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6 September 2018

Tax Treaties, Transfer Pricing and
Financial Transactions Division
Centre for Tax Policy & Administration
Organisation for Economic Co-Operation
and Development

Via Email: TransferPricing@oecd.org

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

Dear Sir or Madam:

In 2013, the OECD launched its base erosion and profit shifting (BEPS) project addressing perceived issues regarding multinational corporations' cross-border tax planning (the BEPS Project or Project). Pursuant to the Project, and in an attempt to address the perceived tax planning issues, the OECD released a series of final reports under the Project's 15 action items in October 2015. At the same time, the OECD acknowledged that additional guidance remained to be completed on a number of the 15 action items. Actions 8-10, grouped under the title *Aligning Transfer Pricing Outcomes with Value Creation*, were among the items needing further work.

In this regard, on 3 July 2018, the OECD issued a public discussion draft under Actions 8-10 requesting input from relevant stakeholders on the transfer pricing aspects of financial transactions (the Discussion Draft or Draft). On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 57 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.[1]

[1] TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

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Executive Summary

TEI commends the OECD, its Committee on Fiscal Affairs, and Working Party No. 6 for the work reflected in the Discussion Draft regarding the transfer pricing aspects of financial transactions. Financial transactions are a difficult subject for transfer pricing experts and thus additional guidance is welcome. Overall, TEI views the Discussion Draft as providing a well-structured overview of the considerations that apply to transfer pricing of intra-group financial transactions. That said, the generally disjointed nature and the many discrete questions included in the Draft makes it difficult to compose an overarching set of principled comments in reply, and in particular to draft a coherent Executive Summary of such comments.

Nevertheless, a general executive summary of TEI's primary points include:

- Any OECD guidance on the transfer pricing aspects of financial transactions should be practical and take into account taxpayer compliance costs.
- The Draft could be improved by including guidance on negative interest rates.
- The analysis of recharacterization of a financial instrument as debt or equity, either in whole or in part, is misplaced in the Draft and should be removed or significantly modified.
- Accurate delineation of a transaction should start with the contractual terms between the parties and such terms should be respected so long as the parties act consistently with them.
- Business (i.e., non-tax) drivers of the decision to fund a related company with debt or equity include: flexibility of the funding mix, currency exposure, joint venture requirements, cash extraction, commercial considerations, and matching costs with income.
- Much of the guidance on the determination of a risk-free rate of return, and the allocation of return in excess of a risk-free rate, is inconsistent with the experience of unrelated parties and is likely to cause controversy and practical issues related to allocation of a "residual" return to a party that is not a party to the underlying financial instrument.
- The most efficient way to reward the cash pool members, including the cash pool leader, is to reflect any synergies and other group benefits, as well as the functions performed by the cash pool leader, in the interest rate paid or charged by the cash pool leader.
- TEI believes that an MNE group member would almost always choose to participate in a cash pooling arrangement as compared to options offered by unrelated parties.

- With respect to guarantees, Paragraph 140 states that if a guarantee permits a borrower to borrow a greater amount of debt than it could in the absence of the guarantee, then "the remainder of the loan granted should be regarded as effectively a loan to the guarantor followed by an equity contribution by the guarantor to the borrower." This describes a recharacterization that is not practicable, is unrealistic, and will raise difficult issues in other areas (such as withholding taxes).
- Indicators for recognizing that an insurance policy issuer, including a captive insurer, actually assumes the risks it contractually assumes are whether (i) losses are paid by the captive insurer, or they would be paid if a loss occurred, whether or not the captive reinsures risk; (ii) the captive is regulated and audited; and (iii) the licensed and/or regulated fronting insurance carrier is issuing policies and reinsuring with the captive.
- The approach set forth in Paragraphs 187 and 188, which suggests that captive insurance policies earn a greater return than policies from unrelated parties, is flawed and is inconsistent with the arm's length standard and should not be included in the final guidance.

More broadly, TEI encourages the OECD to hold a public consultation on the Discussion Draft in the near future so stakeholders' views can further be expressed and discussed. Finally, and as noted, given the disjointed nature of the Draft, TEI also recommends the OECD issue a second discussion draft on this topic – whether or not it also holds a public consultation. Hopefully with the inclusion of views of stakeholders and further consideration by Working Party No.6, any such second draft will be closer to a consensus and enable stakeholders to provide additional principled comments.

TEI Comments

Set forth below are TEI's comments, generally following the order of issues as they appear in the Discussion Draft.

General Comments on the Discussion Draft

In TEI's view, OECD guidance regarding the transfer pricing aspects of financial transactions should be practical, taking into account compliance issues and the impact on taxpayer staffing, training, expense, and compliance costs. In this regard, the Discussion Draft makes significant progress in many areas. One aspect lacking in the Draft, however, is with respect to negative interest rates on intra-group loans and cash-pooling. Guidance on the approach to determining arm's length interest rates in the context of negative interest rates would be welcome, as this is a contentious subject with certain tax authorities.

Moreover, the Draft could be improved by providing a clear distinction between the Draft's proposed guidance on financial transactions and the relevant guidance to financial institutions in the 2010 OECD Report on Attribution of Income to Permanent Establishments (the

"PE Report"), specifically Part II (Special Considerations for Banks) and Part III (Special Considerations for Global Dealing of Financial Instruments). The PE Report contains well established rules that taxpayers in the financial services industry have been implementing for nearly a decade. In the interest of clear guidance and certainty, TEI recommends that the OECD clarify that it does not intend for the final version of the Discussion Draft to modify or inform the guidance in the PE Report. Alternatively, if the OECD does intend the Draft to modify the PE Report, TEI recommends the OECD specifically note the modifications.

Detailed Comments in Response to the Discussion Draft

Question to Commentators in Box B.1. Regarding Articles 9 and 25 of the OECD Model Tax Convention (MTC)

Section B. of the Discussion Draft addresses the interaction of the Draft's guidance with Chapter I, Section D.1. of the OECD Transfer Pricing Guidelines (the TPG) and the MTC. Draft Section B. notes that the official OECD Commentary to Article 9 of the MTC (the Commentary) states that Article 9 is relevant to both interest rate on an intracompany loan – *i.e.*, the "price" of the loan – and whether "a *primie facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital."[2]

While the Commentary contemplates that tax authorities may recharacterize a financial instrument as debt or equity in contrast to the taxpayer's characterization of the same instrument as equity or debt, TEI submits a discussion of the possibility of recharacterization is misplaced in the Discussion Draft. In TEI's view, the Draft should focus on providing clear and practical guidance on the pricing of financial transactions and the characterization of a financial instrument is primarily a consideration of local law.[3] In addition, recharacterization of a financial instrument may result in economic double taxation, which is contrary to the objectives of the OECD MTC and the TPG. For these reasons, TEI recommends that the final OECD transfer pricing guidance on financial transactions omit the debt versus equity characterization question and include only commentary on the appropriate pricing of financial instruments.

If the OECD is determined to proceed with recommending recharacterization in its final financial transactions guidance, TEI suggests the OECD set forth standard approaches to the issue to avoid inconsistent application by tax administrators that would likely result in double taxation. The Discussion Draft describes many factors to consider when addressing the arm's length nature of the debt versus equity question for financial instruments. These include the particular point of an industry in its lifecycle, the effect of government regulations, the availability of financial resources in a given industry, the difference between industry sectors in amounts and type of funding, *etc*. Considering these factors and determining their relative weight is an exercise that will by definition be subject to a high degree of judgement. Asking taxpayers, their advisors, and

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2 Discussion Draft at p.4.

3 *See*, *e.g.*, comments of Kevin Nichols, senior counsel of the U.S. Department of the Treasury's Office of International Tax Counsel, Tax Notes International, June 11, 2018, at pages 1336-37 (reporting that Mr. Nichols stated that the position of U.S. officials remains that article 9 and the arm's length principle should focus on pricing rather than characterization issues).

tax authorities around the world to apply these factors will lead to a large variety of potential outcomes. Instead of providing guidance that leaves it open to anyone to develop a position and hence create almost infinite potential outcomes, TEI suggests the OECD provide guidance that helps taxpayers reach a reliable result.

In practice this could be achieved by providing guidance for safe-harbors and/or rebuttable presumptions (e.g., thin-cap rules, combinations of covenants in loan agreements that are frequently found in the open market and can easily be benchmarked). Such guidance would provide taxpayers and tax administrators certainty and reduce the risk of lengthy and costly disputes in court and/or the mutual agreement procedure. With respect to the latter, TEI recommends the OECD reaffirm its view that States should ensure that double taxation resolution procedures function in an efficient and effective manner, consistent with the guidance under BEPS Action 14.

More broadly, the final report under BEPS Action 2 sets forth more than 450 pages of guidance regarding how States may address a cross-border financial instrument characterized as debt in one State and equity in the other State. Despite its length, the Action 2 report may be a simpler solution to any tax planning opportunities available to multinational enterprises from the inconsistent characterization of an instrument across jurisdictions.

Question to Commentators in Box B.2. Regarding the Example in Paragraph 17

In general, the OECD should suggest approaches that would recharacterize a portion of a loan as equity only for those situations where it is beyond any doubt that a taxpayer has a non-arm's length leverage ratio. The concept of "realistically available alternatives" as discussed in Paragraph 19, creates significant uncertainty due to the subjective nature of the factors listed in the paragraph that tax authorities may consider when determining what alternatives independent parties may have chosen. Paragraph 19 lists such things as the funds needed to service an entity's operational requirements, choosing to carry less debt than an entity is capable of to avoid placing negative pressure on its credit rating, increasing its cost of capital, and jeopardizing its access to capital markets and its market reputation. Such considerations are generally difficult overall operational decisions subject to considerable business judgement. TEI recommends the OECD clearly state that tax administrators should not challenge sound business decisions based on the administrators' subjective observations as to how a taxpayer "should have" acted. In this regard, the guidance should specifically acknowledge section 1.122 of the 2017 TPG, which states "the mere fact that the transaction may not be seen between independent third parties does not mean that it should not be recognized. Associated enterprises may have the ability to enter into a much greater variety of arrangement than can independent enterprises . . . ."

Further, the example in Paragraph 17 is, perhaps of necessity, simplistic. TEI notes that if the circumstances of the example portend, recharacterization should only apply to a portion of the loan, not the entire amount, if Company B could have borrowed a smaller amount from an

unrelated lender.[4] Moreover, business operations change over time and tax authorities are inclined to use hindsight on audit when evaluating taxpayer decision. Using the facts of the Paragraph 17 example, assume that at the loan's origination both Company B and Company C expect Company B to be able to repay the loan's principal and interest based on financial projections available at the time. If, however, business or economic circumstances change, Company B may not be able to repay the loan as initially expected. In such a case, tax authorities may discard initial projections in retrospect and disregard the loan, even if the loan was an arm's length transaction when made, based upon the expectations at the time. TEI would thus welcome guidance clarifying that *bona fide* projections should not be disregarded when circumstances change.

There may also be situations where Company B could not obtain a loan from an unrelated lender, but this circumstance should not automatically cause a loan granted by Company C to Company B to be recharacterized as equity (e.g., Company B operates in a country without a robust banking system and/or has regulatory restrictions preventing foreign banks from lending to Company B).[5]

Finally, bifurcation of a loan into one-part debt and another part equity, with the demarcation being the maximum amount that an independent party would have been willing to lend, would lead to confusion and unnecessary complexity. First, the "maximum amount that an unrelated lender would have been prepared to advance to Company B" can be vague. Should tax authorities consider the possibility of posting collateral, implicit support by the group, the strategy of the group, or the reputational damage to Company B? Second, a partial recharacterization raises the chances of inconsistency between two countries' views of the entity's capital structure. Third, recharacterization should have a high bar, *i.e.*, if it can be easy to separate and recharacterize a certain percentage of a loan to equity, it may easily lead to tax authorities recharacterizing the entire amount. Finally, it is difficult to devise an instrument that independent parties would view as debt on one hand and equity on the other if the terms of the instrument are identical, as would be the case with bifurcation.

Comments on Paragraph 31 Regarding Economically Relevant Characteristics

Paragraph 31 notes that "precise timing of the issue of a financial instrument in the primary market or the selection of comparable data in the secondary market can … be very significant" and thus concludes it is unlikely that multiple year data on loan issuances would provide useful comparables. TEI's view is that the quantitative data is not useful for years that show substantial changes, such as during the 2008 financial crisis. However, rather than the issue date of a loan or bond, in TEI's opinion the yield to maturity of instruments with similar remaining maturity should be the tested transaction, if they otherwise have similar risk profiles, currency, and seniority. The current market price of such instruments should ensure comparable pricing, leaving the period in which the instruments were issued less relevant.

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4 See also the text below.

5 See also the above referenced note to section 1.122 of the 2017 TPG.

Question to Commentators in Box B.3. Regarding Financial Factors and Allocation of Risks

The accurate delineation of a transaction should start with the contractual terms between the parties, in TEI's view. Thus, the characterization of a transaction in the contractual agreement should not be disregarded unless the parties do not act in accordance with its terms. If the characterization of a transaction can be agreed, then TEI submits that a more detailed analysis may be required to determine the arm's length interest rate. Such an analysis would account for the functions of the parties, risks assumed, and assets used.

With regard to risk allocation, it may be difficult to determine who, within a multi-national enterprise (MNE) group, bears the risks associated with an advance of funds. As noted with respect to the delineation of the transaction, such an analysis should start with the contractual terms between the parties. Financial policies of the MNE group regarding solvency, capital structure, and actual behavior in situations that can be viewed as precedents also may be relevant.

Finally, we submit the following business (i.e., non-tax) drivers of the decision to fund a related company with debt or equity for the OECD's consideration:

- *Flexibility of the funding mix*: Loan funding can be easily repaid as part of a sale or dilution. Capital is less flexible. Decapitalization is even more difficult in countries where court approval is required (i.e., where it is not a private process);
- *Currency exposure:* An equity instrument may have to be denominated in local currency whereas lending in foreign tender may avoid valuation issues. Furthermore, equity needs to be funded outright, but loans do not and can be swapped for a different currency; equity therefore requires long term currency exposure, which can be costly if the entity plans to repatriate cash in the near term;
- *Joint Venture requirements:* In joint ventures where proportionate funding is a requirement, funding is a cooperative process: both equity and debt funding have to be consistent, and shared, amongst venture partners;
- *Cash extraction:* Capital intensive industries may incur losses in the early years of the venture, whereas payments with respect to debt (principal or interest) would not need to satisfy the requirements of dividend distribution (e.g., current or prior year earnings);
- *Commercial considerations:* Debt and interest payments can be recoverable from third parties in circumstances that equity may not;
- *Matching cost and income:* Where a business that heavily depends on loans or leases to acquire assets, a matching debt investment, as opposed to equity, would simplify the ongoing operations. The entity's owner may also seek to recover its own cost of funding via matching terms with its third-party lender.

Question to Commentators in Box B.4. Regarding Guidance on the Risk Free Rate of Return

TEI believes the guidance in Paragraph 1 of Box B.4. is too rigid and should be revised. For example, suppose Company A, a member of an MNE group, has funds in excess of its business needs (this could be the result of a partial divestiture, or large payment received from a competitor pursuant to a settlement or lawsuit). Company B, another member of the same MNE group has a need for funds, and Company A is willing to lend funds to Company B. Company A may not have the personnel with the skill and experience to make key decisions relative to the transactions on its own, whereas Company C, a third member of the MNE group, has such personnel and agrees to support Companies A and B with respect to the loan and the required controls. In such a case, it would seem contrary to the arm's length standard to compensate Company A with only a risk-free rate of return, especially when it is using its own cash to fund the loan and where it assumes the financial risks of the loan to Company B.

Having said that, even if all functions related to a transaction involving the creation of a financial asset (the intercompany loan) were separated from the capital provider, *i.e.*, Company A performs all the people functions while Company B has the capital to make the intercompany loan, the flat assumption in Box B.4. that the "funder" (Company B) would only be entitled to a risk-free return lacks any support. In a third-party context, a lender that has the ability to bear the risk of loss on an instrument would not agree to only a risk-free return even if it outsourced all functions related to management of those funds. Even if one were to accept the notion that the entity that performs all functions (Company A) is entitled to any amount above the risk-free return, the unanswered question is whether that entity would also have to share in any losses. Without the financial capacity to bear losses, that arrangement would be very difficult to support.

Separately, the Discussion Draft attempts to allocate income to the functions performed under the implicit assumption that the functions are performed in a high tax jurisdiction, while the entity that possesses the capital is located in a low tax jurisdiction. It is highly questionable whether the suggested transfer pricing approach is the correct way to address the assumed tax avoidance. It would be far more efficient and effective to address this form of perceived tax avoidance through stringent controlled foreign company legislation rather than a strained reading of the transfer pricing rules.

TEI also notes that, as mentioned in the Discussion Draft, no investment has zero risk. The remainder of this section of the Draft aims for the closest available proxy, but it is never made clear when "closest available" is "comparable." Particularly in relation to the mention 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.

Moreover, Paragraph 1 in the Box is too restrictive. It states that "a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset" is only entitled to a risk-free return. The paragraph does not consider real-world third-party cases where funds or individuals follow and rely on the due diligence and risk management skills of a lead investor or money manager. Such investors may

not perform functions or directly control the risk in the financial asset, but nevertheless would expect much more than a risk-free return.

Finally, Paragraph 7 in the Box raises potential confusion in comparing the risk-free rates between different countries issuing instruments in the same currency and then choosing the lowest rate between them. First, it is not clear in TEI's view that the tested party would be able to issue an instrument in the countries other than Country X, Company A's country of residence. Further, TEI views a compensation adjustment of sovereign risk as a better approach when comparing or selecting between the three countries issuing in the same currency rather than merely picking the lowest rate of return of the three.

Question to Commentators in Box B.5. Regarding Realistic Alternatives to Government Securities to Approximate Risk-Free Returns

A potential alternative to government issued securities to approximate a risk-free rate of return would be the short-term interbank rate (the rate at which banks lend to one another). This is an external rate that is easy to determine and is also updated daily so it reflects changes in the market. Another alternative is long-term state-backed infrastructure bonds or instruments issued by sovereign wealth funds.

Question to Commentators in Box B.6. Regarding Allocation of Return in Excess of a Risk Free Amount

In TEI's view, attributing a risk-free return to a lender that lacks the capability to control the risk associated with investing in a financial asset and allocating the residual interest (the difference between the risk-free interest rate and the arm's length rate) to a different related party who exercises control over the risk is likely to cause significant practical difficulties. As the other related party is not a party to the loan agreement and is not in fact lending funds to the borrower, it seems difficult to construe the return received as "interest." If not, this situation then raises the question of how to characterize such remuneration. The characterization matters for a variety of reasons, including withholding taxes, transfer pricing, financial accounting and reporting, as well as VAT and other indirect taxes.

Associated questions include: what kind contractual relationship between the other related party and the lender and/or the borrower would be required (or imputed) to allow for a payment from the lender or the borrower to this other related party? How should the payment to the other related party occur? Potential options include a direct payment from borrower to other related party, or payment of the full interest rate by borrower to lender with a subsequent payment by lender to other related party. These uncertainties are likely to create controversies and may result in double taxation in the absence of clear guidance from the OECD and consistent application by the jurisdictions involved.

Paragraphs 12-15 are difficult to apply in practice as it is often not possible to separate financing and operational risks. Further, there is an unrealistic asymmetry in the example. Why would Company F bear the potential risk of Company D failing to develop an intangible asset

and yet accept that its upside is limited to only a risk adjusted return if the development is highly successful/profitable?

Finally, in paragraph 18, realistic alternatives to an intra-group loan in a risky research and development (R&D) venture may not be bond issuances or loans, which are uncontrolled transactions, but rather private equity or venture capital funding. Similarly, corporate bonds of independent parties in the same industry as Company B are insufficient to ensure reliability of comparability, instead one should compare the specific use of funds *i.e.*, R&D activities, rather than just stop at similarity of industry.

Comments on Paragraphs 43 and 45 of the Discussion Draft Regarding the Treasury Function

Paragraph 43 of the Draft seems to posit an MNE's treasury function as merely administrative support, conducting low value-added activities. TEI does not share this view. Treasury is a financial risk and asset management function and as such helps to drive business strategy. Risk and asset management conducted by Treasury protect the MNE group from material exposures that could have a significant impact on the group's financial statements, solvency, ability to raise funds, and continue or expand its operations.

Paragraph 45 of the Discussion Draft also seems to consider that Treasury operates only as a back office function, merely applying MNE policies set elsewhere in the group. This notion related to Treasury functions is not strictly true as these group policies are often designed by Treasury itself. A group's Treasury function will also often partner with the MNE's CFO and the Board of Directors with respect to higher strategic decisions, which then drive the group's financial policies (rather than the other way around).

Comments on Paragraph 52 Regarding a Loan from a Parent to a Subsidiary

TEI suggests this paragraph be modified in accordance with the third-party lender practice that implied security in an intra-group loan is a credit/risk assessment decision as opposed to a pricing adjustment or rejection of comparables.

Comments on Paragraphs 61 and 64 of the Discussion Draft Regarding Use of Credit Ratings

Paragraph 61 states "[i]nformation is readily available in many lending markets on the different rates of interested charged for differently rated enterprises . . . ." While this statement may be true for mature markets (although query how easy and cost effective it is to access such information), it is not generally true of emerging markets, leaving taxpayers with an information deficit for purposes of transfer pricing.

Moreover, in contrast with the description of the commercial tools referenced in Paragraph 64, our understanding of the credit rating analysis provided by such tools is that their methodology does <u>not</u> differ significantly from the methodology applied by independent rating agencies. That is, it uses both quantitative data (e.g., multiple years of financial statements) and qualitative data (industry, business, country risk, etc.), as do the rating agencies. Our members also have experience with certain tax authorities using such tools when conducting audits, which is an indication that they are reliable and gaining acceptance.

Question to Commentators in Box C.1. Regarding Entity Autonomy over Financial Transactions

In response to this question, and generally with respect to the Discussion Draft, clarification would be helpful to distinguish the Treasury function of an MNE that operates in the financial services industry from MNEs that do not. As noted above, extensive guidance is provided in the OECD PE Report on this question.

General Comments on Boxes C.2., 3., and 4 Regarding the Effect of Group Membership

The Draft asks for commentators' views on whether an independently derived credit rating at the group level may be taken as the credit rating of each group member, with or without an adjustment to the rating, for pricing and compliance purposes; for definitions of credit ratings of an MNE group and stand-alone MNEs (for the benefit of non-rated groups or entities); and the relevance, effect, and measurement of implicit support.

We agree with the concept of implicit support, and that an MNE's stand-alone creditworthiness may be related to the group's creditworthiness, depending on facts and circumstances. Where an MNE's ties to the group are strong and strategic in nature, it would be appropriate to apply an adjusted group rating as third-party financiers would do, commonly referred to as the "halo effect," and result in a higher rating for the strategic MNE. Where an MNE 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, makes more sense (externally rated joint ventures being the clearest relevant example).

Question to Commentators in Box C.2. Regarding Credit Rating Rebuttable Presumptions

Guidance with respect to the use of the MNE group's credit rating as a rebuttable presumption should aim at simplicity and certainty. In this regard, a rebuttable presumption that the independent credit rating of the group parent may be applied to each group member would be simple to apply. Special consideration is required for MNEs: from developing countries who may have relatively low ratings at the group's headquarters due to being located in a country with higher sovereign risk; who may have subsidiaries; who may acquire groups in developed countries who have strong stand-alone ratings; or who have treasury centers in locations other than the home jurisdiction. In such instances, it would be useful for the OECD to include guidance as to how the presumption can be rebutted, such as an example of how to adjust the ratings for a subsidiary group located in a developed country with a strong stand-alone rating. Finally, the OECD should provide guidance that any approach tax authorities adopt be consistent; *i.e.*, tax authorities should not cherry pick group or entity level ratings depending on which is more advantageous (the same should be expected of taxpayers, of course).

In addition, in the absence of a credit rating provided by an independent agency, an MNE group should be permitted to estimate a credit rating using financial analysis, consulting firms, and/or tools available on the market, as long as the group retains documentation supporting its calculation. In the absence of a publicly-available rating, there may be a possibility of getting individual instruments rated or there is a possibility of paying credit rating agencies to do a shadow rating. Where the rating is not provided by a credit rating agency such as by a

commercial ratings provider but there is a rigorous methodology behind it, it should not be rejected outright but instead assessed as the next best alternative, rather than rely on predominantly a qualitative assessment.

Finally, 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 assertion is a generalization that does not recognize 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 internal needs of the MNE.

Question to Commentators in Box C.3. Regarding a Definition of a 'Stand-Alone' Credit Rating of an MNE Group Member

The concept of stand-alone credit rating, without consideration for implicit group support of an entity belonging to an MNE group may not be relevant or helpful in the analysis of creditworthiness and risks associated with a loan to such entity because of the impact of group support, whether such support is implicit or explicit. Measuring the impact of group support may present difficulties and is a matter of judgement. With respect to the impact on the entity providing such support, unless there is explicit support provided by specific entities, a practical approach would be to assume the group parent company provides such support.

Question to Commentators in Box C.4. Regarding the Extent of Group Support of a Borrowing Entity

TEI welcomes the guidance supporting the position that implicit group support has an impact on the creditworthiness of individual group entities and should be considered when determining comparables and the arm's length interest rate. We note that implicit group support must be considered for all group entities, both when an entity borrows from a central treasury company and when the entity provides deposits to the central treasury company. At a minimum, tax authorities should consistently either apply the assumption of implicit group support, or not apply such assumption, rather than applying or not applying it when convenient to the authorities' position in particular circumstances.

We agree that assessing the impact of implicit MNE group support is a matter of judgement, based on all the relevant facts and circumstances, but the publicly available application of adjustments by rating agencies should be considered. Facts and circumstances should include whether the affiliated group has allowed a group entity to default, whether it provides a letter of comfort to unrelated lenders, and the strategic importance of the borrower, among other things.

Comments on Paragraphs 70-74 Regarding MNE Group Entity Support

In respect to Paragraph 70, if an entity is integral to an MNE group's identity or important to the group's future strategy, the OECD should consider a rebuttal presumption that the analysis should start from that of the group rating.

With respect to Paragraph 73, it is difficult to understand the need to cap an entity whose rating[6] is above that of the group if such rating is from an independent third-party agency or if it reflects the reality that independent lenders in the market would be willing to lend at that higher rating.

Regarding paragraph 74, in line with the guidance on publicly stated policy in respect of an MNE group's approach and commitment to a member, it would be helpful for the guidance to clarify the treatment of other forms of "soft" or assurances that fall short of a full legally binding guarantee such as issuing a comfort letter to a bank. Examples to illustrate if such statements of support may have an effect on the ratings of a relatively unimportant entity described in paragraphs 71 and 72, would also be useful, especially if such statement brings them to the level of passive association rating of the group as a whole.

Question to Commentators in Box C.5. Regarding Credit Default Swaps and Economic Models

The treatment of credit default swaps is a complex area for both tax and non-tax purposes. As such, there are differing views among TEI members on whether credit default swaps can be accurate comparables for pricing intra-group loans, as this depends on the facts and circumstances of each particular company and the associated credit default swap. For this reason, TEI recommends that the OECD be cautious about including guidance on the use of credit default swaps for pricing intra-group loans.

With respect to economic models, ensuring the appropriate comparables and accurately reflecting the transaction are key factors to be considered in any particular model. It is also critical that any modeling tool can be practically used and does not require extensive resources to efficiently operate, which may impact the organizational efficiency of the MNE group.

That said, interest determination methods used by credit institutions, particularly those that are used for regulatory reporting or that are submitted to or are verified by regulators are particularly reliable. TEI notes that, just as the OECD permits MNEs to use regulatory reporting numbers for purposes of country-by-country reporting under BEPS Action 13, the use of these regulatory methods should be permitted provided it is used consistently

Question to Commentators in Box C.6. Regarding Realistic Financial Alternatives to Intra-Group Loans

In TEI's view, realistic financial alternatives to intra-group loans include third-party (bank) borrowings, equity infusions, and metrics used for a merger and/or reorganization. Whether and to what extent these options are realistic alternatives will vary depending on the relevant facts and circumstances, of course.

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[6] The relevant passage is "For example, if the stand-alone credit rating of an entity is higher than that of the group, it may be appropriate to consider capping the issuer rating for the entity at the group level in circumstances where the parent would likely be able to impose requirements that would undermine the existing rating."

Question to Commentators in Box C.7. Regarding External Debt as an Internal CUP

In TEI's view, the average interest rate paid by an MNE group on external debt is unlikely to be a reliable internal comparable for the application of the CUP method. As an average, the external debt rate does not reflect specific conditions such as maturity, currency, market, type of instrument *etc*.

Moreover, for financial institutions, the cost of funds analysis is far more complicated than for non-financial institutions due to the multitude of sources and uses of funds and the resulting inability to trace the cost of specific funds to specific assets. This should be acknowledged by the OECD in final guidance with the caveat that such guidance is difficult to apply directly to financial institutions

Question to Commentators in Box C.8. Regarding the Allocation of Risk in Cash Pools and Allocation of Cash Pooling Benefits

An MNE group can operate its cash pool in a myriad of ways and the identity of which MNE entity bears the relevant risk will vary with the manner of the cash pool operation. Thus, a cash pool leader may assume risks like non-collection (of interest and principal) or currency exposure. In those cases, the cash pool leader should be rewarded accordingly.

With respect to the three approaches to allocate cash pool benefits set forth in paragraphs 124-129, TEI has the following comments. First, we believe that the most efficient way to reward the cash pool members, including the cash pool leader, is to reflect any synergies and other group benefits, insofar applicable based on the accurate delineation of the transaction, as well as the functions performed by the cash pool leader, in the interest rate paid or charged by the cash pool leader. The spread applied by the cash pool leader can include several components, including functions performed and risks assumed.

Moreover, applying the same interest rate to all participants, whether they are depositors or borrowers, and irrespective of the facts and circumstances of each participant (such as the participant's functional currency) will not be acceptable to many tax authorities and will result in controversy. Further, allocating cash pooling benefits only to depositors is also likely to be challenged by tax authorities of borrowers. In practice, it is also likely that depositors risk level will be very low (due to implicit or explicit group support to the cash pool leader) while the cash pool leader may have a higher risk level with respect to the funds advanced to borrowers.

Finally, the cash pool leader should be allocated risks, rather than remunerated as mere service providers where they either (i) raise and manage a significant part of the pool's assets (e.g., where the leader is a headquarters entity), or (ii) perform sophisticated hedging and risk management activities including exercising control and actively managing risks with skilled individual traders or treasury managers in a manner that none of the cash pool participants are able to nor have the skills to perform such high value functions.

Comments on Paragraph 99 Regarding Notional Cash Pooling

The Discussion Draft assumes that most of the functions related to notional pooling are performed by the third-party bank and that the MNE cash pool leader does not add value. We disagree with this view. There are multiple ways to administer a cash pooling arrangement, and certain functions may be performed by the pool leader or another related entity rather than by the third-party bank. When an unrelated bank operates an MNE's cash pooling, it is for efficiency and productivity purposes, which allows the MNE cash pool leader to focus on cash forecasting and liquidity risk management. The value created by such functions should therefore be reflected in the intra-group pricing. We note that the MNE cash pool leader often also absorbs the cost charged by the bank for the pooling service.

Question to Commentators in Box C.9. Regarding an Unwilling MNE Group Member's Required Participation in an MNE Cash Pooling Arrangement

TEI questions the assumption underlying this question: that an MNE group member would choose not to participate in a cash pooling arrangement as compared to options offered by unrelated parties. TEI can only see benefits for participants to a cash pooling arrangement, which generally provides flexibility, efficiency and productivity in cash management, risk minimization and a low cost/benefit ratio.

Moreover, the Discussion Draft invites tax administrators to assume an entrepreneurial role to determine what a given taxpayer should and should not accept in an intercompany situation. The OECD should clarify that MNE's make decisions for a consolidated group that make good business sense and benefit all group companies, even where an argument could be made that a stand-alone a group member may have taken a different approach.

The question in Box C.9 also does not acknowledge that independent taxpayers can make illogical and even detrimental decisions, especially with the benefit of hindsight. Related party transactions arising from a group-wide policy, whether for cash pooling or a requirement to use a specific global supplier for computer equipment, should be respected unless there is clear evidence in a related party situation that the transactions were entered into solely to obtain a tax benefit.

Finally, the reality for many subsidiaries is that the Treasury function and expertise is concentrated at the company headquarters or certain regional hubs. Therefore, even if local rates from independent parties may be more favorable, it may not be practicable for them not to participate in the pool and arrange their own funding even if one does not factor in the group policy's need for uniformity across the group's members.

Paragraphs 105 and 111 Regarding Delineation and Pricing of Cash Pooling

We agree that cash pool members generally obtain more favorable interest rates from an MNE cash pool leader than they would from a third-party bank. However, interest rates are more favorable because of lower spreads applied by the cash pool leader, and also because many MNE

groups do not charge negative interest rates on deposits, which is contrary to the policy of unrelated banks.

As indicated under our response to paragraphs 43 and 45, we believe that cash pool leaders often perform more than a coordination or agency function because they often have skilled personnel with the capability to manage risks and investments. Their remuneration should reflect such value adding functions and risk management

Question to Commentators in Box C.10 Regarding Cross-Guarantees

In the absence of contractual clauses, in TEI's view a cash pool participant should not be considered as providing an implicit guarantee to other pool participants. Contractual relationships are between each cash pool participant and the cash pool leader, not between participants. Such an implicit guarantee would likely not be recognized by country commercial or corporate laws, which may require guarantees (in particular those provided to related parties) to be approved by local Board of Directors and disclosed to statutory auditors.

For a number of reasons, including but not limited to legal reasons, TEI opposes the practice of assuming that implicit cross-guarantees are present, required, or even advisable in cash pooling arrangements. As indicated above, we believe that implicit group support should be attributed to the MNE group's ultimate parent company.

That being said, if such cross-guarantees are explicit and the practical effect is that members with strong credit support and enhance the credit of members that are weak or large net borrowers, then it seems unusual to equate the effect of such guarantees with mere passive association. But to calculate a guarantee fee that varies with the credit profile of each participant is clearly impracticable in many instances. Therefore, one possibility is that if the cross-guarantee includes the parent and covers substantially the entire funding need of the subsidiary, then the ratings of the subsidiary can be raised to at or close to the group level ratings.

Comments on Paragraph 131 Regarding Cross-Guarantees and Set-Off Rights

The guidance in Paragraph 131 should clarify what is meant by "regarded as capital contribution" in the sentence "If the prevailing facts and circumstances support such a conclusion, no guarantee fee would be due, and any support, in case of a default from another group member, should be regarded as a capital contribution." That is, does the sentence mean there is an automatic re-characterization into equity? If so, how will the secondary effects of the recharacterization be considered within the context of the cash pool?

Comments on Paragraphs 132-136 Regarding Currency Risk

Cash pooling arrangements are generally set to minimize a participant's currency exposure, with the cash pool leader assuming any currency risk. For example, participants will deal in their own functional currency, while the cash pool leader will deal in multiple currencies, concentrate the group's currency exposure, and arrange hedging. When currency exposure is concentrated by the cash pool leader or a treasury center, these entities bear the relevant risks and should be rewarded accordingly.

Question to Commentators in Box C.11 Regarding Offsetting Positions in a Single MNE Group

The general aim with respect to offsetting positions is to centralize risk exposures where possible and create "natural" hedges. Hedging exposures requires expertise and are often a key factor in why group policy only allows local teams to naturally hedge.

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. Where a treasury company hedges an exposure in an operating company, one entity typically benefits from the hedge, while the other takes the cost. Assuming an accurate delineation and arm's length terms, this should not result in a correction.

Natural hedges can occur in a number of ways and in a number of forms whether timing, currency, forwards/futures and so on. It is not possible to identify, set-off/net-off and continuously monitor such positions. Therefore, the most practical guidance may be to treat these as similar to group synergies and not require specific TP analysis unless the taxpayers chooses to identify certain corresponding pairs of positions that net off each other (such as to account for mandatory position dictated by group policy). In such cases, the guidance for set-offs can be adopted i.e. that each corresponding and offsetting position be disclosed.

Question to Commentators in Box D.1. Regarding Guarantees

In TEI's opinion, the OECD's guidance on guarantees should not give the impression that a guarantee is easily imputed where there is generally none in related party transactions in the absence of any explicit undertaking. The terms of a guarantee can vary widely and imprecise language in OECD guidance could lead to broad interpretation and incorrect assumptions related to the terms of an imputed guarantee. For this reason, close regard should be given to established industry practices in the relevant taxpayer's business segment. For example, if there are long-term financing of projects or investments that regularly see export-import bank guarantees, then it may be appropriate to consider whether there should have been a guarantee where there was none previously.

With respect to the circumstances in which a guarantee is requested by a third party lender, and its impact, the answer depends on the facts and circumstances of the borrower. It is important to emphasize that if third-party lenders require formal guarantees, letters of awareness or comfort are also an accepted practice by many banking institutions and have a positive impact on loan pricing. Thus, higher standards should not be required when dealing with parent guarantees related to intra-group loans.

Comments on Paragraphs 140 and 143 Regarding Guarantees

In regard to Paragraph 140, the last sentence "the remainder of the loan granted should be regarded as effectively a loan to the guarantor followed by an equity contribution by the guarantor to the borrower" describes a recharacterization that is not practicable and unrealistic. This recharacterization exercise complicates matters and effectively makes a borrower-lender loan relationship a tri-partite one with the addition of an equity contribution by the guarantor. It

is too far removed from the basic arm's length principle in that it is not conceivable that independent parties by granting a loan could have envisaged that they become equity holders. Further, such a recharacterization could run counter to the banking regulatory view of the transaction to which one or more of the parties may be subject.

In situations where a guarantee increases the debt capacity of the borrower, the Discussion Draft suggests that the loan or portion of the loan granted pursuant to the guarantee should be regarded as effectively granted to the guarantor, followed by an equity contribution by the guarantor to the borrower. While such an approach may have some merits from an economic perspective, TEI is concerned that the approach would exclude the ability of the borrower to deduct interest expense paid to the bank. Reasons for this include:

(i) that the loan is recharacterized as equity; or

(ii) the guarantor is not a party to the loan agreement with the bank, which means it does not record interest expense on its books nor does it make actual interest payments and, under local law, for an expense to be deductible it must be recorded in the entity's local books.

Such an extreme result seems inconsistent with the application of the arm's length principle. In addition, this approach could also have unexpected withholding tax consequences if the tax authorities of the guarantor decide to source the relevant interest expense in their country. For these reasons, we believe that the recharacterization proposed by the Draft is likely to create controversies and should therefore be reconsidered.

Separately, Paragraph 143 implies that a guarantee by a related corporation and the concomitant guarantee fee are never appropriate. This view is inconsistent with current business practice and the experience of TEI's members.

Question to Commentators in Box E.1. Regarding Captive Insurance Arrangements

In TEI's view, indicators for recognizing that an insurance policy issuer actually assumes the risks it contractually assumes are whether (i) losses are paid by the captive insurer, or they would be paid if a loss occurred, whether or not the captive reinsures risk; (ii) the captive is regulated and audited; and (iii) the licensed and/or regulated fronting insurance carrier is issuing policies and reinsuring with the captive.

With respect to the specific risks needed to be assumed by the policy issuer for it to earn an insurance return, it would be the risk that the captive could experience a loss above the amount of its premium collected.

On what control functions would be required for these risks to be considered to have been assumed, evidence that the captive insurer is regulated, audited, and professionally managed by personnel with insurance experience, should be sufficient.

In general, the insurance industry has specific regulators and rules that govern reserves and the amount of risks that can be underwritten. Therefore, as a general approach, alignment to

regulation should be acceptable as a default for transfer pricing purposes so as to minimize the potential inconsistency between a transfer pricing and a regulatory position

Comments on Paragraphs 166, 172 and 183 Regarding Captive Insurance Arrangements

Paragraph 166 suggests that, as evidence of the real economic impact, a captive insurer either should include a significant portfolio of non-group risks or reinsure a significant proportion of the risks outside of the MNE group. TEI submits that another possibility would be if the breadth and depth of the MNE group would be sufficient to diversify risks without an external party. We also recommend that the reference to "i.e., the captive insurer either…" be changed to "for example" so as not to suggest the possibilities in the relevant parenthetical are the only possibilities.

Regarding Paragraph 172, a key reason for a captive insurer is the efficient use of the group's capital, assuming insurance is among the MNE's realistically available and preferred options.

Finally, Paragraph 183 suggests that there are differences between capital requirements of commercial insurers and captives, and that a commercial insurer's drive for capital efficiency is not reflected in a captive. This is not necessarily the case – capital efficiency may be the primary commercial driver of a captive if it is acting as an insurance company.

Question to Commentators in Box E.2. Regarding Actuarial Analysis

Commercial insurance premiums usually incorporate a technical actuarial analysis, but also factor in the commercial situation, *i.e.*, in today's insurance market with excess supply, competing insurance firms are known to offer premiums below the technical price. Nevertheless, taking actuarial input into consideration is an appropriate method to help determine an arm's-length premium.

Comments on Paragraph 185 Regarding Group Synergy

TEI questions whether the group synergy in the example is realized because the captive insurer can negotiate and has the skills and knowledge of the insurance business and techniques. If so, then the captive's expertise adds value and should be rewarded accordingly.

Question to Commentators E.3 Regarding the Example in Paragraphs 187-88

The central tenet of the example in Paragraphs 187 and 188 appears to be the notion that the relevant insurance contracts are highly profitable and that the profit Company B earns is above the level of profit realized by third-party insurers providing similar coverage. This assumption is then used to posit that Company A is entitled to a remuneration in excess of the arm's length sales commission it receives from Company B. In TEI's view such an approach is flawed and has no basis in the TPG.

The example states that Company A offers accidental damage and theft coverage for the products it sells to third parties at the point of sale and receives a commission from Company B

for A's role in the process. The example then states that "Benchmarking studies show that the commission paid to A is in line with independent agents selling similar cover as a standalone product." Based on these facts, the only conclusion can be that the commission received by Company A from Company B constitutes arm's length compensation for the functions performed, assets used, and risks assumed by A in offering the insurance policy to A's customers. Given that A merely offers insurance coverage provided by a third party which involves very little effort for A's employees, no significant use of assets and virtually no risk for A, it only stands to reason that A would be satisfied with a commission in line with independent agents selling similar coverage to enhance its overall profits from the sales of products at its point of sale and even reduce its own product liability risk.

The first sentence of paragraph 188 attempts to provide a technical basis for assigning a remuneration to A in addition to the sales commission by stating one needs to "consider how *the high level of profitability* of the insurance policies is achieved and the *contributions of each of the parties to that value creation*" (emphasis added) when considering how the conditions of the transactions between A and B differ from those which would be made between independent enterprises. This statement is incorrect for two reasons.

First, as stated in paragraph 1.6 of the TPG, the comparability analysis is at the heart of the application of the arm's length principle. The comparability factors stated in the TPG do not include consideration of how a high level of profitability by one party to the transaction is achieved. In Paragraph 188 the argument is put forward that "[t]he sales agent has the advantage of offering the insurance policy to its customer alongside the sale of the goods to be insured." While this argument appears to be a correct factual statement- it is then followed by "[i]t is the advantage of intervening at the point of this sale which provides the opportunity to earn a high level of profit" and "[t]he ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer contact at the point of sale". Even within the limits if the facts provided in the example, this conclusion is evidently incorrect. Company B's ability to earn a profit is inherent in the nature of the insurance product: the fact that a third party customer is willing to pay a certain price and B's risk management and mitigation strategies. The involvement of A at the point of sale has no bearing on the profitability of the insurance product and therefore B's profitability. A high level of profitability for one related party may be an indicator to a tax auditor that non-arm's length pricing has occurred, but it cannot be construed as a required consideration in the determination of an arm's length price. The only reason for introduction of the consideration of a high level of profitability appears to be (as per the last sentence of paragraph 188) to adjust the remuneration for B to a benchmarked return for insurers insuring similar risks and allocating the balance of the profit to A and in fact bypass the comparability analysis as required by paragraph 1.6 of the TPG.

Second, the TPG state that one of the comparability factors is the functional analysis (paragraph 1.36) and paragraph 1.51 indicates that the contributions of related parties to value creation are a consideration. Where it is evident (as stated in the example) that A merely offers the insurance at the point of sale without using any assets and/or assuming any risk in relation to the insurance coverage offered, while B assumes all risks and performs all risks management and

mitigation functions with regard to the insured risk and possesses the capital to support these risks, the selection of the most appropriate transfer pricing method requires determination as to whether there are sufficiently comparable uncontrolled transactions. As stated in the example, that is the case and no compensation over and above the sales commission would be supportable when a comparable uncontrolled price can be determined.

Conclusion

TEI appreciates the opportunity to comment on the Discussion Draft regarding the transfer pricing aspects of financial transactions. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose chair is Giles Parsons. If you have any questions about the submission, please contact Mr. Parsons at gilesparsons55@gmail.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, bshreck@tei.org.

Respectfully submitted,
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