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MACFARLANES

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Dear Sir/Madam,

1. We write in response to the request for comments on the Discussion Draft on Financial transactions (BEPS Actions 8 -10). The comments presented in this letter are by Arendt, Arthur Cox, Chiomenti, Cuatrecasas, Gide Loyrette Nouel A.A.R.P.I., Gleiss Lutz, Homburger, and Macfarlanes LLP.

2. The pricing of financing transactions is highly complex and often highly contentious as evidenced by the fact that there have been high profile disputes in this area. Overall, we believe that the Discussion Draft does provide useful guidance on the transfer pricing of financing transactions. In our view, the key point in the Discussion Draft is that a financing transaction should be analysed in such a way as to accurately reflect the capital structure of a MNE as it pertains to a tested party and the wider group it belongs to.

3. Section B.2 provides some helpful guidance on economically relevant characteristics that should be taken into account when delineating financing transactions. The Discussion Draft makes it clear that the guidance provided is not intended to prevent countries from implementing approaches to address matters of capital structure and interest deductibility under domestic legislation. It follows that, in this sense, domestic legislation and practice precedes the application of this Discussion Draft and we are of the view that this should be more clearly set out within the Discussion Draft.

4. Box B.2 raises the question with respect to the relevance of the maximum amounts that a lender would have been willing to lend and a borrower would have been willing to borrow. Whilst it is accepted that both parties would structure the debt financing of the transaction at the maximum amount that a lender would be willing to lend and the maximum amount a borrower would be willing to borrow, it is less clear how the context for the analysis should be set out and to what extent (and how) its various elements should be prioritised and weighed against each other. For example, to the extent that a transaction requires surplus funding above the level of debt capacity established by the maximum lending and borrowing amounts, such surplus should be delineated as equity for transfer pricing purposes in the context of calculating ratios such as gearing ratios and liquidity ratios. However, the Discussion Draft should more clearly and explicitly confirm the type (and order) of analysis needed in order to perform a proper transfer pricing view of what properly constitutes debt as opposed to equity. Consequently, it is our view that the guidance provided under Paragraph 17 should be further expanded to stress that a proper debt/equity analysis relating to a tested party's capital structure is necessary.

5. Box B.3 – the Discussion Draft invites comments on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction. In our view, the Discussion Draft already provides sufficient guidance on this. To summarise the key factors that should be considered:

   5.1. Factors that a ***lender*** will take into account



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5.1.1. ability of the borrower to repay interest and principal on the loan based on future cash flows of the business;

5.1.2. credit risk of the borrower;

5.1.3. macroeconomic conditions;

5.1.4. cost of capital associated with the financing arrangements; and

5.1.5. terms on the loan including covenants, guarantees and security.

5.2. Factors that a ***borrower*** will take into account

5.2.1. borrower's ability to repay interest and principal (i.e. solvency and liquidity risk);

5.2.2. the terms of the loan including covenants, guarantees and security;

5.2.3. cost of capital associated with the financing arrangements; and

5.2.4. other options available such as equity financing.

6. Section B.2 makes it clear that a functional analysis should not only focus on the functions performed by the borrower but should also provide information on the functions performed by the lender. The functions performed by a lender are often overlooked when delineating financing arrangements because in most cases a related party lender performs limited functions. It is very helpful that the Draft Discussion acknowledges the fact that it is reasonable for a related party to perform limited functions when compared to a third party lender.

7. Section B.2 does acknowledge the wide variety of financial products and services in the open market which is helpful.

8. An important clarification that should be provided concerns the granting of capital contributions. According to the OECD Transfer Pricing and multinational enterprises Report of 1979, capital contributions made to a controlled company by its parent were deemed to be legitimate, although not being productive of interest. Indeed, capital contributions were not to be considered an exception to the general principle of remunerability of interest-free funding for transfer pricing purposes, but as a different and specific case. On this issue, it would be appreciated if the OECD would expressly undertake that capital contributions do not fall in the general principle of remunerability for transfer pricing purposes being not comparable to loans from a juridical and economic standpoint.

9. Box B.4 – currency risk is highly complex and the treatment of currency risk will differ on a case by case basis. Hedging arrangements may affect the willingness of a borrower/lender to enter the financing arrangements. In our opinion the guidance provided in section C.3 is helpful however it would be useful if further guidance is provided on the pricing techniques that can be used in the context of hedging arrangements and examples of the pricing of such arrangements.

10. Box B.5 – in our view it is generally accepted that government securities are the most appropriate proxy for the risk free rate. There are few alternative measures for a risk free rate but it could be argued that interbank rates (such as LIBOR and EURIBOR) are an informative alternative. Inflation is an important component of a nominal interest rate however the Draft Discussion provides no guidance on the treatment of inflation. It would be useful to provide guidance on the use of real interest rates versus nominal interest rates and the treatment of inflation with respect to assessing the pricing of loan arrangements.

11. Section C.1.1 – we note that certain jurisdictions, for example the German Federal Ministry of Finance takes the view that only those terms and conditions of intra-group loans are at arm's length if the borrower and an independent bank or financial institution would have agreed upon such terms and conditions in a comparable situation on a specific financial market, taking into account the

mutual dependencies of currencies and interest rates. Whereas the borrower may choose the respective financial market at its own commercial discretion, the German tax authorities also compare interest rates paid on other financial markets to determine the arm's length rate, in particular, if such interest rates are lower than those paid on the chosen market. However, since value creation at the borrower's and the lender's level is always closely linked to the financial market on which they are doing business, section C.1.1. of the Discussion Draft should also mention that the financial market the borrower would have used, if no intra-group loan had been advanced, is relevant for the purposes of the comparability analysis. Further, the German tax authorities focus on the borrower's perspective and, consequently, on comparable debt interest rates an unrelated bank or financial institution would charge. However, as the lender might have alternatively deposited the loan amount advanced to the borrower on the account of another bank, the interest on deposits should also be considered determining the arm's length rate. The middle ground between deposit and lending rates might be adequate. The refinancing interest rate of a third party lender may also provide guidance.

12. Section C.1.1 – paragraph 52 suggests that granting of security over its assets is not necessary for a subsidiary which is borrowing from its parent because the parent already has control and ownership of its assets. It follows that if those assets are not already pledged as security to another lender, any parental loan could be priced as if it were secured. This is an important and controversial view point and it could be argued that such a view point contradicts with the arm's length principle.

13. Section C.1.1 – paragraph 54 seems to provide an example which will hold in very narrow circumstances. In our view, this example is controversial and vague and therefore it is our recommendation that this example should be deleted.

14. Section C.1.2 – credit ratings may provide potential comparables for loan transactions between related and unrelated parties. However, a rebuttable presumption that an independently derived credit rating at group level may be taken as the credit rating for each group member seems questionable. Credit ratings, inter alia, reflect the ability of the individual borrower to fulfil its payment obligations and the ability of the lender to enforce its payment claims, each from an economic perspective. Both depend on the individual financial situation of the borrower. Legally, only the borrower is obliged to repay the loan, and the lender can only assert its repayment claim against the respective borrower and not against the group as such. Therefore, the creditworthiness of the individual group company appears to reflect the credit default risk best and not the credit rating of the group as a whole. It seems rather unlikely that an independent third party lender would calculate the term and conditions of a loan contract on the basis of the credit rating at group level, presuming that the latter would correspond to that of the individual borrower. However, the credit rating of the group may affect the individual credit rating of the borrower in cases of implicit group support.

15. Box C.2 – in our view the proposal that the credit rating of any subsidiary can be assumed to be the same as that of the parent company of the group as a whole is incorrect. In our view this proposal contradicts the arm's length principal. It is unlikely that a credit agency or a bank would take such an approach, rather the credit rating of a subsidiary is likely to be estimated on a standalone basis and then adjusted for any implicit financial support (if any) or alternatively the credit rating of a parent is estimated and adjusted for a lack of group financial support. Finally, with the aim of determining the MNE group credit rating in the absence of a publicly-available rating, a largely accepted solution could be represented by analysing a set of key financial ratios at the group level (e.g., ROE, ROA, debt-to-equity ratio, EBITDA/debt, etc.) to be identified in advance by the OECD.

16. Box C.3 – a standalone credit rating of an MNE refers to the credit rating of a specific entity within the MNE group. When determining a standalone credit rating of an MNE, implicit support should not be taken into account and the standalone credit rating should be estimated based on the financials and operations of the specific entity on an arm's length basis. The *adjusted* standalone credit rating should take into account implicit support (to the extent it is applicable).

17. Box C.5 – a credit default swap is a derivative contract between two parties, a credit protection buyer and credit protection seller, in which the buyer makes a series of cash payments to the seller and receives a promise of compensation for credit losses resulting from the default – that is, a pre-

defined credit event. Credit default swaps can be used to manage credit risk and should be taken into account in scenarios where such derivative contracts are used to manage credit risk for intragroup arrangements. The role of credit default swaps in pricing of intra-group loans is highly complex. Broadly credit default swaps assist in transferring the credit risk from one party to another. Therefore it could be argued that a lender could assume higher levels of risk, if provided with the option to enter into credit default swap transactions. But lenders could be deterred from entering into such arrangements because of the associated transaction costs. In the open market, credit default swaps are typically over the counter products and the structure of such products vary for different transactions.

18. Box C.5 - economic models used to analyse credit risk include structural models and reduced form models. Such economic models are based on option pricing techniques and are commonly used by credit agencies to measure credit risk.

19. Box C.6 – realistic alternatives to intra-group loans include the following:

    19.1. third party loan financing;

    19.2. equity financing;

    19.3. convertible loan financing; and

    19.4. possibility of not investing in the project because of high financing costs versus the rate of expected return on the investment project.

20. Box C.7 – in our opinion, it is unlikely that an arm's length lender will estimate the interest rate on the loan as the MNE group's average interest rate paid on its external debt because such an interest rate is unlikely to take into account the credit risk associated with the financing.

21. Box C.8 - Physical and notional cash pooling structures imply financial relationships between the pool and each of its participants. The pooling benefits should be allocated to both, borrowers and lenders, since net depositors, even if they have a genuine capital risk across all net borrowers from the pool, may receive a higher interest rate from the pool than under short-term deposit agreements with independent banks. Cross-guarantees should not be required to constitute a pool, which is subject to specific transfer pricing guidelines, since cross guarantees would not occur between independent parties. However, in case the particular cash pooling arrangement in place provides for such guarantees, they should not have an impact on allocating the pooling benefits among the participants. The respective depositor's genuine capital risk should neither increase nor decrease if the pool participants grant security by cross guarantees, since debit and credit balances in the pool must always offset one another to keep the pool alive. Where an MNE is obliged to participate although it derives no benefits from the cash pool arrangement given the particular conditions, the participation itself would not meet the arm's length principles. From a tax perspective, any borrowing and lending under such an arrangement should not qualify as a cash pooling transaction. Whether the terms and conditions of such a transaction are at arm's length should be subject to the general transfer pricing guidelines for financial transactions.

22. Box D.1 - the German Federal Ministry of Finance takes the view that, as a general rule, financial guarantees at market conditions are a necessary prerequisite for any intra-group debt financing at arm's length. However, the presence of group support may substitute that prerequisite. Losses on debt financings which do not match the prerequisites of the arm's length principle would not be recognized for German tax purposes. The German Federal Ministry of Finance further ruled that guarantees may only be recognized if the guarantor has an economic reason of its own to guarantee the financial obligations of an affiliated company. Otherwise, the affiliate might not be entitled to deduct guarantee fees as expenses. The discussion draft should address those rulings.

23. Paragraph 153 – the Discussion Draft states that under the cost approach the additional risk borne by the guarantor is estimated by valuing the expected loss that the guarantor incurs by providing the guarantee. The Discussion Draft states that the popular pricing models can be used to price

guarantees including treating the guarantee as a put option and using option pricing models, credit default swap pricing models, etc. It will be very helpful if further guidance and examples are provided on the pricing of guarantees under the cost approach.

24. Paragraph 154 – it will be very helpful if examples are provided on the application of the valuation of expected loss approach using the CAPM model.

25. Paragraph 155 – it will be very helpful if examples are provided on the application of the capital support method. It would also be helpful to provide guidance on how the yield approach differs from the capital support method or whether such pricing techniques are economically equivalent.

26. Box E.2 – it will be very helpful if further guidance and examples are provided on the actuarial analysis that is required when conducting a transfer pricing analysis in the context of captive insurance.

Yours faithfully,

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