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Comments on the BEPS Actions 8-10, focusing on the transfer pricing aspects of financial transactions

Dear Sir / Madam,

Taxand welcomes the opportunity to provide comments on the transfer pricing aspects of financial transactions as laid out in the public Discussion Draft released 3 July 2018. Our thoughts are based on our experience in dealing with setting up general transfer pricing policies for cross-border financing, but also with tax audits and controversy in various jurisdictions where we have encountered differing approaches and results.

We have attempted to respond to each question in an exhaustive manner below.

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.

8. Although this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I of these Guidelines to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the capital structure under domestic legislation before pricing the interest on the debt so determined. These approaches may include a multi-factor analysis of the characteristics of the instrument.

9. Accordingly, this guidance is not intended to prevent countries from implementing approaches to address capital structure and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I as the only approach for determining whether purported debt should be respected as debt.

10. Although countries may have different views on the application of Article 9 to determine the capital structure of an entity within an MNE group, the purpose of this section is to provide guidance for those countries that use the accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, in particular a contribution to equity capital).

Historically, the spirit and the letter of the internationally accepted tax rules have been crafted with the main idea to prevent any double taxation arising from mismatches resulting from differential treatments of the same arrangement further to any local regulations. More recently, the output from the BEPS project underlined these same principles and introduced commonly accepted new rules eliminating double non-taxation.

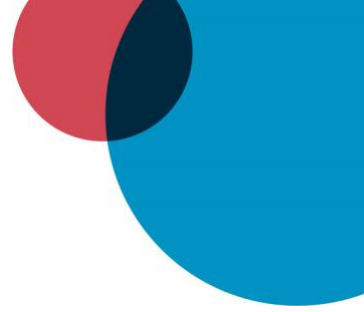
Accordingly, these principles would need to be upheld in all contexts of the analysis of transfer pricing, including the analysis of financial transactions. The existing tools such as the mutual agreement procedure (MAP), the provisions included in individual double tax treaties as well as the provisions introduced by the MTC and the BEPS project deliver the appropriate instrumentation for adjustments where tax authorities have differing views on the analysis of a specific arrangement, including the capital structure and overall interest deductibility arising from financial transactions.

As with other types of transactions, ***certainty should be provided to taxpayers that access to these tools is not hindered or discontinued by local tax authorities*** (either from a legislative or from a more general practical perspective) and that taxpayers can effectively and efficiently benefit from these principles in line with the spirit of the internationally accepted tax framework.

Applying the same principles, it is expected that a common delineation of the financial transaction between the jurisdictions of the lender and the borrower must be achieved for transfer pricing purposes which would result in an arm's length interest deductibility (i.e. arm's length interest rate applied to an arm's length quantum of debt). As it may be the case in many jurisdictions, this may create a conflict with other local legislation such as thin capitalization rules, whose standalone application may alternatively give rise to double taxation. In such cases, we believe that any clash and dispute between the two jurisdictions would need to be resolved using the above-mentioned tools with the view to eliminate double taxation.

In addition, some domestic regulations provide for safe harbour rules on interest rates. For the sake of clarity, we would also like this Discussion Draft on financial transactions to address the interaction with the guidance in section E of Chapter IV. More specifically, comments on the ***circumstances and conditions under which such safe harbour provisions must be disregarded*** would be appreciated by both taxpayers and tax administration.

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.



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 from related Company C which is denominated as a loan 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. Accordingly, the accurately delineated amount of Company C's loan to Company B for transfer pricing purposes would be a function of the maximum amount that an unrelated lender would have been prepared to advance to Company B; and the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow from Company C. (See Section C.1.1 The lender's and borrower's perspectives). Consequently, the remainder of Company C's advance to Company B 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.

For transfer pricing purposes, it is required that the conditions imposed in controlled transactions be in line with conditions achievable between unrelated parties. The case for the apportionment of the capital structure between debt and equity of the related party subsidiary should be no exception.

In the case where there are differences between (i) the lender's and the borrower's perspectives and (ii) the actual funding needs, the apportionment of the intragroup funding between "equity-in-kind" and "debt-in-kind" should be done based on what would happen between independent companies. In other words, the split should be done up to the level that is deemed to be achievable between unrelated parties, and the reassessment / disallowance of the funding above that arm's length level would be done for transfer pricing purposes.

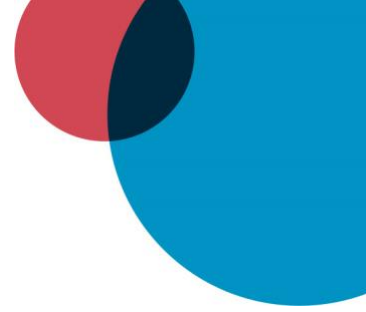
In our opinion, full disallowance of the total funding would apply only in the following cases:

- There is a clear evidence that the lender, at the time of negotiations, was unwilling to take on any credit risk vis-à-vis that borrower [i.e. they were unwilling to provide any lending to the borrower]; or,
- The financial health of the borrower, **including the value of the asset financed by the funding**, would not present clear evidence that the borrower would be able to at least service or reimburse the funding.

All these cases are consistent with the arm's length principle.

Commercially, there are a few clear examples where behaviour between independent lenders and borrowers can point to what happens at arm's length where funding needs are higher than available financing:

- "Amend-and-extend" policies applied by the banks during the after-math of the financial crises (2009-2010) and in the wake of the sovereign debt crisis (2010-2011), where borrowers en masse were not able to keep up with their pre-crisis financial covenants due to significant asset write-downs and in certain cases write-offs. The arm's length reaction from the banks back then was to:



- Allow borrowers to “kick the can down the road” – by continuing to service their debts on the basis of the generated cash-flow, borrowers were allowed to continue paying interest and re-evaluate the situation in subsequent periods; for borrowers which were not able to continue servicing their interest payments, debt restructuring programs were put in place, where old debt was replaced / refinanced partly with capital and partly with new, more expensive debt.
- Disregard leverage covenants based on asset valuations, which under normal conditions would have required either additional equity injections from borrowers (deemed impossible in many cases e.g. where real estate funds lost 50% of their pre-crisis market value) or early repayment of those debts (also deemed impossible as this would have entailed fire sales of assets for even lower valuations than their contemporaneous fair market values).

Accordingly, the banks did not outright reclassify / convert their loans into equity capital which would have completely changed their own balance sheets, due to the massive write-downs, and would have impacted their own financial health by swapping guaranteed loan repayments with less regularly administered dividends (under best case scenarios). The lenders were rather more concerned with keeping the nature of their original funding the same, while trying to minimise their credit risk through some restructuring of the previously-provided lending, which in turn allowed the lenders to charge some additional fees.

- Speculative development financing (principle is similar with any infrastructure funding or cases where the asset is currently not generating any cash flow and not expected to generate any for some time): Company A is envisaging to borrow funds to purchase land on which to build a new property and to finance the construction of a property.

Based on a valuation of the land (location, expected size of the development, features of the future property, target tenants, etc.) Company A approaches third party banks to help finance the development. During the negotiations it becomes clear that the banks would be willing to provide up to 70% of the combined land and construction costs. Company A will not be able to pay any interest during the development stage (which covers a large part of the life of the loan provided by the banks), and interest will accrue and capitalise until the property is completed, at which point management may decide to sell the property or to rent it out. Due to the numerous financial restrictions of the third-party funding, management decides that for operational reasons Company A will need more flexibility relative to the financing terms and accordingly request shareholders to fully finance the purchase of the land and the construction budgets. Accordingly, they split the financing between debt (70%) and equity capital (30%) in line with the indicative terms they have received from the third-party banks.

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.

The factors aiding in the accurate delineation of the actual debt transaction would be different depending on the type of transaction (and sometimes the sector and purpose of the loan) that we are trying to delineate.

The financial industry is very specific and financial transactions have features and economic characteristics that sometimes cannot be exactly modelled on traditional business.

Therefore, to accurately delineate a loan transaction, we consider that the following factors should be identified and analysed for pricing purposes:

- Characteristics of the financial instrument and contractual terms;
- The purpose of the funding;
- Functional analysis of the lender and the borrower;
- The sector and country risk (and other adjustments);

1. Characteristics of the financial instrument and contractual terms

The features and the conduct of the parties in relation to different types of debt transactions may be quite different – e.g. a “bullet loan” will have different characteristics from an amortizing loan, from a zero-coupon bond, from a revolving credit facility (“RCF”), from a private equity sponsored payment-in-kind notes (“PIK”), from repurchase agreements, etc. These transactions will carry different financial risk and thus will have different security requirements from the perspective of the lender. The most common factors for the classification of a loan transaction vs equity capital in our opinion are:

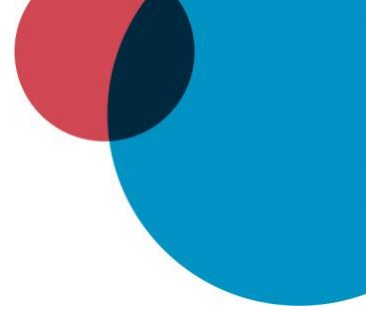
- The obligation and regularity of interest payments (or accruals in the case of PIK notes, or RCFs);
- The right to enforce payments by the lender (either interest only, or interest plus principal, again depending on the type of the transaction);
- The existence of a fixed repayment date;
- The collateral necessary to secure the lending;
- The restrictive covenants that would be tested over regular periods (e.g. at the end of every year);
- Restrictions to obtain funding from other unrelated sources (or the existence of an inter-creditor agreement which would define the conditions of repayment and the ranking of the various senior / junior lenders);
- The clear stipulation of what the borrower would need to pay, in case of failure of repayment.

2. The purpose of the funding

This factor should necessarily be taken in account to conduct an appropriate comparability analysis. Depending on purpose of the financial transaction analysed, the risks, ratios and functions assessed to evaluate the credit worthiness from a lender's perspective are different. In arm's length conditions independent parties would consider different proxies to determine the credit rating of specific transaction depending the purpose of the funding.

For example, this can be confirmed for these three types of funding:

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- Current operations / working capital - for this kind of funding, the credit worthiness of the borrower is generally based on historical financial data and the specific characteristics of the loan (i.e. maturity, issue date, payment rank, etc...).
- Real estate asset funding - frequently a real estate acquisition is made through financial vehicles incorporated for the purpose of the deal. For this type of transactions, the asset remains the most relevant proxy to evaluate the credit risk. Therefore, the pricing of such a transaction can be reasonably made only by assessing the creditworthiness of the asset purchased. In this respect, an analysis of the nature of the real estate opportunity investment, the quality of the real estate asset, the potential costs and revenues expected, and the relative exposition to the risk reflected by the loan to value/cost ratio (which is one of the specific ratio to the real industry sector) should be performed as a part of the accurate delineation of the transaction.
- Project finance/start-up funding - under this kind of transactions, the funding entails a loan structure that relies primarily on the project's future cash flow for repayment, with the project's assets, rights and interests held as secondary collateral. Therefore, in addition to the debt instrument characteristics, the risks related to the different phases of the project (i.e. construction, installation or exploitation) should be identified and analysed to evaluate the credit risk. It should be noted that each project has its specific risks and those risks are not of the same level and intensity whether, for example, the project is in its construction or operation phase

3. Functional analysis:

We agree with the guidance presented in paragraph B.2.2.

In our view, besides the functions performed and the risks assumed by the borrower and the lender in a specific financial transaction, it is important to also consider the role of the treasury company at a global level. Indeed, the allocation of certain risks (i.e. hedging) might have a significant impact on the applicable methodology to price the tested controlled transaction.

4. Sector and country risk

A financial transaction should also be assessed according to the sector in which the MNE operates and look at the activity of the borrowing entity. Financial transactions cannot be properly analysed without considering the features of the industry. One should specifically look at the volatility within the sector, the capital intensity within the market, the cash conversion cycle, etc.

If we take the example of the Debt-to-Equity ratio - it will be higher in a sector which needs high level of investments in infrastructure. A company providing energy will have a higher Debt-to-Equity ratio than a company providing technology services.

Moreover, a company with a long cash conversion cycle will need more short-term debt than a company with a short cash conversion cycle as it will need a short-term loan to face its short-term cash needs. In other cases, the use of a ratio using the EBITDA will not be appropriate say in the real estate industry.

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The analysis of the sector will also help to determine the average need of financing within the sector and will help to better understand the rationale of the financial transaction. The analysis of the sector is thus essential and will help to select the appropriate benchmarking ratio. The use of the industry's average of this appropriate ratio could then help to support the arm's length price for a financial transaction.

The country risk is also very important in delineating a financial transaction. It determines a part of the risk that should be assessed while looking at a financial transaction considering the local market features: inflation, stability of the market, political stability, local laws, etc. These features might have a great impact on the pricing, e.g. lending to a company operating in an emerging market can be riskier than lending to a company in a mature country.

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

- 1. Where, in accordance with the guidance in Chapter I of these Guidelines, the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain.*
- 2. A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.*
- 3. An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk. The intention of this guidance is to outline an approach for reference purposes without suggesting that a particular government security should always be used to determine a risk-free rate.*
- 4. To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the investor's cash flows, i.e. the functional currency of the investor rather than its country of domicile. When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return as any difference in rate must be due to differences in risk between the issuers. (See paragraph 32)*
- 5. Another relevant aspect in determining the risk-free rate of return will be the temporal proximity of the reference security to the tested transaction. The security should ideally be issued at the time as the controlled transaction was entered into to eliminate the effect of differences which may be present between securities issued at different times. (See paragraph 31)*
- 6. Another key consideration would be the maturity of the financial instrument. The duration of the reference security should match the duration of the investment since the duration of an investment will usually affect its price. The duration of the controlled investment should be determined as part of the*

process of accurate delineation of the actual transaction. For example, a financial instrument which is short-term under the written contractual terms between the parties but which is consistently replaced with a new instrument may, depending upon the exact facts and circumstances, be accurately delineated as a long-term investment.

7. *Due to difficulties in practice, practical solutions might be considered for estimating the risk-free rate of return. For instance, assume a situation where Company A, a member of an MNE group, is not entitled to any more than a risk-free return under the guidance in Chapter I in relation to an advance of funds with a term of 1 year to an associated party, Company B. In approximating that return, the starting point would be to identify a security issued at the time of the provision of the funding in the same currency as Company A's functional currency. Assume that the tax administration of Country X, where Company A is resident, identifies three securities issued in Company A's functional currency by the governments of Country X, Country Y and Country Z with a term of 1 year. The credit ratings of the issuing governments are A for Country X, B for Country Y and AA for Country Z. In specifying a minimum credit rating for the issuing government to consider the issued security as a risk-free investment comparable to the controlled financial transaction, the tax administration of Country X may select the security issued by Country Z as a reference for the risk free rate of return since it represents the lowest rate of return available at the time of the provision of the funding on all outstanding government bonds in the relevant currency with a term of 1 year.*

8. *To approximate risk-free rate of returns, government issued securities are not the only reference, and other alternatives may be considered on prevailing facts and circumstances of each case.*

We agree with the majority of guidance presented in this section, with one small exception – the practical solution presented in para 7 above.

In the case where the tax administration of Country X can select the interest rate paid by a different government, Country Z, denominated in the same currency as that of Country X and for the same maturity, assumes explicitly that debt markets are no longer national and local but rather international and global. Whereas we agree that this may be the case over the past several years (and lack of financial data has practically made it necessary to look for comparable data from other geographical markets), we think that ***it is extremely important that tax authorities participating in the OECD forum reach an agreement on the main principles of how to delineate the appropriate reference market for comparison.***

As can be expected, there are two schools of thought:

- Funding markets are global – therefore, e.g. comparable transactions from the Italian Euro debt markets are acceptable by the French tax authority, assuming all other features of the transactions are comparable; in this case, we would agree that the risk-free return for Country X may be the risk-free return in the economy of Country Z, as a borrower in Country X would be able to borrow on Country Z's market (which is not always the case and may warrant additional review of the facts and circumstances of the individual case); or,
- Funding markets are local - in which case risk-free rates of return would need to be based on local benchmarks. This appears to be the relevant feature under section B.2.3 (para 28) of this

Discussion Draft, where the “*geographical location of the borrower*” is considered a key characteristic of the transaction for pricing purposes.

In our experience, there are plenty of examples where either of these assertions may be true:

- An example of global markets would be the private equity funding market which is not as developed, say in Eastern Europe so corporates may revert to using global comparables or comparables from Western Europe;
- in a different example, the French corporate debt market may be considered relatively developed so data for local comparables may be available;
- In yet another set of circumstances, one may choose comparables from a different market (where the risk-free rate is lower) and make adjustments for local market reasons. This can be described with the following very recent real-life example - in September 2018, two comparable bonds (7 year, fixed rate, same rating) were issued by 2i Rete Gas (Italian) and by Telefonica (Spanish) groups. The Italian company paid a spread of 165 bps, while the Spanish spread was limited to 95 bps. The appropriate analysis in our mind would be to consider:
 - Risk-free rate (lowest possible risk of default); and,
 - Risk premium, depending on (a) the credit risk of the borrower (per their rating) and (b) the country risk of the borrower that, per the example above, as it is not reflected in the rating of the borrower.

Therefore, the analysis would need to refer to the pricing of (i) comparable bonds issued on the Italian market, or (ii) comparable bonds issued in the European Union and subsequently adjust for the country risk premium.

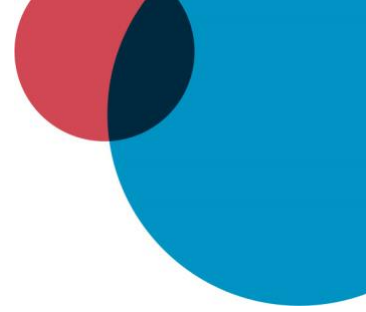
In our experience, we have seen tax authorities in various countries taking positions in contradictory ways. This situation only brings additional confusion to taxpayers as the principles are never consistent.

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.

9. *The risk-free rate of return may be relevant, for example, as a component in calculating a risk-adjusted rate of return on an investment or as the return allocable to an investor who has provided funding but has not assumed any of the risks related to the funding.*

10. *Paragraph 1.85 gives an example of circumstances where an investor would not be entitled to any more than a risk-free return as an appropriate measure of the profits it is entitled to retain, where it lacks the capability to control the risk associated with investing in a financial asset. In such circumstances, the risk will be allocated to the enterprise which has control and the financial capacity to assume the risk associated with the financial asset. That enterprise will be entitled for transfer pricing purposes to the return commensurate with the risk allocated to it. Reference is also made in paragraph 1.103 to the possibility of an assessment being needed of the commercial rationality of the transaction in paragraph 1.85 based on the guidance in Section D.2, taking into account the full facts and circumstances of the transaction.*

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The closest proxy for risk-free returns on the market are provided by:

- Bond indices drawn on the pricing of government bonds – these are in essence directly related to the individual government bonds but may be a better proxy than individual government bond pricing, particularly during turbulent times (e.g. Greek bond prices / yields during the government bond crisis of 2012 was exhibiting extreme volatility making it very unreliable when trying to set a corporate loan interest rate for a Greek corporate);
- Credit market benchmarks such as Libor, Euribor, Stibor, etc. or their long-term equivalents – i.e. the swap rates equivalents to short term floating rates. These are an appropriate alternative as they represent the cost of debt of equivalent highly-rated organizations and are available in multiple maturities, currencies and geographies, which makes them easy to use and apply. They also represent highly liquid instruments – a feature that is also present with government bonds under normal market conditions.

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.

11. Where a funder lacks the capability to control the risk associated with investing Risk-adjusted rate of return in a financial asset and so is entitled to no more than a risk-free rate of return, subject to other constraints, the funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in Chapter I.

12. As stated in paragraph 6.61, "where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding." (See also Section D.1.2 and paragraphs 1.85 and 1.103 in particular).

13. Therefore, in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, e.g., for developing an intangible asset. Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60-6.64.

14. For instance, consider a situation where Company F advances a loan to an associated party, Company D, which undertakes the development of an intangible. Under Chapter I guidance, it is determined that Company F controls and consequently is allocated the financial risk associated with funding the development of the intangible, including the potential risk of Company D failing to develop the intangible and therefore being unable to repay the loan. However, Company F does not assume the risk of developing

the intangible, which is entirely assumed by Company D under the accurate delineation of the actual transaction. Accordingly, in the event that the ex post results derived from the exploitation of the developed intangible were higher (or lower) than the results calculated on an ex ante basis, Company F would not be entitled to that difference but to a risk-adjusted rate of return as described in this section.

15. In general, the expected risk-adjusted rate of return on a funding transaction can be considered to have two components, i.e., the risk-free rate and a premium reflecting the risks assumed by the funder.

16. When the funder is assuming the financial risk under the guidance in Chapter I and is therefore exposed to the potential playing out of that risk, it will encounter the upside and downside consequences of that risk outcome. Therefore, the assumption of that risk will warrant an expected remuneration higher than a risk-free rate of return.

17. A risk-adjusted rate of return can be determined under different approaches, for example, based on the return of a realistic alternative investment with comparable economic characteristics or the cost of funds.

18. It may be possible to find a reasonable indicator of a risk-adjusted rate of return from comparable uncontrolled transactions or by considering realistically available alternative investments reflecting the same risk profile. Depending on the facts and circumstances, realistic alternatives to an intra-group loan could be bond issuances or loans which are uncontrolled transactions.

19. Another approach to determining the risk-adjusted rate of return would be to add a risk premium to the risk-free return, based on the information available in the market on financial instruments issued under similar conditions and circumstances.

20. For instance, consider the same fact pattern as described in paragraph 7 but, in this particular scenario, assume that Company A is found to be entitled to a risk-adjusted rate of return under Chapter I. To determine that return, the tax administration of Country A considers adding a risk premium to the risk-free rate of return, i.e., the security issued by the government in Country C with a term of 1 year. To estimate the risk-adjusted return, Country A's tax administration considers that corporate bonds issued by independent parties resident in Country A operating in the same industry as Company B yield a return comparable to the one that an independent party would have expected had it invested its funds in Company B under comparable circumstances.

21. Under an approach based on the cost of funds, the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower. That mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in paragraphs 89 to 91.

In an ideal world, we would be able to engage all concerned jurisdictions while applying the principles described in the paragraphs above. The cases where multiple jurisdictions are concerned (e.g. in the case of complicated treasury activities being performed across several jurisdictions), the APA program should be the best tool to use to make sure that the assumption and the management of financial risks are properly remunerated. In cases where tax audits give rise to a reassessment and re-allocation of the interest income / expense would need to be introduced, the MAP program should be the appropriate tool to use. Given the potential frequency of disputes related to funding transactions, may be a more straightforward / slimmed down version of the MAP may be introduced to minimise the time spent for MAP along a more simplified / direct filing, so as not to present additional strain on the resources of

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involved tax authorities (e.g. in the UK, HMRC provide access to an Advance Thin Capitalisation Agreement program, which is an APA-style, slimmer from a procedural perspective alternative).

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

38. The organization of the treasury will depend on the structure of a given MNE group and the complexity of its operations. Different treasury structures involve different degrees of centralisation. In the most decentralised form, each MNE within the MNE group has full autonomy over its financial transactions. At the opposite end of the scale, a centralised treasury has full control over the financial transactions of the group, with individual group members responsible for operational but not financial matters.

The treasury activities in a group normally require two components for a successful deployment:

- A team of very experienced people with sophisticated financial skills and good connections to the market (banks and investors); and,
- A high level of capitalisation to be able to establish the appropriate contractual relationships with counter-parties, as well as put in place the IT and middle office capabilities necessary to support the transactions.

As is the case with other transversal functions in global organisations, MNEs manage to gain certain efficiencies (in terms of costs and risk management) when the treasury team(s) is managed across the whole organisation in a more centralised manner. The main case where “complete decentralisation” and independence in the running of the treasury functions exists as a result of M&A activities (an acquisition that has not been completely integrated in the group, or the case where as part of the preparation of a potential spin-off the group is separating the integrated treasury function to the business unit to be sold) or ring-fencing of a specific business unit for regulatory, or commercial reasons. In our experience, in 99% of the cases, the treasury function is integrated across the group (whether in one jurisdiction or across a few geographies that are with significant presence for the group) and independent functioning of individual treasury teams is not really happening. In a similar manner, KPIs that treasury teams are measured against are also set in a way to evaluate the performance of the overall team, rather than the performance of the individual sub-team, that is part of the whole organisation.

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

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

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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.

To the extent that individual members of the MNE are considered to be separate companies (i.e. on the basis of the merits of their own assets, business performance and collateral, without any explicit guarantees or support from the group), we are of the opinion that it would be wrong to automatically base individual credit ratings of the borrowing subsidiaries on the rating of the group or to automatically assume that the rating of the group should be the starting point of the determination of the borrowing subsidiary. The group rating should be a factor to consider, along the lines of the likelihood that the subsidiary be supported in times of financial hardship, as this discussion has already mentioned.

This is driven by the behaviour of third party lenders, as commercially there are clearly two extreme cases which would be observed at arm's length:

- (1) Where a group company with significant assets requests financing from a third party (local) bank, the bank would probably provide the financing and ask for guarantees against the assets of this subsidiary (with the accompanying anti-asset stripping provisions), rather than the assets of the parent of the MNE. In this case, group rating would probably be a factor, but of lesser importance, as the lender would be able to have direct guarantee provided by the assets and performance of the borrower;
- (2) Where a group company request third party financing and does not have any significant assets (or assets are of questionable quality / negative equity), the third-party lender will ask for an explicit guarantee from the parent, and if the borrowing is significant (relative to the size of the group), it is likely that additional security against other subsidiaries of the group (commercially called "obligors") may be requested. In this case, the rating of the group will be more relevant than in the first case above.

We can also confirm that most of the cases in our practice fall in-between these two cases and professional judgement needs to be applied to arrive at a sensible result. From this perspective the approach described in this Discussion Draft about the importance of the subsidiary in the MNE is very relevant.

In our practice, particularly during the years after the financial crisis, tax authorities have also brought up a few interesting cases where there is a "negative implicit support" or "negative halo effect" – i.e. where the rating of the individual borrowing subsidiary is considerably better than the rating of the group (as the group was going through difficult times in other key markets). For the purposes of determining of the interest rate applicable to that particular "crown jewel" subsidiary, tax authorities have requested that better intragroup funding conditions are provided to that subsidiary than the general transfer pricing policy applied across the group, due to the special status of that particular

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subsidiary. In those cases, if the presumption is that we should apply the group rating to this subsidiary, there will clearly be in violation of how third-party banks would commercially approach the subject.

Definition of an MNE group credit rating: the opinion of an independent market player (a credit rating agency or a bank) on the strength of the balance sheet, commercial and business strategy, cash-flow generation potential, borrowing capacity and historical performance of a group, compared to a number of peer enterprises over time, and expressed numerically. The group rating takes into consideration the combined strength of all the subsidiaries of the group (including their assets and liabilities), including, if any, off-balance sheet liabilities.

Determination of an MNE group rating in the absence of a public one: as mentioned in this Discussion Draft, there are a number of commercially available models provided by credit rating agencies, which are built upon:

- (i) historical financial and statistical data about a particular sector / geography, and
- (ii) that are supported by the full faith of the rating agencies. These models are commercially sold and used by a number of market participants, and whereas they do not cover any detailed qualitative review of the group, provide, per official marketing materials from the rating agencies, a very good correlation between the ratings done by the quantitative model and the actual ratings provided by the rating agencies. These models may be supplanted with a qualitative review of the groups' strategy, management teams track record, prepared by the consultant / taxpayer and the respective tax authorities on the basis of public information (this process is similar to the process used by the rating agencies when they arrive at their full ratings); additional information may be collected through management interviews in order to achieve full coverage.

Box C.3. Commentators are invited to provide a definition of the stand-alone credit rating of an MNE. Commentators' views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the Discussion Draft, and how that effect can be measured.

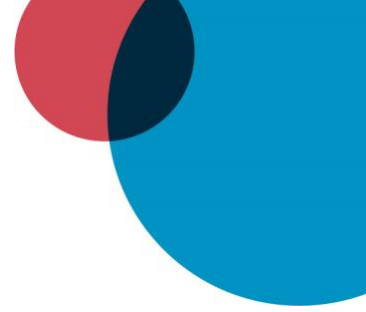
The definition of the standalone credit rating of an MNE is similar to the rating of the group MNE (see above), with the exception that it only focuses on the financial components, assets, and history of the individual subsidiary, rather than on the combined effect of the subsidiaries in the group.

We agree with the proposed language / approach with respect of the considerations of implicit support. We can confirm that some of the rating providers have published guidelines very similar to what has been included in this Discussion Draft (para 68-74). In addition, they have already included reviews of some of these factors mentioned as key in this Discussion Draft and they are already a part of the ratings methodologies achieved by their models.

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

70. In assessing the extent to which it may be reasonable to assume that the group would be likely to support a particular entity, a group member with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other group members than a less integral member. The impact of an assessment of

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implicit support is a matter of judgement but depending on the particular facts and circumstances it may be appropriate to treat those entities most likely to receive group support as having a credit rating more closely linked to the group rating.

The application of the group rating to selected important members of that group should not be automatic and though it could be used as a starting point for the analysis of the rating of the subsidiary. As with any topic in transfer pricing, the analysis to reach the conclusion on whether to use the group rating should be fact-based.

In general, a subsidiary may be considered strategically important if (list is not exhaustive):

- It is the main subsidiary representing the group in a particular geographical market;
- It shares the name of the group / the brand of the group and uses it in conducting its business;
- It is considered a key market for the expansion of the group, per contemporaneous business strategy;
- Even in cases, where the subsidiary may not have been financially successful in a specific market, it may be considered strategically important due to its geographical market, or more general group strategy.

Accordingly, based on such analysis, it may be appropriate to start the review on the basis of the group rating, but downward adjustments should not be excluded based on, e.g. the financial strength of the balance sheet of the subsidiary and asset intensity.

In addition, in performing an analysis on whether to use the group rating as a starting point, we should also review the behaviour of willing third-party lenders in those specific markets. Based on our experience, we can say that there are the following approaches typically seen in practice by third party lenders when they consider providing finance to members of MNEs, which may be directly related to the use of the group credit rating or not:

- In the case where the borrower has significant assets, a working business, and sufficient financial strength and collateral security that they are willing to provide to the lender, then the association to the group would be a lot less relevant when determining the terms and conditions to provide the financing, irrespective of how strategically important that subsidiary is within the group;
- In case the borrower is new to the market, does not have financial history, valuable assets, no or limited cash flow generation capacity until the business is up and running, etc. then the association to the group would play a much more important role. In such cases, third party lenders may request various types of financial guarantees, such as Letters of Credit or direct parent guarantees, in addition to the fact that the subsidiary is part of the group. In the absence of an explicit guarantee, the group rating would be appropriate to be used as a starting point, but the final credit rating used would need to be adjusted for the other features of the transaction (e.g. seniority to other existing debt, requirements to abide by strict covenants, etc.);

In a similar fashion, another case which need to be appropriately reviewed when considering the use of the group rating is where cross-guarantees are provided by the various subsidiaries within the group.

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This is relatively common in many cases where third party financing is provided to the group, at the holding level and the cash is used to support the business of the various subsidiaries, but as part of the negotiations, some or all subsidiaries (the ones which own most of the assets) have provided collateral to the bank, in order to receive the funding. In such cases, those subsidiaries which have provided the security will evidently need to receive better pricing terms, compared to those subsidiaries which have not, despite the fact that all the subsidiaries in the group may be considered strategically important. Accordingly, the adjustments to the respective terms and conditions would need to take into consideration these additional features.

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

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

In our experience, credit default swaps are used by some treasurers as a proxy for base / risk-free rates in the computation of appropriate rate on intragroup loans. This approach may be considered appropriate when other closer alternatives are not available (e.g. when government bond debt of similar rating and / or maturity is not publicly traded) or when extreme volatility does not render steady base rates (e.g. at the peak of the government debt crisis, government yields for Greek bond were not stable over a short period of time).

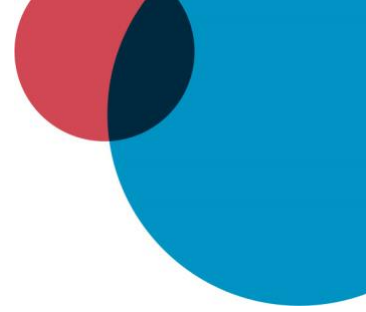
Economic models used by credit institutions may be relevant for the purposes of pricing of intragroup loans to the extent that these models are not polluted by the overall relationship between the credit institution and the borrower. As may be expected, banks have various departments and credit-related businesses, so when they decide to provide a specific loan, that pricing may be polluted by the additional business that they intend on offering to that borrower. Unfortunately, in practice, it is very difficult to determine whether this is the case, and as a result both the taxpayer and the tax authorities suffer from information asymmetry.

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

Intra-group loans do not have alternatives in the world of intragroup financing.

If you mean whether there are other alternatives for comparable transactions to corporate loans in determining the arm's length interest rate, the market offers the following alternatives, depending on the sector of the market / investors' appetite:

- Investment-grade corporate bonds / obligations – these are somewhat different from corporate loans, as they turn to a different audience of primarily institutional investors; during normal market conditions (when there is sufficient supply of money in the market and credit institutions are not shoring up their balance sheets in expectation of further market turmoil), these are more expensive than corporate loans to issue and administer;
- High yield / junk / sub-investment / junior grade corporate bonds (which in terms of ranking could be first-lien, second-lien, etc.);



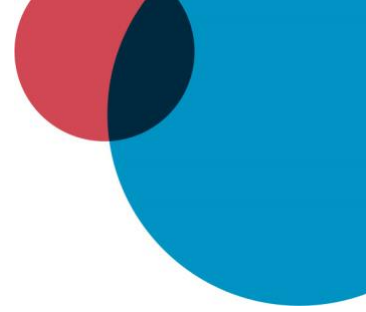
- Asset-backed loans / bonds – these are bonds which have direct collateral on specific assets; the difficulty of using such transactions as comparable is driven by the complexity of properly comparing equivalent assets for similar assets;
- Private placement funding – these are markets where private investors provide funding to corporates; under normal conditions, these bonds / loans are more expensive than traded debt and present more restrictions on borrowers (in terms of making sure that they pay regular interest); the difficulty of using such comparables is that they are impossible to find given that they are typically private transactions between an institutional investor and a corporate borrower;
- Crowd-funding platforms providing debt for small companies – this is a novelty on the market and these platforms do not (yet) offer a real alternative to debt markets; however, they may become more prevalent over the next few years;
- For short-term maturities, there are also several other types of papers, traditionally commercially used by corporate borrowers such as Certificates of Deposits (CDs), Commercial Paper, and notes;
- In certain special circumstances, structured products (e.g. interest rate derivatives) may be appropriate, to the extent that the conditions of the controlled transaction are similar to those occurring between independent parties.

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.

The most appropriate case where external average interest rates for the group may be used as an Internal CUP is when a very large proportion of the external financing (e.g. more than 50%) is provided to one large subsidiary intragroup, whose assets and earnings capacity has been key in determining the terms and conditions on the external financing. In other words, where the purpose of external financing is to support one (or a very small number of) subsidiaries, then the link between the rating of the group and the rating of the individual subsidiary could be straight-forward. In most other cases, average external interest rate would be decoupled from intragroup funding costs.

Box C.8. With respect to the operation of a physical cash pool, commentators' views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans. Commentators' views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular:

- ***are there circumstances in which one or another of the approaches would be most suitable?;***
- ***does the allocation of group synergy benefits suffice to arrive at an arm's length remuneration for the cash pool members?;***



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

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

Remuneration of members of a cash pool should be commensurate with the services provided, assets used, and risks assumed (i.e. in line with arm's length conditions). The main difficulty of cash pooling from a theoretical and practical perspective is finding real commercial comparable arrangements, as this is typically an internal function which does not readily exist between unrelated parties, or when it exists the remuneration of the bank / third party which provides that service is opaque and/or coupled with other services that the bank may provide to corporates. In our opinion, each case should be analysed on the basis of its own merits and we cannot generalise with one particular preferred approach.

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.

102. The cash pool member is likely to be participating in providing liquidity as part of a broader group strategy, an arrangement in which the member can participate as depositor or borrower, which may include among its aims a range of benefits that can only be achieved as part of a collective strategy involving the pool members, done for the benefit of all of the pool participants, and the membership of which is limited to entities within the group. Pool participants deposit cash to the pool (or withdraw cash from the pool), and not to (or from) a particular cash pool member. No member of the pooling arrangement would expect to participate in the transaction if it made them any worse off than their next best option.

103. In delineating the cash pool transactions, it may be that the savings and efficiencies achieved are determined to arise as a result of group synergies created through deliberate concerted action (as discussed in Section D.8 of Chapter I).

A member of an MNE would almost always participate in a group cash pool, as this is the most efficient way of using the group's resources for the group's business. The only cases where this would not be applicable, would, in our experience, be driven by commercial restrictions and requirements from external stakeholders (e.g. banks, creditors, governments, etc.). These can be categorised under the following main circumstances:

- i. M&A activity -the entity is expected to be no longer part of the MNE, and as part of the preparation for a spin-off, the group has started separating the functions of the entity which will remain after the sale or the entity has been acquired and it has not been fully integrated in the acquirer's business;
- ii. Ring-fencing for local regulatory reasons: e.g. where business units need to be ring-fenced (e.g. the defence industry due to national defence reasons);
- iii. Commercial ring-fencing when new investments are made in specific industries which are subject to special taxation / regulatory regimes, and which may expose the group to additional financial risks – e.g. in the extraction industry, an individual special purpose vehicle may be set up for a

specific oil well and its results would be subject to local taxation, etc.; the group may decide that they would not invest more / support the subsidiary further than what has already been initially agreed with local governments, etc., until the subsidiary does not start producing positive cash flow. Accordingly, it may be considered necessary for the group to exclude that subsidiary from participation in the cash pool.

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

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

Cross-guarantees are not required per se, even though, in practice they are almost always enforced. Consider the following real-life example:

MNE X is a group operating in the construction of large infrastructure projects. It is split into two separate business units and subsidiaries A and B, one operating essentially on the European market, the other essentially on the US market. Each of subsidiaries A and B are the holding companies and operate regional cash pools for their respective subgroups / markets. There are no formal intragroup cross-guarantees between A and B. The European business is generating positive cash flows and cash pool A is net positive. Cash in A supports the group's business in the US, and all cash from the European subsidiaries is swept overnight to the accounts of A, which in turn re-dispatches the cash to cash pool B. As a result, cash pool A is a net lender to cash pool B.

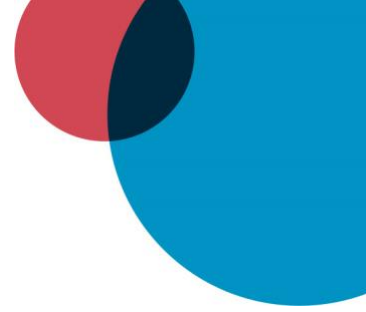
Cash pool B is financing the US subsidiaries of the group. The US business is experiencing some serious financial difficulties and needs capital to pay for unexpected overspent of CAPEX in the US market. The funding provided by A is not sufficient to cover the budget overruns of B, and the US business does not generate sufficient funds to cover the gap. In addition, the US business has external funding which it can no longer service and declares chapter 11 protection to reorganise and restructure its external debt. The funds from cash pool A, as well as the future positive cash from the European business is "on the hook", as part of the restructuring of the US debt.

As a result, A and all its subsidiaries which sent their cash to A are liable to provide resource and pay the debts of the US business, even without a formal cross-guarantee. A is not made whole by the group and has borne an actual commercial financial and operating risk, without have any control over it (i.e. because of the existence of the cross-guarantee).

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?

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The accurate delineation of a hedging transaction under TPG principles would be to consider both legs of the transaction – the risk-assuming and the risk-hedging – together. The mechanism would be to introduce an off-setting adjustment to the tested party which assumes the financial and operational risk, in line with its capability (teams and experience) and financial capacity to cushion against these risks. If a third party (i.e. group entity through a group policy) imposes on the tested party that contractually assumes the financial and operational risks, then the imposing entity is in effect controlling that risk (or controlling another entity within the group which controls that risk and which has put in place an appropriate hedge). The imposing entity would therefore need to make whole the tested entity, possibly through imposing a compensating adjustment from the hedging entity, in line with the group policy (it is expected that a group policy would not result in a *systematic* recognition of losses in one entity for the benefit of the whole group).

Box D.1. Question to commentators Commentators' views are invited on:

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

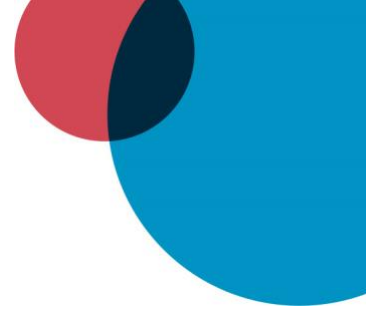
A financial (or any) guarantee is recognized when a guarantor (related party) to a transaction may crystallize a liability in the event of any adverse commercial trading conditions, which would not allow the borrower / guaranteed party to perform financially. A financial guarantee would be:

- a financial service; in most cases, this will be provided by a parent / entity with the financial prowess and management team capable of honouring the liabilities of the guaranteed party. It is expected that such financial service is not free, and the guaranteed party would be benefitting from it;
- a financial asset; in this case, the financial guarantee would be comparable to selling insurance, and its price would be comparable to insurance premium for similar services.

A guarantee would typically be insisted upon by an independent lender when:

- the borrowing entity of the MNE is not sufficiently capitalized or risks of being inappropriately capitalized as a result from some adverse financial conditions;

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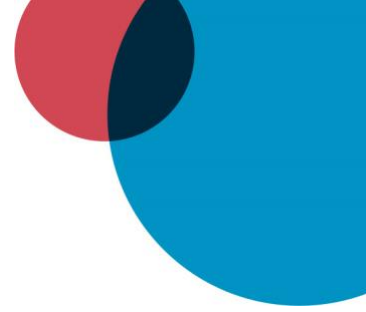


- the financial maintenance / incurrence covenants of a particular transaction have been breached; in this case the guarantee may not necessarily be directly triggered, but certain renegotiation / equity injection may be necessary in order to shield the independent lender from the increased financial risk;
- the borrower / the entity receiving the guarantee would not be in a position to perform per the initially agreed schedule of debt service.

The financial guarantee granted to the borrower would directly create a legal enforceable obligation on the guarantor to make whole the independent lender for the shortfall or failure of the borrower per the financial conditions stipulated by the financial guarantee. In the case of a default from the borrower, this would automatically trigger the responsibility of the guarantor to honour the agreement and cover the liability of the borrower. Accordingly, the credit rating of the borrower would be notched up to the credit rating of the guarantor. In most cases, financial guarantees would have a negative effect on the interest rate charged by independent lenders, as the most collateral is produced (or the more valuable the collateral), the lower the financial risk the independent lender undertakes.

The described situation of borrowers obtaining guarantees from independent guarantors to cover funding from third party lenders is quite an unusual one, within the context of intragroup financing. The main commercial example that fits this description, and that we have seen in practice is in the case of trade finance. The example is as follows:

- the purchaser of goods A has negotiated with supplier B to purchase certain goods or services; both are independent parties;
- payment terms for A are up to 180 days after delivery of the goods / services by B;
- by the nature of the relationship between A and B, B is providing 180-day financing of the accounts payable of A (i.e. financing A's working capital). As such, B is exposed to the financial risk that A runs into a financial failure during that period and is not in a condition to honour its payment obligation;
- As part of the commercial arrangement therefore B requests that A provides either:
 - Letters of Credit from a third-party C (may be a bank or other type of guarantor), to make a payment to a beneficiary (B) once certain criteria are met (e.g. if payment is not made by A at the end of the 180-day period);
 - A bank guarantee is provided by a third-party bank to B, which is a bank's commitment to honour payment to B if A does not fulfil their contractual obligations.
- B may have a requirement that the guarantor (C or other specialised providers of trade finance guarantees, such as Euler Hermes or Aon) has a minimum credit rating / balance sheet strength / reputation and financial robustness so as to be certain that its financial risk is really hedged.
- The pricing mechanism that C would apply would be either:



- In case C is a bank – they would require certain capital to be locked away in an escrow account, which would be computed on the basis of their internal risk management models; in the cases where banks agree to provide that guarantee, the credit rating of the borrower A and its history will be taken into consideration in the determination of the price of the guarantee and the size of the deposit [the riskier the borrower, the higher the price and the higher the deposit; the bank will walk away if it is determined that the risk is too high; in certain cases, they may even ask that their exposure is 100% covered by the deposit in the escrow account – we have several examples for arm’s length behaviour of foreign banks in Eastern Europe over the past 10 years, where banks were only ready to provide funding to third parties if these third parties had a deposit for the same amount blocked in the bank].
- In case C is a specialty insurer, B will be purchasing (or asking A to cover to cost of) the insurance premium to insure the amount that A would owe B within the 180-day period. This premium will be computed on the basis of the expected loss / loss given default model applied to A’s facts and circumstances.

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

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

If the policy issuer is behaving as expected – i.e. performing the functions of independent insurers (e.g. setting regulatory capital in line with Solvency II / Basel III requirements, covering the costs of such events for the insured members of the group, etc.), and has the capital and teams to manage the underlying insurance risks - it is expected that they would *de facto* assume and manage the insurance risk. The return on capital may also be an indicator for the arm’s length nature of the whole arrangement

– in case the return on capital realised by the insurer is way above the return for comparable insurance risk, it would entail that the insured entities have a less expensive alternative – insuring through a third party, which would cost less and be more efficient. Evidently, the levels of risks insured, and other comparability requirements would have to be appropriately met.

In case the insurer does not actually control the insurance risk and only provides capital, the activity would merit a return commensurate with that of a risk-free asset over the life of the insurance policies (when taking into consideration the insurance and administrative costs). The excess would need to be split between the insurance holders, in line with their relative contributions.

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.

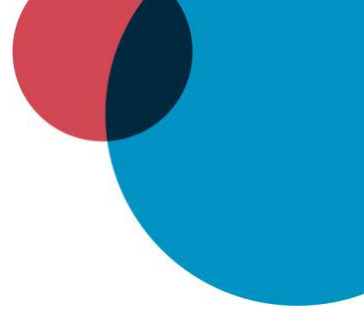
181. Alternatively, actuarial analysis may be an appropriate method to independently determine the premium likely to be required at arm's length for insurance of a particular risk. In setting prices for an insurance premium, an insurer will seek to cover its expected losses on claims, its costs associated with writing and administering policies and dealing with claims, plus a profit to provide a return on capital, taking into account any investment income it expects to receive on the excess of premiums received less claims and expenses paid.

We agree with the description of the price-setting mechanism.

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

187. For example Company A is a high street retailer of high value new technology consumer goods. At the point of sale, A offers insurance policies to third party customers which provide accidental damage and theft cover for a 3-year period. The policies are insured by B, an insurer which is part of the same MNE group as A. A receives a commission with substantially all of the profit on the insurance contract going to B. A full factual and functional analysis shows that the insurance contracts are very profitable and that there is an active market for insurance and reinsurance of the type of risks covered by the policies. Benchmarking studies show that the commission paid to A is in line with independent agents selling similar cover as a standalone product. The profit B earns is above the level of insurers providing similar cover.

188. In considering how the conditions of the transaction between A and B differ from those which would be made between independent enterprises, it is important to consider how the high level of profitability of the insurance policies is achieved and the contributions of each of the parties to that value creation. The product sold to the third party is an insurance policy substantially the same as that which any other insurer in the general market could provide. The sales agent has the advantage of offering the insurance policy to its customer alongside the sale of the goods to be insured. It is the advantage of intervening at the point of this sale which provides the opportunity to earn a high level of profit. A could sell policies underwritten by another insurer and retain most of the profit for itself. B could not find another agent that has the advantage of point of sale contact with the customer. The ability to achieve the very high level of profit on the sale of the insurance policies arises from the advantage of customer contact at the point of sale. The arm's length remuneration for B would be in line with the benchmarked return for insurers insuring similar risks and the balance of the profit should be allocated to A.



In the example above, it transpires that the key component of the value chain of the insurance transaction is the direct connection at the point of sale with the insurance customer. As such, the theoretical bargaining position of A vis-à-vis B is much stronger given (i) the relatively ease of replacing B with an independent insurer for a similar service and (ii) the point-of-sale access to insurance customers which A controls. Under such circumstance, A would be price-setter rather than a price-taker within its interaction with B. Accordingly, it would be expected that B would make an investment return for insurers in line with that of comparable insurance providers, with A keeping the balance of the profits.

Taxand is the world's largest independent tax organisation with more than 400 tax partners and over 2,000 tax advisors in 50 countries. If you have comments or questions, please feel free to contact any of the following:

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Yours sincerely on behalf of Taxand