

# The BEPS Monitoring Group

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

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

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

September 2018

### **SUMMARY**

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

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

This DD is well thought out and clearly represents considerable time and effort to create a cohesive document to provide guidance to taxpayers and tax authorities alike. While an excellent

document in every sense of the word, its subtleties and attention to detail will be lost on the many undeveloped and even some developed countries that simply do not have the resources and skilled personnel necessary to apply these rules. In discussing the need for an accurate delineation of each financial transaction, the guidance makes clear that each situation must be examined on its own merits. This of course means that each financial transaction, of which there may be many within any MNE group and even within each MNE group member, must be separately examined on an ad hoc basis. This requires resources and specialist knowledge of each industry as well as of the complexities of corporate finance that is in short supply; for most tax authorities around the world, it is non-existent. The documentation of these rules is an expensive exercise for MNE taxpayers as well.

Hence, what is sorely needed are simplified methods that are simple to apply and that provide results that are fair to both taxpayers and tax authorities alike. This DD is a chance for the OECD to be a leader in considering such methods and providing meaningful guidance that would be of tremendous utility to many countries.

## **A. GENERAL REMARKS**

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

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

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

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

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

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

(vii) acquisition of tangible or intangible assets followed by a lease or licence to the subsidiary with terms and lease or royalty levels at the discretion of the group.

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

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

## **2. The need for simplicity**

### **a. In General**

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

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

The pricing of intra-group financial transactions affects all countries, including the most developed and the most undeveloped. With the greater relative dependence of undeveloped countries on corporation tax, it is of utmost importance that guidance be provided that is capable of being followed and that provides both a degree of certainty and fair results to both taxpayers

and tax authorities. While the care and theoretical correctness of the guidance within this discussion draft is to be applauded, the results create requirements to perform a highly subjective analysis that most tax authorities will have neither the resources nor the skills to make; most will not even be able to review for reasonableness analyses that MNE groups have prepared. Where a tax authority does have the resources and skills, the high level of subjectivity will simply produce more taxpayer/tax authority disputes. Further, where tax treaties are applicable, and the MAP process is therefore available, these increased disputes will further clog competent authorities' backlog of cases.

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

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

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

#### b. Suggestions

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

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

(TPGs), which mention that ‘a rebuttable presumption might be established under which a mandatory pricing target would be established by a tax authority’ (para. 4.104).

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

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

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

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

## **B. SPECIFIC COMMENTS**

### *Box B.1. Question to commentators*

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

#### **Response:**

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

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

*Administrations* ‘represents internationally agreed principles’ for the application of the arm’s length principle, article 9 ‘remains the authoritative statement’ of that principle.

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

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

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

#### Box B.2. Question to commentators

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

#### **Response:**

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

then they will be conservative in their planning and transfer some amount as equity along with a loan in an amount that they truly believe that they can support as being legitimate.

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

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

Box B.3. Question to commentators

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

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

**Response:**

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

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

... Intra-group lenders may choose not to have covenants on loans to associated enterprises, partly because they are less likely to suffer information asymmetry and

*because it is less likely that one part of a group would seek to take the same kind of action as an independent lender in the event of a covenant breach, nor would it usually seek to impose the same kind of restrictions. ... [Emphasis added.]*

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

Paragraph 22 includes the following:

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

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

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

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

In this light, although paragraphs 24 and 25 along with Section C.1.1. are excellent discussions, they are really theoretical in nature. Internal intra-group transactions such as financings are

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

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

*Box B.4. Question to commentators*

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

**Response:**

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

*Box B.5. Question to commentators*

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

**Response:** None

*Box B.6. Question to commentators*

*Commentators’ views are invited on the practical implementation of the guidance included in paragraph 11 of this Box B.4, and its interaction with Article 25 OECD MTC in a situation where more than two jurisdictions are involved. This could arise, for instance, where a funded party is entitled to deduct interest expense up to an arm’s length amount, but the funder is*

*entitled to no more than a risk-free rate of return under the guidance of Chapter I (see, e.g., paragraph 1.85), and the residual interest would be allocable to a different related party exercising control over the risk.*

**Response:**

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

*Box C.1. Question to commentators*

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

**Response:**

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

*Box C.2. Question to commentators*

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

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

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

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

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

**Response:**

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

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

*Box C.3. Question to commentators*

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

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

**Response:**

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

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

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

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

glazed eyes and a total inability to audit in any fashion the correctness, or even the reasonableness, of the taxpayer's presentation and position.

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

Box C.4. Question to commentators

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

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

Box C.5. Question to commentators

*Commentators' views are invited on:*

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

**Response:** None

Box C.6. Question to commentators

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

**Response:**

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

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

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

Box C.7. Question to commentators

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

**Response:**

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

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

**Box C.8. Question to commentators**

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

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

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

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

**Response:**

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

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

Considering this reality, there should be few, if any, situations in which a cash pool leader has conducted any real ‘lender’ analysis and decision making that would allow it to be seen as carrying credit risk. Accordingly, we believe that cash pool leaders should only be remunerated

for providing services to cash pool participants. If the OECD is able to identify some rare exceptions where the leader does truly conduct these analyses and functions, perhaps this issue could be simplified with a rebuttable presumption that remuneration must only be for services rendered.

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

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

**Box C.9. Question to commentators**

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

**Response:**

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

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

**Box C.10. Question to commentators**

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

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

**Response:** None

*Box C.11. Question to commentators*

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

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

**Response:**

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

*Box D.1. Question to commentators*

*Commentators' views are invited on*

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

**Response:** None

*Box E.1. Question to commentators*

*Commentators' views are invited on the following:*

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

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

**Response:**

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

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

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

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

*Box E.2. Question to commentators*

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

**Response:** None

*Box E.3. Question to commentators*

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

**Response:**

We believe that the example is fine as is. We suggest no changes to it.