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5 September 2018

Dear Sir/ Madam,

PwC's Comments on the non-consensus public Discussion Draft - "BEPS Actions 8 - 10 - Financial transactions"

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the non-consensus public Discussions Draft (DD) entitled "BEPS Actions 8 - 10 - Financial transactions".

We appreciate the initiative and efforts from the OECD in discussing the transfer pricing aspect of financial transactions in order to provide more clarity to taxpayers and consistency in the application of approaches across territories with the aim of minimising transfer pricing disputes and preventing double taxation.

Our response first addresses our core observations in the main body. In Appendix A we then provide some specific comments then pertaining to each section of the DD. In Appendix B we provide detailed responses to the questions raised in the DD.

General observations

In general, we find the DD to provide helpful and informative guidance to taxpayers and tax authorities in an area which has historically raised a lot of challenges in terms of application and consistency. The DD makes important points and background references around the types of key intercompany financial transactions, the relevance and availability of market/ transaction information, the nature of considerations that market participants use around the pricing for such transactions, as well as elements that are unique to multinational groups and may differ from market transactions. In addition, the DD attempts to provide a bridge between factors to consider in the context of the covered financial transactions in light of guidance previously provided by the OECD in the BEPS Action 8-10 paper (now formalised in the OECD 2017 Guidelines). This applies, in particular, in relation to the delineation of transactions and group synergy benefits. It also provides some practical considerations regarding the determination of implicit support. Importantly, there are areas where our network has

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experienced different local country tax authority interpretations around the discussed concepts, and we have attempted to highlight areas where such divergence of views may actually increase the risk of double-taxation and where careful consideration is required around whether or not transfer pricing/ Article 9 and this particular guidance (or this particular guidance alone) is the right forum to address such issues.

The examples provided within the DD are helpful in: a) allowing taxpayers and tax authorities to understand the key features of the identified transactions; and b) applying practical examples to the underlying theoretical frameworks. We have, in this response, sought to provide additional examples which could be included in the revised DD on some of the specific focus areas (notably around the application risk free/adjusted returns, cash pooling and guarantees).

Finally, we consider there are opportunities to clarify or simplify the guidance provided in the DD or where safe harbours/ de minimum thresholds might be appropriate for lower risk transactions (such as entities or financial transactions of a particular size) and we provide the details of these potential revisions within the scope of our responses. In particular we note that the DD in its current form does not recommend that the degree of support/ documentation required to support the underlying loan/ financial transaction is aligned with the materiality of the transaction; as such we are concerned that this places a very high administrative burden on taxpayers with respect to very small, routine and low BEPS risk transactions.

Specific comments

In addition to the general comments noted above, we have also included here a summary of our key observations from specific sections of the DD, divided into the following sections:

- Delineation
- Treasury functions / loan terms / pricing
- Cash pooling
- Guarantees
- Captive insurance

Delineation

The draft guidance regarding delineation provides a bridge to the existing guidance provided in BEPS Actions 8-10 with specific reference to financial transactions. We note that whilst capital structure is introduced in the first few paragraphs within this section, the remainder of the report does not address arm's length capital structure and instead addresses the delineation of transactions with respect to pricing. To ensure focus on transfer pricing matters and coordination with local country requirements, and in light of already concluded guidance (including within other BEPS work streams), we recommend that the paper is limited to the elements and considerations that directly impact pricing. Capital structure is often addressed and restricted under domestic measures and it also may be beyond the scope of Article 9 to address capital structure within the context of international tax treaties. Furthermore, extensive guidance is provided in the OECD Attribution of Profits 2010 paper (the "Authorised OECD Approach" or "AOA") with regard to the analysis of banking and insurance activities and determination of the key value adding functions/ determination of key entrepreneurial risk takers ("KERTs"). This DD should at the least make reference to the guidance provided in the AOA on the same topic areas covered in this DD, and ideally align the wording and approaches accordingly

in order to avoid the potential for misinterpretation of the AOA when compared to the guidance contained in the DD.

We also recommend the distinction between "accurate delineation" and "recharacterisation" is included within the revised DD. The delineation process should follow the steps outlined in this DD (i.e. accurately delineate the actual transaction based on the functions performed by the two parties, the risks borne and decisions made to determine the conditions which would have applied at arm's length). The Section D.2 of the TPG note (paragraph 1.122) that "every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult". Therefore, only if the actual transaction does not possess the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances should the potential for recharacterising the transaction exist. There is extensive reference to the phrase "accurate delineation" within the DD and this should not be used as a tool by tax authorities to recharacterise a transaction unless the specific thresholds within Section D.2 of Chapter I of the TPG have been met.

To the extent any retained guidance includes details regarding a risk-free return, significant further specificity is needed in order to inform how this could work in practice so as to avoid double-taxation and jurisdictional mismatches. For example, it is not clear whether delineation would result in a transaction from the original contractual lender to the new hypothetical lender, or instead a transaction from the contractual borrower to the hypothetical lender. Additional clarity as to how this might interplay with the characterisation of income in the hands of each entity and also the potential withholding tax/ treaty implications would also be helpful.

In the related discussion around substance, one of the more specific areas where more targeted guidance is needed is the nature and extent of substance (in terms of "people functions") required in order to support a particular financial transaction. For example, what substance does the OECD envisage for a full treasury function that bears a wide variety of risks associated with intercompany financing on a daily basis, versus a company that simply on-lends to a borrowing entity with matching terms? In these situations, one might expect the substance required in the first scenario to be more extensive given the risks being borne by the lending entity versus the relative risks of lending on a matched or back-to-back basis. In this regard, the incorporation of the BEPS Action 8-10 risk framework to financial transactions raises some issues.

Risks underlying funding transactions have important differences versus risks underlying an intangible development activity (the latter requires funding but also produces an intangible asset, which generates subsequent returns, separable from the capital that funded the development of the asset). This is linked with the value of capital and the return to capital not being routine (let alone risk free) in the case where the very transaction under review is the extension of capital (whether in the form of debt or equity). In this regard, it is useful to note guidance from the OECD itself acknowledges cases where capital can attract returns well in excess of the risk free rate, and can even attract the residual returns too based on arm's length evidence in areas such as asset management. This is also relevant to the 'delineation' discussion as the functional/ risk/ asset analysis requirements need to acknowledge the potential to outsource management of capital, as one observes in arm's length market transactions on a daily basis.

There may be an opportunity to also provide some form of optional safe harbour or de minimis threshold (for example companies with a turnover of less than a certain size or financial transactions

of less than a certain quantum) which might exempt the taxpayer from the documentary evidence requirement to support the underlying substance. This would help to remove the increased administrative burden associated with documenting the decision making processes at lender and borrower level for transactions which might be considered lower risk in nature (therefore less likely to pose significant BEPS activity).

Treasury functions / loan terms / pricing

This section of the draft guidance provides a market-consistent framework outlining the principles of credit rating assessment, the fundamental terms of a loan agreement and the different characterisation of a treasury function (and associated underlying return). Specifically with regards to the initial assumption that a treasury function might be considered a "service" to the wider group, clarification is warranted around acknowledging the alternative case where the treasury operation is actively managing the liquidity, capital raising, hedging and day-to-day treasury activities of the group (a function that it would be extremely difficult to outsource to an external service provider). A balanced approach may be to provide examples of scenarios wherein a treasury operation might reasonably be considered a service support function for the group, and those where it might be considered to be performing a more entrepreneurial, risk taking function. It would be worth noting that in between these two scenarios there is a spectrum of treasury models, for which the appropriate pricing model might be a form of hybrid between the service provider and entrepreneurial models.

While assessing the options realistically available to lender and borrower with regard to intercompany financing transactions may be a useful exercise in determining what conditions the two parties could and would have been willing to enter into at arm's length, the DD is not clear enough as to why security/ collateral has been provided with such focus and in what scenarios it would be appropriate to imply/ assert security would have been offered by the borrower, or when a borrower might look to access a group guarantee.

For example, in some instances a pledge of assets might be required by an external lender yet it might not provide an incremental interest rate benefit for the borrower (where the pledge is simply by virtue of historic practice exercised by this or other lenders). In other situations, whilst the specific assets of the borrower may not be pledged under an external financing agreement, the external lender may still impose restrictions on what any entity in the group is able to do with its assets/ income (i.e. a negative pledge). In such situations, any imposition of security (even inter-company) would need to be notified to the external lender (and in some cases, an inter-creditor deed may need to be put in place to provide the external lender with comfort as to rights on wind up and the order of preference).

In addition, it may be the case that the parent of the group may not wish to provide explicit guarantees to group entities in certain instances (for example where that part of the business is run separately under a different brand name). We therefore consider that examples would be helpful in this instance, and where certain wording has been leveraged from the Chevron decision or other case law, it would be helpful to make specific reference to the facts/circumstances that led to that conclusion.

Finally, we consider that the draft wording with regard to certain covenants within lending agreements, whilst aligned with what might be seen in external lending agreements, would not always impact the rate imposed between lender and borrower. For example, the application of certain non-quantitative covenants is often one of the final steps in the negotiation of funding between a borrower and lender, after the interest rate and quantum of debt have already been determined. As such, it is

difficult to see how the additional administrative burden placed on taxpayers as a result of imposing the requirement to include covenants addresses a BEPS related risk.

Cash pooling

On the whole, we considered the draft guidance with respect to cash pooling to be constructive to taxpayers and tax authorities. The analysis of the underlying economics of the arrangement is a useful starting point and builds on case law in this area (e.g. Bombardier and ConocoPhilips cases). Additionally, the guidance regarding cross-guarantees and the potential that these may add little incremental value is a pragmatic mechanism for analysis of cross-guarantees that are typical in certain cash pooling arrangements.

One point that we did want to highlight was with respect to the methods for remunerating the cash pool leader, specifically the methodology which allocates the cash pooling benefit between group members based upon their respective positions with the pool (positive or negative). This would seem to imply some form of volume-based discount for both borrowers and depositors to the pool, but we find it difficult to apply this in a financing context (where it would be strange for a borrower with a very large position to receive a larger portion of the benefit than several small depositors). Finally, similar to the discussion around the relative roles of treasury functions and returns to risk, it would be important to acknowledge that real balance sheet risk can be experienced in the event of changes in pool balances as well as the external environment (e.g. in an environment of rising rates with limited returns on investments) and the actual ex ante terms agreed to between the participants and the header lead to different risk (and return) profiles for pools.

Guarantees

The draft guidance with respect to guarantees is informative, particularly in distinguishing between implicit and explicit guarantees and the pricing mechanisms that could be used to determine their impact. Debate remains as to the consideration of implicit support where the contract in question represents an explicit commitment (by the parent in many cases) to undertake a contingent risk. This is an area where jurisdictional differences may continue, but the use of multiple approaches to price the benefit (as suggested by the DD) and acknowledging the range of outcomes may provide a useful tool for pricing agreement.

We would recommend the provision of specific sources of guidance for taxpayers/ tax authorities with respect to applying implicit support adjustments in practice (e.g. credit rating methodology papers) given the subjectivity and alternative approaches that could be adopted.

Additionally, we consider that whilst the methodologies included with respect to pricing guarantees are helpful, there may be scope to provide additional details as to how certain methodologies are applied in practice. More specifically, guidance would (in the form of examples) be welcomed with regard to the Cost Approach, the Valuation of Expected Loss Approach and the Capital Support Method. Additionally, the inclusion of Letters of Credit (LOCs) as a potential CUP approach may also provide a practical reference point. This is especially relevant as the DD does not discuss performance guarantees, but these methodologies become more relevant for such (non-financial) guarantees.

Finally, the DD notes that a guarantee that provides a quantum benefit to the borrower might imply that this portion of the loan is actually borrowed by the guarantor followed by an equity contribution

to the borrower. This is another area where local country debt characterization and interest limitation rules should be used to determine appropriate levels of allowable debt for the borrower and (any) limitations of deductions, and the focus of the DD guidance should be around the pricing of a relevant guarantee for the pricing benefit provided (and not on addressing the question of effective borrower versus equity holder).

Captive insurance

The captive insurance section of the DD provides insight as to captive insurance more generally, fronting and agency arrangements, and reinsurance, along with offering some potential mechanisms for determining the remuneration of the insurance function. The DD appears to suggest that it is for the taxpayer to demonstrate that the captive insurance function is performing genuine insurance activity and has sufficient substance, rather than that to be the expected assumption. Similarly, the DD appears to indicate that captive insurance more generally might be considered a service function on behalf of the group, rather than respecting the separate entity principle and the fact that insurance performed by the captive can be bone fide and akin to what a third party insurer could (and in many cases does) provide. We consider that the accurate delineation of the transactions through an appropriate analysis of the associated functions, assets and risks to be a more suitable starting point for the analysis of a captive insurer.

Yours faithfully,

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Appendix A

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

- Paragraph 6 - this paragraph outlines that this DD provides guidance as to how the concepts of Chapter I of the OECD 2017 Transfer Pricing Guidelines (TPG)"may relate to the capital structure of an entity within an MNE group" - however we note that beyond this reference, most of this DD does not refer to capital but instead to the options available to both parties (lender and borrower) and the potential impact on pricing.
- Paragraph 7 - we consider that by suggesting financing "arrangements made in relation to the transaction, viewed in their totality", the DD may be providing a mechanism to allow transfer pricing to be used as a recharacterisation tool for say, hybrid transactions, where the efforts undertaken by BEPS Action 2 should play that role. In addition, we consider that there needs to be a distinction drawn between transactions entered into by enterprises "behaving in a commercially rational manner" and transactions that would not exist at arm's length under the scope of Section D.2 of Chapter I of the TPG.
- Paragraphs 8 - 10 - the DD indicates that, besides "accurate delineation", other approaches can be used to address the appropriate capital structure under domestic legislation. We consider that it would be useful to be more explicit with regard to how this guidance should be used by tax authorities. Additionally, it would be helpful to outline that a local tax authority needs to determine whether they will apply local domestic rules or if they will apply the guidance in the DD (and should not be able to choose between the two depending on what is most beneficial to the tax authority in those circumstances), and the order of preference in which these might be applied.
- Paragraph 13 - we consider that it would be useful to note that the analysis of relevant factors for delineation may need to (depending on the facts and circumstances) extend beyond just the industry of the tested party to also consider variations in products and markets.
- Paragraph 14 - we consider that reference to the group treasury policy is ambiguous here as a guide for intra-group funding decisions. It would be useful to clarify that the group policy should not necessarily be replicated for all internal funding decisions, which instead may be dealt with on a legal entity-by-entity basis.
- Paragraph 17 (Box B.2.) - we consider that it would be useful to obtain more detail on what the OECD defines as "able to service the debt" (for example, ability to generate a positive free cash flow and be able to repay the interest, or be able to repay the interest and the principal amount over the lifetime of the loan, or consistent with industry financial metrics).
- Paragraph 19 - we consider that where the OECD makes reference to "other investment opportunities" of the lender, on a transactional basis, if the loans are correctly priced based on a risk-return analysis, the lender should be indifferent to alternative investment opportunities based on the risk-reward profile.
- Paragraphs 24 and 25 - the DD comments on the reasonable expectations as to what functions a lender and borrower might reasonably be expected to undertake with respect to a funding arrangement. We request a detailed example of what might be considered "sufficient functions" that might be required as a minimum threshold for even the most basic/routine transactions. There may also be an opportunity to also provide some form of optional safe harbour or de minimis threshold (for example companies with a turnover of less than a certain size or financial transactions less than a certain quantum) which might exempt the taxpayer from the documentary evidence requirement to support the underlying substance. This would help to remove the increased administrative burden associated with documenting the decision

making processes at lender and borrower level for transactions which might be considered lower risk in nature (therefore less likely to pose significant BEPS activity).

Treasury function

- Paragraph 38 - many treasury functions are centralised (from a decision making perspective) but can be decentralised in terms of personnel (e.g. a virtual team of five people spread across multiple countries). This could create challenges with regard to the application of accurate delineation as the key decision makers are spread across jurisdictions and we consider it would be useful to acknowledge this in the DD, with associated guidance as what the potential implication would be for delineation (i.e. in that context who is the appropriate decision maker).
- Paragraph 45 - we consider that it would be worth exploring further the interaction between treasury and group management and in particular the relative significance of these bodies. For example, whilst group management may be responsible for determining guidelines for the group, the treasury team may then have the remit to set treasury policy / determine pricing. As such we consider additional clarity is required to observe the value added by the treasury function in this context, and how the simple shaping of guidelines at group level would not necessarily render the treasury activities to be insignificant / not deserving of a value based return.
- Paragraphs 52 - 54 - we note that significant focus has been applied to the role of security and collateral. In paragraph 52 in particular it is suggested that a parent already controls the assets of the subsidiary, but the assets of that subsidiary may already be secured to an external lender (e.g. if funding is provided directly to the subsidiary). There may also be minority interests influencing the degree of control that the parent might have over those assets. As such, we consider that the suggestion that the parent controls the assets of the subsidiary is not true in a lot of cases, therefore these paragraphs need to be amended to take account of this.
- Paragraph 56 - the DD notes that borrowers will consider the possibility to renegotiate loans to obtain better conditions (for example where there has been a reduction in financing costs in the market). This would typically only be possible in the context of a floating rate instrument (as a lender would not allow a fixed rate instrument to be repaid early without imposing significant early repayment penalties often outweighing the driver for early repayment), unless the loan agreement has embedded optionality allowing for the fixed rate instrument to be repaid early without penalty.
- Paragraph 57 - the DD notes that regulations may impact the position of the parties with the example that insolvency law might influence the degree of subordination of an intercompany loan. We consider that the DD needs to also acknowledge that subordination is not only a product of the underlying insolvency law (for example loans can be structurally subordinate simply by virtue of the fact the borrower is more distant structurally from the underlying fee generating assets).
- Paragraph 58 - we consider that it would be valuable to discuss the different types of public credit ratings and their uses. For example, corporate credit ratings (issuer ratings) versus issuance ratings (linked to the rating of that particular issuance), or credit ratings assigned to regulated entities (e.g. insurance entities). This would be important to recognize that there is a distinction to be made regarding credit risk at the entity level, versus for specific instruments within a credit ladder for a particular entity.
- Paragraph 59 - whilst we agree that there may be “some variance in creditworthiness between companies with the same credit rating”, we consider that this paragraph would benefit from the practical suggestion that this could be dealt with through the use of a statistical measure

(such as the interquartile range) being applied to the comparable set. Without this there is a risk that tax authorities will simply disregard interest rate benchmarking data using a particular credit rating on the basis they consider there might be a theoretical difference with the tested party, based on this wording.

- Paragraphs 63 - 64 - we understand the concern regarding pure "black box" models which rely solely on financial inputs to determine a proxy credit rating. However, it is worth noting that many of these models now incorporate a degree of qualitative overlay, and for many groups with frequent, less material transactions, the use of such models allows for a practical and pragmatic approach to determining underlying credit risk.
- Paragraph 65 - we note that the DD draws into account the interaction of broader operational transfer pricing and how this could influence the proxy credit rating for the subsidiary. Whilst we acknowledge the issue at hand, without further guidance in this regard it will lead to extensive uncertainty for the taxpayer as to how tax authorities might seek to adjust operational transfer prices to determine the proxy credit rating (adjustments which may not be consistent with adjustments being otherwise determined for those operational transfer prices under separate tax audit processes).
- Paragraph 74 - passive association is a reflection of an MNE's willingness and ability to provide support. Reference is made to changing facts and circumstances affecting the likelihood of group support. Once funding has been provided, such facts and circumstances should not be considered for the pricing of the loan as this would be an application of hindsight.
- Paragraphs 75 - 78 - we consider that some covenants, in and of themselves, would not impact the pricing of a loan between two parties unless they are restrictive quantitative covenants (in fact, covenants such as those noted in paragraph 77 in particular are often included as the very final step in the negotiation process). As such, it is unclear what risk is associated with the lack of these covenants being present in an intercompany agreement from a pricing perspective, especially when 1) there is often a wide range of potential metrics associated with financial covenants and 2) the DD proposes an analysis involving the accurate delineation. It might also be useful to clarify what the consequences would be if these hypothesized covenants might be breached during the lifetime of the loan.
- Paragraph 80 - the DD appears to indicate that loan arrangement fees may be lower internally given that external lenders need to offset their costs of raising finance. Clarity is required as to whether a group may be able to take into account its cost of raising equity finance on the same basis.
- Paragraphs 89 - 91 - more guidance would be welcomed as to when and in what scenarios this method can be used. Paragraph 91 refers that it "may" be useful in onlending situations, but we can also see the value in such a methodology for a treasury function when determining whether it is covering its underlying cost base and associated risk exposures.

Cash pooling

- Paragraphs 94 - 96 - the DD appears to assume that cash pooling structures are distinct and separate from wider treasury activities, whereas in a lot of groups the treasury company will also be acting as cash pool leader. Often this will require the treasury company to manage liquidity more holistically (i.e. balancing short and long-term investments with the funding and liquidity needs of the group). Except for reference in Paragraph 112, the DD does not appear to consider that a cash pool leader might otherwise be deserving of more than a service-based return.

- Paragraph 100 - the DD cites Paragraph 1.11 TPG and warns about the difficulty to apply the arm's length principle given that cash pooling is not undertaken by independent enterprises. However, this wording is selective given that Paragraph 1.11 continues and notes that 'the mere fact that a transaction may not be found between independent parties does not of itself mean it is not arm's length'. We consider that it would be helpful to include the additional wording from Paragraph 1.11 in order to limit the assertion by tax authorities that cash pooling transactions should be disregarded simply because they do not exist between independent parties.
- Paragraph 101 - the DD appears to suggest that a cash pool depositor would have different objectives than a company making a simple overnight deposit with a bank; however, in a lot of cases this will be the closest comparable in terms of the options realistically available to the depositor. We suggest the insertion of wording alongside "is likely to differ from a straightforward overnight deposit with a bank or financial institution" of "(albeit that an overnight deposit with a bank or financial institution might provide the closest comparable)".
- Paragraph 127 - the DD provides the suggestion of enhancing the interest rate for all participants based on their absolute positions with respect to the cash pool (i.e. positive or negative). This implies some form of value based discount, which would reward entities obtaining a large borrowing position in preference to rewarding the underlying individual depositors. This seems contrary to the underlying risks associated with the cash pooling arrangement.
- Paragraph 128 - the DD does not appear to offer a suggestion as to how the cash pool leader might receive a return under this scenario. For example, would the cash pool leader receive a separate cost plus or basis point fee?

Bank Opinions

- Paragraphs 92 - 93 - we consider that the guidance here provides a binary viewpoint (i.e. tax authorities should or should not accept bank opinions). However, a formal offer made by a bank, that has passed through a credit analysis and internal credit approvals, should not be dismissed out of hand given this may provide useful insights as to possible market pricing for the same transaction.

Guarantees

- Paragraph 140 - the DD appears to indicate that it might be appropriate to characterise the portion of a loan which has been obtained by a borrower, but that it potentially could not have obtained absent that guarantee from the guarantor, as an equity contribution. Where the funding provided to the borrower is external funding, this would result in the disallowance of third party interest. This paragraph also jumps straight to recharacterisation rather than following the guidance provided in Section D.2 of the TPG in that the transaction should first be delineated and, only if the actual transaction does not possess the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, should the potential for recharacterising the transaction exist. We suggest the removal of this paragraph given that existing mechanisms are in place domestically to limit the deductibility of interest (e.g. local thin capitalisation rules / Action 4 rules). If this is not achievable, we suggest that the application of the paragraph is limited to situations involving the intercompany guarantees of intercompany loan provisions (and additional wording inserted making it clear that the process should follow the guidance contained in Section D.2

of the TPG, first delineating and only in the limited circumstances outlined in Section D.2 recharacterising).

- Paragraph 143 - the DD provides an example of a guarantee not providing benefit when the default of any group member under the external loan agreement would trigger termination of the facility. Whilst this might be possible, more likely the guarantee is yielding additional benefit to the lending party (notably that there are more assets that can be sold to repay the outstanding debt if the entity goes into default).
- Paragraph 144 - the DD notes that guarantees may be in place as part of a comprehensive approach even though there is no difference between the credit standing of borrower and guarantor. This is not just the application of a comprehensive approach; the fact that both borrower and guarantor have the same credit rating does not mean the combined assets / earnings etc. when taken collectively would not result in a higher combined credit rating (which is what the third party lender would be analysing in its pricing decision).
- Paragraph 145 – we suggest clarifying the language “where a guarantee is found to be appropriate” to an alternative such as “where a guarantee has been found to provide a compensable benefit and warrants a guarantee fee”.
- Paragraphs 149 - 150 - the DD notes that the guarantee needs to be priced based on the standalone credit rating of the borrower adjusted for implicit support. However, if the guarantor is not the parent company, then the guarantor rating should also be adjusted for implicit support accordingly.
- Paragraph 153 - we consider that guidance should be included as to how a put option pricing model could be used to determine the price of a guarantee.
- Paragraph 154 - the DD notes that a valuation of loss approach could be applied to determine the guarantee fee (after making adjustments for the expected recovery rate in the event of default). Whist we agree that this establishes a potential guarantee fee or rate, the DD then notes that a return on this amount of capital could be used to establish the guarantee fee (however, an amount of capital has not been established through the calculation).
- Paragraph 158 - the DD provides an example of pricing a guarantee fee. In the example, Company D borrows from the market, but the rate that Company D borrows at is not taken into account (instead, the rate that independent lenders might lend to companies with a credit rating of A or AAA is used). The more relevant value for establishing the yield differential is the rate Company D actually borrows at. Paragraph 159 builds on the same example, and notes that Company D would not pay a guarantee fee of 3% as it is better off absent the guarantee. Whilst we agree with this statement, Company D would be willing to pay something for the guarantee (i.e. the arm’s length fee is not zero for the guarantee in this instance).

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Appendix B

Detailed responses to the questions raised in the DD

Section B: Delineation of transactions

- ***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 MTC, paras 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.***

To ensure focus on transfer pricing matters and coordination with local country requirements, and in light of already concluded guidance (including within other BEPS work streams), we recommend that the paper is limited to the elements and considerations that directly impact pricing. Capital structure is addressed and restricted under domestic measures and it also may be beyond the scope of Article 9 to address capital structure within the context of international tax treaties.

In addition, a clear distinction should be made between transfer pricing and interest limitation rules (e.g. Action 4) which do not use (and are not based on) the arm's length principle, instead using a formulaic approach.

Lastly, the purposes of Article 9 and the interest limitation rules are principally different: the former is dedicated to resolving economic double taxation and non-taxation whilst the latter is dedicated to limiting BEPS through 'excess' interest deductions.

- ***Box B.2. - Commentators' views are invited on the example contained in para 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.***

This example appears to contradict guidance provided elsewhere in this draft as to the options realistically available to the borrower and what they would and could have done at arm's length. The implication of delineating the entire loan as equity is, in effect, to recharacterise the loan. The process should follow the steps outlined in this DD (i.e. accurately delineate the actual transaction based on the functions performed by the two parties, the risks borne and decisions made to determine the conditions which would have applied at arm's length). The Section D.2 of the TPG note (paragraph 1.122) that "every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult". Therefore, only if the actual transaction does not possess the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances should the potential for recharacterising the transaction exist.

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.

We would consider that the factors to be considered with respect to financial transactions should include the contractual terms of the transaction, the control of risk by the two parties and decisions taken based on the options available. This would include, for example, the assessment of financial projections, terms of the transactions, underlying credit ratings and market evidence of alternative transactions / comparable transactions. Other factors include the quantum of debt that may be advanced on a secured, unsecured or subordinated basis and terms and conditions specific to pricing the related party debt advance.

We do not consider that additional factors (such as the inclusion of covenants or lack thereof) which would not have an influence on the pricing of the underlying transaction should be considered as factors relevant to the accurate delineation of the transaction.

- ***Box B.3. - 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.***

In line with Chapter I of the TPG we would consider that the lender should be allocated the risks associated with the advance of funds where the lender can demonstrate that: a) it has the financial capacity / access to funding to bear the risk; and b) the lender can evidence that it made the decision to lend. On b) we would consider that the level of substance documentary evidence required to support the decision made should be aligned with the complexity and materiality of the transaction.

Establishing a risk-free/risk adjusted rate of return

- ***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.***

To the extent any retained guidance includes details regarding a risk-free return, significant further specificity is needed in order to inform how this could work in practice so as to avoid double-taxation and jurisdictional mismatches (see specific detailed responses below).

In addition, Paragraph 20 of Box B.4 in the DD states that "to estimate the risk adjusted return, Country's A tax administration considers that corporate bonds issued by independent parties resident in Country A operating in the same industry as Company B yield a return comparable to the one that an independent part would be expected had invested its funds in Company B under comparable circumstances".

We consider that this paragraphs should be reworded as follows (amendments noted in bold):

"to estimate the risk adjusted return, Country's A tax administration considers that corporate bonds issued by independent parties resident in Country B operating in the same industry as Company B yield a return comparable to the one that an independent part would be expected had invested its funds in Company B under comparable circumstances"

In this regard we strongly believe that reference to issuers resident in Country B and operating in the same industry as Company B would, in principle, provide a more reliable measure of the risk premium due to Country A. If the OECD believe that reference should be made to issuers resident in Country A,

it would be helpful to explain on what basis such issuers should be considered more comparable than those resident in Country B.

- ***Specific questions are as follows:***
  - ***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.***

We note that the examples show that the risk-free rate will depend on the functional currency of the "cash box entity" and the availability of governments issuing securities in that currency. This may create pricing discrimination: for some currencies, securities are only issued by governments entailing a high-country risk, while for others securities may also be issued by countries with lower country risk and some may be issued with a negative return. In other words, the "risk-free return" will highly depend on the availability of securities in a certain currency instead of its "risk-free" approximation.

As an alternative to government bonds, reference could also be made to "interest rate swap" instruments. Although these are not totally risk-free, they may provide a fair approximation of the underlying "risk-free element" and would align with the wording in paragraph 15 of Box B.6. which outlines how an interest rate is comprised.

Or, alternatively, government bonds could be used but based upon the territory of the lender rather than the underlying currency. This would reduce complexity and also retain some of the parameters of the initial transaction (i.e. the country of issuance).

- ***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.***

It is not clear whether delineation would result in a transaction from the original contractual lender to the new hypothetical lender, or instead a transaction from the contractual borrower to the hypothetical lender. Additional clarity as to how this might interplay with the characterisation of income in the hands of each entity and also the potential withholding tax / treaty implications would also be needed.

Under this scenario, you might end up in a case where three different parties (and jurisdictions) have to resolve the case at hand. Double tax treaties are, by definition, bilateral, however Article 25 should be interpreted in such a way that 'triangular' (or more) cases can be resolved. Guidance on 'triangular' cases under the EU Arbitration Convention has already been developed.

In addition, in cases where the contractual lender has its own financing costs, via say a loan, then there are a number of other conceptual questions which require clarification such as:

- On what amount should the risk free return for the contractual lender be calculated? Should this be on the entire principal of the original loan, or only on the amount of the original loan principal that is funded by the contractual lender out of equity?
- Would a deduction for such financing costs incurred by the lender be available and by whom? We consider there to be three possible scenarios:

- the hypothetical lender receives a hypothetical interest deduction for the contractual borrower's funding costs (though this would create questions as to the deductibility of such notional interest in that 3rd territory); or
- the "residual interest" allocable to the hypothetical lender referred to in Box B.6 would be calculated only after allowing deduction for any financing costs of the contractual lender (if so, on what basis would it be determined which interest expenses is appropriate to be netted off for this purpose and under the tax laws of which jurisdiction?); or
- the interest deduction of the contractual lender for its funding costs would simply be limited to a risk free rate (such that the contractual lender ends up in a net neutral position) with the full difference between the contractual interest rate and the risk free return being allocated to the hypothetical lender.

We consider that it would be helpful to include an example covering the intended application of the guidance in such a scenario in the next draft.

Section C - Treasury function

- ***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.***

Groups often operate through separate SPVs (sometimes due to regulatory reasons), for example in the energy sector. As such, the SPVs need to appropriately manage their underlying financial requirements and capital structure positions on a decentralised basis (and will often have independent credit ratings from the wider group). Similarly, there are regulated businesses in the financial services sector that are required to have stand-alone funding and capital structure positions. Some trading shops also have trading desks that are funded independently and deploy capital independently.

As an alternative example, some automotive and heavy equipment manufacturers have a captive finance arm that, while often guaranteed, is required to report separate financials and have an independent credit rating for the issuance of debt and access to wholesale funding.

Intra-group loans

- ***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;***

The use of a group credit rating for subsidiaries of the group appears to be a divergence from the arm's length principle and the separate entity approach. This approach may be elective for the taxpayer for simplicity or where the full credit rating analysis leads to the result that the subsidiary rating is aligned with that of the group. As both the taxpayer and the tax administration may reject a rebuttable presumption, this creates tax uncertainty (in particular, there will always be a tax authority having an interest doing so, i.e. on the lender's or borrower's side). It may be useful to consider this rating

assumption more e.g. as a “safe harbour” approach, which would need to be respected on both the lender and borrower sides of the transaction in order to mitigate potential double taxation.

- ***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.***

This second approach seems to create neither certainty nor compliance. The paragraph indicates that adjustments need to be made anyway so this seems to result in a “normal” credit rating analysis.

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

All credit rating agencies (Moody’s, S&P, Fitch) provide significant publications on the establishment of stand-alone credit ratings and the adjustments to be made for implicit or group support.

Note that, as an aside, corporate credit ratings (issuer ratings) differ from issuance ratings (linked to the rating of that particular issuance), or credit ratings assigned to regulated entities (e.g. insurance entities). It is important to recognize that there is a distinction to be made regarding credit risk at the entity level, versus for specific instruments within a credit ladder for a particular entity.

- ***Box C.3. - Commentators’ views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured (the effect of implicit support).***

The impact of implicit support should be measured in line with guidance provided by credit rating agencies (and the DD should make reference to the fact that this guidance is available from credit rating agencies in order to provide a reference point for taxpayers and tax authorities). We note that credit rating agencies and arm’s length lenders first start with a bottom-up stand-alone approach and evaluate the borrower as a distinct and separate entity, which is consistent with the arm’s length principle. Considerations of membership in a group and resulting implicit support are then incorporated based on specific facts. This should also consider that that there are a spectrum of cases where the value of implicit support is zero and cases where its material.

There is a related consideration here around different types of entities (and related entity ratings) versus different types of instruments and funding. There may be strong reasons to consider group ratings and simplified notching approaches for ratings with respect to liquidity and short term funding transactions, such as within cash pools. In contrast, term debt issued as part of acquisition structuring or other longer term funding is often tied to specific entity profiles and uses where a stand-alone approach may be more indicative of the entity characteristics and instrument specific terms and conditions. This makes the important connection to ensuring consistency of pricing for financing transactions with the operational transfer pricing considerations that impact earnings (and resulting cash) available to service different types of funding.

- ***Box C.4. - Commentators' views are invited on the relevance of the analysis included in paragraph 70 of this discussion draft (the example outlined of integral group members being most likely to receive group support and therefore will have a credit rating being more closely linked to the group rating).***

We would consider it more helpful to refer to the guidance published by credit rating agencies rather than try to simplify the analysis in the DD with regard to how that implicit support adjustment should be made.

- ***Box C.5. - Commentators' views invited on:***
  - ***The role of credit default swaps ("CDS") in pricing intra-group loans;***

We consider that CDSs are used more commonly in the pricing of guarantees (being reflective of the default risk of the underlying instrument based on the respective credit ratings) rather than interest rates (on the basis interest rates can be more readily priced using loan or bond pricing data). In fact, if one were to review syndicated loan offering documents, for example, pricing indications and comparisons are made using comparable loan and bond transactions.

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

We consider these such models to be helpful provided that it is clear where the underlying data is sourced from and that the loans/bonds supporting the established range can be identified.

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

No specific responses to this question.

- ***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.***

The average interest rate paid on external debt can be used as an internal CUP in those situations where the estimated creditworthiness of a subsidiary on a stand-alone basis is rated higher than its parent company. In these rare cases, we recognise that: 1) in the absence of legal or regulatory ring fencing, a subsidiary is seldom rated higher than the MNE (passive association both, increases and decreases legal entity creditworthiness); and 2) an individual legal entity may not be able to borrow at the same interest rate as the MNE and therefore, the internal CUP should act as the minimum interest rate for the related party transactions.

More broadly, we do not consider that the average interest rate paid on external debt can act as an internal CUP. For example, when considering a treasury function, its cost of funding will depend on the actual cost of borrowing and not average cost (and if it were to lend out based solely on the average cost of funding, it may not generate a return on its costs, particularly if there are differences in currency, maturity etc.). Further, this would disconnect the various sources of funds and their differential risks from the subsequent uses of funds and the relevant terms and conditions governing the use of such funds.

Cash pooling

- **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.**

It is **important** to acknowledge that real balance sheet risk can be experienced in the event of changes in pool balances as well as the external environment (e.g. in an environment of rising rates with limited returns on investments) and the relevance of the ex ante terms agreed to between the participants and the leader result in different risk (and return) profiles for pools. In such situations, the cash pool leader can be exposed to a wide variety of risks associated with the multi-currency nature of the pool, the underlying balance of investments it must make versus deposits from the pool and ensuring sufficient liquidity for the pool on a day-to-day basis.

- **Box C.8. - 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 other approach would be most suitable?**

We note that all of the methods assume that the netting effect can be easily computed. This is often not the case as the cash pool leader function is often combined with roles (such as the wider treasury function). Moreover, groups often have various cash pool leaders simultaneously (various layers, various currencies) with interdependencies between those cash pool leaders.

Methods 1 and 2 allocate the netting effect via the interest rates. This is likely to be impractical given the following:

- In case the cash pool is net positive, it may need to invest this excess at very low or even negative rates. If it were to provide the internal depositors with rates close to the borrowers rate, it would provide a loss to the cash pool leader
- The net positive/ negative position will fluctuate on a day-to-day basis so any method where the netting effect is allocated via the interest rates will need to be readjusted permanently to ensure the correct allocation
- A more feasible approach would be to apply CUPs for both lending and deposit rates and then reallocate the netting effect to the participants based on e.g. a month-end adjustment. However, this raises questions on the qualification of such an adjustment for other purposes e.g. WHT, interest limitation rules, etc.
- Method 1 would also seem to imply some form of volume based discount for both borrowers and depositors to the pool, but we find it difficult to apply this in a financing context (where it would be strange for a borrower with a very large position to receive a larger portion of the benefit than several small depositors).

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

We consider this to be a simplification of the accurate delineation of the transaction, and instead we would suggest that any analysis of a cash pooling arrangement follows the same process as for

intercompany financing (i.e. delineating the actual transactions and pricing these accordingly) rather than starting with the position that any synergistic benefits are automatically shared to pool participants.

- **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?**

In practice we would consider it to be more common that groups would determine the appropriate return to the cash pool leader, and ensure that the cash pool participants receive incremental benefit from accessing the pool (versus the rates they could have otherwise obtained) rather than determining the overall pool benefit and allocating the synergy benefit accordingly.

- **Box C.8. - 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.**

No specific responses to this question.

- **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 consider that care should be taken to ensure that guidance is not provided that indicates that an ex post negative return to a cash pool participant would indicate that that participant would not have entered into the arrangement at arm's length. As with intercompany funding and guidance provided in Section B of the DD, the full context and economic circumstances surrounding the decision to enter the pool should be taken into account.

- **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.**

We consider that cross-guarantees are often provided in the context of cash pooling arrangements, yet the incremental benefit provided by the cross-guarantee to each individual participant can often be negligible / zero. We therefore consider the guidance offered by the OECD in this regard to be helpful.

- **Box C.10 - 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.**

No specific responses to this question.

Hedging

- ***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.

We consider that the determination of the appropriate treatment for the hedging transaction should be considered in line with Chapter I regarding risk control functions, in particular the discussion on control over risk and outsourceable risk mitigating functions.

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

We consider that the entity setting the group policy should ultimately assume the unhedged position as it is the entity having the ability to control and manage the risk. Under the OECD Transfer Pricing Guidelines, such entity should be liable for the unhedged MNE in case of losses as no other realistic option would be available to the unhedged MNE.

Section D - Guarantees

- **Box D.1. - Commentator views 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 GE Capital Case in Canada reviewed related party guarantees in detail. The decision produced a useful three-step approach to evaluating related party guarantees. These are: 1) evaluating whether the guarantee produced a compensable benefit, which may include considering the result if the related party guarantee was removed from the transaction; 2) identify the appropriate method(s) to value the related party guarantee transaction; and 3) quantify the appropriate compensation given the facts and circumstances applicable to each party to the transaction.

- **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;**

In our experience, as a matter of course, lenders will require or request maximum collateral or coverage, which includes guarantees from multiple affiliates to simplify the underwriting process and ensure maximum recourse in events of default. A specific example of this could be the provision of export credit insurance, or alternatively the credit committees of banks might request a guarantee even though the borrowing entity is very strongly credit rated. As a matter of course, lender can require guarantees from multiple affiliates to simplify the underwriting process and ensure maximum recourse in events of default.

- **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**

There are documents that have been published by credit rating agencies that detail the impact of different guarantees on the creditworthiness of the recipient of the guarantee. Where the guarantee provides a rate benefit to the underlying borrower then there are grounds to conclude that the borrower would have paid for the guarantee at arm's length (regardless of whether the independent lender insisted upon the guarantee, or if it was offered by the borrower).

- **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.**

No specific responses to this question.

Section E - Captive insurance

- ***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;***

The main indicator is whether the contract is a bona fide contract of insurance, recognised by the regulator in the policy issuer jurisdiction as well as in the territory of the insured. The policy issuer needs to have access to the resources (whether through its board, its employees or outsourced service providers) to evaluate and assume the insured risk (through the underwriting process) and to administer the claim should the insured event occur. It should equally have sufficient financial resources (see below) to be able to pay out the claim.

The list of indicators stipulated by the OECD is misleading and there will be circumstances when those indicators are not met, and yet the use of a group insurance company remains appropriate. For instance, if a captive is used to pool risks in order to access the external insurance market, there may be little or no diversification of those risks, in the captive. That should not preclude the arrangements from being considered arm's length. Equally, there are very few circumstances where a captive insurance company will insure anything other than the risks of the MNE of which it is a part.

In the discussion on the rationale for a captive, there are a number of key reasons why many MNEs choose to self insure that are not articulated. For instance, some choose to insure internally because of the less contentious claims administration processes (reducing the time between when a claim in made and when that claim is paid); others will self insure because the policies available in the market are inadequate (in terms of policy wording or exclusions); still others will vary whether or how much they choose to self-insure over the insurance cycle as market premiums rise or fall with market conditions.

  - ***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***

For the policy issuer to earn an insurance return, it needs to have the financial resources to be able to meet the expected claims costs, based on an appropriate actuarial analysis of the likelihood (i.e. frequency) and severity of the insured events occurring. The policy issuer needs to be able to meet those claims costs and remain solvent. The ability to meet the expected claims costs will hinge on the policy issuer having the appropriate financial strength - reflected in its capital base (including contingent capital such as issued but unpaid share capital) - and liquidity (through the holding of sufficient liquid assets) or access to equivalent sources of liquidity (such as funding lines).

The control functions that a policy issuer should be capable of exercising to warrant earning an insurance return are well documented in Part IV of the AOA to insurance branches in sections C-2 ii) a) [Underwriting insurance risk] and C-2 ii) b) [Risk management and reinsurance]. Given the typical investment profile of many captive insurance companies, the capability to manage asset-related risk is diminished where the assets are reinvested with the MNE in a way which provides appropriate liquidity (e.g. short term loans to the parent or its nominated treasury vehicle).

Given the extensive work from the OECD and industry bodies to develop the framework in Part IV, there appears to be little value or sense in attempting to define an alternative risk control framework to implement this element of the BEPS Actions 8-10.

- ***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;***

There are market examples of circumstances where an insurance company can outsource the acceptance of insurance risk to third parties (for example, brokers, Managing General Agents or other authorised insurance intermediaries). In these circumstances, the relative importance for the insurance company of certain aspects of the underwriting process are increased.

In particular, setting the underwriting policy (as defined in C-2 ii) a) [Underwriting insurance risk]) with reference to detailed underwriting principles or parameters within which risks may be accepted. Where a captive has outsourced aspects of the underwriting process, the ability to demonstrate that it has defined an appropriate underwriting policy, coupled with its ability to monitor the compliance of the outsourced service provider with the parameters stipulated in that policy will be critical.

A captive that outsources ALL aspects of the underwriting process (as defined in C-2 ii) a) [Underwriting insurance risk]) without adequate control or oversight functions should not earn an insurance return. In many jurisdictions in which captives are based, the outsourcing of all aspects of the underwriting process (without adequate control or oversight functions) would be inconsistent with the minimum regulatory standards required to operate an insurance business.

- ***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.***

In principle, where a captive insurance company does not satisfy the control of risk requirements in relation to underwriting, the underwriting result (profit or loss) should be allocated to the territory where those control functions are exercised. Where a captive insurance company does not satisfy the control of risk requirements in relation investment activities (though see above in relation to the importance of these activities in the context of a captive insurance company), the investment return earned by the insurance company should likewise be allocated to the territory where those control functions are exercised. In these circumstances, the captive insurance company would be entitled to little other than a return on the operational costs it incurs.

In practice, this concept may be difficult to apply for long tail risks, when there is a substantial time lag between when the risk is underwritten, compared to when the claim is made.

The discussion on the use of fronting insurers is misguided and fails to adequately recognise the role and responsibility of the fronting insurer. In the event of a legitimate claim by the insured, the fronting insurer has the primary responsibility to pay out that claim. The fronter must recover from the captive reinsurer that amounts that the captive owes to the fronter. If the captive is unable to do that, Par. 166 provides some useful indicators. However, the addition of “all or substantially all of which would typically be met” can be interpreted as “conditions” rather than “indicators”.

The DD suggests as an indicator that “the captive has the requisite skills, including investment skills, and experience at its disposal, including employees with senior underwriting expertise”.

- In a third party context, the investment of the premiums is often outsourced to a third party against arm’s length management fee. Although the captive should be able to define its investment strategy and to carry-out credible oversight of the investments, it does not necessarily need to have to have specific investment skills.
- We agree that a captive should have underwriting experience. Depending on the nature of the activities of the captive, the latter’s activities may range from very to little time consuming activities. Hence, the condition that captives should have “employees” may in certain cases not be required.

- **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 (application of actuarial analysis)**

Actuarial pricing models rely on a set of assumptions as well as industry metrics for calibration purposes that might lead the models to suffer from a perceived black box argument. As such they should be used judiciously but their reliability cannot be dismissed off-hand.

- **Box E.3. - Commentators’ views are invited on the example described in paragraphs 187 and 188 of this discussion draft (agency sales)**

We consider that this specific example draws indications / facts from the DSG Retail v HMRC case. On that basis, we consider that this case deserves a broader and more in depth discussion given that the conclusions from that case (which broadly are included in the DD) were very fact specific and would not apply in all agency situations.