ICC Comments on OECD Discussion Draft BEPS Actions 8-10 (Financial Transactions)

The International Chamber of Commerce (ICC) welcomes the opportunity to provide input on the Organisation for Economic Co-operation and Development's (OECD) consultation draft on transfer pricing of financial transactions.

It is ICC's view that the submission of OECD work for public consultation presents an indispensable aspect of building and maintaining credibility with taxpayers and tax administrations.

With this in mind, ICC presents the following comments and contributions for consideration with the aim of achieving improved and generally accepted Transfer Pricing Guidelines. Comments are provided on both the explicit questions put forward in the discussion draft as well as on other aspects of the draft.

Executive Summary / Fundamental comments:

The key issue that runs through several aspects of the paper is whether the arm's length principle, including a full functional analysis and delineation of the transaction, should be applied when analysing the conditions surrounding intercompany financial transactions. ICC supports the OECD position as set out in the most recent transfer pricing guidelines, in particular para 1.14:

"the view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the working of the open market in cases where…services are rendered between associated enterprises….[The arm's length principle] generally produces appropriate levels of income between members of MNE groups acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market."

ICC supports this position as it is the best way to avoid double taxation and therefore encourage cross-border trade and investment. Alternatives, at their worst, may encourage groups to fund locally as this may be cheaper (after double tax) than funding at the group level, even if the interest rates are higher. This reduces the overall profits of multi-national enterprises.

Therefore, ICC would support the application of only the arm's length principle to the conditions surrounding intercompany financial transactions, in particular:

- Selecting the credit rating for the borrower
- Benchmarking the interest rate applied
- Pricing the return for a cash pool leader
- Analysing the price of intercompany insurance

ICC believes that rebuttable presumptions may result in non-arm's length results. Therefore, we support them only when selected by the taxpayer, who should retain the option to perform a full functional analysis and to determine an arm's length price. Any adjustment needed should only bring the transaction into the arm's length range not, for example, delineating the entire capital structure as equity. Where the arm's-length principle is departed from to implement the outcomes of BEPS Action 4, or where a taxpayer has opted to use a safe harbor, this should be done in a way that reduces double taxation and therefore encourages cross-border trade and investment.

ICC also supports the OECD's position when it states, at para 1.6 of the guidelines, that the "separate entity approach treats the members of an MNE group as if they were independent entities". Therefore, the parent does not legally own the assets of the subsidiary and should not be seen as controlling those assets unless the functional analysis supports that.

ICC considers the best way to apply the arm's length principle to intercompany funding is to:

1. Apply to the borrower a credit rating following the publically available information available on credit rating agencies' websites
2. Find comparable bond data to price the interest rate
3. Adjust as necessary for tenor, subordination, liquidity etc.

The ICC would welcome further examples to help clarify the application of the arm's length principle, in particular in the following areas:

- How and when the options realistically available to the participants of the cash pool should be considered
- Situations where hedging activity may generate intercompany transactions
- To illustrate the effect of outsourcing specific underwriting functions on the income allocated to the MNE group member that issues insurance policies
- Clarifying when a captive is operating a business other than an insurance one

ICC believes that the OECD should clarify whether its transfer pricing guidance for financial transactions should apply retroactively, setting out whether or not this is seen as a clarification of the existing transfer pricing principle and guidelines.

Specific comments:

Sec 3: ICC can confirm that due to minority interests, regulation, independent directors and other factors, an MNE group does not always have the discretion to decide upon the amount of debt and equity that will be used to fund any entity within the group. There are many valid commercial reasons for the split between debt and equity that apply in both controlled and uncontrolled transactions. For example, a revolving loan facility can be far more practical then issuing and then buying back equity.

<u>*Box B.1. Question to commentators:*</u>
Sec. 8-10: Clear rules are needed to resolve double taxation especially where there is an interaction between multiple factors such as capital structure, debt pricing and domestic interest limitation rules. For Article 25 matters ICC suggests that where the country of the related party borrower has instituted interest limitation rules that are consistent with the outcomes of BEPS Action 4, the country of the lender should make a corresponding adjustment to relieve double taxation as consistent with the purpose of the double tax treaty to avoid double taxation. Where a country's interest limitation rule is not consistent with BEPS Action 4, ICC suggests that Article 25 matters may be resolved by the country of the borrower allowing a tax deduction up to maximum amount that would be consistent with BEPS Action 4 with only an equal and off-setting amount taxed as interest in the country of the lender. ICC further considers that the taxpayer should have a right to amend its interest limitation deduction after any mutually agreed procedure (MAP) claim has been concluded in respect of interest and/or debt.

Sec. 10: ICC does not consider that the current wording in paragraph 10 ("*the purpose of this section is to provide guidance for those countries that use the accurate delineation under Chapter I*") is appropriate where potential double taxation is referred to MAP; ICC considers that the paper should establish a single clear principle that related party financial transactions referred to MAP should be resolved by the Competent Authorities via the accurate delineation methodology and wider transfer pricing approach set out in the 2017 Transfer Pricing Guidelines.

Sec. 16: It is not clear to ICC how the status of the funder helps to accurately delineate an advance of funds. In addition, ICC would request OECD confirmation that an on-going dividend is a valid commercial reason for borrowing in third party situations.

Box B.2. Question to commentators:
Sec. 17: Generally, apart from extreme and clearly abusive cases, the capital structure and thus the use of debt or equity capital chosen by a company and its shareholders should be accepted. Generally, the fiduciary duties placed on a lender's directors will not allow them to make loans that they know cannot be repaid. Regarding the example in paragraph 17, it should be taken into account that independent companies on a regular basis also find themselves in situations where they are unable to service loans that they have taken out (and which a third party lender has granted). Furthermore, this serves to illustrate that *ex ante* financial projections often do not sufficiently reflect the credit default risk that may be obvious in hindsight. Thus, by itself, the fact that a company (related borrower) is unable to service a loan does not constitute sufficient evidence that taking out or granting a loan was in violation of the arm's length principle. Secondly, the example explicitly states that "all good-faith financial projections" show that the lender "would be unable to service a loan" and that "an unrelated party would not be willing to provide such a loan". ICC is of the view however, that this example is unrealistic as the situation in practice is rarely as clear-cut. Rather, the taxpayer and the tax administration may disagree as to whether it could or should have been foreseen that the lender would be unable to service the loan. Thus, guidance should be provided on how to identify such situations. Finally, assuming that a situation was as clear-cut and unambiguous, ICC agrees that possibly only the "arms-length" part of the loan might be accepted as such, with the remainder being delineated as equity.

ICC considers that additional examples on the relevance of debt/equity re-characterisation would be helpful including guidance on when tax authorities should not seek to apply section 17. Most helpful would be an example clarifying that a tax authority should not challenge situations where the financial metrics of the related party lender are more conservative than that of its MNE group.

An example of a commercial situation where a full delineation of the transaction indicates that a departure from "normal" debt levels would be justified would also be welcomed. For example, a related party lender might increase its borrowing levels if in financial distress or making an acquisition to develop its business and economic opportunities. In such situations, an increase in the maximum amount that an unrelated lender would be willing to lend may be arm's length as would an increase in the borrower's normal debt level.

ICC would welcome an approach similar to the "Thin Capitalisation Approach" set out in the OECD's 2010 report on the allocation of profits to Permanent Establishments so that the capital structure of an entity could not be challenged by a tax authority if it had a similar capital structure to independent entities "carrying on the same or similar activities under the same or similar conditions in the country".

ICC considers that the latter part of the question in Box B.2 ("*the entire amount needs to be accurately delineated as equity*") does not satisfy the arm's length principle and needs to be reconsidered. The only amount that should be accurately delineated as equity is the remainder above the maximum amount that the unrelated lender/borrower would have agreed. Whilst paragraph 17 refers to this remainder as the appropriate amount that would not be recognised as a loan, the latter part of the question in Box B.2 does not.

Box B.3. Question to commentators:
ICC believes that it is hardly possible to define a set of factors to be taken into account. Rather, the transaction intended by the transaction partners, i.e. the related partners, such as documented by written agreements (e.g. loan agreement) and/or other evidence should in principle be accepted by the tax authorities. The tax authorities must bear the burden of proof that a certain transaction intended by the transaction partners should be "transformed" into something else. Moreover, this should only be acceptable in cases of gross abuse.

Box B.4. Question to commentators:
1. ICC does not agree that a funder – regardless of its capabilities and decision-making functions – should necessarily be entitled to no more than a risk-free return. Apart from the fact that a risk-free return is very difficult, if not impossible, to determine in practice, the return of a funder should always reflect the risks in fact borne by that party. Moreover, between unrelated parties – regardless of how one-sided the distribution of functions and risks – a funder will never earn but a risk-free return.
2. Given that the determination of transfer prices is an inexact science at best and that also between unrelated parties, for any given transaction a wide range of transfer prices can usually be observed, it should be fully sufficient to approximate a risk-free rate of return. However, ICC agrees that in fact no

investment will entail zero risk.
3. ICC agrees that using government issued securities (assuming the government is triple-A-rated) constitutes a viable reference for a risk-free return.
4. ICC agrees that the respective currency of the financial transaction to be priced should correspond to the currency of the government issued security.
5. ICC agrees that one should strive for temporal proximity with regard to the transaction to be priced.
6. ICC agrees that one should consider the maturity and strive for a respective congruence.
7. ICC believes that the example is too hypothetical and unrealistic to sufficiently comment on.
8. ICC agrees that securities other than government issued securities might be used to approximate the risk-free rate of return.
9. ICC disagrees with the concept that the tax administration of a country may select the security of a higher-rated country as the risk free-rate if issued in the same currency. The Greece tax authorities, for example, should not be able to reference a German bund as an appropriate risk-free rate for exposure to the Greek market.

Box B.5. Question to commentators:
9. In principle ICC agrees that the risk-free rate is useful as a component in calculating risk-adjusted returns. However, in practice it is often the experience that tax authorities will rarely accept such approaches and would rather prefer the application of the Comparable Uncontrolled Price (CUP) method and more often, a simple cost-plus approach. Against this background ICC respectfully encourages the OECD to issue guidance with a view to strengthening the acceptance of such approaches and expressing a preference for the CUP method.

10. ICC finds the reference to Paragraph 1.85 helpful albeit financial transactions may be more complex and more commonly dis-aggregated than the examples within Paragraph 1.85. The appropriateness of, and interaction with, Paragraph 1.93 to 1.97 should also be considered with respect to financial transactions especially since it is common for financial special purpose vehicles (SPV) to be used for individual financing transactions to enable efficient circulation of cash and to mitigate exposure to foreign currency risk and default risk. SPVs may outsource certain or all risk-control functions to other legal entities (which may or may not be related parties) such that the SPV's directors manage and control risk, but may not have their own FTEs to directly conduct day-to-day risk control. Provided a functional analysis established that appropriately-capable directors exercise real control and authority over the risks including the implementation and periodic review of any outsourced risk management functions, ICC considers that risk should still be allocated to that SPV.

Box B.6. Question to commentators:
11. Generally, as expressed above, ICC questions the practicability of deviating from the transaction actually concluded by the involved parties. If, however, a borrower pays an arm's length interest rate, then this payment should be accepted as a tax deductible expense regardless of which party might actually be due the paid amounts. Therefore, the question of allocating the residual amount between the "funder" and the "different related party" might be subject to Mutual Agreement Procedures between the involved countries according to Article 25 OECD-MTC.

ICC considers it would be helpful for the OECD to provide additional detail on the typical risk-control functions and capabilities exercised by third party lenders. Many financial transactions such as lending are typically subject to only a periodic review which does not require extensive resources to manage the inherent risk – especially where experienced financiers oversee and manage those risks.

Box C.1. Question to commentators:
Sec. 38: ICC believes that it cannot be defined in the abstract when a company that is part of a multi-national enterprise group has full autonomy over its financial transactions. Generally, this should be assumed to be the case until and unless there is clear and unambiguous evidence to the contrary.

While no specific questions were asked with respect to the paragraphs listed below, ICC respectfully provides its comments as follows:

Intra-group loans:
Sec. 47: ICC fully agrees that both the lender's and the borrower's perspective should be taken into account. In this regard, ICC notes that both parties' perspectives are ideally taken into account by applying the CUP method. However, it should be noted that, in practice, information available usually allows focus of the analysis more on the borrower's side

Sec. 50: ICC would be grateful if the OECD would confirm that the evaluation of, decision to take on, and management of risk can be managed periodically by relatively few people in a relatively short time.

Sec. 51: ICC agrees that between related parties the same processes will not take place (especially from a formal, procedural view) as between independent parties. However, it is ICC's view that this is often not necessary because much of the information that an independent lender intends to gain through a formal due diligence process is readily available within a corporate group.

Sec. 52: ICC does not agree that the parent has ownership of the assets of the subsidiary; as a matter of legal fact, the subsidiary owns those assets. If the subsidiary is wound up, creditors will typically have first claim on those assets. The subsidiary, which may have independent directors and/or minority interest shareholders, can only dividend up assets as allowed by local law and its own constitution. ICC does not agree that one can generalise who has control of the assets without a detailed functional analysis. However, a parent company typically has particular insights into the financial position of a subsidiary that external lenders do not have. Thus, there may be situations in which a parent company might lend money to its subsidiary without risk (and, hence, at a risk-free rate). Moreover, in such situations no formal agreement or collateral is necessary.

Sec. 54: ICC agrees that borrowers seek to optimise their weighted average cost of capital for the chosen business strategy whilst having the right funding to meet both short-term and long-term objectives. From this aspect, it is reasonable to assume that some borrowers will pledge collateral to optimise their cost of finance. However, whether or not to pledge collateral can also depend on other factors such as the financial benefit from pledging collateral (where the assets are held in a regulated industry there may be limited financial benefit, if any, since the loan provider may struggle to either operate or on-sell those regulated assets without significant costs) and whether pledging collateral may restrict future funding options due to the business strategy adopted by a borrower. It is possible that a borrower values the flexibility of securing future funding more than the cost of financing at the point of entering into the loan in question. The fact that there are countless third party loans lent without collateral can support this point.

The example listed in paragraph 54 discusses that in some circumstances, it is suitable to assume that collateral will be used when the borrowers have assets which can be used as collateral. Without clarifying what those circumstances and adding another example to illustrate the possibility of loans not having collateral, this example could be misleading to tax authorities and could lead to conclusions not in line with the actual commercial reality. Therefore, it is recommended to remove this example.

Sec. 55: One reason why a business may borrow is to take advantage of the tax shield interest payments normally provide. It would be helpful if the OECD would state that this is a valid commercial reason.

Sec. 56: ICC would welcome confirmation from the OECD that loans which are repayable, such as revolving facilities, as opposed to term loans, provide less upside to the lender, as a borrower may repay early if interest rates rise, and therefore will typically command a higher interest rate.

Sec. 58: ICC respectfully encourages the explicit statement that if a credit rating has been established, interest rates may be determined by applying the external CUP method and using publicly available information (e.g. on similar loans or bonds issued by companies of a similar rating).

Sec. 61: It would be useful if the OECD could confirm that different lending instruments have different interest rates, even for the same borrower. For example, arm's length prices indicate that loans tend to have higher interest rates than bonds which are typically more liquid and require upfront bond issuance costs. Bond issue costs quickly become sunk and are not typically included within simple spot yield calculations despite being a cost of issuing bonds.

Sec. 63-64: These two sections seem to suggest a hierarchy preference of official credit ratings, that credit ratings provided by independent credit rating agencies are preferable to all other approaches. ICC respectfully disagrees. Unlike official credit rating agencies, commercial lenders assume the real credit default risk and implement procedures to manage and control the default. A generalisation that the official credit ratings analysis is "far more rigorous analysis" than that of commercial tools absolutely should not be made without a detailed analysis of the facts. It is ICC's view that where an accurate assessment of the circumstances dictates, a commercial lender's perspective (including their commercial tools and models) may in fact need to be prioritised over official credit rating agencies[1]. Furthermore, the OECD should be aware that for small groups or subsidiaries, it may be highly or disproportionately costly to obtain a valuation by an official credit rating agency.

Sec. 65: It is ICC's view that this comment is at best confusing and therefore, suggests deleting or amending it. Naturally any analysis of one transaction must be built upon the premise that the underlying data is not biased. However, as it stands, the comment might easily be misinterpreted in a way that the analysis of a credit transaction necessarily involves the analysis of (all) other transactions.

Box C.2/3. Question to commentators:
ICC supports the use of rebuttable assumptions and safe harbours only when it is the taxpayer's option to use them and when the tax payer retains the right to perform a full functional analysis and to determine an arm's length price.

Sec. 67-69: The arm's length principle asks us to consider what would happen in a third-party situation. We know from evidence that arm's length official ratings agencies and banks do not always give subsidiaries the same rating as their parent. Nor do they rate all subsidiaries by taking the parent's credit rating and adjusting down. ICC considers that potentially having two methods of credit rating presents the risk of double taxation. This could occur if the lender rebuts the assumption and uses an individual credit rating and the borrower does not rebut the assumption, using a group-level rating. Therefore, ICC recommends that the OECD:

1) Allows the use of a stand-alone credit rating adjusted to take account of implicit support of the group. The adjustment for implicit support should consider the approach taken by commercial lenders and official credit rating agencies as appropriate, and
2) Ensures that where a taxpayer has elected to make use of a presumption or safe-harbour that any double tax can be relieved under a MAP

Box C.4. Question to commentators:
Sec. 70: ICC agrees that in assessing the question of whether a group will be likely to support a specific member a higher degree of integration and importance of that member to the group will make it more likely that this member will be supported by the group. Therefore, all else being equal the more important an entity is to a group and its future strategy the higher the credit rating the entity is likely to have. However, there would still typically be a difference in the parent rating and that of the subsidiary. However, such analysis will necessarily always remain qualitative in nature, i.e. ICC believes that it is still virtually impossible to assess the specific consequences for granting an intra-group loan to that member.

Sec. 74: ICC requests the OECD to make clear that tax authorities should take care when placing any reliance on a group's publicly stated comments on their subsidiaries – few companies would make a statement they would not support a subsidiary or that they are looking to dispose of that company. To do so could affect staff morale, key-stakeholder decisions, or adversely affect the value that may be realised on disposal.

Sec. 75: ICC agrees that covenants in a loan agreement can reduce the risk of the lender. Therefore it would be useful if the paper can make it clear that covenant light intra-group agreements may result in the lender bearing more risk than in comparable loans (subject to the OECD's rules regarding the allocation of risk, set out in the guidelines) and therefore may require a higher interest rate to compensate for those risks.

Sec. 80: ICC questions the relevance of this section as most pricing of intra-group financial transactions relies upon the CUP or CUFT methods rather than cost plus approach. Also, there seems to be little

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[1] The OECD may find it useful to refer to Judge Robertson J's decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation, Federal Court of Australia (2015)* for a considered view on the relevance of banking evidence over credit rating evidence. For example, paragraph 503 of the first instance decision of Robertson J: "*In my opinion, the correct perspective is that of a commercial lender. A commercial lender would not approach the question of the borrower's credit worthiness in the same way as would a credit rating agency.*"

evidence provided to show that the costs (for example) a bank may incur are greater than a related party lender on a loan by loan basis let alone in relation to the amount lent.

Box C.5. Question to commentators:
ICC holds credit default swaps (CDS) to be a valuable means of pricing a loan, or corroborating the pricing of a loan. In particular, it is possible to derive the risk premium demanded by unrelated investors which, together with a risk-free rate of return can be used to price debt. However, the respective information is often not available to smaller groups of companies and will seldom be a comparable transaction. For this reason CDS may be of limited practical assistance in pricing many intra-group loans.

Sec. 82 et seq.: In practice, the CUP method is widely used and perfectly reasonable under the arm's-length principle. Therefore, it should be borne in mind that the application of the CUP does not require identical, but merely similar/comparable transactions (possibly with an adjustment to the price derived by applying the CUP). Moreover, when applying the CUP, generally any price (interest rate) of a range of similar comparables should be acceptable. Sec. 82 et seq. should reference the important of CUPs being from the same country where possible. Similar to ICC's comments on sec. 63-64 above, sec. 82 should be amended to also accept the consideration of other commercial tools used by commercial lenders as opposed to focusing solely on credit ratings. Whereas sec. 83 suggests widespread and frequent comparables, it should be noted that a lack of transparency in the primary loan market (and a limited secondary market for loans) coupled with typically few loan issuances in the same country, industry sector and at a similar issue date to the tested transaction can make finding recent comparables difficult.

Box C.6. Question to commentators:
ICC also supports the use of bond data. It is more widely available than loan data, has a more active/liquid secondary market and so should not be ignored. ICC would, however, add the caveats that bond yields do not take account of up-front fees and also tend to be priced lower than loans due to a number of factors, including the fact that the bond markets are more liquid, with greater price transparency, than the secondary loan markets.

Box C.7. Question to commentators:
ICC feels that it is highly unlikely that internal CUPs will be available to price intra-group transactions as the credit rating, financial performance, funding requirements etc. will vary materially between the members of the group. Also, it is highly unlikely that a group member will borrow from both a third party and a related party close enough together in time, with similar terms and conditions, as to make the transactions comparable. ICC can only see a situation where a related party "steps into the shoes" of an independent lender, allowing a third party revolving facility to be repaid and closed by lending on very similar terms, as being one in which internal CUPs would be of use.

Sec. 89: From ICC's perspective, the "cost of funds" method does not necessarily arrive at arm's length prices (interest rates), because it does not take into account either the potential borrower's alternatives, nor the lenders'. However, there may be transactions where the lender does not analyse and evaluate the risks of the loan, does not perform the decision-making functions, nor monitors the risk on an on-going basis. It might also be the case that the lender does not have the financial capacity to lend to the borrower with itself borrowing an equal and off-setting amount. In this situation the functional analysis may find the lender is acting less like a bank lender and more like a conduit. Therefore, any profit margin might be low, reflecting the low level of functions performed, assets used and risk borne. Similarly, a parent company may not require a risk premium (cf. above).

Sec. 92 et seq.: Bank opinions – going beyond a simple letter for informational purposes – may also prove useful as a source of information regarding the CUP. Hence, bank opinions should not be dismissed out of hand. In practice, it may be difficult for a bank to withdraw from its previously stated intentions.

Cash pooling:
In addition to the comments below, ICC requests the OECD to clearly set out how double taxation within a cash pool should be resolved. The balances held by participants to any given cash pool will often fluctuate with multiple depositors and borrowers. There is rarely any clarity as to which borrowing relates to any given deposit and hence no certainty on the appropriate bilateral double tax agreement for a MAP claim. An Article 25 MAP claim could potentially be submitted to a number of double tax agreement partners. ICC suggests that, provided the Article 25 request is submitted to a Competent Authority which has at least the opposite net interest position to the party suffering double taxation, it should be accepted for MAP. If the OECD prefers a MAP claim to be submitted to the country of either the cash pool leader or the

legal entity which “zeros” the pool, then that should be clearly explained.

Box C.8. Question to commentators:

ICC believes that the guidelines should clearly state that both in principle are acceptable under the arm’s-length principle: A cash pool leader that acts as an entrepreneur, bearing material risks and exercising material functions, and a cash pool leader that acts as a service provider of a routine activity. Moreover, functional and risk profiles in between may occur. As a result, the allocation of group synergies very much depends on the specific cash pool and the allocation of functions and risks.

Box C.9. Question to commentators:

Sec. 102: It is difficult to conceive a situation in which participation in a cash pool would make a participant worse off than their next best option that is genuinely an option that is realistically available to them. Otherwise, this is only practically imaginable if there are extremely high transaction costs and/or other conditions (interest rates) which are worse than on a stand-alone basis.

ICC considers it would be helpful for the OECD to provide additional guidance to tax authorities as to how and when they should consider the options realistically available to the participants of the cash pool. For example, where companies have objectively decided they want to hold cash for commercial reasons in addition to their key investment criteria for that cash (e.g. risk-free, immediately-available assets), then provided there is no reason to question those objective commercial decisions, options which do not satisfy their decided criteria should not be put forth by the tax authorities as realistically available options.

Sec. 111: ICC does not agree with the standard assumption that the cash pool leader performs no more than a coordination function. Rather, this should always depend on the case at hand.

Box C.10. Question to commentators:

Sec. 130: ICC believes that a (physical) cash pool does not require guarantees. This is because the cash pool typically only covers over-night lending/deposits, which are inherently less risky than almost any other kind of financing. Furthermore, if it is the parent company that manages the cash pool, the cash pool leader may not require any collateral/security from its subsidiaries (cf. above). If it is the parent company issuing guarantees for its subsidiaries, it is doubtful whether this needs to be remunerated. If, however, a remuneration is called for, these costs might be allocated or remain with the cash pool leader (depending on the type of arrangement).

Box C.11. Question to commentators:

ICC believes it is necessary to first understand the purpose of the hedging transactions. Some may be entered into to hedge the return the parent makes. For example, a group may report earnings in US Dollars but have one group member which is located in the EU which has costs and revenues denominated in Euros. The treasury function may wish to hedge the budgeted net earnings of the European subsidiary by entering into a US Dollar v Euro foreign exchange transaction. ICC’s view is that the P&L credit or debit related to that transaction should not be transferred to the European subsidiary.

Alternatively, there may be situations where the European subsidiary has an internal hedging requirement. For example, it may pay suppliers in sterling but generate its own revenues from customers, and report in Euros. In this case, the subsidiary may wish to hedge itself against foreign exchange risk and that would be the same if it were an independent entity. The MNE’s internal policy may prevent the European subsidiary hedging from entering into a hedge itself. Instead the treasury function may manage the foreign exchange risk. One way could be to have another group member enter into a foreign exchange transaction with a third party bank. Another way could be to leave an off-setting position (such as a subsidiary which pays its staff in Euros but receives payment from customers in sterling) unhedged. Either should be considered a related hedge and the smaller of the debit or credit should be transferred to match the economic outcomes in the same taxpayer.

Guarantees:

Box D.1. Question to commentators:

Sec. 137: Generally, guarantees are also issued and priced between third parties and, should therefore be priced accordingly between related parties. Having said this, there are special circumstances to be considered when looking at related parties. *Inter alia*, the implied support due to group membership constitutes a kind of guarantee which under the arm’s length principle should not be remunerated.

Sec. 140: ICC does not agree with this section. ICC believes the suggested approach of subdividing loans into different portions to be overly complicated and not feasible in practice. This is exacerbated by the fact that it is highly unlikely that both tax administrations involved in such transactions will accept any such subdivision. If the tax administration of the guarantor does not respect the analysis then there is the risk of double taxation as the interest income may be fully taxable in the hands of the lender but there is a portion of the interest deductible neither by the borrower nor the guarantor. There may also be double taxation if a portion of the guarantee fee is disallowed in the borrower but fully taxed in the guarantor. Rather, ICC believes that to the fullest extent possible the legal structure chosen by the taxpayer should be accepted by tax administrations and priced under the arm's-length principle. If not, then all members of the OECD should agree that the element of interest relating to the capital that the lender would not have lent save the guarantee should be deductible by the guarantor.

Sec. 141: ICC supports the idea that including any payment for guarantee should still leave the borrower better off overall. Moreover, both tax administrations involved (especially on the side of the payee) should accept this payment as a tax deductible expense. Furthermore, ICC supports the idea that only an explicit and legally binding guarantee may warrant remuneration. Everything below that threshold should not be compensated under the arm's-length principle. ICC questions the relevance of cost in this section as most pricing of intra-group financial transactions relies upon the CUP or CUFT methods rather than cost plus approach. Also, there seems to be little evidence provided to show that the costs (for example) a bank may incur are greater than a related party guarantor on a guarantee by guarantee basis let alone in relation to the amount guaranteed.

Sec. 142: It is ICC's view that the all the risk of default in the original loan still exists if the loan is guaranteed. It is just that some of it has passed from the lender to the guarantor. As little else, if anything, has changed one would expect the interest paid to the lender plus the guarantee fee to be paid to the guarantor in aggregate to be very similar to the interest on the original loan. Therefore, ICC favours the yield approach above the other proposed approaches.

Sec. 142 et seq.: ICC suggests undertaking the process without any payments if there is a large number of cross-guarantees. In such situations it would be much too complicated to accurately delineate and price each transaction. Additionally, there are good reasons to believe that also under the arm's-length principle this does not warrant remuneration, unless such cross-guarantees are in effect one-sided.

Acknowledging that intra-group guarantees is a complex field, where both tax authorities and taxpayers usually have limited experience, ICC remains available to provide further input and expertise to support the future steps of the process. ICC welcomes and encourages the OECD's continued engagement with the business community in order to address pragmatic and effective approaches.

Captive Insurance:
Box E.1. Question to commentators:
ICC would welcome the OECD to provide a number of examples to illustrate the effect of outsourcing specific underwriting functions on the income allocated to the MNE group member that issues insurance policies.

If an MNE group member does not satisfy the control of risk requirements of Chapter 1, then per the Guidance this would conclude that the policy issuer did not perform the decision making functions required to appropriately manage and control the economically significant risks. It is our view that full delineation of the transaction is still required to assess the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed (including whether the policy issuer assumes risk and has the financial capacity to assume the risks) in determining the arm's length return to be earned by the policy issuer.

Sec. 166: The OECD states that an indicator that a transaction that is genuinely one of insurance is that "*the insured risk would otherwise be insurable outside the group*." Sec. 173 also states that "*Another possible reason for the use of a captive insurer by an MNE group in addition to those listed is the difficulty or impossibility of getting insurance coverage for certain risks. Where such risks are insured by a captive insurer this may raise questions as to whether an arm's length price can be determined and the commercial rationality of such an arrangement*." ICC wishes to highlight that there are instances where MNEs identify real commercial risks and potential liabilities that they wish to insure against, however third party insurers are unable to issue policies (or affordable policies) as they firstly want to understand the level of risk. During this 'incubation' period, an MNE may still wish to self-insure to demonstrate to third party insurers how the risk is being mitigated and managed, with a view to externally insuring part (or all) of the risk once the third party insurer achieves a suitable level of comfort. ICC therefore wishes to highlight that a related party transaction may have an element of risk not insurable outside the group (at least for a short period of time) where the commercial rationality should not be questioned as a consequence.

Sec. 176: ICC would welcome the OECD to expand the commentary, and perhaps give examples of when "*an MNE may lack the scale to achieve significant risk diversification and may lack sufficient reserves to meet additional risks represented by the relatively less diversified portfolio of the MNE group.*" Are there any particular thresholds or examples which could clarify when a captive is operating a business other than an insurance one?

Box E.2. Question to commentators:
Sec. 181: ICC acknowledges and agrees that an 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. However, ICC would like to see further commentary in this area (including examples) to assist in determining an arm's length price under this method, as often the actuarial analysis will calculate a 'technical' rate which could differ from the market rate for a particular risk.

In addition, the Discussion Draft does not consider the use of broker quotes, a very common method of establishing arm's length pricing for captives. Brokers will quote by looking at the range of commercial rates available in the market, rather than a pure "technical" rate determined by actuarial analysis. We are of the view that actuarial analysis, brokers' quotes, or a combination of both can be adopted to establish arm's length prices for premiums.

Sec. 182: ICC disagrees that a comparable uncontrolled price can be arrived at simply by considering a combined ratio and return on capital. Specifically, we consider the approach to be too simplistic and formulaic in comparison to actuarial analysis, and such an approach does not take into account many other commercial factors and complexities that a captive needs to assess when determining its premium pricing.

In addition, the combined operating ratio approach seems to suggest that the return for captives should be relatively moderate, even if the captive is assuming significant underwriting risks and has a real risk of incurring significant claims. This appears to be at odds with sec.175, which, in the context of considering whether the transaction is one of insurance, states that, "*The assumption of risk by the insurer can only take place if the insurer has a realistic prospect of being able to satisfy claims in the event of the risk materialising*." If there is no realistic prospect for a captive to generate sufficient capital reserves to satisfy its claims and remain solvent (in addition to meeting the regulatory requirements), a captive will be unable to operate as intended.

Sec. 183: ICC disagrees that the capital requirements of a captive are likely to be "considerably lower" than an insurer writing policies for unrelated parties (or that insurance regulators frequently set lower regulatory capital requirements for captives). Since the introduction of Solvency II, any regulated captive operating under the new regulatory framework will operate under a strict framework, where establishing adequate capital (plus buffers) and proving its solvency are regularly required to ensure that the captive can continue to operate and meet its expected claims.

Sec. 185: Whilst we recognise that the operation of a captive can generate group synergies in the re-insurance market (some of which should be allocated amongst the insured) ICC disagrees that, "*The synergy benefit arises from the collective purchasing arrangement, not from value added by the captive*". The relevant insurance experience and skill set of a properly established captive's employees enables the MNE group to purchase the best possible re-insurance (not just in terms of price but also limit structure, coverage, terms etc.). Without the functions and activities of the captive, it is unlikely that MNEs could achieve the same level of benefit, and as such a detailed analysis of the functions, assets and risks of the captive needs to be undertaken to ensure that the captive is also adequately rewarded for its role in generating value for the insured parties.

Box E.3. Question to commentators:
Sec. 187-188: The example provided by the OECD makes the assumption that the insurance product sold is substantially the same as that which any other insurer in the general market could provide, and also that A could sell policies underwritten by another insurer and retain most of the profit for itself. Whilst ICC agrees that the arm's length remuneration for the insurer should be in line with the benchmarked

return for insurers insuring similar risks in the specific example, it will often be the case that there are key differences between insurance products that need to be considered by undertaking a detailed functional analysis. These differences could, for example, be the coverage of the policy, the excess and the likelihood of the insurer satisfying claims, and also the wider functions, assets and risks of the insurer and the retailer, all of which need to be fully evaluated in determining the arm's length pricing for a specific transaction. It cannot simply be assumed that the retailer in the example should retain most of the profit for itself without undertaking a detailed analysis of the relevant transaction.

The International Chamber of Commerce (ICC)

Commission on Taxation

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