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Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

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By e-mail to: TransferPricing@OECD.org

Our comments on the Public Discussion Draft on Financial Transactions

Dear Sirs,

T/A Economics and WTS Germany as part of WTS Global appreciate the opportunity to submit comments regarding the Organization for Economic Cooperation and Development's (OECD's) Public Discussion draft on BEPS Actions 8- 10 Financial Transactions dated 3 July 2018 (the "discussion draft").

Our commentaries are organized in two parts – this main letter and appendices.
In the main letter we cover the following:

I. Overall comments and fundamental issues
II. Closing remarks

In the appendices we cover two main sections:

A. Detailed commentary to the specific boxes of the discussion draft
B. Additional information

We trust that our comments provide you with additional insights to carry on your important work, and remain at your disposal in case you would like further clarifications and/or supportive analyses.

Yours sincerely,

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I. Overall comments and fundamental issues

In this section we provide our overall comments in respect of the discussion draft, and highlight our key concerns with what may constitute fundamental issues.

A. Importance of the work undertaken

Firstly, we want to recognize the importance of the work that Working Party 6 has undertaken, and appreciate the complexity of the subject matter, both from a technical as well as tax policy perspective.

Indeed, for the first time, since the 1979 report of the OECD Committee of Fiscal Affairs on Transfer Pricing and Multinationals, containing transfer pricing guidance on "loans" (Chapter V), the OECD undertakes to provide further transfer pricing guidance on the topic, which already back then has been earmarked as an increasingly important topic for MNEs. We are glad to see that further work is undertaken since in our experience – dealing with financial transactions intensively – for more than a decade – indeed heavy debate takes place on the subject matter which increasingly forms the basis of transfer pricing adjustments and double taxation accordingly.

We appreciate that financial transactions may add a level of technical complexity to the discussion of what constitutes arm's length conditions in relation to the subject matter. Therefore, there may be some debate on certain theoretical approaches or differences in economic school of thoughts, or even misconceptions on how the investment community deals with investments in financial assets in a non-transfer pricing environment, even if one only narrowly looks at tax motives in a transfer pricing context.

The extended timing of the publication of the discussion draft in combination with the fact that the discussion draft represents a non-consensus document has led to the general presumption of the tax community that different jurisdictions tend not to be in agreement on several aspects. Moreover, it can be argued that the discussion draft also incorporates certain aspects that may not necessarily comply with the arm's length principle.

We have therefore listed our key concerns in respect of some fundamental issues in the following. Details on the individual questions raised in the boxes of the discussion draft are covered in the appendices together with additional information.

B. Our key concerns in respect of some fundamental issues

In this section we raise our concerns both from a general technical perspective, as well as from a standard setting view, which we find to be fundamental to the appropriate application of the arm's length principle. The arm's length principle should be the sole standard for dealing with conditions attached to the financial and commercial relations and consequently transactions within MNE groups in respect to financial transactions.

Below you may find an overview of our most fundamental remarks that you may retrieve in our extended commentary covered in the appendices as well:

- **We would urge that next versions of the discussion draft should focus on providing further detailed guidance in respect of the arm's length principle solely** – and not make any reference or give any consideration to non-economic taxation measures such as interest deduction limitations (BEPS action 4). Nevertheless, we would welcome if the OECD would in the meantime also work further on guidance in respect of article 25 to further strengthen taxpayer's chances of getting relief from double taxation as a consequence of the BEPS measures combined.

- One could argue that the discussion draft starts off with a rather debatable presumption in paragraph 3. It is not only within MNE groups that tax is a key consideration when assessing an appropriate capital structure. Under arm's length conditions, it is one of many factors considered, which also include risk appetite. It should be appreciated that the freedom to finance is great and that the rationale for capital structures within the boundaries provided by the market economy (which may be very broad) is very case-specific. Therefore, when tax payers take duly care of substantiating their rationale for particular capital structures, taxpayers should be able to rely on any (sound) economic argument without having aforementioned presumption of seeking to avoid taxation, whilst tax administrations should bear the burden of proof whether such rationale would be abusive.

- Notwithstanding we appreciate that efforts have been sought to retain guidance in line with the general approach and terminology used in the 2017 OECD TP Guidelines, it should be recognized that **financial assets are a particular and specific category of assets with one feature in common: They are essentially all based on <u>contractual claims, and therefore this should be reflected in the comparability analysis (and further guidance)</u>**. This has two important consequences in our view that should be explicitly mentioned in further guidance:

    - Firstly, in particular in respect of financial transactions, contractual reality not only is a starting point, it is relatively speaking <u>the most important comparability factor</u> in accurately delineating the controlled transaction; and

    - Secondly, whilst actual conduct in respect of financial transactions obviously also should be assessed, in terms of aforementioned importance of the contractual / juridical set-up of the controlled transaction as contemplated by the taxpayer, the functions performed by the parties concerned are relative speaking of a lesser degree of importance. In particular, the functions that are deemed to be performed by the lender are clearly not to be exaggerated for assessing whether the lender has sufficient control over the risks attached to the financial asset which boils down to the risk profile of the borrower and the further risks embedded in the contractual claim. From that perspective, in contrast to operational business, the decision-making functions for having control over risk do not require continuous risk management (rather periodic and ad hoc), as well as do not require significant amounts of (lower) management (if at all – e.g. organized on board level)

- The discussion on the RFR and risk-adjusted return in our view do not specifically belong to scope of financial transactions, and the further guidance provided showcases why the RFR should not be used as a single measure of return, certainly not for the purposes purported – i.e. in the case of lack of control. Any return, in our view, should be risk-adjusted as we commented in the appendix.

- **The discussion draft can be interpreted in a manner that it sets certain standard presumptions that could be considered to not be in accordance with the arm's length principle**, such as:

  - The (rebuttable) presumption that all subsidiaries within an MNE group should be attributed the same level of credit worthiness as the group as a whole;

  - The presumption that group treasury, and more in particular a cash pool leader in general would not be able to constitute anything more than a mere service provider not incurring any of the risks attached to the cash pool. In our view, this is not consistent with the general guidance contained in the 2017 OECD TP Guidelines that controlled transactions should be accurately delineated before an appropriate transfer pricing method can be selected, and the specific guidance contained in the 2017 OECD TP Guidance (paragraph 1.76) that 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, and not merely being involved in setting general policies.

  - The presumption that to qualify as a captive insurance entity having rights to insurance related return all (or substantially all) features of an independent insurer should be met, which in our observation feels like an "all-or-nothing" approach to transaction delineation. In our view this is not consistent with the general guidance contained in the 2017 OECD TP Guidelines that controlled transactions should be accurately delineated before an appropriate transfer pricing method can be selected, and moreover is not consistent with the specific guidance contained in the 2017 OECD TP Guidance (paragraph 1.11) that there should not be a presumption that the mere fact that a transaction may not be found between independent parties would not of itself mean that it is not arm's length.

- According to the discussion draft, 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) (also) access to a larger financing amount. Under (ii), it should be assessed if (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. 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. 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.

We would appreciate it if next versions of the discussion draft would touch upon these points.

C. What the objective of further drafts should be in our view

Accordingly, most importantly, our view is that any further draft in relation to transfer pricing considerations for financial transactions should primarily safeguard the arm's length principle as the sole standard for assessing the conditions of the controlled transaction (with reference to Chapter 1 of the 2017 OED TP Guidelines), together with the following objectives:

- Maximize measures to resolve double taxation issues → article 25 MTC
- Appreciate the specificities of what financial assets are
- Avoid presumptions that are not in line with the arm's length principle, and to this extent include with each example that actual outcomes may differ depending on more detailed facts and circumstances

Furthermore, it should be considered if the discussion on risk-free rate and risk-adjusted rate should be taken out of the scope of the project on financial transactions in particular, and the materials be reviewed separately and within the broader scope of its application.

From a timing perspective, we suggest to carry on with the most developed materials and put the issues that require further substantially detailed work in a next phase (e.g. hedging and guidance on non-financing guarantees) on hold.

II. Closing remarks

We welcome again the opportunity we have been given to comment on this important, but complex issue of transfer pricing for financial transactions. While we acknowledge that a significant amount of work has been done, it is our view that a significant amount of work remains to be done.

Most importantly we have raised some potential fundamental issues, which we view should be cleared before further appropriate technical guidance can be issued. Therefore, we urge that the OECD foresees sufficient time for further public consultation (probably in multiple rounds).

In the appendices, we have given our insights from a technical nature within the scope of the arm's length principle. Most importantly, the arm's length principle should be safeguarded as the sole appropriate standard, now and in the future, and not be mixed with any deviating approaches or presumptions that could lead to non-arm's length approaches.

We wish Working Party 6 a fruitful continuation of their work and public consultation rounds, and remain at your disposal for further analyzing details or explanations of our viewpoints.

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