Copenhagen Economics
Kungsgatan 38, 5tr – 111 35
Stockholm – Sweden

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD - Centre for Tax Policy and Administration
2, Rue André Pascal
75775 - Paris,
France

Submitted by email: TransferPricing@oecd.org

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Public Discussion Draft – BEPS ACTIONS 8 – 10, Financial transactions
3 July- 7 September 2018

Copenhagen Economics welcomes the opportunity to comment on the OECD's Discussion Draft on BEPS 8 - 10, Financial transactions, issued on 3 July 2018.

Copenhagen Economics supports the OECD's efforts to develop rules to prevent base erosion and profit shifting by engaging in financial transactions.

Copenhagen Economics believes that additional clarifications on the proposed guidance and examples will help both the taxpayer and the tax administration in addressing the practical challenges concerning intercompany financial transactions.

It is our opinion that clear and pragmatic guidance on intercompany financial transactions would represent a further step in the proper allocation of profits based on economic substance.

We present our comments and feedback to the discussion draft below.

1 BACKGROUND

The 2015 report on BEPS Actions 8-10 mandated follow-up work on the transfer pricing aspects of financial transactions. Under that mandate, the discussion draft, which does not yet represent a consensus position of the Committee on Fiscal Affairs or its subsidiary bodies, aims to clarify the application of the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines. This particularly pertains to the accurate delineation analysis under Chapter I to financial transactions. The work also addresses specific issues related to the pricing of financial transactions as well as the remuneration of parties potentially involved in the transaction (e.g. centralized treasury functions) such as:

- Intra-group loans;
- Cash pooling;
- Hedging;
- Guarantees; and
- Captive insurance.

Given this purpose, the OECD released a discussion draft (the "**Discussion Draft**") on 3 July 2018 with the aim to clarify, improve and strengthen the guidance on intercompany financial transactions.

2 OUR COMMENTS TO THE DISCUSSION DRAFT

2.1 Accurate delineation of the transaction

As indicated in the OECD Guidelines[1] (para 1.33), the accurate delineation of the actual transaction represents the very first step in any comparability analysis concerning one or more controlled transactions between entities, which are part of the same multinational enterprise ("**MNE**"). The accurate delineation of the controlled transaction(s) consists of identifying "*the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated*".

We believe that the reference to "other approaches to address the capital structure" made in the Discussion Draft (para 8-10), and the relationship between these "other approaches" and the accurate delineation of the transaction, is not completely clear.

It is our opinion that the accurate delineation of the controlled transactions, for financial as well as other types of controlled transactions, is a key element of the comparability analysis and does not prevent domestic legislations to address the issue of the capital structure.

It is our opinion, indeed, that an in-depth analysis of (among others) the economic circumstances and the business strategies is key in 1) delineating the profile of the financial transaction and 2) determining whether the transaction is to be considered – for transfer pricing purposes – as a loan or as a capital contribution.

In particular, when dealing with external financial institutions, the main elements that are considered include, among others:

- A description of the main purpose related to the financial transaction (i.e. strategic acquisitions, investment in capital expenditures, working capital financing, etc.);
- An analysis of the balance between the level of debt (prior entering the financial transaction) and the amount of owned assets or capital;
- An analysis of the creditworthiness of the borrower;
- An analysis of the cash flows related to past and future periods at the company or project level;
- An industry analysis including e.g. cash flow generation/absorption and capital structure.

These features are value drivers analysed in the course of a third party financial procedure. Hence, they should also be taken into consideration in the course of a transfer pricing analysis, in order to accurately delineate the controlled transaction(s). Therefore, it is our opinion that the accurate delineation of the controlled transaction(s) is key to determine whether the transaction has to be considered (fully or partially) a loan or a capital contribution for transfer pricing purposes.

[1] OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris.

2.2 Risk-free rate of return: general considerations

As indicated in the Discussion Draft (Box B.4, para 1) "*Where [...] 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*".

The risk-free rate of return is defined in the Discussion Draft (Box B.4, para 2) as "*the hypothetical return which would be expected on an investment with no risk of loss*".

In our view, even in the situation where the funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, the remuneration should be proportionate to the financial risks linked to the profile of the asset. Where the analysis of the contractual terms and the functional analysis provide evidence that the funder is actually exposed to financial risks, a risk-free rate of return is likely to underestimate the arm's length remuneration to the funder.

It is important to delineate the transactions as stipulated in para 1.33 and mentioned above. First, the arm's length remuneration to the funder is to be determined based on the financial risks linked to the borrower's profile (i.e. creditworthiness) and to the riskiness of the asset (e.g. secured vs. unsecured loan). Second, any support provided by any other related party (e.g. a group entity hosting the central treasury function) in the management of decision-making functions and in the control of risks related to the provision of funds is to be considered in the transfer pricing analysis, given the delineation of the transactions indicated above.

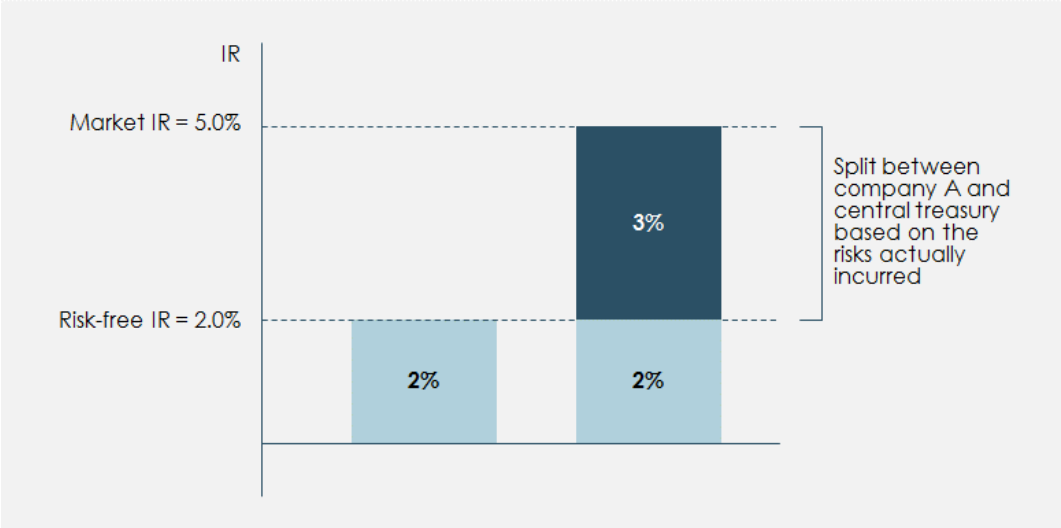
Assume that a company A, part of a MNE group, provides to company B, part of the same MNE group, a loan for a specified amount, under the guidance and supervision of the central treasury function at company C, also part of the MNE group. Based on the facts and circumstances of the case, company A presents a limited functional profile and does not perform the decision-making functions to control the risk associated with investing in a financial asset. Nonetheless, based on the analysis of contractual terms and the actual conduct of the parties, company A is to some extent exposed to financial risks related to the granted loan.

Assume then that the arm's length remuneration for comparable loans provided on the free market is found to be around 5.0% and that the risk-free rate of return is found to be around 2.0% (see Figure 1 below).

Based on the argumentations reported in the Discussion Draft, the funder is to receive a 2% risk-free remuneration.

In our opinion, the funder (company A) is to be remunerated with 1) the risk-free interest rate (2.0% in the example); and 2) a portion of the difference between the market interest rate and risk-free interest rate (3.0% in the example), based on the risks actually incurred. The remaining part of this difference is to be attributed by company A to the central treasury for the support received in the management and risk-control of the loan.

Figure 1
Exemplary comparison between risk-free and arm's length interest rates



Note: IR: Interest rate.

2.3 Risk-free rate of return: determination

The Discussion Draft specifies the determination of the risk-free interest rate as follows (Box B.4, para 3): "*An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk*".

The Discussion Draft (Box B.4, para 4) suggests with specific regards to currency factor that: "*To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the investor's cash flows, i.e. the functional currency of the investor rather than its country of domicile. When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return*".

We identify two different issues, as indicated below:

1. The risk-free interest rate should be based on security issued in the functional currency of the investor rather than its country of domicile. The Discussion Draft does not consider the possibility of a loan extended in a currency (e.g. US Dollar) differing from both the currency of the country of domicile (e.g. Swedish Krona) and the functional currency (e.g. Euro).
2. The Discussion Draft indicates that in the case of "*multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return*". We see a potential deviation from the arm's

length principle as then the risk-free rate is not based on the most appropriate return on securities, but arbitrarily on the on the lowest level.

2.4 Risk-adjusted rate of return: mark-up on costs

As indicated in the Discussion Draft (Box B.6, para 21), a cost approach may be used to determine the risk-adjusted rate of return in controlled financial transactions "*where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk*".

Based on this approach: *"[…] the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower*".

In our view, the described cost approach does not necessarily reflect the time-value of the anticipated funds from the perspective of both, the lender and the borrower. Indeed, the cost approach may well be suitable to determine the remuneration related to the centralized support services concerning intercompany financing (see Discussion Draft para 39-41). However, it hardly reflects the benefit to the borrower stemming from the funds received and the potential return to the lender.

In addition, we believe that a guidance on how to determine the profit mark-up should be provided in the Discussion Draft for the computation of the risk-adjusted rate of return.

2.5 Pricing approaches to determining the arm's length interest rate of intercompany loans: internal CUPs

The Discussion Draft indicates that (para 88) *"[…] it may be possible to identify potential comparable loans within the borrower's or its MNE group's financing with an independent lender as the counterparty*".

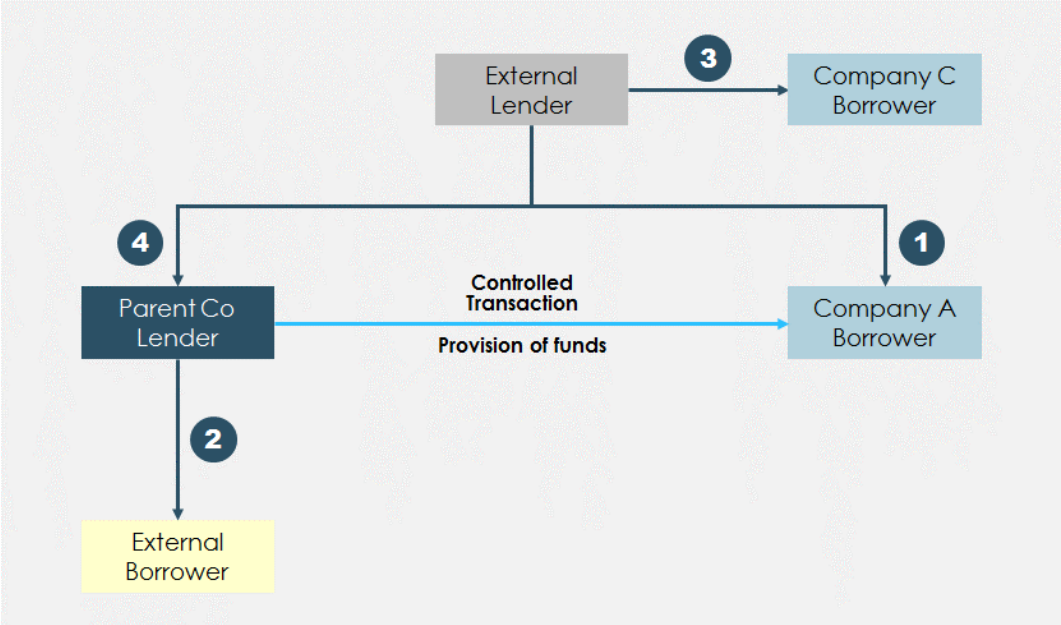
Given an exemplary intercompany provision of funds granted by the parent company P to a related company A (the controlled transaction), here below we describe four examples of internal CUPs, ordered according to their degree of comparability (see also Figure 2).

- **External transaction no. 1**: loan provided to company A by an external lender L. In this situation, we consider the comparability to be the highest, given the same borrowing entity with the same creditworthiness.
- **External transaction no. 2**: loan provided to an external borrower B by the parent company P. In this situation, B serves as a comparable borrower to company A, assuming that its profile (i.e. credit rating) is sufficiently similar.
- **External transaction no. 3**: loan provided to an associated company C (part of the same MNE group) by an external lender L. In this situation, the transaction can be considered as an internal CUP, assuming that the profiles of the borrowers (company A and company C) are sufficiently similar, although none of the related companies involved in the intercompany financial transaction is part of the independent one.[2]

[2] Although this transaction cannot be strictly considered as an internal comparable uncontrolled transaction, following the wording included in the Glossary of the OECD Guidelines (Page 24), it may represent a valid reference to compare the controlled transaction, since one of the parties to the independent transaction (company C) is part of the same MNE Group.

- **External transaction no. 4**: "pass-through" loan provided to the parent company P by an external lender L. This situation is considered to be less comparable, as the parent company's profile is unlikely to be sufficiently comparable to company A's profile.

Figure 2
Exemplary internal CUPs



Referring to the question in Box C.7 of the Discussion Draft, in our opinion the MNE group's average interest rates paid on external debt may be considered as a proxy of internal CUP when the characteristics of the external loans (in terms of amount, maturity, currency, etc.) are sufficiently comparable to the controlled transaction under analysis.

For clarification of any aspect of our responses presented above please contact:

Hendrik Fügemann	Partner	hef@copenhageneconomics.com
Vincenzo Zurzolo	Senior Economist	viz@copenhageneconomics.com
Charlotta Zienau	Economist	chz@copenhageneconomics.com