual transaction, may relate to the capital structure of an entity within an MNE group.” We do not believe that the arm’s length principle is so elastic. We question whether a multinational’s capital structure can be evaluated by subjective considerations of ‘what unrelated parties would do.’

- In particular, we believe that the OECD is conflating two distinct questions: firstly, the question of whether particular funding transactions should be characterized as debt or as equity for tax purposes, and secondly, the question of accurately delineating the particular terms and conditions of debt funding transactions (e.g., overnight commercial paper versus 30-year term debt, the amount of senior versus the amount of subordinated debt, etc.). Both of these questions fall under the broad framework of capital structure (i.e., correspondingly debt versus equity, and debt structure itself), but we think that they should be addressed separately in the discussion draft. In what follows, we describe our views on the appropriate guidance for questions of debt versus equity, while the accurate delineation of debt transactions is covered in our response to box B.2.

- We understand that part of the motivation for framing capital structure issues within the framework of Article 9 is to facilitate access to MAP and relief of double taxation. Unfortunately, in practice such relief would be undermined by the lack of a principled basis for agreement, since there would be a lack of principled basis for the underlying initial adjustment. Instead, we think that a better approach would be for treaty partners to agree to thin capitalization rules as long as they are within the parameters of the BEPS Action 4 report.

- The issue of debt and equity is raised in other parts of the MTC, and it would be important that a broader treaty perspective is applied, which would require the input of Working Party No. 1. The definition and treatment of dividends and interest are determined in Articles 10 and 11 of the MTC, which gives deference to the character determination of the source country. The OECD has addressed this in its prior BEPS work, and we do not think that it can be improved upon. In fact, we fear that the prior work will be significantly undermined by attempting to super-impose an arm’s length framework to capital structure.

- The document asks whether there is an ‘arm’s length’ capital structure. We think that this is an impractical and unanswerable question. As we have alluded to above, “capital structure” is far broader than simply the analysis of debt funding versus equity funding. Two enterprises in the same industry may choose to fund their operations with a different mixture of equity, preferred equity, subordinated debt, secured debt, revolving credit facilities, commercial paper, repurchase agreements, customer and trade payables, borrowed assets, asset-backed financing such as factoring or securitizations or other forms of financing unique to their particular situations. Each component of the enterprise’s funding is interdependent with the other components and exposes the enterprise to a unique mixture of risks and rewards and the subjective preferences of management and shareholders. It is difficult to see how it would be practically possible to assess whether a particular capital structure is ‘arm’s length’ or not. In fact, one may observe a broad
spectrum of capital structures adopted by entities, even within a single industry. As such, the application of the industry average and/or the respective MNE group’s capital structure as a point of reference in our view should be discouraged,

Further, the fact that capital structure optimization depends on the tax treatment of debt versus equity suggests that relying on the arm’s length standard to analyze capital structure would be inherently circular. Here again we do not think that the arm’s length principle provides an appropriate framework, and certainly not a better framework than domestic rules and their interaction with existing treaty provisions (e.g., Articles 10 and 11 of the MTC).

We think that it is very important for the OECD to reach clear consensus on this basic issue before attempting to provide separate guidance tailored to “those countries that use the accurate delineation under Chapter I of the OECD Transfer Pricing Guidelines (the TPG) to determine whether a purported loan should be regarded as a loan for tax purposes,” to the exclusion of other countries who quite rightly do not believe that this is appropriate under the arm’s length principle. Bifurcated guidance is never a good idea, and will simply lead to unresolvable disputes, and broader treaty inconsistencies.

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.

We understand that part of the motivation for framing capital structure issues within the framework of Article 9 of the MTC is to facilitate access to MAP and relief of double taxation under Article 25 of the MTC. Unfortunately, in practice such relief would be undermined by the lack of a principled basis for agreement, since there would be a lack of principled basis for the underlying initial adjustment under Article 9 of the MTC.

Instead, we think that a better approach would be for treaty partners to agree to thin capitalization rules as long as they are within the parameters of the BEPS Action 4 report. Irrespective of whether domestic legislation exists as to thin capitalization, once this issue has been resolved for non-transfer pricing purposes, then transfer pricing principles should apply to the determination of the intra-group loan rate.

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.

Paragraph 17 presents an example in which a company (Company B) receives funding for its business activities that, based on the financial projections, would not generate enough income to service the funding required to undertake the business activity. The example concludes that that an unrelated party would not have been willing to provide such a loan to Company B, and that the transaction would be more accurately delineated as a smaller loan with otherwise similar terms.

First, introducing a criteria that looks at the maximum amount an independent lender would be willing to advance to a company would in the first instance require one to determine what type of lenders would be considered in this assessment. For example, venture capitalist or mezzanine financiers are willing to tolerate (volume) risks that no mainstream bank would accept.

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2 Paragraph 10 of the discussion draft.
Second, we note that loans are not required to be fully paid off from current operations in order to be considered valid. Unrelated parties commonly incur debt that they expect to service and refinance over time with no intention of ever decreasing their leverage. For example, the business may be a strategic investment that is expected to pay off over a much longer term than 10 years, with the loan expected to be refinanced in the future. We suggest that the OECD clarify that planning to refinance the debt in a future period should be considered as a possible factor when delineating the transaction, under the principles outlined in Section 2 of Chapter I of the TPG.

Furthermore, the suggested test with regard to the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow is also a subjective one, as two companies, with identical operations, under the same facts and circumstance, may adopt two completely different capital structures. In reality, the amount and structure of debt cannot be determined by the application of a simple mathematical formula. Instead, selection of the appropriate capital structure is part of the company’s management decision making process, which depends on many quantitative and qualitative factors, including the risk appetite of the company itself and its shareholders, the management’s long-run strategic plan, the manner in which the management intends to grow the company, etc. We believe that such a decision process cannot be replicated by the application of the arm’s length principle.

Additionally, we strongly believe that it is neither reasonable nor possible to use the arm’s length standard to assess something as multi-dimensional as a company’s capital structure. In situations such as the one described in paragraph 17, it may be possible to conclude that the arrangement between the parties is commercially irrational and re-characterize the debt as a different form of funding. However, we think re-characterization should be strictly limited to instances where commercially irrational behavior is observed.

The broad and overly subjective guidance described in paragraph 17 will make transfer pricing more cumbersome and more complicated than necessary by introducing a line of thinking that is too subjective to be able to be applied consistently and transparently, which we believed not to be the original intention of the OECD (taking into account the guidance provided as part of the BEPS Action 4 report).

**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 think that the characteristics of the transaction are most relevant in providing a basis for the comparability in pricing a financial transaction, rather than providing for a basis for re-characterizing the transaction and/or “re-constructing” its terms and conditions. In any event, in our view it would be highly important to clarify that the accurate delineation of the actual transaction should be an exercise performed from the time perspective of the transaction’s effective date, and not a dynamic test that can be continuously re-applied over the lifetime of a financial transaction.

Factors that are material to determination of an intra-group lending rate may include:

- Term;
- Fixed or floating rates;
- Embedded options (e.g., prepayment options, pay on demand options, convertibility, etc.);
- Type of debt (i.e., term loan, uncommitted credit facility, committed credit facility, revolving line of credit);
Repayment type (e.g., bullet repayment, amortized term loan, flexible repayment)

Interest deferral features;

Borrower’s credit rating (subject to considerations regarding group credit rating) and credit quality of the transaction;

Currency(ies) used;

Leverage and collateral (if not accounted for in credit rating analysis);

Guarantees;

Local sovereign risk (if not accounted for in credit rating analysis); and

Rank (e.g., seniority, subordination, etc.,).

In addition, often the broad industry sector (e.g., non-financial sector corporates, private equity, etc.) and the loan purposes (e.g., working capital, project finance, refinancing, merger / acquisition) may be relevant, too.

Finally, the lender should generally be allocated all of the financial risks associated with lending funds, (e.g., credit risk, market risk, liquidity risk, etc.).

We also note that once the financial risks have been allocated to the lender, such risks may materialize, causing the lender to suffer losses in the future.

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.

Risk free rate of return

This category should be noted as an unusual situation and not a typical analysis for tax administrations to engage in. Applying the risk free rate of return to price financial transactions can be considered a hybrid, or compromise, between respecting the transaction under the arm’s length standard and disregarding it outright. Such “compromise” will only lead to increased tax controversy and ultimately lead to unsatisfactory results for all stakeholders. Assuming that in certain cases applying the risk free rate of return is determined to be appropriate, then in these cases the rate that should be applied should be the yield of an investment in the functional currency of the lender, with no default risk over the same time-frame as the investment. This is could be estimated as the highest rated debt obligation denominated in the functional currency of the lender, with comparable term and time of issuance; which will often but not always be issued by the local sovereign.

Risk adjusted rate of return

The concept of applying a risk adjusted rate of return was discussed in the 2015 BEPS final reports on Actions 8-10 related to funding, however the work in this remains to be finished, specifically regarding the topic of “what is the appropriate ex post return to a funder who controls its funding risk?” Paragraph 6.62 of the TPG states “The contractual arrangements will generally determine the terms of the funding transaction, as clarified or supplemented by the economic characteristics of the transaction as reflected in the conduct of the parties.” An accompanying footnote to paragraph 6.62 of the TPG states: “Further guidance will be provided on the economically relevant characteristics for determining the arm’s length conditions for financial transactions, including when the funding is used for project finance, in particular investments in the development of intangibles. This work will be undertaken in 2016 and 2017.”
In our view, paragraphs 12-21 of comment box B.4. (relating to risk-adjusted rate of return) do not yet adequately address this issue. The guidance currently contained in Chapter I and Chapter VI of the TPG, relating to funding, describes scenarios on a much broader scale, as compared to funding transactions in the form of a loan. These chapters also cover funding that is associated with putting capital at risk, specifically relating to the activity that is funded. The two alternative forms of funding, and the nature of the risks associated with them, are fundamentally different.

There are two types of funding: direct funding (whose return is a direct function of the success or failure of the funded activity, and is analogous to an investment), and indirect funding (whose return is a function of the ability of the recipient to pay back the funds, and is analogous to a loan). There are also two types of funders: those who control their funding risk (and accordingly are entitled to a risk-adjusted anticipated return), and those who do not control their funding risk (and accordingly are entitled to a risk-free return on their investment). Finally, there are also two types of returns: ex ante (anticipated) returns and ex post (actual) returns. The following table illustrates these scenarios.

<table>
<thead>
<tr>
<th>Funder controls funding risk</th>
<th>Indirect funding (analogous to loans)</th>
<th>Direct funding (analogous to equity-type investments)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ex ante return</td>
<td>Ex post return</td>
<td>Ex ante return</td>
</tr>
<tr>
<td>Ex post return</td>
<td>Ex post return</td>
<td>Ex post return</td>
</tr>
<tr>
<td>(1) Appropriate risk-adjusted return: arm’s length interest rate</td>
<td>(2) Arm’s length interest rate, less effects from materialized risks (e.g. borrower’s ability to pay)</td>
<td>(3) Appropriate risk-adjusted return</td>
</tr>
<tr>
<td>(4) Variable return depending on success or failure of funded activity</td>
<td>(5) Risk-free return</td>
<td>(6) Risk-free return</td>
</tr>
<tr>
<td>(7) Risk-free return</td>
<td>(8) Risk-free return</td>
<td></td>
</tr>
<tr>
<td>Funder does not control funding risk</td>
<td>(5) Risk-free return</td>
<td>(6) Risk-free return</td>
</tr>
<tr>
<td>Ex ante return</td>
<td>Ex post return</td>
<td>Ex post return</td>
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<td>Ex post return</td>
<td>Ex post return</td>
<td>Ex post return</td>
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</tbody>
</table>

The OECD needs to acknowledge, if not provide guidance on, each of boxes 1 through 4 in the table above. Currently, the discussion draft and the guidance contained in the TPG do not clearly differentiate between the different types of funding, and leaves many areas unclear. For example, the OECD has provided little guidance on what an appropriate risk-adjusted return is. Most importantly, we recommend that the OECD acknowledge that the funders (including those providing loans) may lose money; currently the guidance and examples provided in the discussion draft assume that the ex post return is always positive and is reasonably similar to the ex ante return.

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.

As discussed in our response to question box B.4, assuming that in certain cases applying the risk free rate of return is determined to be appropriate, then in these cases the rate that should be applied should be the yield of an investment in the functional currency of the lender with no default risk over the same time-frame as the investment. Typically, this is best estimated as the highest rated debt obligation denominated in the functional currency of the lender, with comparable term and time of issuance; which will often but not always be issued by the local sovereign.

In currencies where the only debt securities available carry a high amount of default risk, the risk-free rate should be approximated following market practice in that currency at that time, which will vary.
**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.

Applying the risk free rate of return to price the contribution of a funder who is not entitled to more than a risk free rate of return should not impact the deduction of the interest at the level of the borrower. Regarding the interaction with Article 25 of the MTC, we feel that in this example, the issue should be resolved between the jurisdiction of the funder and the jurisdiction of the party exercising control over the risk, if either of these jurisdictions make an adjustment. The jurisdiction of the borrower should allow an arm’s length deduction.

### 3. Section C – Treasury function

General comments:

- It is not entirely clear whether the guidance provided in paragraph 37 through paragraph 46 of the discussion draft is primarily aimed at the corporate treasury function on its own, or should be also directly applicable to treasury companies, which usually record a number of financial assets and liabilities on their balance sheets, resulting in profit & loss statements similar to those for financial services companies, and reflecting the underlying risk profile associated with the mix of financial assets and liabilities.

- Specifically, MNE groups often deploy a treasury setup with a separate treasury company (similar to the one described in Example 2 of the discussion draft), whose operations are supported by the corporate treasury team (either at the MNE group’s headquarters or other affiliates). As such, it would be helpful to clarify if the initial guidance in Section C was meant only for the corporate treasury activities (i.e., services), or both the corporate treasury function and separate treasury companies. In our view, such clarifications are relevant in the context of risk allocation under the TPG, especially given that situations described in paragraph 1.93 and 1.94 of the TPG often apply in light of the activities undertaken by separate treasury companies.

- In particular, we are of the view that even if the treasury function would be characterized as providing a support service to the main value creating operation (as suggested by the discussion draft), this does not per se mean that an MNE group’s treasury company(ies) should be entitled to a stable but routine remuneration. Rather, such separate treasury companies would be often entitled to a risk-related reward, whilst at the same time accepting the possibility of the financial risks materializing resulting in losses.

- With respect to the overall treasury function within an MNE group, we believe that to the extent the delineation of the transaction exercise determines that the MNE group’s headquarters entity and/or group treasury company demonstrates risk control functions, and also has the financial capacity to bear the respective risks (e.g., by putting sufficient capital at risk), then such separate treasury companies could be characterized as more than mere providers of an intra-group service and should be compensated for the assumption of the risk.

- This is relevant on a broader scale, including affiliates which manage hedging and/or cash pooling activities, amongst other activities. The functional profile of an affiliate performing treasury activities should not be considered in isolation from each type of financial transactions assumed by that affiliate (e.g., term loans, cash-pooling, hedging, etc..) and the related risks, but rather be a holistic analysis which may conclude that a separate treasury company is more akin to an external
financial institution, with affiliates interacting with the treasury company as they would with an independent bank, ultimately indicating that it should receive a remuneration above a routine service provider (which also may result in losses).

3.1. Section C.1. - Intra-group loans

General comments:

- The guidance regarding the two-sided perspective and commercial rationality may be too burdensome and open to interpretation, which is likely to result in intensified controversy. Given that as part of the BEPS deliverables (the Action 4 report), the OECD considered non transfer pricing measures as the primary tool to combat excessive interest payments, the proposals contained in the discussion draft regarding delineation of intra-group loans list too many areas for hypothetical exploration with little practical applicability. Instead, EY recommends respecting the contractual terms of intra-group loans for transfer pricing purposes, as long as an arm’s length range of interest rates can be established using reliable comparable transactions, and the decisions of the lender and the borrower are sufficiently documented.

- The evaluation of options realistically available (ORAs) should not be intended to create a requirement for taxpayers to document all possible hypothetical ORAs. Rather, the intention is to consider and document the commercial rationale behind specific terms and conditions (including debt amount) of a loan to be provided to a respective borrower. We recommend the OECD to reiterate that decisions of the parties should be respected, as long as they are sufficiently documented.

- EY recommends acknowledging that, in the event a borrower defaults on an intra-group loan, if that loan was properly delineated and priced, the lender should be able to deduct the credit loss under the arm’s length principle. The same should also apply with respect to interest rate risk, foreign exchange risk, and liquidity risk (when applicable).

- There are significant differences between generic corporate debt finance and more specific financing instruments such as project finance, structured finance, or real-estate finance, which are relevant when applying an arm’s length test. EY recommends clarifying the main differences and their impact on determining an arm’s length price.

- For avoidance of doubt and in order to prevent erroneous outcomes, it would be important to acknowledge that a credit rating assessment should reflect the consolidated perspective of the borrower (i.e., the legal entity itself and its direct and indirect subs). In this respect, the OECD may also want to comment on the concept of structural subordination.

- With respect to credit ratings, we feel that any presumption that borrowers would always pledge suitable collateral is not correct.

- We also strongly disagree with the suggestion contained in the discussion draft that quantitative credit rating models do not produce reliable results because they may be subjective. These quantitative credit rating models are developed by independent credit rating agencies, primarily for commercial (and not transfer pricing) purposes. Such models are also used by independent parties (including banks and financial institutions), therefore representing market practices.

- Unless adopted as a safe harbor, EY strongly recommends against any requirement for taxpayers to apply the MNE group credit rating, or for taxpayers being required to reconcile group member credit ratings to the MNE group’s credit rating.

- Finally, we recommend that the OECD acknowledge that official credit ratings assigned by independent rating agencies may differ between agencies. It would be important to recognize that a
Credit rating assessment is not an exact science, hence an outcome of a credit rating analysis in an intra-group context may also reflect a range of credit ratings, instead of just a single rating.

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

In practice, situations where MNEs have fully decentralized treasury structures can be considered rare. There are instances, of course, where a decentralized treasury function may allow for a certain level of autonomy for affiliates of the MNE group to manage and execute (within boundaries) its own financing strategy. Similarly, it can be usual in such instances, that final authorization is performed by the management of the legal entity for legal and corporate governance/liability reasons. However it is almost always the case that a central treasury function sets the group's funding policy and acts as the primary decision-maker.

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.

We strongly feel that such a rebuttable presumption deviates from the arm's length principle. This rebuttable presumption is likely to not be true outside of a few, rare instances. Based on independent rating agency guidance, the independent credit rating is the preferred approach under arm's length conditions. Further, banks generally do not treat individual members of an MNE group as sharing the group credit rating. We feel that introducing such a rebuttable presumption is not appropriate, as it only creates additional administrative burden for the taxpayer to bear the burden of proof to demonstrate that the credit rating of a given group member is not the same as the MNE group credit rating, unless such presumption is aimed to merely serve as a safe harbor. EY therefore considers that if taxpayers properly address implicit support considerations (where applicable), there should be no other presumption that group member credit ratings be equivalent to those of their MNE group.

- 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.

We similarly are of the view that introducing a rebuttable presumption that an independently derived credit rating at the MNE group level be adjusted to conclude the credit rating for each group member will only introduce additional administrative burden to taxpayers, unless such presumption is aimed to merely serve as a safe harbor. Any requirement for taxpayers to reconcile the estimated independent credit rating estimate of a member to its MNE group credit rating is not relevant for a credit rating analysis, and therefore would impose an unnecessary administrative burden to the taxpayer. For example, a financially distressed group member that is likely to be liquidated in the future should not have its credit rating associated with the MNE group credit rating, where its independent rating would likely be equivalent to its standalone rating.

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Independent credit rating refers to the estimated parent-implied credit rating of an entity (e.g., its standalone credit rating, adjusted, if necessary, due to the implicit support considerations).
In some cases, such as a highly strategically important entity that occupies a critical place in a MNE’s business strategy, a direct link between the group rating and the entity rating may be appropriate. However, such linkage should be evaluated on a facts and circumstances basis according to the guidance available from rating agencies and evidence of how independent lenders such as banks have factored in implicit support in similar facts and circumstances.

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.

We feel that the use of a combination of the bottom-up (using stand-alone credit ratings) and the top-down approach (using the group credit rating as a starting point), dependent on the specific facts and circumstances, is in line with the application of the arm’s length principle. These approaches reflect the best practices followed by rating agencies, banks and other participants in the financial markets.

The use of an MNE group credit rating for purposes of tax certainty and tax compliance to determine the credit rating of a borrowing MNE, could be adopted as a safe harbor.

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.

In those situations where it is relevant, we suggest the MNE group rating be defined as the credit rating that a lender would consider for debt that is guaranteed by all members of the MNE group, which is usually the same as the rating of the parent company. In the absence of a publicly-available rating, a group credit rating may be determined by:

- Considering non-public ratings; for example, a bank or other third parties may have assigned a MNE group an internal rating as part of a private bank loan;
- If the group is not rated, but it has issued debt that is rated, the debt rating may be adjusted to arrive at a group rating;
- Considering the implied credit rating of the MNE group, by assessing what credit rating corresponds to the rate at which the MNE group can borrow from third parties (we note this method is not always applicable, as some MNE groups do not have any external debt with terms and conditions that make rating estimation reliable);
- Synthetic credit rating of the MNE group, based on models used by banks or credit rating agencies and based on the consolidated financial statements of the MNE group.

The reliability of these methods will depend on the data available and assumptions made and is likely to vary from case to case.

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

We believe a stand-alone credit rating of an MNE group member should be defined consistently with how credit rating agencies define “stand-alone credit profile,” namely, as the rating a lender would consider for a loan to that stand-alone entity of an MNE under the assumption that the stand-alone entity would not receive any support from affiliates within the MNE group.

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.

We are of the view that determining and measuring the impact of implicit support should be based on an analysis of how third parties treat implicit support in cases with similar facts and circumstances.
We do note that there are various methodologies available for assessing implicit support. For example, credit rating agencies have developed extensive, detailed methodologies for assessments of implicit support; these models depend on both quantitative and qualitative inputs and are highly sensitive to subjective judgment. Furthermore, guidance from different rating agencies will not align in every case. In contrast to the views of rating agencies, evidence suggests that in many cases banks may disregard implicit support entirely. Nonetheless, we are of the view that a structured, transparent and consistently applied method of assessing the level of implicit support available (where the facts and circumstances determine that implicit support is available), during a credit rating analysis is in line with application of the arm’s length principle, and thus should be respected by tax administrations.

Furthermore, there are many jurisdictions, including OECD member states, which have legislation or case law which does not recognize the implicit support concept, and instead favor the stand-alone credit rating approach. Similarly, many countries have thin capitalization rules that consider only the borrower on a stand-alone basis. We encourage the OECD to provide guidance on how to deal with situations where different approaches for determining credit ratings may be applicable by separate tax jurisdictions.

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

EY generally agrees with the commentary included in paragraph 70 of the discussion draft. It should be stressed that the specific facts and circumstances of the taxpayer is critical in determining if implicit support would influence a third party lender. If implicit support is deemed to exist based on the facts at hand, then a structured, transparent and consistently applied method of assessing the level of implicit support during a credit rating analysis is in line with application of the arm’s length principle, and thus should be respected by tax administrations.

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

- the role of credit default swaps (CDS) in pricing intra-group loans;

We feel the role of CDS instruments in pricing intra-group loans should be limited. There are other instruments in financial markets that may provide better results as they are more analogous to intra-group loans, such as yields on comparable bonds which are more widely available in the public domain. Given that the CDS market is also prone to a high degree of speculation and volatility, and subject to price distortion arising from counterparty risk and other market imperfections, we feel the role of CDS should be limited to cases where the analysis is used only as a secondary or corroborative method, rather than the primary pricing approach.

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

We acknowledge that economic models can be helpful means in certain environments, e.g. if market value of assets are available and a model used by third parties such as private equity or real estate lenders can be applied reliably. However, we feel that in general the use of economic models to price intra-group loans should be limited. Again, as we highlighted in our reply to the first bullet point, there are generally instruments which are more readily available to reliably price intra-group loans, with less administrative burden on taxpayers to develop complex economic models, and more reliant on actual transactions.

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

The most generally applicable comparable transaction to intra-group loans would be comparable bond and marketable note transactions. Other financial transactions, or instruments, which may be considered as realistic alternatives (subject to the performance of a comparability analysis, and adjustments where necessary) to price intra-group loans could consist of commercial paper, repo agreements or other forms of secured financing, wholesale deposits and bank loans (especially if it is possible to confirm they are not tainted by subsidized “relationship lending”).

Please note that we understand the OECD’s intention in this section is to illustrate which transactions may be comparable to intra-group loans. The OECD could consider clarifying, specifically in paragraphs 85 and 86 of the discussion draft, that the intention is to determine comparable transactions, as the use of the term “realistic alternatives” may confuse both taxpayers and tax administrations and imply that the transaction could be re-characterized to a realistic alternative, which we feel should not be the intention of this section.

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.

An MNE group’s average interest rate paid should not be considered as an internal CUP. The comparability factors contained in Chapter I of the TPG would not be fulfilled when comparing an MNE group’s average interest rate paid on its external debt, to a potential intra-group financing transaction.

There are situations in which external financing costs could serve as the starting point for adjustment calculations to take into account differences in comparability. After taking into account comparability of an MNE group’s external debt to an intra-group financing transaction, average external interest rate paid could be considered a reasonable proxy or at least a useful corroborating analysis, with due consideration to the fact that significant adjustments may be needed based on differences in term, currency, level of seniority and market conditions during the period the debt was issued.

3.1. Section C.2 – Cash pooling

General comments:

- We strongly recommend the OECD to acknowledge that access to liquidity should not be considered a free service.
- The proposed guidance on the allocation of synergy benefits seems to be based on the presumption that the “netting benefit” (reflecting the spread between the borrowing and lending positions), is simply derived from the savings made from offsetting debit and credit positions. The guidance should reflect that “netting benefit” is associated with the assets and liabilities mismatch, and the corresponding liquidity risk arising out of this mismatch. Specifically, on one hand, the excess cash balances of depositing participants are typically structured as very liquid positions, available to the depositors on demand, at any time. On the other hand, borrowing participants have a continuous access to overdraft in the pool (used primarily for working capital purposes) and may remain indebted over a longer period of time (similar to a situation if they had credit facilities, including revolving lines of credits, with third party banks). The cash pool leader usually provides (implicit) commitment to lend funds to group entities that are in a cash deficit position, and at the same time it does not have any payable on demand options. Also, the cash pool loans do not carry any fixed repayment dates, which creates significant asset and liability mismatches in terms of the maturity profile, resulting in an increased spread. However, if the cash pool leader’s assets and liabilities (i.e., credit and debit balances of group companies) were matching in terms of maturity (all other things
being equal), the “netting benefit” would be remote or even non-existent. In other words, the mere offsetting of debit and credit positions does not result in a significant spread, unless the maturity profile (and potentially other characteristics) of assets and liabilities are not matched. As such, the so-called “netting benefit” reflects the risk-related return (liquidity and credit risk premium), not a group synergy. As such, netting benefits should be allocated to parties assuming such risks.

- We would also welcome the OECD to provide guidance regarding the appropriate characterization of netting benefits, if allocated to cash pool members and/or other parties, including whether these could be seen as additional payments of interest, guarantee fees, or as having some other character, since this can have important consequences from a corporate tax and withholding tax perspective.

- We recommend that the OECD acknowledge that there needs to be symmetric treatment between the allocation of netting benefits and the assumption of losses that may arise upon the materialization of risks assumed. We think this is critical, as the guidance in the discussion draft implicitly treats all the savings that would be earned by a cash pool as a benefit without considering the risks that are involved and the potential for losses (e.g., if cash pool depositors all need to withdraw funds, a group entity defaults, a bank defaults, the money market fund, where the cash pool leader invested excess funds, loses value, etc.).

- We recommend the OECD to emphasize that cash pool arrangements can be set-up in different ways and for different purposes, so the use of “one-size-fits-all” approaches when analyzing cash pool transactions should be discouraged. For example, a set-up where there are only participants with excess cash and a cash pool leader acts as an asset manager is different from a situation where a cash pool leader operates as an internal bank, which borrows and lends funds to MNE group members.

- If paragraph 108 of the discussion draft implies that the actual returns of the cash pool leader and cash pool participants should be determined and documented in a taxpayer’s local file, we feel this may create an undue and unnecessary administrative burden to taxpayers.

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.

Generally speaking, we concur the guidance contained in the discussion draft which emphasizes that each cash pool needs to be analyzed based on its own facts and circumstances, following the performance of a detailed functional and risk assessment. However, we feel that the current guidance in the discussion draft, and especially the examples mentioned in paragraphs 114 through 123, need to be revisited to underscore the importance of firstly performing a detailed functional and risk analysis when it comes to analyzing cash pool structures. These two examples illustrate opposite extremes of a cash pool leader’s functional and risk profile. In practice, many cash pooling structures will fall in between the two examples illustrated in the guidance. Following a detailed functional and risk analysis indicating so, we would agree that a cash pool leader may (in certain circumstances) be appropriately characterized as a provider of services to the wider group including when the risks are effectively borne by other entities of the MNE group, as in Example 1. However in practice we have observed that it is unusual for a cash pool leader to purely perform a coordination role and bear no (or very low) risks in relation to its cash pool leader role.

It is more usual for a cash pool leader to bear at least a degree of credit risk, interest rate risk, foreign exchange, and liquidity risk. We do not believe that the risk profile of a cash pool leader depends on whether the same entity performs a range of other roles and bears risks, as set out in Example 2. In
particular, as we elaborate on below, the discussion draft seems to assume that the cash pool will always generate profit and ignores the possibility that the risks assumed will result in a loss for the cash pool leader or other cash pooling participants.

The examples, in their current form, may as a result be misleading to both tax administrations and taxpayers alike. Low operational functionality (in terms of the contribution often made by the partner bank to the running of the cash pool) should not necessarily be indicative of the assumption of low or no risk, by the cash pool leader. We recommend the OECD to continue to emphasize that each cash pool structure needs to be analyzed based on its own facts and circumstances and consider including an additional example reflecting a functional and risk profile of the cash pool leader which bears risks, but does not perform a suite of other functions as mentioned in Example 2. As a result, the OECD should acknowledge that the cash pool leader in many cases is likely to be characterized as more than a mere service provider, especially in cases where the cash pool leader is allocated financial risks resulting from the mismatch of assets and liabilities.

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?;

The second approach (i.e. the one described in paragraph 128 of the discussion draft) would usually lead to a non-arm’s length result if implemented. Entities with the same credit rating will usually pay a higher rate to borrow from an unrelated lender, then it would receive if it deposited the amount instead, in similar circumstances. Further, although the OECD acknowledges that the primary purpose of a cash pool is to manage liquidity, the second approach assumes that only credit risk is relevant and ignores the liquidity risk involved in cash pooling. In practice, liquidity risk is the primary reason why deposit rates are lower than lending rates between third parties, even when the credit ratings are equal.

There are no clear circumstances in which one of the other two approaches would be more suitable. In addition, we recommend that the guidance in the discussion draft more clearly reflect that in some circumstances, it may be considered arm’s length for the cash pool leader to retain (some or all) of the cash pooling benefits. Cash pool structures, including the allocation of netting benefits needs to be analyzed based on its own facts and circumstances, which requires a detailed functional and risk assessment to be performed. In particular, the analysis should consider all risks assumed by the cash pool leader, including foreign exchange risk and liquidity risk, and not focus solely on credit risk, which is currently the implied guidance in the discussion draft.

- does the allocation of group synergy benefits suffice to arrive at an arm’s length remuneration for the cash pool members?;

In principle, the allocation of netting benefits (taking into account the methods we have described above), when coupled with the application of arm’s length borrowing and depositing rates, should function to create an arm’s length remuneration for the parties assuming financial risks associated with the cash pool arrangements (i.e., cash pool participants, the cash pool leader, or the MNE group parent, depending on the facts and circumstances of the case).

We do recommend that the guidance be clearer on the difference between synergy benefits (such as volume benefits) and netting benefits.

- 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?
Our view is that the proper application of the arm’s length principle in the context of a cash pooling structure (i.e. determining an arm’s length remuneration for the cash pool leader, the cash pool participants, and group guarantors, if any) should start with the application of arm’s length borrowing and depositing rates, coupled with the allocation of pooling benefits, including netting benefit (which can be considered risk-related return). In practice, and as described in our comments above, this needs to follow a thorough functional and risk analysis to determine which parties are entitled to the allocation of pooling benefits. Given the variety of cash pooling structures and varying financing strategies, this can result in netting benefits being allocated to cash pool participants (in a manner reasonable to the facts and circumstances of the case), being retained by the cash pool leader, being allocated to the parent (if acting as a guarantor), or a combination of these options.

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.

Any approach to the allocation of netting benefits needs to follow an accurate delineation of the transaction and a detailed functional and risk analysis, with the netting benefits being allocated to the parties to reflect the parties assuming the risks, which in certain structures may be the cash pool leader.

For example, if the functional and risk analysis identifies that credit and liquidity risks are assumed by the cash pool leader, then an arm’s length outcome could be for the pool leader to retain the netting benefits. If, on the other hand, certain risks are assumed by the cash pool participants (e.g. through the presence of a cross guarantee arrangement), then allocating cash pooling benefits to the cash pool participants could reflect an arm’s length outcome.

We do note that in many cases, cash pools are implemented by setting a borrowing rate and a deposit rate such that the ex ante expectation is that the participants and the cash pool leader will earn an appropriate return, leaving no need for ex post allocation of benefits. We would welcome guidance from the OECD on ex ante versus ex post allocation of cash pool benefits, especially in cases where the ex post outcome is different than expected (for example, if the cash pool leader incurs a loss through investment of excess funds).

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.

We agree that an individual affiliate operating at arm’s length would act in its own best commercial interests and seek to achieve the most advantageous funding terms while depositing its surplus cash where it could maximize the level of return consistent with its individual risk appetite, however it is unnecessary burdensome to presuppose that a detailed options realistically available analysis (which could be an implied outcome of this section) should precede the action of entering into a cash pooling arrangement by a participant, or to continually judge a cash pooling participant’s actions to remain in a cash pool arrangement. MNE’s impose a number of group wide strategies upon its affiliates, both in the financing sphere as well as operational. 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.

Although cross guarantees are not always required in the context of cash pools, they are commonly present in such arrangements, often at the request of the external partner banks. With respect to the need for a guarantee fee payment, we agree with the guidance in the discussion draft that it is difficult to determine the degree of real risk that each cross guarantor assumes in a cash pooling context due to the large number of participants and constant fluctuations in balances. Determining a guarantee fee for
each cross guarantee likely would place an undue burden on the MNE group, while accruing no benefits to any party in practice.

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.

Whether or not cross-guarantees are explicitly in place, or in effect but not in written contractual form, should not change our conclusions stated in question box C.10. In many cases, such types of un-written contractual guarantees could be considered either akin to passive association.

3.2. Section C.3 – Hedging

General comments:

- We believe description of the possible hedging mechanisms in paragraph 134 is correct. However we believe that there are even more frequent mechanisms occurring within MNE groups that are not described in paragraph 134 of the discussion draft, and that should not be ruled out.

- With regard to hedging, an MNE group treasury company is often interposed between individual MNE group members and market counterparties, and from a legal perspective is a direct counterparty to financial institutions. As such, the group treasury company is exposed to certain financial risks, including the credit counterparty risk on both the external parties and the group companies. In absence of guarantees or other contractual risk limitations (e.g., provided by the ultimate parent or potential cross-guarantees by individual group members), the group treasury company bears a risk related to potential default of a group company or a third-party, which has a positive likelihood (e.g., the recent global financial crisis demonstrated that even AAA rated financial institutions can collapse and default on their obligations).

- In this respect, to the extent that as part of the delineation exercise it is determined that the group treasury company has control over and the financial capacity to bear the respective risks (e.g. by putting sufficient capital at risk), the centralized hedging function should be viewed as providing more than merely an intra-group service. In particular, arm’s length remuneration not only for the functions performed (i.e. hedging service fee) but also for risks assumed might be due.

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?

We believe that the guidance contained in the TPG, particularly the sections in Chapter I regarding risk assumption, are equally applicable regardless of whether or not risks are offset by another member of the MNE group. We do not think there is any need for special guidance in the case of intra-group offsets. We do note that just because a MNE group policy forbids external hedges of internally offset positions, it does not mean that the entity with the unhedged risk could not control or mitigate its risk. For example, it could enter into an internal hedge with another group member, if it chose to do so. It could also choose to simply not hedge and take the underlying risk.

We are concerned that guidance in the discussion draft, suggesting that internal hedges should generally be “inferred” from internally offset risks is likely to invite double taxation. Such guidance
would invite tax administrations to assert ex post reallocation of losses to other group members, based on unprovable arguments about whether or not third parties “would have” hedged those risks or what the MNE “would have” done absent a group policy. What should be relevant in such an analysis is what the individual entities have done, and that re-characterization should only occur under extraordinary circumstances.
4. Section D - Financial guarantees

General comments:

- We believe that the realistic alternatives standard requirement as outlined in the discussion draft to take into account both the borrower's and the guarantor's perspectives when determining whether an intra-group guarantee is provided at arm's length may be unnecessarily cumbersome for taxpayers, increasing the administrative burden. Instead of applying two separate transfer pricing approaches (e.g., the benefit approach, in the form of the yield approach, and the cost approach, in the form of expected loss approach) to determine a range of guarantee fees through a maximum and minimum fee derived from those two approaches, we believe that it may be more appropriate to select the most appropriate method based on the facts and circumstances of the transaction, and determine a range of guarantee fees through other assumptions during the application of the method selected.

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);

Application of the arm's length principle should distinguish between explicit and implicit guarantees when determining an arm's length remuneration for the transaction. Explicit guarantees, contractually binding to the guarantor in case certain criteria are met (e.g. default of a borrower), should be considered to attract a form of consideration under the arm's length principle. Distinction should also be made between “comfort letters”, which in many cases do not contain covenants which are legally binding, and an explicit guarantee.

With regard to explicit, legally binding financial guarantees, consideration should be given to the purpose of providing the guarantee and the actual benefits received by the guaranteed party when determining the arm's length remuneration for the provision of the guarantee. A clear understanding of the benefits received should be the starting point for any analysis of how to accurately delineate or price the guarantee. For example:

- When a financially strong parent guarantees a financially weak subsidiary, the benefit likely includes a significant reduction in the interest rate paid by the subsidiary
- When a parent company guarantees a financing subsidiary, and the financing subsidiary raises funds which are then on-lent to other group members, it may be the case that the benefit is received by the ultimate borrowers and not by the financing subsidiary, and the pricing of the guarantee fee and the intra-group debt should reflect the benefits received
- In some cases, a publicly rated parent company may guarantee a subsidiary that is not publicly rated, but is independently at least as creditworthy as the parent. In this case, the benefit may be limited to providing additional liquidity assurance to the lender and to facilitating the borrowing (by removing the need for the subsidiary to seek an independent credit rating)

Similarly, after an acquisition, it is common for the new owner to be forced to guarantee all of its new subsidiaries’ external debt in order to avoid triggering default under change-of-control clauses. Implicit guarantees, on the other hand, would be more viewed as akin to passive association, and as a result, be considered a group synergy with non-allocable benefits (i.e. the lack of concerted group action), and as a result not attract any form of a stand-alone consideration.
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;

It is rare for third-party lenders to provide loans to a member of a MNE group without a parental guarantee or pledged assets, except in the case of ring-fenced, independently capitalized entities with binding legal protection to prevent the parent company from stripping funds out of the subsidiary, in cases where there is a third-party minority shareholder, or in case of long-established relationship between a bank and a particular subsidiary. Further, we note that in circumstances where a loan is made without a parental guarantee, it is usually the case that the borrowing subsidiary is independently rated.

In the situations where a guarantee is insisted upon by an independent lender, it should be first determined what the primary reason was for such a request, which may include:

- Protection against moral hazard;
- The lack of sufficient debt capacity by a subsidiary to independently raise debt;
- Reducing the level of credit risk by the lender, resulting in improved terms and conditions for the borrower;
- To meet regulatory requirements of the borrower, such as a requirement to only lend to entities formally assigned an investment-grade credit rating or capital requirements that depend on counterparty credit rating.

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

If the credit rating of the guarantor is better than the credit rating of the borrower, and the guarantee meets regulatory requirements (being legally binding, unconditional, irrevocable, etc.), the credit quality of the loan would be determined based on the guarantor’s credit rating. Subsequently, this would directly impact the loan pricing.

- 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.

Transactions in which an independent (non-governmental) entity guarantees the third-party borrowing of an unrelated (non-governmental) entity are very limited, and little detail is available about the process or mechanism by which a price is arrived at.

In our view, given the difficulty in identifying robust direct comparable transactions, it is more appropriate to price financial guarantees by considering the benefit to the guaranteed party and the risk to the guarantor based on the specific facts and circumstances of the intra-group guarantee, e.g. interest savings or liquidity enhancement.
5. Section E - Captive insurance

General comments:

- We generally welcome further guidance and examples as potentially providing greater clarity relating to the treatment of captive insurance transactions, but it is not clear why guidance specifically relating to captive insurance was included in the discussion draft. An accurate delineation of captive insurance transactions does not present any particular novel challenges worthy of further and targeted guidance. To the extent that the discussion draft recognizes that captive arrangements can result in a genuine transfer of insurance risk, then the guidance is welcomed as a counterweight to positions taken by tax administrations in this area.

- There have previously been extensive discussions with industry during the development of the guidance on Article 7 of the MTC or the preparation of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments, Part IV on insurance, which contained key insights. Although we don't believe that the Article 7 concept relating to key entrepreneurial risk taking (KERT) functions and the Article 9 concept of control of risk generally align, we think that they do so as it relates to insurance. We firmly believe the decision to exclude it is fully justified by the impact that regulation has on the delineation of the commercial and financial relations in intra-group reinsurance. Regulatory discipline significantly reduces the scope for the cedant and reinsurer to deviate from the contractual reinsurance arrangement. The comments below include sections that set out the circumstances where regulators requirements cause the delineation of intra-group reinsurance in the insurance industry to diverge from captives in a non-insurance group.

- **Captive insurance in a non-insurance group**
  - We believe that regulation alters the commercial and financial relations of intra-group reinsurance in the insurance industry such that the control of risk will invariably be aligned to the contractual assumption of risk.
  - The guidance should set out exactly what “control” means in the context of the assumption of insurance risk; combined with an example along the lines of paragraph 1.70 in Chapter 1 of the TPG. This would go some way to clarify how the particular meaning of control of risk in the transfer pricing guidelines applies to captive insurance. Our view is that the functions of the captive that are compatible with the control of the assumption of risk are: policy setting, assessing risk selection, pricing, deciding to retain or lay-off the risk further and the acceptance of the insurance risk. A definition of control of assumption of risk along these lines is compatible with the guidance on KERT function in part IV of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments. Adoption of this definition will ensure consistency between profit attribution and transfer pricing principles and ensure that there is no conflict when transfer pricing guidelines are applied to profit attribution by analogy.
  - The draft also contains six hallmarks of what can be expected of an independent insurer. Some of these hallmarks describe intra-group reinsurance in the insurance industry and not all of the hallmarks are relevant to the accurate delineation of captive insurance arrangements. In our view the hallmarks need to be significantly reworked to be relevant to captive insurance.
  - Hallmarks for captives should recognize the commercial rationale for entering into captive insurance. These include:
    - Increasing the effectiveness and efficiency of risk protection.
- Enhancing the organization’s ability to take advantage of the commercial reinsurance market.
- The insurance market may have limited capacity/ appetite for certain low frequency/ high impact risks and whilst these risks are insurable groups may find that they have a better appreciation of the nature of the insured risk and are able to self-insure for a smaller premium.
- The captive also effectively ring fences funds to enable claims to be met whereas funds left on the balance sheet of the insured could be called upon to meet other creditors or distributed to shareholders.
- Captive insurance may also form part of a group’s wider risk mitigation function by providing risk managers with increased visibility of the insured risk and incentives for minimizing the claims.

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 recognizing that the policy issuer is actually assuming the risks that it is contractually assuming;

Our suggestion for a definition that distinguishes between intra-group reinsurance and captive insurance builds on the Solvency II Directive definitions of ‘captive insurance undertaking’ and ‘captive reinsurance undertaking’. In article 13 of Solvency II defines captive insurance and reinsurance undertakings:

“(2) ‘captive insurance undertaking’ means an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c)11 or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member;

[...]

(5) ‘captive reinsurance undertaking’ means a reinsurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c) or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.”

We agree that the captive should have the financial capacity to assume the risk. Captives within the EU and some other territories are subject to similar levels of regulation and supervision as insurance groups. Further, captives are sometimes rated by well-established rating agencies, providing independent opinions to demonstrate a captive’s financial strength and performance against best practice to a variety of stakeholders. Therefore provided that a captive insurer holds capital in line with the level of capital that would be expected from an independent insurer and has a track record of paying out in the event that claims have been made, we consider this should be sufficient to demonstrate that the captive has the financial capacity to assume risk.

Captives subject to light touch regulatory regimes could provide an actuarial analysis to demonstrate that they have the financial capacity to assume the risk.
Our view is that the functions of the captive that are compatible with the control of the assumption of risk are: policy setting, assess risk selection, pricing, deciding to retain or lay-off the risk further and the acceptance of the insurance risk. A definition of control of assumption of risk along these lines is compatible with the guidance on KERT function in part IV of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments.

We agree that risk diversification is an important requirement for a properly functioning insurance business. The question of what is and what is not adequate diversification is generally an issue for actuarial consideration based around the law of large numbers. However when considering diversification care should be taken to distinguish between the number of insurance policies and the number of risks. E.g. where a captive insures a motor fleet in three locations there may be three policies but thousands of individual motor risks. In that case the captive is likely to have sufficient risk diversification.

Provided that the captive has the financial capacity to assume the insurance risk, the functional capability to control the assumption of that risk and a diversified portfolio of risks, the threshold for recognizing that it has assumed the risk should be met.

- 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;

Firstly the risk assumed should be an insurance risk as defined under IFRS 4 or similar accounting standard. The accounting standard notes that a contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract. Therefore we consider that this point is met almost exclusively by the existing accounting standard rules contained within IFRS 4 (to be superseded by IFRS 17 as of January 1st, 2021).

For an entity to be recognized as assuming the insurance risk it must set policies, assess risk selection, pricing, decide whether to retain or lay-off the risk further and then decide whether to accept the insurance risk. These activities form part of the underwriting function and acknowledgement that these activities amount to control of the assumption of risk would be consistent with the KERT concept used in the 2010 OECD Report on the Attribution of Profit to Permanent Establishments.

- 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 outsourcing 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; and

It is a common feature throughout the captives market that management functions are outsourced to a third party captive manager. This is generally on the basis of producing cost efficiencies as well as input into the set-up and ongoing management of the captive. Functions outsourced to third party captive managers do not result in the assumption of risk insurance by the outsourcer. In comparable situations where functions are outsourced to a member of the MNE group it may be inferred that the outsourcing arrangements do not change the analysis that the captive has assumed the insurance risk.

Beyond the elements of the underwriting function that we have identified as consistent with the control of assumption of risk other parts of underwriting activities may be undertaken by outsourcers without the captive relinquishing control of the assumption of insurance risk. We believe that guidance should include a definition of ‘underwriting’ and distinguish between those parts of the function that may be
outsourced without having transfer pricing consequences and functions that are central to the control of risk. Our view is that the delineation of the transaction should examine the underwriting function through the five components of underwriting function described in Part IV of 2010 OECD Report on the Attribution of Profit to Permanent Establishments (paragraph 34):

- Setting the underwriting policy
- Risk classification and selection
- Pricing
- Risk mention and analysis
- Acceptance of insured risk

These components of the underwriting function can be examined individually and where they do not contribute to the KERT function of the assumption of insurance risk they can be performed by the outsourcer and the captive can still exercise control of risk requirements in paragraph 1.65 of the TPG.

The relationship between captives and outsource service providers is similar to the asset management example in paragraph 1.70 of the TPG. There are enough similarities in the financial and commercial relations between the outsourcer and the captive to the commercial and financial relations between the asset manager and the investor in the example for it to be capable of being adapted to form the basis of a captive insurance example. The example could be adapted to create a captive insurer example (changes to the current example in paragraph 1.70 are reflected in bold):

Assume that a captive insurer hires an outsourcer to manage its insurance business. Depending on the agreement between the captive and the outsourcer, the latter may be given the authority to make investments, pay claims, execute insurance contracts and enter into reinsurance contracts on behalf of the captive on a day-to-day basis in a way that reflects the risk preferences of the captive, although the risk of loss where claims exceed premiums would be borne by the captive. In such an example, the captive is controlling its risks through four relevant decisions: the decision about its risk preference and therefore about the required diversification of the risks attached to the different insurance risks that are part of the portfolio, the decision to hire (or terminate the contract with) that particular outsourcer, the decision of the extent of the authority it gives to the outsourcer and objectives it assigns to the latter, and the decision of the amount of insurance risk that it asks this outsourcer to manage. Moreover, the outsourcer would generally be required to report back to the captive on a regular basis as the captive would want to assess the outcome of the outsourcer’s activities. In such a case, the outsourcer is providing a service and managing his business risk from his own perspective (e.g. to protect his credibility). The outsourcer’s operational risk, including the possibility of losing a client, is distinct from the captive’s insurance risk. This illustrates the fact that a captive who gives to another person the authority to perform risk mitigation activities such as those performed by the outsourcer does not necessarily transfer control of the insurance risk to the person making these day-to-day decisions.

If the OECD decides against including an example in guidance, then it should be made clear that it is possible for captives with outsourced operating models to demonstrate that they are capable of assuming insurance risk if they execute the key decisions on whether to select and assume insurance risk, lay off or retain that risk, assess and negotiate pricing and terms and as long as the outsourcer’s role is limited to the performance of day to day functions and services.
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.

Where, following the accurate delineation of the transaction, it is concluded that a captive does not control the acceptance of insurance risk assumed, the effect on the MNE group will depend on the outcome of the delineation exercise. It may be the case that the exercise concludes that the risk has not been transferred, in which case the correct conclusion may be that the insurance premium is not recognized. If another entity in the MNE group is recognized as assuming the risk, the answer could be that this entity should be compensated for has assuming that risk.

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.

We understand that applying market pricing to a captive insurer has intrinsic difficulties because of the lack of available information on market pricing and we agree that using a technical actuarial approach can result in a price within or close to the market price.

The suggestion that a comparable uncontrolled price could be determined using a profit level indicator based on return on capital is a reasonable practical solution to the difficulties that tax administrations may find in applying the actuarial method, or other OECD approved methods. The base level of capital would have to be examined and set at a level consistent with the level of capital held by independent insurers acting at arm’s length.

We consider combined ratios to be too sensitive to market factors to provide a reliable method for determining the arm’s length price.

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

The example as currently provided in the discussion draft 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 in certain situations, 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 excess profits, all facts and circumstances of the transaction should be considered, including the POS advantage. It must be first established and demonstrated that a POS advantage exists, and that it is the significant determinant of the excess profits across 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. Accordingly, analysis of an insurance product’s profits should be based on a careful assessment of the relevant functions, assets, and risks.

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.
Appendix - List of EY contact persons

If you have any comments or questions, please feel free to contact any of the below persons:

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Milan, 6 September 2018

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Sent via e-mail to TransferPricing@oecd.org

Re: Comments on the public discussion draft regarding transfer pricing aspects of financial transactions (BEPS Actions 8-10)

Dear Sirs and Madams,

We would like to thank the OECD for the opportunity to provide our comments on the discussion draft regarding transfer pricing aspects of financial transactions (BEPS Actions 8-10), which have been increasingly under scrutiny by tax administrations in the absence of specific indications at international level.

In such respect, we have greatly appreciated the efforts of the OECD to build consensus on the most relevant transfer pricing aspects of financial transactions and find that the current draft already provides a good level of guidance. We trust that these comments may be useful in further enhancing the analysis of financial transactions in the transfer pricing field.

For ease of reading, we have summarised our comments in an executive summary and included in the detailed comments provided afterwards the headings of the relevant sections of the discussion draft as well as the Box number to which they refer.

Yours faithfully,

Prof. Augusto Fantozzi

Prof. Roberto Fossati
EXECUTIVE SUMMARY

In order to be as specific as possible, we have replied to the questions contained in the discussion draft focusing on the following topics:

- **Accounting vs. Transfer Pricing treatment of financial transactions**: since international accounting standards require to determine interest rates at “market” conditions also for intra-group transactions, we wonder whether the guidance contained in the discussion draft may also be relevant for accounting purposes;

- **Interest-free loans**: as Italian Courts have given conflicting opinions on interest-free financing, we would recommend reaching a definitive conclusion on the matter also in light of the possible re-qualification of an interest-bearing loan into equity as per Box B.2.;

- **Deposits**: the discussion draft does not deal explicitly with deposits (either intra-group or with third party banks) outside cash pooling structures. In our experience deposits are a common tool for managing excess liquidity and minimizing risks. Their specific nature can therefore represent a good proxy for risk-free rates in contexts where the funding party is not managing nor controlling risks connected to the advance of funds;

- **Relevance of stand-alone ratings**: we appreciate the effort made in suggesting a simplified approach based on group rating, however, in our opinion and in order to ascertain the need to perform adjustments to the same, it is fundamental to derive also the stand-alone rating in the most objective way;

- **Possible benchmark approaches for intra-group loans**: while internal CUPs should be regarded, in our view, as a primary source of comparable transactions, in case these are not available or sufficiently reliable, additional tools such as CDS spreads, economic models and sector curves could be considered for pricing intra-group loans (in addition to third party bonds and loans);

- **Simplified approach proposed for cash pools**: since often intra-group rates are defined with reference to the rates applied by the third party bank on the master account while the cash pool leader can be considered as a low value-adding service provider, we suggest rewarding the cash pool leader with a cost plus 5% approach and re-distributing the excess netting benefit to the participants.

- **Guarantees**: we finally share some experiences on financial guarantees that may be helpful for enlarging the scope of applicability of the guidance provided and provide a possible interpretation of the European Court of Justice (“ECJ”) decision regarding the case no. C-382/16.

For further clarifications you may reach Raffaello Fossati at rfossati@fantozzieassociati.it
DETAILED COMMENTS

B. INTERACTION WITH THE GUIDANCE IN SECTION D.1 OF CHAPTER I

Comments on Boxes B.1. and B.2.

On an overall basis, we agree with the indications and considerations contained in the discussion draft and in the documents referred to therein as they represent a valid guide to:

i. accurately delineate intra-group transactions and
ii. determine arm’s length interest rates.

With respect to the first aspect we would like to point out that the best practice approach recommended by the BEPS Action 4 Report entails a fixed ratio rule based on the net interests/EBITDA ratio (possibly supplemented by a group ratio rule) which would seem to supersede any other type of rule regarding interest deduction and, in particular, thin capitalization rules. As the content of the discussion draft seems to recall a thin capitalization analysis, we would recommend coordinating as much as possible the accurate delineation of transactions approach with other possible rules in order to limit the re-qualification by tax administrations of loans into equity only to the really relevant cases. In this context, additional clarifications may also be needed in light of the interpretation of the European “proportionality test” given by the ECJ in case no. C-382/16, as discussed in our comments below regarding financial guarantees.

With respect to the second topic, it should be recalled that, according to international accounting standards, the entering in the financial statements of financing granted not at “market” conditions must be aligned with the economic substance of these transactions, so that the relevant market interest rate is to be determined in order to bring (if necessary) any appropriate accounting adjustments.

Therefore, if financing arrangements are concluded between related parties, the analysis conducted for transfer pricing purposes might also be used for accounting purposes: this calls for a clarification as to the possible overlapping of these two analyses or, similarly to other cases (e.g., valuation of intangibles for accounting purposes), for an indication of the possible differences between the accounting treatment and the transfer pricing approach.

We would also like to highlight that the content of the discussion draft (consistently with what is established by international accounting practice) seems to rule out the possibility of granting interest-free loans unless the capital contribution mentioned in Box B.2. is construed, incorrectly in our opinion, as interest-free financing. The Italian Courts have given conflicting opinions on interest-free financing, so an international stance would be welcome to definitively settle the issue. In this respect, the fact that, in accounting terms,
interest-free loans are *de facto* considered as interest-bearing, would prompt us to believe that the same conclusion is valid also for transfer pricing purposes.

In fact, both when identifying the effective nature of intra-group financial relationships and when applying the market interest rate, it would be appropriate to consider the fact that contractual interest (receivable or payable) may diverge from accounting interest entered in the financial statements.

In addition, these differences may derive from the calculation and subsequent posting in the financial statements of receivables and payables at the amortised cost based on the effective interest rate. The latter criterion, introduced by international accounting standards, has become by now a generally accepted criterion that has been incorporated into the domestic accounting systems of many countries as an expression of the substance over form principle. The practical application of this criterion means that, when initially calculating a receivable or payable, this can be stated at a different amount from the nominal value.

For financial receivables or payables, this can happen, for instance, when the contractual interest rate is significantly lower than the market interest rate. In these cases, the initial posted amount of the receivable is equal to the value of future financial flows, discounted by applying the market interest rate, while the difference compared to the nominal value of financing (granted or received) is stated under another item (so-called “day one loss” for the party granting financing, which is matched by a “day one profit” for the party receiving such financing). Accounting interest stated in the profit and loss account after the first posting will be determined by applying the market interest rate to the book value of the receivable or payable, net of repayments.

In a transaction between independent parties, the differences from the first posting must be stated in the profit and loss account on a single occasion in the year when the receivable or payable is first stated. The fact that, in accounting terms, a transaction between third parties can be considered as a “non-market” transaction raises doubts, for transfer pricing purposes, since the transactions that might be regarded as comparable in a benchmark analysis could require adjustments for accounting purposes, potentially prejudicing the results of the benchmark itself.

On the contrary, if financing at a lower-than-market interest rate is granted to a subsidiary and is intended as an addition to the equity of the same, the differential between the amount first posted and the nominal value of the receivable should, in principle, be entered to increase the cost of the investment, as a capital contribution to the subsidiary company. In a symmetrical way, such representation should also be confirmed in the financial statements of the subsidiary company, which will enter the differential between the liquidity received and the present value of the financial outflows at the market rate as a non-refundable payment (i.e. capital contribution received).
In this context, the Guidelines should indicate how the data collected and the analyses carried out for the purposes of the financial statements can be used also for transfer pricing analyses and vice versa. Finally, the accounting representation already implies a qualification of the transaction - with the possible distinction between financing and capital components - and a quantification at market rates (accounting interests are already determined by applying a market rate).


In general terms we agree with the guidance contained in the whole Box B.4. and we find it consistent with the Pricing approaches described in Section C.1.7 to the extent that the risk adjusted rate of return can be determined with reference to the mentioned pricing approaches (i.e., once the arm’s length interest rate has been determined according to one of the suggested pricing approaches, the risk premium is represented by the difference between the arm’s length interest rate and the risk-free rate).

In certain cases, also government bonds (e.g., 5-year German Bund) and high investment-grade corporate bonds, have shown negative returns. An analysis of the options realistically available to companies with excess cash that would like to minimize investment risks in the current scenario, could lead to the conclusion that they would have considered the alternative of depositing this cash in their bank accounts on an overnight basis (in case no negative rates are applied by the bank) or for a longer period (in order also to achieve a higher remuneration).

The above would implicate a recommendation to consider the possibility to apply a floor in the determination of the risk-free rate (as we have noted that this is a standard practice both in third party and intra-group deals) and to consider bank deposits as a possible alternative to government bonds yields. Deposit rates are generally published monthly by central banks therefore it should be easy to obtain such information. In addition, the fact that the rates are aggregated on a country or regional basis should allow for a sufficient level of reliability and stability.

In addition, in our experience tax administrations tend to recharacterize intra-group deposits into loans without verifying the actual assumption of risks by the depositor. The guidance contained in Box B.4. is particularly helpful in explaining that if a company has no capabilities to manage the relevant investment risks (as in the case of a deposit by an operating company to a group finance entity) it should not be entitled to a risk-adjusted rate of return. With respect to the questions contained in Box B.3., in addition, we would like to underline that a deposit transaction generally does not entail for the depositor the management and control of significant risks as, both when the deposit is made to a third party bank and to a group treasury entity, the purpose of the depositor is to secure its excess liquidity (by means of a transfer to a counterparty with a higher credit rating) rather than to pursue more entrepreneurial strategies (that are instead put in place by the group
treasury entity and by the bank). With respect to the re-qualification of a deposit into a loan, we would like to emphasize that, being deposit a contractual form existing also among third parties, its de-recognition by tax administrations should be prevented (especially when the functional and risk profile of the parties is consistent with the contract) as per par. 1.122 of the Guidelines.

With respect to the example described in paragraphs 1.85 and 1.103 of the guidelines we agree on the fact that if a company is not assuming the investment risk it should only receive a risk-free remuneration.

In this last regard - based on the examples described above - we observe that in case, subsequent to the functional analysis relating to the risk of a specific intra-group financial transaction (as per Chapter I, Section D.1.2.13, of the Guidelines) it appears that:

- company “X”, resident in country “S”, grants a loan to its related party “Y”, resident in country “R”, and does not control or manage the risk of this loan;
- company “Z”, resident in country “W”, that is part of the same group of “X” and “Y”, is the entity which actually controls and manages the risk of the loan carried out from “X” to “Y”, without having concluded any formal agreement that governs the transaction;

to determine the correct allocation of risk and interests relating to the loan, the tax administration of country “W” should firstly challenge the existence of a new intra-group transaction and, subsequently, identify the correct remuneration of the same.

Consequently, a discussion could be triggered - in the form of Mutual Agreement Procedure pursuant to art. 25 of the Model Tax Convention, “MAP” - between (i) the tax administration of “X” (which should reduce its interest income to the risk-free rate) and (ii) the tax administration of “Z”; the involvement of the borrower’s tax administration (i.e., country “R”), instead, is necessary only if the risk-adjusted rate is found not in compliance with the arm’s length principle by the tax administration of “W”.

Therefore, it would be recommendable to offer “Z” (namely the MNE that controls and manages the risk), the following options:

- apply for a MAP with the tax administration of country “S”, if the challenge concerns only the omitted recharge of the risk premium to “X”, avoiding the inclusion in the procedure of the tax administration of country “R”. In such a case, if the tax administration of country “W” refrains from challenging the non-arm’s length nature of the risk-adjusted rate, the MAP would involve only two competent authorities (favouring an easier conclusion of the procedure); or
- apply contemporaneously for two distinct MAPs:
iii. one with the tax administration of country “R” to determine the arm’s
length risk-adjust rate and,

iv. one, with the tax administration of country “S” to determine the risk
premium attributable to “Z”.

In this last option, if an agreement is not reached in both MAPs and the arbitration
procedure is available, the taxpayer should be allowed to ask for the joint analysis of the
two different aspects.

C.1.3 EFFECT OF GROUP MEMBERSHIP


In our view, whenever available, group credit rating (intended as the rating of the group as
a whole and based on consolidated financial statements) should be taken into consideration
in order to conclude on the creditworthiness of the borrowing entity. With respect to the
two envisaged approaches, we are of the opinion that the former has the significant
advantage of simplification and, in case the rating is provided by a rating agency, of the
highest level of objectivity. However, such an approach would have as main disadvantage
the fact that it could induce taxpayers to price loans to various subsidiaries with the same
interest rate (assuming that all the other features of the transactions are similar), de facto
limiting in-depth analyses on the actual creditworthiness of the single entity only to specific
cases. In theory, the assumption that all the subsidiaries share the group rating would
implicate that the same interest rate the group pays on its external debt should be replicated
in the intra-group funding transaction and that in any case no additional risk is borne by
the group treasury in its transactions. Therefore, this could represent a viable approach only
in case the group treasury is configured as a pure service centre/intermediator. In addition,
the assumption that all the group entities share the same rating may have an impact on the
maximum amount of debt that an external lender would be willing to lend (as described in
par. 17 of the discussion draft).

On the contrary, in case the group rating has to be estimated by the taxpayer as it is not
available from a rating agency, the envisaged simplification would not provide any benefit
in terms of administrative burden as the estimation of the group rating could reveal much
more complex than the analysis on a single entity level (e.g. due to various countries
involved and the number of entities to be considered).

Therefore, we appreciate the simplification intent of the first approach but believe that only
the second approach could represent a viable solution, in particular if the need for
adjustments derive from the difference with the stand-alone rating. We would envisage the
process as follows:
• assuming that the credit rating of the group is available from a rating agency;

• the stand-alone rating of the borrower is estimated based only on quantitative aspects, as explained below, and is lower than the group rating;

• the implicit support analysis described in section C.1.3 is then used to adjust (downward) the group rating.

In our view, it is fundamental to (also) estimate the borrower’s stand-alone rating (as typically this is not available from rating agencies) in the most objective way (and to compare it with the group one if available). This could be achieved:

• by using appropriate commercial tools which are based on the single entity financial data and information regarding the industry in which the borrower operates or by means of in-house models;

• by comparing interest rates paid to third party banks, if any, with rated loans or bonds in order to derive an “inverse” rating of the borrowing entity (which could already include the effect of implicit support);

• for Italian small and medium enterprises, by using a rating tool that has been made publicly available (https://www.mcc.it/rating/) by the Ministry of the Economic Development.

If the stand-alone rating is derived from quantitative information and the group rating is available from a rating agency, the qualitative analysis to be performed can be focused on the factors provided for by S&Ps in the “Corporate Ratings Criteria” which are summarized in par. 69 of the discussion draft. The relevance of the adjustment can be determined as a proportion of the difference between the group rating and the stand-alone one (e.g., if the difference is 4 notches and the implicit support is estimated to be 50% the adjustment would be of 2 notches).

In case no credit rating is available from a rating agency a possible simplification could be to base the analysis on the stand-alone rating determined on quantitative elements only (possibly providing for a rebuttable presumption that qualitative factors and the effect of implicit support does not exceed, e.g., a couple of notches of upward adjustment).

Comments on Box C.5.

In our experience CDS can represent a valid tool for determining the risk spread of a certain company or country (when reliable information is available). CDS can also be used to determine guarantee fees under the assumption that the risk premium connected to the default is represented by the CDS spread. In principle, therefore, their use for pricing intra-group loans should not be prevented, especially if CDS data is available for the specific
borrower and there are no significant adjustments to be performed due to the specific features of the intra-group transaction to be priced.

In addition, CDS can be used to estimate country risk and this could also be a reference in case the credit rating of the borrower is strictly connected with the rating of the country in which it operates (e.g. the largest bank in a specific country). However, there are some concerns in the use of CDS data, mainly related to the volatility of CDS spreads as compared to other instruments and to the “credit events” that may trigger settlement under a CDS contract. In addition, the existence of CDS data generally implicate that the relevant company already has a public credit rating and may have issued bonds, therefore, it should be generally easy to obtain information on possible benchmarks using less volatile instruments.

With respect to economic models used by credit institutions, they basically tend to resemble the pricing approach used with third party borrowers and are used when a significant number of deals have to be priced. These models are generally based on an equation that starts from a risk-free rate and adds various components (e.g. maturity premium, country risk premium) to arrive at a “risk-adjusted rate”. In this respect, it is important to ascertain that all the components are correctly estimated and there is no duplication. To the extent that:

- there is no more direct evidence of market rates (e.g. internal or external comparable transactions for the application of the CUP method),
- the parameters of model are clearly defined and based on market data/regulatory provisions,
- the same model is applied consistently over time and as a standard practice also with third parties

their use should not lead to biased results.

In our experience, these models also use a certain level of inference/interpolation to estimate the various components under different scenarios (e.g., to derive a maturity spread across all the available maturities even in presence of limited market observations). In such cases, it is important to corroborate the results achieved with such models with alternative methodologies and, to the extent possible, to indicate a range of values (rather than a single rate for a specific transaction). This could be done, for financial institutions for instance, deriving so-called “tendency curves” using data that is available. The following chart represents an example of a possible approach that can be adopted in presence of data regarding secondary market yields on the financial institution senior debt (red curve) and interbank market rates on transaction concluded by the same financial institution (green curve). The area comprised between the two (logarithmic) curves should be considered at arm’s length (assuming that the borrowing entity has the same credit rating) and can be used to test all the transactions occurring in a certain period (day/week/month) even if
derived from an economic model (which to a certain extent relies on such information to price intra-group transactions).

C.1.7 PRICING APPROACHES TO DETERMINING AN ARM’S LENGTH INTEREST RATE

Comments on Box C.6.

In addition to third party loans and bond, we would like to suggest the use of the so-called “sector curves” which are constructed by specialized databases using mid-yields from senior unsecured bonds from the same industry, credit rating category and currency denomination. To be eligible for the inclusion in the panel used for constructing the curves, bonds should have sufficient liquidity in the market, limited volatility, fixed rate and standard structures (e.g., no put/call options).

These curves therefore may represent a valid alternative to the search of single transactions. The main advantage of these curves is that the yield, directly provided by the database for the specific maturity/day (under a standardized approach which limits the need for adjustments), is available for several years (also when the original bonds may have matured and the related information could not be available anymore) and proves particularly useful in case of subsequent challenges (in order to verify the information selected and/or re-perform the analyses).

In addition, as already mentioned in the comments with respect to the risk-free rate, we would recommend including a specific section with respect to deposits highlighting the need for a different analysis as compared to loans.
Comments on Box C.7.

As a preliminary comment, we would like to point out that in our view internal CUPs should be considered as a first instance since they could allow to identify transactions where:

- The credit rating of the borrower is exactly the same (and does not need to be determined)
- The evaluation of the third-party funder is based on the specific circumstances of the case (while in the search for external transactions it is not possible to ascertain that all the relevant features are actually comparable)

Therefore, in case internal CUPs are available there should be a preference for them, performing the necessary adjustments required by the specific case, if any. Under such assumption, we would recommend moving par. 87-88 prior to par. 81.

With specific respect to the question regarding the average rate on the external debt, this information is in any case important to set a floor for intra-group prices. We have seen various cases where the tax administrations have challenged intra-group rates identifying interest rates that were significantly below the group cost of funds. Such an approach is evidently flawed and should be expressly prevented.

In addition, the external funding rate can represent a proper benchmark for intra-group loans in situations where:

- There is a strong correlation in credit rating between the group and the borrowing entity or the borrowing entity is the same;
- Other features of the loans are not significantly different or appropriate adjustments can be performed;
- The funding rates can be used to establish an arm’s length range (there are at least 3 or 4 observations)

Such a range could be used to set/test the intra-group rates. Please also refer to our comments to Box C.4. where two alternative measures of cost of funding are used to derive a possible arm’s length range to test intra-group loans (borrowings).

In addition, guidance would be helpful on the application of the TNMM in the context of financial transactions. Reference is made, e.g., to the state aid decision no 2326/2016 where the ECJ did not reject the application of such method in the presence of a “limited risk financial entity”. We would therefore suggest indicating whether and under which circumstances such method can be considered appropriate for testing the arm’s length nature of various financial transactions involving a single legal entity.
C.2 CASH POOLING

Comments on Box C.8.

As a general remark, we basically agree with the content of paragraph 52 of the draft, therefore in case the cash pool is operated by the parent company or by another company of the group with a guarantee of the parent company (as in Example 1 in paragraphs 114-118), the configuration of the cash pool leader as a service provider would seem appropriate. In our experience, a more entrepreneurial role of the cash pool leader can be envisaged in the situation where the cash pool is operated by a different legal entity without an underlying agreement with a third-party bank that covers all the possible outcomes of the aggregated cash pool balance (e.g., there is no overdraft line in case the limit on the cash pool is exceeded). We have seen cases where the cash pool leader is financed via long term loans and, in case the daily overall balance remains negative for a significant period, these resources could not be enough to cover an unexpected cash out. In another case, the agreement with the bank did not provide for the master account to result in a positive balance, therefore this circumstance may implicate an additional risk at the cash pool leader level that would be also in charge for the investment of excess funds.

From a practical point of view, instead, during inspections tax administrations are more interested in analysing the interest rates applied rather than in the allocation of group synergy benefits. Starting from this fact and with respect to possible approaches for rewarding the cash pool members, in our practical experience we note that often the intra-group rates are defined with reference to the rates that are applied by the bank on the master account. In this case, the netting benefit would be earned by the cash pool leader while the volume benefit (represented by the more favourable interest rates achieved at group level) would be allocated among all the participants based on their contributions. This may replicate (partially) the approach described in par. 127 in the sense that the intra-group cash pool rates are more favourable than market rates on a stand-alone basis (see Scenario 3 in the table provided in the Annex). As an alternative, far more favourable rates could be applied (as in Scenario 3bis). The main advantage of these approaches, however, is that the cash pool leader is not incurring losses (regardless of the cash pool overall balance) and this would be consistent with its limited risk nature that should insulate it from adverse effects. On the opposite, approaches described in paragraphs 128 and 129 may avoid losses at the cash pool leader level only in the following circumstances (see Scenarios 4 and 5 in the table provided in the Annex for an example):

- the approach named “Applying the same interest rate for all participants” avoids losses for the leader only if the balance of the cash pool is equal to zero (and even is such a case there would be no remuneration for the leader);

- the approach named “Allocating the cash pool benefits to the depositors” avoids losses for the leader only if the balance of the cash pool is negative or zero.
Our comments are based on the scenarios included in the table provided in the Annex which represents possible outcomes of a simple cash pool case where two entities (Company A and Company B) pool their liquidity in a master account managed by the cash pool leader (that adds no liquidity to the pool). For each scenario we have computed the benefits for each entity under three different options (positive, null or negative balance of the master account). The parameters of the examples are the following:

- market rates in the absence of cash pool for deposits equal to 5bps and for borrowings equal to 120 bps;
- interest rates on the master account in the presence of cash pool for deposits equal to 10bps and for borrowings equal to 110 bps;
- enhanced intra-group rates (scenario 3) for deposits equal to 10bps and for borrowings equal to 110 bps;
- further enhanced intra-group rates (scenario 3bis) for deposits equal to 20bps and for borrowings equal to 90 bps;
- intermediate intra-group rate (scenario 4) applied both for deposits and borrowings equal to 60bps;
- intra-group rates applied in order to allocate most of the benefits to depositors (scenario 5) equal to 60bps for deposits and equal to 120 bps for borrowings.

From this simple exemplification it is however possible to infer that the approaches mentioned in par. 128 and 129 may not reach the purported goal (unless it is possible to foresee exactly the balance of each participant). In this respect, there could be room for proposing a “simplified” approach where the intra-group rates are set in accordance with the rates applied on the master account to be adopted in the cases where the cash pool can be considered as a “low value-adding” service provider. In case the cash pool leader earns a netting benefit that is considered excessive, as compared to the low value-adding nature of the activities performed and to the costs actually borne to run the cash pool, this could be allocated (ex post) to the participants based, for instance, on the full year balance of each participant.

The proper remuneration for the low value-adding cash pool leader could then be determined by applying a 5% mark-up on the costs borne. The excess profit (deriving from the netting benefit) would then be allocated to the to the participants as follows:
Scenario 3 - Cash pool in place using master account rates as intra-group rates (Enhancing the interest rate for all participants)

<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
<th>Cash Pool Leader</th>
<th>Company A</th>
<th>Company B</th>
<th>Cash Pool Leader</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance</strong></td>
<td>100,000</td>
<td>-100,000</td>
<td>-100,000</td>
<td>40,000</td>
<td>-100,000</td>
<td>-60,000</td>
</tr>
<tr>
<td><strong>Relevant interest rate</strong></td>
<td>0.10%</td>
<td>1.10%</td>
<td>-</td>
<td>0.10%</td>
<td>1.10%</td>
<td>1.10%</td>
</tr>
<tr>
<td><strong>Interests on the balance of the single accounts</strong></td>
<td>100</td>
<td>-1,100</td>
<td>-</td>
<td>40</td>
<td>-1,100</td>
<td>-660</td>
</tr>
<tr>
<td><strong>Intra-group interests for the leader</strong></td>
<td>-</td>
<td>1,000</td>
<td>-</td>
<td>1,000</td>
<td>-</td>
<td>1,060</td>
</tr>
<tr>
<td><strong>Benefit as compared to Scenario 1</strong></td>
<td>50</td>
<td>100</td>
<td>100</td>
<td>20</td>
<td>100</td>
<td>400</td>
</tr>
<tr>
<td><strong>Cash Pool Leader costs + 5% mark-up</strong></td>
<td>-</td>
<td>200</td>
<td>-</td>
<td>-</td>
<td>200</td>
<td>-</td>
</tr>
<tr>
<td><strong>Excess benefit to be allocated</strong></td>
<td>-</td>
<td>800</td>
<td>-</td>
<td>800</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Allocation of excess benefit</strong></td>
<td>400</td>
<td>400</td>
<td>-800</td>
<td>57</td>
<td>143</td>
<td>-200</td>
</tr>
<tr>
<td><strong>Net interests on the cash pool</strong></td>
<td>500</td>
<td>-700</td>
<td>200</td>
<td>97</td>
<td>-957</td>
<td>200</td>
</tr>
</tbody>
</table>

Comments on Box C.9.

Paragraph 102 seems to be inspired by the contents of Section D.8 of Chapter I and, therefore, the decision to join the cash pool would seem to represent a deliberate concerted group action that may generate benefits for certain members and burdens for others. These latter, according to the Guidance contained in Section D.8 and in Chapter IX, should in principle be indemnified in case they were able to obtain better financing conditions on a stand-alone basis as compared to the cash pool. The indemnification for the worse off participants could derive from the allocation of benefits to the other members. In determining whether this specific allocation of benefits should be on a permanent or temporary basis, an element to be considered is the source of the more favourable financing conditions:

- in case these derive from a better creditworthiness of the specific entity or from the particular conditions of the financial markets of the country where this is located, it is likely that the specific allocation of benefits should be structural;

- in case these derive from a favourable offer from a local bank hoping to attract business from other group members (see par. 1.160), the indemnification could be temporary or one-off.
Comments on Box C.10.

In our view, the guidance contained in Section D.1.2.1 of Chapter I would determine in most of the cash pool cases (e.g., in industrial MNEs) the conclusion that a large part of the participant is not able to assume and manage risks with respect to other participants as they have neither hierarchical control nor sufficiently skilled personnel to manage financial risks. Based on this assumption, it would be hard to find cases where cross-guarantees require a specific remuneration, since in general (as mentioned also in par. 144 of the discussion draft) there would be no risk control function on other participants. In addition, the presence of implicit support would tend to equalize the creditworthiness of the various participants to a level where the incremental benefit of an intra-group guarantee would be close to 0, also considering the short-term nature of the cash pool.

As a result, a cash pool guarantee could be envisaged in cases where there is a low level of implicit support to certain participants which also have worse stand-alone ratings and negative cash pool balances for a prolonged period of time. Under such circumstances, the net depositors in the cash pool could require a specific remuneration either via a differentiation in intra-group rates or via separate payments.

D. GUARANTEES

Comments on Box D.1.

In our view the accurate delineation of the transaction should focus on determining the following elements:

- the purpose for which the guarantee is granted (e.g., obtaining a lower interest rate, obtaining additional funding or other purposes) and the actual level of risk incurred by the guarantor;
- the differential in terms of credit rating between the guarantor and the guaranteed entity as well as the level of implicit support;
- the ability of the guarantor to control and manage the risk (e.g., by exercising control on the guaranteed entity or by facing the potential liability in case of default of the guaranteed entity);
- subordination of the guarantee to other undertakings of the guarantor;
- the description of the pricing model applied and, in particular, how the parameters applied are determined and whether these are used also in pricing guarantees to third parties (in case the group also grants guarantees to its clients).
In our experience, the basic case where a guarantee is granted relates to a parent company supporting a subsidiary with a lower credit rating. However, there are some particular cases relating to financial guarantees that would require additional clarification in the guidance:

- in case the differential in terms of credit rating is limited (or null) or the level of implicit support is very high, even in presence of a formal guarantee (granted, e.g., to issue a bond in a market to which only the subsidiary has access), the remuneration of the same should not be linked to the risk borne but to the administrative burden connected with the issuance of the guarantee. In such a case the fee could be expressed in terms of basis point or as a cost-plus service fee;

- in case the group rating is low there could be instances in which various subsidiaries jointly guarantee the issuance of a bond by a group entity and the funds collected are then distributed across the various guarantors at the same or similar interest rate paid to the market. In such a scenario and given the complexities mentioned in par. 144 of the discussion draft, the remuneration of the “up-stream” or “cross-stream” guarantee should be limited to an administrative fee or even zero (the alternative would be that the guarantee fee paid by the bond issuer is then recharged as an increase of the interest rate in the on-lending of the funds raised) and the transaction might be considered as an intentional set-off as per Section A.3.2 of Chapter III of the Guidelines;

- if the guarantee is subordinated to other undertakings of the guarantor, the relevant pricing should be adjusted accordingly and taking into account the possible interdependencies of the various liabilities of the guarantor and between these and the borrower ones.

In terms of guarantees, reference should also be made to the ECJ decision on case no. C-382/16 (Hornbach-Baumarkt AG) since the case deals with the remuneration of letters of patronage and concludes (see par. 56 of the decision) that, in compliance with the proportionality test, “terms that deviated from arm’s-length terms […] could be explained by the economic interest […] in the financial success of the foreign group companies, in which it participates through the distribution of profits, as well as by a certain responsibility of the applicant in the main proceedings, as a shareholder, in the financing of those companies”. Under par. 22 of the decision, the proportionality test requires that, "in a situation where it cannot be excluded that a transaction does not correspond to that which would have been agreed upon under market conditions, the taxpayer has the opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction".

Such a conclusion might not be totally aligned with the content of the Guidelines and of the discussion draft. In particular, the need for remuneration should, in our view and based on
the content of the discussion draft, be part of the accurate delineation of the transaction and not an *ex-post* “correction” to deviate from arm’s length results.

In addition, by interpreting the examples of commercial justifications provided in the decision under the approach described in par. 140 of the discussion draft, it would seem that the ECJ is assuming an extreme situation where the loan from a third party bank to a group borrower could be entirely qualified as a loan to the related guarantor, which in its turn contributes the same amount of equity into the borrower, and no guarantee would then exist (as there is no residual loan from the bank to the borrower to be guaranteed). Additional guidance, therefore, may be due on this point regarding the remuneration of the guarantee (that may deviate from arm’s length results), also in light of the possible doubts on the deductibility of interests by the borrower (and not by the guarantor).
ANNEX - Examples of application of the models proposed to allocate cash pool benefits among the participants

<table>
<thead>
<tr>
<th>Possible Cash pool scenarios</th>
<th>Overall positive balance</th>
<th>Overall null balance</th>
<th>Overall negative balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Company A</td>
<td>Company B</td>
<td>Total</td>
</tr>
<tr>
<td>Scenario 1 - no cash pool in place</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>100,000</td>
<td>- 40,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Relevant interest rate</td>
<td>0.05%</td>
<td>1.20%</td>
<td></td>
</tr>
<tr>
<td>Interests</td>
<td>50</td>
<td>- 480</td>
<td>- 430</td>
</tr>
<tr>
<td>Scenario 2 - Cash pool in place using external rates as intra-group rates</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>100,000</td>
<td>- 40,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Relevant interest rate</td>
<td>0.05%</td>
<td>1.20%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Interests</td>
<td>50</td>
<td>- 480</td>
<td>60</td>
</tr>
<tr>
<td>Intra-group interests for the leader</td>
<td>430</td>
<td></td>
<td>1,150</td>
</tr>
<tr>
<td>Benefit as compared to Scenario 1</td>
<td>-</td>
<td>-</td>
<td>490</td>
</tr>
<tr>
<td>Scenario 3 - Cash pool in place using master account rates as intra-group rates (Enhancing the interest rate for all participants)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>100,000</td>
<td>- 40,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Relevant interest rate</td>
<td>0.10%</td>
<td>1.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Interests</td>
<td>100</td>
<td>- 440</td>
<td>60</td>
</tr>
<tr>
<td>Intra-group interests for the leader</td>
<td>340</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Benefit as compared to Scenario 1</td>
<td>50</td>
<td>40</td>
<td>400</td>
</tr>
</tbody>
</table>
### Possible Cash pool scenarios

<table>
<thead>
<tr>
<th>Scenario 3bis - Cash pool in place using further enhanced interest rates for all participants</th>
<th>Overall positive balance</th>
<th>Overall null balance</th>
<th>Overall negative balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance</strong></td>
<td>Company A</td>
<td>Company B</td>
<td>Cash Pool Leader</td>
</tr>
<tr>
<td>100,000</td>
<td>- 40,000</td>
<td>60,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Relevant interest rate</strong></td>
<td>0.20%</td>
<td>0.90%</td>
<td>0.10%</td>
</tr>
<tr>
<td><strong>Interests on the balance of the single accounts</strong></td>
<td>200</td>
<td>- 360</td>
<td>60</td>
</tr>
<tr>
<td><strong>Intra-group interests for the leader</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Benefit as compared to Scenario 1</strong></td>
<td>150</td>
<td>120</td>
<td>220</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 4 - Cash pool in place applying the same interest rate for all the participants</th>
<th>Overall positive balance</th>
<th>Overall null balance</th>
<th>Overall negative balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance</strong></td>
<td>Company A</td>
<td>Company B</td>
<td>Cash Pool Leader</td>
</tr>
<tr>
<td>100,000</td>
<td>- 40,000</td>
<td>60,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Relevant interest rate</strong></td>
<td>0.60%</td>
<td>0.60%</td>
<td>0.10%</td>
</tr>
<tr>
<td><strong>Interests on the balance of the single accounts</strong></td>
<td>600</td>
<td>- 240</td>
<td>60</td>
</tr>
<tr>
<td><strong>Intra-group interests for the leader</strong></td>
<td></td>
<td></td>
<td>- 360</td>
</tr>
<tr>
<td><strong>Benefit as compared to Scenario 1</strong></td>
<td>550</td>
<td>240</td>
<td>- 300</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 5 - Cash pool in place allocating the cash pooling benefits to the depositors</th>
<th>Overall positive balance</th>
<th>Overall null balance</th>
<th>Overall negative balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance</strong></td>
<td>Company A</td>
<td>Company B</td>
<td>Cash Pool Leader</td>
</tr>
<tr>
<td>100,000</td>
<td>- 40,000</td>
<td>60,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Relevant interest rate</strong></td>
<td>0.60%</td>
<td>1.20%</td>
<td>0.10%</td>
</tr>
<tr>
<td><strong>Interests on the balance of the single accounts</strong></td>
<td>600</td>
<td>- 480</td>
<td>60</td>
</tr>
<tr>
<td><strong>Intra-group interests for the leader</strong></td>
<td></td>
<td></td>
<td>- 120</td>
</tr>
<tr>
<td><strong>Benefit as compared to Scenario 1</strong></td>
<td>550</td>
<td>-</td>
<td>- 60</td>
</tr>
</tbody>
</table>
Executive Summary

Following a detailed review of OECD’s public discussion draft document entitled “BEPS Actions 8-10 Financial Transactions”, FERMA’s views on the boxed questions are detailed in this paper. In addition, the FERMA’s Information Paper sent to the OECD in June 2017 is the foundation for our comments.

1. Any new guidance from OECD relating to captive insurance companies should be consistent with certain fundamental accounting and insurance regulations with which MNEs already comply. More specifically, this means referring to IFRS 17 and the International Association of Insurance Supervisors (“IAIS”) definition of “genuine insurance transaction” and “insurable risks”, rather than introducing new definitions.

2. In this regard, we believe that the arm’s length principles of any transfer pricing arrangement involving a captive insurance company should mean that it is treated as a genuine insurance transaction, satisfying the conditions of IFRS 17, provided it falls within the specific categories of insurance classes which the captive is authorised by the insurance regulations to conduct in the jurisdiction.

3. Currently, the draft discussion paper includes certain comments and examples that we think could create unnecessary uncertainty and administrative burdens for both MNEs and tax authorities.

1. Box E.1
FERMA believes that to evaluate whether a captive is actually assuming a risk, tax authorities can rely on principles which are already well understood and widely applied, such as IFRS 17 and the insurance regulations that generally follow the standards laid down by the European Union directives and/or the IAIS. Another set of indicators is not needed.

Furthermore, the current insurance regulations are extremely stringent about the various functions of a captive such as underwriting, outsourcing, etc. A further layer of regulations by the OECD could create a risk of confusion, ambiguity, uncertainty and ultimately more administration for multinationals and the corresponding tax authorities. The OECD can acknowledge and take advantage of the standards, rules and regulations already set out by the International Accounting Standards, the European Union, the IAIS and the respective insurance supervisory regimes.

In line with these regulatory standards, demonstrating a captive actually assumes the risk can be completed as follows:

a) There should be a real possibility for the captive to have an underwriting loss, and the captive’s capitalisation should be commensurate with the risks underwritten.

b) There is a realistic “risk gap” for the specific risks to be assumed, i.e. the annual maximum probable losses could exceed collected premiums.

c) The decision-making aspect of “underwriting function” usually remains with the captive Board (or a committee). Typically, it is the administration and accounting aspect of the underwriting function that is outsourced. However, if the function is outsourced, then the provider should be paid appropriate remuneration and captive would retain only profits related to risk and capital. But the wider governance of the captive should be considered, not just the underwriting function.

d) The decision-making and control of risk are with the captive Board (or a committee). Insurance regulations would not allow a situation where the Board had no say in risk underwriting and declining. However, if some functions are executed outside the captive, again due remuneration should be paid to provide for the function, and captive would retain only profits related to risk and capital. In an extreme case where the captive has so little governance that its mind and management are not deemed to be within its domicile, existing Controlled Foreign Companies (“CFC”) legislation already address this situation and the captive risks having its entire earnings assessed at a parent company level.

2. Box E.2
Actuarial analysis is a widespread and core pricing methodology in the insurance market, and FERMA welcomes the approach described in paragraph 181. This approach is in line with international supervisory rules such as the Solvency II Directive. As well as a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and provide robust support for the risk retention / transfer decision.
From a transfer pricing perspective, actuarial pricing is equivalent to a Cost-Plus method. The cost element will be made of expected losses (or so called “pure” premium or “burning cost”) and the margin element will comprise:

a) A risk margin for volatility due to low frequency / high severity losses;
b) Compensation for running costs associated with underwriting and claims management;
c) Compensation for costs associated with distribution network / broking;
d) A profit margin.

3. Box E.3
FERMA believes that a captive insurer that insures third party risks introduced by a connected group company, such as an agent, is not really a captive. Such a vehicle is treated as an insurance company by local supervisory authorities – particularly those in the European Union.

These companies are regulated in respect to the remuneration they derive for the nature of risk and cover they provide to third parties. Such arrangements generally follow open market conditions, and the profitability of the captive is usually commensurate with the risks it takes and the capital it has to support its commitments. The agent is paid an arm’s length commission, again commensurate with those prevalent in the market.

a) Introducing an example of a captive arrangement in the discussion draft should create more understanding of the practical application of the guidance to actual transactions. FERMA welcomes that.
b) But we believe that the example described in §187 and §188 is not helpful.
c) The key value creation aspect of an insurance contract, and therefore its pricing, is the risk transfer and risk bearing capital aspects of it. Functions such as the distribution network, underwriting and claims are complementary.
d) In the example, the agent clearly provides the distribution function and should receive an arm’s length remuneration for that. Then the captive provides risk and capital, as well as underwriting and claims functions, and it should receive an arm’s length remuneration for that as well. If any of those two components are not arm’s length, then the situation should be adjusted, but they are separate elements of added value that should not be mixed. We find the example confusing in that respect.
e) To be more specific, A would not have retained any higher profits if it had sold policies underwritten by another insurer, unlike what is described in the example (unless the commission in the example is not arm’s length). If A had worked for a commercial insurer, it would have received the same distribution network commission, but the insurer would have kept the entire underwriting profit. Using a captive in the framework enables the MNE to capture this underwriting profit by providing risk and capital in addition to the distribution activities of A. This additional piece of added value in the process, and therefore the corresponding remuneration, is created by the captive itself as a risk bearing insurance carrier within the MNE.

In addition to the comments to the specific boxed questions, we urge OECD to review and perhaps revise a number of paragraphs in the draft discussion paper, in particular numbers 165, 167, 171, 172, 173, 176, 178, 183, 184 and 185. We believe that these paragraphs are either mistaken or misleading and could create uncertainty and confusion not only among MNEs, but also insurance supervisors and tax authorities. The reasons for this conclusion are detailed in later sections of this response.

Finally, FERMA would like to reiterate points made in its Information Paper sent to the OECD in June 2017. At the core of FERMA’s paper are proposed guidelines which are meant to support national tax authorities when transposing BEPS actions into their national laws. These guidelines cover three areas which raised certain questions of interpretation by OECD members during the implementation stage of the BEPS actions published in 2015: commercial rationale, substance and governance, and transfer pricing - premium setting process.

The objective of our guidelines is primarily to avoid a patchwork of diverging national legislation. The FERMA Information Paper also outlines in detail the commercial reasons why a multinational forms a captive insurance company. It provides evidence that MNEs set up a captive insurance company to manage the Total Cost of Risk (TCOR) and get technical support from the (re)insurance market, not for tax purposes.

We, therefore, hope that OECD will review the 2017 Transfer Pricing Guidelines for tax authorities to follow when considering the captive structure, governance and insurance arrangements.
Introduction

FERMA thanks OECD for the invitation to comment on the discussion draft produced by Working Party No. 6 ("WP6") entitled “BEPS Action 8: Financial Transactions” and more specifically the chapter about captive (re)insurance companies.

We welcome the presence of a whole section dedicated to captive insurance as step that was needed to address efficiently the specificities of captive insurance transactions. We appreciate, in particular, the fact that captive insurance companies are now more generally perceived as one way for multinational entities (“MNEs”) to manage risks within the group (§162) and as a component of their risk and insurance management strategies (§172 and §173).

The OECD discussion draft offers also a better understanding of captives as small insurance enterprises, especially by suggesting that they are regulated entities (§166) and by recognising the various types of captive with an improved understanding of what is a reinsurance captive (§177).

FERMA’s main objectives in commenting on the discussion draft are to:

- Clarify understanding regarding the use of captive (re)insurance companies by MNEs;
- Promote consistency in the way BEPS principles are applied to captives going forward;
- Encourage practicality and proportionality in future OECD guidance in the context of the efficiency of multinationals’ insurance operations and risk management strategy.

FERMA, therefore, wishes for OECD final guidance that is clear, unambiguous and robust enough to provide MNEs with some legal certainty. Our aim is to reduce legal disputes and avoid any disproportionate increase in the administrative burden which would be detrimental for international businesses without providing the expected outcome for tax authorities.

The following pages gather the comments and recommendations of FERMA to the Public Discussion Draft issued by OECD in respect of BEPS Actions 8-10 and summarise the view of the European risk management community, i.e. the 22 national risk management associations member of FERMA in 21 European countries, representing 4700 risk and insurance managers throughout Europe.
Executive Summary

Following a detailed review of OECD’s public discussion draft document entitled “BEPS Actions 8-10 Financial Transactions”, FERMA’s views on the boxed questions are detailed in this paper. In addition, the FERMA’s Information Paper sent to the OECD in June 2017 is the foundation for our comments.

1. Any new guidance from OECD relating to captive insurance companies should be consistent with certain fundamental accounting and insurance regulations with which MNEs already comply. More specifically, this means referring to IFRS 17 and the International Association of Insurance Supervisors (“IAIS”) definition of “genuine insurance transaction” and “insurable risks”, rather than introducing new definitions.

2. In this regard, we believe that the arm’s length principles of any transfer pricing arrangement involving a captive insurance company should mean that it is treated as a genuine insurance transaction, satisfying the conditions of IFRS 17, provided it falls within the specific categories of insurance classes which the captive is authorised by the insurance regulations to conduct in the jurisdiction.

3. Currently, the draft discussion paper includes certain comments and examples that we think could create unnecessary uncertainty and administrative burdens for both MNEs and tax authorities.

1. Box E.1
FERMA believes that to evaluate whether a captive is actually assuming a risk, tax authorities can rely on principles which are already well understood and widely applied, such as IFRS 17 and the insurance regulations that generally follow the standards laid down by the European Union directives and/or the IAIS. Another set of indicators is not needed.

Furthermore, the current insurance regulations are extremely stringent about the various functions of a captive such as underwriting, outsourcing, etc. A further layer of regulations by the OECD could create a risk of confusion, ambiguity, uncertainty and ultimately more administration for multinationals and the corresponding tax authorities. The OECD can acknowledge and take advantage of the standards, rules and regulations already set out by the International Accounting Standards, the European Union, the IAIS and the respective insurance supervisory regimes.

In line with these regulatory standards, demonstrating a captive actually assumes the risk can be completed as follows:

a) There should be a real possibility for the captive to have an underwriting loss, and the captive’s capitalisation should be commensurate with the risks underwritten.

b) There is a realistic “risk gap” for the specific risks to be assumed, i.e. the annual maximum probable losses could exceed collected premiums.

c) The decision-making aspect of “underwriting function” usually remains with the captive Board (or a committee). Typically, it is the administration and accounting aspect of the underwriting function that is outsourced. However, if the function is outsourced, then the provider should be paid appropriate remuneration and captive would retain only profits related to risk and capital. But the wider governance of the captive should be considered, not just the underwriting function.

d) The decision-making and control of risk are with the captive Board (or a committee). Insurance regulations would not allow a situation where the Board had no say in risk underwriting and declining. However, if some functions are executed outside the captive, again due remuneration should be paid to provider for the function, and captive would retain only profits related to risk and capital. In an extreme case where the captive has so little governance that its mind and management are not
deemed to be within its domicile, existing Controlled Foreign Companies (“CFC”) legislation already address this situation and the captive risks having its entire earnings assessed at a parent company level.

2. Box E.2
Actuarial analysis is a widespread and core pricing methodology in the insurance market, and FERMA welcomes the approach described in paragraph 181. This approach is in line with international supervisory rules such as the Solvency II Directive. As well as a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and provide robust support for the risk retention / transfer decision.

From a transfer pricing perspective, actuarial pricing is equivalent to a Cost-Plus method. The cost element will be made of expected losses (or so called “pure” premium or “burning cost”) and the margin element will comprise:

a) A risk margin for volatility due to low frequency/high severity losses;
b) Compensation for running costs associated with underwriting and claims management;
c) Compensation for costs associated with distribution network / broking;
d) A profit margin.

3. Box E.3
FERMA believes that a captive insurer that insures third party risks introduced by a connected group company, such as an agent, is not really a captive. Such a vehicle is treated as an insurance company by local supervisory authorities – particularly those in the European Union. These companies are regulated in respect to the remuneration they derive for the nature of risk and cover they provide to third parties. Such arrangements generally follow open market conditions, and the profitability of the captive is usually commensurate with the risks it takes and the capital it has to support its commitments. The agent is paid an arm’s length commission, again commensurate with those prevalent in the market.

a) Introducing an example of a captive arrangement in the discussion draft should create more understanding of the practical application of the guidance to actual transactions. FERMA welcomes that.
b) But we believe that the example described in §187 and §188 is not helpful.
c) The key value creation aspect of an insurance contract, and therefore its pricing, is the risk transfer and risk bearing capital element aspects of it. Functions such as the distribution network, underwriting and claims are complementary.
d) In the example, the agent clearly provides the distribution function and should receive an arm’s length remuneration for that. Then the captive provides risk and capital, as well as underwriting and claims functions, and it should receive an arm’s length remuneration for that as well. If any of those two components are not arm’s length, then the situation should be adjusted, but they are separate elements of added value that should not be mixed. We find the example confusing in that respect.
e) To be more specific, A would not have retained any higher profits if it had sold policies underwritten by another insurer, unlike what is described in the example (unless the commission in the example is not arm’s length). If A had worked for a commercial insurer, it would have received the same distribution network commission, but the insurer would have kept the entire underwriting profit. Using a captive in the framework enables the MNE to capture this underwriting profit by providing risk and capital in addition to the distribution activities of A. This additional piece of added value in
the process, and therefore the corresponding remuneration, is created by the captive itself as a risk bearing insurance carrier within the MNE.

In addition to the comments to the specific boxed questions, we urge OECD to review and perhaps revise a number of paragraphs in the draft discussion paper, in particular numbers 165, 167, 171, 172, 173, 176, 178, 183, 184 and 185. We believe that these paragraphs are either mistaken or misleading and could create uncertainty and confusion not only among MNEs, but also insurance supervisors and tax authorities. The reasons for this conclusion are detailed in later sections of this response.

Finally, FERMA would like to reiterate points made in its Information Paper sent to the OECD in June 2017. At the core of FERMA’s paper are proposed guidelines which are meant to support national tax authorities when transposing BEPS actions into their national laws. These guidelines cover three areas which raised certain questions of interpretation by OECD members during the implementation stage of the BEPS actions published in 2015: commercial rationale, substance and governance, and transfer pricing - premium setting process.

The objective of our guidelines is primarily to avoid a patchwork of diverging national legislation. The FERMA Information Paper also outlines in detail the commercial reasons why a multinational forms a captive insurance company. It provides evidence that MNEs set up a captive insurance company to manage the Total Cost of Risk (TCOR) and get technical support from the (re)insurance market, not for tax purposes.

We, therefore, hope that OECD will review the guidance in the Information Paper for tax authorities to follow when considering the captive structure, governance and insurance arrangements.

1 FERMA Information Paper to OECD in order to propose Captive (Re)Insurance Guidelines to National Tax Authorities (June 2017).
Preliminary comment

FERMA believes it is crucial to start by highlighting its comments and recommendations about the core principle of what is a “genuine insurance transaction” before addressing the various questions and commenting on the discussion draft produced by WP6.

The definition of a “genuine insurance transaction” is the cornerstone of how OECD’s BEPS guidance should apply to captive transactions. FERMA believes this should be an unquestionable principle and would like to see clarification of the delineation of what is a genuine insurance transaction in order to avoid misinterpretations and uncertainties.

**Genuine insurance transaction**
The primary underlying principle to assess the transfer pricing aspect of a captive insurance transaction is first and foremost to determine whether it is a genuine insurance transaction.

FERMA believes the WP6 discussion draft could be more precise about this core principle and define it more clearly.

For instance, §166 mixes two different concepts in amalgamating “what is a genuine insurance transaction” and “what would be expected from an independent insurer”. FERMA believes this is confusing, because it implies that an entity should be an “independent insurer” in order to carry on “genuine insurance transactions”. This is not necessarily the case. A “genuine insurance transaction” must remain the primary driver, rather than the nature of the (re)insurance risk carrier, and should be defined by its own core features.

§166 mentions that a typical feature of an “independent insurer” is that “the insured risk would otherwise be insurable outside the group”. If we take this principle literally, it means that no innovation would be possible in the insurance market, as the first insurer to sell a new product would not be carrying on a genuine insurance business. This somewhat absurd argument aims at showing that insurance must be defined by its core characteristics, instead of the nature of the entity carrying the insurance business.

A traditional way of defining an insurance transaction is to refer to an agreement whereby one party (the (re)insurer), is obliged to indemnify the other party (the (re)insured) upon the occurrence of a fortuitous and uncertain future event in which the (re)insured has a material or pecuniary interest. A fortuitous event is understood as an event beyond the direct control of either party.

FERMA strongly believes OECD should bring clarification to what are the key features of a genuine insurance transaction in order to avoid inconsistencies across jurisdictions and to allow MNEs to operate in a stable regulatory environment with delineated boundaries allowing predictability and legal certainty.

To this end, FERMA strongly recommends following two main sets of core principles for defining a “genuine insurance transaction”, IFRS 17 definition and Regulatory Insurance Classes of Business, to avoid introducing new definitions and, therefore, greater uncertainty.

1- **IFRS 17**
Most, if not all, captive insurance companies owned by MNEs must prepare their regulatory returns and financial statements in accordance with International Financial Reporting Standards (“IFRS”) or equivalent. Therefore, so that there is no ambiguity about how the definition of an “insurance contract” can be interpreted, FERMA recommends that IFRS 17 – Insurance Contracts Principles (which replaces IFRS 4 from 1
January 2021 – but companies can adopt it earlier), applies to all insurance and reinsurance contracts and is used to set out principles for the recognition, measurement, presentation and disclosure of insurance contracts.

IFRS 17 requires an entity to identify a contract as an insurance or reinsurance contract under which the insurance entity accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

According to IFRS 17, at least one of the following must be uncertain at the inception of the insurance contract:

- The probability of an insured event occurring;
- When the insured event will occur; or
- How much the captive insurance company will need to pay to the policyholder if the insured event occurs

IFRS 17 defines insurance risk as “a risk, other than financial risk, transferred from the holder of a contract to the issuer”. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

IFRS 17 provides further guidance on “significant risk”. Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e. no discernible effect on the economics of the transaction).

2- Regulatory Insurance Classes of Business

Insurance regulations generally require all captive insurance companies to be licensed to issue contracts of insurance and reinsurance under classes of insurance businesses.

For instance, the EU Solvency II Directive 2009/138 defines the 18 following non-life insurance classes of businesses:

1. Accident 10. Motor vehicle liability
2. Sickness 11. Aircraft liability
3. Land vehicles 12. Liability of ships
5. Aircraft 14. Credit
6. Ships 15. Suretyship
8. Fire and natural forces 17. Legal expenses
9. Damage to property 18. Assistance

Conclusion
Therefore, FERMA argues that any contract of insurance issued by a captive insurance company and meeting following criteria should be considered as a “genuine insurance transaction” without further or additional challenge:

a) The transaction is about an insurable risk that falls under the specific classes stipulated by the local insurance regulations.

b) The risk being insured must be an uncertain future event at the inception of the contract and must be fortuitous, i.e. beyond the direct control of both the insured/reinsured and the captive.

c) The risk must be in respect of an “insurance risk” and not a “financial risk”.

d) There must be a realistic probability the captive could suffer a loss.

It is also worth noting that captives are subject to insurance regulation by the supervisory authorities in their respective jurisdictions. Such supervisors will review the captive’s business plan before granting the licence and then will perform regular audits all along the captive’s life to ensure that it is properly managed, governed and appropriately capitalised to meet its financial obligations.

As such, any transaction that would not satisfy the definition of genuine insurance, that would be mispriced compared with insurance market practice, or where the captive would clearly have no control over the potential exposure it is underwriting, would not be accepted by the local insurance supervisor.
FERMA’s Response to “Questions to commentators”

Box E.1. Questions to commentators

The first two questions in Box E.1. are:

- 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?

FERMA believes these two questions are intrinsically linked and can be answered by asking:

- How can it be demonstrated that a captive company actually assumes the risk that it has contractually accepted?
- What risks should be borne by and considered at the captive level to determine whether it is actually assuming the insurance transaction and as such is entitled to the related insurance earnings?
- What indicators or controlling analysis could be used to verify these risks have been actually assumed?

How can it be demonstrated that a captive company actually assumes the risk it has contractually accepted?

In order to understand how a captive actually assumes the risk that it has contractually accepted, we first refer to § 1.63 and 1.64 of Chapter I of the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which state the following:

1. “Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises”.
2. “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”.

This means that:

1. There should be a real possibility for the captive to have an underwriting loss, and
2. The captive’s capitalisation should be commensurate with the risks underwritten.

The principal points to address in this regard therefore are that:

- There should be a reasonable probability of transfer of value between the captive and the MNE entities paying the premiums, i.e. claims payments can potentially be more than the premiums collected by the captive, and
- The captive must have sufficient capital in addition to its premiums to be able to honour its contractual obligations. Such capital would be set with regard to regulatory requirements and a pragmatic
economic assessment, i.e. does the captive have sufficient assets (liquid or contingent) to be able to pay a maximum foreseeable loss under a policy in addition to predictable claim payments.

What risks should be borne by and considered at the captive level to determine if it is actually assuming the insurance transaction and as such is entitled to the relating insurance earnings? Further to these principles, it seems clear that the main risk to be borne by a captive entity is the insurance risk.

According to the OECD 2010 Report on the Attribution of Profits to Permanent Establishments, insurance risk “is the potential for the amount or timing of actual claims cash flows to differ from expected cash flows”.

In other words, there should be a realistic “risk gap”, i.e. the likelihood that collected premiums are insufficient to cover claims and expenses. Actual claims may differ from expected ones because of extreme (severity) or irregular (frequency) events.

That insurance risk must be seen at the company level as the difference between annual earned premium and annual maximum probable loss, thereby creating a true possibility for the captive to have an underwriting loss.

In a Solvency II environment, for instance, this would be demonstrated by an Own Risk and Solvency Assessment (“ORSA”) report assessing the impact of potential loss scenarios on the captive’s financial strength. Obviously, this should be measured against “reasonably expected” large losses and not total exposure, as an insurer in the market is unlikely to have enough surplus assets/capital to absorb a total loss on its portfolio without re-capitalisation.

To the extent that an insurer, be it a captive or not, assumes insurance risk, it will command a risk premium that will compensate it for the risk it is assuming.

FERMA believes there is no need to consider any specific “indicators” to assess whether the captive is actually assuming any risk. According to the very detailed accounting guidelines (IFRS) usually accepted by tax authorities and the insurance regulatory principles overseeing captive operations, creating another set of “indicators”, could lead to confusion, uncertainty, and inconsistency.

However, for the sake of clarity and as an illustration, FERMA would like to highlight again the various ratio and analyses that allow an efficient but simple assessment of the actual insurance risk assumed by a captive (or any insurance or reinsurance carrier):

- **UNDERWRITING**
  - Loss ratio (net claims / net premiums)
- **PROFITABILITY**
  - Net profit before tax (NPBT) / gross written premiums (GWP)
- **SOLVENCY**
  - Net assets / GWP

**Important**: Because nature of insurance is also to compensate losses over time, FERMA believes it is of utmost importance that any such indicator is assessed on a mid- to long-term period, and not individually on any given year. In addition, OECD should stipulate that all contracts of insurance satisfy the conditions of IFRS 17.
Box E.1. Questions to commentators

Third item in Box E.1.:

- whether an MNE group member that issues insurance policies to other 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 group member that issues insurance policies.

Paragraph 1.65 of Chapter I states the following:

“Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (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”.

When talking about the “underwriting function”, one needs to differentiate between the decision-making and administrative elements of it. What is typically outsourced to professional captive managers in the market is the administrative part relating to policy issuance, premium collection, claims payments, reporting, etc.

The decision-making element is not outsourced but always remains with the captive’s Board of Directors or Underwriting Committee, delegated by the Board. Decisions at that level include which risks to underwrite or not and under what conditions, as well as which reinsurance mitigation should be purchased in the market or not.

Key criteria should include the ability to demonstrate that there is a sufficient (proportionate) process in place to determine the acceptance of the risk. The captive should be able to show that it has access to the appropriate skills, expertise and depth of resources to undertake its activities. There is no need for own or internal resources as long as the remit under which it operates is clear and defined. Where the resources are provided by a service provider, then appropriate outsourcing/consultancy contracts, incorporating service level agreements should be in place. Where the functions are provided by other employees of the MNE, there should be clear segregation of duties. These resources should be available for use by the captive in its domicile.

FERMA also believes that emphasising only the underwriting function provides an incomplete view of what is required within a captive.

The requirement should be that the captive has the relevant governance structure in place allowing it to make knowledgeable and informed decision through the right and required combination of skills (financial, technical, actuarial, legal and managerial). As such, mentioning the governance structure and the necessary set of skills seems to us more useful than designating a specific function.

This is, indeed, what many insurance regulations require from captive (re)insurance companies: to put in place a proportionate risk management system and general governance procedures.
For instance, within the EU, under Solvency II, Chapter IV, Section 2, Article 44, the captive’s risk management systems must address, in written policy documentation, the following risks: underwriting and reserving, asset liability management, investments, liquidity and concentration, operational, and reinsurance.

The policy document must be reviewed annually by the Board of Directors. The captive Board of Directors is responsible for implementing the above. Whilst the captive is meant to be a lean organisation to ensure that the group’s Total Cost of Risk (“TCoR”) is economical and optimal, the responsibilities of the board cannot be “outsourced” to third parties.

The governance rules of the local regulatory body impose strict requirements on the board to ensure that the risk management policy covers the type of risk that the captive should underwrite, its underwriting procedures and parameters such as limits, retentions, reinsurance, and terms and conditions.

Given the level of activity in a captive in the terms of the number of contracts of insurance and reinsurance, the number of policyholders, the limited amount of risks, etc., it is frequently uneconomical to hire full time underwriters or other dedicated employees as it would disproportionately increase the TCoR of the multinational parent company. Therefore, the captive may use outsourced suppliers to execute the policies and procedures set by the board.

In addition, we refer to Chapter 3.2. Substance and Governance of the FERMA Information Paper to OECD from in which FERMA suggested a full set of guidelines to assess the appropriateness of a captive’s substance. It seems to FERMA that it gives a broader and more comprehensive view than a single technical area of the captive’s business can do.
Box E.1. Questions to commentators

Fourth item in Box E.1.:

- 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?

As per paragraph 1.51 of Chapter I: “Functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions”.

Therefore, in a captive transaction there are 3 elements to consider:

1. Who performs the critical decision making and control activities?
2. Is there actual risk transfer?
3. Is the captive actually providing capital to bear the risk?

In this respect, FERMA believes there should be no reason to challenge the transaction as long as:

1. The captive’s Board of Directors (or Underwriting Committee) is making the underwriting decisions and control of risk activities,
2. There is a “real” risk gap with possibility for the captive to make a loss, and
3. The captive’s capitalisation is commensurate with the risk it underwrites.

The question could lead to a situation where the Board of Directors of the captive did not have any say in the underwriting strategy of the captive and would not have the possibility to decline underwriting. Such a situation would not be possible under insurance regulations, as the supervisor ensures constantly that there is adequate governance locally, and the captive’s Board, or its legal representative, is accountable to the local supervisor in this respect.

Moreover, even in such case, if there is still actual risk transfer to the captive and the captive does provide risk bearing capital, it would not justify tax authorities challenging the allocation of premiums and claims under transfer pricing rules as they are directly attached to the risk transfer and risk bearing capital aspects of the transactions.

If some functions are executed outside the captive, the question from a transfer pricing perspective is more relevant to the appropriate remuneration of those functions through service level agreements.

And, in an extreme case where the captive has so little governance that its mind and management are not deemed to be within its domicile, then this situation is already addressed within existing CFC legislation and the captive risks its entire earnings being assessed at a parent company level.

The FERMA Information Paper outlines how the captive insurance company should be structured, governed and set its insurance premiums to satisfy the various transfer pricing rules of the OECD member states. As we have stressed, multinational enterprises do not form or use captive insurance companies for tax avoidance purposes. They are primarily a risk management tool. Chapter I states in paragraph 1.2 that “Tax
administrations should not automatically assume that associated enterprises have sought to manipulate their profits”. The FERMA Information Paper released in June 2017 clearly shows in the form of verifiable data that captive insurance companies’ premium income, reserving, taxable profits and corporate income tax are comparable with those of third party insurers.

If the contract of insurance issued by the captive insurance company and the manner in which the captive is governed and structured do not satisfy the requirements of the local regulations, IFRS and transfer pricing rules, then it would lead to one or more of the following:

- The captive loses its licence as insurance or reinsurance company in its jurisdiction;
- Insurance supervisor is criticised for not regulating the licensed insurance companies in accordance with the Insurance Core Principles (ICP – as amended in November 2017) issued by the IAIS. The ICP provide a globally accepted framework for the supervision of the insurance sector (including captive insurance companies). The ICP statements are the highest level in the hierarchy of supervisory material and prescribe the essential elements that must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection;
- Insurance premiums paid to the captive are not treated as a tax deductible expense;
- The captive will not pay losses suffered by the group entities;
- If the captive is reinsured with third parties, it is quite possible that those reinsurance monies will not be received as the captive has not paid any claims to the insured;
- The losses suffered by the MNE group entities will be treated as tax deductible expense in their respective local tax computations;
- This could create fluctuations in the return on investments and dividend flows between group companies, and could require an injection of additional capital from the parent to a loss-making subsidiary within the group;
- The Board of Directors may be criticised by the shareholders for mismanagement of funds and avoidable adverse share price movements.
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.

A starting point is that actuarial analysis is a core pricing methodology for the entire commercial insurance market. Every insurer, when underwriting a risk will have actuarial pricing performed, either on a portfolio basis (e.g. motor risk, household risk), or an individual basis (e.g. industrial property risk).

The actuarial analysis is particularly relevant for classes of business where there are material volumes of claims and it is the basis that insurers will use to price such policies. Where losses for an individual insured are too few for this approach in isolation, an actuarial approach can still be used for extrapolation by supplementing the experience from relevant industry losses and/or by using extreme events market models (various sources exist within the industry for this).

For instance, natural catastrophe modelling can be used to provide a modelled price for certain perils and industry rating curves can be used to inform loss frequency used in actuarial modelling. As well as providing a basis for transfer pricing, actuarial modelling can provide a technical price to assess the value of commercial insurance and inform the risk retention / transfer decision.

From a transfer pricing perspective, actuarial pricing is equivalent to a cost-plus method. The cost element will be made of expected losses (or so-called “pure” premium or “burning cost”) and the margin element will comprise:

1) A risk margin for volatility due to low frequency/high severity losses
2) Compensation for running costs associated with underwriting and claims management
3) Compensation for costs associated with distribution network / broking
4) A profit margin

Actuarial analysis is a widespread pricing methodology in the insurance market and FERMA welcomes the approach described in paragraph 181.

Additionally, this approach is in line with international supervisory standards. For instance, ICP 8 from the IAIS requires any insurer to have an effective actuarial function capable of evaluating and providing advice regarding, at a minimum, technical provisions, premium and pricing activities, capital adequacy, reinsurance and compliance with related statutory and regulatory requirements.

Similarly, under the Solvency II regime, all captives are required to utilise, where appropriate, the services of an actuary to set insurance and reinsurance premiums and technical reserves.
Introducing a captive arrangement example in the discussion draft should allow for more understanding of how to practically apply the guidance to actual transactions. FERMA welcomes the principle but finds the example in paragraphs 187 and 188 is misleading for the following reasons:

As per the IFRS 17 definition, an insurance contract is “a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.”

Therefore, the key value creation aspect of an insurance contract is the risk transfer and risk bearing capital aspects of it. As explained under Box E.2 in respect of actuarial pricing, expected losses and risk margin are the primary building blocks of insurance premium setting. Running costs to compensate for the key functions of distribution network, underwriting and claims are then added, as well as a profit margin.

In the example, the agent clearly provides the distribution function and should receive an arm’s length remuneration for that. Then the captive provides risk and capital, as well as underwriting and claims functions, and it should receive an arm’s length remuneration for that. If either of those two components are not arm’s length, then the situation should be adjusted, but they are separate elements of added value that should not be mixed. We find the example confusing in that respect.

Indeed, in the example, introducing a captive arrangement into the framework allows overall greater profitability to the MNE rather than just taking a commission from an insurer. But this would not be possible without the captive providing risk and capital. More precisely, whilst the commission would capture a share of the profit to compensate for running costs of the distribution network, the insurance carrier will look to generate underwriting profit and a return on capital for itself. Only the captive involvement provides access to this underwriting profit.

To be more specific, A would not have gained higher profits for itself if it had sold policies underwritten by another insurer, contrary to what is described in the example (unless the commission in the example is not arm’s length). If A had worked for a commercial insurer, it would have received the same distribution network commission and the insurer would have kept the entire underwriting profit. Using a captive enables the MNE to capture this underwriting profit by providing risk and capital in addition to the distribution activities of A. This additional piece of added value in the process, and therefore the corresponding remuneration, are clearly created by the captive itself as a risk bearing insurance carrier within the MNE.
FERMA’s Comments on Specific Paragraphs

The insurance and reinsurance industry operates in a highly regulated environment. Supervisory and regulatory authorities around the world are governmental bodies or agencies applying rules incorporated in national laws and overseen and coordinated at the international level, for instance by the European Insurance and Occupational Pensions Authority (EIOPA) or the IAIS.

Although the regulatory requirements may obviously vary from one country to another, FERMA’s overall comment is that WP6 does not seem to have taken these requirements into account.

Further to its answers to “questions to commentators”, FERMA wants to highlight concerns about several statements within the WP6’s draft discussion.

- **Paragraph 165**
  It is inappropriate to state that the insured can influence its product liability risk. In any case, as per insurable risk definition in the appendix, only fortuitous events would be insured and any loss that is the consequence of the insured’s voluntary action will not be eligible for claim under a valid contract of insurance.

- **Paragraph 167 (...local regulators may impose a lighter regulatory regime)**
  We disagree with that statement which is not in line with market practices and does not acknowledge the way insurance supervisory and regulatory regimes are implemented around the world.

  Captives are not subject to “lighter” regulatory regime, as they are fully regulated like all other (re)insurance entities. What is applicable in almost all supervisory regulations is the “Principle of Proportionality” (“PoP”). The PoP means that supervisory authorities should apply regulatory requirements to all entities in a proportionate way, i.e. in line with their nature, scale and complexity. That does not mean a “lighter” regulatory regime but the application of the full regulatory regime to all companies, whether captive or not, in a proportionate way, for example the extent of detail required in documentation or reporting to allow the supervisory authority to verify all regulatory requirements are met.

  This is not the same as a “lighter regulatory regime”. Proportional supervisory actions do not apply to captives only but also to various commercial insurance companies, for instance to small, traditional companies that specialise in one line of business only. Another way to illustrate the point is that very large captive companies will not have access to proportional regulation because of their nature, scale and complexity of their business, regardless of their “captive” nature.

- **Paragraph 171**
  It is the captive’s Board of Directors or a delegated Underwriting Committee that makes the decisions about assuming the risk of insuring. Other entities within the group would typically propose the risk to the captive, but they cannot make decisions on behalf of the captive’s Board of Directors.

- **Paragraph 172 (...potential commercial reasons for an MNE to use a captive include... to benefit from tax and regulatory arbitrage...)**
  FERMA strongly disagrees with that statement which seems to imply that “tax and regulatory arbitrage” is one of the key commercial reasons for an MNE to set up a captive.
We again highlight the main underlying reasons for an MNE to set up a captive, which are:

1- **(Re)insurance pricing technicalities**: via the captive, the MNE gets access to technical elements relating to (re)insurance covers and pricing structures which allow it to optimise the risk financing process. This includes reduction or stabilisation of the TCoR, buffering market conditions and developing an accurate (re)insurance strategy for financing low- to medium-impact risks over the years. A captive gives the MNE direct access to worldwide reinsurers, mutualisation of non-correlated risks, central negotiation tool, etc.

2- **Risk control**: a captive may add improvements to the overall risk management and control process of an MNE thanks to its central position in the MNE, and its data collection capabilities for losses, prevention and control measures, etc. As such, a captive can be used as a central unit for insurance data collection. It can, therefore, promote greater awareness of factors that commonly give rise to losses and be a strong support to improve loss prevention and control policies, as well as to initiate relevant control actions.

The feasibility and viability of a captive as an effective risk management tool will always be assessed on genuine commercial basis, even if tax is part of the calculation of its overall cost efficiency.

As such, FERMA believes that “benefiting from tax and regulatory arbitrage” should be removed from the list as it is not a genuine commercial reason.

- **Paragraph 173 (stating that if a captive covers a risk which is difficult or impossible to cover in the insurance market, the commercial rationality of such an agreement could be questioned, and subsequently the possibility to assess the arm’s length principle)**

FERMA does not agree that using a captive to insure risks which have not been accepted by the traditional insurance market could raise questions about the commercial rationale of such transactions. Instead, we want to emphasise that a captive may provide solutions that an MNE needs in case of insurance market inadequacies, such as coverage for non-traditional or overpriced risks.

From time to time, the traditional (re)insurance market dictates restrictions to some policies, particularly in hard market conditions, and is unwilling to provide cover for certain risks. A short term shortage of capacity can create spikes in cost. The use of a captive to buffer market conditions or to provide additional capacity can be an answer. The captive actively helps its parent company to avoid carrying uninsured risks or paying for overpriced insurance solutions.

A traditional example of the value a captive (re)insurance company can add to its group to provide coverage for risks that are emerging and for which little capacity is yet available from the insurance market, as was the case with cyber risks, or because of their very specific nature and potential impact of the risk, such as nuclear, aircraft, natural disasters, etc.

FERMA believes the key driver should not be “market benchmarking”, as traditional insurers’ risk appetite may be restricted for multiple reasons, but the characteristics of a “genuine insurance transaction” and “insurable risks” as described above.

The distinction between “insurable risks” and other considerations that commercial insurers may have in building their portfolios is essential and primary in the captive context. All “insurable risks” can potentially be insured, but commercial insurers will not wish to underwrite them all. It varies among insurers, and over time depending on insurance market cycles and competition. Filling this gap between what is insurable and what commercial insurers are willing to underwrite with acceptable conditions at a certain point in time is a
Key element of the captive strategy. Therefore, the reference point to assess a captive transaction is not necessarily what other insurers are doing in the market, just as the innovative insurance product launched by one commercial insurer cannot be judged according to what its competitors are underwriting or not.

- **Paragraph 176**
  
  We believe this paragraph is too vague and does not acknowledge insurance supervisory regulation by governmental authorities. Lack of diversification will be taken into consideration by the insurance supervisory bodies to determine the minimum capital requirement of any (re)insurance entity, be it a captive or not. Lack of diversification is not an exclusive characteristic of a captive but can also affect independent (re)insurers. It is just one important technical component of any (re)insurance entity management and can have multiple causes. For example, the insurance entity is focusing on one territory or one line of insurance products or it is a new company starting a portfolio from scratch.

In all situations, the insurance supervisory authority will assess and authorise (or not) such an underwriting strategy and can require additional capital to ensure any less diversified insurer can meet its contractual obligations. If the (re)insurance entity is not sufficiently capitalised to meet its underwriting exposure, the insurance supervisory authority would cancel its licence.

The OECD statement suggests that considerations other than the existing regulatory and supervisory ones may be applied to assess the right level of diversification within a given (re)insurance entity, which raises the question about what methodology would be needed in addition to supervisory and regulatory rules.

- **Paragraph 178 (stating that fronting arrangements involve third parties that are indifferent to the price of the transaction)**
  
  This statement is not accurate. A fronting insurer is not indifferent to the level of premium paid by its insured, mainly because of its own compliance, regulatory and supervisory requirements. A fronting insurer will always require that the right level of premium is paid by its insured, regardless of whether or not it is reinsured by a captive. The premium must adhere to its internal underwriting guidelines set by the Underwriting Committee and Board of Directors and the insurance regulations of the jurisdiction in which it is resident.

In addition, fronting arrangements are not “particularly complex” transactions: they usually involve a risk sharing between the fronter and the captive in the form of a quota share reinsurance agreement (with corresponding profit split on the underwriting result), alongside a fronting commission paid by the captive to the fronter as compensation for the administrative work involved (e.g. policy issuance, claims management, underwriting and claims reporting, etc.). The fronting insurer will be using underwriting technical analysis in setting or agreeing to the premium ceded to the captive, as it retains share of the same risk.

- **Paragraph 183 (stating that capital adequacy requirements for captives are likely to be lower than for traditional insurers)**
  
  Capital adequacy requirements of captives are not lower than those applied to traditional insurers. It is important to look not just at minimum capital requirements, but also consider what risk-based capital requirements are applicable.

In absolute terms, the amount of capital required for a captive will be lower than most commercial insurance entities, because the portfolio of risks is smaller, but proportionally to risk exposure, captives’ capital requirements actually tend to be higher, mainly because of lower diversification effects and minimum requirements applicable.
Captive insurance portfolios have the potential to be significantly more volatile than those of commercial insurers due to their limited size. Where commercial insurers can have a loss or loss and expenses that exceed the premiums collected, it tends to be a few percentage points over 100%, whereas captives can have loss ratios of several hundred percent in one year and then be very profitable for multiple years. As such, straight comparison with commercial insurers’ profitability is not necessarily relevant any one year in isolation. The underwriting ethos of many captives is to break even over the long run, not wishing to make a regular profit at the expense of the MNE’s trading subsidiaries, so this considerable year to year volatility will be accepted with comfort provided by the related nature of the business.

We refer back to the Principle of Proportionality, which is the only principle allowing a supervisory body to apply a proportionate control process to (re)insurance entities depending on their nature, scale and complexity. Captive companies must meet exactly the same level of capital adequacy requirements like all other (re)insurance entities.

- Paragraph 184 and §185 (about group synergies)

Whilst synergy does come from combined purchasing, this is only practically possible by the utilisation of the captive as a regulated (re)insurance entity which provides risk and capital. Only the captive can (i) unify the attachment point of the policy to cater for different risk appetites within the MNE before going to the market and (ii) access the reinsurance market. Without the existence of the captive within the MNE, the benefit of the synergy could not be achieved by the insured participants themselves.

Once again, the underwriting ethos of many captives is to break even over the long run, so the assessment of profitability will not be necessarily relevant any one year in isolation.

We believe, therefore, that the value added by a captive vehicle to an overall risk financing strategy goes far beyond the single “collective purchasing agreement”.

-oOo-
APPENDIX

References to international rules applicable to insurance entities including captive insurance companies

1. IFRS 17 Insurance contracts - APPENDICE A - Defined terms
   - Insurance contract
   - Insurance risk
   - Significant insurance risk
   - Uncertain future event

   - Recital 10 – Inclusion of captive insurance companies in the Solvency II Directive
   - Recital 21 – Principle of Proportionality (nature, scale and complexity of insurance business)
   - Article 13 – Insurance definitions
   - Article 42 - Fit and proper requirements
   - Article 44 - Risk management
   - Article 45 – ORSA (Own Risk and Solvency Assessment)
   - Annex I - Classification of risks according to classes of insurance

   - Article 306 – ORSA (Own-Risk and Solvency Assessment) supervisory report

   - Article 25 Product oversight and governance requirements

5. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 – Chapter 1 The Arm’s Length Principle
   - 1.51 - Functional analysis
   - 1.61 - Risk assumption
   - 1.63 - Financial capacity
   - 1.65 - Control over risk

   - Actuarial function 8.6 (p.85)

7. IAIS Application Paper on the Regulation and Supervision of Captive Insurers (Nov 2015)
   - Chapter 2 – definition of a captive insurance

8. IAIS - ICP 19A: Statistical Basis for Insurance Basic-level Module - Insurance Supervision Core Curriculum
   - Characteristics of insurable risks (p.6-7)
Contact Person: Julien Bedhouche, FERMA EU Affairs Adviser, julien.bedhouche@ferma.eu

FERMA - The Federation of European Risk Management Associations brings together 22 national risk management associations in 21 European countries. FERMA represents the interests of more than 4700 risk and insurance managers in Europe active in a wide range of business sectors from major industrial and commercial companies to financial institutions and local government bodies. More information can be found at www.ferma.eu
5 September 2018

Tax Treaties, Transfer Pricing and Financial Transactions Divisions
OECD/CTPA
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CC: Laura Beretta

RE: Comments on Discussion Draft on BEPS Actions 8-10, Financial Transactions

Dear Sirs,

_Federazione Nazionale Imprese elettrotecniche ed Elettroniche_ ("ANIE") thanks the OECD for the opportunity to provide comments in response to the OECD Centre for Tax Policy and Administration's Discussion Draft on Financial Transactions (the "Discussion Draft").

ANIE greatly appreciates the work of OECD Working Party No. 6 on providing guidance on the very complex and articulated matter of financial relationships between related parties. This letter comments on certain aspects of the Discussion Draft and suggests areas for further improvement and clarification. We hope that our comments may be useful in enhancing the effectiveness of the new proposed guidelines, in particular with regard to the practical issues that may arise in the application of the proposed guidance.

**General Comment on the Discussion Draft**

ANIE acknowledges the complexities of providing guidance on the complex area of intra-group financial transactions. In general, the implementation of the guideline proposed by the OECD would necessarily rely on certain subjective evaluations, in particular on the delineation of the actual transaction. For example, the capital structures of independent companies vary significantly as the mix of debt and equity derives from business decisions, and there are many combinations of debt and equity, which can be observed on the market. Therefore, the actual capital structure of a company should be challenged only in exceptional circumstances.

**QUESTIONS TO COMMENTATORS**

**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.
It is our understanding that the BEPS are not intended to overcome any specific local rules in terms of deduction of interest expenses (e.g. thin capitalization rules). Such rules, however being one-side only, could generate double taxation cases.

We indeed consider it very useful that general guidance is provided by the OECD in order to ensure that there is a common approach from a transfer pricing perspective on how to treat intra-group financial flows. The fact that specific OECD transfer pricing provisions are implemented together (in parallel) with specific local rules should not penalize the MNE as the purpose of transfer pricing guidance is to minimize double taxation cases.

**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 consider that the total amount of debt should never be considered as equity, unless independent parties would have done so. If there is clear evidence that the amount of a loan exceeds the amount which would have been agreed between independent parties, then only the excess should be considered as equity. Transfer pricing guidance will be applied to assess whether and to which extent the amount classified as debt from a legal perspective can be seen as such also from an economic standpoint, and thus whether the relevant interest expense can be deducted.

**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.

Once the debt capacity of the borrower is confirmed, the contractual terms of the loan would generally provide most of the elements which needs to be considered (e.g. size, maturity, currency, subordination). Additional comparability factors could also be considered but, as with all comparable analyses, it is also necessary to find the right balance between the need to consider a wide range of elements and the need to finally obtain a sufficient number of comparables to obtain a reliable range.

**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.

Making reference to government bonds of highest credit rating countries denominated in the most stable/traded currencies (euro or dollar) should guarantee the identification of the interests rate referred to the less risky assets available on the market. However, this may create a permanent loss for the lending entity, as it is unlikely that lenders will be able to raise funds at such a low interest rate. An alternative approach would be to grant the lender a return equal to its cost of funding.

To minimize the risk of controversies and double taxation, it would be useful to provide further clarification on this issue and, in particular, on whether - in these circumstances - the lender should recoup its cost of funding or consider it acceptable to be in a permanent loss.
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.

In general, very short-term rates among financial players may approximate what the OECD indicates as a risk-free rate (e.g. LIBOR, EONIA).

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.

As indicated in the response to Box 4, the proposed guidance might increase controversy and disagreement between tax payers and tax authorities, and also between different tax authorities, with a potential increase in double taxation. This may happen in particular when profit or losses are allocated to companies which are not involved in the original transaction carried out by the multinational group. In the light of this, it would be extremely important that countries commit to improve the MAP procedures pursuant to Article 25 OECD MTC to resolve double tax cases.

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.

Examples of cases of decentralized treasury functions:

— A MNE group whose financial structure is articulated in regional hubs;
— A Group growing through acquisitions without integrating the financial structure;
— A MNE group that needs to comply with specific local governance rules.

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.

On a stand-alone basis, a subsidiary may or may not have the same credit rating as the MNE group, depending on its financial structure, the sector in which it operates etc. However, the approaches described in Box C.2. are interesting, as in some way the group’s credit rating is naturally linked to
those of its components and this may represent a simplification for both MNE groups and the tax authorities for tax compliance purposes. Being rebuttable presumptions though, they may increase tax certainty only if they are implemented as safe harbours for taxpayers.

Further clarification is needed on what would happen in the case these presumptions are rebutted by the tax authorities in tax audits. The approaches would be useful only to the extent that the taxpayer position, although rebutted by the tax authorities, is not subject to penalties.

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.

The stand-alone credit rating of an MNE is the qualification of its capability to honour its debts. In assessing this, implicit support might be needed. As provided for in the OECD Guidelines, a stand-alone credit rating analysis is required in most cases for transfer pricing purposes, e.g., when assuming that a party is not linked to any group.

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

Broadly speaking, the analysis included in paragraph 70 seems reasonable.

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).

While CDS could be a useful reference in the analysis of loans, generally they have significant limitations and drawbacks (e.g. significant volatility) and would not be as useful as more traditional analyses, which are based on comparable uncontrolled transactions and CUPs.

CDS data often refer to MNE groups, hence they may not be useful to price loans on a stand-alone basis.

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

Two examples can be:
- Bonds that have similar characteristics;
- Yield curves, i.e. indexes that reflect the return on the bond market on a daily basis.

The above-mentioned potential comparables may need adjustments, for example related to the degree of liquidity of the selected instruments, as bonds tend to be more liquid than 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 MNE group average interest rate on its external debt would depend on the group credit rating and on the characteristics of the underlying debt instruments. Therefore, the average interest rate can be considered as an internal CUP only if the subsidiary receiving intra-group loans has the same credit rating as the group and the instrument can be considered comparable to the average of the instruments used by the group (in terms of maturity, currency etc.).

**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.

*Cash pooling is a typical transaction of an MNE group as similar transactions are not carried out by independent parties. The most suitable approach to regulate a cash pooling arrangement would depend on the actual facts, as well as the functional and risk analyses of the parties involved. The way it is arranged and the relative role of the parties determine whether it should be seen as a provision of routine treasury service or as a form of very short-/short-term deposit/loans.*

*The cash pool pricing policy should provide for the allocation of synergy benefits but this would not suffice to arrive at an arm's length remuneration for the cash pool members unless the underlying interest rates are also on an arm's length basis.*

**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 those cases where an MNE is obliged to participate in a cash pool arrangement, the cash pool pricing policy should be revised to consider the specific features of the MNE, as no independent entity would enter into a transaction unless it is economically rational to do so.*

**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.

*As cash pooling arrangements are typical transactions carried out within an MNE group and guarantees would assume an ancillary role and their effectiveness would vary from case to case.*
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?

Off-setting positions should be settled between the parties with hedging needs, in order to balance gains and losses in the same way as it would happen between independent parties.

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.

As for every transaction understanding the rationale and a functional analysis are necessary to assess the nature of the transaction. In terms of pricing, guarantees can be priced with reference to the benefit provided to the guaranteed entity and/or to the expected cost for the guarantor. In the case of guarantees, it is important to consider that generally only the risk component has to be remunerated (not other elements such as, for example, the cost of funding).

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 1.66, 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 would recommend clarifying whether the principles under Section E are applicable to insurance groups or only to insurance transactions undertaken by companies outside the insurance business. We made the following considerations:
— all the items listed at paragraph 166 are very important from a qualitative perspective. Both qualitative and quantitative issues need to be take into account in order to reply to the question;
— the underwriting risk and control functions on this risk;
— if the underwriting risk is outsourced, reference should be made to cases where independent parties outsource underwriting risks;
— if the control over risk is not exercised, the transaction should be more accurately delineated as it is likely that the company is not performing any insurance activity.

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.

If the internal/external CUP methodology is not applicable, the best way to assess the arm's length nature of an insurance transaction is to apply actuarial/statistical methods.

We understand that, in these cases, in pricing premiums using actuarial methods the following elements should be considered: cost of future claims, cost of reinsurance, administrative cost, mark-up /equity remuneration.

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

We agree with the example.

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We hope that the OECD will find our comments useful and that you will not hesitate to contact us should you wish to discuss the issues we have raised in this paper in more detail.

For further information, please contact Laura Beretta [laura.beretta@prysmiangroup.com] who has assisted ANIE in preparing this submission.

Yours sincerely,

Maria Antonietta Portoluri
About ANIE

The Italian electrical engineering and electronics industry association (ANIE) is one of the major industry associations in Italy, representing electrical engineering and electronics companies. It was founded in 1945 and is a member of Confindustria. It has more than 1,300 members, with a combined workforce of 468,000 and a combined turnover of €74 billion in 2016.

ANIE brings together very large multinationals as well as small and medium-sized Italian enterprises. Its members place high importance on research and innovation and account for over 30% of private Italian investment in research and development.

Nationally and internationally, ANIE and its network of members seek to encourage and strengthen entrepreneurial values, promoting their development in pursuit of the general interest of the country and acting to ensure transparent rules. ANIE is part of the European Engineering Industries Association.
Tax Treaties, Transfer Pricing and Financial Transactions Division
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5 September 2018

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Dear Sirs

Response from FTI Consulting to the OECD Public Discussion Draft on BEPS Actions 8-10 Financial Transactions.

We welcome this opportunity to comment on the OECD's Discussion Draft on Financial Transactions under BEPS Actions 8-10, published on 3 July 2018.

We agree to have our comments posted on the OECD website.

We would like to thank you for the opportunity to comment on the discussion draft and hope our comments are helpful.

Yours sincerely,

Ruth Steedman

Additional Contributors:

- Martin Brooks
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Response to the OECD discussion draft on financial transactions BEPS Actions 8 – 10

Introduction

Thank you for this opportunity to respond to the discussion draft on Financial Transactions under BEPS Actions 8-10 (the “Discussion Draft”). We have identified areas where we believe the guidance would benefit from additional clarification and where applicable, provided examples and a number of the specific questions raised by the discussion draft have been addressed below.

Specific Answers to Questions

1. 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 Discussion Draft includes the criteria that must be considered when establishing a risk-free rate of return such as the instrument being offered by a government, the issue date, the maturity, and the currency. FTI considers that complications may be encountered when attempting to implement this approach during or while covering a period of abnormal or unusual economic conditions. For example, the rate observed on a government issue may be zero or even negative at a particular point of time, as was the case during the 2008 financial crisis with several government issues. Perhaps using an average rate for a government-issued security that has been identified as a suitable benchmark for a risk-free rate of return could be considered when faced with such circumstances.

Another challenge may arise when a member of an MNE group identifies a government-issued security as a benchmark for a risk-free rate when this respective government has previously defaulted on its interest payment and/or principal. Whilst the argument may be, that a central bank or a government has the ability to print money and therefore could be considered as risk-free, an argument could also be made that some government-issued debt may in fact not be risk-free.

2. 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.

Firstly, FTI considers that it would be useful if a clarification is made as to whether these two approaches are considered as alternatives or whether they complement each other.
Secondly, FTI considers that a credit rating of an entity within an MNE group will depend on many factors such as whether a formal written guarantee exists and the level of strategic importance the entity possesses within the Group. Hence, whilst we can appreciate the attraction of a simple method (first rebuttable presumption above) i.e. that the group credit rating is applied to each group member regardless of their specific facts and circumstances, FTI considers this as too simplistic an approach.

A notching approach from the rating of the Group on a consolidated basis could be a reasonable compromise. However, it would then be helpful to set out the factors that should be considered when notching down (or not) from the Group rating.

3. **Box C.2** - 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.

FTI considers that an MNE group credit rating could be defined as a credit rating based on the global consolidated figures of the MNE group and the combined economic features of the members that form it. In the absence of a publicly available rating, commercial rating tools could be used. However, these tools may lack the rigour and the qualitative analysis applied by the rating agencies (as indicated in this Discussion Draft).

An alternative method could be to perform a benchmark search where comparable external enterprises with public credit ratings are identified in accordance with specific criteria (i.e. size, industry, number of employees, profitability, capitalisation, geography) and where the default probabilities and credit ratings are then used as a benchmark.

4. **Box C.8** - 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.

With regards to the three approaches for allocating benefits to the cash pool participants, FTI agrees that each approach has some merit but each one is only applicable with certain facts and under certain circumstances. For example, with regards to enhancing the interest rate for all participants, this approach is only appropriate if over time each member both borrows and deposits in equal measure.

5. **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.

FTI considers that this method may be too time consuming and costly due to its complexity. A lack of familiarity with actuarial models and concepts, may hinder the process of identifying whether a transaction has been priced according to the arm’s length principle for both tax authorities and tax professionals.
6. Box E.3 - Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

FTI considers the examples provided to be a valuable illustration of the fact that third party insurers that do not have direct access to customers could not expect to operate under similar profitability conditions to those who do and this must be factored into any analysis surrounding the transfer pricing implications of a captive insurer.

Conclusion

Overall, the additional guidance contained within the discussion draft is both welcomed and helpful.
Grant Thornton Discussion Draft Response

BEPS Action 8-10 Financial Transactions

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD Public Discussion Draft entitled BEPS Action 8-10: Financial Transactions (“the Public Consultation Draft”), issued 3 July 2018. Our detailed responses to the questions are set out in this document.

Commentary on paragraphs 3 to 7 of the Public Discussion Draft

• The commentary in section B1 notes 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.” This is not the case for many financial services businesses, which often have regulatory requirements to maintain specific capital ratios.

• It is also important to note that in our experience, at arm’s length many independent lenders do not typically look at the level of equity in the business so long as the borrower can afford the interest and capital repayments and has sufficient security in the event of financial distress. This means that at arm’s length, the focus by lenders is not on the capital structure of the borrower but on the affordability of the debt.

Questions B1 – 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 have concerns that where one country adopts the arm’s length principle (which we strongly support as the basis for work in this area), and another country prefers domestic legislation (possibly with ‘safe harbours’), then at best it is confusing for taxpayers and at worst can result in double taxation. Our comments below expand further on this point.

• Paragraph 9 of the Public Discussion Draft states that the guidance is not intended to prevent countries from implementing approaches to address capital structure and interest deductibility under domestic legislation. It makes a significant difference whether interest deductibility is refused because of domestic thin cap legislation or whether interest is not tax deductible because the loan is requalified as equity following a transfer pricing analysis.

• Where interest payable is not tax deductible due to domestic thin capitalisation legislation, a taxpayer does not have the right to appeal to the Mutual Agreement Procedure included in Article 25 of the MTC, and the continued taxation of the interest receipt could result in double taxation.

• Furthermore, where a loan is reclassified as equity, based on transfer pricing regulations, the interest will also not be tax deductible at the level of the borrower. However, in this case, the taxpayer does have the right to appeal to the Mutual Agreement Procedure.

• We consider it important that the OECD should agree a consensus at an international level to prevent double taxation in this area. Specifically, the priority of domestic and transfer pricing rules should be agreed because the order in which these two sets of regulations are applied will have different consequences for the taxpayer.

• For example, if first a reclassification as part of the transfer pricing analysis takes place, then the borrower has the right to use the Mutual Agreement Procedure for the interest that is not tax
deductible following the reclassification. If afterwards, part of the interest is not tax deductible because of domestic thin cap regulations, economic double taxation may still occur but should be limited.

- Alternatively, if first domestic thin capitalisation regulations are applied, the taxpayer cannot appeal to the Mutual Agreement Procedure to resolve the created economic double taxation. Only in a case where a reclassification still takes place after applying the thin capitalisation regulation, for that part, the Mutual Agreement Procedure remains available. This will in our view, often be more disadvantageous for the taxpayer.

- Consequently, from a taxpayer’s perspective, the reclassification based on transfer pricing principles should take precedence over the application of domestic thin cap regulations.

- Notwithstanding that we are of the opinion that a reclassification of a loan should take precedence over the application of domestic thin cap regulations, we are also of the opinion that the reclassification of a loan should be the method of last resort when evaluating a loan from a transfer pricing perspective. A better option is to adjust the pricing applied for the loan, to ensure that it meets the arm’s length principle.

- Furthermore, different countries may have different thresholds, evaluation procedures, etc to determine when and whether a reclassification of a loan should take place. This could result in different classifications of the same financial instrument. If this is the case, the number of Mutual Agreement Procedures might increase significantly.

- Furthermore, a reclassification to equity should not be the single and automatic solution. A reclassification to another type of financial instrument with an appropriate pricing adjustment should also be considered.

**Question B2 – Commentators’ views are invited 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 other amounts are less than the total funding required for the particular investment.**

- We consider it important that the actual borrowing and lending transaction be respected in the first instance unless the underlying commercial rationale for the loan is irrational. Our further comments are as follows.

- We note that borrowers have different risk profiles, but also lenders have different risk preferences too. Therefore, the amount and conditions that a lender is willing to grant to a specific borrower may differ from lender to lender at arm’s length.

- The characteristics of the loan will also have an impact on the amount and conditions that a lender is willing to grant to a specific borrower and that a borrower is willing to take. The amount of guarantees, repayment terms of the loan, etc. will have an impact on the willingness of the lender and borrower to conclude a loan agreement.

- Consequently, the maximum amount a lender would be willing to lend and the amount a borrower is willing to borrow, will vary/evolve in light of the characteristics of the financial instrument and the related market pricing conditions. Therefore, independent lenders/investors as well as borrowers will not automatically just choose between a straight loan and an equity
investment but will consider all types of funding (financial instruments) and will respectively diversify their investment portfolio and type of required funding.

- Where companies make use of a higher risk financial instrument, the interest to be paid by the borrower, related to that specific financial instrument, will be higher. Nevertheless, from a borrower’s perspective, such a higher cost funding may be more attractive than allowing additional shareholder’s funds. From an investor’s perspective, such higher risk financial instrument may be more attractive than an equity investment as it results in higher returns than granting a classic financial instrument but it remains less risky than an equity investment.

- Therefore, we are of the view that for determining when and for what amount a loan should be reclassified as equity for transfer pricing purposes, one should evaluate whether an independent party would prefer equity to any other type of debt instrument.

- As such, in our view, it will be extremely difficult to determine what ‘unique’ amount an independent lender is willing to grant as a debt instrument to a borrower before (partly) shifting to an equity investment.

- From a practical perspective, we have the following further observations:
  
  - The timing of evaluation of the threshold for reclassification is important. Evaluation at the moment of planning the need for additional funds may be different from that determined by an evaluation post factum. In our view, the arm’s length nature of the financial instrument should be assessed at the moment the loan was introduced based on the facts and circumstances realistically known at that time by the parties concerned.
  
  - Paragraph 19 suggests an onerous analysis of all inter-company borrowing and lending decisions to determine “all other options realistically available to them”. This would seem unnecessarily burdensome so we recommend a de minimis threshold be introduced to limit the amount of detailed analysis required.
  
  - Paragraph 20 refers to the fact that “it is more likely that potential comparables will differ from the tested transaction”. In our experience, such comparables are rarely comparable but the potential comparability adjustments referred to in the paragraph are many times themselves subjective. This is not to say that taxpayers should not try to make adjustments and identify comparables but the expectations of both taxpayers and tax authorities should be set in this context.

**Question B3 – 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.**

Commentator’s 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.

- Paragraph 22 notes contractual arrangements between associated enterprises may be insufficiently detailed to determine whether the conduct of the parties is in line with the loan documents. Many intra-group loan documents that we see are prepared by non-group legal advisers and often reflect the headings and terms seen in third party lending agreements. Furthermore, paragraph 24 refers to the lender considering similar information to that used by commercial credit rating agencies. In practice, groups (with the exception of financial institutions)
often do not have the skills or resources to perform a credit rating analysis in this way on every loan.

Question B4 – 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.

Question B5 – 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.

Question B6 – 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.

As boxes B4 through B6 are interrelated, we provide general comments to all boxes rather than focusing on individual questions.

- As a general observation, we note that the main thrust of Box B4 appears to be cases where entities with little or no functions are providing financing to other members of an MNE group. The focus of the report should be more on providing guidance for MNE groups with regards to their financial transactions in general. Hence, the positioning of this focus at the front of the draft gives it undue prominence, as it only relates to specific cases. The ‘tone’ of this section of the report could be improved if this example was referred to as an extreme case rather than the current suggestion that this is the norm for MNE groups.

Returns for Lenders with Limited Functions and Risks

- By trying to set a return for such entities corresponding to their function and risk profile via the interest rate on financing, the Public Discussion Draft is applying a non-arm’s length approach to a common arm’s length transaction. In doing so, it is then creating further non-arm’s length situations elsewhere in the value chain – for example, identifying what is a risk-free rate.

- Specifically, paragraph 1 states that where 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 implication of this and further statements in Box B4 is that the interest rate on the funding should be set so that the funder receives this risk-free rate of return. This does not correspond to arm’s length behaviour, where the interest on funding is linked to the risk of the investment, i.e. the borrower, not the lender. Given that this is the approach taken by third parties when pricing financing, then as long as the arm’s length principle remains the core standard by which transfer prices are set, this is also per se the correct approach to take in cases like these.

- The non-arm’s length nature of the OECD draft’s approach is then apparent when in paragraph 11 it states that where a funder lacks the capability to control the risk associated with investing in a financial asset and so is entitled to no more than a risk-free rate of return, subject to other constraints, the funded party would still be entitled to a deduction up to an arm’s length amount
in respect of the funding. In other words, the OECD Draft’s approach creates a situation where two distinct, and likely very different, prices for the same transaction should be used. Different prices for the two parties to the same transaction cannot correspond with an arm’s length handling of the situation, quite aside from the issues involved in such a situation relating to factors such as accounting, invoicing, on which the OECD Public Discussion Draft remains silent.

- A single price should be used for both parties to the same transaction. Under the arm’s length principle, the price should be set in the same manner that third parties would set prices. In the case of financing transactions, they would focus on the risk of the investment, ie the risk profile of the borrower, the amounts involved and other factors noted elsewhere in the Discussion Draft. The current Public Discussion Draft appears to focus more on the functions performed by the lender.

- The OECD Draft appears to have concerns where the resultant interest rates would lead to profits at the lender not commensurate with its function and risk profile. However, these concerns arise from the OECD Draft by only looking at the financing transaction in isolation and not the complete picture. The lender may have limited or no functions and risks. However, it stands to reason that a) someone must have provided the lender with the capital to provide the lending, and b) someone must be making the investment decisions, monitoring the investment, and performing other duties regarding the lending. These activities should also be remunerated, either as a service to the lender, or with the interest income passed on from the lender to the decision maker with a service remuneration remaining at the lender; what is most appropriate will depend on the facts and circumstances of the case.

- In other words, the OECD Draft is concerned about financing interest leading to inappropriate returns at companies with limited decision-making power and risks. However, the answer is not to recharacterise the debt as equity or artificially change the appropriate method for determining the interest, but instead to ensure that appropriate remuneration is in place for other parties that provide the capital, make the decisions and/or ultimately bear the risks, which could lower the profits of the lender beyond the level of the interest income.

**Risk-Free Rate of Return**

- Finally, we would note that the use of a risk-free rate of return is something that we would generally expect to see more in valuation scenarios than in the pricing of financial transactions. No lending could be risk-free (only low-risk) and in the current market even traditional government bonds are not necessarily risk-free.

- While financial transactions often have floating interest rates, these are normally based on a certain margin above a money-market rate such as LIBOR or EURIBOR, and hence these are often also used as the base rates for floating interest rates between related parties. However, these rates merely represent a market standard for the base rate of a floating interest rate and are not approximations of risk-free rates; the banks on which the underlying data is based bear risk and therefore cannot be risk-free.

**Question C1 - 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 of the draft report states that,
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.

- In this respect, the OECD draft asks for examples where there is a decentralised treasury structure, where each MNE within the MNE group has full autonomy over its financial transactions. Given the context of the question, we understand that the term “financial transactions” in this case is referring specifically to those financial transactions related to treasury operations.

- Treasury management is generally understood to incorporate the management of liquidity and mitigating risks such as operational, financial and reputational risk. These activities may include collections, disbursements, concentration, investment and funding activities, trading in bonds, currencies, financial derivatives and the associated financial risk management.

- These activities are often concentrated in the parent or head operational company of the MNE group. Nevertheless, paragraph 38 is correct in stating that different forms of centralisation are possible. Hence, an analysis of such should depend on the facts and circumstances of the individual case. It is possible, in particular with regards to smaller groups, for each MNE to remain in control of their own treasury functions.

- Even without full decentralisation, there may also be a partial decentralisation in terms of region and creating regional finance hubs, e.g. a certain continent, group of countries, or even an individual country where there are several MNEs within one country. Another example is when one MNE group purchases another MNE group, but allows the purchased group to remain operating on a stand-alone basis.

Question C2 - 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.

Question C3 - 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.

Question C4 - Commentators’ views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft.

“70. In assessing the extent to which it may be reasonable to assume that the group would be likely to support a particular entity, a group member with stronger links, that is integral to the group’s identity or important to its future strategy, typically operating in the group’s core business, would ordinarily be more likely to be supported by other group members than a less integral member. 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.”

- The issues being raised in C2 to C4 can be approached by addressing the following interdependent questions:
  1. Whether consideration should be paid to the influence of group association on the underlying credit risk attached to an associated borrower;
  2. The extent to which such a passive benefit would (or should) be considered in an arm’s length context; and
  3. In the absence of publically available credit ratings for the group or the stand-alone borrower, how could an implied rating for the group or for the borrower be reliably estimated?

- While guidance is available from rating agencies regarding the consideration of passive association on borrower rating and the determination of implied credit ratings, in an arm’s length context, the existence of a non-arm’s length relationship between the borrower and lender introduces subjectivity in applying such guidance. This has produced uncertainty for the taxpayers especially when dealing with tax administrations that may have conflicting positions on the nature of implicit support in a non-arm’s length scenario.

- Paragraph 78 of the Public Discussion Draft observes how information asymmetry and divergent economic interests—present in an arm’s length situation—are arguably absent or at least reduced (to various degrees) between affiliated parties. The observation was used to argue the superfluity of including covenants in intercompany loan agreements. However, to what extent should this lack of information asymmetry also inform an assessment of credit risk, and the possibility of parental support, on a loan made to an affiliated borrower?

- Despite the potentially reduced information gap between an affiliated borrower and lender, there does in fact remain a degree of uncertainty arising from the specific facts and circumstances that may exist at the time of the incidence of financial distress; and relatedly, the possibility of financial support extended by a lending parent to a borrowing subsidiary in the absence of explicit financial guarantees.

- As pointed out in paragraph 74 of the Discussion Draft, it is difficult to impute the existence of a pre-mediated policy to support distressed affiliates as no group consensus or decision may in fact exist until the eventuality for such support arises. Even in situations involving an arm’s length lender to a distressed subsidiary, the degree of support offered by the parent could be motivated by a number of factors, including the ability of creditors to pierce the corporate veil or
Among any other legal means that could implicate a corporate parent into a bankruptcy proceeding e.g., failure of fiduciary responsibilities etc.

- Apart from the potential legal recourse available to a subsidiary’s creditors, it is generally argued that a parent corporation has a strong motive to voluntarily provide financial support to a failing subsidiary in order to avoid severe reputational damage in the credit markets. This incentive is particularly acute for highly leverage industries, such as banking, real estate, utilities, where strong access to capital markets is a core competitive advantage. Yet, despite these considerations, the distinctive financial circumstances and forms of legal protection available to the parent could still incentivise it to withhold financial support to a distressed affiliate.

- The following bankruptcy case originating in Canada and involving a prominent multinational retailer may help illustrate the point:

- Target Canada Co was a wholly owned subsidiary of US-based Target Corporation. In early 2015, Target Canada filed for and received bankruptcy protection from a provincial court under the Companies’ Creditors Arrangement Act (CCAA), which helped distance the US-based Target Corporation from its Canadian subsidiary. Furthermore, Target Corporation continued to sustain an intercompany claim on its Canadian subsidiary for $1.4 billion which was eventually ceded by the US parent in exchange for Canadian creditors’ absolving the US corporation on some of its guarantee obligations. Based on a recently proposed recovery plan (May 2018), senior unsecured creditors stand to receive between 67 and 77 percent of their proven claims, while Target Corporation has continued to maintain its investment grade credit rating of A2 and A from Moody’s and S&P, respectively.

- While the circumstances of this case may be unique owing to the magnitude of the creditor obligations and protections offered by the provincial courts, it still serves to illustrate the error of making broad predictions on the behaviour of associated entities—especially during periods of financial distress. Hence, there exist a number of circumstantial factors that can influence the degree of implicit support materialising from a parent, including whether financial distress is confined to a specific group of subsidiaries or more widespread in nature.

- It still makes sense, however, that in the majority of cases, some degree of implicit support may arise from the parent due to concerns over reputational risks. From this viewpoint, the stand-alone credit rating for a borrowing entity could lie between (a) the independent credit rating of the borrower (excluding any influence of credit enhancement through group affiliations) and (b) the stand-alone rating being equal to the group-wide rating. In practice, however, an arm’s length lender would determine the credit risk of a borrower to lie somewhere between the two extremes and the credit risk calibrated within a band of uncertainty rather than as a precise estimate.

- Rating agencies such as S&P and Moody’s provide some prescriptive guidance on applying adjustments to credit ratings to account for implicit support based on whether the issuer is considered to be core, highly strategic, strategically important, moderately strategic or nonstrategic to the group as a whole. This is a similar concept to the observation made in Paragraph 70. However, it may not be practical to perform such a detailed analysis of credit risk, especially for smaller loans (less than €1,000,000) or multiple loans issued to numerous subsidiaries at various points in time. The prescribed method would require every loan to be evaluated based on an exhaustive three-part analysis covering (i) the credit rating of the borrower on a standalone basis, (ii) credit rating of the consolidated group, and (iii) a subjective determination concerning the relative importance of the affiliate to the broader group. Furthermore, this analysis is beneficial only to the extent that the legal arrangement between an intercompany borrower and lender and the resulting allocation of credit risk is respected by the
governing tax authority. As such, significant uncertainty would still exist based on any potential re-characterisation of the intercompany arrangement and related the redistribution of risk based on an assessment of functions and risks discussed earlier in Sections B4 to B6.

- Consideration should then be given to balancing what is theoretically accurate and what is a practically feasible level of economic analysis for the taxpayers to demonstrate and for the tax administrations to be able to review and validate. A possible solution to resolving this uncertainty is to provide a safe harbour for taxpayers to apply a group wide rating (if available) for the purposes of pricing intercompany loans provided that the same approach is applied across all intercompany loan transactions rather than being selectively applied in situations where it may prove to be advantageous to the taxpayer.

- In instances where publicly available group rating may not exist, the following alternatives could be considered:

  - In situations where the group has obtained unrated third-party loans from banks or private lenders, an implied rating could be imputed by comparing the loan pricing against publicly available loan indices by rating groupings (e.g. A, BB, B etc.). There are some potential drawbacks to this approach:

    - Ratings can be imputed only to the extent that publicly available loan pricing indices may exist for the underlying currencies/countries and across a broad enough spectrum of credit rating bands; and

    - Even when such pricing indices do exists, comparisons are usually imperfect as the indices tend to represent an average pricing on loans across a range of tenors, industries, stand by fee provisions etc. Furthermore, there would still be significant pricing impact within a specific rating band (e.g. between B+ and B-) that would be neglected.

**Question C5 - 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) can serve as useful proxies for market-based pricing in the absence of real-time pricing on more comparable instruments, such as loans or bonds. In situations when publicly available pricing is not available on loan transactions denominated in certain currencies or involving borrowers situated in less transparent credit markets, there may exist publically traded CDS contracts that can serve as representative proxies of loan level pricing information. However, a number of adjustments may need to be considered when using CDS contract pricing to proxy loan pricing. These could include adjustments for the underlying base rate, recovery assumptions, liquidity, and bankruptcy event exclusions e.g. restructuring.

- Economic models could also be useful for benchmarking intercompany loans in the absence of actual comparable transactional data. This is particularly useful to gauge pricing on privately funded mezzanine or high yield capital. Publicly available pricing information does not often exist for niche instruments such as construction loans.
In practical terms, given that many inter-company loans are long term in nature, looking at sources of bond data could be useful especially as there is data in the public domain, it is real-time and it reflects long-term financing.

Granting a loan to a group entity or independent party always entails risk for the lending entity. The risk incurred by the lender is in principle reflected in the arm’s length interest rate to be applied. We understand that input is requested on situations in which additional risk is attributed to the lender, without being compensated by a higher remuneration for the lender.

A situation in which additional risk is borne by the lender might be a situation in which a loan is granted to a strategically important subsidiary of a multinational group. When determining the credit rating of the borrower, an (upward) correction to the credit rating is often applied when the borrower is part of a multinational group. The upward correction is performed in order to reflect the implicit guarantee that is offered by the parent company to the (strategically important) group entity. In order to avoid reputational damage, a parent company will normally support its subsidiary in case of financial difficulties. By providing an implicit guarantee and consequently applying a lower interest rate (due to the improved credit rating), part of the risk relating to the loan is shifted additionally from the borrower to the lender in case the parent entity is the lender.

**Question C6 - Commentators are invited to identify financial transactions that may be considered as realistic alternatives to intra-group loans.**

- In transactions that are considered to be at the lower end of the middle market segment, the publicly available pricing on much larger loan and bond transactions may not accurately reflect the steep premium that is often paid by small borrowers in private lending arrangements. There exist a number of databases such as GF Data®, which provide market pricing on micro loans. However, due to confidentiality agreements with the information providers, the pricing information is only available as an average of multiple transactions.

- In addition, bond issuance data may also be a relevant source of benchmarking information. For example, inter-company loans are often long-term financing, which is similar to many bond issues. Furthermore, from a practical perspective there is more (and more up to date) bond issue data available in the public domain, compared with other sources of benchmarking data.

**Question C7 - 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.**

- There are only a limited number of scenarios in which the average rate on external debt can be considered similar to an internal CUP. We have listed some possible conditions under which a comparison could potentially be made:
  - Terms and conditions on external loans are sufficiently similar to those on the intercompany instrument, including currency, standby fee provisions, economic and legal circumstances in the borrower’s jurisdiction etc.;
  - The external loans were all made in relative proximity to the intercompany loan issuance; and
  - The external loans were made to a group-level entity which has a credit profile similar to that of the affiliated borrower (due to the affiliate being considered a core/ highly strategic unit of the overall group); or
The inter-company loan is likely to be subordinated to the external debt and the interest cost associated with this subordination would have to be adjusted for as part of the analysis.

From a theoretical standpoint, there are only a limited number of instances in which using average external loan pricing can be considered equivalent to an internal CUP – and a better alternative to external benchmarking. However, from a position of practicality, the method could be a convenient compromise to the taxpayer undertaking a comprehensive external benchmarking for smaller loan amounts.

Question C8 - 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.

Question C9 - 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.

Question C10 - 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.

As questions C8-C10 are all related to cash pooling arrangements, we provide general comments below to all questions rather than focussing on individual questions.

- Functions and risks should be the key determinants of the remuneration of the participants and header company in a cash pool. When the header company actually provides active management (e.g. investing excessive cash in the pool, negotiating with third party banks on rates and transactions costs, and deciding on how to hedge relevant risks arising from the cash pooling arrangement), the header company is more likely to be allocated risks with respect to lending within the MNE group. Similarly, risks such as credit risk, liquidity risk and foreign exchange risk
should be taken into account when determining the policy for the Group’s cash pooling arrangement.

• When allocating the cash pooling benefits to participating cash pool members, credit rating of the intra-group borrowers should be taken into account. It could be difficult to quantify precisely the benefits arising from such arrangement, especially on the synergy benefits. The most apparent/easiest benefit to be quantified is the saving made from offsetting debit and credit positions (‘netting benefits’). In practice, we have seen in most cases the netting benefits have been allocated, rather than the overall group synergy benefits. A more detailed guidance on how to quantify such synergy benefits might be required for multinationals, unless a qualitative approach could be accepted to determine the quantum of such benefits.

• It seems appropriate to enhance the interest rate for all participants (by relating this to size of the balance that they contribute to the pool), but the credit rating of each borrower/depositor in the group should also be looked at as this could have an impact on how much the enhancement could be of.

• In a situation where all cash pool members have the same or a similar credit profile, applying the same interest rate for all participants seems reasonable. However, this is a big assumption to be made as in reality, it is unlikely that all participants will have a similar credit rating.

• Allocating the cash pooling benefits to the depositors does remunerate the depositors for contributing their capital at risks but they should not earn more than a risk free return as they do not make additional contribution by actively managing the excessive cash etc.

• Cross-guarantees seem implicit and it is rather difficult to separately identify and quantify for intercompany transactions. The participants in the cash pool would have been benefited by the Group’s credit rating as a collective result of the header company’s arrangement with the third party bank. However, given that the synergy benefits are difficult to be quantified, it would be very difficult for the value of such guarantees to be quantified as well. The price of the cross guarantees should not be higher than the benefit received by the intercompany borrowers from the enhancement of the credit rating, and more importantly, as the guarantors have no control over the quantum of the default risks, it seems more reasonable to consider it as a capital contribution. We rarely see charges are made for cross-guarantees or even just in written contractual form in practice.

**Question C11** - 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?

• The nature of hedging activities is to mitigate potential risks arising from operations in certain areas and the motivation is not profit driven. A perfect hedge could eliminate all the risks from the transaction; however, this is more theoretical and very unlikely to take place in practice.
• It is important to identify who bears the actual risks and who performs the risk management activities when delineating transactions in relation to hedging. The risks are nominally borne by the companies who enter into the contracts for the instrument, while the risks can be managed by a separate entity in the group (mostly likely the treasury company). If the contracts are signed by the treasury company, ideally there should be an intercompany agreement to transfer all the risk exposure from the operating entity to the treasury company, so that the risks and hedging P&L could match and set off against each other. The treasury company should charge an arm’s length fee for the hedging/ risk management activities, on the condition that the treasury company has been identifying and selecting instruments and actively managing the risks.

• Where a member of an MNE group has a risk exposure that 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 risks should not be borne by the entity with such risk exposure as it is forced to be exposed to such risks. The unhedged MNE as a group should bear such risk as the risks are passively managed by the off-setting position elsewhere in the group. If such risks are eliminated, the unhedged MNE benefits from such a natural hedge. Conversely, when the risks are not eliminated, the unhedged MNE ie the whole group should assume such risks, rather than the entity that sets the group policy.

Question D1 - 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.

• A financial guarantee is required by a third party lender to mitigate the potential default risk arising from the financial transaction. The lender’s risk would be expected to be reduced by having access to the assets of the guarantor(s) in the event of the borrower’s default.

• A guarantee is usually insisted when a borrower’s credit rating / credit profile is not as good as that would be required by a third party lender for the deal the borrower is seeking to close. Therefore, guarantee could be considered as an enhancement of credit rating, but it would not have an actual impact on the credit rating of the borrower.

• The pricing of the guarantee is usually based on the benefits obtained by the borrower, for example, better credit rating achieved by the borrower. Therefore, an arm’s length range of prices can be derived from the difference between the borrower’s credit rating and the actual credit rating the borrower has achieved in the deal.
• It is unlikely for a third party to provide a guarantee for a loan borrowed by an unrelated party, unless the third party guarantor could have access to the borrower’s assets as collateral for the deal. This could have been achieved by providing the collateral to the third party lender.

Question E1 – 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.

• We have no further specific comments on this section.

Question E2 – Commentator’s views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft

• Actuarial analysis is a complex piece of work and by its nature costly to undertake. For the most part, the analysis is performed by specialised staff using high value analytical tools and the combination of these factors make it difficult (and expensive) for tax advisers, small and medium sized MNEs and tax authorities to apply, monitor or audit an actuarial analysis.

• Furthermore, actuarial analysis can necessitate access to big data, which will not be available for every sector or activity where captive insurance would nevertheless be relevant.

• Application of actuarial analysis by major MNE’s should only be advised if it will be accepted by the relevant tax authorities

Question E3 – Commentator’s views are invited on the example described in paragraphs 187 and 188 of this discussion draft

• This example focuses solely on the perceived value associated with the ‘point of sale’ advantage, which accrues in this example to Company A. There are however, other functions and risks that are central to the successful function of this transaction. For example, Company B as the insurer has to carry sufficient capital to meet its regulatory requirements and importantly, Company B takes the insurance risk associated with the transaction. Company B also has to maintain a sufficient claims-handling and administration function to support the level of product sales.
• Given that the insured products are high value new technology consumer goods, were they to break / be lost / stolen, it is likely that the consumer would claim on their insurance. The costs of this would be borne by Company B.

Furthermore, consumers are savvy and they often research where to buy their product (and any add-on services such as installation or insurance) on the internet prior to making their purchase. This suggests that the price point of the ‘total package’ of goods and insurance is important to the consumer and the selling skills of the people employed by Company A are unlikely to be an influential factor in the decision to buy. This implies that the ‘super-profit’ (but note such profit excludes the costs of repair that may happen several years later) potentially available on the transaction is by virtue of the contribution of both Company A and Company B.
Dear Sirs,

I thank the OECD for inviting public comments on the discussion draft pertaining to Financial Transactions in relation with BEPS Action Plan 8 – 10. I have been keenly following the BEPS Project from its very inception and I take this opportunity to commend the OECD for the commitment it has displayed for the BEPS Project.

To introduce myself, I am admitted to practice law in India having been called to the Bar in 2016. Additionally, I have completed the Advanced Diploma in International Taxation from the Chartered Institute of Taxation, UK in the same year. Having worked for two years in M&A and PE Tax practice of a Big4 in India, I am now assisting a Senior Advocate specializing in Direct tax laws.

The discussion on intra-group Financial Transactions are significant under the mandate of the above Actions Plans (requiring active deliberation and discussion) as these transactions constitute a sizeable portion of the overall transactions amenable to the transfer pricing regime.

The following represent my personal comments seriatim and should not be construed as professional advice. Hereinbelow, I am guided by the 2015 OECD report on Action Plan 8 – 10 which seeks to assure that the transfer pricing outcomes are in line with principle of value creation and the jurisprudence surrounding it.
Comments and suggestions

In identifying the true import of a financial transaction, the draft states to the effect that countries have full discretion to determine the characterization of the capital structure and interest deductibility under their domestic laws, however, it seems to me that there should be a few ‘minimum standards’ that the OECD should incorporate as leaving capital structure and interest deductibility completely to the domestic tax legislation may call into question these statutes in the domestic tax courts on the ground being discriminatory in nature. Since the same clauses may not be present for domestic companies. Therefore, interpretation of para 1 and 2 of Article 9 needs to be read with the non-discrimination clause and a specific reference to the said clause should be made in the MTC.

*Per-se* rule wherein any amount ‘loaned’ to an AE by the parent in excess of the loan that may be available to it from any third party to be constituted as equity, would not do augur very well for that jurisdiction as the same gives a very subjective flavour and amplifies the powers to the Tax Office to sit in judgment of the commercial prudence of businesses. To give an illustration, Project finance is one such industry where if the parent does not provide the ‘extra’ credit support at least during the construction period of the project the lenders will simply not lend at all. Parental support enables the project to achieve better pricing terms and hence lower the debt deductions in the longer run. Further, the onus of proof in these cases are a very crucial factor and the transaction should be presumed to have been carried out in good faith drive by commercial considerations and these should be rebutted (if deemed so) by the Tax Office. The effect of an opposite situation, results in uncertainty even after the Tax Payer incurs substantial compliance cost for the transaction.

Therefore, basis the documentation provided by the Tax Payer and the commercial considerations involved the Tax Office should conclude independently on the (real) nature of the transaction applying their own mind. This helps the tax ecosystems and in-turn the economy in a number of ways, viz., only those transactions that Tax Office, believes and have a reason to believe, only such transaction come under litigation and second, the Tax Payer is free to carry out the commercial activity in ways that appeal most to his commercial prudence. Here, I am reminded the words of David Porter who said “litigation is the basic legal right which guarantees every corporation its decade in court”. Suppose a situation where IndiaCo. (ICo.) who has made the borrowing to ForeignCo. (FCo.) on interest rate comparable with export packing credit rate, however, the Tax Office applies the rate that ICo. would earn advancing a loan to
an unrelated party in India but ultimately the courts hold that since the ICo. income was exempt there is no ‘benefit’ being derived by the ICo. and therefore, no adjustment is warranted. This may seem like a straight jacket case however, to come to this conclusion the matter had to reach to the level of a High Court in India\(^1\). This increases the cost of the transaction substantially and therefore a *per-se* rule seems undesirable.

Further, to support the proposition that these types of cases are hinged on a complex law on a complex set of facts, (and therefore *per-se* rule in that sense may not be of much relevance) I draw the attention of the reader to US Tax Court case of *Illinois Tool Works Inc.* wherein the Tax Court upheld the characterization of a cross border inter-MNE financing transaction. While this was, as always in these cases, quintessentially fact-intensive inquiry (mentioned earlier that presumption should lie in favour of the Tax Payer), the US Tax Office (‘IRS’) contended that the upper-tier CFC (the HoldCo.) lacked an independent ability to pay interest or repay the principal loan because the upper-tier CFC was relying upon the operations of its subsidiaries. The Tax Court while rejecting this argument held that a potential creditor would evaluate the ability of the HoldCo. taking into effect the whole structure of the MNE. If this argument is accepted, the Tax Court held, that it would imply that a HoldCo. is incapable of entering into a genuine inter-MNE financing transactions. This again may be relevant where the Parent needs to guarantee and give credit to an SPV for execution of a large project.

Additionally, what looks apparent in the discussion draft that the OECD has suggested that Article 9(1) of the MC may be used as a thin capitalization platform wherein should the domestic law of the country of the support thin capitalization then Article 9(1) may be invoked unfettered. This does not seem to be the interpretation promulgated by the OECD. Assuming a country does not have thin capitalization in its domestic tax law, may it invoke Article 9(1) to seek to disallow thinly capitalized companies?

However, once this is established that such debt : equity ratio is in excess and gauging by the facts of the case are just a tool employed by the Tax Payer only for taking a tax benefit, the excess amount may not straightaway be classified as ‘equity’. These should be treated on case-to-case basis (along with Group ratio test – wherein debt : equity ratio of the whole group is taken into account) since it might be improper to hold any transaction qualifying as ‘equity’ infusion *per-se* since it’s not a debt obligation. The excessive ‘interest’ may be disallowed/ stricter withholding tax obligation be imposed on the ‘excessive’ interest to protect the base

\(^{\text{1}}\) Cotton Naturals, Delhi High Court
of the source country and terms of the agreement be modified to make it comply with Arm’s Length Principle in terms of extending period of credit, vary interest rate etc. Additionally, there should be certain safe harbour rules inbuilt into this debt characterization regime. Here what is pertinent is whether such funds have been advanced a shareholder action or a commission agent.

The OECD TP guidelines addresses the scenario where a capital-rich company of the MNE group provides funding but performs zero or modest activities in relation to that area. If this AE does not control the financial risk associated with its funding (it just provides funds without any assessment of whether the party receiving the money is creditworthy), then it will be entitled to no more than a risk-free return. The current draft is seeking to extend this method to financial transactions as well. According to this discussion draft if the funding entity does not perform the decision-making functions or controls the risk associated with investing, it will be entitled to no more than a risk-free return as an appropriate measure of the profits retained. This is a welcome move when accompanied by the CbC reporting requirement.

One significant area in this regard has been the guarantees issued to overseas subsidiaries by the ICos. and associated litigation thereto. The question in essence arises whether this will be considered as a shareholder action vis-à-vis commission agent. To determine whether the Tax Payer acted as one of the two above, the draft enlists a circumstance wherein in absence of a certain guarantee, the overseas subsidiary is unable to generate the credit supply it requires, that is post implicit guarantee the funds could not be generated then the guarantee shall be considered as a shareholder action. Whereas, should the subsidiary be able to generate a supply credit and an express guarantee is given by the Parent, which provides a low rate of interest this may be considered as a guarantee commission in form of a split of savings. In addition, it may be worth clarifying that these tests are dependent on/supplement the characteristic functions of shareholder or guarantee agent, as the case may be, (depending upon the documentation, in absence thereof guidance in maybe para 78 used), and are not to be seen independently only in light of the borrowing capacity of the AE. Finally, numerical examples may be used to illustrate the point and provide additional clarity.

Conclusion

I appreciate the work performed by OECD in this complex area of law and as such welcome the discussion draft. My whole purpose of writing this document is to remind ourselves that
BEPS is essentially a tool to protect the base of the countries where value is generated and as such that should be our guiding light. While we follow this avowed objective, we should be cognizant of the complex litigation the MNE’s may face in a lot of jurisdictions and that it should not result from a policy of double non-taxation to double taxation.

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Thank you once again for considering these comments and the opportunity to share my views on this issue. I hope you find the comments useful to the discussion.

I look forward to continued collaboration with the OECD.

Sincerely,

Hardeep Singh Chawla
ICC Comments on OECD Discussion Draft BEPS Actions 8-10 (Financial Transactions)

The International Chamber of Commerce (ICC) welcomes the opportunity to provide input on the Organisation for Economic Co-operation and Development’s (OECD) consultation draft on transfer pricing of financial transactions.

It is ICC’s view that the submission of OECD work for public consultation presents an indispensable aspect of building and maintaining credibility with taxpayers and tax administrations.

With this in mind, ICC presents the following comments and contributions for consideration with the aim of achieving improved and generally accepted Transfer Pricing Guidelines. Comments are provided on both the explicit questions put forward in the discussion draft as well as on other aspects of the draft.

Executive Summary / Fundamental comments:

The key issue that runs through several aspects of the paper is whether the arm’s length principle, including a full functional analysis and delineation of the transaction, should be applied when analysing the conditions surrounding intercompany financial transactions. The ICC supports the OECD position as set out in the most recent transfer pricing guidelines, in particular para 1.14:

―the view of OECD member countries continues to be that the arm’s length principle should govern the evaluation of transfer prices among associated enterprises. The arm’s length principle is sound in theory since it provides the closest approximation of the working of the open market in cases where…services are rendered between associated enterprises…. [The arm’s length principle] generally produces appropriate levels of income between members of MNE groups acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer’s particular facts and circumstances and adopts as a benchmark the normal operation of the market.‖

The ICC supports this position as it is the best way to avoid double taxation and therefore encourage cross-border trade and investment. Alternatives, at their worst, may encourage groups to fund locally as this may be cheaper (after double tax) than funding at the group level, even if the interest rates are higher. This reduces the overall profits of multi-national enterprises.

Therefore, ICC would support the application of only the arm’s length principle to the conditions surrounding intercompany financial transactions, in particular:

- Selecting the credit rating for the borrower
- Benchmarking the interest rate applied
- Pricing the return for a cash pool leader
- Analysing the price of intercompany insurance

ICC believes that rebuttable presumptions may result in non-arm’s length results. Therefore, we support them only when selected by the taxpayer, who should retain the option to perform a full functional analysis and to determine an arm’s length price. Any adjustment needed should only bring the transaction into the arm’s length range not, for example, delineating the entire capital structure as equity. Where the arm’s length principle is departed from to implement the outcomes of BEPS Action 4, or where a taxpayer has opted to use a safe harbor, this should be done in a way that reduces double taxation and therefore encourages cross-border trade and investment.

ICC also supports the OECD’s position when it states, at para 1.6 of the guidelines, that the “separate entity approach treats the members of an MNE group as if they were independent entities”. Therefore, the
parent does not legally own the assets of the subsidiary and should not be seen as controlling those assets unless the functional analysis supports that.

ICC considers the best way to apply the arm’s length principle to intercompany funding is to:

1. Apply to the borrower a credit rating following the publically available information available on credit rating agencies’ websites
2. Find comparable bond data to price the interest rate
3. Adjust as necessary for tenor, subordination, liquidity etc.

The ICC would welcome further examples to help clarify the application of the arm’s length principle, in particular in the following areas:

- How and when the options realistically available to the participants of the cash pool should be considered
- Situations where hedging activity may generate intercompany transactions
- To illustrate the effect of outsourcing specific underwriting functions on the income allocated to the MNE group member that issues insurance policies
- Clarifying when a captive is operating a business other than an insurance one

ICC believes that the OECD should clarify whether its transfer pricing guidance for financial transactions should apply retroactively, setting out whether or not this is seen as a clarification of the existing transfer pricing principle and guidelines.

Specific comments:

Sec 3: ICC can confirm that due to minority interests, regulation, independent directors and other factors, an MNE group does not always have the discretion to decide upon the amount of debt and equity that will be used to fund any entity within the group. There are many valid commercial reasons for the split between debt and equity that apply in both controlled and uncontrolled transactions. For example, a revolving loan facility can be far more practical then issuing and then buying back equity.

Box B.1. Question to commentators:
Sec. 8-10: Clear rules are needed to resolve double taxation especially where there is an interaction between multiple factors such as capital structure, debt pricing and domestic interest limitation rules. For Article 25 matters ICC suggests that where the country of the related party borrower has instituted interest limitation rules that are consistent with the outcomes of BEPS Action 4, the country of the lender should make a corresponding adjustment to relieve double taxation as consistent with the purpose of the double tax treaty to avoid double taxation. Where a country’s interest limitation rule is not consistent with BEPS Action 4, ICC suggests that Article 25 matters may be resolved by the country of the borrower allowing a tax deduction up to maximum amount that would be consistent with BEPS Action 4 with only an equal and off-setting amount taxed as interest in the country of the lender. ICC further considers that the taxpayer should have a right to amend its interest limitation deduction after any mutually agreed procedure (MAP) claim has been concluded in respect of interest and/or debt.

Sec. 10: ICC does not consider that the current wording in paragraph 10 ("the purpose of this section is to provide guidance for those countries that use the accurate delineation under Chapter I") is appropriate where potential double taxation is referred to MAP; ICC considers that the paper should establish a single clear principle that related party financial transactions referred to MAP should be resolved by the Competent Authorities via the accurate delineation methodology and wider transfer pricing approach set out in the 2017 Transfer Pricing Guidelines.

Sec. 16: It is not clear to ICC how the status of the funder helps to accurately delineate an advance of funds. In addition, ICC would request OECD confirmation that an on-going dividend is a valid commercial reason for borrowing in third party situations.
Box B.2. Question to commentators:
Sec. 17: Generally, apart from extreme and clearly abusive cases, the capital structure and thus the use of debt or equity capital chosen by a company and its shareholders should be accepted. Generally, the fiduciary duties placed on a lender’s directors will not allow them to make loans that they know cannot be repaid. Regarding the example in paragraph 17, it should be taken into account that independent companies on a regular basis also find themselves in situations where they are unable to service loans that they have taken out (and which a third party lender has granted). Furthermore, this serves to illustrate that ex ante financial projections often do not sufficiently reflect the credit default risk that may be obvious in hindsight. Thus, by itself, the fact that a company (related borrower) is unable to service a loan does not constitute sufficient evidence that taking out or granting a loan was in violation of the arm’s length principle. Secondly, the example explicitly states that “all good-faith financial projections” show that the lender “would be unable to service a loan” and that “an unrelated party would not be willing to provide such a loan”. ICC is of the view however, that this example is unrealistic as the situation in practice is rarely as clear-cut. Rather, the taxpayer and the tax administration may disagree as to whether it could or should have been foreseen that the lender would be unable to service the loan. Thus, guidance should be provided on how to identify such situations. Finally, assuming that a situation was as clear-cut and unambiguous, ICC agrees that possibly only the “arms-length” part of the loan might be accepted as such, with the remaining being delineated as equity.

ICC considers that additional examples on the relevance of debt/equity re-characterisation would be helpful including guidance on when tax authorities should not seek to apply section 17. Most helpful would be an example clarifying that a tax authority should not challenge situations where the financial metrics of the related party lender are more conservative than that of its MNE group.

An example of a commercial situation where a full delineation of the transaction indicates that a departure from “normal” debt levels would be justified would also be welcomed. For example, a related party lender might increase its borrowing levels if in financial distress or making an acquisition to develop its business and economic opportunities. In such situations, an increase in the maximum amount that an unrelated lender would be willing to lend may be arm’s length as would an increase in the borrower’s normal debt level.

ICC would welcome an approach similar to the “Thin Capitalisation Approach” set out in the OECD’s 2010 report on the allocation of profits to Permanent Establishments so that the capital structure of an entity could not be challenged by a tax authority if it had a similar capital structure to independent entities “carrying on the same or similar activities under the same or similar conditions in the country”.

ICC considers that the latter part of the question in Box B.2 (“the entire amount needs to be accurately delineated as equity”) does not satisfy the arm’s length principle and needs to be reconsidered. The only amount that should be accurately delineated as equity is the remainder above the maximum amount that the unrelated lender/borrower would have agreed. Whilst paragraph 17 refers to this remainder as the appropriate amount that would not be recognised as a loan, the latter part of the question in Box B.2 does not.

Box B.3. Question to commentators:
ICC believes that it is hardly possible to define a set of factors to be taken into account. Rather, the transaction intended by the transaction partners, i.e. the related partners, such as documented by written agreements (e.g. loan agreement) and/or other evidence should in principle be accepted by the tax authorities. The tax authorities must bear the burden of proof that a certain transaction intended by the transaction partners should be “transformed” into something else. Moreover, this should only be acceptable in cases of gross abuse.

Box B.4. Question to commentators:
1. ICC does not agree that a funder – regardless of its capabilities and decision-making functions – should necessarily be entitled to no more than a risk-free return. Apart from the fact that a risk-free return is very difficult, if not impossible, to determine in practice, the return of a funder should always reflect the risks in fact borne by that party. Moreover, between unrelated parties – regardless of how one-sided the distribution of functions and risks – a funder will never earn but a risk-free return.
2. Given that the determination of transfer prices is an inexact science at best and that also between unrelated parties, for any given transaction a wide range of transfer prices can usually be observed, it should be fully sufficient to approximate a risk-free rate of return. However, ICC agrees that in fact no
investment will entail zero risk.
3. ICC agrees that using government issued securities (assuming the government is triple-A-rated) constitutes a viable reference for a risk-free return.
4. ICC agrees that the respective currency of the financial transaction to be priced should correspond to the currency of the government issued security.
5. ICC agrees that one should strive for temporal proximity with regard to the transaction to be priced.
6. ICC agrees that one should consider the maturity and strive for a respective congruence.
7. ICC believes that the example is too hypothetical and unrealistic to sufficiently comment on.
8. ICC agrees that securities other than government issued securities might be used to approximate the risk-free rate of return.
9. ICC disagrees with the concept that the tax administration of a country may select the security of a higher-rated country as the risk-free rate if issued in the same currency. The Greece tax authorities, for example, should not be able to reference a German bund as an appropriate risk-free rate for exposure to the Greek market.

Box B.5. Question to commentators:
9. In principle ICC agrees that the risk-free rate is useful as a component in calculating risk-adjusted returns. However, in practice it is often the experience that tax authorities will rarely accept such approaches and would rather prefer the application of the Comparable Uncontrolled Price (CUP) method and more often, a simple cost-plus approach. Against this background ICC respectfully encourages the OECD to issue guidance with a view to strengthening the acceptance of such approaches and expressing a preference for the CUP method.

10. ICC finds the reference to Paragraph 1.85 helpful albeit financial transactions may be more complex and more commonly dis-aggregated than the examples within Paragraph 1.85. The appropriateness of, and interaction with, Paragraph 1.93 to 1.97 should also be considered with respect to financial transactions especially since it is common for financial special purpose vehicles (SPV) to be used for individual financing transactions to enable efficient circulation of cash and to mitigate exposure to foreign currency risk and default risk. SPVs may outsource certain or all risk-control functions to other legal entities (which may or may not be related parties) such that the SPV’s directors manage and control risk, but may not have their own FTEs to directly conduct day-to-day risk control. Provided a functional analysis established that appropriately-capable directors exercise real control and authority over the risks including the implementation and periodic review of any outsourced risk management functions, ICC considers that risk should still be allocated to that SPV.

Box B.6. Question to commentators:
11. Generally, as expressed above, ICC questions the practicability of deviating from the transaction actually concluded by the involved parties. If, however, a borrower pays an arm’s length interest rate, then this payment should be accepted as a tax deductible expense regardless of which party might actually be due the paid amounts. Therefore, the question of allocating the residual amount between the “funder” and the “different related party” might be subject to Mutual Agreement Procedures between the involved countries according to Article 25 OECD-MTC.

ICC considers it would be helpful for the OECD to provide additional detail on the typical risk-control functions and capabilities exercised by third party lenders. Many financial transactions such as lending are typically subject to only a periodic review which does not require extensive resources to manage the inherent risk – especially where experienced financiers oversee and manage those risks.

Box C.1. Question to commentators:
Sec. 38: ICC believes that it cannot be defined in the abstract when a company that is part of a multinational enterprise group has full autonomy over its financial transactions. Generally, this should be assumed to be the case until and unless there is clear and unambiguous evidence to the contrary.

While no specific questions were asked with respect to the paragraphs listed below, ICC respectfully provides its comments as follows:

Intra-group loans:
Sec. 47: ICC fully agrees that both the lender’s and the borrower’s perspective should be taken into account. In this regard, ICC notes that both parties’ perspectives are ideally taken into account by applying the CUP method. However, it should be noted that, in practice, information available usually allows focus of the analysis more on the borrower’s side
Sec. 50: ICC would be grateful if the OECD would confirm that the evaluation of, decision to take on, and management of risk can be managed periodically by relatively few people in a relatively short time.

Sec. 51: ICC agrees that between related parties the same processes will not take place (especially from a formal, procedural view) as between independent parties. However, it is ICC’s view that this is often not necessary because much of the information that an independent lender intends to gain through a formal due diligence process is readily available within a corporate group.

Sec. 52: ICC does not agree that the parent has ownership of the assets of the subsidiary; as a matter of legal fact, the subsidiary owns those assets. If the subsidiary is wound up, creditors will typically have first claim on those assets. The subsidiary, which may have independent directors and/or minority interest shareholders, can only dividend up assets as allowed by local law and its own constitution. ICC does not agree that one can generalise who has control of the assets without a detailed functional analysis. However, a parent company typically has particular insights into the financial position of a subsidiary that external lenders do not have. Thus, there may be situations in which a parent company might lend money to its subsidiary without risk (and, hence, at a risk-free rate). Moreover, in such situations no formal agreement or collateral is necessary.

Sec. 54: ICC agrees that borrowers seek to optimise their weighted average cost of capital for the chosen business strategy whilst having the right funding to meet both short-term and long-term objectives. From this aspect, it is reasonable to assume that some borrowers will pledge collateral to optimise their cost of finance. However, whether or not to pledge collateral can also depend on other factors such as the financial benefit from pledging collateral (where the assets are held in a regulated industry there may be limited financial benefit), if any, since the loan provider may struggle to either operate or on-sell those regulated assets without significant costs) and whether pledging collateral may restrict future funding options due to the business strategy adopted by a borrower. It is possible that a borrower values the flexibility of securing future funding more than the cost of financing at the point of entering into the loan in question. The fact that there are countless third party loans lent without collateral can support this point.

The example listed in paragraph 54 discusses that in some circumstances, it is suitable to assume that collateral will be used when the borrowers have assets which can be used as collateral. Without clarifying what those circumstances and adding another example to illustrate the possibility of loans not having collateral, this example could be misleading to tax authorities and could lead to conclusions not in line with the actual commercial reality. Therefore, it is recommended to remove this example.

Sec. 55: One reason why a business may borrow is to take advantage of the tax shield interest payments normally provide. It would be helpful if the OECD would state that this is a valid commercial reason.

Sec. 56: ICC would welcome confirmation from the OECD that loans which are repayable, such as revolving facilities, as opposed to term loans, provide less upside to the lender, as a borrower may repay early if interest rates rise, and therefore will typically command a higher interest rate.

Sec. 58: ICC respectfully encourages the explicit statement that if a credit rating has been established, interest rates may be determined by applying the external CUP method and using publicly available information (e.g. on similar loans or bonds issued by companies of a similar rating).

Sec. 61: It would be useful if the OECD could confirm that different lending instruments have different interest rates, even for the same borrower. For example, arm’s length prices indicate that loans tend to have higher interest rates than bonds which are typically more liquid and require upfront bond issuance costs. Bond issue costs quickly become sunk and are not typically included within simple spot yield calculations despite being a cost of issuing bonds.

Sec. 63-64: These two sections seem to suggest a hierarchy preference of official credit ratings, that credit ratings provided by independent credit rating agencies are preferable to all other approaches. ICC respectfully disagrees. Unlike official credit rating agencies, commercial lenders assume the real credit default risk and implement procedures to manage and control the default. A generalisation that the official credit ratings analysis is “far more rigorous analysis” than that of commercial tools absolutely should not be made without a detailed analysis of the facts. It is ICC’s view that where an accurate assessment of the
circumstances dictates, a commercial lender’s perspective (including their commercial tools and models) may in fact need to be prioritised over official credit rating agencies. Furthermore, the OECD should be aware that for small groups or subsidiaries, it may be highly or disproportionately costly to obtain a valuation by an official credit rating agency.

Sec. 65: It is ICC’s view that this comment is at best confusing and therefore, suggests deleting or amending it. Naturally any analysis of one transaction must be built upon the premise that the underlying data is not biased. However, as it stands, the comment might easily be misinterpreted in a way that the analysis of a credit transaction necessarily involves the analysis of (all) other transactions.

**Box C.2/3. Question to commentators:**
ICC supports the use of rebuttable assumptions and safe harbours only when it is the taxpayer’s option to use them and when the tax payer retains the right to perform a full functional analysis and to determine an arm’s length price.

Sec. 67-69: The arm’s length principle asks us to consider what would happen in a third-party situation. We know from evidence that arm’s length official ratings agencies and banks do not always give subsidiaries the same rating as their parent. Nor do they rate all subsidiaries by taking the parent’s credit rating and adjusting down. ICC considers that potentially having two methods of credit rating presents the risk of double taxation. This could occur if the lender rebuts the assumption and uses an individual credit rating and the borrower does not rebut the assumption, using a group-level rating. Therefore, ICC recommends that the OECD:

1) Allows the use of 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 and official credit rating agencies as appropriate, and

2) Ensures that where a taxpayer has elected to make use of a presumption or safe-harbour that any double tax can be relieved under a MAP

**Box C.4. Question to commentators:**
Sec. 70: ICC agrees that in assessing the question of whether a group will be likely to support a specific member a higher degree of integration and importance of that member to the group will make it more likely that this member will be supported by the group. Therefore, all else being equal the more important an entity is to a group and its future strategy the higher the credit rating the entity is likely to have. However, there would still typically be a difference in the parent rating and that of the subsidiary. However, such analysis will necessarily always remain qualitative in nature, i.e. ICC believes that it is still virtually impossible to assess the specific consequences for granting an intra-group loan to that member.

Sec. 74: ICC requests the OECD to make clear that tax authorities should take care when placing any reliance on a group’s publicly stated comments on their subsidiaries – few companies would make a statement they would not support a subsidiary or that they are looking to dispose of that company. To do so could affect staff morale, key-stakeholder decisions, or adversely affect the value that may be realised on disposal.

Sec. 75: ICC agrees that covenants in a loan agreement can reduce the risk of the lender. Therefore it would be useful if the paper can make it clear that covenant light intra-group agreements may result in the lender bearing more risk than in comparable loans (subject to the OECD’s rules regarding the allocation of risk, set out in the guidelines) and therefore may require a higher interest rate to compensate for those risks.

Sec. 80: ICC questions the relevance of this section as most pricing of intra-group financial transactions relies upon the CUP or CUFT methods rather than cost plus approach. Also, there seems to be little

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1 The OECD may find it useful to refer to Judge Robertson J’s decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation, Federal Court of Australia (2015)* for a considered view on the relevance of banking evidence over credit rating evidence. For example, paragraph 503 of the first instance decision of Robertson J: “In my opinion, the correct perspective is that of a commercial lender. A commercial lender would not approach the question of the borrower’s credit worthiness in the same way as would a credit rating agency.”
evidence provided to show that the costs (for example) a bank may incur are greater than a related party lender on a loan by loan basis let alone in relation to the amount lent.

**Box C.5. Question to commentators:**
ICC holds credit default swaps (CDS) to be a valuable means of pricing a loan, or corroborating the pricing of a loan. In particular, it is possible to derive the risk premium demanded by unrelated investors which, together with a risk-free rate of return can be used to price debt. However, the respective information is often not available to smaller groups of companies and will seldom be a comparable transaction. For this reason CDS may be of limited practical assistance in pricing many intra-group loans.

Sec. 82 et seq.: In practice, the CUP method is widely used and perfectly reasonable under the arm’s-length principle. Therefore, it should be borne in mind that the application of the CUP does not require identical, but merely similar/comparable transactions (possibly with an adjustment to the price derived by applying the CUP). Moreover, when applying the CUP, generally any price (interest rate) of a range of similar comparables should be acceptable. Sec. 82 et seq. should reference the importance of CUPs being from the same country where possible. Similar to ICC’s comments on sec. 63-64 above, sec. 82 should be amended to also accept the consideration of other commercial tools used by commercial lenders as opposed to focusing solely on credit ratings. Whereas sec. 83 suggests widespread and frequent comparables, it should be noted that a lack of transparency in the primary loan market (and a limited secondary market for loans) coupled with typically few loan issuances in the same country, industry sector and at a similar issue date to the tested transaction can make finding recent comparables difficult.

**Box C.6. Question to commentators:**
ICC also supports the use of bond data. It is more widely available than loan data, has a more active/liquid secondary market and so should not be ignored. ICC would, however, add the caveats that bond yields do not take account of up-front fees and also tend to be priced lower than loans due to a number of factors, including the fact that the bond markets are more liquid, with greater price transparency, than the secondary loan markets.

**Box C.7. Question to commentators:**
ICC feels that it is highly unlikely that internal CUPs will be available to price intra-group transactions as the credit rating, financial performance, funding requirements etc. will vary materially between the members of the group. Also, it is highly unlikely that a group member will borrow from both a third party and a related party close enough together in time, with similar terms and conditions, as to make the transactions comparable. ICC can only see a situation where a related party “steps into the shoes” of an independent lender, allowing a third party revolving facility to be repaid and closed by lending on very similar terms, as being one in which internal CUPs would be of use.

Sec. 89: From ICC’s perspective, the “cost of funds” method does not necessarily arrive at arm’s length prices (interest rates), because it does not take into account either the potential borrower’s alternatives, nor the lenders’. However, there may be transactions where the lender does not analyse and evaluate the risks of the loan, does not perform the decision-making functions, nor monitors the risk on an on-going basis. It might also be the case that the lender does not have the financial capacity to lend to the borrower with itself borrowing an equal and off-setting amount. In this situation the functional analysis may find the lender is acting less like a bank lender and more like a conduit. Therefore, any profit margin might be low, reflecting the low level of functions performed, assets used and risk borne. Similarly, a parent company may not require a risk premium (cf. above).

Sec. 92 et seq.: Bank opinions – going beyond a simple letter for informational purposes – may also prove useful as a source of information regarding the CUP. Hence, bank opinions should not be dismissed out of hand. In practice, it may be difficult for a bank to withdraw from its previously stated intentions.

**Cash pooling:**
In addition to the comments below, ICC requests the OECD to clearly set out how double taxation within a cash pool should be resolved. The balances held by participants to any given cash pool will often fluctuate with multiple depositors and borrowers. There is rarely any clarity as to which borrowing relates to any given deposit and hence no certainty on the appropriate bilateral double tax agreement for a MAP claim. An Article 25 MAP claim could potentially be submitted to a number of double tax agreement partners. ICC suggests that, provided the Article 25 request is submitted to a Competent Authority which has at least the opposite net interest position to the party suffering double taxation, it should be accepted for MAP. If the OECD prefers a MAP claim to be submitted to the country of either the cash pool leader or the
legal entity which “zeros” the pool, then that should be clearly explained.

Box C.8. Question to commentators:
ICC believes that the guidelines should clearly state that both in principle are acceptable under the arm’s-length principle: A cash pool leader that acts as an entrepreneur, bearing material risks and exercising material functions, and a cash pool leader that acts as a service provider of a routine activity. Moreover, functional and risk profiles in between may occur. As a result, the allocation of group synergies very much depends on the specific cash pool and the allocation of functions and risks.

Box C.9. Question to commentators:
Sec. 102: It is difficult to conceive a situation in which participation in a cash pool would make a participant worse off than their next best option that is genuinely an option that is realistically available to them. Otherwise, this is only practically imaginable if there are extremely high transaction costs and/or other conditions (interest rates) which are worse than on a stand-alone basis.

ICC considers it would be helpful for the OECD to provide additional guidance to tax authorities as to how and when they should consider the options realistically available to the participants of the cash pool. For example, where companies have objectively decided they want to hold cash for commercial reasons in addition to their key investment criteria for that cash (e.g. risk-free, immediately-available assets), then provided there is no reason to question those objective commercial decisions, options which do not satisfy their decided criteria should not be put forth by the tax authorities as realistically available options.

Sec. 111: ICC does not agree with the standard assumption that the cash pool leader performs no more than a coordination function. Rather, this should always depend on the case at hand.

Box C.10. Question to commentators:
Sec. 130: ICC believes that a (physical) cash pool does not require guarantees. This is because the cash pool typically only covers over-night lending/deposits, which are inherently less risky than almost any other kind of financing. Furthermore, if it is the parent company that manages the cash pool, the cash pool leader may not require any collateral/security from its subsidiaries (cf. above). If it is the parent company issuing guarantees for its subsidiaries, it is doubtful whether this needs to be remunerated. If, however, a remuneration is called for, these costs might be allocated or remain with the cash pool leader (depending on the type of arrangement).

Box C.11. Question to commentators:
ICC believes it is necessary to first understand the purpose of the hedging transactions. Some may be entered into to hedge the return the parent makes. For example, a group may report earnings in US Dollars but have one group member which is located in the EU which has costs and revenues denominated in Euros. The treasury function may wish to hedge the budgeted net earnings of the European subsidiary by entering into a US Dollar v Euro foreign exchange transaction. ICC’s view is that the P&L credit or debit related to that transaction should not be transferred to the European subsidiary.

Alternatively, there may be situations where the European subsidiary has an internal hedging requirement. For example, it may pay suppliers in sterling but generate its own revenues from customers, and report in Euros. In this case, the subsidiary may wish to hedge itself against foreign exchange risk and that would be the same if it were an independent entity. The MNE’s internal policy may prevent the European subsidiary hedging from entering into a hedge itself. Instead the treasury function may manage the foreign exchange risk. One way could be to have another group member enter into a foreign exchange transaction with a third party bank. Another way could be to leave an off-setting position (such as a subsidiary which pays its staff in Euros but receives payment from customers in sterling) unhedged. Either should be considered a related hedge and the smaller of the debit or credit should be transferred to match the economic outcomes in the same taxpayer.

Guarantees:
Box D.1. Question to commentators:
Sec. 137: Generally, guarantees are also issued and priced between third parties and, should therefore be priced accordingly between related parties. Having said this, there are special circumstances to be considered when looking at related parties. Inter alia, the implied support due to group membership constitutes a kind of guarantee which under the arm’s length principle should not be remunerated.

Sec. 140: ICC does not agree with this section. ICC believes the suggested approach of subdividing loans
into different portions to be overly complicated and not feasible in practice. This is exacerbated by the fact that it is highly unlikely that both tax administrations involved in such transactions will accept any such subdivision. If the tax administration of the guarantor does not respect the analysis then there is the risk of double taxation as the interest income may be fully taxable in the hands of the lender but there is a portion of the interest deductible neither by the borrower nor the guarantor. There may also be double taxation if a portion of the guarantee fee is disallowed in the borrower but fully taxed in the guarantor. Rather, ICC believes that to the fullest extent possible the legal structure chosen by the taxpayer should be accepted by tax administrations and priced under the arm’s-length principle. If not, then all members of the OECD should agree that the element of interest relating to the capital that the lender would not have lent save the guarantee should be deductible by the guarantor.

Sec. 141: ICC supports the idea that including any payment for guarantee should still leave the borrower better off overall. Moreover, both tax administrations involved (especially on the side of the payee) should accept this payment as a tax deductible expense. Furthermore, ICC supports the idea that only an explicit and legally binding guarantee may warrant remuneration. Everything below that threshold should not be compensated under the arm’s-length principle. ICC questions the relevance of cost in this section as most pricing of intra-group financial transactions relies upon the CUP or CUFT methods rather than cost plus approach. Also, there seems to be little evidence provided to show that the costs (for example) a bank may incur are greater than a related party guarantor on a guarantee by guarantee basis let alone in relation to the amount guaranteed.

Sec. 142: It is ICC’s view that the all the risk of default in the original loan still exists if the loan is guaranteed. It is just that some of it has passed from the lender to the guarantor. As little else, if anything, has changed one would expect the interest paid to the lender plus the guarantee fee to be paid to the guarantor in aggregate to be very similar to the interest on the original loan. Therefore, ICC favours the yield approach above the other proposed approaches.

Sec. 142 et seq.: ICC suggests undertaking the process without any payments if there is a large number of cross-guarantees. In such situations it would be much too complicated to accurately delineate and price each transaction. Additionally, there are good reasons to believe that also under the arm’s-length principle this does not warrant remuneration, unless such cross-guarantees are in effect one-sided.

Acknowledging that intra-group guarantees is a complex field, where both tax authorities and taxpayers usually have limited experience, ICC remains available to provide further input and expertise to support the future steps of the process. ICC welcomes and encourages the OECD’s continued engagement with the business community in order to address pragmatic and effective approaches.

Captive Insurance:

Box E.1. Question to commentators:

ICC would welcome the OECD to provide a number of examples to illustrate the effect of outsourcing specific underwriting functions on the income allocated to the MNE group member that issues insurance policies.

If an MNE group member does not satisfy the control of risk requirements of Chapter 1, then per the Guidance this would conclude that the policy issuer did not perform the decision making functions required to appropriately manage and control the economically significant risks. It is our view that full delineation of the transaction is still required to assess the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed (including whether the policy issuer assumes risk and has the financial capacity to assume the risks) in determining the arm’s length return to be earned by the policy issuer.

Sec. 166: The OECD states that an indicator that a transaction that is genuinely one of insurance is that “the insured risk would otherwise be insurable outside the group.” Sec. 173 also states that “Another possible reason for the use of a captive insurer by an MNE group in addition to those listed is the difficulty or impossibility of getting insurance coverage for certain risks. Where such risks are insured by a captive insurer this may raise questions as to whether an arm’s length price can be determined and the commercial rationality of such an arrangement.” ICC wishes to highlight that there are instances where MNEs identify real commercial risks and potential liabilities that they wish to insure against, however third party insurers are unable to issue policies (or affordable policies) as they firstly want to understand the level of risk. During this ‘incubation’ period, an MNE may still wish to self-insure to demonstrate to third party insurers how the risk is being mitigated and managed, with a view to externally insuring part (or all)
of the risk once the third party insurer achieves a suitable level of comfort. ICC therefore wishes to highlight that a related party transaction may have an element of risk not insurable outside the group (at least for a short period of time) where the commercial rationality should not be questioned as a consequence.

Sec. 176: ICC would welcome the OECD to expand the commentary, and perhaps give 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." Are there any particular thresholds or examples which could clarify when a captive is operating a business other than an insurance one?

Box E.2. Question to commentators:
Sec. 181: ICC acknowledges and agrees that an 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. However, ICC would like to see further commentary in this area (including examples) to assist in determining an arm’s length price under this method, as often the actuarial analysis will calculate a ‘technical’ rate which could differ from the market rate for a particular risk.

In addition, the Discussion Draft 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. We 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.

Sec. 182: ICC disagrees that a comparable uncontrolled price can be arrived at simply by considering a combined ratio and return on capital. Specifically, we consider the approach to be too simplistic and formulaic in comparison to actuarial analysis, and such an approach does not take into account many other commercial factors and complexities that a captive needs to assess when determining its premium pricing.

In addition, the combined operating ratio approach seems to suggest that the return for captives should be relatively moderate, even if the captive is assuming significant underwriting risks and has a real risk of incurring significant claims. This appears to be at odds with sec.175, which, in the context of considering whether the transaction is one of insurance, states that, “The assumption of risk by the insurer can only take place if the insurer has a realistic prospect of being able to satisfy claims in the event of the risk materialising.” If there is no realistic prospect for a captive to generate sufficient capital reserves to satisfy its claims and remain solvent (in addition to meeting the regulatory requirements), a captive will be unable to operate as intended.

Sec. 183: ICC disagrees 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). Since the introduction of Solvency II, any regulated captive operating under the new regulatory framework will operate under a strict framework, where establishing adequate capital (plus buffers) and proving its solvency are regularly required to ensure that the captive can continue to operate and meet its expected claims.

Sec. 185: Whilst we recognise that the operation of a captive can generate group synergies in the reinsurance market (some of which should be allocated amongst the insured) ICC disagrees that, “The synergy benefit arises from the collective purchasing arrangement, not from value added by the captive”. The relevant insurance experience and skill set of a properly established captive’s employees enables the MNE group to purchase the best possible re-insurance (not just in terms of price but also limit structure, coverage, terms etc.). Without the functions and activities of the captive, it is unlikely that MNEs could achieve the same level of benefit, and as such a detailed analysis of the functions, assets and risks of the captive needs to be undertaken to ensure that the captive is also adequately rewarded for its role in generating value for the insured parties.

Box E.3. Question to commentators:
Sec. 187-188: The example provided by the OECD makes the assumption that the insurance product sold is substantially the same as that which any other insurer in the general market could provide, and also that A could sell policies underwritten by another insurer and retain most of the profit for itself. Whilst ICC agrees that the arm’s length remuneration for the insurer should be in line with the benchmarked
return for insurers insuring similar risks in the specific example, it will often be the case that there are key differences between insurance products that need to be considered by undertaking a detailed functional analysis. These differences could, for example, be the coverage of the policy, the excess and the likelihood of the insurer satisfying claims, and also the wider functions, assets and risks of the insurer and the retailer, all of which need to be fully evaluated in determining the arm’s length pricing for a specific transaction. 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.
The International Chamber of Commerce (ICC)

Commission on Taxation

The International Chamber of Commerce (ICC) is the world’s largest business organisation with a network of over 6 million members in more than 100 countries. We work to promote international trade, responsible business conduct and a global approach to regulation through a unique mix of advocacy and standard setting activities—together with market-leading dispute resolution services. Our members include many of the world’s largest companies, SMEs, business associations and local chambers of commerce.

ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.

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Introduction and Summary

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS)\(^1\), a group of global insurance and reinsurance companies, in response to the OECD’s paper of 3 July 2018 entitled *BEPS Actions 8-10 Financial Transactions* (the Discussion Draft). The stated aim of the Discussion Draft is to provide guidance on the application of the Transfer Pricing Guidelines Chapter 1 D1 (identifying commercial or financial relations) to financial transactions. Section E of the Discussion Draft has specific analysis in relation to “captive insurance” companies.

While further guidance and examples are generally welcome in terms of providing greater clarity relating to the treatment of financial transactions, it is not clear why the OECD considered that additional guidance was required specifically in relation to financial transactions involving global insurance and reinsurance groups, or captive insurance. In our view there is nothing that prohibits the current Chapter 1 guidelines from applying to financial transactions or arrangements involving insurance or captive insurance.

More specifically:

- The Discussion Draft does not appear to acknowledge the extensive discussions that have already taken place with industry during the development of the guidance on Article 7 of the OECD Model Tax Convention or the preparation of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments Part IV on insurance. Prior work by OECD in this area has been extensive, as have the consultations with industry on these issues. This prior work and conclusions should be incorporated into any final analysis relating to transfer pricing guidelines and financial transactions.

- As was the case in this prior work, it is important to take into consideration the role of regulators and the impact they have on the accurate delineation of reinsurance transactions in a regulated insurance group. The financial capacity to assume risk and functional capability to manage risk are fundamental concerns of regulators. Because the OECD has already recognised that the regulatory frameworks in which banks and insurers operate require separate consideration, at a minimum, the Discussion Draft should defer to its prior work in the 2010 OECD Report to ensure clarity of the applicable rules and consistency in application. We direct the OECD to its prior acknowledgement that non-tax rules apply to the insurance industry for arranging risk. The first footnote in Chapter 1 D.1.2.1 of the Transfer Pricing Guidelines makes note of the regulatory constraints imposed on regulated industries and directs the user to the guidance provided in the 2010 OECD Report. We recommend a similar statement be provided in these guidelines.

\(^1\) The members of the Working Group are AIA Group Limited; American International Group, Inc.; MetLife, Inc.; Prudential Financial Inc.; Prudential plc; Swiss Re, AXA, and XL Catlin. Note that references to the "insurance sector" and "insurance groups" in this document include reinsurance & reinsurers.
• The OECD should also take into consideration the prior work and consultations with the industry relating to the proper treatment of interest expense, as the treatment of debt between related parties is also a fundamental aspect being addressed in the Discussion Draft. Specifically, its 2016 final report on Action 4, entitled “Limiting Base Erosion Involving Interest Deductions and Other Financial Payments,” explores factors that can impose constraints on the ability of banking and insurance groups to engage in BEPS involving interest, together with limits on these constraints. “Overall, significant regulatory and commercial considerations reduce the risks posed by banking and insurance groups, but differences exist between countries and sectors. Each country should identify the specific risks it faces, taking into account the characteristics of banking and insurance groups and the requirements of regulators. Where BEPS risks involving interest are identified, a country should introduce rules which are appropriate to address these risks, taking into account the regulatory regime and tax system in that country. In all cases, rules to protect countries from BEPS should not weaken the effectiveness of capital regulation in providing protection against a future financial crisis.”

• Much of the Discussion Draft fails to acknowledge the important distinctions between reinsurance within a regulated insurance group that ultimately relates to the insurance of third party risk, and with captive insurance within a non-insurance group. Much greater clarity should be given to the differing characteristics of each to ensure that any guidance published is as helpful as possible both to taxpayers and taxing authorities. This would allow both parties to have adequate assistance in applying the guidelines depending on whether the transaction in question is one within a regulated insurance group carrying out insurance of third party risks as its main business and thus subject to regulatory constraints, or whether it represents an intra group pooling of a group’s own risks by a captive insurer. Our suggestion would be that the definition of a captive versus an insurance company leverage from the Solvency II definitions. Solvency II is a pan-European regulatory framework developed over decades with the cooperation of member states. It is also used to define captive insurance in the EU Anti-Tax Avoidance Directive. Broad alignment with these definitions could allow for greater clarity without risking arbitrage beyond the definitional boundaries. Alternatively, such guidance could be based on the functional hallmarks of a commercial intra group reinsurance, as set out in the OECD’s Report on Action 3 (“Designing Effective Controlled Foreign Company Rules”) of the BEPS project (and not the amended hallmarks included in the Discussion Draft, for reasons discussed below).

Our position is that regulatory and commercial factors that apply to intra group reinsurance within a regulated insurance group significantly reduce the opportunity for BEPS activity. To the extent that intra group reinsurance is within a regulated insurance group, these activities should be specifically excluded from the guidelines suggested in the Discussion Draft. The hallmarks of regulated intra group reinsurance discussed in the final Action 3 report are an excellent reference point for making this distinction and are discussed in more detail in the “Hallmarks” section below. Our recommendation is consistent with the original scope of the working party’s work on financial transactions and would not exclude intra group reinsurance from other applicable guidance such as the 2010 OECD Report. If the working party believes that there is value in including intra group reinsurance in the guidance then there should be a

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separate discussion of the subject to ensure that due weight is given to the influence of regulatory and financial factors in the delineation of the transaction.

For the sake of clarity, in the rest of this submission, intra group reinsurance refers to retrocession by a regulated insurer of third party risks to an affiliated regulated reinsurer in an insurance group. Captive insurance refers to insurance (or reinsurance) of the underlying risk of an un-regulated entity to an affiliate captive insurer or reinsurer in a non-insurance group.

II. Background

Insurance of third party risks and intra group reinsurance (within an insurance group) is a highly regulated activity. Regulators require insurers to hold sufficient reserves to meet expected claims and adequate capital to absorb losses from additional claims and adverse events. Both the cedant (the insurer or reinsurer ceding its risk to the reinsurer) and the reinsurer’s regulators require the reinsurer to have the appropriate reserves and be adequately capitalised before they recognise the assumption of insurance risk by the reinsurer. The financial health of insurance groups is also closely monitored by credit rating agencies. Most insurance groups would be capitalized at the holding company level with a cushion above the level that satisfies regulators and rating agencies, but insurers at the entity level seek to maintain levels of capital closer to the minimum requirement of regulators. Given the cost of capital and the difficulties in bringing capital out of a subsidiary, there is no benefit to overcapitalizing or maintaining “surplus capital” in an insurance subsidiary. The regulatory requirements and credit rating agency scrutiny creates transparency on the levels of capitalisation required by independent insurers. This transparency makes it easier for stakeholders to identify “surplus” capital and shareholders typically expect insurers to distribute surpluses over the capital necessary to maintain a commercial credit rating. This makes it difficult for insurers to over capitalise locations as a means of BEPS activity, whilst the regulatory scrutiny of the balance sheet of the reinsurer ensures that the reinsurer will have the financial capacity to assume the risk.

When reviewing intra group reinsurance the regulators of both the cedant and the reinsurer also require the reinsurer to be capable of managing the insurance risk transferred to it. The regulators’ requirement that the reinsurer is capable of managing the insurance risk overlaps with the concept of management and control of risk discussed in Chapter 1 D1.2.1. The cedant and reinsurer’s regulators acceptance that the risk has been assumed by the reinsurer should be conclusive evidence that the parties have followed the contractual terms of the reinsurance contract.

In our view, sufficient regulatory and commercial safeguards exist to significantly reduce the likelihood that an accurate delineation of an intra group reinsurance contract would conclude that an entity other than the reinsurer has assumed the reinsured risk. Ideally the discussion draft should be amended to specifically exclude reinsurance transactions within regulated insurance groups when those transactions are related to the reinsurance of third party risk. If not, there should be more commentary on the regulatory and commercial factors specific to intra group reinsurance and how they influence the conclusions reached from an accurate delineation of intra group reinsurance transactions.

III. The Discussion Draft

Our comments on the Discussion Draft first address the specific questions raised in relation to section E on “Captive Insurance,” before commenting more broadly on areas of concern raised by the discussion draft.
Section E – Captive insurance. Questions included at Box E1 p37.

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 view is that guidance should distinguish between intra group reinsurance within an insurance group that ultimately relates to the insurance of third party risk where both the cedant and reinsurer are subject to external scrutiny from regulators, and captive insurance.

A good place to start on building a definition could be the EU definition of captive. The Solvency II Directive definitions of ‘captive insurance undertaking’ and ‘captive reinsurance undertaking’ are more tightly drawn than is the case in some jurisdictions. Article 13 of Solvency II defines captive insurance and reinsurance undertakings as follows:

(2) ‘captive insurance undertaking’ means an insurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c)11 or by a non-financial undertaking, the purpose of which is to provide insurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member;

(5) ‘captive reinsurance undertaking’ means a reinsurance undertaking, owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings within the meaning of Article 212(1)(c) or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which it is a member.”

Many other countries, including Bermuda, have adopted or are adopting measures aimed at securing a determination of Solvency II equivalence that will also separately define captive insurance.

Captive insurers can add value to a non-insurance group through increasing the effectiveness and efficiency of risk protection and also enhancing the organisation’s ability to take advantage of the commercial reinsurance market. The insurance market may have limited capacity/ appetite for certain low frequency/ high impact risks and whilst these risks are insurable, groups may find that they have a better appreciation of the nature of the insured risk (for example, better access to, and a deeper understanding of, data, particularly market sensitive or proprietary data) and are able to self-insure for a smaller premium. The captive also effectively ring fences funds to enable claims to be met whereas funds left on the balance sheet of the insured could be called upon to meet other creditors or distributed to shareholders. Captive insurance may form part of a group’s wider risk mitigation function, including reducing third-party credit risk, by providing risk managers with increased visibility of the insured risk and incentives for minimising the claims. Captive insurance can also allow the group to centralize assets for more effective and efficient investment management.
Captives within the EU and some other territories are subject to similar levels of regulation and supervision as insurance groups. Further, captives are sometimes rated by well-established rating agencies, providing independent opinions to demonstrate a captive’s financial strength and performance against best practice to a variety of stakeholders. Therefore, in some cases a captive insurer will have demonstrated the financial capacity to assume contractual risk provided that it holds capital in accordance with the appropriate regulatory regime for its jurisdiction, as well as has a track record of paying out in the event that any claims have been made. The captive would also need to demonstrate that it had the functional capacity to assume such risk.

If the captive is subject to a lighter touch regulatory regime, the captive could provide an actuarial analysis to demonstrate that it has the financial capacity to assume the risk. Where its capital is within the range that independent insurers typically hold it would be safe to conclude that it has the financial capacity to assume the risk. Most insurers have capital sufficient to support a credit rating in the S&P A range and a captive with capital that would support at least a BBB rating is indicative of adequate financial capacity.

We have dealt with the threshold for the necessary function for the control and management of the assumption of risk in the section on outsourcing.

**Intra group reinsurance**

In the case of intra group reinsuance, where both regulators recognise that the reinsurer has contractually assumed the insurance risk, the regulators will have judged it to be capable of managing the risk. If regulators as external third parties recognise that the risk has transferred to the reinsurer there should be a presumption that the parties’ conduct is consistent with the reinsurance contract. In the exceptional case where the reinsurer does not have the capital and functions to assume the risk the regulator would conclude that the risk has not passed from the cedant and would require the cedant to hold the reserves and capital necessary to meet claims.

*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?*

Under IFRS 4, the definition of an insurance contract refers to the transfer of insurance risk from the holder of a contract to the issuer. In particular, the accounting standard notes that a contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract. Therefore we consider that this point is met almost entirely by the existing accounting standard rules contained within IFRS 4. (From 01/01/2021 IFRS 4 will be superseded by IFRS17)

Looking to the UK as an example to provide further context in relation to this interaction of accounting standards with tax law, the UK corporation tax legislation defines an insurance premium as “any payment received under the contract by the insurer, and in particular includes any payment wholly or partly referable to-

(a) Any risk,
(b) Costs of administration
(c) Commission
(d) Any facility for paying in instalments or making deferred payment (whether or not payment for the facility is called interest), or
(e) Tax
Further, the regulatory definition (to which captives would be subject) defined by the Bank of England Prudential Regulation Authority, (PRA) defines a premium to mean the consideration payable under a contract of insurance by the policyholder to the insurer.

For the avoidance of doubt, neither captive insurers nor insurers in a regulated insurance group can “control” insurance risk. While this is acknowledged by the OECD in para. 1.67 of the Report on BEPS Actions 8-10 ("Aligning Transfer Pricing Outcomes with Value Creation"), this is particularly true of insurance risk, which is by its very definition an uncertain event. Insurers in general cannot exert any influence over the crystallisation of risk into loss; instead, the entity must set policies, assess risk selection, pricing, decide whether to retain or lay-off the risk further, and then decide whether to accept the insurance risk. These functions appear to be broadly equivalent to the key entrepreneurial risk taking functions described in the 2010 report on attribution of profit, and the activities defined as "risk management" in para. 1.61 of the Actions 8-10 Report. This analysis is also relevant to the issues raised in paragraph 174, relating to the “existence of insurance.”

**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.**

Whilst it is a common feature throughout the captives market that management functions are outsourced to a third party captive manager, this is generally on the basis of producing cost efficiencies as well as input into the set-up and ongoing management of the captive. It is axiomatic that functions outsourced to third party captive managers do not result in the assumption of risk insurance by the captive manager. Similar functions outsourced to members of the captive’s group do not result in the assumption of the insurance risk by that group member.

In addition, elements of what may be classified as underwriting activities may be undertaken by outsourcers without the captive relinquishing control of the assumption of insurance risk. It is necessary to clarify what is meant by “underwriting” in guidance and distinguish between those parts of the function that may be outsourced without having transfer pricing consequences and functions that are central to the control of risk. Assumption of risk through underwriting is the KERT function for any insurance company, captive or otherwise, and therefore this is not a function capable of being outsourced.

Part IV (para 34.) lists five components of underwriting as

- Setting the underwriting policy
- Risk classification and selection
- Pricing
- Risk retention analysis
- Acceptance of insured risk

These components of the underwriting function can be examined individually and where they do not contribute to the KERT function of the assumption of insurance risk they can be performed by the outsourcer and the captive can still exercise control of risk requirements in paragraph 1.65. It is difficult to see how a captive could still be said to have control over the risks it was assuming if it had outsourced the acceptance of insurance risk, an exception possibly being if underwriting policy and other components were so rigidly defined that risk acceptance itself became a checklist exercise.
In the absence of a specific example, however, the guidance should make it clear that it is possible for captives with outsourced operating models to demonstrate that they perform the key decisions on whether to select and assume insurance risk, lay off or retain that risk, and assess and negotiate pricing and terms as long as the outsourcer’s role is limited to the performance of day to day functions and services.

*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.*

There is already existing guidance in place in Chapter I of the Guidelines, where to the extent it is concluded that a captive does not control the acceptance of insurance risk assumed the guidance could either recharacterise as a cash deposit or restrict the captives return to that of a risk free (or risk adjusted) return. In this case, the balance of the return, or profit, would be allocated to the non-insurance company that is deemed to have assumed the risk. However, a symmetrical result should follow in the case of a loss, in which the non-insurance company should be allocated a portion of that loss.

*Section E – Captive insurance. Question included at Box E2 p41.*

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

It is not clear why this section is considered necessary in the context of a discussion draft on the identification of commercial or financial relations in chapter 1 D.1.

Chapter II of the existing OECD guidelines already sets out clear transfer pricing options, and it is unclear why financial transactions would need specifically defined separate options. We understand that applying market pricing to a captive insurer has intrinsic difficulties because of the lack of available information on market pricing and we agree that using a technical actuarial approach should result in a price within or close to the market range. In addition, disputes over actuarial findings can be complex and difficult for independent tribunals to resolve.

The suggestion that a comparable uncontrolled price could be determined using a profit level indicator based on return on capital is a reasonable practical solution to the difficulties that tax authorities may find in applying the actuarial method or other OECD approved methods. There is no one appropriate level of capital but as a minimum we would expect the captive to be capitalised to a level that would at least support an S&P rating range of BBB to AA for the captive on a standalone basis. No two insurers have the same pricing policy or risk profile. Differences in individual insurers pricing policy and their claims experience will result in very different combined ratios across insurers writing insurance in similar classes of business. These differences make it impossible to identify an arm’s length combined ratio to benchmark against the results of the captive. Given the sensitivity of combined ratios to pricing policy and risk profile, we consider that combined ratios are too sensitive to market factors to provide a reliable method for determining the arm’s length price.

**IV. Other comments**

In addition to the areas noted above where comments were specifically requested we also have the following areas where we would like to provide comment:

In para 163 there is a loose definition of a captive stating that a: *so-called “captive” insurance company, a group member that provides insurance –type services exclusively or mainly to members*
of the multi-national group”. This wording is fairly broad and therefore we would recommend that the definition be clarified further so that it is aligned to regulatory definitions which distinguish between captives insuring wholly or mainly affiliate risk where the group is not an insurance group and intra group reinsurance within an insurance group. We have explained that intra group reinsurance arrangements are inherently less likely to deviate from the contractual arrangements and require a different analysis from captives.

**Hallmarks**

Para 166 notes hallmarks for what might be considered to be a “good captive.” These hallmarks are leveraged from the examples on intra group reinsurance in Action 3. The original Action 3 hallmarks are a good summary of the features of intragroup reinsurance that make it less of a transfer pricing risk than captive insurance and would make a suitable basis for guidance that draws out the difference between the two arrangements. The final Action 3 report, relating to CFC rules, states:

“For example, CFC rules that attribute insurance income could exclude income from reinsurance activities that meet all or most of the following features:

- The reinsurance contract is priced on arms-length terms.
- There is diversification and pooling of risk in the reinsurer.
- The economic capital position of the group has improved as a result of diversification and there is therefore a real economic impact for the group as a whole.
- Both the insurer and reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels.
- The original insurance involves third party risks outside the group.
- The CFC has the requisite skills and experience at its disposal, including employees in the CFC or a related service company with senior underwriting expertise.
- The CFC has a real possibility of suffering losses.”

However the revised hallmarks in para 166 contain flaws which mean they are not appropriate for either intra group reinsurance or captive insurance. For example:

- The economic capital position of the group has improved as a result of diversification and there is therefore a real economic impact for the group as a whole (i.e. the captive insurer either: (i) does not only insure group risks but diversifies those group risks by inclusion within its portfolio of a significant proportion of non-group risks, or (ii) it reinsures a significant proportion of the risks it insures outside of the MNE group);

The wording in bold appears to misunderstand how diversification is achieved. By pooling a sufficient quantum of “group” risks (i.e. insurance or reinsurance risks originally underwritten by other group entities) within an intra group reinsurer it is entirely possible to obtain an economic / capital benefit from diversification without either any non-group risks being included or any further reinsurance outside of the MNE group. We strongly recommend that the wording in bold (not included in the original Action 3 hallmarks) be dropped from any definition of “good” intra group reinsurance.

In addition, as far as captive insurers are concerned, the below hallmark (which was included in the Action 3 report with reference to intra group reinsurance) also cannot apply:
Both the insurer and any reinsurer are regulated entities with broadly similar regulatory regimes and regulators that require evidence of risk transfer and appropriate capital levels.

Outside the insurance industry, the insured will not be a regulated entity making it impossible for captives to demonstrate they have met the hallmark for the cedant and the reinsurer to have broadly similar regulatory regimes. In the absence of a regulated cedant there is no base economic capital position to measure the improvement against and, furthermore, it is extremely rare for captives to take on third party risk. Including these as criteria for judging the bona fides of the captive could encourage tax authorities to conclude that most captives do not have these features they are necessarily bad. As outlined in the Discussion Draft, many captive arrangements are structured using third party fronting insurers to provide licences in locations where the captive may be unlicenced. The ‘fronter’ then cedes the risk to the captive. In this scenario the ‘insurer’ (being the third party) would be regulated but since this is a commercial transaction between two unconnected parties, we have concluded that this was not the intended target for this hallmark.

For captives, particularly in the life science and extractive industries, the ability to self-insure risks that are difficult or expensive to place externally is an important part of risk management and a captive should not be penalised by the presumption that insuring these risks is evidence of a bad purpose.

The OECD should consider an alternative set of hallmarks for captive insurance. The recent U.S. case law on captive insurance in Reserve Mechanical Corp v Commissioner of Internal Revenue and Benyamin Avharami v Commissioner of Internal Revenue are not transfer pricing cases but the concepts used to decide those cases overlap with transfer pricing principles and might be a useful reference for developing hallmarks of good and bad captive insurance.

**Rationale for intra group reinsurance and captives**

In terms of the rationale for having a captive set out at para 172, we suggest that this should be expanded to also include ring fencing of funds to fund losses which may not be given priority on a single balance sheet of the operating company. In industries exposed to low frequency, high impact risks, ring-fencing risks in a captive insurer clearly identifies the funds provided for the realization of those risks. This helps relieve pressure from shareholders to pay excessive dividends from surpluses.

We also note that benefitting from tax or regulatory arbitrage has been cited as part of the rationale for a captive. We consider that whilst this point is useful background for anyone looking to enhance their understanding of why captives may be established in a particular way, the existence of a tax motive should not automatically be viewed as a reason to consider that the captive is not adequately assuming risk or that the transaction should be recharacterised. For example, the OECD has recognized that business can take local tax rates into account when choosing where to locate substantive operations.

**Arm’s length pricing**

Our final points on the discussion draft are in relation to Section E5 and the determination of arm’s length pricing. In particular, it is not clear why this section is considered necessary in the context of a discussion draft on the identification of commercial or financial relations in chapter 1 D.1.

Paragraphs 177 and 178 that deal with fronting arrangements do not make it clear that the relationship between the MNE group and a third party fronter are by definition at arm’s length and that any transfer pricing issue is between the group and its captives. The guidance could also emphasise that although fronting arrangements may be complex the same principles apply to the
delineation of a fronted transaction as they would to a straightforward transaction to a captive. It may also be worth noting that arrangements which “artificially” inflate premiums will also generally increase premium taxes or other indirect tax costs (which in most jurisdictions are levied and withheld on insurance premiums in the country of situs of the risk). In many jurisdictions, such indirect taxes may be substantially more significant than corporate income tax costs.

**Group Synergy**

The Group synergy discussion in paragraph 184 does not take account of the cedant’s and reinsurer’s regulators requirement that there has been a genuine transfer of risk in intra group reinsurance. Where both regulators recognise that the reinsurer has assumed the risk contractually assigned to it the correct delineation of the transactions should be that the reinsurer gets a risk based return of the risk assumed and is not just performing a service for group members.

For captive insurance the example does not truly consider the group synergies of being a captive insurer; rather, it focusses on the ability to pool risks for reinsurance. In terms of the arrangements sought to be covered here it is clear from the next paragraph at 185 that it is intended to capture arrangements whereby the genuine value to the group is only from the diversification in terms of lowering the premiums paid by groups to the external insurance market rather than there being any benefit from the initial captive insurance. The example does not explicitly state that 100% of the risks aggregated into the captive are reinsured into the third party market, nor does it describe the services performed by the captive. In reality similar arrangements may include a retention of insurance risk by the captive in order to achieve better pricing of reinsurance in the external market. This is because many reinsurers will prefer cedants to retain some of the risk in order to ensure they have “skin in the game” and thus eliminate “moral hazard” (being the inherent assumption that all risks will be covered by an insurance policy which could result in neglect of risk management behaviours). Additionally, the captive may play an active role in putting together the insurance proposal and subsequent administration of claims and other support functions. The guidance should make it clear that the captive should receive an arm’s length reward for the functions performed and risks assumed.

**Agency sales**

The discussion of agency sales in E.6 covers a niche arrangement and is not strictly captive insurance because the group insurer is accepting risk from third parties; however, it is a useful summary of the principles used to decide the UK transfer pricing case of DSG Retail v IRC.

**V. Conclusion**

As global insurers and reinsurers, in this submission:

- We have urged the OECD to specifically exclude intra group reinsurance that is within a regulated insurance group from the guidelines suggested in this Discussion Draft. Our position is that regulatory and commercial factors that apply to intra group reinsurance within a regulated insurance group significantly reduce the opportunity for BEPS activity and that these regulatory and commercial factors will, at times, run counter to the analysis included in this Discussion Draft. In addition, prior OECD transfer pricing and other guidance developed as part of the BEPS project is more than sufficient to address BEPS concerns raised by individual tax authorities.
We have requested that a clear distinction be drawn in future guidelines between intra group reinsurance within a regulated insurance groups and the “captives” that seem to be a greater focus of the Discussion Draft. We have discussed why we believe this distinction is necessary and recommend that the OECD work with the captives industry to develop more specific definitional parameters for captive insurers that are not part of an insurance group in order to more accurately and precisely draw this distinction.

We very much look forward to continuing to work with the OECD on this project and other matters, and will be happy to follow up on this submission to answer any questions or provide any further information that may be helpful.
Insurance Europe welcomes the opportunity to comment on this public Discussion Draft on the transfer pricing aspects of financial transactions. The response is focussed on Section E — Captive Insurance.

General comments:

- Insurance Europe recommends applying existing Chapter 1 guidance to captive insurance, rather than introducing special guidance. This is because Chapter 1 guidance already sets out the principles for the delineation and recognition of transactions. In cases where the Chapter 1 analysis leads to the conclusion that the captive insurer’s business is other than that of insurance, Chapter 1 also gives guidance on how to recharacterise the transaction.

- If special guidance for captives is considered necessary, Section E should begin by a more detailed description of captive insurance and captive insurance transactions, to properly differentiate these from other forms of (re)insurance between members of a regulated insurance group.

- Insurance Europe notes that the entire Section E refers to MNE groups and their members. In the absence of further clarification, Section E guidance would therefore also end up applying to intra-group reinsurance between members of a regulated insurance group or intra-group retrocession in a regulated reinsurance group.

- Providing additional clarity would ensure that the guidance is properly focussed on non-insurance MNE groups in which a company provides (re)insurance to other group members (as Insurance Europe understands is the OECD’s intention).

- Insurance Europe disagrees with the statement in paragraph 163 that a captive insurance company does not provide insurance but rather insurance-type services.

E.1. Overview of insurance

Regarding the descriptions provided in paragraphs 164 and 165, Insurance Europe would point out that there are many risks that an insured is able to influence by applying loss control techniques. It is insured events and not risks that should be outside of the control of the insured, as paragraph 164 rightly states.
Insurance Europe believes that Part IV of the 2010 Report on Attribuition of Profits to Permanent Establishments should be explicitly referenced in paragraphs 169-171 and that it should be clearly stated that, for regulated (re)insurance groups, the Transfer Pricing Guidelines are to be applied consistent with the Part IV analysis.

E.2. Rationale for a captive

While arm’s length pricing might be challenging in situations where it is difficult or impossible to obtain insurance cover, the legitimate use of captives should not be prohibited even if the legitimate purpose may not lie in the present, but rather in the future (e.g. using the captive allows to collect information regarding the respective risks required to generate an insurance appetite with professional insurers, such as for cyber-security).

E.3. Existence of insurance

The terms “insurance” and “reinsurance” are defined in regulatory/legal and accounting standards and the qualification of insurance/reinsurance for tax purposes should follow these existing standards. Insuring or reinsuring risks of multiple legal entities across the MNE represents risk distribution (pooling). Much of captive business is done on a reinsurance basis, with a professional insurer providing the insurance cover towards multiple legal entities across the MNE group and ultimately bearing the credit risk for the sufficient reserving of the captive.

The term “captive insurance” covers a wide range of transactions which can be as small as a single contract of insurance within an MNE group, to a fully-fledged insurance or reinsurance program covering multiple risks in multiple locations. A captive insurer may write only business with associated enterprises, only business with third parties, or a combination thereof. Regulation and capital requirements can accordingly range from light to heavy, depending on the location of the regulator and the mix of business.

Given this wide definition, Insurance Europe recommends applying existing Chapter 1 guidance to captive insurance, rather than introducing special guidance. Indeed, Chapter 1 guidance already sets out the principles for the delineation and recognition of transactions. In cases where the Chapter 1 analysis leads to the conclusion that the captive insurer’s business is other than that of insurance, Chapter 1 also gives guidance on how to recharacterize the transaction.

If special guidance for captives is still preferred by the OECD, Insurance Europe believes that the guidance should be focussed on the following factors, which are similar to those in paragraph 166:

- Substance in the captive: are there sufficient qualified and experienced staff within the group and/or in the location of the captive to manage the insurance business of the captive?
- What is the commercial rationale of the captive? What are the realistically available alternatives?
- What risks are being insured and do these meet risk transfer tests under accounting rules? Is there pooling of risk for capital purposes? Can capital benefits from diversification of risk be quantified?
- Does the group reinsure externally? This can be evidence that risks transferred are insurable especially where the captive is lightly regulated.
- Does the captive have the financial capacity to bear loss? Have claims been paid when there is a loss?
- Conversely, is the captive over-capitalised compared to benchmarks? What is the return on capital for the captive?

Paragraph 174 refers to insurance being “defined above”. It should be made clearer which paragraphs this is referring to (presumably 164 -166). Paragraph 1.98 of Chapter 1 states that an entity must both exercise control of risk and have the financial capacity to assume that risk. This discussion draft focuses only on control of risk and there does not seem to be any reference to financial capacity, which is essential to insurance business.
E.4. Reinsurance captives – Fronting

Fronting reinsurers often keep a proportion of the risk insured and are subject to regulation. In this context, Insurance Europe does not understand 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”.

E.5. Determining the arm’s length price of captives

Insurance Europe would not recommend specific guidance on what constitutes insurance risk, or how to satisfy control over risk in this context, because facts and circumstances can vary so widely that giving specific guidance in this case could have the unintended consequence of helping MNE groups to navigate around the rules.

Similarly, giving specific guidance on pricing (E.5.1) is not recommended, because this is not a metric appropriate for all insurance business and it does not consider the insurance cycle or functional differences between companies that could drive expense ratios. Further, investment return is heavily influenced by regulatory requirements for what types of assets can be held, so Insurance Europe would not recommend detailed transfer pricing guidance on this either.

Regarding section E.5.2, Insurance Europe does not believe that, by using the combined ratio, a comparable, uncontrolled price for annual premiums and underwriting profit can be achieved. In addition, Insurance Europe does not understand the description given in paragraph 182 for the identification of the captive’s combined ratio.

Insurance Europe believes that the guidance on group synergies (E.5.3) is too prescriptive.

- In most cases, the captive insurer is not functionally equivalent to a central procurement entity so the examples in Chapter 1 would not read across easily.
- The captive insurer will be taking on significant insurance/financial risk that a procurement entity would not, so the functions performed, assets used and risks assumed are very different.
- The comparison in paragraphs 184 and 185 is therefore not justified. The suggestions included in these two paragraphs neglect the nature of reinsurance (risk transfer, not service) and are not treating captives in accordance with arm’s length principles. Unaffiliated reinsurers would not be expected to share an underwriting profit.
- There are many cases where it would not be appropriate for any savings made in relation to reinsurance to be passed back to the insured participants; this would be very much depend on the functional analysis of the transaction so a full Chapter 1 analysis should be undertaken.
- Suggesting that an insurance return should be allocated to other group members disregards the nature of (re)insurance. For example, when a claim occurs, other entities in the group do not have the financial capacity to settle it. Claims are paid using reserves backed by investment assets, purchased with premium income and these assets are in the legal ownership of the captive. Therefore, it is the captive that has the financial capacity to settle a claim.
- The discussion draft makes no reference to losses and whether these should also be allocated to other members of the group.

E.6. Agency sales

Finally, the example used for agency sales is of limited use given that the captive insurer in the example has only external business, which is an unusual case. It is also unclear why a group synergy analysis would not apply in this case. Again, using the standard Chapter 1 analysis steps would be of more use in these cases.
Regarding the Discussion Draft for Financial transactions please find our comments:

Part B.1. Identifying the commercial or financial relations.

Box B.2. Regarding the example in paragraph 17 of the draft, it mentioned financial projections to evaluate the capacity to service the complete amount of the loan in the term of the agreement. From this perspective can it be affirmed that, before the discussion of the interest rate arm’s length compliance, a complete projected cash flow analysis should be performed to determine first the capability of the lender to advance such amount and the borrower to service it? In addition, the credit rating impact should also be considered before concluding that third parties would have agreed to enter in a similar transaction?

Also this two analysis could have an impact or required and adjustment on the price (interest rate) considering the fact of the possibility of placing a negative pressure on credit rating and for instance a bigger interest rate should be expected.

Paragraph 20. Mentioned that comparability adjustments to improve the reliability of a comparable are more likely to be achievable when they are based on quantitative factors instead of qualitative. It can be then considered that sometimes it will be better to select comparable transactions from other countries or currencies even though there is public information on the selected party country, if significant qualitative differences appear between the transactions, for example business strategies.

Box B.3. Regarding the factors that should be consider for the delineation of the actual transaction, the common factors we see for the analysis are: currency, term, collateral, issue date, borrower solvency, borrower industry, country, level of seniority, type of interest rate. However some other specific factors could have an impact in the price and should be considered such as, grace period, purpose of the loan, stand by amounts, upfront fees, risk involvement of the lender, cash flows projections, lender possibility to invest in different projects, etc. However this kind of analysis could be really complex and price adjustment may be not as reliable because of subjective information need in the assumptions.

Part B.2. The economically relevant characteristics of actual financial transactions.

Paragraph 24. Included a monitoring and review of the loan analysis periodically as part of the functional analysis. So it can be understood that the analysis and the arm’s length compliance at the issuance of the loan is not enough, a periodical analysis should be include as part of the transfer pricing documentation?

Paragraph 31. It is mentioned the importance of the precise timing of the issue of the financial instrument. It specifically questioned a multiple year data comparable set. Regarding the secondary market, it is understandable that instruments with frequently MtM valuations could be considered but at the adjusted price just at the moment of the intercompany instrument is agreed.
Paragraph 32. In addition to the specific factors related to the currency, mentioned in this paragraph, possible additional adjustments should be evaluate, for example if the currency of the loan is not the functional currency and the country of the borrower. A USD loan would not be the same in a company resident in the US than a company in Mexico, even though all the other terms are the same.

Paragraphs 33-35. Regarding the business strategies, considering the information that must be include in the Master File there could be more access to this information in order to understand and delineate the control transaction, however the main issue will still be to have public information for the comparable set of transactions.

Box B.4.

Question 1. Referring to the decision-making functions, to control the risk associated with investing in a financial asset, does this functions are considered then directly related to the risks assumptions? If the funder lacks the capability to perform those decisions, does it implies there is no risk in the funding? Such as credit risks or liquidity?

Question 2. Regarding the prevailing facts and circumstances for approximating a risk free rate of return, can be considered facts such as geography, currency or it can also be consider any other accessibility to invest the money even though it is in another country?

Question 3. An example to not consider a government security as a risk free rate could be a country which government already is on default.

Question 4. The cash flows and the functional currency of the borrower is then more important than the funding currency itself to select the appropriate risk free rate?

Question 5. In normal conditions, what would be a reasonable period of time when selecting reference securities if there are not for exactly the same date of the controlled transaction? Or an adjustment should always be included?

Question 7. Idem Question 2

Box B.5.

Guaranteed short term loans with real collaterals, Repos, interbank rates could be examples or other risk free rates of returns?

Question 15 and 19. Should build-up analysis could be then reasonable to use then?

Question 18. In this question it is mentioned the risk profile, which minimum elements should be take into account to determine a risk profile?

Question 21. Using the cost approach method in which the analysis consists in reviewing the mark-up applied to the cost incurred by the lender to raise the funds, the interest rate then should not be analyze then?
C. Treasury function

Paragraph 43. In case the treasury functions corresponds to a support service, shall the interest rates be analyzed or just the compensation for the services?

C.1. Intra-group loans

Regarding the lender’s and borrower’s perspectives, some examples will be useful to understand this section. However this kind of analysis could be really complex and price adjustment may be not as reliable because of subjective information needed for the assumptions.

Paragraph 65. Considering that the financial metrics in credit rating analysis may be influenced by controlled transactions, it would be necessary to verified first the arm’s length compliance of the other transactions before analyzing the credit rating.

Paragraph 66. Are there minimum parameters or recommendations in selecting a specific methodology for credit rating analysis?

Box C.3. To provide a definition of a stand-alone credit rating of an MNE turns very complex, considering the operations within related parties can be very related and profits or losses depends mainly or totally on this transactions, for example a service provider which only clients are part of the group, low risk distributors which operations depends on intangible assets owned by the related parties, a holding which only function is to be the owner of the subsidiaries but have not any other operations. So a stand-alone credit rating might use consolidate information netting the effect of any controlled transaction.

Paragraph 80. Charge fees form part of the terms and conditions in loans within unrelated parties. If such charges are seen in a loan between associated enterprises, they should be evaluated. In case there are not this type of charges it should not be evaluated too the arm’s length of the lack of this conditions.

Paragraph 86. Bond issuances could be a realistic alternative comparable transactions, but it should be treated carefully to effectively consider the complete yield (including coupons and price movements) and adjust the periodicity of the payments in order to make it really comparable to the controlled transaction.

Box C.7. In cases in which and MNE group obtained funds raising debt in order to fund the operation of the group, for example a cash pool leader, the average of the interest rate paid to its external debt could be used as an internal CUP at least as a floor of the interest it has to recover from its related parties.

Box C.8.

- There are many factors that have to be consider in order to conclude which approach would be better, but an example could be to evaluate and measure the real benefit that could be obtained from assuming the liquidity, credit, solvency risks internally, if there is a company with a lot of cash available, more than the liquidity need, it could be better to manage everything internally saving intermediation costs such as commissions,
movements fees etc. On the other hand if the company cash available is variable maybe taking this risk at a long term would imply bigger costs on interest rates because of timing.

- The allocation of group synergy benefits could represents an arm’s length remuneration for the cash pool members only if this benefits are enough to return the functions, time incurred, risks assumed by entering in the cash pool.
- Another approach could be the analysis of the active and passive interest rates, in order to verify they complies with the arm’s length principle. However in this case it should also be evaluated the final result as an overall of the cash pool.

Paragraph 102. All factors and parties involved should be take into account and verified none of them enter into a worse situation of what they can find in the market.

Paragraph 128. When applying the same interest rate within all the members participating in the cash pool, it should also be evaluated if another compensation should be include, (maybe as a service provider) to the cash pool leader or any member that incurred in additional processes on behalf of the other parties.

D. Guarantees

Box. D.1.

- In accordance to the guidance of the TPG a financial guarantee as any other transactions should be evaluated considering, assets, functions and risks involved. If this guarantee, for example, is just a letter of commitment but there is not any restricted asset involved, and risks assumed by the guarantor are not significant, this could be just classify as a financial service. On the other hand, when assets are involved and risks are allocated in both parties, then a return related to the amount guaranteed could be a better approach.
- Sometimes even the financial statements of the borrower support solvency and payment capacity, when the name of the company is not very known against the holding or other entity of the group which has the trademark for example, a guarantee could be asked in order to give some security to the lender.
- Guarantees may affect credit rating and loan pricing, because of the effect in the risk they have, they are supposed to decrease credit risk, uncertainty (when for example fixed assets are used as a collateral). So when existing guarantees credit ratings trends is to go up and interest rates to decrease.
- A clear example in which an independent borrower need guarantees are start-ups, because there is not historical information to support the solvency of the company. Another common example is a lessee with an endorsement or surety or bonding companies. The typical compensations founded for this transactions are a % of the amount guaranteed. Another approach could be that the benefit obtained in the rate caused by the guarantee should be the compensation to the guarantor.
E. Captive insurance

Box E.1.

- In order to be able to recognize that a policy issuer is actually assuming the risks first evaluating the financial capacity to confront the insured claims. Another important factor is to evaluate the conditions of the policy including the currency. Also the specific clauses in which the insurance proceed and in which not and the timing to confront the claim.
- The fact that the policy issuer outsource the underwriting function not necessarily means it not is assuming the risk, however important decisions regarding risks assumptions are taken outside the entity so it should be evaluated the fair compensation for this key function and an important control or limits are expected to be performed and precise by the insurance company.

Box. E.2. Paragraph 181. Just to clarify the fact of the profit to provide return on capital for any investment income received on the excess of premiums less claims and expenses, should be expected, but assuming that the insurance company is the one that is assuming the risks, there could also be situation in which a loss could be present more if we consider diversify risk within companies of the same group is not as possible as with third parties.
The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (“JFTC”) in response to the invitation to public comments by the OECD regarding the Public Discussion Draft on “BEPS Actions 8-10: Financial Transactions” released on July 3rd, 2018.

JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of the JFTC’s Accounting & Tax Committee is to submit policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

I. General Comments

➢ As the transfer pricing rules on financial transaction remain relatively underdeveloped, we basically support OECD efforts to clarify transfer the pricing rules for intra-group financial transactions.

➢ However, the choice of funding methods in investment activity, such as loans and equity investments, is not based solely on tax considerations but essentially on the investment strategy of the MNE group, regardless of whether the investee is a member of the group or not. Therefore, excessive application of transfer pricing rules to the capital structure of group enterprises would unfairly narrow the range of available business options. Additionally, such excessive application will cause less predictability on taxation from the taxpayers’ point of view and this may become an obstacle to business judgment. For these reasons, we believe the deliberate consideration should be conducted.

➢ In order to prevent double taxation caused by early adoption of the new transfer pricing rules on financial transactions in particular countries, we hope the OECD will
continue to guide and monitor that the national governments and tax administrations should act in unison. Furthermore, we request the inclusion of additional guidance regarding transactions where reasonable pricing has been continuously maintained through such means as the use of external CUPs, so that the validity of pricing is not rejected solely on the grounds that it does not completely conform with the guidance provided in this Discussion Draft or solely for the reason that other methods have been cited in the examples given.

➢ This Discussion Draft examines a number of key issues related to group financing, such as intra-group loans, guarantees and credit rating. It should be noted that these factors are mutually interdependent and influence each other in financial transactions. Therefore it will be insufficient to establish rules that only cover a certain portion of these factors, provided that the new transfer pricing rules are established for financial transactions in the course of this initiative. In other words, we believe that there should be comprehensive and consistent clarification of the treatments of above key issues.

➢ The Discussion Draft treats all MNEs equally, regardless of whether or not they are primarily engaged in finance and insurance businesses. Given that all factors cited in this Discussion Draft must be taken into consideration on determining the pricing relating to financial transactions, MNE groups that are not primarily engaged in finance and insurance businesses would be subjected to excessive cost and undue burden in the transfer pricing and documentation processes. Therefore, we request that MNE groups that are not primarily engaged in finance and insurance businesses should be treated differently and separately from MNE groups primarily engaged in finance and insurance businesses.

II. Specific Comments

Box B.1.

➢ Concerning the determination of the characteristics of financial instruments, various tax systems other than transfer pricing rules (in particular, thin capitalization taxation and earnings stripping rules) already exist for counteracting tax avoidance. The adoption of a transfer pricing taxation approach on financial transactions may actually lead to double taxation and other negative outcomes such as increased administrative burden on taxpayers and rejection of interest deductibility due to determination of facts based on ambiguous criteria. If a transfer pricing approach is to be adopted, in the interest of avoiding BEPS and dual taxation, all countries should adopt the same approach for determining the characteristics of financial instruments. For this reason, we strongly request that the adoption of a transfer pricing approach into financial transaction should be mandate, not optional.

Box B.2.

➢ As mentioned in the General Comments, the choice of funding methods in investment activity, such as loans and equity investments, are not based on solely tax
considerations, and such choices are significantly affected by investment strategies of MNE groups. Therefore, in the context of the example given, before examining delineation of transactions between associated enterprises in transfer pricing, a determination should first be made on the extent to which transfer pricing rules should be applied to the capital structure of group enterprises.

- When delineating transfer pricing in loans between associated enterprises in this Discussion Draft, determination of whether a provision of funds constitutes a loan or an equity investment should not be based on such factors as the creditworthiness of the borrower for which there are no concrete indicators or external indication. We are concerned that such a determination would lack objectivity, generate unreasonable taxation, and would result in unfairly narrowing the range of available options in the investment strategies of MNE groups.

**Box C.1. (In particular, Para 43)**

- In a specific case that the function of an enterprise that supplies intra-group funding in an MNE group can be regarded solely as service provision on ensuring intra-group liquidity and optimization of funding efficiency, we don’t have uncomfortableness on the Discussion Draft that such support services are regarded as the Intra-Group Service described in Chapter VII of the Transfer Pricing Guidelines.

**Para 54**

- Paragraph 54 states that an independent business will seek the most cost effective solution in borrowing. However, in actual practice, an independent business will consider such factors as the diminishing long-term cost of funding and the maintenance of relationships (accessibility to the sources that will continue to provide funds in the face of deteriorating financial environment). Therefore, due attention should be paid to the fact that decisions are not made simply on the basis of cost at time of borrowing.

**Box C.2.**

- As indicated in Section D (Guarantee) of this Discussion Draft, the questions related to the application of transfer pricing rules to guarantees provided by group enterprises remain unsettled. In order to clarify the relation between the credit rating of the group and the credit rating of individual group members, we believe it is necessary to first clarify the scope of the application of transfer pricing rules to guarantees and to thereafter apply credit rating rules in a manner that is consistent with the transfer pricing rules.

- The following comments are predicated on the above condition. It should be noted that in many instances, equity in the individual members of an MNE group is either wholly or principally held by intra-group associated enterprises, and individual members generally are not independently rated by external agencies. Therefore, to a
certain degree, it is reasonable to treat the group’s rating as the rating of individual members (or to apply a rating obtained by making some adjustment to the group’s rating). We believe this would contribute to stability in taxation.

- We are comfortable with the position that credit ratings are useful in identifying comparable transactions (with the exception of start-up companies, special-purpose vehicles and entities that have recently undergone M&A). However, regarding adjustments made in credit ratings for pricing interest by tax administrations, we believe that differences of opinion between tax administrations and taxpayers should be reconciled, and we strongly request that clear guidance be adopted on this point.

**Box C.3. – C.4.**

- This Discussion Draft presents the criteria for measuring the level of implicit support (strategic importance, degree of operational integration, shared name, etc.) benefiting individual members of an MNE group, and states that credit ratings are affected by differences in such support level. However, it concerns us that such criteria can easily become arbitrary and can readily lead to differences in interpretation between taxpayers and tax administrations. On the question of guarantee fees, the Discussion Draft includes the statement that fees are not payable for credit support derived from group membership (Para 142). For purposes of consistency, we believe the same treatment should be allowed for implicit support, in other word, it should be allowed for taxpayers to adopt an approach that the implicit support has no effect to the creditworthiness of each group company within a MNE group.

- The level of implicit support cannot be readily measured given the lack of clarity in the definition of implicit support. For this reason, we request the addition of guidance and examples on implicit support.

**Box C.5.**

- Market rates can serve as useful metrics only in an orderly market. Because markets for credit default swaps are small, contracted prices may not reflect intrinsic risks and returns when supply and demand are fluctuating significantly. For this reason, it is inappropriate to use credit default swaps in pricing interest rates on intra-group loans.

**Box C.7.**

- Concerning intra-group financing, the Discussion Draft states that written indications from independent banks lack effectiveness for determining transfer pricing on financial transactions. Although it is the fact that such written indications do not constitute an actual record of funding, we believe they do have a certain degree of effectiveness as a statement of opinion presented by a third-party financial institution.

- As a means to improving intra-group funding efficiency, it is possible that loans from unrelated parties may not be combined with intra-group financing in meeting the
funding needs of a borrower. Thus, although the concept of using pricing between independent enterprises based on internal CUP is understandable, in certain instances this may not function in actual practice. Therefore, we believe that the use of the cost-of-funds approach should also be allowed.

**Box C. 8.**

- In this Discussion Draft, it appears that cash pooling and intra-group loans are clearly differentiated. However, in actual practice, cash pooling exists as one of the methods used in providing intra-group loans. Therefore, instead of considering the allocation of cash pooling benefits, this should be treated as an issue in the validity of interest pricing as in the case of intra-group loans.

**Box C. 11.**

- This Discussion Draft contains very few statements on hedging. We therefore request that examples and other forms of guidance be added in the future.

**Box D.1.**

- In this section, this Discussion Draft intends to classify the effect of intra-group guarantees to the borrower’s improved credit rating and ability to borrow and the cost reduction of borrowing in order to verify the delineation of transfer pricing in guarantees. In actual practice, however, it is extremely difficult to objectively differentiate these hedging and to objectively determine whether or not the effect of guarantees constitutes credit support or other forms of implicit support derived merely from group membership. Weighing the cost-benefit for both taxpayers and tax administrations, it is unlikely that this approach will function efficiently. Therefore, we believe this matter should be examined with due caution.

**Para 149-152.**

- We are comfortable with the statement that it is difficult to use the CUP method in determining fees for intra-group guarantees. On the other hand, with regard to the application of the yield approach, determining internal CUP would be difficult in certain cases because some member companies do not borrow from the third parties. Therefore, we believe taxpayers should be allowed flexibility in choosing an approach that matches their situation.
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Nagase & Co., Ltd.
Nippon Steel & Sumikin Bussan Corporation
Nomura Trading Co., Ltd.
Shinyei Kaisha
Sojitz Corporation
Sumitomo Corporation
Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.
Executive Summary on Discussion Draft on BEPS Actions 8-10, Financial Transactions

KPMG LLP ("KPMG" or “we”) welcomes the opportunity to engage with the Organisation for Economic Co-operation and Development ("OECD") regarding its draft guidance on financial transactions dated July 3, 2018 (the “Discussion Draft” or “guidance”). KPMG has considered input from non-U.S. member firms of KPMG International in developing our comments but submit on our behalf alone.

KPMG commends the OECD for engaging the transfer pricing and tax community in this project at an early stage.

Executive Summary

Our comments will directly address, and where relevant expand on, specific “questions to commentators” included in the Discussion Draft, reflecting the following major themes:

1. The accurate delineation of the actual transaction, as applied to financial transactions, must account for key differences in the nature of intercompany financial transactions and those involving tangible or intangible assets. This includes the fact that the financing function may be separable in tangible or intangible transactions, while it is at the core of a financial transaction. The OECD recognizes the importance of accurate delineation of the transaction, and therefore should take note that issues with such delineation based on misunderstanding of key features of financial transactions will lead to more disputes between taxpayers and tax authorities.

KPMG recommends against specification of factors to be taken into consideration when delineating a financial transaction. Rather, guidance should allow taxpayers to characterize and defend the nature of their intercompany transactions according to their facts and circumstances. KPMG recommends specific edits to paragraph 11 of the guidance, as well as elimination of paragraphs 13-15.

KPMG believes that an entity’s capital structure should be respected unless there is evidence that it is outside the norm of market practices. The OECD should also clarify that any re-characterization of intercompany debt under an accurate delineation of the actual transaction approach is an arm’s length issue subject to Article 25 procedures.

2. In most cases, the accurate delineation of a financial transaction should focus on comparing its terms, along with the financial capacities of the parties involved, to observable market benchmarks, largely respecting the contractual allocation of risks and responsibilities among the parties but for cases of clear and egregious distortions of those roles and the resulting pricing of the transactions.

Where the terms of a related-party transaction depart significantly from market convention, or from the taxpayer’s established policies when dealing with third parties, taxpayers may need to include in their transfer pricing documentation some justification for their terms and conditions. However, KPMG recommends against any rules that would automatically impose certain terms on transactions among related parties (e.g., covenants).

3. Consideration of implicit support in a lending or guarantee transaction, and its impact on arm’s length pricing, should be based on the particular facts and circumstances of each taxpayer, and not follow from any “rebuttable presumptions” regarding the relationship between the MNE group’s credit rating and that of an individual entity. Assertions of implicit support, by either taxpayers or tax authorities, should be based on thorough analysis or market evidence.
KPMG recommends altering paragraph 67 and deleting paragraphs 68 and 69 of the guidance. We also suggest replacing paragraphs 70-74.

4. KPMG believes that there are many situations where opinions provided by third parties, such as banks or insurance brokers, can be helpful in determining arm’s length pricing. Such indicators should not be pre-emptively ruled out. Rather, taxpayers should be allowed to advocate for such opinions on a case by case basis, based on the degree of rigour with which the opinions are established and the extent to which this approach can be shown to be more reliable under the facts and circumstances than alternative methods. Consequently, the OECD should consider revising paragraph 93 of the guidance.

5. Regarding cash pooling, the allocation of group synergy benefits is not typically taken into consideration when benchmarking deposit and lending rates. In most cases, the recommended approach would be excessively costly and data intensive, and should therefore be applied only in exceptional situations.

6. The OECD’s draft guidance on captive insurance companies should be significantly revamped to better reflect the nature of risks that they tend to assume, the curbing role of regulators, and practically applicable pricing methodologies. Assessment as to whether or not a captive insurer exercises adequate control of risk should take into consideration unique features of the industry and market, as well as typical functional profiles for a captive.

The BEPS actions have helpfully renewed the focus on financing transactions in particular. The arms-length approach of the transfer pricing guidelines will overlap, and potentially conflict, with domestic rules on related party pricing as well as anti-hybrid and thin capitalisation rules. KPMG believes that the guidance in the Discussion Draft would in some cases increase the potential for disagreement with tax authorities. It is important that the guidelines provide clear rules and approaches to minimise differences and uncertainty. To the extent they arise, the guidelines should allow clear and speedy resolution of disputes.
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The BEPS actions have helpfully renewed the focus on financing transactions in particular. The arms-length approach of the transfer pricing guidelines will overlap, and potentially conflict, with domestic rules on related party pricing as well as anti-hybrid and thin capitalisation rules. KPMG believes that the guidance in the Discussion Draft would in some cases increase the potential for disagreement with tax authorities. It is important that the guidelines provide clear rules and approaches to minimise differences and uncertainty. To the extent they arise, the guidelines should allow clear and speedy resolution of disputes.

### 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.

Chapter I of the Transfer Pricing Guidelines discusses the role of risk in accurately delineating intercompany arrangements, including a functional analysis with respect to risk control and mitigation, the assumption of risk, and the financial capacity to bear it. KPMG agrees that accurate delineation of the actual transaction is relevant to financial transactions. However, any assessment of the management and control of risk, along with the accompanying key decision-making functions, must take into account the distinctive nature of these transactions.

Example 3 in the Transfer Pricing Guidelines (paragraph 1.85) describes a company which owns a valuable tangible asset while other group companies make key decisions regarding investment, utilization, exploitation, and disposition of the asset. The owner’s contribution, therefore, is limited to financing the acquisition of the asset. Section D.1.1.6 of the Guidelines indicates that under these circumstances, the asset owner is entitled to no more than a risk free return. The returns on the business risks incurred in the transaction should be allocated to other group companies who control and manage that risk.

The risks incurred in a financial transaction are different from those pertaining to investments in tangible or intangible assets. The latter require a different sort of business decision making, throughout the life of the asset, with regard to commercial opportunities and strategies to exploit them, including marketing plans, delivery of the asset and associated services to customers, and eventually possible disposition of the asset or other resolution of the project. These key contributions can be separated from the financing role when the latter is only one aspect of the transaction. When it comes to loans, however, the financing role is at the core of the transaction,
and that is where the key decisions are made. Further, a lender is usually able to avail itself of widely available, standardized, and disseminated market information when deciding on whether or not to extend financing, and at what terms. Those terms also govern the timing and circumstances of the asset's disposition (i.e., a predetermined maturity date or prepayment option). Consequently, much of the decision-making responsibilities relevant to tangible or intangible assets is taken off a lender’s hands. We cannot apply functional criteria relevant to risk management functions for non-financial assets to a purely financial transaction, and the guidance should explicitly recognize distinctions between financial transactions and those involving development, production, and exploitation of tangible or intangible assets. Accordingly, the OECD should consider altering paragraph 11 of the guidance to read:

11. In determining the arm’s length conditions of financial transactions, MNE groups and tax authorities should apply the principles of Chapters I-III of the OECD Transfer Pricing Guidelines (“TPG”) in a way which reflects the commercial reality of these transactions as distinct from intercompany transactions involving tangible or intangible assets. Accurate delineation of a financial transaction should primarily concern the contractual terms of the transaction, compared with market instruments, and grant, for example, the ability of a related-party lender to outsource functions to the same extent as independent lenders in the marketplace without prejudicing its right to a market return.

Paragraphs 13-15 can largely be eliminated.

KPMG does agree that a related lender should undertake certain risk management functions, appropriate to the facts of each case and the general nature of financial transactions.1

Even without key differences between financial and non-financial transactions, an accurate delineation approach for a financial transaction, particularly with respect to identification of economically relevant characteristics or comparability factors, is also limited by the availability of information on the relevant factors. For example, while the MNE group’s business and funding strategies and the functions performed by the related lending entity may be discernible, the same is not likely to be true of any potential comparable transactions. If the comparable transactions are individual corporate loans, for example, we may be able to conduct some limited research into the funding strategies and other relevant economic circumstances pertaining to the borrower, but will likely have to rely on some conjecture regarding these factors due to lack of opportunity to interview the borrower’s management. Similarly, we are not likely to have much visibility into specific functions performed by the lender. Such information will be even less available in the case of a standardized financing instrument such as a bond market issuance. Consequently, consideration of such factors in identifying comparable transactions will often not be possible, or will not lead to reliable results.

Even with sufficient information, the delineation features listed in the Discussion Draft are subject to varying interpretations by relevant parties, potentially leading to a divergence of conclusions stemming from the same set of facts. For example, companies and tax authorities are bound to disagree on the role and interpretation of industry life cycle, macroeconomic trends, or options realistically available to the borrower and lender. This risk is heightened if some countries deviate from the accurate delineation approach and evaluate capital structure under domestic legislation or practices.

KPMG therefore recommends against specification of factors, even in broad categories, to be taken into consideration when delineating a financial transaction. Instead, the guidance should allow taxpayers to characterize and defend the nature of their intercompany financial transactions according to their facts and circumstances, with a focus on readily observable attributes for which market comparability can be established, such as the contractual terms of the transaction and the financial capacity of the parties. The list of factors relevant to a comparability analysis will differ in

1 Further to this point, the Discussion Draft acknowledges that financing transactions among related parties will often be characterized by functional profiles which differ from what would be observed among unrelated parties.
each case; consequently, taxpayers should not be penalized for omission of any factor if they deem it not to apply to their circumstances (though of course a tax authority could disagree with such an assessment).

Finally, no matter what form the final guidance on accurate delineation takes, KPMG encourages the OECD to establish materiality thresholds for the guidance prescribed in the Discussion Draft. At present, the Discussion Draft seems to be geared towards a standardized and untailored approach requiring taxpayers to apply a series of complicated analyses and tests to all loans. We request the OECD to reconsider whether this is truly a practical approach; in particular, applying the guidance to the full extent as detailed in the Discussion Draft to relatively smaller loans, working capital, etc., would be overly burdensome to taxpayers. To potentially remedy this, we recommend that the OECD incorporate a ‘prudent business management’ type concept into the Discussion Draft, distinguishing the expected analysis required for different types and sizes of loans and acknowledging that the vast majority of financing activities between related parties may not warrant complicated or very detailed analysis (including regarding capital structure), which may be more relevant to larger loans (i.e., where borrowing capacity may be more of a factor).  

**Risk of Double Taxation**

Multiple views on arm’s length capital structure are likely to lead to more double taxation situations, even if none of the relevant parties adopt an accurate delineation approach, and these disagreements may become intractable if Mutual Agreement Procedures under Article 25 of the OECD MTC are not applicable. Consequently, the OECD should reassert that capital structure is an arm’s length issue subject to corresponding adjustments and mutual agreement procedures among relevant jurisdictions. While the Commentary to Article 9 of the MTC prescribes adjustments in “State B” to relieve double taxation when a transaction is “rewritten” by “State A” so as to increase taxable income, the Commentary also suggests that an adjustment may not be due if State B does not agree that the adjusted profits in State A reflect arm’s length dealings. This question goes beyond the quantum of a potential adjustment, to the principle governing it. Consequently, OECD Guidance should clarify that re-characterization of intercompany debt under an accurate delineation of the actual transaction approach is an arm’s length issue subject to Article 25 procedures.

Similar clarification and assertions are needed with respect to national rules limiting interest deductibility under BEPS Action 4. Arm’s length capital structure and interest rates remain highly relevant even as some countries adopt versions of Action 4 since any “fixed ratio” test can leave room for a significant amount of deductible interest payments, especially if paired with a group ratio test and the ability to carry over interest expense to future tax years. Formula-driven limitations on interest deductions are a separate and distinct issue from arm’s length capital structure and interest rates, but may lead to disputes among taxing jurisdictions and double taxation of the corresponding income.

In this regard, it would be helpful to have a consensus on the effect of domestic safe harbour formulae. Some countries allow a safe harbour ratio for deductible interest. This tends to become a default maximum allowable debt and may or may not equate to an arms-length capital structure as envisaged by the draft guidelines. Although the two tests (an arms-length rate and allowable deductible interest) achieve different things, alignment of the two tests is at least desirable for consistency.

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2 We note it is very common for a large multinational group to borrow at the top parent level and then make the funding available to group entities. For such groups, there will inevitably be a multitude of intercompany funding arrangements, and significant compliance efforts would be required in order to apply the comprehensive analysis expected by the OECD.

3 See paragraph 5 of the Commentary to Article 9 of the OECD MTC.

4 Paragraph 6 of the OECD MTC Commentary.

5 Some jurisdictions do not currently entertain tax disputes regarding capital structure, limiting their focus to the interest charge.
KPMG believes that a borrower’s capital structure should be respected unless there is compelling evidence that it is outside the norm of market practices. In any transaction there are typically many combinations of debt and equity that are consistent with arm’s length behaviour, so capital structure cannot be policed by a one-size-fits-all approach or set of formulas.\footnote{The OECD should also consider the impact of a reclassification of debt to equity on other components of a company’s capital structure. For example, how does such a reclassification impact other debt that may be pari passu with the impacted loan(s)?}

**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.

KPMG agrees that a focus on the contractual terms of an agreement, the interaction of those terms with arm’s length pricing, and a robust analysis of a borrower’s ability to bear debt are necessary and appropriate. These are typical components of an intercompany financing transfer pricing analysis, and directly address the question of how much a lender would be willing to lend to a particular borrower on the basis of that borrower’s credit worthiness.

The example in paragraph 17 prudently highlights good-faith financial projections of a borrowing entity over the life of an intercompany loan as a primary determinant of a lender’s willingness to lend. Other measures of the borrower’s creditworthiness, including a credit rating analysis, can also be useful. KPMG believes that any other consideration of a lender’s willingness to lend, or a borrower’s willingness to borrow, beyond an evaluation of a borrower’s creditworthiness is bound to open the door to varying interpretations of the relevant facts. For instance, regarding the maximum amount that an unrelated borrower would be willing to borrow, alternative strategies for and sources of financing are not readily determined; two independent companies with similar characteristics can reach differing conclusions as to working capital needs, and optimal sources for that capital.

Similarly, evaluation of a lender’s other investment opportunities is not likely to be fruitful. Investment opportunities are characterized by various combinations of risk and return. Every investor chooses where he wishes to be along that spectrum, and no one choice is objectively superior to any other as long as they are all on the “efficient frontier” of optimal risk/return combinations. If a related-party loan is priced at arm’s length relative to the borrower’s creditworthiness, with a return commensurate with the market’s assessment of its risks, then it is by definition among the population of optimal investment choices for the lender (and acceptable to the borrower).

KPMG suggests that paragraph 17 of the Discussion Draft not include any reference to “the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow,” while maintaining its focus on the lender’s willingness to lend based on the borrower’s ability to service the loan.

An emphasis on the borrower’s ability to repay a loan, relative to comparable borrowers and market instruments, reduces the prospect that a transaction will need to be delineated as part debt and part equity. For example, a borrower’s financial projections do not need to demonstrate an ability to pay off the full amount of a loan upon maturity, but rather a reasonable percentage of the principal. It is typically assumed in an arms-length scenario that the remainder of the loan amount can be refinanced. In situations where the analysis of a borrower’s ability to service and repay a loan establishes a clear limit on borrowing ability, partial delineation as equity can be considered. For example, in their interagency guidance certain U.S. regulators (e.g., the Federal Reserve and the Federal Deposit Insurance Corporation) set expectations of borrower repayment at 50 percent of...
total debt over a five to seven year period. This or a similar standard could be considered when evaluating debt characterization based on cash flow projections.

**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.

Factors that need to be considered as part of the accurate delineation of the transaction should be largely limited to the contractual terms of the financing, along with the functions performed by the lender relative to uncontrolled lenders. Analysing debt capacity and pricing based on those terms will largely confirm that the actual transaction is accurately delineated.

A related lender would not necessarily be expected to undertake the same functions, at the same intensity, as an unrelated one (as the Discussion Draft notes – paragraphs 24 and 51) Much of the information that would need to be evaluated by an unrelated lender will be available to a related one due to its association with the borrower. Also, a lender that is part of an MNE group may have more opportunities to outsource certain functions to related parties (such outsourcing to be compensated on an arm’s length basis, where appropriate). It is also possible for an unrelated lender to depend on an outside rating agency evaluation for a significant portion of its risk management functions, similar to the estimated credit analysis of the borrower that would typically be performed as part of a transfer pricing study.

While the Discussion Draft recognizes that a comparison of functions between related and unrelated lenders should take into account associations among MNE members, the allowance for lesser functionality expected of a related lender needs to be reconciled with the emphasis on KERT functions typical of an independent lender when accurately delineating a transaction. KPMG believes that accurate delineation should emphasize the need for an affiliated lender to be in a position to, and actually make, informed decisions as to whether and on what terms to extend credit, while de-emphasizing certain support activities that might contribute to such decisions in an uncontrolled financing transaction (and could be outsourced by a third-party lender, for instance).

Whether or not an associated lender performs all of the functions of an independent lender, outsources some of those functions, or can circumvent them due to the availability of information within an MNE group, the lender should be attributed risks with respect to an advance of funds within an MNE group as long as it can be demonstrated, based on contractual terms and, where relevant, demonstrated behaviour, that the lender is the ultimate bearer of those risks. As discussed earlier, the criteria for adequate risk control functions are different for a purely financial transaction as compared to one involving a tangible or intangible asset, particularly so if the lender and borrower are related parties.

Relevant economic circumstances are normally taken into consideration when benchmarking a financial transaction. For example, taxpayers and transfer pricing practitioners should match or adjust for currency and timing of any comparable loans. In addition, comparables are usually identified for the same geographic region (or perhaps as part of a global financial market that is largely standardized). Where possible, industry/business sector are also matched, or relevant adjustments are applied. The reasons for the financing can influence the choice of comparables; for

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8 Also, the examples of functions expected of a related-party lender appear to include non-KERT activities, e.g., organizing and documenting the loan (paragraph 24). Can these functions not be outsourced without impacting the accurate delineation of the transaction?
example, it may make sense to benchmark loans used to finance acquisitions (or other similar projects) using market data on mezzanine debt.

Application of the accurate delineation approach to certain industries which tend to operate through branches merits careful consideration. The authorized OECD approach to computing business profits for a permanent establishment requires that it be treated as a functionally separate entity. Further guidance is requested as to whether this would obligate banks, for example, to determine the accurate delineation of transactions involving their branch operations, which could run afoul of strict regulatory standards in many jurisdictions. The OECD should consider an industry "carve-out" to the recommended approach, assuming it remains a part of the final guidance, for banking and other highly regulated industries.

Box B.4. Question to commentators

Commentators' views are invited on the guidance contained in this Box [regarding the risk free rate of return] 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.

KPMG disagrees with the Discussion Draft’s assertion that, in cases where a funder lacks the capability or willingness to perform relevant decision-making functions to control the risk associated with investing in a financial asset, the funder would necessarily be entitled to "no more than a risk-free return," however determined. A lending entity, or indeed any entity that engages in transactions with other members of an MNE group, should be compensated for its functions and risks on an arm's length basis; however, there is no reason to believe that arm's length compensation will automatically equal a risk-free return as defined in Box B.4. Consider what would happen in the case of an actual default by a borrower; would any related entity other than the funder of a loan be directly impacted by the loss in principle, and therefore have a claim against the borrower? If that risk and responsibility fall to the funding entity, then a risk-free return would undercompensate it. Looked at from a different perspective, if the excess over the risk-free return is attributed to another entity, then that entity must also have the financial capacity to bear the risk of loss commensurate with risk-taking activities. Even if there is no risk of default, limiting a lending entity to a risk-free return may lead to perpetual losses there if the entity has to fund itself at higher than a risk free rate in the market.

It is more accurate to view a return based on a government security rate, for example, as a *reference rate* when benchmarking the total arm’s length interest rate payable to a lender (one that adequately bears and controls the credit risk). That is, the arm’s length interest rate would equal a risk-free rate plus a credit spread. The risk-free interest rate on its own is not, except by chance, equal to arm’s length compensation for a funding entity which does not exercise sufficient control over risk.

With regard to identifying an appropriate risk-free return (as a first step in benchmarking an arm’s length interest rate, not as compensation to a lender which does not perform risk management functions), KPMG offers the following observations:

- Currency risk can be eliminated by identifying a reference security issued in the same currency as the loan. If this is not available, then currency adjustments using swap market data can be helpful.
- Temporal proximity of the reference security to the tested transaction can allude to the date of issuance of a comparable security or of its pricing in the secondary market.
- We agree that the duration of a reference security should be matched to that of an intercompany loan to the extent possible, and note that duration, or time to maturity, can be adjusted using market yield curve data.
- A short-term financial instrument which is consistently replaced with a new instrument could under some circumstances be accurately delineated as a long-term loan, but it may be difficult
to justify such a delineation unless the borrower and the lender are obligated to allow the replacement.

- In a case where more than one government issues securities denominated in the functional currency of the loan in question, the choice of risk-free instrument should reflect risk factors attributable to the borrowing entity, including relevant aspects of country risk, rather than always be equal to the lowest rate of return available.

**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.

Realistic alternatives to government-issued securities to approximate risk-free rates of return, i.e., rates that reflect overall market movement regardless of credit risk, include swap rates and the London Inter-Bank Offered Rates (LIBOR), to be used as reference rates in pricing loans (i.e., as a component of the risk-adjusted rate of return), depending on the tenors and other terms of the loans in question. The U.S. Prime Rate, or analogous indicators in other countries, are also sometimes used as a base to price loans.

Another alternative is the SOFR (Secured Overnight Financing Rate), a U.S. short-term borrowing rate which is expected to replace LIBOR by the end of 2021. For transfer pricing purposes, SOFR has the advantage of reflecting actual transactions, while LIBOR is determined through surveys of participating banks.

**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.

The scenario described illustrates the potential for double taxation of income associated with financial transactions due to divergent views held by the relevant jurisdictions, as well as the arbitrary grant of a risk-free return to the funding entity. Assume that the borrower is in Country A, the funder is in Country B, and a third related party which performs key risk management functions is in Country C. Assume further that the taxpayer follows the guidance of the Discussion Draft and takes the position that the funding entity is entitled to no more than a risk-free return. The balance of an arm’s length interest rate, which compensates for bearing of the credit risk, would then go to the Country C provider of risk management functions. However, if the Country B tax authority disagrees with the taxpayer’s delineation of the transaction, the whole of the interest payments could be taxed by Country B, partly duplicating the credit risk component taxed by Country C. Further, in case of default, the taxpayer’s position would obligate the Country C entity to bear the losses, although the contractual funding entity is in Country B.

If the taxpayer instead assigns a routine return to the service provider in Country C, allocating a greater share of the total interest to the funding entity in Country B, the Country C tax authority
could potentially apply the guidance of the Discussion Draft and impose an upward adjustment to Country C taxable income, perhaps with no offsetting downward adjustment for Country B.⁹

The risk of these types of distortions may be heightened by an accurate delineation approach applied to financial arrangements but reflecting business and economic realities of non-financial transactions. As we stated in our response to Box B.1., it is not clear that procedures under Article 25 of the OECD MTC will be available to address any resulting points of controversy arising among the jurisdictions involved.

**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.

Situations where each member of an MNE group has full autonomy over its financial transactions are not uncommon. KPMG interprets this to mean that each member makes autonomous decisions as to whether and how much to borrow/repay loans, and under what terms. Funds can be supplied by other individual MNE members with excess cash, but more likely from a centralized treasury operation (which sources its cash internally or externally).

For example, a group treasurer can administer a revolving credit facility, with each member making independent decisions as to how and when to utilize that facility. Borrowing terms would be agreed to, or set by the treasurer. The primary operating entities could enjoy a high degree of autonomy in how and when they use the facility, including the option to look to outside sources of capital for better terms. External financing policy would likely be set and managed by the treasurer, with varying degrees of input from the borrowing entities. Smaller or less important entities in the MNE structure may not be able or willing to assert the same level of independence.

A variation would be a notional or physical cash pooling system, though that would likely raise the level of interdependence (and reduce the degree of autonomy) among the MNE members in that the terms of the transactions would tend to be more uniform.

**Considerations for Banking**

It is important to note that treasury operating models vary widely from one group to another. One industry where treasury operations are complex is regulated financial services, in particular banking. The treasury function in a bank is closely integrated with nearly all other functions of the bank and plays a key role in managing some of the principal risks that the bank faces, such as interest rate risk and liquidity risk. Another circumstance to factor in is that regulators closely oversee the treasury function; their review ranges from approving internal models to agreeing to operational aspects of the function. It is therefore imperative that a detailed functional analysis be performed before concluding on the appropriate transfer pricing methodology, taking into account the specifics of the banking industry and the impact of government regulation, as required by paragraph 13 of the Discussion Draft.

**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

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⁹ If opposing perspectives on the functions and risks of the entities involved in the lending process call into question the beneficial ownership of the interest payments, issues outside of transfer pricing may be raised (e.g., withholding tax, anti-hybrid rules).
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.

In the absence of explicit guarantees, from a parent company or perhaps through a system of cross guarantees involving at least the major operating entities in the MNE group, KPMG does not agree that there should be a rebuttable presumption that an independently derived credit rating at the group level should be applied to each group member, or used as a starting point. This approach would start with the assumption that each group member is equivalent, or nearly so, to the group as a whole, even though members can vary significantly in terms of revenues, assets, and other key financial measures, as well as their importance to the global business. Whether or not a group member’s credit rating should be established by direct reference to the group rating can be determined by market evidence and/or careful analysis of the MNE’s business and industry, as well as the relationships among the relevant members of the group.

Situations where the group rating can accurately be applied to individual members, or act as a meaningful starting point to determine the credit rating of an individual borrower, are possible and, in some cases, may be desirable, but should not be assumed as a norm. Specification of a rebuttable presumption may place undue onus on taxpayers to refute a position which does not accord with their facts. Instead, taxpayers should be allowed to base their analysis and conclusions on their specific circumstances, including if those circumstances support the OECD recommended approach.\(^\text{10}\)

A stand-alone credit analysis for a borrowing entity, using commercial credit rating tools and leveraging rating agency views as appropriate, can in many cases provide the foundation to benchmark an arm’s length rate for an intercompany loan. Factors which may indicate a degree of internal support meaningful enough to impact a credit rating, and therefore the pricing of a loan or other financial transaction, should be considered but are unique to each taxpayer and the MNE group members involved.\(^\text{11}\)

KPMG suggests that paragraph 67 of the guidance be edited to read:

67. The question of implicit support due to group association is a difficult one, though worthy of consideration. In pricing an intra-group loan, the borrower is viewed as an independent enterprise. This does not mean that the presence of the rest of the group is necessarily ignored. Therefore, the potential impact of passive association on creditworthiness and other terms should be taken into account when there are compelling reasons to believe that an unrelated lender would consider it. These reasons could include, for example, pricing of previous loans from unrelated parties which reflected an enhanced credit status of the borrower, or of an affiliated entity, relative to what a stand-alone analysis would have produced. Similarly, the past behaviour of a group as regards providing support can be a useful indicator of future behaviour.

\(^{10}\) The principle of group support is accepted by some, not all, credit rating agencies.

\(^{11}\) Guidance from rating agencies on parent-subsidiary links may be taken into consideration when applicable.
It is also possible that a comprehensive economic analysis of the company, its strategies, and its markets, in the context of the industry in which it operates, can support a conclusion that an individual entity would be expected to benefit from a certain amount of support from the group, given that entity’s functions and contributions to the overall business. Taxpayers are free to express and support such reasoning (as are tax authorities); otherwise, an assessment of the borrowing entity’s capacity to service the debt and the contractual terms of the loan – such as term, currency, security, covenants, and so forth – should be determinative.

Paragraphs 68 and 69 of the guidance can largely be deleted.

An analysis such as that described in KPMG’s proposed new paragraph 67 would ideally be a thorough one, taking into account all available information (potentially including informed and detailed bank opinions regarding interest rates that would be charged to individual entities12) Otherwise, determining interest rates under the assumption of some degree of implicit support when none is forthcoming raises the risk of undercompensating the lending entity, which may not be able to depend on anything beyond the financial resources of the borrower in times of economic distress, thereby potentially distorting the allocation of capital among an MNE group.

Nevertheless, the guidance should recognize that a high volume of intercompany lending activity, perhaps combined with limitations on available financial data at the entity level, may make application of a group rating approach unavoidable, at least for some borrowers, even without evidence or analysis indicating that an unrelated lender would take implicit support into consideration. In some circumstances, corporations might have frequent low value / short term loans, so some sort of notching down approach may be considered as a potential quasi safe harbour to reduce the burden of having to perform detailed analysis for numerous simple / uncomplicated loans. When it is impractical to perform credit analyses on a large number of borrowers or loans, taxpayers should have the option to focus their analyses on the largest transactions or most active borrowers, while applying notching concepts to 'fill in the gaps' in evaluating borrowers and loans for which the same level of analysis would be overly burdensome or not possible (e.g., due to lack of sufficient financial information). Credit ratings and loan rates for these entities can be calibrated against the larger transactions, if possible, through a combination of quantitative and qualitative factors, and the rationale for conclusions reached should be included in transfer pricing documentation. However, we do not consider that this should be an overriding concept that is mandated or applied to all loans.

The MNE group credit rating is most reliably assigned by an outside credit agency. If no public rating has been assigned, then, as with an individual entity, the group rating can be determined using a commercial tool or equivalent, applied to the financial results of the group as a whole. (See our response to Box C.3 below.)

**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.

The stand-alone credit rating of an MNE is based on its ability to meet financial obligations with no help from another party, related or unrelated. The stand-alone credit rating can be determined using commercially-available tools, such as from Moody’s and S&P, or is assigned by a public credit agency. A public credit rating is relatively rare for a single member of an MNE group; consequently, it is important to understand how a stand-alone credit rating analysis can be performed absent a credit rating by a rating agency. The work performed by rating agencies when assigning a credit rating to an issuer (or a particular instrument) is very different from the outcome of some of the tools in the market. However, practitioners have developed some best practices in estimating stand-

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12 See our response to Box C.7.
alone credit ratings using available market tools in order to be able to judge whether the result is reasonably comparable to the outcome of a full blown rating analysis by agencies. Many tax authorities use these tools for their own analyses.

A rating agency analysis can focus on a particular issuance or on the issuer as a whole. In the first case, the analysis issues a view of how likely investors in a particular instrument are to recover their investment and the agreed interest. The second case assesses the general credit worthiness of an issuer over all its outstanding debt obligations. In assessing the credit worthiness of a group or a company, the rating agencies undertake a combination of quantitative and qualitative steps. This generally involves an analysis of the financials of the company, including projections; stress test analysis of those projections; and key current and projected financial ratios. The process also involves interviews with management to understand a range of issues affecting the company from key markets, primary suppliers, strength of management team, etc.

Different agencies would have slightly different approaches, but some key areas worth considering are whether the agency allows for the rating of a company in a given country to be above that of the Sovereign issuer, and whether a group company can have a credit rating above that of the group. There is no consensus on those two points by the credit agencies so even with an independent rating we could see a wide range of results for a given company or debt issue, depending in part on whether those two constraints to the rating analysis are imposed or not.

**Credit Rating Tools**

The available tools in the market provide a good way of estimate the credit worthiness of a stand-alone company. It is worth noting that some of them such as the ones licenced by Moody’s and S&P are often used by banks to determine credit worthiness of companies that do not have an independent credit rating and where internal models cannot be applied. In broad terms, the credit rating tools work as follows:

- Financials of the company are input into a model;
- The model produces an estimate of the expected default frequency (“EDF”) for that company. This result can be adjusted by reference to the economic cycle; and
- The EDF for that company is mapped against a credit rating.

The models used are generally based on detailed statistical analyses. Explanations of the models are available from the providers in a sufficient level of detail for users to understand that the output is based on solid economic and statistical principles.

It is best practice to perform a series of corroboratory checks to the output of the models, if data is available. Some high level statistics that allow a mapping of financial ratios to credit ratings are available from different sources, so it is possible to check that the results are reasonable. The tools also produce a detailed sensitivity analysis so that it is generally possible to see what variables have the most impact on the credit rating. It is also important that practitioners perform relevant adjustments to the company financials to ensure that all variables that are affected by transfer pricing are reflective of arm’s length pricing.

A general observation: The scope of any such analysis applied to a particular entity or transaction depends on the availability of the needed data, required resources, and the materiality of the intercompany payments, among other factors. As mentioned earlier, the OECD should allow for practical approaches to analyzing and documenting financial transactions, including materiality thresholds, so as not to overburden taxpayers by obligating them to comprehensively cover all intercompany interactions even when profit shifting potential is relatively low.

As suggested in our response to Box C.2., the possible impact of implicit support on an MNE group member might be observed in situations where an MNE group member borrows directly from a third party without the benefit of a guarantee, i.e., by comparing the credit rating implied by the interest rate on the loan to the stand-alone credit rating of the borrower. The difference between the two...
ratings can then roughly be applied to each borrowing entity in the group. However, the impact of implicit support may vary materially from one affiliate to another, and even from one loan to another for the same affiliate depending on the facts. It is therefore problematic to impose a one-size-fits-all assumption regarding the credit rating of an individual entity (or loan) in relation to that of the group. This is where a company and industry analysis, as described in our response to Box C.2. (and our proposed new paragraph 67) could be helpful.

As we suggested earlier, paragraphs 68 and 69 of the Discussion Draft can largely be deleted.

### Box C.4. Question to commentators

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

KPMG recommends that paragraphs 70-74 of the guidance be replaced with the following:

70. **Taxpayers should address the question of implicit support in good faith, reflecting and documenting their specific transactions and circumstances, with an emphasis on any market evidence to support an assertion of group support impacting the pricing of intra-group financial transactions.** Transfer pricing documentation should include any information known by the taxpayer, and perhaps not available to tax authorities, pertinent to the taxpayer’s conclusion as to the presence and impact of group support. Whatever evidence for group support is cited, taxpayers and tax authorities should consider whether that evidence reflects circumstances which no longer apply to the time period in which the tested transaction is entered into.

### Covenants

KPMG does not believe that it is appropriate to assume or impose the presence of incurrence or maintenance covenants in related-party loans if none are specified in the actual loan contracts. If we assume that, due to the relationship between the parties and/or the lack of information asymmetry, the equivalent of a prohibition against incurring additional debt exists, for example, that assumption can subsequently be contradicted if additional debt is indeed issued. The consequence is that the original loan would have been mispriced. In order for a loan covenant to be taken into consideration when pricing a loan, it should be specified from the start in a loan agreement, rather than assumed to exist due to the association between the parties. This would attest to the parties’ intention to adhere to the restrictions of the covenants, which cannot be assumed simply because they are related parties. (Lack of information asymmetry does not reveal the intentions of the borrower and lender.)

Taxpayers should be able to structure internal loans as they wish, assuming the terms are reflective of market practices and can be reliably priced. Where the terms of a related-party transaction depart significantly from market convention, or from the taxpayer’s established policies when dealing with third parties, particularly when such a departure has a meaningful impact on pricing, taxpayers may need to include in their transfer pricing documentation some justification for their terms and conditions. However, KPMG recommends against any rules that would automatically impose certain terms on transactions among related parties.

Paragraph 78 of the Discussion Draft can therefore be revised as follows:

78. **There may be less information asymmetry (that is, better visibility) in the intra-group context than in situations involving unrelated parties. However, the presence and impact of covenants (or other terms) in intra-group loans will not be assumed unless specifically included in the contract between the parties.**

### 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).

Unless we view the MNE group member’s credit rating as equivalent to that of the group as a whole, CDS benchmarks may be of limited use in the absence of market data on CDS issued directly by the entity in question. Additionally, even if the applicable data exists, CDS spreads can be notoriously volatile and so may not be reliable indicators of underlying credit fundamentals. However, CDS spreads observed over a sufficiently long period, perhaps adjusted for business cycle, can be a useful indicator of the market’s perception of risk for the MNE group as a whole, helping to identify a range relevant to their credit rating, currency, and tenor. This range may be useful for applying adjustments to market data pertaining to the borrowing entity, or as a floor for the spread to be applied to any individual group member.

Economic models can be reliably applied to intra-group loans, assuming that the correct inputs are available and accurately measured, and the models are specified in a way to mirror credit rating methodologies applied by rating agencies and/or corresponding commercial tools.

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

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

For the identification of reliable comparable data, realistic alternatives to intra-group loans are mostly limited to i) loans between independent parties and ii) bond market investments. A member of an MNE group who borrows from a related party is not likely to also have loans from unrelated parties, as internal loans are usually the easier to obtain and administer. On the other hand, there is available data on loans between members of different groups (i.e., corporate loan data) from which arm’s length pricing ranges can be derived. The difficulty with uncontrolled corporate loans is that they often include customized sets of covenants which can make them difficult to match or adjust to a particular intercompany loan.

Market bond yields reflect more standardized loan rates, for which differences having to do with tenor, currency, interest rate payment or reset schedules (e.g., fixed or floating rates), and embedded options can be adjusted to match the loan being analysed. Bond market data is often the most reliable way to reflect market rates in pricing an intercompany loan, but its relative anonymity hinders any effort to follow the OECD draft guidance and account for economic and business factors that impact accurate delineation of the transaction (another reason why consideration of such factors is impractical).

**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.

An MNE group’s average interest rate paid on its external debt can, in theory, be considered as an internal CUP if we assume that each MNE member’s credit rating is equivalent to, or at least closely aligned with, that of the group. As discussed above, however, the assumption of rating equivalence is a dubious one. Even if it were not, there would need to be adjustments for maturity and other differences in terms between the external and any internal debt. Moreover, average interest paid on external debt is often difficult to determine, particularly if attempting to apply that external cost to a
specific intra-group loan whose terms and economic circumstances will usually differ from those pertaining to external funding.

However, if the proper adjustments are made, there could be situations where an MNE group’s interest on specific components of its external debt can be used at least as a starting point for benchmarking rates on internal financing. One example is a cash pooling arrangement, particularly in the presence of parent or group cross-guarantees. Another example is the concept of a “financing club,” wherein the affiliates of an MNE join forces and engage one company to source debt in the market on behalf of all of them. In both these cases, significant adjustments need to be made when applying the external rate to transactions among affiliates.\textsuperscript{13}

Alternatively, the cost of funds approach may be applicable in cases where a related party is acting as a conduit to an external lender, and the latter bears the credit risk.\textsuperscript{14} If the credit risk is shared between an internal and external lender, however, then a cost approach is not likely to result in arm’s length compensation for the internal party.

The Discussion Draft mentions the importance of “considering the lender’s cost of funds relative to other lenders’ operating in the market.”\textsuperscript{15} However, we are not likely to be able to determine the costs incurred by other lenders in the market, other than to assume that their cost of funds would be based on market rates. In that case, once we adjust for credit risk (including which party is bearing that risk), the cost of funds approach will largely reduce to a CUP methodology.

**Bank Opinions**

The extent of the Discussion Draft’s admonishment against the use of bank opinions to price loans (paragraphs 92 and 93) needs to be refined. The quality of such an opinion can vary, depending on the extent of any analysis performed by the bank in support of it. A superficial opinion which does not consider the actual facts of a transaction, including the financial capacity of the borrower and any entity supporting it, is not likely to be indicative of market pricing. However, an opinion which does explicitly consider those facts and evaluates them according to broadly accepted standards of credit analysis may be the best indicator of arm’s length pricing (including by providing a reliable quantification of the impact of group support). KPMG therefore suggests that, rather than impose a broad prohibition, the OECD should recommend that tax authorities allow taxpayers support their positions with such opinions, noting that the weight given to such evidence should be based on the degree of rigour and clarity of underlying evidence provided therein.

Consequently, the OECD should consider revising paragraph 93 of the guidance as follows:

93. A bank opinion may be a reliable indicator of arm’s length pricing if it can be demonstrated that the opinion is based on a rigorous analysis of the facts and circumstances of an intra-group loan, including key elements of the due diligence process that the bank would follow in the case of an actual transaction. Evaluation of the reliability of such opinions relative to that of market data on actual transactions between unrelated parties should follow the criteria in Chapter III of the Guidelines.

**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.

\textsuperscript{13} Cash pooling is discussed below.

\textsuperscript{14} Paragraph 91 suggests that a related party acting as an intermediary to an external lender is entitled to the costs of that agency function, plus a markup, and not the costs of the “services.” This confuses two different concepts, however; cost of external funds, which is relevant here, with costs incurred in providing underlying services which are facilitated by an agent.

\textsuperscript{15} Paragraph 90.
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.

The evaluation and pricing of risk in a cash pooling arrangement will depend on several elements of that arrangement, including 1) whether or not a third-party bank is involved; 2) if there is a third-party bank, whether it views the cash pool leader (CPL) or the individual entities as counterparties to loans; 3) the existence or absence of parental or cross guarantees (or possibly implied group support); and 4) the credit profiles of the cash pool participants.

To take a typical example, if a cash pool is administered with the involvement of a third-party bank, and that bank requires either a parental guarantee or a matrix of cross-guarantees from all participants in the pool, then the CPL is not ultimately responsible for net debit positions with the bank and so may be entitled to no more than an arm’s length service fee. On the other hand, if the CPL is the sole counterparty to the bank, or if no bank is involved, then the leader would be entitled to a return commensurate with the credit risk that it bears vis a vis the pool participants. That return would mostly be reflected in the debit rates paid by cash pool participants, either equal for all participants (i.e., if guarantees are involved or implied,16 or if the pool members have similar credit scores) or varying depending on individual credit ratings.

**Cash Pooling Benefits**

Whatever the risks and remuneration of the cash pool leader, the debit and credit rates may be impacted by group synergy benefits. As described in paragraph 125 of the Discussion Draft, cash pool benefits are based on 1) the deposit and borrowing rates credited/charged by the third-party bank, relative to the aggregate that would have been earned/paid by each cash pool member acting on its own (this is the “volume benefit”); plus 2) the group savings that result from netting the group’s cash needs against internal surplus cash (the “netting benefit”). If quantifiable, this aggregate benefit may be allocate to each participant based on its contribution in generating it. A residual profit split approach could make sense, wherein routine functions are first rewarded, and the residual is allocated through a combination of premiums on deposit rates and discounts on borrowing rates.

Generally, pool benefits can arise from a combination of deposit and borrowing activities. Deposits make internal funds available to borrowing members, thereby reducing the need for external borrowing (netting benefit). On the other hand, borrowing from the pool contributes to the group’s ability to access favourable rates from the outside bank on an aggregate basis (volume benefit). Note that pool deposits also contribute to the realization of volume benefits, for bank crediting rates, and pool borrowers aid in maximizing netting benefits by borrowing internally.

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16 The presence of cross-guarantees might lead a bank to view the cash pool participants as the ultimate counterparties to the loans, as opposed to the cash pool leader.
In practice, quantifying group benefits can be labour-intensive at best, and unreliable as well, since it requires determination of the deposit and borrowing rates that would be realized by each participant, at least the major ones, individually. Depending on the circumstances, this could in turn require individual credit analyses (along with consideration of the impact of implicit support). The Discussion Draft takes note of potential difficulties arising from a lack of needed information on the cash pool members (paragraph 108). In our experience, the allocation of group synergy benefits is not the approach used in practice to determine transfer pricing policy for a cash pool. Instead, deposit and borrowing rates tend to be evaluated using more traditional pricing methods. Challenges in measuring pool benefits, including obtaining the needed information, likely contribute to this practice.  

Taxpayers should be allowed flexibility in supporting an alternative approach for allocating benefits, such as described in paragraphs 128 and 129 of the Discussion Draft, or in concluding that any allocation would be unnecessary or possibly distortive, depending on their particular facts and circumstances. For example, where the cash pool leader is largely responsible for generating the benefits, sharing those benefits among pool participants could lead to non-arm’s length results. If benefits can be quantified and allocated, KPMG does not believe that it is necessary or practical to vary the proportion of benefit attributed to each pool member depending on the source of that benefit (e.g., run multiple allocation models), although individual taxpayers may want to adopt such an approach if it can be supported.

The challenges and costs involved in quantifying group benefits and adjusting individual pool deposit and lending rates accordingly should be taken into consideration in the OECD recommendations. Cash pools tend to operate on thin margins and are properly aimed at the most efficient transfer of cash within the pool. Requiring taxpayers to follow the recommended approach can generate costs that are significantly disproportionate to any countering of profit shifting. Consequently, the OECD could recommend that taxpayers address the potential impact of group benefits on their transfer pricing policies, including data and cost restrictions in taking those benefits into account, with application of the methodology described in the Discussion Draft reserved for cases where the benefits are likely to be significant and relatively easily quantifiable.

**Pool Deposit Rates**

In evaluating an arm’s length deposit rates in a cash pooling arrangement, the concept of a so-called in-house bank risk premium could be adopted. This measures the effect of additional counter-party risk assumed by the intra-group depositor (e.g., with no guarantee protection) in comparison to depositing the funds with a regulated business bank (with a potentially higher credit rating). This in-house bank risk premium could be applied for deposit transactions to cash pool leaders with a poorer credit rating (e.g. if the MNE has a group credit rating in the speculative grade area).

Any deposit rates determined in this manner may or may not be adjusted for the impact of group benefits. (A significant deposit premium could significantly impact the presence and measurement of such benefits.)

**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.

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17 As do the policies of individual countries when it comes to acceptable cash pooling debit and credit rates, policies which do not always reflect the overall nature and benefits of cash pooling arrangements.
If it can be shown that a particular MNE member is placed in a disadvantageous position by being compelled to participate in a cash pooling arrangement, taxpayers and tax authorities can consider allocating a sufficient amount of pool benefits to that member so as to at least make it whole relative to reasonable alternatives for meeting its liquidity needs. This approach would have to be balanced against imposing unfavourable allocations of benefits to other group members, and can perhaps be partly justified by reference to the particular MNE member’s contribution to the aggregate pool benefits (relative to the quantum of those benefits without its participation).

Alternatively, if a particular MNE group member is able to obtain more favourable rates on its own, outside of the cash pooling arrangement, and if allocating a sufficient amount of the benefits to it makes the arrangement uneconomical for other members, the taxpayer may need to consider excluding the particular MNE member from participation in the pool. In most cases, the existence of netting and volume effects will mean that the cash pool is beneficial to all members, and an MNE would not be expected to put in place a cash pooling arrangement unless there is a net benefit to the group.

The benefits to an individual taxpayer of the cash pool must be evaluated in a comprehensive manner. For example, it is sometimes the case that a cash pool member will have higher deposit rates available to it in the market, while it can take advantage of a lower borrowing rate within the pool. Consequently, evaluating its alternatives by looking only on the deposit side of the equation could miss the overall advantages of pool membership. It is important to also note that pool benefits to any one member can vary over time.

Finally, KPMG agrees that situations where a cash pool member is always a depositor or lender call into question the accurate delineation of the arrangement. However, it may be important in such situations to consider alternatives reasonably available to the member. For example, a company may choose to maintain positive balances with a cash pool leader over a longer-than-usual period of time if it does not have access to higher returns in alternative investment vehicles. This behaviour may be more difficult to support with larger persistent cash pool balances.

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.

In KPMG’s experience, third-party banks do often require guarantees to be put in place, either from the parent or through a system of cross guarantees by the pool participants, or both. Moreover, guarantees are increasingly being required under tightening bank regulatory frameworks such as Dodd-Frank and Basel III. This trend applies to both physical and, particularly, notional cash pools. As stated earlier, the likely presence of cross guarantees for notional cash pools could impact the

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18 This may happen if the particular MNE member has a significantly higher stand-alone credit rating than the average pool participant, and there are no guarantees supporting the arrangement.

19 For this reason, KPMG believes that any kind of “floor” deposit rate is usually unnecessary. One possible exception could be to implement a 0% floor if the base rates are negative (as the Euribor has been in recent years). If the MNE can demonstrate that the contractual terms with its third party counterparties (e.g. banks) also have a floor, it would be reasonable to mirror these conditions also in the cash pool.
characterization of the cash pool members as direct counterparties to the loans (as opposed to the cash pool leader).  

From a regulatory perspective, formal written guarantees will typically be required; implicit support by the group is not likely to be viewed as sufficient.

**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?

If the group policy is to hedge all exposed positions, but that hedging is effectively accomplished through offsetting positions within the group (e.g., one MNE member long a position and another MNE member short the same asset), and assuming that the group hedging policy is set by other than the individual MNE group members (e.g., the parent), then accurate delineation of the transaction could impute intercompany payments between and among MNE group members to balance gains and losses (or between each entity and a centralized treasury operation) as the market value of the underlying asset fluctuates.

If an exposed position remains for the MNE group as a whole after matching of internal positions, the treasurer could enter into a hedging contract externally to cover the risk, with the costs (including the treasurer’s relevant internal expenses) spread among MNE members or allocated to the parent, based on an analysis of benefits.

On the other hand, if the policy is to not hedge all market exposure, then the consequences of movements in the value of the underlying assets accrue to an individual MNE member or to another entity in the group, depending on where that policy is set. For example, if an individual MNE member chooses to be exposed to market movements, and has the freedom to do so, then it should bear the risk of volatile markets. If instead the decision to bear risk is made on a group-wide basis by the parent, then the consequences of market movements belong there. In any case, accurate delineation of the transaction would impute corresponding intercompany payments to achieve financial results for all entities consistent with their functions, risks, and choices.

We encourage the OECD to consider what its expectations are – is the OECD requesting taxpayers to start employing very complicated financial modelling (e.g., Black-Scholes, options pricing) to price each hedge on an individual basis? We would consider this to be clearly inappropriate for most circumstances and overly burdensome, especially for mid-sized or smaller size companies lacking the resources for such efforts. Nonetheless, we do understand there might be ad-hoc cases that may call for bespoke analyses. As such, we request the OECD to state clearly its expectations.

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20 If cross-guarantees are provided to third-party banks, some MNE have implemented via an intra-group agreement the order of liability if a credit event occurs. These would in a first step allocate the credit risk to the cash pool leader, and in a second step to the ultimate parent company. Only if these companies default, the other companies would be liable on the basis of their (cross) guarantees issued.

21 Caution should be advised when recommending the imputation of payments given hedging gains and losses may be subject to specific tax rules (e.g., Treas. Reg. § 1.1221 in the United States) and the MNE member to whom hedging losses are imputed may not be able to deduct them.
on when more complicated approaches to hedging would be required and when more practical approaches (e.g., total return swaps) can be applied.

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.

A guarantee could be required by a third-party lender in situations where the loan is large relative to the perceived stand-alone financial resources of the borrower, and/or the lender does not detect an adequate level of implied internal support. A lender may also require a guarantee in order to reduce its calculated risk and regulatory capital requirements. If not required by the lender, a financial guarantee may be sought by a borrower (or imposed by the parent or another related party) in order to raise the borrower’s credit rating (in effect, substituting the financial resources of the guarantor), thereby lowering the borrower’s interest costs. It’s also possible that a guarantee will help justify a larger loan (see below). 22

A financial guarantee should be delineated and priced based primarily on how it would be priced in the market. In a related-party context, the pricing should reflect the benefits that it provides. For example, for a guarantee that results in interest savings for the borrowing entity, the fee can be benchmarked accordingly. 23 However, the benefits of a guarantee are not always measured by a reduction in interest expense. A borrower may pay the same interest rate with or without a guarantee, but is perhaps able to borrow a larger amount from a particular lender (as opposed to having to go to another lender(s)), or access capital in a different market (e.g., geographic or in terms of the financial product issued), or with less onerous information disclosure and administrative burden. In these situations, the financial guarantee confers tangible benefits which are not based on interest savings. Accurate delineation of a guarantee transaction generally requires determination of the compensation an unrelated guarantor would be entitled to given its costs and risks as well as the benefits realized by the opposing party. KPMG agrees that in some situations no benefits will be provided by the guarantee, though ‘benefits’ should be broadly defined.

Impact on Borrowing Capacity

A word about situations where a guarantee may be seen as increasing borrowing capacity beyond what would be “accurately delineated as a loan” (paragraph 140). KPMG believes that re-characterization of part of the transaction (e.g., as a loan to the guarantor followed by an equity contribution to the borrower) should be considered only as a last resort, i.e., if it can be demonstrated conclusively that the borrower would not have been able to obtain the full quantum of

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22 It should also be noted that lenders will at times ask for parental guarantees as a matter of course, with no impact on the terms of the loan.
23 As described in paragraphs 149-152 of the Discussion Draft.
the loan under any circumstances, by accessing any global capital market, or through alternative financial products. A guarantee’s benefit may be to provide the borrower with additional financing options, without increasing its overall borrowing capacity as determined by its financial wherewithal.

**Implicit Support**

KPMG agrees that, in theory, the value of the guarantee should be adjusted for the impact of any implicit support. (This may be particularly relevant for guarantees that raise credit scores and reduce interest expense.) However, as is the case with loan pricing, taxpayers should have the freedom to make a case for implicit support in a manner that is relevant to their business and circumstances. An important consideration is that a third-party guarantor would not necessarily give the same weight to affiliation as a third-party lender. When pricing a related-party guarantee, it is the perspective of a hypothetical unrelated guarantor that should count.

**Pricing**

With respect to pricing methodologies for guarantees, we note that reliable market data on CUPs is unlikely to be available. The yield differential approach is typical and workable, assuming that the guarantee does result in interest savings. Taxpayers can determine, given their facts and circumstances, the portion of the interest savings that can be paid as a guarantee fee. (Tax authorities may want to consider providing safe harbours for this.) The cost, valuation of expected loss, and capital support methods can each be useful in some circumstance, though perhaps more likely to be hampered by data constraints.²⁴

Finally, with respect to cross-guarantees, if the arrangements are pervasive throughout an MNE group, the impact might be to equate the credit rating of each individual member to the group rating. However, there may be tricky issues with respect to the benefits realized by each individual member versus their contributions.

**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;

- 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; [and]

- 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.

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²⁴ Variations on these alternatives could be applicable to performance guarantees (which the Discussion Draft does not address).
KPMG appreciates that captive insurance transactions are among the financial transactions which the OECD set out to address as part of the BEPS project, and acknowledges that these transactions can raise specific transfer pricing issues for which guidance would assist both taxpayers and tax authorities. Section E of the paper would, however, be strengthened from substantial revision to ensure a proper application of the arm’s length principle.

KPMG also notes that this section refers consistently to “MNE groups”, which could in theory include insurance groups. The OECD has written extensively on the functions, risks, business strategies, etc., of the insurance and reinsurance industry in the Report on Attribution of Profits to Permanent Establishments Part IV (2008 / 2010). It does not appear to be its intention to address the industry again in this discussion draft, as it receives no specific mention. We recommend that the OECD clarify the extent, if any, to which the final guidance on captives should be applied to an insurance/reinsurance group. In our view, it should not be applied, and transactions between members of such groups should be dealt with under the general principles of the Guidelines and the specific guidance in Part IV, taking into account the regulatory approach to risk allocation in the industry as recommended by the footnote to Section D.1.2.1 of the Guidelines.

As a general observation, paragraphs 162 to 178 appear primarily concerned with documenting reasons why these transactions might be disregarded. The questions in Box E.1. continue the theme, being largely based on the implicit premise that there is an unusually significant hurdle to overcome before captive insurance can be recognised for transfer pricing purposes. Paragraph 163 refers to a captive as providing “insurance-type” services rather than insurance, paragraph 166 cites as a “frequent concern” whether the transaction is “genuinely one of insurance”, and Section E.3. is entirely dedicated to the “existence of insurance.” There are many more examples of this implicit challenge to the transaction itself.

This approach is not apparent for other financial or non-financial transactions, either in the current draft or the Guidelines, and does not appear to be necessary. The transactions should simply be considered on their own merits and logical conclusions drawn in the light of the Guidelines.

Scope

An insurance company provides a regulated financial service of insurance to policyholders. A captive insurance company is simply an insurance company whose main purpose is to insure members of the group of which it is a part, or their customers. It does not provide “insurance-type” services, it provides insurance. That is the legal form of the transaction, and to provide this service the captive insurer must obtain a regulatory licence from the country in which the insurer is domiciled and/or operates.

In our experience, such a definition is sufficient to identify the transactions and the companies with which guidance on captive insurance should be concerned. If unregulated intra-group transactions exist to which similar principles might usefully apply, that is a matter to be determined based on the facts and circumstances of those transactions, but they are not insurance.

Accurate Delineation

The steps required for accurate delineation are set out in the Guidelines at paragraph 1.60. Steps 1 and 2 should be relatively straightforward, as an insurance policy issued by a regulated insurer will define clearly the risks covered, the limits, deductibles, territory and many other relevant details.

Step 3 requires consideration of control of risk, including financial capacity, and the conduct of the parties. In the case of a regulated insurance transaction, a third party, the regulator of the captive’s domicile, has a legally binding interest both in ensuring the terms of the policy are respected and that the insurer has adequate financial resources. A captive with insufficient capital to bear the risks it assumes, or which fails to honour its policies by paying claims, will lose its licence. (Further, we disagree with statements in paragraph 183 of the Discussion Draft that capital requirements of a captive are likely to be ‘significantly lower’ than an insurer writing policies for unrelated parties; as regulated insurers, captives will also be required to hold adequate capital to support their positions).
Furthermore, as in many areas of financial services, important insurance functions can be outsourced to third parties, both by captives and independent insurance companies. A professional captive manager will often be employed to handle claims payments, prepare regulatory returns and actuarial forecasts, etc., further ensuring the captive behaves as an independent insurance company would. The conduct of the parties is usually, in our experience, consistent with the policies written by the captive.

The key aspect of accurate delineation to be addressed is therefore control of risk, which is broadly the focus of the questions in Box E.1. KPMG believes the guidance in paragraph 166 of the Discussion Draft provides appropriate indicators for recognising control of risk in the captive. The board of directors and, in larger captives, the underwriting committee should understand the risks the captive is assuming and have access to the relevant information, for example. They should have the capability to perform decision-making functions relating to the insurance risks the captive assumes under intra-group policies, and should actually perform those functions. Once again, it is likely to be a regulatory requirement that this is the case. The International Association of Insurance Supervisors states:

“In the case of a captive that does not employ the services of an insurance manager, supervisors should require the board members and senior management of the captive to demonstrate that they have the required skills and experience to effectively carry out their roles, including appropriate underwriting and accounting skills.

Supervisors should require that the captive’s board of directors collectively possesses the skills, experience and knowledge to oversee effectively the insurance managers and any other outsourced service providers. The board should also demonstrate that it has a broad knowledge of the business being written and that the directors can individually properly exercise their responsibilities.”

A third-party captive manager may provide services and advice, and in some cases may conclude policies on behalf of the captive within pre-approved limits. If the board and its subcommittees where relevant perform the equivalent of the four risk control functions identified in chapter 1.70 of the Guidelines, they should be seen as exercising control in the same way as the fund in that example exercises control through those functions over the risks assumed on its behalf by the fund manager. The same logic applies where functions are outsourced to another group member.

Provided the captive exercises this degree of control, it should be treated as assuming the insurance risks under the policies it issues and therefore should earn an insurance return. Paragraph 1.97 of the Guidelines states “the test of control should be regarded as being met where comparable risk assumptions can be identified in a comparable uncontrolled transaction.” Further, the insurance industry provides multiple examples of insurance risks being assumed on behalf of another entity by an independent third party; this is the case of Managing General Agents, for example, and, in the Lloyd’s market, of Managing Agents and “Coverholders” on behalf of Syndicate members.

The effect on the treatment of claims, premiums and investment income of a determination that control is not exercised by the captive would be highly complex and potentially subject to conflicting assertions from tax authorities in multiple jurisdictions, depending on their view of where control is exercised or whether the transaction is recognised. MNE groups wishing to establish a captive do so in jurisdictions which have appropriate levels of supervision for such entities and local skills in the day-to-management and legal / regulatory requirements of captives. Many of these jurisdictions also have favourable tax regimes, with the result that the profits of the captive are taxed in the parent’s jurisdiction under CFC rules or domestic law elections. If control of risk is asserted by a country which is neither that of the captive nor the parent, there is a significant risk of double taxation: once under transfer pricing in the country asserting control of risk, and again under CFC rules in the parent company. No relief under MAP would be available. This is a further reason why KPMG considers that control of risk should generally be recognised in the captive where it has met

the standards required by regulators, with any valuable functions performed outside the captive jurisdiction being rewarded with an arm's length fee. We believe that there should be a high threshold for asserting that an externally regulated insurance company should be treated as lacking the level of control required by the Guidelines.

A related issue to recognise is that if claims are paid in return for premiums by another member of the group which is not a licensed insurance company, it is likely to breach multiple insurance laws in its territory. If other, non-licenced, group members participate in the captive's control of risk functions, they should therefore receive a commensurate reward for their functions but not be allocated the insurance risk and reward. This is consistent with paragraph 1.105 of the Guidelines, and with arrangements at arm's length for the services of third parties described above. We note, however, that at arm’s length, Managing General Agents and others do not share in the ‘downside’ in the year in which the insurer makes an overall underwriting loss; they may however have reduced income in future years under a ‘claw-back’ clause.

**Role of Reinsurance**

Reinsurers and direct insurers have different pools of diversified risk, and a different cost structure (being business-to-business enterprises), which can make it beneficial for a group to pool risk in a captive in order to access the reinsurance market. We also note that a captive which reinsures its risks remains liable to the policyholders in the event of failure of the reinsurer. It therefore assumes significant credit risk, for which it is required to hold capital. In the event that the risks are reinsured with a single reinsurer, capital requirements may be higher due to concentration risk. These factors are also recognised by insurance credit rating providers, and must be respected by those captives with an external rating. The reward of a captive which reinsures all its business should therefore not be limited to a services reward but should also reflect a reward for credit risk assumed.

Typically, however, the reinsurance will leave a higher level of deductible in the captive, i.e., the amount from the first dollar of loss to the level at which the reinsurer starts to pay claims, than the deductible each operating company would have to bear under a direct insurance policy. Captives typically provide direct insurance below this level in addition to the amounts covered by reinsurance, and necessarily retain that risk. ‘Pure’ reinsurance captives that reinsure 100% of the risk are less common than those that retain some risk themselves.

In addition, as insurance capacity varies in the market throughout the cycle, the captive may insure and retain risks for ‘gaps’ in the group’s programme of insurance relating to the attachment points, as well as limits of the third party insurance or reinsurance cover or the number of ‘reinstatements’ allowed by third parties once a claims limit has been reached.

Where the captive insures and retains group risks for either of these reasons, KPMG believes the transactions should be respected and priced at arm’s length, subject to the earlier comments on control of risk. It is therefore a concern that paragraph 173 suggests “the difficulty or impossibility of getting coverage for certain risks” should raise questions about the commercial rationality of the arrangement. We would suggest paragraph 173 makes this distinction clear, for example by referring to the difficulty of getting coverage for certain risks due to their nature, as opposed to difficulties relating to market capacity.

With respect to fronting companies and reinsurance captives, paragraph 177 states:

“Captive insurers may not be able to deal with all risks in the same way as traditional insurance companies. For instance, certain insurance risks must be placed with regulated insurers as a legal requirement. This may lead to the use of a fronting arrangement...”

We disagree on two grounds: all insurance must be placed with a regulated insurer, not merely “certain risks”, and ‘traditional’ insurers also use fronting arrangements. Fronting arises because many countries, or administrative sub-divisions, require certain risks to be placed with an insurer regulated in that country or sub-division, and do not allow insurers regulated in other territories to insure them directly. For example, a potential customer in Country A wishes to insure their property
in Country A. An independent insurer, B Co, licenced in Country B wishes to offer insurance for the property. Under the law of Country A, Country A property can only be insured by a company licenced in Country A, but B Co only has a licence in Country B. A common solution is for B Co to arrange for an independent insurer in Country A to insure the property and reinsure 100% of the risk to B Co, retaining a commission or ‘fronting fee’. Independent insurers can, in this way, assume insurance risks in far more countries than they have licenses, and regularly do so. ‘Fronting’ is in no way confined to captive insurance companies; they regularly rely on such an arrangement to satisfy the needs of the MNE of which they are a part, but this is also true of independent insurers with MNE clients. They are no more complex to price than intra-group insurance without a fronting company, contrary to the suggestion in paragraph 178.

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.

Section E.5 raises a number of issues. Paragraph 180 refers to the availability of ‘external comparables’: insurance policies are generally private contracts and it is not at all clear where such external comparables could be found. Where, as is usually the case, internal comparables are not available, the most reliable price setting methods for intra-group insurance tend to be based on advice from professional brokers and insurers / reinsurers and actuarial methods. According to the facts and circumstances, these can then be complemented by TNMM methods as discussed below.

KPMG endorses an actuarial approach to pricing premiums, assuming the relevant data is available. Actuarial methods are particularly relevant to life insurance and pensions, where premiums and benefits arise over long periods of time. They are also highly relevant to low-frequency, high-severity risks such as natural catastrophe, or risks such as cyber-crime and professional indemnity where pricing at arm’s length is based on appropriate statistical distributions due to the limited number of data points on which to assess the risk. Actuarial approaches can also be important in modelling the impact of different limits and deductibles on the risks assumed by the captive.

It is important to note, however, that such approaches result in the ‘technical’ price for assuming the risk. Insurance transactions between third parties are also impacted by features of the market at any point in time, including the supply of capital to the insurance market and the insurance ‘cycle’. For example, prices may rise (“harden”) following severe losses in the market, as insurers attempt to recoup losses and insurance capacity is reduced. The arm’s length price may therefore be higher than the technical price predicted by statistical models.

In many cases, MNE groups seek price quotes from insurance brokers when benchmarking captive premiums. These quotes are often based on deep knowledge of the risks and markets involved, supported by analysis of the captive’s specific circumstances, including substantial data submissions by the insured of a kind and detail that would be required by a third-party insurer. They are often the most reliable indicator of arm’s length pricing. Consequently, analogous to the case of bank opinions on loans (see KPMG’s response to Box C.7.), we believe that the use of brokers’ quotes should be explicitly recognized in the guidance among the benchmarking approaches available to MNE groups that include captive insurance entities. Taxpayers should be able to advocate for such opinions on a case by case basis, whether pricing loans or captive insurance premiums, based on the degree of rigour with which the pricing exercise is shown to be carried out and the extent to which this approach can be shown to be more reliable under the facts and circumstances than alternative methods.27

26 If the captive is regulated, relevant data will be required and therefore should be available.

27 A more general comment on the Discussion Draft – the OECD should clarify the extent to which guidance in one section of the paper applies to other sections or types of transactions.
TNMM Method

Paragraph 182 suggests a comparable uncontrolled price can be arrived at by considering the captive’s combined ratio and the investment return on its capital. This appears, in fact, to be the application of two TNMMs:

- the combined ratio compares a profit level indicator, underwriting profit, to a base which is premiums;
- investment return on capital compares a profit level indicator, the return to a base which is capital.

As noted above, a TNMM approach can be useful as a corroborative method, but this is not a CUP. KPMG agrees that return on capital can be a useful measure, and that this requires consideration of the level of capitalisation of the captive, while recognising that any insurance company necessarily requires a reasonable buffer in excess of regulatory minimum requirements. It should also be recognised, when considering the capital put at risk, that independent insurance companies generally underwrite a range of different classes of business, each with greater or lesser degrees of risk, i.e., volatility of claims volumes, but do not publish separate capital balances held against each line. Establishing whether a captive could reasonably hold less capital against the risks it has assumed therefore requires caution.

However, any approach based on the comparability of balance sheet or P&L ratios must take into account the nature and timing of the pattern of claims in the particular class of business underwritten. In insurance, an up-front premium is paid in return for the assumption of a risk, within certain financial limits, by the insurer. When that risk is realised, the insurer pays a claim, but the claim may well be in a future period: an example is third party liability insurance, where claims for injury may arise in the years following the period in which the premium is paid, sometimes after a period of dispute over the amount of the claim.

A further example is where insurance covers an event which is low-frequency but high severity in nature, such as a major fire in a factory or loss of control of an oil well. The captive may receive premiums for many years with no such incident arising. It will appear to have high profits and high return on capital in each of those years. A single incident, however, may give rise to claims equal or greater to all the profits in earlier years.\(^{28}\)

Other types of insurance may give rise to large numbers of annual claims in a more predictable manner, known as ‘attritional’ business. Such business may have relatively stable ratios from one year to the next, with some variation due to market factors.

It is essential to determine the characteristics of the insurance underwritten with respect to the pattern of claims (as well as the reserves taken), and in most cases carry out a multi-year analysis. For low-frequency, high-severity claims, that analysis might extend over a longer period such as five to 10 years or more.

Group Synergies

Group synergies may arise where captives exist primarily to access the reinsurance market. These do not arise from collective negotiation. An insurer offered 10 similar factories to insure assumes considerably more risk than an insurer covering only one, other factors being equal, and there is no evidence to suggest that the premium would be discounted as might be the case in the bulk purchase of goods from a manufacturer. The price is affected by the impact on diversification for the insurer; it may in fact reduce diversification to assume the insurance of a large number of similar risky assets, making its portfolio of risks too heavily weighted toward a particular group of correlated risks.

\(^{28}\) Reserves may be taken based on the probability of future losses. Depending on the jurisdiction, such provisioning may or may not be tax deductible.
In addition, any allocation of synergy benefits among insured entities runs the risk of inadequately compensating captives for the risks they assume, potentially running afoul of regulatory standards.

**Terminology**

The draft would benefit in a number of places from more careful use of language. In paragraph 162, a series of examples are given of ways in which an MNE group could “manage” risks. Some of these appear in fact to be alternative approaches to funding the consequences of the realisation of certain risks, e.g. “set aside funds in reserves”, while “acquire insurance from third parties” is a way to mitigate risks. “Self-insure” is not defined, nor is it clear how it is distinguished from “simply elect to retain the specific risk” or indeed from “set aside funds” or “pre-fund potential future losses” (itself an obscure term).

The point of paragraph 162 is unclear. It appears to address policy at the group level, in which case the alternatives are to insure certain risks outside the group or retain these risks within the group.

Paragraph 176 refers to “risk distribution”, a term closely associated with US case law around premium deductibility, where broadly it seems to designate whether group risks are combined with non-group risks. Otherwise, distribution refers to the statistical characteristics of a particular type of risk. The pooling of risks, as referred to in the definition in paragraph 166, is risk diversification and is recognised by regulators as giving rise to a diversification benefit. The same paragraph goes on to refer to risk diversification, arguing a captive insurer may lack it. Theoretically a captive insurer might lack risk diversification, for example if it writes a single policy covering one building, but if it pools multiple risks and those risks are not highly correlated, it achieves risk diversification in the same way as an independent insurer regardless of whether or not the risks are those of connected parties.

In general, the draft clearly shows the influence of domestic case law in a number of countries. This can be seen in the discussion on whether what captives provide is insurance at all, the section on ‘agency sales’, and other areas. While KPMG accepts that case law can sometimes provide useful insights, it necessarily concerns cases where taxpayer and tax authority have been unable to reach agreement. Often, it relates to extreme facts and circumstances and is not therefore representative of a majority of taxpayers’ affairs. In the case of captives, we note that while tax authorities naturally wish to understand the substance of the captive and the commercial rationale for the transaction, in the majority of cases enquiries have focused on the pricing of premiums, and agreement has been reached. We would urge the OECD in its guidance to reflect this and place less emphasis on the extreme cases that are the subject of litigation.

Box E.3. Question to commentators

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

Paragraphs 187 and 188 describe a scenario wherein Company A, a retailer of high value technology consumer goods, offers insurance policies to third-party customers. The carrier for the policies is a related party, Company B, which earns above-market profits while Company A retains arm’s length commissions. The example concludes that Company A deserves the residual profits earned on the arrangement since they are largely generated through the advantage of customer contact at the point of sale; Company B should earn returns which are in line with those earned by independent insurers assuming similar risks.

If the functional analysis indeed confirms that customer relationships are the key drivers of profits, perhaps combined with Company A’s acumen in jointly marketing the technology products with the insurance, as well as the relatively commoditized nature of the insurance, then the conclusion in paragraph 188 is probably correct. However, if the total premium charged to the customer is a third-
party price,\textsuperscript{29} Company A’s excess profits would need to be sourced to point of sale or other marketing advantages. Further, assuming a competitive market for Company B’s insurance products, Company A’s advantages would have to be unavailable to Company B from other retailers.

Higher profitability in Company B could be justified if it offered non-standard insurance products which represent a significant share of the perceived overall value to customers (i.e., sales of the technology products would suffer appreciably without the ability to pair them with insurance protection that would be otherwise difficult to procure).

\textsuperscript{29} Assuming the customer does not “overpay” for the insurance for the sake of convenience.
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