

Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development
By email

PUBLIC DISCUSSION DRAFT, BEPS ACTION 8-10: FINANCIAL TRANSACTIONS

September 7th, 2018

Dear Sir / Madam,

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

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

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

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

Yours Sincerely,

On behalf of EY

Ronald van den Brekel

Tom Tsiopoulos

Executive summary

General comments

- ▶ We strongly believe that the guidance in the discussion draft should not be intended for MNE groups operating in the financial services industry given the presence of extensive regulatory restrictions that restrict the ability of MNE groups in the financial industry to enter into non-arm's length transactions, as well as the very different nature of their business models, value chains, and operating activities.
- ▶ There needs to be a new, alternative, or supplementary mechanism available to MNE groups, such as a form of arbitration, to resolve disputes in cases where there could be substantial double taxation, especially if all countries cannot accept that capital structures can be addressed under tax treaties and by reference to the arm's length principle.
- ▶ We are also concerned about members of the inclusive framework not reaching a consensus position on the contents of the discussion draft. It would be extremely helpful, for both taxpayers and tax administrations alike, if country observations and positions on the various topics be included in future draft guidance, if the guidance is non-consensus. Ultimate consensus on the final guidance, however, remains critical.
- ▶ The discussion draft unnecessarily shifts the main focus from determining an arm's length price, given the respective form and terms and conditions of a financial transaction, to a delineation exercise, which in the case of financial transactions is likely to result in intensified controversy.
- ▶ Tax administrations tend to often deny the deductibility of losses, arising due to the materialization of financial risks assumed. Under the arm's length principle, such losses should not be disregarded by tax administrations.

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

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

Section C – Treasury function

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

Section C.1 – Intra-group loans

- ▶ The guidance regarding the two-sided perspective and commercial rationality may be too burdensome and open to interpretation, which is likely to result in intensified controversy.
- ▶ The evaluation of options realistically available (ORA) should not be intended to create a requirement for taxpayers to document all possible hypothetical ORAs. We recommend the OECD to

reiterate that decisions of the parties should be respected, as long as they are sufficiently documented.

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

Section C.2 - Cash pooling

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

Section C.3 - Hedging

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

Section D - Financial guarantees

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

Section E - Captive insurance

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

1. General comments to the discussion draft

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

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

- ▶ The financial services industry is subject to significant regulation on acceptable capital structures, and may not have the flexibility to conform to additional restrictions for tax purposes. Regulators already require financial services companies to maintain adequate capitalization at a legal entity level and have clear guidance on various forms of debt, equity and other funding that can be relied upon. Applying the guidance in the discussion draft would result in conflicts between non-tax and tax rules, increasing the administrative burden on MNE groups in this industry.
- ▶ Regulators impose requirements for sufficient substance (both capital as well as mind and management) and local control of risks. A further layer of requirements for tax purposes would be at best redundant and at worst contradictory. Regulators are unlikely to accept retroactive changes to the income of regulated entities based on tax authority challenges to the substance of transactions that were respected by regulators.
- ▶ The discussion draft implicitly suggest that assuming financial risks such as credit risk, foreign exchange risk, liquidity risks, interest rate risks, etc. are ancillary to an MNE's business and can be separated from an MNE's core operations. For financial services companies, this is not true; the primary business of a financial services company is to assume, manage and invest in such risks. Attempting to apply the guidance in the discussion draft to financial services companies would lead to non-arm's length results in areas concerning the remuneration of these core risks
- ▶ Implicit support in the context of MNE groups operating in the financial services industry is materially different from other industries, and has very different considerations. Financial services companies have significant restrictions on their ability to "bail out" other group members under regulatory restrictions, e.g., regulations preventing a bank from bailing out a failing bank holding company and resolution plans that force a particular path to insolvency. Financial services companies have a very strong incentive to bail out affiliates if it can be accomplished within the bounds of regulation, because the reputational damage to a financial services company of allowing any affiliate to become insolvent could easily trigger a group-wide insolvency.

The elimination of double taxation

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

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

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

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

Respecting the form and terms and conditions of a financial transaction

The BEPS Action 4 report¹ states that an arm's length test "*...can be resource intensive and time consuming for both taxpayers and tax administrations to apply...*" and that its outcomes "*...can be uncertain*". However, the guidance included in the discussion draft on the accurate delineation of financial transactions, including the identification of commercial and financial relations between the parties, as well as analyzing the terms and conditions of financial transactions, appear to be even more burdensome and open to interpretation. In our view, the discussion draft unnecessarily shifts the main focus from determining an arm's length price, given the respective form and terms and conditions of a financial transaction, to a delineation exercise, which in the case of financial transactions is likely to result in intensified controversy.

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

¹ Paragraph 12 of the BEPS Action 4 report

and the decisions of the related parties are sufficiently documented, and only allowing the re-characterization of financial transactions in exceptional and rare cases.

Accepting losses arising due to materialization of financial risks

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

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

General comments:

- ▶ We had hoped that the OECD would leave issues of capital structure and the definition of debt and equity to the helpful guidance already contained in the BEPS Action 4 report, and to the more appropriate domain of domestic anti-abuse provisions such as thin capitalization. Notwithstanding the Article 9 commentary of the OECD Model Tax Convention (the OECD MTC) language mentioned in paragraph 5, the arm's length principle as an analytical framework does not really provide useful insights on this matter, as discussed below. In addition, and for the same reason, we do not think that this will prove to be an area of consensus, nor should it. We were concerned to read that *"the concepts of Chapter I, in particular the accurate delineation of the actual transaction, may relate to the capital structure of an entity within an MNE group."* We do not believe that the arm's length principle is so elastic. We question whether a multinational's capital structure can be evaluated by subjective considerations of 'what unrelated parties would do.'
- ▶ In particular, we believe that the OECD is conflating two distinct questions: firstly, the question of whether particular funding transactions should be characterized as debt or as equity for tax purposes, and secondly, the question of accurately delineating the particular terms and conditions of debt funding transactions (e.g., overnight commercial paper versus 30-year term debt, the amount of senior versus the amount of subordinated debt, etc.). Both of these questions fall under the broad framework of capital structure (i.e., correspondingly debt versus equity, and debt structure itself), but we think that they should be addressed separately in the discussion draft. In what follows, we describe our views on the appropriate guidance for questions of debt versus equity, while the accurate delineation of debt transactions is covered in our response to box B.2.
- ▶ We understand that part of the motivation for framing capital structure issues within the framework of Article 9 is to facilitate access to MAP and relief of double taxation. Unfortunately, in practice such relief would be undermined by the lack of a principled basis for agreement, since there would be a lack of principled basis for the underlying initial adjustment. Instead, we think that a better approach would be for treaty partners to agree to thin capitalization rules as long as they are within the parameters of the BEPS Action 4 report.
- ▶ The issue of debt and equity is raised in other parts of the MTC, and it would be important that a broader treaty perspective is applied, which would require the input of Working Party No. 1. The definition and treatment of dividends and interest are determined in Articles 10 and 11 of the MTC, which gives deference to the character determination of the source country. The OECD has addressed this in its prior BEPS work, and we do not think that it can be improved upon. In fact, we fear that the prior work will be significantly undermined by attempting to super-impose an arm's length framework to capital structure.
- ▶ The document asks whether there is an *'arm's length'* capital structure. We think that this is an impractical and unanswerable question. As we have alluded to above, "capital structure" is far broader than simply the analysis of debt funding versus equity funding. Two enterprises in the same industry may choose to fund their operations with a different mixture of equity, preferred equity, subordinated debt, secured debt, revolving credit facilities, commercial paper, repurchase agreements, customer and trade payables, borrowed assets, asset-backed financing such as factoring or securitizations or other forms of financing unique to their particular situations. Each component of the enterprise's funding is interdependent with the other components and exposes the enterprise to a unique mixture of risks and rewards and the subjective preferences of management and shareholders. It is difficult to see how it would be practically possible to assess whether a particular capital structure is 'arm's length' or not. In fact, one may observe a broad

spectrum of capital structures adopted by entities, even within a single industry. As such, the application of the industry average and / or the respective MNE group's capital structure as a point of reference in our view should be discouraged,

- ▶ Further, the fact that capital structure optimization *depends on* the tax treatment of debt versus equity suggests that relying on the arm's length standard to analyze capital structure would be inherently circular. Here again we do not think that the arm's length principle provides an appropriate framework, and certainly not a better framework than domestic rules and their interaction with existing treaty provisions (e.g., Articles 10 and 11 of the MTC).
- ▶ We think that it is very important for the OECD to reach clear consensus on this basic issue before attempting to provide separate guidance tailored to *'those countries that use the accurate delineation under Chapter I of the OECD Transfer Pricing Guidelines (the TPG) to determine whether a purported loan should be regarded as a loan for tax purposes,'*² to the exclusion of other countries who quite rightly do not believe that this is appropriate under the arm's length principle. Bifurcated guidance is never a good idea, and will simply lead to unresolvable disputes, and broader treaty inconsistencies.

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

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

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

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

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

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

² Paragraph 10 of the discussion draft.

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

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

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

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

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

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

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

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

- ▶ Repayment type (e.g., bullet repayment, amortized term loan, flexible repayment)
- ▶ Interest deferral features;
- ▶ Borrower's credit rating (subject to considerations regarding group credit rating) and credit quality of the transaction;
- ▶ Currency(ies) used;
- ▶ Leverage and collateral (if not accounted for in credit rating analysis);
- ▶ Guarantees;
- ▶ Local sovereign risk (if not accounted for in credit rating analysis); and
- ▶ Rank (e.g., seniority, subordination, etc.,).

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

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

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

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

Risk free rate of return

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

Risk adjusted rate of return

The concept of applying a risk adjusted rate of return was discussed in the 2015 BEPS final reports on Actions 8-10 related to funding, however the work in this remains to be finished, specifically regarding the topic of "what is the appropriate ex post return to a funder who controls its funding risk?" Paragraph 6.62 of the TPG states "The contractual arrangements will generally determine the terms of the funding transaction, as clarified or supplemented by the economic characteristics of the transaction as reflected in the conduct of the parties." An accompanying footnote to paragraph 6.62 of the TPG states: "Further guidance will be provided on the economically relevant characteristics for determining the arm's length conditions for financial transactions, including when the funding is used for project finance, in particular investments in the development of intangibles. This work will be undertaken in 2016 and 2017."

In our view, paragraphs 12-21 of comment box B.4. (relating to risk-adjusted rate of return) do not yet adequately address this issue. The guidance currently contained in Chapter I and Chapter VI of the TPG, relating to funding, describes scenarios on a much broader scale, as compared to funding transactions in the form of a loan. These chapters also cover funding that is associated with putting capital at risk, specifically relating to the activity that is funded. The two alternative forms of funding, and the nature of the risks associated with them, are fundamentally different.

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

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

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

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

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

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

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

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

3. Section C – Treasury function

General comments:

- ▶ It is not entirely clear whether the guidance provided in paragraph 37 through paragraph 46 of the discussion draft is primarily aimed at the corporate treasury function on its own, or should be also directly applicable to treasury companies, which usually record a number of financial assets and liabilities on their balance sheets, resulting in profit & loss statements similar to those for financial services companies, and reflecting the underlying risk profile associated with the mix of financial assets and liabilities.
- ▶ Specifically, MNE groups often deploy a treasury setup with a separate treasury company (similar to the one described in Example 2 of the discussion draft), whose operations are supported by the corporate treasury team (either at the MNE group's headquarters or other affiliates). As such, it would be helpful to clarify if the initial guidance in Section C was meant only for the corporate treasury activities (i.e., services), or both the corporate treasury function and separate treasury companies. In our view, such clarifications are relevant in the context of risk allocation under the TPG, especially given that situations described in paragraph 1.93 and 1.94 of the TPG often apply in light of the activities undertaken by separate treasury companies.
- ▶ In particular, we are of the view that even if the treasury function would be characterized as providing a support service to the main value creating operation (as suggested by the discussion draft), this does not per se mean that an MNE group's treasury company(ies) should be entitled to a stable but routine remuneration. Rather, such separate treasury companies would be often entitled to a risk-related reward, whilst at the same time accepting the possibility of the financial risks materializing resulting in losses.
- ▶ With respect to the overall treasury function within an MNE group, we believe that to the extent the delineation of the transaction exercise determines that the MNE group's headquarters entity and/or group treasury company demonstrates risk control functions, and also has the financial capacity to bear the respective risks (e.g., by putting sufficient capital at risk), then such separate treasury companies could be characterized as more than mere providers of an intra-group service and should be compensated for the assumption of the risk.
- ▶ This is relevant on a broader scale, including affiliates which manage hedging and/or cash pooling activities, amongst other activities. The functional profile of an affiliate performing treasury activities should not be considered in isolation from each type of financial transactions assumed by that affiliate (e.g., term loans, cash-pooling, hedging, etc..) and the related risks, but rather be a holistic analysis which may conclude that a separate treasury company is more akin to an external

financial institution, with affiliates interacting with the treasury company as they would with an independent bank, ultimately indicating that it should receive a remuneration above a routine service provider (which also may result in losses).

3.1. Section C.1. – Intra-group loans

General comments:

- ▶ The guidance regarding the two-sided perspective and commercial rationality may be too burdensome and open to interpretation, which is likely to result in intensified controversy. Given that as part of the BEPS deliverables (the Action 4 report), the OECD considered non transfer pricing measures as the primary tool to combat excessive interest payments, the proposals contained in the discussion draft regarding delineation of intra-group loans list too many areas for hypothetical exploration with little practical applicability. Instead, EY recommends respecting the contractual terms of intra-group loans for transfer pricing purposes, as long as an arm's length range of interest rates can be established using reliable comparable transactions, and the decisions of the lender and the borrower are sufficiently documented.
- ▶ The evaluation of options realistically available (ORAs) should not be intended to create a requirement for taxpayers to document all possible hypothetical ORAs. Rather, the intention is to consider and document the commercial rationale behind specific terms and conditions (including debt amount) of a loan to be provided to a respective borrower. We recommend the OECD to reiterate that decisions of the parties should be respected, as long as they are sufficiently documented.
- ▶ EY recommends acknowledging that, in the event a borrower defaults on an intra-group loan, if that loan was properly delineated and priced, the lender should be able to deduct the credit loss under the arm's length principle. The same should also apply with respect to interest rate risk, foreign exchange risk, and liquidity risk (when applicable).
- ▶ There are significant differences between generic corporate debt finance and more specific financing instruments such as project finance, structured finance, or real-estate finance, which are relevant when applying an arm's length test. EY recommends clarifying the main differences and their impact on determining an arm's length price.
- ▶ For avoidance of doubt and in order to prevent erroneous outcomes, it would be important to acknowledge that a credit rating assessment should reflect the consolidated perspective of the borrower (i.e., the legal entity itself and its direct and indirect subs). In this respect, the OECD may also want to comment on the concept of structural subordination.
- ▶ With respect to credit ratings, we feel that any presumption that borrowers would always pledge suitable collateral is not correct.
- ▶ We also strongly disagree with the suggestion contained in the discussion draft that quantitative credit rating models do not produce reliable results because they may be subjective. These quantitative credit rating models are developed by independent credit rating agencies, primarily for commercial (and not transfer pricing) purposes. Such models are also used by independent parties (including banks and financial institutions), therefore representing market practices.
- ▶ Unless adopted as a safe harbor, EY strongly recommends against any requirement for taxpayers to apply the MNE group credit rating, or for taxpayers being required to reconcile group member credit ratings to the MNE group's credit rating.
- ▶ Finally, we recommend that the OECD acknowledge that official credit ratings assigned by independent rating agencies may differ between agencies. It would be important to recognize that a

credit rating assessment is not an exact science, hence an outcome of a credit rating analysis in an intra-group context may also reflect a range of credit ratings, instead of just a single rating.

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

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

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

- a rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;

We strongly feel that such a rebuttable presumption deviates from the arm's length principle. This rebuttable presumption is likely to not be true outside of a few, rare instances. Based on independent rating agency guidance, the independent³ credit rating is the preferred approach under arm's length conditions. Further, banks generally do not treat individual members of an MNE group as sharing the group credit rating. We feel that introducing such a rebuttable presumption is not appropriate, as it only creates additional administrative burden for the taxpayer to bear the burden of proof to demonstrate that the credit rating of a given group member is not the same as the MNE group credit rating, unless such presumption is aimed to merely serve as a safe harbor. EY therefore considers that if taxpayers properly address implicit support considerations (where applicable), there should be no other presumption that group member credit ratings be equivalent to those of their MNE group.

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

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

³ Independent credit rating refers to the estimated parent-implied credit rating of an entity (e.g., its standalone credit rating, adjusted, if necessary, due to the implicit support considerations).

In some cases, such as a highly strategically important entity that occupies a critical place in a MNE's business strategy, a direct link between the group rating and the entity rating may be appropriate. However, such linkage should be evaluated on a facts and circumstances basis according to the guidance available from rating agencies and evidence of how independent lenders such as banks have factored in implicit support in similar facts and circumstances.

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

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

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

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

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

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

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

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

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

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

We are of the view that determining and measuring the impact of implicit support should be based on an analysis of how third parties treat implicit support in cases with similar facts and circumstances.

We do note that there are various methodologies available for assessing implicit support. For example, credit rating agencies have developed extensive, detailed methodologies for assessments of implicit support; these models depend on both quantitative and qualitative inputs and are highly sensitive to subjective judgment. Furthermore, guidance from different rating agencies will not align in every case. In contrast to the views of rating agencies, evidence suggests that in many cases banks may disregard implicit support entirely.⁴ Nonetheless, we are of the view that a structured, transparent and consistently applied method of assessing the level of implicit support available (where the facts and circumstances determine that implicit support is available), during a credit rating analysis is in line with application of the arm's length principle, and thus should be respected by tax administrations.

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

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

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

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

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

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

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

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

⁴ Ibid.

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

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

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

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

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

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

3.1. Section C.2 - Cash pooling

General comments:

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

being equal), the “netting benefit” would be remote or even non-existent. In other words, the mere offsetting of debit and credit positions does not result in a significant spread, unless the maturity profile (and potentially other characteristics) of assets and liabilities are not matched. As such, the so-called “netting benefit” reflects the risk-related return (liquidity and credit risk premium), not a group synergy. As such, netting benefits should be allocated to parties assuming such risks.

- ▶ We would also welcome the OECD to provide guidance regarding the appropriate characterization of netting benefits, if allocated to cash pool members and/or other parties, including whether these could be seen as additional payments of interest, guarantee fees, or as having some other character, since this can have important consequences from a corporate tax and withholding tax perspective.
- ▶ We recommend that the OECD acknowledge that there needs to be symmetric treatment between the allocation of netting benefits and the assumption of losses that may arise upon the materialization of risks assumed. We think this is critical, as the guidance in the discussion draft implicitly treats all the savings that would be earned by a cash pool as a benefit without considering the risks that are involved and the potential for losses (e.g., if cash pool depositors all need to withdraw funds, a group entity defaults, a bank defaults, the money market fund, where the cash pool leader invested excess funds, loses value, etc.).
- ▶ We recommend the OECD to emphasize that cash pool arrangements can be set-up in different ways and for different purposes, so the use of “one-size-fits-all” approaches when analyzing cash pool transactions should be discouraged. For example, a set-up where there are only participants with excess cash and a cash pool leader acts as an asset manager is different from a situation where a cash pool leader operates as an internal bank, which borrows and lends funds to MNE group members.
- ▶ If paragraph 108 of the discussion draft implies that the actual returns of the cash pool leader and cash pool participants should be determined and documented in a taxpayer’s local file, we feel this may create an undue and unnecessary administrative burden to taxpayers.

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

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

It is more usual for a cash pool leader to bear at least a degree of credit risk, interest rate risk, foreign exchange, and liquidity risk. We do not believe that the risk profile of a cash pool leader depends on whether the same entity performs a range of other roles and bears risks, as set out in Example 2. In

particular, as we elaborate on below, the discussion draft seems to assume that the cash pool will always generate profit and ignores the possibility that the risks assumed will result in a loss for the cash pool leader or other cash pooling participants.

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

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

- are there circumstances in which one or another of the approaches would be most suitable?;

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

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

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

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

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

- whether, in commentators' experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

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

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

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

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

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

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

We agree that an individual affiliate operating at arm's length would act in its own best commercial interests and seek to achieve the most advantageous funding terms while depositing its surplus cash where it could maximize the level of return consistent with its individual risk appetite, however it is unnecessary burdensome to presuppose that a detailed options realistically available analysis (which could be an implied outcome of this section) should precede the action of entering into a cash pooling arrangement by a participant, or to continually judge a cash pooling participant's actions to remain in a cash pool arrangement. MNE's impose a number of group wide strategies upon its affiliates, both in the financing sphere as well as operational. Box C.10. Commentators' views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

Although cross guarantees are not always required in the context of cash pools, they are commonly present in such arrangements, often at the request of the external partner banks. With respect to the need for a guarantee fee payment, we agree with the guidance in the discussion draft that it is difficult to determine the degree of real risk that each cross guarantor assumes in a cash pooling context due to the large number of participants and constant fluctuations in balances. Determining a guarantee fee for

each cross guarantee likely would place an undue burden on the MNE group, while accruing no benefits to any party in practice.

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

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

3.2. Section C.3 - Hedging

General comments:

- ▶ We believe description of the possible hedging mechanisms in paragraph 134 is correct. , However we believe that there are even more frequent mechanisms occurring within MNE groups that are not described in paragraph 134 of the discussion draft, and that should not be ruled out.
- ▶ With regard to hedging, an MNE group treasury company is often interposed between individual MNE group members and market counterparties, and from a legal perspective is a direct counterparty to financial institutions. As such, the group treasury company is exposed to certain financial risks, including the credit counterparty risk on both the external parties and the group companies. In absence of guarantees or other contractual risk limitations (e.g., provided by the ultimate parent or potential cross-guarantees by individual group members), the group treasury company bears a risk related to potential default of a group company or a third-party, which has a positive likelihood (e.g., the recent global financial crisis demonstrated that even AAA rated financial institutions can collapse and default on their obligations).
- ▶ In this respect, to the extent that as part of the delineation exercise it is determined that the group treasury company has control over and the financial capacity to bear the respective risks (e.g. by putting sufficient capital at risk), the centralized hedging function should be viewed as providing more than merely an intra-group service. In particular, an arm's length remuneration not only for the functions performed (i.e. hedging service fee) but also for risks assumed might be due.

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

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

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

We are concerned that guidance in the discussion draft, suggesting that internal hedges should generally be "inferred" from internally offset risks is likely to invite double taxation. Such guidance

would invite tax administrations to assert *ex post* reallocation of losses to other group members, based on unprovable arguments about whether or not third parties “would have” hedged those risks or what the MNE “would have” done absent a group policy. What should be relevant in such an analysis is what the individual entities *have* done, and that re-characterization should only occur under extraordinary circumstances.

4. Section D – Financial guarantees

General comments:

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

Box D.1. Commentators' views are invited on:

- how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);

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

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

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

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

- the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;

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

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

- ▶ Protection against moral hazard;
 - ▶ The lack of sufficient debt capacity by a subsidiary to independently raise debt;
 - ▶ Reducing the level of credit risk by the lender, resulting in improved terms and conditions for the borrower;
 - ▶ To meet regulatory requirements of the borrower, such as a requirement to only lend to entities formally assigned an investment-grade credit rating or capital requirements that depend on counterparty credit rating.
- where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and

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

- examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

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

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

5. Section E - Captive insurance

General comments:

- ▶ We generally welcome further guidance and examples as potentially providing greater clarity relating to the treatment of captive insurance transactions, but it is not clear why guidance specifically relating to captive insurance was included in the discussion draft. An accurate delineation of captive insurance transactions does not present any particular novel challenges worthy of further and targeted guidance. To the extent that the discussion draft recognizes that captive arrangements can result in a genuine transfer of insurance risk, then the guidance is welcomed as a counterweight to positions taken by tax administrations in this area.
- ▶ There have previously been extensive discussions with industry during the development of the guidance on Article 7 of the MTC or the preparation of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments, Part IV on insurance, which contained key insights. Although we don't believe that the Article 7 concept relating to key entrepreneurial risk taking (KERT) functions and the Article 9 concept of control of risk generally align, we think that they do so as it relates to insurance. We firmly believe the decision to exclude it is fully justified by the impact that regulation has on the delineation of the commercial and financial relations in intra-group reinsurance. Regulatory discipline significantly reduces the scope for the cedant and reinsurer to deviate from the contractual reinsurance arrangement. The comments below include sections that set out the circumstances where regulators requirements cause the delineation of intra-group reinsurance in the insurance industry to diverge from captives in a non-insurance group.
- ▶ *Captive insurance in a non-insurance group*
 - We believe that regulation alters the commercial and financial relations of intra-group reinsurance in the insurance industry such that the control of risk will invariably be aligned to the contractual assumption of risk.
 - The guidance should set out exactly what "control" means in the context of the assumption of insurance risk; combined with an example along the lines of paragraph 1.70 in Chapter 1 of the TPG. This would go some way to clarify how the particular meaning of control of risk in the transfer pricing guidelines applies to captive insurance. Our view is that the functions of the captive that are compatible with the control of the assumption of risk are: policy setting, assessing risk selection, pricing, deciding to retain or lay-off the risk further and the acceptance of the insurance risk. A definition of control of assumption of risk along these lines is compatible with the guidance on KERT function in part IV of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments. Adoption of this definition will ensure consistency between profit attribution and transfer pricing principles and ensure that there is no conflict when transfer pricing guidelines are applied to profit attribution by analogy.
 - The draft also contains six hallmarks of what can be expected of an independent insurer. Some of these hallmarks describe intra-group reinsurance in the insurance industry and not all of the hallmarks are relevant to the accurate delineation of captive insurance arrangements. In our view the hallmarks need to be significantly reworked to be relevant to captive insurance.
 - Hallmarks for captives should recognize the commercial rationale for entering into captive insurance. These include:
 - Increasing the effectiveness and efficiency of risk protection.

- Enhancing the organization's ability to take advantage of the commercial reinsurance market.
- The insurance market may have limited capacity/ appetite for certain low frequency/ high impact risks and whilst these risks are insurable groups may find that they have a better appreciation of the nature of the insured risk and are able to self-insure for a smaller premium.
- The captive also effectively ring fences funds to enable claims to be met whereas funds left on the balance sheet of the insured could be called upon to meet other creditors or distributed to shareholders.
- Captive insurance may also form part of a group's wider risk mitigation function by providing risk managers with increased visibility of the insured risk and incentives for minimizing the claims.

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

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognizing that the policy issuer is actually assuming the risks that it is contractually assuming;

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

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

[...]

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

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

Captives subject to light touch regulatory regimes could provide an actuarial analysis to demonstrate that they have the financial capacity to assume the risk.

Our view is that the functions of the captive that are compatible with the control of the assumption of risk are: policy setting, assess risk selection, pricing, deciding to retain or lay-off the risk further and the acceptance of the insurance risk. A definition of control of assumption of risk along these lines is compatible with the guidance on KERT function in part IV of the 2010 OECD Report on the Attribution of Profit to Permanent Establishments.

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

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

- when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed;

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

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

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

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

Beyond the elements of the underwriting function that we have identified as consistent with the control of assumption of risk other parts of underwriting activities may be undertaken by outsourcers without the captive relinquishing control of the assumption of insurance risk. We believe that guidance should include a definition of 'underwriting' and distinguish between those parts of the function that may be

outsourced without having transfer pricing consequences and functions that are central to the control of risk. Our view is that the delineation of the transaction should examine the underwriting function through the five components of underwriting function described in Part IV of 2010 OECD Report on the Attribution of Profit to Permanent Establishments (paragraph 34):

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

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

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

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

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

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

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

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

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

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

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

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

The example as currently provided in the discussion draft seems to suggest that the assumption of risk is routine, and that the only driver of profits within the example is the point-of-sale (POS) advantage. This may be the case in certain situations, however the guidance should make it explicitly clear that a proper delineation of the transaction, followed by a detailed functional and risk analysis, is required to establish that the POS advantage exists before categorizing the assumption of risk as routine.

When seeking to price intra-group captive insurance transactions, and subsequently apportion excess profits, all facts and circumstances of the transaction should be considered, including the POS advantage. It must be first established and demonstrated that a POS advantage exists, and that it is the significant determinant of the excess profits across all possible determinants. Even if a POS advantage exists, it may be one of many factors that contribute to overall profits for an insurance product. Alternatively, it may not constitute an intangible as it may not create a lock-in advantage for the seller of the insurance if the purchaser has other options available to it in the insurance market. Accordingly, analysis of an insurance product's profits should be based on a careful assessment of the relevant functions, assets, and risks.

The underlying risks borne by the insurers must also be thoroughly analyzed, given that they may be complex and highly conducive to high yields and returns. The determination of the profit drivers of the transaction in question, and whether potential intangibles such as POS are relevant to driving profit, will differ across different business and insurance products.

Appendix - List of EY contact persons

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

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