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DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS

Dear Mr. Van Hove,

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

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

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

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

[1] In addition, we believe those groups whose primary business is financial services should be explicitly excluded from the guidelines.

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

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

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

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

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

Sincerely,

Will Morris

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Chair BIAC Tax Committee

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General Comments

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

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

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

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

5. We believe that the guidance should aim to provide as much certainty as possible with a focus on limiting the compliance burden required, at least with regards to many common

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

6. Related to this point, in some areas (as noted in detail below) while we would not support deviations from the ALP, we believe the analysis of FT may slightly differ from other types of transactions in the steps and analysis required to determine an appropriate transfer price that is consistent with the objectives of the ALP.[2] We encourage a view that weighs the importance of functions, assets and risks relative to one another in the analysis. This approach should provide an ability to provide flexibility and simplification – still within the objective of the ALP. For example, it is possible that fewer people are required and fewer "activities" / functions needed to manage and control FTs when compared to, for example, the activities relevant to developing a new product, even where the value at risk of each type of transaction to a business is the same. This is already partially evidenced by the differences in detail provided in the DD on the functional activities of a lender or borrower on a loan compared with the significant focus given to the myriad "functions" relevant to a DEMPE analysis within the context of Chapter VI.

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

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

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

[2] *Business at OECD* continues to believe that the ALP properly applied by both taxpayers and governments, still offers the best prospect of classifying transactions according to "real-world" economics, and equitably and consensually dividing income between countries based on economic activity. If this is not clearly articulated in guidance, and practical supporting rules are not provided, then we are concerned that we will see an acceleration in a worrying trend (already apparent in the TP audit practices of numerous countries), where a broad interpretation of "BEPS principles" is used to justify new unilateral rules and automatic application of non-arm's length approaches in routine situations. As noted in our detailed comments, several aspects of the DD should be revised to not explicitly or implicitly undermine the validity of the ALP. Further, this guidance should remain consistent with existing guidance provided (e.g., the OECD's 2010 report on the Attribution of Profits to Permanent Establishments).

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group as a safe harbour similar to the group ratio test devised under BEPS Action Item 4. This approach is not in line with the arm's length principle, but (given group credit ratings will typically be stronger than individual entities) if such an approach is available at the behest of the taxpayer rather than the Tax Administration, this may reduce the compliance burden without posing BEPS risks.

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

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

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

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

11. Outside the technical merits, we also found the format of the DD to be distracting in parts. For example, the first substantive section focuses on accurate delineation of FT, also including guidance with regards to pricing some FT. Then, in the subsequent sections, relevant issues are identified along with pricing guidance – although certain sections

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continue to revert back to whether each respective FT is properly delineated. We would welcome a restructuring of the paper, so the pricing guidance (and transaction delineation guidance) is clearly recognized. One such solution may be to organize the DD along the following lines (either within, or with, subsections for different types of transaction within scope): (1) accurate delineation guidance, (2) pricing options, and (3) related issues and considerations. A more clear structure would distinguish between what items are relevant considerations and academic insight versus practical guidance to be used by both taxpayer and Tax Administration, as the TPG are intended.

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

Specific Comments

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

Reponses to Questions

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

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

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

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guidance that will impact on many thousands of related party transactions. This statement could explore things like:

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

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

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

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

Box B.2: Commentators' views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire

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amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

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

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

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

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

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22. In our view, considering the potential for cascading effects, the Tax Administrations should bear the burden of proof if they are trying to change the treatment of a loan to equity.

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

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

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

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

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

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

- *Flexibility of the funding mix*: loan funding can be easily repaid as part of a sale or dilution, or even to absorb positive working capital movements. Capital is less flexible. Decapitalisation is generally even more difficult in countries where court approval is required (i.e., is not a private process);

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- *Currency exposure:* An equity injection may have to be in local currency; lending in a different currency (e.g., USD) can avoid volatility in value of the subsidiary and may provide MNE groups flexibility to manage economic exposures. Furthermore, equity injections need to be purchased outright, but loans can be swapped - equity therefore leads to a long-term currency exposure, which can be costly if the entity plans to repatriate cash in the near future;

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

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

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

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

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

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

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

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

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

28. Theoretical considerations given in B.4. that a funder that lacks the capability or is not performing the decision-making functions to control the risk associated with an investment should only earn a risk-free return is not without merit. However, the DD rightfully concedes that there is no investment with zero risk.

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29. When taking the return on government bonds as a proxy for the risk-free return, the draft does not distinguish between the issuing yield and the secondary market yield of government bonds. Since the actual rate of return is derived by the combination of issuing yield and issuing price focusing on the issuing yield of government bonds alone can be insufficient. Further clarification would be welcomed, but if one was chosen, we would expect the secondary market yield of government bonds to be a superior proxy. For almost all relevant currencies national central banks frequently publish the secondary market yield for almost all terms of maturity.

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

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

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

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

34. Similarly (but more broadly), it is critical to recognise that even in so called "low risk" lending scenarios, there is ultimately a risk that the funds will not be repaid such that the

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lender would "write-off" the loan. While it is a legitimate concern that in such instances within groups, the MNE may effectively have a choice as to where to recognise the loss (which is clearly not true for external funding providers), guidance on such scenarios (and confirmation that in such scenarios the "risk-free" return should be assumed to continue with the true risk-bearer suffering the loss) would be welcomed. Further, explicit guidance regarding how one should classify such transactions (e.g., where the write-off is transferred for accounting purposes and how it should be characterized for tax purposes) would be helpful.

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

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

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

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

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

38. The TPG define in paragraph 1.65 that "[c]ontrol over risk involves the first two elements of risk management […] (i) the capability to make decision to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making

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function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function." We have doubts as to whether the compensation due to the related party exercising control over the risk (in the hypothetical scenario where it is not the same legal entity as the actual lender) will be treated as interest or alternatively as some other form of income (e.g., service fee). This can lead to different WHT treatment and may be of particular difficulty should the different jurisdictions not share a similar interpretation. Also, in the hypothetical scenario – where the funder's income is required to be adjusted via a TP adjustment to a risk-free rate – taxpayers may find constraints should the funder be located in a jurisdiction where the rules only permit upward adjustments (e.g., UK).

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

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

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

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

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- Such an approach raises several related questions:
  - What is the impact if more than one shared service centre entity has provided treasury services in relation to one loan?
  - How do we determine what exactly is the risk-taking function at what point in time, and can this change over the life of the FT (i.e., could the residual be "allocated" to a different entity year by year)?
  - What is this excess payment from a legal perspective – is it still interest or something else?
  - What is the WHT analysis and what treaties would apply if all entities are in different territories?
- Accordingly, we are of the view that it should be a very rare occurrence to re-characterize the risk premium component of the arm's length return from the actual lender to another entity deemed to bear the financial risk, unless answers are provided to the questions outlined above.

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

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

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related entities must be objective, manageable and consensual among countries. If not, such will create more issues and double taxation than the existing system.

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

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

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

Additional Comments

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

47. We also encourage the OECD to bear in mind the economic and legal realities under which MNEs are operating. Each legal entity is going to be subject to certain rules and regulations – thus, even though the company is part of a global group, such does not mean that they are able to ignore existing legal regimes and practices. For example, company directors have legal, fiduciary duties which would prevent them from

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deliberately taking action that is not in the interest of the company (e.g., deliberately making loss making loans). This provides one general example of the issue of diverging from the traditional norm of the separate entity approach.

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

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

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

50. When pricing the transaction paragraph 19 endorses a two-sided analysis for FT which is quite a departure from the historical approach where the majority of the analysis has been on the borrower (this is also mentioned and expanded in the functional analysis in paragraphs 24 and 47). While our members do report that Tax Administrations are increasingly looking at multi-sided analyses in any event, we remain concerned of OECD endorsement of an approach that increases the required level of analysis and consequential documentation trail that would need to be completed for all (or more) FTs

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without any corresponding benefit to Tax Administrations or taxpayers. This additional focus on the lender's perspective will require additional guidance on how this can be practically applied.

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

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

C. Treasury function

Reponses to Questions

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

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

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

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

54. As a general matter, we welcome the OECD seeking to provide simplification measures to provide tax certainty. However, if such a rule is to be endorsed, we would strongly suggest such be a safe harbour[3] – eliminating the ability to rebut on the part of the Tax

[3] Alternatively, if safe harbours are not provided, we would still prefer additional tax certainty with a presumption rule provided such is generally in line with the ALP and has objective parameters – e.g., the

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Authorities – versus simply a rebuttable presumption. Further, we welcome the introduction of a materiality threshold where for less material transactions these approaches could be followed (similar to the existing guidance on intra-group services, i.e., low-value added services). For example, FT only exceeding USD 10 million would need to be comprehensibly documented, and any transactions below the threshold would be considered as priced at arm's length.

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

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

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

57. See comments above.

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

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

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government can only rebut if the credit rating would vary by a "significant" amount and the loan is "material" (with definitions of a significant variation and materiality).

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

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

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

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

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

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

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

64. Implicit support is a widely recognised consideration, used in practice by external rating agencies, but with little evidence in transactions that may be used as comparables. Two to three notches seems to have developed into an industry-wide norm, based on rating agencies' credit reports. Moody's in particular is quite transparent in how it applies the concept of strategic importance and implicit support in its rating framework.

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65. Current wording for applying implicit support seems to be quite subjective and "a matter of judgement" (paragraph 70). Thus, additional guidance and clear, practical examples would be welcomed. In our view, a key outcome of this consultation process would be to provide clarity and international consensus on this issue, as currently many Tax Administrations hold differing views and approaches in this area.

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

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

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

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

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

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

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

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

69. It is highly unlikely that an internal CUP will be available to price intra-group transactions as so many key characteristics (credit rating, maturity, size of loan, currency etc.) will vary

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materially between the members of the group versus the group as a whole. Therefore, a MNE group's average interest rate paid on its external debt should not be considered as an internal CUP.

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

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

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

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

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

73. The cash pool leader may also manage and bear financial risks, which should be considered when establishing the arm's length return. The cash pool leader will bear financial risks where depositor balances and interest payments are protected with no cross-guarantees. In this case the cash pool leader will assume market risk and black-swan event risk on external investments, credit risk on lending, liquidity risk if investments are in fixed-rate instruments versus the floating rate paid to depositors, and potentially foreign exchange risk if multiple currencies are invested in the pool.

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74. In this context, it may be appropriate to consider a service-based return for back-office activities, but with additional return required for the other activities / management and assumption of risks. For the services element, a service fee CUP could be established by reviewing the service fees/annual fees charged by third-party lenders for back-office tasks, which are intended to cover the cost of arranging a loan and any related transaction fees and account maintenance costs. These are often expressed as an additional basis point spread on the loan balance in the loan agreement. In no event should this result in a recharacterisation of the cash pool leader as not lending to the borrower.

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

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

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

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

77. This residual "benefit" amount could be distributed amongst all members. However, it may be more appropriate to only share with depositors if the residual benefit was primarily driven by the investment of the cash they made available to the cash pool (e.g., by lending to affiliates or investing in external financial instruments). Again, this would depend on the facts and circumstances and it would be beneficial for the OECD to include commentary on the salient factors in this regard.

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78. Specifically, the OECD should provide guidance on the appropriate mechanism for sharing the residual benefit with members. This could be through a lump sum payment at the end of the year once the actual cash pool results are calculated, for example. If so, guidance is required on the character of this payment (e.g. interest). Alternatively, an additional interest spread could be added to the rate paid to depositors throughout the year. If so, guidance on how this spread would be established would be beneficial (e.g. whether accurate forecasts, which are difficult in a dynamic interest rate environment, would be required).

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

79. See comments above.

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

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

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

- Access to a permanent source of financing without large facility or arrangement fees payable to third party banks or the requirement to provide covenants (e.g., access to overdrafts without punitive overdraft rates and penalties).
- Access to liquidity that may not otherwise have been available from the local external banks, with the funds being available immediately for use.
- Reduced exposure to external bank counterparty credit risks, particularly in markets with limited access to highly-rated financial institutions.
- Access to foreign exchange, treasury and banking expertise and global treasury management systems, which would be inefficient to procure individually.
- Access to a more diverse portfolio of external investments and economies of scale on transaction costs and management costs which would not be available to the individual entity.
- More cost effective / reliable access to external debt.

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82. In paragraph 111, a cash pool leader performs no more than a co-ordination or agency function and the DD implies that by considering a low level of functionality their remuneration as a service provider will generally be limited. The DD then includes Example 1 to illustrate such a scenario. However, we believe that this scenario (and others) may raise other tax questions and/or challenges.

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

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

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

84. N/A – see above.

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

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

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

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

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any service fee payable to the treasury function should come from the entities with the exposure.

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

Additional Comments

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

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

90. Paragraph 52 states that parent "already has control of the assets of the subsidiary" so it is important to consider that the "absence of contractual right over the assets of the borrowing company does not necessarily reflect the economic reality of the risk inherent in the loan." However, we disagree with this statement as a matter of legal fact. The subsidiary owns those assets, not the parent. If the subsidiary is liquidated, creditors will have first claim on any asset. The subsidiary, which may have independent directors and/or minority interests, can only distribute up assets as allowed by corporate law and its own memorandum and articles of association. As such, we caution against broad and over-generalised statements and believe determination of control of the assets for tax purposes should be made based on the facts and circumstances. Further, simply ascribing control of the subsidiary's assets directly to the parent could create unintended Permanent Establishment consequences.

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91. We agree with the comment in paragraph 54 that borrowers seek to optimise their WACC for the chosen business strategy whilst having the right funding, and that some borrowers will pledge collateral to reduce their cost of finance. However, whether to pledge collateral can also depend on other factors (some underlying assets are unsuitable to be used as collateral as cannot be used or sold on by the lender). The fact that there are many third-party loans lent without collateral should inform any arm's-length analysis.

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

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

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

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

96. It would be extremely helpful should the guidance also incorporate a reference as to whether Central Bank data is (or not) encouraged/dismissed as suitable for TP purposes.

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

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

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

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

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

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

99. As mentioned above, DD fails to provide clear guidance with regard to some difficult issues. In addition to the overarching question of whether determining the capital structure of a MNE should be tested using TP and the ALP or whether this falls outside of TP, other controversial topics, albeit mentioned in the DD, also do not provide clear guidance. A specific example is the discussion of whether a cash pooling balance is short or long term in nature. This topic is referenced in Paragraph 107 where it is stated that

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that "one of the practical difficulties in such situations will be deciding how long a balance should be treated as part of the cash pool before potentially be treated as something else, for example a term loan." The DD acknowledges the practical difficulties of the subject yet fails to provide further insight as to what should constitute short term vs. long term from a TP perspective.

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

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

D. Guarantees

Reponses to Questions

Box D.1: Commentators' views are invited on

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

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102. There are different forms of guarantees, ranging from license-to-operate performance guarantees, to access to backup funding, to formally improving a group company's creditworthiness to attract 3rd party funding. In our view, the DD focuses on the latter – the guarantee is explicit support to support the already available implicit support. These guarantees are effectively part of the funding structure, and hence, pricing should be based on the respective loan pricing principles applied; and the same concerns apply as well (e.g., if the total range of ratings between group and entity is split between a guarantee and implicit support, an inability to value implicit support makes it difficult to value the guarantee).

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

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

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

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

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

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Additional Comments

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

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

E. Captive Insurance

Reponses to Questions

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

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

110. If the aim of this DD is to target only industrial captives, such should be explicitly stated. On the other hand, if the intention is to include (re)insurance groups, then significant work is required to address regulatory, capital and other matters that impact insurers. In our view, (re)insurance groups should be excluded from these rules (see our general comment above regarding the regulated financial services industry) as both parties to the reinsurance will be subject to regularly supervision. In addition, given that similar regulation applies to industrial captive insurers, we question the benefit of applying special tax rules.

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111. As mentioned several times above, Business at OECD strongly supports the ALP and such should be applied if the facts and circumstances allow. In this context, a full functional analysis may be required to properly allocate the risk. Guidance that is too prescriptive in the captive insurance section could result in pricing not in accordance with the ALP.

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

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

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

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

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

117. In paragraph 171, the DD states "that risk will be controlled by either the insurer or (more likely in a captive insurer scenario) another entity within the group." However, insurance companies do not and cannot "control" risk. It is the nature of the insurance industry to take on risks that cannot be controlled (if they could, the industry would not exist in its current form). Insurers can manage (or mitigate) risk by reinsuring and by setting up

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reserves to cover future claims. However, they do not control the risk, thus in the context of captive insurers control of risk is not relevant. To be consistent with Part IV of the OECD 2010 report, mentioned above, it is the decision to take on risk which is key.

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

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

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

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

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

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

123. Paragraph 185 concludes that "[t]he synergy benefit arises from the collective purchasing arrangement, not from value added by the captive." However, a functional analysis may show that without the functions and activities of the captive, it is unlikely that MNEs could

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achieve the same level of benefit, which is something an insurer would be compensated for in an uncontrolled transaction. The captive is the vehicle which allows the “collective purchasing arrangement” to be realised.

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

124. The example provided makes two assumptions:

- That the product sold is materially the same as that which any other insurer in the general market could provide; and

- That A could sell policies underwritten by another insurer and retain most of the profit for itself.

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

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

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

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

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