

## **APPENDIX A – Detailed comments to the boxes**

Please find below our specific comments to the questions raised in the boxes of the discussion draft.

**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.

Paragraphs 8 to 10 of the discussion draft (and also those preceding – i.e. paragraphs 3 to 7) relate to the application of the arm's length principle hereafter "ALP" to determine the capital structure within an MNE group. However, it is being noted that on this matter, the OECD members did not find a 'consensus'.

In view of its interaction with other provisions that may be included in domestic legislation (local thin cap rules) or BEPS action 4 (interest deduction limitations), we note that the application of the ALP to the qualification of an acceptable debt-level, in particular whether the conditions of the intercompany loan target to be re-characterized as and replaced by a hypothesized equity investment, should be treated with extreme cautiousness – certainly given the apparent non-consensus that exists – since this will definitely create double taxation issues. Nevertheless, we suggest that the Working Party 6 continues to work in the first place on economic sound principles in view of the application of the ALP, independent of the non-economic measures formulated in the BEPS Action 4 Report, or the myriad of thin capitalization measures that may exist domestically, whereas during the consultation preceding the BEPS Action 4 Report, Working Party 11 explicitly refrained from taking into consideration the ALP. Now, since we are convinced that the different approaches that will exist (although both are OECD-based) will lead to double taxation issues almost certainly. Irrespective of whether the double taxation issues are permanent (if the excess interest would never be tax deductible in the hands of the borrower) or temporary, still from a tax cash perspective a timing issue will exist. Therefore, we urge the OECD undertakes further work to resolve such issues, amongst others in view of Article 25 of the OECD MTC.

In view of the application of ALP to determine the capital structure of an entity within a MNE group, we have the following comments.

Notwithstanding, we are of the view that the ALP can play an important role in capital structure considerations. First of all, the discussion starts off with a wrong presumption in paragraph 3 of the discussion draft stating that the balance of debt and equity funding between independent enterprises will be the result of various commercial considerations, whereas in contrast to this, within an MNE group other considerations such as tax consequences are taken into account. We note that also outside of the context of the MNE group internally, tax is a key consideration. Independent companies will seek an optimal capital structure in view of its most optimal Weighted Average Cost of Capital ("WACC") (which both depends on market/sector-related, as well as company-specific features of risk and return), including the cost of debt, taken after-tax, and the cost of equity, by definition after-tax, under the Capital Asset Pricing Model ("CAPM"). Therefore, as the cost of equity is more expensive (due to seniority and tax deductibility) is more expensive from an economic point of view than the cost of debt, also outside of scope of MNE group's internal funding decisions, tax (next to other considerations) matters.

The optimal WACC could be furthermore understood as the lowest attainable WACC, and for determining an adequate debt-level also takes into account risk appetite. With reference to the 2010 OECD Report on the Attribution of Profits to Permanent Establishments (“OECD PE Report”), under the Authorized OECD Approach (“AOA”) in view of the allocation of an appropriate level of ‘free capital’ (equity) vs. interest-bearing debt, it is being acknowledged in paragraphs 132-133 of Section 1, that a multitude of factors may need to be taken into consideration including risk appetite (but also: location, quality and nature of assets, cash flows, business sector, business strategies, capital acquisitions and disposals, market conditions, etc.). Therefore, capital structure decisions within an MNE group should be approached in line with the ALP, but it should be acknowledged that from the company’s requiring capital funding there are a range of both objective and subjective factors of rationale that are considered in a non-transfer pricing context that should be recognized as proper argumentation for transfer pricing purposes as well as under the ALP. Therefore, adjustments introduced by tax administrations should be treated with extreme caution.

Furthermore, from an investor perspective, one underlying principle of a modern “market economy” is the discretionary power of the entrepreneur with respect to its enterprise (*‘freedom to finance’*). One of the most fundamental decisions of the entrepreneur is to invest equity and become a shareholder or invest debt and become lender to an entity – a decision that has implications beyond the (tax treatment of associated) returns. Indeed, the decision to invest debt or equity will not only impact the remuneration of the investor but also the right of the investor in its enterprise. Further, it may impact the analysis whether an investor is qualified as an affiliated entity. Moreover, by requalification of debt to equity, the OECD could intervene in the capital structure of a company and affect its shareholder structure.

Chapter D.1 of the OECD guidelines handles the delineation of transactions based on the contractual terms, functions performed, characteristics of the “underlying, economic circumstances and pursued business strategies. The OECD clearly follows a substance over form approach.

For financial transactions, the contractual regulations will be much more important than in the commercial business relations. The general idea of a financial transaction is to provide funds to another entity whereby the investor acquires certain rights in this entity. Therefore, also the contractual regulations will primarily determine which rights the investor acquires, and whether the financial transaction should be recognized as debt or equity accordingly from an economic perspective. Thus the basic consideration to invest with debt or equity should generally not be changed for transfer pricing purposes, in particular not solely based on a general function and risk analysis, which is of limited guidance for financing transactions when it does not consider the specific features of financial assets.

**In respect to the discussion above, we may conclude that further clear guidance on the applied criteria is absolutely necessary whilst eliminating a wrong bias to start with and explicitly acknowledging that companies in situations of independence also have a broad range of decision-making freedom to finance, evidenced by broad ranges of debt-to-equity structures observable in the market. There are however sound economic models available to further assess capital structure appropriateness that are also used for independent investor purposes that may be useful for transfer pricing purposes as well.**

**Furthermore, in our view, tax administrations should refrain from re-characterizing debt into equity – i.e. to alter contractual reality - in all cases but exceptional cases – in line with the general transfer guidance contained in the 2017 OECD TP Guidelines (Section D.2 of Chapter I), and considering the specificity of financial assets being essentially contractual claims, only in even more exceptional circumstances. The burden of proof in respect of the non-justification of the rationale underlying the capital structure decision in our view should lie clearly with the tax administration. Furthermore, we request the OECD in light of the interaction with BEPS Action 4 Report to maximize the prevention of double taxation, and extend guidance in this respect for MAPs.**

***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.*

In paragraph 17, an example of the re-characterization of debt into equity is provided, which in our view is overly simplified and lacks sufficient nuance considering our aforementioned comments. As mentioned above, the ALP should be applied to delineated capital structure in the broadest sense possible, and therefore we appreciate that it is hard to capture all relevant features in one example.

Furthermore, in practice it will not be obvious at the time the funds are provided that the loan cannot be serviced within ten years. The funds will be shown as assets in the balance sheet of the debtor and principally enabling their repayment. As soon as it is obvious that the debtor cannot pay back the funds or the interest (e.g. in case of insolvency/over indebtedness) the loan and resulting refinancing has to be handled accordingly under the ALP (e.g. via waivers /capital contributions/refinancing measures). Also, it should be stated that there might be instances whereby there is still a lender's third party market for borrowers that apparently cannot service debt. Indeed, it should not be a de facto consequence of a failed debt service capacity analysis to conclude that the debt instrument reviewed should be re-characterized as equity. In this context, we may potentially refer to leveraged finance and asset-based lending for example. Also, other options for refinancing could be taken into consideration or a re-characterization of debt instrument in view of tenor and collateral. Re-qualification into equity should remain (very) exceptional – i.e. only in clearly abusive cases or cases where clearly no parties in the open market could have a commercial or financial rationale for entering into the transaction – e.g. when providing the funds (e.g. borrower is already under insolvency, over indebtedness).

Finally, in view of the specific question in Box B.2. whether in the example provided in paragraph 17 of the discussion draft the total amount should be considered for re-characterization, despite our comments above, for the mere sake of replying to the question, we are of the view that only the (substantiated) 'excess' should be subject to the consideration of re-qualification as equity.

**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.

Please find our general remarks on the function and risk analysis of intercompany loans in Box B.1 above, more particularly that the contractual situation as given in respect of financial assets is a key comparability factor (compared to dealing with other assets). In their simplest form, the functions of the borrower result in the repayment of the funds and following other requirements of the underlying loan contract. It is the risk attached to the contract, and the borrower that are of primary importance. The functions of the lender on the other hand in our view are of less importance and should be limited to satisfying its options realistically available of providing the funding at market conditions, or not, and risk appetite such as 'prudence' should not be a defining factor. Also, in our view, the 'control over risk functions' of the lender should not be exaggerated, since there are many risks that simply cannot be controlled and considering that financing transactions do not necessarily require continuous risk management and decision-making and/or a large amount of decision-makers.

In view of the more detailed (than in current practice) functional analysis requirement imposed in particular, it would therefore be welcomed if more as well as correctly nuanced guidance could be provided on the relative importance and significance of the functions from the perspective of the lender and the borrower engaged in concluding financial arrangements. Paragraph 24 of the discussion draft in our view provides a good example of putting lender functions in perspective, whilst paragraphs 25 and 26 correctly evidence the importance of contractual reality, as given.

Finally, in respect of timing of the analysis, we agree with what has been put forth in paragraph 31, but wish to note that this is exactly what makes it difficult to find sufficiently comparable data (CUPs) in primary (loan) markets. This stands in contrast to the discussion draft purporting that such data would be available in abundance. The secondary (bond) market and yield curve analyses (adjusted CUPs already statistically processed) are therefore in practice essential tools to effectively operate transfer pricing policies in a consistent and manageable manner, and in our view should be explicitly accepted under the ALP.

**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.

In Box B.4. the OECD asks for comments on the guidance contained in the box's sub-paragraphs 1 to 8 on the so-called "**risk-free rate of return**", which we hereafter shall abbreviate to "**RFR**". Moreover, comments are invited on the interaction of the RFR with other sections of the discussion draft, and in particular with Section C.1.7 Pricing approaches to determining an arm's length interest rate. We will start with the latter request.

***Interaction between RFR and determining arm's length interest rates (in practice)***

In view of the approaches in determining an arm's length interest rate as presented in Section C.1.7, and their interaction with the RFR, we note first of all that the RFR is not mentioned there – just the notion of “risk premium” (in a context of adding that to the cost of funds...). Also, this is an essential point in view of defining RFR, since otherwise it has hardly any use. A “risk premium” can only have meaning when it is consistently applied in conjunction with the base over which the premium is determined and therefore captures all the differentiating features of risk not captured by the basis on which it is applied whilst avoiding double-counting of risks that would appear in both basis as well as premium.

The RFR serves to better understand the sources of total return. Therefore, the basis for interest determination in theory and conceptually *could* be the RFR, to which a risk premium is to be added provided this risk premium is relevant and does not omit risks not captured by RFR and/or does not double-count risks already captured by RFR. In practice, the RFR is rarely a useful concept in respect of setting arm's length interest rates as risk premiums (most notably when one thinks of credit margins as a type of risk premium, in fixed income investments they are usually applied over a basis different than the RFR (e.g. swap rates most notably), and those accordingly are not RFR (as we will comment further on this and the subsequent box). Hence, unless one would apply an interest build-up (economic) model that uses the RFR as basis and risk premiums (taken as differential in respect of the same RFR), or unless one could identify (sufficiently comparable) CUPs of the format “RFR + margin”, the concept of RFR and its interaction with determining interest rates in our view is very limited from a practical point of view.

***Interaction between RFR and discussion draft on financial transactions in general***

Subsequently, in assessing the interaction between the RFR and the discussion draft in more general terms, we are also of the view that its particular use is not particularly very relevant, or at least is limited to the more general and earlier guidance on when to apply the RFR in transfer pricing – cf. 2017 OECD TP Guidelines, paragraphs 1.103 (cross-referencing to the example in paragraph 1.85 where there is a deemed lack of control over investing in and exploiting tangible assets), paragraph 58 of the Annex to Chapter VI (examples on intangibles, where there is a deemed lack of control over the DEMPE functions, and moreover a deemed lack of control over the financial risks of the derived 'mere' funding of the intangibles, so that the funding itself should not attract a return greater than the RFR. Not only have these been highly debated examples that the OECD nevertheless included in its transfer pricing guidance, in our opinion, the OECD now introduces intentionally further thought on this topic with a larger impact than just financial transactions. So, considering the continued debate on the topic we experience in the field – whereby in our view we remain of the position that the guidance contained in the aforementioned examples and in particular in respect of the example on intangibles goes beyond the ALP as it may contradict with how independent parties may choose to cooperate on developing intangibles and sharing (potential) returns in the real world – we would suggest not masking or mixing the guidance with what may constitute a RFR with a potential chapter in the future OECD TP Guidelines on financial transactions in particular.

Now, for the sole purpose of commenting on this important discussion draft, we will not further discuss the issues we had and have with the use of the RFR in aforementioned example(s), but will stick to the guidance contained in the box's sub-paragraph 1 to 8.

**Comment to Box B.4. paragraph 1: Appropriateness of RFR as concept for establishing an arm's length return in case of lack of control over risks**

Except indirectly perhaps for one comment in respect of that particular first paragraph of the box, where it is indeed stated in line with the aforementioned examples that “in accordance with the guidance in Chapter I of the 2017 OECD TP 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”.

It is of particular interest to see that in this specific perspective of investing in a financial asset, we can demonstrate the flaws of the concept of adjusting returns to the RFR for establishing an arm's length rate of return.

First of all, a few questions pop in mind: What are financial assets? What are the specific characteristics of those assets, compared to other type assets? What are those economic relevant risks attached to investing in assets – in particular financial assets? If there are such different features, why would the same principle-based “rule” as lack of control over risk apply to all type of assets, or should it be case-dependent, what is meant by lack of control? In our view it is essential to understand the answers to these question.

» **What are financial assets?**

According to IFRS, a financial asset is “any asset that is (i) cash [legal tender] (ii) an equity instrument of another entity [being any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities], (iii) a contractual right to receive cash or another financial asset from another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or (iv) a contract that will or may be settled in the entity's own equity instruments and is: (a) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments or (b) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. In view of the 2017 OECD TP Guidelines disliking ‘accounting’ definitions, like for “intangibles” to put it more simply, a financial asset is an asset that gets its value from a contractual claim.

» **How does this relate to other type of assets?**

Unlike non-financial, real/ tangible assets, a financial asset does not have a physical presence, but as stated above one derived from a contractual claim on an underlying asset (which can be real or intangible asset). The value of real assets indeed is derived from their physical substance and properties, whereas non-financial, intangible assets are not physical by definition and derive value from intellectual, but also legal rights, and from the value they add to other assets. Non-financial assets are important as collateral for incurring financial liabilities by providing sustainable market value. Real assets tend to derive market value for the current company constellation, whereas intangible assets tend to contribute to future

market value. Intangibles therefore hardly can be used as collateral for raising loans, but rather attract equity investments. In short, there are some important differences among the different types of assets, but on the other hand they are linked to each other, we might conclude.

» **What are the economically significant risk attached to investing in financial assets?**

In our view, this depends on the nature of the investment whereby broadly speaking we have equity investments and fixed income investments.

- › Notwithstanding the latter are obviously of most interest in respect of the discussion draft, we start with the key economically significant risks attached to equity investments since this is where the CAPM and RFR's legacy lie. In short, with reference to Appendix B where you may find further details:
  - › Under the pure CAPM, the cost of equity can be determined though adding a risk premium to the selected RFR, whereby it reflects a real rate, inflation and currency risk, and whereby the premium covers risks related to country risks, market equity risks, sector risks and company-specific risks
  - › Under the hybrid CAPM, country-specific risks are added to the risk premium, and currency inflation movement and country premium are added to the RFR (the latter being removed from the premium)
- › Conclusion from the perspective of investing in an equity instrument, where the use of a RFR is common practice - being part of the (hybrid) CAPM for estimating the cost of equity:
  - › The RFR is a relative measure, built on the premises to understand the differential in risks attached to an equity investment for the purposes of valuing (an investment) in this financial asset, and by no means a reward system as such – i.e. not to be used in isolation in such a manner.
  - › Accordingly, there are different views on what the RFR is meant to capture, depending on the differential to be measured, and the purpose of use.
  - › **As such, since the RFR in our view is no (and has never been intended to be) return measure as purported in the 2017 OECD TP Guidelines** – in the case at hand when there allegedly is a lack of control over risks – the statement should be refuted that the RFR could constitute by any means an appropriate arm's length return in any case, including the case targeted by the 2017 OECD TP Guidelines.
  - › In any event, a risk-adjusted return should be applied, considering all relevant facts and circumstances, including legal (contractual) status,

actual opportunity costs underlying the transaction as effectuated and the appreciation of control over risk in an appropriate context next to merely considering functional (e.g. DEMPE) substance, or the lack thereof. A simple example constitutes special purpose vehicles in acquisitions that clearly serve a particular purpose and are designated with a real risk and value in economic transactions.

- › Subsequently, we turn to investments in fixed income, where the use of RFR is applied in practice to a lesser extent since for the estimation of the cost of debt generally observable interest rates can be used (yield to maturity), whereas it reflects both the default risk of a company as well as the market risks. The RFR on the other hand may be used rather when a company's marginal cost of debt for long term financing is to be estimated. In such case, the RFR is used in conjunction with a risk premium – accordingly, also from a debt perspective not surprisingly the RFR is used in conjunction with, or relative to, another parameter which is the premium. So here again the purpose of the RFR, it is not a use in isolation, but rather to inform the fixed income investor in this manner on the relative valuation in view of the risks attached which may consist of for example (please refer to Appendix B for further details):
  - › **Market interest rate risk** – Yield curve risk, inflation risk, macro-economic / (global) PEST-related risks
  - › **Credit risk** – Default risk, credit spread risk, downgrade risk
  - › **Liquidity risk**
  - › **Call/Put risk** – Reinvestment risk, volatility risk
  - › **Exchange rate risk**
  - › **Event risk**
  
- › Conclusion from the perspective of investing in a fixed income instrument, where the use of a RFR is not common practice other measures being more directly observable (like yield to maturity for corporate bonds):
  - › Again, the RFR is a relative measure, built on the premises to understand the differential in risks attached to a fixed income investment for the purposes of valuing (an investment) in this financial asset, and by no means a reward system as such – i.e. not to be used in isolation in such manner.
  - › **As such, also from this perspective, since the RFR in our view is no (and has never been intended to be) return measure as purported in the 2017 OECD TP Guidelines** – in the case at hand when there allegedly is a lack of control over risks – the statement should be refuted that the RFR could constitute by any means an appropriate arm's length return in any case, including the case targeted by the 2017 OECD TP Guidelines.

- › In any event, a risk-adjusted return should be applied, considering all relevant facts and circumstances, including legal (contractual) status, actual opportunity costs underlying the transaction as effectuated and the appreciation of control over risk in an appropriate context next to merely considering functional (e.g. DEMPE) substance, or the lack thereof. A simple example constitutes special purpose vehicles in acquisitions that clearly serve a particular purpose and are designated with a real risk and value in economic transactions.
  - › Moreover, it should be clear that in the sphere of fixed income also a myriad of risks may be applicable, which can be broadly classified as either market based or entity based, and even those exogenous to both market or corporate control. The question accordingly can be raised of what constitutes having “control”, or the lack thereof being penalized by the arbitrary principle to have a maximum return equal to the RFR.
- » ***Then, what is lack of control (in view of financial assets in particular) in case the RFR could provide for an appropriate return?***

As mentioned above, there is a multitude of risks involved in investing in financial assets; So, what can constitute “control” over these risks as purported in the six-step risk analyzer of the 2017 OECD TP Guidelines? According to paragraph 1.65 *“Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. It is not necessary for a party to perform the day-to-day mitigation, as described in (iii) in order to have control of the risks. Such day-to-day mitigation may be outsourced, as the example in paragraph 1.63 illustrates. However, where these day-to-day mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance as described above in order to exercise control over a risk.”*

In particular, in relation to financial assets, as demonstrated above, “control” over risks should not be over-exaggerated (as lot of risk is market based and even exogenous). This should be made explicit in the guidance for financial transactions;

Moreover, unlike operational business risks, in financial transactions being heavily reliant on contractual claims, there should be a strong tendency to be more heavily focused on the decision-making side of accepting the risks, whilst requiring a lesser extent of ongoing decision-making over the lifetime of the financial asset. Compared to other direct business related assets, the risk management for financial assets tends to be more discretionary rather than continuous (and accordingly does not require continuous decision-making, but rather

periodic and ad-hoc decision making and risk management, rather at board level than on the floor one may even say).

Overall, our conclusion in respect of the appropriateness of the RFR as a concept for establishing an arm's length return for cases where there is a deemed lack of control over risks as put forth in paragraph 1 of Box B.4, for the reasons argued above, is negative:

- › **The RFR is not intended to be a return measure to be used in isolation; It rather is a relative measure, and certainly not suitable nor intended to be used for the purpose put forth by the discussion draft (and for that matter put forth by the 2017 OECD TP Guidelines), and therefore, the RFR cannot an appropriate (conceptual) benchmark for assessing arm's length conditions, as a principle;**
- › **In particular, in relation to financial asset investments, control over a myriad of risks (market-based, company-based, or even exogenous to market and company) is not to be over-exaggerated; Therefore, all risks are to be factored in, also those that cannot be "under control", and de facto do not fit the risk management framework of functional substance as hypothesized by the OECD. E.g. in intercompany lending, for these reasons, the day-to-day functions of the lender in our view are of lesser importance than the risk attached to the contractual claims attached to the financial asset (essentially making the loan a financial asset), and therefore, the RFR cannot represent an appropriate (conceptual) benchmark for assessing arm's length conditions, as a principle.**

#### ***Comment to Box B.4. paragraphs 2: Definition of RFR***

The definition as it reads in the paragraph on the surface looks OK, but as aforementioned a risk-free rate, in our view, is not a measure of return on its own, but relates to (i) its purpose of use, and (ii) the differential it tries to explain under certain assumptions useful for the purpose of use. As such the definition of the RFR is case-specific and defines which risks it incorporates and which it does not.

Nevertheless, to elaborate a bit further on the theme of what constitutes a risk-free rate, we should look at what constitutes risk. Investors who purchase assets have an expectation of return that they will make over the time horizon that they intend to hold the asset. When there is a variance of the actual return from this expected return, then we may say that risk materializes.

Only under 2 mutual conditions assets can be truly risk-free.

- › Firstly, **there cannot be any default risk**. This is quite a logic condition, but rules out basically any security. Government-issued securities may come the closest, since they at least have the discretionary power to print currency to meet their commitments. However, to be complete, governments may also decide to not honor claims made by previous regimes and when they borrow in foreign currencies.
- › Secondly, and less obvious perhaps, an asset can only be risk-free when **there cannot be any reinvestment risk**. Whilst investing in a government bond of 10 years – which may be default-free – may provide you as an investor with a fixed coupon payment every 6 months,

the investor cannot predict at what rate he can reinvest those funds. Now, it is only as a pragmatic solution that in investment valuation, yields of zero-coupon government bonds are taken to overcome this issue, which is known as one of the key assumptions of the CAPM (constant reinvestment rates). In reality, actually such valuation would require different risk-free rates.

Nevertheless, in most developed markets, government bonds in local currency can be used, but the selection of the RFR, as explained above, has implications on how risk premiums are to be estimated, the RFR is not to be used in isolation.

In developing markets, the assumption that government bonds are default-free is a larger leap of faith, and accordingly requires a different approach. Moreover, governments in these markets tend to borrow long term in other currencies. Another question that consequently should be addressed is whether to use nominal rates or real rates, for estimating the RFR. The answer depends on consistency with cash flows on which the risk-free rate (as part of a discount factor, its proper use) applies,

In short, the risk-free rate is the starting point for expected return models – hence, an integral part of a larger whole, and used for other purposes than put forth in the discussion draft – and therefore its definition depends on the consistency with the cash flows to be appraised (its proper use).

#### ***Comment to Box B.4. paragraphs 3: Use of government bonds***

As mentioned above, the use of government bonds is wide-spread, but within that spectrum still certain decisions are to be made on how to define the RFR, depending on the purpose and consistency with cash flows (e.g. real terms vs. nominal terms).

Furthermore, there are also alternatives to government bonds that may be used (depending on the purpose and features of what to measure). We refer to our comments on this matter further below (comments to Box B.5.).

#### ***Comment to Box B.4. paragraphs 4: Functional currency and lowest possible***

It is suggested in paragraph 4 to use the functional currency. As consistency with the cash flows, when applying the RFR is important, we generally agree with this proposition in particular in developed markets. However, as explained above, when dealing with emerging markets – where governments are de facto not default-free and/or have major long-term borrowings in foreign currency – alternative methods may need to be assessed. Therefore, using other currency instruments, and making adjustments should be an acceptable approach as well – e.g. by using interest rate parity and for instance long-term USD/EUR-denominated forward contracts on the foreign currency FC:

$$\text{Forward Rate}_{FC, USD/EUR}^t = \text{Spot Rate}_{FC, USD/EUR} \times (1 + \text{Interest Rate}_{FC})^t / (1 + \text{Interest Rate}_{USD/EUR})^t$$

Furthermore, it is suggested to use the lowest available rate within the currency, even when it is not in the market. From an RFR perspective, this may make sense, but that is only since the incremental market risks (with a proper use of the RFR), would adjust the relative risk premium for these risks.

This approach should also be taken only when capital can effectively be invested in the other market (or to adjust for incremental cost for doing so).

***Comment to Box B.4. paragraphs 5: Timing***

We agree that proximity in timing is key, as the prevailing market conditions impact pricing. Considering that financial assets are contractual claims, prevailing market conditions just or reasonable up-front agreement are to be considered. When the contractual claim does not foresee in a reset mechanism to adjust for future changes in market interest rates, there should be no further adjustments on a later than agreement date, unless both parties would under arm's length conditions have re-negotiated conditions to satisfy their options realistically available at that time (including the additional costs for instance for or as a consequence of renegotiating).

***Comment to Box B.4. paragraphs 6: Maturity***

Again the maturity depends on the use of the RFR (and risk premium), but in general we agree that matching the tenor of the RFR should match the investment horizon.

One problem we see in valuation is that with short investment horizons, in the low interest environment of the past years, the RFR ends up being negative. If then applied in the manner put forth by the discussion draft, does this mean that for instance the lender lacking control over the risk attached to the fixed income asset, would need to pay compensation itself whilst being denied returns notwithstanding that this lender has at least assumed an opportunity cost? In our view, again this particular (but currently frequent) case indicates why the RFR is not an appropriate measure for the use purported by the OECD.

In respect of the example provided, we flagged another potential fundamental problem (not so much related to maturity in fact). That is, when a contract is novated (not when an extension clause is exercised), it should be considered a new contract, a new contractual claim – this is a juridical reality. Parties may in negotiating take into account (to a higher or lesser extent) their joint contractual history, but essentially the status of the novated, new contract should be retained as a new contractual obligation, and therefore a new financial asset.

Hence, only when it can be substantiated that third parties indeed would factor in their mutual past (as part of their analysis of options realistically available) to set the terms and conditions of the new contract (e.g. by arguing a longer tenor from a lender's perspective when a history of multiple novation is apparent), a re-delineation should occur.

Hence, tax administrations should be very cautious in arguing so and denying contractual reality (in connection to financial assets), and re-delineation of conditions should be exceptional, when the options realistically available clearly indicate that conditions would have been set differently in arm's length negotiations.

***Comment to Box B.4. paragraphs 7: Cross-border***

We refer to our earlier comments above, only if a real opportunity of real and similar investment exists cross-border. We note that differences in inflation and country-risks may come into play as well

depending on the selection of the CAPM's premium definition. As said before, this is one of the reasons why the RFR as a single return measure in our view does not make sense.

### **Comment to Box B.4. paragraphs 8: Alternatives**

Please refer to Box B.5.

**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.

In (valuation) practice, there are a few alternatives to using government bond yields, but most notably in any case this means that the market risk premium should be adjusted as well since both are linked. Alternatives include (non-limitative):

- › Using highest quality corporate bond yields
- › Using credit default swaps or quantitative easing studies to normalize yields
- › Using build-up model – e.g. by using Fisher equation [ $1+Rate = (1+RealRate) \times (1+Inflation)$ ]

In respect of the latter, we furthermore note the since 2015 yields have turned negative over much of the term structure. Accordingly, the Fisher equation implies low sources of interest rate risk: real rate and expected inflation. However, when durations are longer, two additional risks in fact need to be taken into consideration: unanticipated market changes (reinvestment risk evidenced by an increase in horizon premium) and unexpected changes in inflation (inflation risk, depending on the ability and desire of central banks to control inflation). The market accordingly risks to misprice assets. Using a build-up model through the Fisher equation, one may aim to neutralize the potential effect of the market mispricing assets to obtain a “normalized” risk-free rate.

**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.

Box B.6. explicitly refers to paragraph 11 of the discussion draft, whereas paragraphs 12 to 21 deal with the “risk-adjusted return” on which no specific comments are requested. Nevertheless, here we will deal with both.

### **Paragraph 11: Lack of control over risk adjustments**

In paragraph 11 it is that “where a funder lacks the capability to control the risk associated with investing 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.”*

We feel we have commented sufficiently in the aforementioned boxes on:

- › Why the RFR should not be used as a (single) measure for attributing returns, also not for transfer pricing purposes in case of lack of control
- › Extreme cautiousness should be paid on what may constitute a lack of control considering specifically the features of financial assets being in essence contractual commitments, whereby it should be noted that the functionality of the lender should not be exaggerated in case of loan transactions (ad hoc, high-level decision-making)

Now, for the purpose of answering the question raised in Box B.6. specifically, we assume that the purported adjustment is appropriate (but not at the level of RFT). As mentioned in our comments to Box B.1. we are of the view that the work of Working Party 6 should focus only on the application of the ALP and not consider interest rate limitation guidance developed in the BEPS Action 4 report. Inevitably, as mentioned earlier as well, double taxation issues will arise in view of its interaction with interest rate limitations, and therefore we recommended that the OECD duly further discusses this issue for resolution under article 25 of the MTC, but also in general double taxation may arise, where income accrued to the lender is deflected to another group entity (e.g. the parent company). The double taxation that may arise between the lender and the parent company for instance, obviously should also be resolved under article 25 of the MTC.

#### ***On risk-adjusted return (paragraphs 12 to 21)***

In our view, any return should be risk-adjusted, since we cannot imagine that investing in a financial asset, would occur without assuming any of the risks not covered by the RFR by the intended party – even without the level of substance we believe the discussion draft puts forth for risk management, but just by once-off board decision for instance, to put it extreme. Hence, in this light we would suggest to alter the provisions that state that in case of a lack of substance in view of dealing with financial assets in particular, it should also be assessed on a case-by-case basis which risk-adjustments on the RFR apply, in any case, considering the specificities of the case at hand and of investing in financial assets.

Indeed, even if Company X has no staff, but has a board that makes the decision to take on risk of investing in a financial asset, but does not do anything else in a continuous manner, and just assesses periodically or ad hoc the performance of the financial asset by the means of those periodic or ad hoc board meetings – Company X in our view effectively has made decisions over control of risk, or at least partially those which are market driven and exogenous (perhaps not the company-specific), and therefore the RFR should not be applied, but rather a risk-adjusted return, always, at least for the contractual juridical consequences of the investment and the opportunity cost attached.

Like we anticipated above, in paragraph 12, indeed the discussion draft refers to intangibles as well. Therefore, the discussion on RFR and risk-adjusted return does not belong to a discussion draft on specifically financial transaction, but is a more fundamental discussion. We suggest at least in a later stage, not to decide when a chapter would be added to the 2017 OECD TP Guidelines on specifically financial transactions to mix this with the RFR and risk-adjusted return discussion. Strongly, we

would suggest to review the concept of application the RFR overall, as aforementioned by applying risk-adjustments in any case.

If the statements made in paragraph 13 would be correct, the question remains how to separate financial risk from other risk in practice as there may be a high correlation. Financial risks are all the risks that are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by economic shock or credit crisis, but can also be internally driven through controls, investment decisions, credit terms, and through outcomes of infrastructure or operational risks

As mentioned before, models like the CAPM but also other like the hybrid CAPM – thereby using the RFR with a risk premium where the two are communicating vessels, and not used in isolation – can be used to give these insights necessary for valuation and subsequently pricing.

The example provided in paragraph 14 is not very realistic, and lacks sufficient nuance in our view. We therefore suggest to eliminate this example or to add more realistic nuance to it. We have no specific comments on paragraphs 15 and 16.

In respect of paragraphs 17 to 21, we are of the view that not much more is proposed than effectively performing an appropriate benchmark of a genuine comparable loan for finding an alternative investment with comparable economic characteristics. Indeed, in our view, there will in practice not be any difference with a benchmark (yield analysis) since de facto the return (premium) over the selected RFR will need to be deducted from all-in-yields effectively.

We reject the cost of funds as an appropriate method in view of the ALP since interest rates in our view should be consistent with the characteristics of the borrower (credit worthiness) and the debt instrument (tenor, currency, collateral, rank, etc.) in the first place. The cost of funds to the lender are not a determining factor in our view for determining arm's length rates, and should not be used except for in the following limited (2) cases:

1. If the cost of funds (given), plus an appropriate return (should be interpreted broad since subjective to opportunity cost and risk appetite) of the lender would be lower than the arm's length interest rate to the borrower, then arguably indeed the transaction would not satisfy the options realistically available test from the lender's perspective. Therefore, while we are of the view that the cost of funds approach should not be used as an interest setting approach, it may be useful as a test for assessing the lender's options realistically available (in a reasonable manner).
2. Only when clearly the cost of funds exists of funding that explicitly at the lender's inbound perspective serves the purpose of on-lending to the borrower, the cost of funds approach (but limited to those inbound funding transactions that explicitly serve aforementioned purpose) in our view may comply with the ALP and as in that case, the inbound funding rate would consider the features of the eventual borrower.

**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.

In practice, it will rarely happen that a single legal entity within a MNE has the “full” autonomy over its financial transactions. There will always be some involvement of the head office regarding significant financing decisions. At least the influence of the head office cannot be excluded due to existing reporting lines. But in the end it will be up to a function and risk analysis to decide on the autonomy of the legal entities on their financing decisions. The fact that there is an overall strategic framework does not stand in the way of a proper application of the ALP. In this respect we may refer to paragraph 1.76 of the 2017 OECD TP Guidelines<sup>1</sup>.

**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, 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.

The presumption that the independently derived credit rating at the group level may be taken as the credit rating for each group member is not in line with the ALP. Given the freedom of companies to finance their business activities as desired (within the legal national framework), this should also be reflected in the way a group finances their affiliated entities.

The assumption that the parent would step in and protect each of the subsidiaries equally when they get into financial difficulties would not necessarily hold in reality. Therefore, the assumption that a group entity has the same credit rating by definition/as a presumption as the overall group rating is

<sup>1</sup> Control over a specific risk in a transaction focusses on the decision-making of the parties to the transaction in relation to the specific risk arising from the transaction. This is not to say, however, that in an MNE group other parties may not be involved in setting general policies that are relevant for the assumption and control of the specific risks identified in a transaction, without such policy-setting itself representing decision making. The board and executive committees of the group, for example, may set the level of risk which the group as a whole is prepared to accept in order to achieve commercial objectives, and to establish the control framework for managing and reporting risk in its operation.

the same as the assumption that a parent entity would always step in if the affiliated entity is in financial difficulties and hence would result in the assumption of an implicit guarantee. To preserve the core idea of the ALP, the contractually laid out parameters should still be considered as the basis for the determination of an arm's length interest rate. Therefore, an implicit guarantee should be part of the consideration whether the parent entity is (likely) to step in despite the absence of an explicit financial guarantee, in the same manner as third parties would make such consideration – e.g. depending on the strategic importance of the subsidiary.

We opine that the credit scoring tools made available by credit rating agencies such as S&P or Moody's should represent the most objective common ground for the determination of a credit score where an official credit rating issued by one of the most known rating agencies is not available. Such credit score would represent typically the financial strength of the borrower on a stand-alone basis for senior unsecured borrowings. Even though it may be a simplified credit scoring approach compared to a full credit rating analysis conducted by the official credit rating agencies themselves, it should still be considered as a suitable tool to assess financial strength on the financial information of a company. Moreover, most credit scoring tools provide market- and sector-driven models where a distinction can be made based on whether an entity operates in certain sectors like Real Estate Investment Trusts, Healthcare or Technology etc. Furthermore, the fact that the financial metrics of an entity might be affected by internal transactions may lead to a vicious circle as the determination of one transfer price may be affected by another transfer price that was wrongly set. Therefore, the assumption that other transfer prices were not at arm's length should not be part of the equation when performing such an analysis. It is our practical experience that when using the tools provided by credit rating agencies such as S&P or Moody's for companies that also have an official credit rating, they provide a solution that results in outcomes very close to the actual credit rating of an entity (+- 2 notches). We therefore believe that these tools are still the best approximation on the market as they are reasonably accurate and objective. In specific circumstances further adjustments on a qualitative basis may be made next to the assessment of whether and to what extent implicit support should play a role.

Consideration of the overall credit worthiness of the MNE group should in the best case only be considered as part of the assessment of implicit support. or when explicit guarantees are existent. Furthermore, we believe that it depends on the strategic importance of the subsidiary in the group that should decide on whether the overall group rating can be taken as a basis for the determination of the credit rating of another group entity. The assumption that the group credit rating equals the entity's credit rating without any adjustments should not be considered.

**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.*

Please refer to our comments in the boxes above and below.

This is a starting point of the analysis.

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

Indeed, implicit support has to be assessed to determine whether the stand-alone credit score is to be adjusted and to what extent. Strategic importance in view of the party that is deemed to provide such support, thereby is indeed a proper assessment for which moreover assessment frameworks (and rating notching consequences) exist as published by formal credit rating agencies.

**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).*

Credit Default Swaps (CDS) are derivative instruments and in no way comparable to (intercompany) loans. CDS could be used under certain circumstances to adjust CUPs gained through market data. However, as market data for loans/bonds is generally available we object the usage of CDS as comparables for intercompany loans.

As mentioned above there is generally good market data available to identify comparables for intercompany loans (and other intercompany financing products). However, in view of interest rate benchmarking in practice the market data for primary (loan) markets is often insufficient (unless a broad comparability tolerance is accepted), mainly related to loan conditions being expressed as coupon data whilst timing is of essence. Secondary (bond) market data in that respect is in practice much more convenient as the typically continuously yield (spreads) are published on individual and aggregate basis for a variety of sectors, main currencies, various tenors and main credit ratings, whereby the bond indentures are stripped from embedded options for incremental comparability.

Indirect interest determination methods can be used to support market data, as long as the applied approaches are objective, transparent and applied on the market as well. They are also helpful tools when no market data is available.

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

As discussed above, the most obvious source for comparables) are the loan and bond markets – most notably the secondary bond market.

Generally, third party loans do not provide a rating and show a fixed margin, since they are not publicly traded. Thus, their application in practice is limited. Bonds on the other hand are generally publicly traded, they often provide a rating and a current yield. Also having some differences (in general

a higher nominal value, a higher liquidity) bonds should be accepted as CUPs for intercompany loans.

Additionally, bond data allows for industry specific analysis and to take into account other features like seniority, maturity, currency etc. of the underlying loan. The main advantage of bond data is that they provide yields and reflect current market developments much better than margin data of intercompany loans.

Finally, fair market yield curves can be a good indicator on expected yields given a rating and a maturity of a loan. The key advantage of fair market yield curves is that these are manageable to operationalize into a transfer pricing policy – in particular within MNEs that have a large quantity of intercompany loan transactions – since they are available for major currencies, credit ratings, sectors and tenors, on a continuous basis so that prevailing market conditions can be assessed in a highly contemporaneous manner without having the need to perform extensive manual analysis. Notwithstanding at first instance, these may look like ‘black boxes’, underlying these curves which are actually constituent bonds and their trading data. What essentially a yield curve does is applying comparability adjustments (stripping the impact of embedded options) and statistical analysis (bootstrapping) to present a term structure for various comparability factors. Accordingly, in our view, the yield curves could be viewed as adjusted CUPs for which the statistical analysis already has taken place, and thereby offers a measure of central tendency without the need to give in (to relax) key comparability factors such as currency, tenor, credit rating, sector and timing. A downside might be that only a measure of central tendency is given in this manner, but further statistical analysis and measures (e.g. standard deviation of underlying data, Bollinger Bands, etc.) may resolve this issue. Finally, it should be noted that also in a non-transfer pricing context, yield curves are a major source of intelligence for key decisions in investment communities. We strongly recommend that the (proper) use of yield curves is further discussed in view of a next discussion draft.

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

In our view this is never going to be the case, unless it consists of one loan that then moreover would moreover need to be comparable across all relevant key comparability factors. External debt, however, may be informative in view of assessing credit worthiness for instance. Hence, external debt should be considered and assessed indeed.

**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.*

With respect to the first question, where it is being requested to give examples of situations where the cash pool leader would be allocated risks with respect to lending within the MNE group rather than to act as a mere service provider to the cash pool participants, we may at least come with the following three situations:

- › Firstly, it may be the case that the cash pool leader does not have to rely on bank funding, but has sufficient financial capacity to put its equity at risk. In our view this is a clear case of when a cash pool leader takes on (the highest extent of) economic significant risks. Although this situation might be extreme, we note that we have seen this in practice; Moreover, when the cash pool leader has to rely on bank funding, in our view, this does not mean directly that the cash pool leader is a pure service provider not putting any of its own equity at risk, as we will further argue below. On the contrary, in instances where the cash pool leader has to rely on bank funding, the cash pool leader might bear liquidity and interest rate risk and hence – depending on the functional and risk set-up surrounding the cash-pool – might be entitled to the full interest rate differential between the deposit and lending rate for the cash pool. This is notably the case where the cash pool leader acts as an “in-house bank”.
- › Secondly, an indicative situation for a cash pool leader to effectively take up a role which is more value-contributing than it would be in the capacity of a mere routine service provider, is one where the cash pool leader effectively markets its cash pool offering towards the participants, and market participants can (genuinely) enter and exit at free will – i.e. the set-up of a cash pool is not a concerted action initiated by the cash pool participants. Obviously, the cash pool offering would need to fit overall global finance policy principles – which in our view is not sufficient to conclude that the resulting income should be redirected towards the level where such general principles are laid down (cf. also paragraph 1.76 of the 2017 OECD TP Guidelines) – but in essence the cash pool leader in this situation is fully accountable for arranging the cash pool set-up including convincing the cash pool leaders of the benefit for participating (satisfying their options realistically available: to enter the system, or not). At first it might be counter-intuitive to think that certain treasury centers would have such freedom to arrange for such financial products vis-à-vis their internal market, but extensive experience in the field teaches us that this effectively takes place. Firstly, the cash pool leader may rely on external funding (under the form of revolving credit facility and likely not a cash pool arrangement with the bank where the bank accepts participants), and in this example would also effectively incur a credit risk as the cash pool leader would be responsible for the access to and exit from the cash pool perimeter (and as such should have sufficient financial capacity to assume such risk whilst effectively managing the risks) for ensuring liquidity and hence bearing liquidity and interest rate risk. Secondly, the cash pool leader may incur an operational risk when on a forecasted basis, the benefit to be allocated to the participants to convince them of participating would consist only of a netting benefit, and when on an actual basis it occurs that the gross netting benefit is not sufficient to cover for the cost for operating the cash pool which may need to be absorbed by the cash pool leader if it doesn't want the cash pool participants to be worse off.

- › Thirdly, when a bank is part of the overall cash pool arrangement, we are of view that it should not be excluded that the cash pool leader can incur economically significant risks – e.g. as indicated above operational risks which may prove to make the cash pool inefficient in meeting its purpose, or even default risk as we will further illustrate.

Instead of asking whether there are situations in which a cash pool leader would be allocated risks, one could basically reverse the question and wonder whether there are situations when a cash pool leader should not be held accountable for incurring risks. Indeed, if a cash pool participant enters into a cash pool arrangement, most often he has a joint and several liability towards the other members of the cash pool. Considering that any single cash pool participant generally does not have an accurate view on the financial situation of any other cash pool participant, as a cash pool participant in (hypothesized) arm's length negotiations would require the cash pool leader to take up accountability for duly monitoring the risk situation of the cash pool, and perhaps putting own equity at risk (which then may attract a return), before demonstrating willingness to enter into the cash pool arrangement.

Because of the above, careful consideration should be given to all the relevant facts and circumstances specific to the case.

**Therefore, we reject the presumption put forth in the discussion draft (already in paragraph 43, but continuously throughout Section C of the discussion draft) that a cash pool leader would not constitute anything more than a mere service provider not incurring any of the risks attached to the cash pool, and suggest not to include such explicit statements referring to presumed characterizations.**

Now, before addressing the second question of Box C.8 – on how to allocate cash pool benefits – we first need to look into the preceding paragraphs up to and including paragraph 123<sup>2</sup>.

- › We appreciate that there is a difference between a physical and notional cash pool, but in practice, often due to fact that the cash pool members are held jointly and severally liable towards the cash pooling bank offering (the) credit line(s), from an economic transfer pricing perspective, these differences should not lead to significant differences in the underlying principles of a proper transfer pricing analysis. In paragraph 99, it is noted that the transactional costs of both types of pools are expected to be different, but in our view this impacts the net benefit to be allocated rather than the core principle that a benefit should be allocated towards the members of the cash pool (not the gross cash pool benefit). We suggest not to make an explicit difference in approach between physical and notional pooling whereas if there would be any differences these would lie in the risk assumption area and are case-specific in any case – certainly when dealing with hybrid cases. Whilst we agree with the description of the difference, we suggest to state that the transfer pricing consequences should not be attached to the labeling, but to the specific case at hand, and that the core principles apply equally to both from a transfer pricing perspective.

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<sup>2</sup> This also includes Box C.9 but this will be dealt with in a next section.

- › In view of the accurate delineation of the cash pooling “mechanics” (title C.2.2. of the discussion draft), we would suggest not using the word “mechanics”, but sticking to “transactions” and “relations” as referred to in general in the 2017 OECD TP Guidelines whereby transactions are the consequence of relations (paragraph 1.42).
- › In paragraph 100 of the discussion draft it is stressed that cash pooling arrangements are hard to find, if at all, between independent parties. This is correct, but we would suggest not only referring to the difficulties that are the consequence of this, but also to refer to the 2017 OECD TP Guidelines statement that this does not mean that cash pooling arrangement would not be able to produce arm’s length outcomes.
- › We agree fully with the statement in paragraph 101 that cash pool transactions – insofar the cash pool leader would not be characterized as an in-house bank<sup>3</sup> – differ from straightforward deposits (or for that matter, credits). We note that based on our experience, there might be different views on this point across the globe.
- › On the other hand, we do have issues with the statements in paragraph 102 where reference is made to the fact that it is likely that cash pool arrangements are set up following a “broader group strategy” or “collective strategy” combined with the presumption that is explicitly made in paragraph 111 (and elsewhere) that a cash pool leader in general “performs no more than a coordination or agency function”. In respect of the latter presumption, we refer to our earlier comments. Here, we have a fundamental issue with the perception that is being created that there is a direct link between the presumed low functionality and the fact that the arrangement is the consequence of a group (which in this context of overall strategy formulation we may translate as headquarter) decision to implement a cash pool. This referral to a cash pooling being a mere group decision should not be made since it is irrelevant for assessing the transfer pricing consequences. In our view, the fact that the group decides to implement a cash pool does not interfere with the case-specific transfer pricing consequences of such decision, but rather one should look at the functions and risks for actually setting up and managing the cash pool. Rightfully it is stated in the last sentence that even in case of a “group decision” still the transfer pricing policy should be set so that the cash pool participants at least expect to not be worse off. However, if the first part of the paragraph gets interpreted wrong and the link with low functionality is made in a direct manner, extrapolating this to general transfer pricing considerations, in virtually any MNE group all subsidiaries would be characterized as having limited functionality and limited control over risk – and that is the fundamental issue we have. To put it as simple as it gets, also in general business operations, the overall strategy is set at a certain high-level in the group, and the members of the group are to execute this strategy (collectively). As long as the entity setting the overall strategy does not get actively involved in the operationalization thereof, this formulation of strategy in general terms should not interfere with the consequences of the strategy being intragroup relations and subsequently intragroup transactions. So, it should not be the case that when the parent entity (in a distribution group)

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<sup>3</sup> For the remainder of this section, our comments will be based on the cash pooling situation where the cash pool leader would not be characterized as an in-house bank retaining the full spread of debit and credit rates.

formulates a strategy for vertically integrating manufacturing activities, those manufacturing entities could not have a functionality in excess of that of a toll or contract manufacturer. In our view, there is a distinction when such parent company would become actively involved in setting up and managing the manufacturing related functions and risks going forth.

- › In general, it is true that a cash pool can be assessed to be the consequence of a concerted action of multiple parties, as stated in paragraph 103, but for completeness sake, as mentioned in the first part of our comments, we are aware of cases where the treasury team of a multinational group individually 'sold' their cash pool solution 'unilaterally' to group members that could decide to enter, or not.
- › We acknowledge that also in our experience the issue stated in paragraph 106 often is a subject of debate in many countries. However, we miss some more detailed guidance (principle-based) on this issue, whereby we would suggest that the general principles of re-characterization are to be respected (i.e. in exceptional cases). Therefore, we suggest that the solution to the issue should be based on the analysis of the options realistically available (but in a reasonably manageable manner) rather than (solely) on the basis of the guidance included in paragraph 107.
- › In view of the documentation requirement (suggestion) stated in paragraph 108, we suggest sticking to the (level of) requirements contained in Annex I to Chapter V of the 2017 OECD TP Guidelines, as a general description of the cash pool transfer pricing policy would already be included.
- › In respect of the paragraphs 109 up to and including 123 we feel that most of all the presumption made in paragraph 111 should be taken out of the guidance. We suggest to explicitly state that the 2 examples provided are actually 'extremes' – i.e. that there in reality are multiple flavors – most of all, that each case should be assessed based on its own specific facts and circumstances. In our view, the examples are even too extreme to be of much help in a debate between tax payers and tax administrations that require and deserve more nuance. For example, it should be noted that the myriad of functions undertaken by Company T by no means are a minimum requirement for characterizing the cash pool leader as having more than low functionality.

Now, we will address the last question of Box C.8. – i.e. on how to allocate the benefits (or detriments) amongst the cash pool members:

- › First of all, we assume that where benefit reference is made to the net benefit (or detriments) – i.e. after having remunerated the cash pool leader – unless based on the characterization of the cash pool leader also the cash pool leader would be entitled to a share of the benefits (or detriments) – which for completeness sake should not be limited to a routine or low value adding cost plus type of remuneration.
- › In respect of the first proposition – to enhance the interest rate for all participants – we are of the view that this should be the base method since we are mostly dealing with a (net) netting

benefit to be allocated – whilst a volume benefit in our general approach<sup>4</sup> would get allocated to the participants in any case by taking the effective interest rates applicable on the cash pool (as determined by the third party bank) as a starting point before enhancement (potential differences in credit worthiness are most often in practice negligible since (i) it concerns short-term/overnight positions (there are far less credit rating classes for short term positions than the ‘standard’ longer term credit ratings), (ii) very often joint and several liability applies, and/or (iii) further credit risk is limited often through the specification of individual credit limits). In such a case, where netting is the sole or key driver, the benefit is created by the offsetting of debit and credit balances, hence both the group of participants contributing the debit balances as well as the group of participants contributing the credit balances equally contribute to the benefit to the extent of the benefit. Therefore, we are of the view that the benefit should be allocated equally amongst both groups (theoretically on a daily basis<sup>5</sup>), and that accordingly within each group the benefit is to be allocated further to the individual participants on a relative volume basis. If the cash pool leader acts as an in-house bank, the benefit should solely be allocated to the cash-pool leader. A final remark we wish to make is that the net benefit can be negative when there is no sufficient actual offsetting. Whether or not to pass through these detriments, depends on the case-specific functions and risks analysis. Also, it should be noted that in the policy where the bank rates effectively applicable on the netted cash pool transactions vis-à-vis the bank are used as basis for enhancement, even when detriments are passed on to the participants, effectively volume benefits have already been passed on.

- › We understand the second proposition – to apply the same interest rate for all participants – to imply that there is only one rate applied on both debit as well as credit balances. We would like to note that it is generally not possible to bring this approach in line with the ALP based on behavior that can be observed on the financial market. Transactions between independent parties on the financial market apply a (lower) deposit rate for savings / investments and a (higher) lending rate for financing needs. If only one and the same interest rate was applied to all cash pool participants, this would generally require that all participants either deposit money into the cash pool or withdraw money from the cash pool. In line with our comments above, no benefit could be derived by offsetting debit and credit balances which is however the fundamental original purpose of setting up a cash pool. That said, we have seen in practice that – in case of inbound cash pools and a local cash pool participant recurrently depositing money into the cash pool - tax authorities have argued that (i) the foreign cash pool leader merely acts as a service provider and hence should be remunerated on a cost plus basis and (ii) due to the routine nature of the cash pool leader, the local cash pool participant recurrently depositing money into the cash pool essentially provides the financial means for (certain parts of) the cash pool and hence should charge a lending rate directly to the foreign cash pool participants requiring financing. This line of argumentation essentially serves to attribute the benefit to the local cash pool participant recurrently depositing money into the cash pool by (re)characterizing deposits into (short-term) loans. As detailed in this section, there are many instances where the cash pool leader has functions and bears risks

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<sup>4</sup> Upon request, we can provide a presentation on how we generally approach cash pooling in more detail.

<sup>5</sup> In practice, netting on a daily basis is feasible on ex-post basis whilst the ex-ante transfer pricing policy is based on the basis of an ex-ante contractual formula for remunerating the cash pool leader and subsequent division of benefits amongst the participants. Upon request, we can further illustrate an example for operationalizing an arm's length pooling policy in this respect.

that surpass those of a mere service provider. With regards to the sharing/allocation of benefits, if any, these should be based on the results obtained by offsetting debit and credit balances but generally not by re-characterizing deposits into loans.

- › In respect of the third proposition – i.e. allocating the cash pooling benefits to the depositors – we first of all note, based on our experience and based on thorough functional and risks analysis – whereby the risks attached to a cash pool (if structured properly) should be put in the correct perspective – that the genuine credit risk to the depositors is most often not very economic significant. We refer to our earlier comments under the first method, that considering the short term nature of the credit (in combination with flexible exclusion provision) where there is less differential in credit ratings, credit limits imposed by the bank (often on an individual basis) and generally requested joint and several liabilities, a high differential in credit worthiness amongst participants should not be presumed. Now, if it would be the case that for certain depositors, taking all facts and circumstances into consideration, the credit risk is more significant, then indeed their return should be adjusted for that fact. In our approach, we would, however, not by definition in such a case allocate all benefits but still use the first approach proposed as a basis and further quantify adjustments for such fact pattern, since there still would be value in the benefit of the creditors contributing offsetting volume.

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

We refer to our comment in this respect under Box C.8., where we concluded that the mere fact of 'being obliged' from a general group perspective to participate in the cash pool does not impede the proper application of the ALP.

**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.*

In principle, this would be a requirement imposed by the banks in our experience. For having a (cross-)guarantee structure in place for intragroup purposes only, we refer to the fact that this is a risk-appetite decision and that the functional risk is a consequence thereof.

**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?*

Section C.3 on hedging only provides a very high level view. The sections states that a centralized treasury function which arranges a hedging contract that the operating entities enters into, should receive an arm's length compensation. Even though this statement is very broad, we can generally agree with this. However, no guidance is provided on the more complex examples in paragraph 136.

Regarding the accurate delineation of situations where there are off-setting positions within an MNE group, it is key to consider functions, risks and assets. In line with our earlier comments, contractual arrangements are very important in this respect (when dealing with financial assets).

Regarding the scenario in the second paragraph of box C.11, the example does not provide sufficient detail to provide meaningful conclusions. What would be the outcome if a risk would materialize / what is the policy in this respect? The reply to this question is key.

All-in-all, we appreciate that hedging can be a very complex issue. The OECD still has plenty of work in this area, but we would suggest - given the technical complexity of the topic - to give perhaps priority to the other topics and deal with hedging in a later stage.

**Box D.1.** *Commentators' views are invited on;*

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

The suggested guidance on guarantees in the discussion draft focuses on financial guarantees. We concur that financial guarantees are the type of guarantees most frequently put in place between related parties. In addition to financial guarantees, several MNEs have put in place other types of guarantees such as supplier or performance guarantees. It would be helpful for businesses to also receive guidance on the application of the ALP for non-financial guarantees. In the following, our comments solely relate to the provided guidance on financial guarantees.

***Accurate Delineation in accordance with the guidance in Chapter 1***

The discussion draft states that the accurate delineation of the actual transactions requires an analysis of the economically relevant characteristics of the transaction including the contractual terms of the transaction, the functional, asset and risk (“FAR”) analysis, the characteristics of financial products and services, the economic circumstances as well as the business strategies. This is in line with the guidance in Chapter 1 of the 2017 OECD TP Guidelines.

The discussion draft points out that it should be distinguished whether the guarantee allows the borrower (i) to receive a beneficial interest rate beyond the implicit support of the group or (ii) access to a larger financing amount. If the guarantee enables the borrower to (also) receive a higher amount of external financing, according to the discussion draft, it has to be considered whether (this relevant part of) the loan should be characterized as a loan to the guarantor, followed by an equity contribution from the guarantor in relation with the original borrower. We would like to note that in practice, it will be difficult to distinguish what portion of the loan leads to a benefit in the form of better credit conditions or access to a larger amount of financing. In circumstances where the guarantee does not lead to a credit enhancement beyond implicit group support, this should not automatically lead to the assumption that the guarantee leads to access to more capital, followed by a re-characterization of the loan to the guarantor. Please also refer to our comments on the freedom of financing provided in response to the questions raised in Box B.1. Based on experience, banks might ask for a guarantee of the parent company in line with internal financing policies. Based on our experience banks have increasingly relied on guarantees since the financial crises. In such cases, the guarantee might not necessarily lead to the injection of more capital by the bank and would just serve a pro forma purpose. Please refer to our further comments.

***Categorization of suggested methods to price intercompany guarantees in line with the OECD transfer pricing methods***

The discussion draft discusses five methods to quantify the price for guarantees: The CUP method, the yield approach, the cost approach, the valuation of expected loss approach and the capital support method. The CUP method as described in section D.1.2. of the Discussion Draft refers to instances where independent guarantors provide guarantees in respect of comparable loans to other borrowers or where the same borrower has other comparable loans which are independently guaranteed. The yield approach (interest rate for comparable loans or bonds), the cost approach (e.g. financing options for required capital, put options etc.) and the valuation of expected loss approach (e.g. recovery rate, return on guaranteed amount) generally rely at least in part on data traded on the financial market between unrelated parties. Therefore, when selecting the most appropriate transfer pricing method as part of a transfer pricing guarantee analysis, it has been general practice in the industry to subsume these methods under the CUP method. We would welcome guidance from the OECD if especially the yield and valuation of expected loss approach may be subsumed under the CUP method or if the yield approach, possibly the cost approach, the valuation of expected loss approach and the capital support method should rather be categorized as “other method”. Further guidance would also be welcomed on the differences, if any, between the valuation of expected loss approach and the cost approach when the cost approach relies on quantifying the additional risk borne by the guarantor by estimating the value of the expected loss that the guarantor incurs from the guarantee.

***Relation between guarantee, credit rating and loan pricing and use of methods to price inter-company guarantees***

Considering the existing guidance of the 2017 OECD TP Guidelines on service transactions, a chargeable service is typically rendered if amongst others, the service transaction (i) is of a more or less routine nature and hence by default not connected with significant risks and (ii) provides the recipient with an economic or commercial value to enhance its business position (paragraph 7.6 of the 2017 OECD TP Guidelines). As long as the guarantor assumes the expected default risk of the borrower, and hence carries risk, the traditional service concept for which the cost plus method is frequently applied in practice should in most cases not be applicable to intercompany guarantee transactions as detailed below.

The purpose of a(n explicit) financial guarantee is to protect the lender from the financial consequences of the risk that the borrower will not be able to meet its obligation under the credit agreement (in time). Thus, the guarantee essentially represents a risk mitigation instrument for the lender which is assumed by the guarantor. The reduced risk for the lender is generally passed on to the borrower by means of better credit conditions, e.g. a lower interest rate granted to the borrower compared to a situation without the guarantee. Under the ALP, (i) the risk assumption by the guarantor should give rise to the need for a remuneration of the intercompany guarantee transactions from the perspective of the guarantor and (ii) the received benefit above and beyond implicit group support by the borrower should lead to the willingness of the borrower to pay for the guarantee. Under these circumstances, we concur that an arm's length guarantee fee might be best priced by reflecting the outcome of a bargain made at arm's length between the borrower - often in line with the yield approach - and the guarantor - e.g. involving a return on the expected loss given default. Therefore, under a straight forward case as described above, a guarantee generally does not qualify as a routine financial service for which the traditional cost plus concept would be appropriate given that the inherent purpose of the guarantee is a shifting of (part of) the expected default risk of the borrower from the lender to the guarantor. The guarantor usually does not become a routine service provider but often rather overtakes risk.

There may be instances in practice where a guarantee represents a mere treasury service associated with a loan for which no separate remuneration might be required. One such example might be where the main operating subsidiaries guarantee a larger (syndicated) bank loan granted to an intermediary or main associated shareholding entity and where the loan proceeds are available for the financing needs of the group. Syndicated credit facilities are often structured in a way so that they allow various affiliated entities to cover their liquidity needs from the facility based on conditions agreed upon globally. The operating subsidiaries guaranteeing the bank loan thus have a direct benefit from the syndicated loan agreements which they guarantee. Specifically, they are able to borrow funds that generally reflect the overall favorable credit conditions and financial substance of the whole group. From the perspective of the guarantors, it might also be argued that the cost of providing the guarantee is compensated by the benefits received in the form of access to financial funding at beneficial group credit conditions. From the perspective of the bank, the explicit guarantee in the form of secured collateral essentially only enables the bank direct access to the assets to which it has access via the shareholding borrower anyways. Without an explicit guarantee e.g. in the form of provided collateral by subsidiaries, the bank would need to first enforce the collateral via the shareholder (e.g. pledge of shares). In a second step, it would be possible for the bank to realize the assets of the subsidiaries. Therefore, providing an explicit guarantee in the form of secured collateral

only enables the bank direct access to the assets to which it is entitled to anyways, possibly with a certain timing advantage and legal cost savings. But no autonomous value is attached to explicit guarantees for the bank as such. Therefore, it may be in line with ALP not to charge a guarantee fee.

### ***Circumstances where guarantees are likely to be insisted upon by independent lenders***

Based on our experience, an independent lender is likely to insist on a guarantee from an (intermediate) associated shareholding entity or entrepreneur when an external loan is granted to an operating subsidiary having a weaker credit rating than the associated shareholding entity or entrepreneur.

There might be cases where guarantees are requested to provide the borrower access to a larger financing amount. In these cases, the proceeds of the loan are often used by associated entities beyond the contractual borrower. Rather than automatically assuming a re-characterization of the loan to the guarantor, these circumstances require a careful analysis of the facts and circumstances surrounding the loan and could lead to no intercompany guarantee charges due to e.g. financial covenants or strong financial interdependence of the group.

It is seen in practice that guarantees are requested by banks from the ultimate parent company even if the ultimate parent company does not have a significantly better credit rating or even a worse credit rating than the related subsidiary. In such case, there would be no significant benefit to the borrower in line with the yield differential approach. Hence, from the perspective of the borrower it is questionable if the borrower would be willing to pay for any guarantee fee. From the perspective of the bank, the guarantee might represent a legal obligation of the parent company to step in, in case of default of the borrower. In such cases, the guarantee can be thought of as representing an insurance for the bank. For strategic operating entities acting as borrowers, the shareholder / parent guarantee might only represent a treasury service associated with the loan for which no guarantee might be warranted as the parent company would likely step in anyways in case of financial difficulties of the strategic affiliated borrower. This example might fall under one of the circumstances as detailed in paragraph 143 of the discussion draft; the operating ties between the parent company and its affiliated subsidiary are so strong that it would not be possible to abandon the borrower since if it would encounter financial difficulties, the group would suffer a credit downgrade. For non-strategic operating subsidiaries acting as borrowers, a guarantee fee might be warranted to the extent the guarantor has the financial capacity to step in, in case of default of the borrower. If a guarantee fee may be charged depends on the bargaining position of the borrower and the parent company requested to act as guarantor by the bank. If the bargaining should result in the charging of a guarantee fee, the cost or valuation of expected loss approach might represent an appropriate way to determine an arm's length guarantee fee.

Besides all the financial theory, it can be observed that banks take what they can get in terms of security, collateral and also guarantees, possibly in accordance with internal banking policy and especially since the financial crisis. This at times leads to a situation where guarantees are requested by banks even if the financing set-up would not necessarily require any guarantees based on financial theory. Hence, a careful analysis of the underlying facts and circumstances surrounding the loan to be guaranteed is indispensable.

**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.

It should be noted that captives can fulfil a genuine risk management purpose for MNE groups and so should not be regarded as a tax avoidance vehicle by definition. In line with the paper "Captives in a post-BEPS World" FERMA (Federation of European Risk Management Associations), there are many examples of commercial rationale that can play an important role for MNE groups to set-up a captive, but generally speaking using a captive allows for an increase of the overall efficiency of the risk management and financing processes. Furthermore, it can ensure more stability in insurance covers through mitigation of insurance market pricing and capacity volatility, and allows for flexibility in risk retention and risk transfer strategies.

Furthermore, more specifically, the following reasons for setting up a captive (insurance/reinsurance) may play a role (in a non-limitative manner) according to FERMA in summary:

- › Increase overall efficiency of risk management
- › Increase long term stability by mitigating market pricing and capacity volatility
- › Obtain coverage for risks not readily available or economically feasible in the commercial markets
- › Provide flexibility in responding to changes in risk retention and risk transfer strategies
- › Build better awareness of the cost of risk and loss control with central accountability for risk management
- › Reduce and/or smooth the TCOR (*Total Cost of Risk*) including administration costs
- › Access reinsurance markets
- › Maintain control over claims
- › Obtain access to government pools, e.g. terrorism insurance via GAREAT or Pool Re

In the discussion draft, to us it seems that the functionality of the captive insurance industry is heavily based on the workings of an independent insurer without giving sufficient consideration to the specific rationale of any captive set-up which may include all of the aforementioned, or more, or specific parts of the aforementioned. In our view, the functionality of the captive insurance entity should be linked to the rationale for its existence (its key purposes) and accordingly the transfer pricing policy should reflect that as well.

Indeed, in our appreciation, the discussion draft tends to overly rely on indicators that are “all or substantially all” presumed to be existing for an independent insurer. As stated above, the purpose of the captive insurer may not exactly be the same as that of an independent insurer, and therefore the indicators provided should act as a minimum checklist for accepting an intercompany transaction between group members and a captive insurance entity. The indicators nevertheless may be of important in our view to accurately delineate the transaction for transfer pricing purposes, and subsequently the level of remuneration.

Therefore, we would suggest making it clear that the stated indicators may serve as important elements of the comparability factors, rather than formulating them as minimum thresholds for recognizing the transaction as it appears to be the case now. The latter in our view would also not be in accordance with paragraph 1.11<sup>6</sup> of the 2017 OECD TP Guidelines – a core principle. Indeed, the mere fact that the type of transaction set up within the MNE group (i.e. with the captive insurance entity) cannot be exactly matched with transactions that can be observed between independent parties (i.e. with independent insurers) does not mean that the intercompany transactions cannot be in accordance with the ALP. Therefore, instead of non-recognition of the transaction of the intercompany transaction when the features of the captive insurance entity do not (entirely/exactly) match those of independent insurance entities, the focus should lie still on the accurate delineation of the intercompany transaction, and potential implications thereof in pricing mechanism for the intercompany transaction compared to transactions with independent insurers.

**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.

An insurance premium transfer pricing policy can from a technical perspective be set through standard actuarial methodologies for determining a model-based technical premium using loss history data and/or and/or exposure measures and/or cost of capital.

Alternatively, standard transfer pricing methods can be applied such as the CUP method, TNMM or (Residual) Profit Split method – depending on the accurate delineation of the controlled transaction. As noted earlier, indeed in an intragroup constellation the controlled insurance transaction may be very well different from those with independent insurance companies – for instance given the different purpose of the captive insurance entity and/or whether the individual transaction is a result of a collective concerted action to pool risks, or not, etc. Again, in our view, the specificities of the controlled transaction should have an impact on the selection of the appropriate transfer pricing method rather than being a basis for non-recognition.

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<sup>6</sup> „A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.”

**Box E.3.** Question to commentators on the example described in paragraphs 187 and 188 of this discussion draft.

In relation to the solutions presented, we are of the view that the use of the residual profit split method has been overlooked.

- › In paragraph 187, the seller of the products and insurance cover is considered to be a routine agent in respect of the insurance, whereby the insurance company gets the full residual profit. Indeed, one may argue that in this way no compensation is being paid by the insurance company for what may constitute an intangible for transfer pricing purposes linked to the customer base (presumably being different in terms of value from the viewpoint of the seller of the product to be insured from the value from the viewpoint of an independent insurance agent that needs to convince the customer to take insurance on the product separately, i.e. being more advantageous).
- › In paragraph 188, the insurance company is de facto regarded as being a routine insurance company (that would work through independent agents selling the insurance contract to the customers of an independent seller of the products, and therefore has to engage in more selling efforts presumably – cf. comment above). From this perspective, one may argue that the intercompany insurance company through the deal with the seller has a different profile than the benchmarked insurance company, whereas the intercompany insurance company arguably has less impact on selling strategies and flexibilities as its intercompany insurance agent may not be entirely dedicated to sell the insurance contract, having a primary focus on the sales of the products.

Accordingly, the example probably does not accurately reflect the actual situation, and in line with the 2017 OECD TP Guidelines, in our view, a two-sided analysis might be recommendable, including assessing the value of the combined offer vis-à-vis the customer to assess whether the intercompany transaction should be priced using the (residual) profit split (which may be the case), or whether for the specific case at hand, the relative value contribution for either party is sufficiently high enough to consider the other party as the tested party indeed (which may be the case for both scenario's). Actual conduct should be leading, and whether this constitutes a concerted action of both parties involved may also be indicative of the correct answer. In any case, bottom-line, both parties involved should be able to satisfy their individual options realistically available.

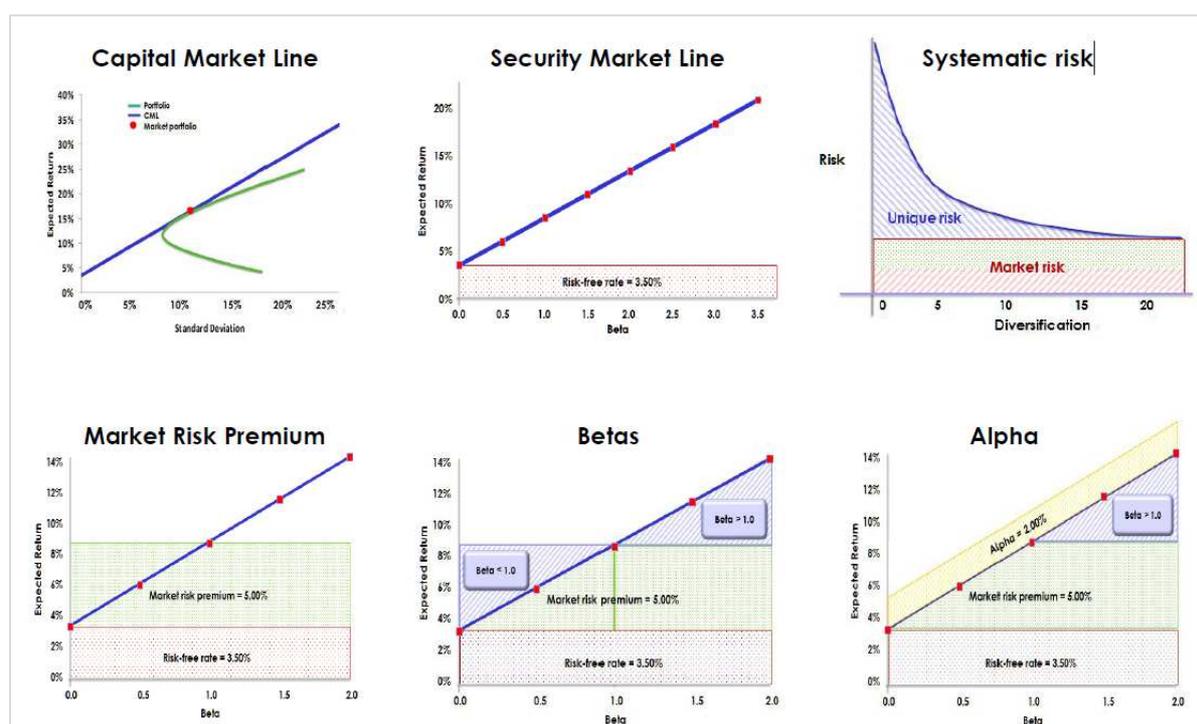
## **APPENDIX B – Further background information**

In this appendix, we provide for further background information on:

- › B.1. Risks attached to investing in equity instruments
- › B.2. Risks attached to investing in fixed income instruments

**APPENDIX B.1 – Risks attached to investing in equity instruments**

CAPM in pictures



Source: Financial Seminars Ltd. 2018

Pure CAPM

$$\text{Cost of equity} = \text{RFR} + \text{Beta} \times \text{Market Risk Premium}$$

**RFR** Real rate + Inflation + Currency risk

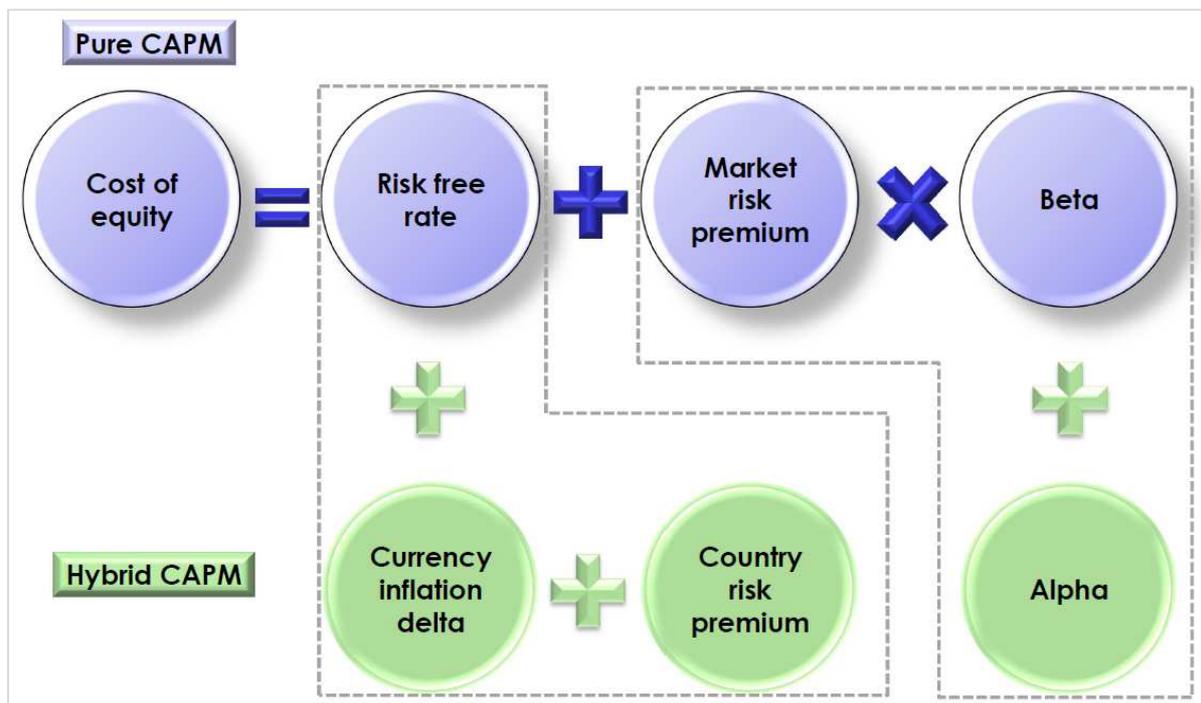
**BETA** Sector / Comparator + Cyclical risk + Exposure to market risks + Correlation risk

**MRP** **Country risk** (expropriation, nationalization, political, catastrophe, default)  
**+ Market equity risk** (commodity prices, availability of finance, underlying economy, strength of competition, market structure)

Hybrid CAPM

$$\text{Cost of equity} = \text{RFR} + \text{Beta} \times \text{Market Risk Premium} + \text{Alpha}$$

- RFR** Real rate + Inflation + Currency risk  
+ **Currency inflation delta** + **Country risk premium**
- BETA** Sector / Comparator + Cyclical risk + Exposure to market risks + Correlation risk
- MRP** ~~Country risk~~ (expropriation, nationalization, political, catastrophe, default)  
+ **Market equity** (commodity prices, availability of finance, underlying economy, strength of competition, market structure)
- ALPHA** **Company-specific risks** (size and dependency, barriers to entry, substitute products, market position, illiquidity, operating risks, forecasting risks, specific exposures)



Source: Financial Seminars Ltd. 2018

## APPENDIX B.2 – Risks attached to investing in fixed income instruments

- › **Market interest rate risk** – the risk of unanticipated changes in market rates, whereby this represents the vulnerability of the financial asset to movements in prevailing market rates; A high market volatility translates into a higher interest rate risk; Also, interest rate risk tends to increase with the tenor of the contractual obligation attached to the financial market – being market based, reflected by a (parallel) shift of the yield curve (in absence of yield curve risk)
  - › **Yield curve risk** – the incremental interest rate risk related to how different instruments on the yield curve with different tenor exposures react differently on a rise in market levels - i.e. the yield curve may shift in a non-parallel manner (steepening/flattening)
  - › **Inflation risk** – the risk of inflation to rise to a level calling short of the inflation considered in the contractual obligation, thereby lowering purchasing power, whereby the market level of interests correlates with levels of inflation with yields being contractually committed (partially/fully), and whereby inflation risk in turn is inversely correlated with an accepted level of credit risk
  - › **Macro-economic / (global) PEST-related risks** – i.e. risks attached to macro-fundamentals including tightening (global) financial conditions (e.g. following quantitative easing), (global) trade frictions, (global) politics, economics, social and technologic evolutions, that incrementally impact (global) market volatility
- › **Credit risk** – i.e. the risk that expresses the financial instrument's sensitivity to default, changes in credit spread and downgrade risk
  - › **Default risk** – the risk that the contractual obligations of paying interest and principal cannot be fulfilled, in full or partially),
  - › **Credit spread risk** – the risk that the contractual obligations of paying interest and principal cannot be fulfilled, in full or partially),
  - › **Downgrade risk** – the risk that the credit worthiness deteriorates,
- › **Liquidity risk** – the risk that the financial asset cannot be converted into cash (sold) easily at the last indication of market price or for a price close to the true value of the underlying asset
- › **Call/Put risk** – the risk that a party to the contractual obligation exercises its embedded (call/put) option before maturity, in a changing market rate environment so that a reinvestment risk is (suddenly) apparent
  - › **Reinvestment risk** – the risk of an adverse timing of returning interest or principal linked to the prevailing market interest rate levels.

- › **Volatility risk** – the risk of volatility effects financial assets with embedded options and the impact thereof on the value of these embedded options
- › **Exchange rate risk** – the risk of receiving less in domestic/functional currency when investing in another currency
- › **Event risk** – the risk related to unforeseeable events having an adverse effect on the ability to make the payments under the committed obligations, as a cause of for instance natural disasters or industrial accidents, corporate takeovers or restructuring, and regulatory risks