To	Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA	Date	Sep-18
From	KPMG LLP, United States	Ref	KPMG Comments on Discussion Draft on BEPS Actions 8-10, Financial Transactions
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Comments on Discussion Draft on BEPS Actions 8-10, Financial Transactions

KPMG LLP ("KPMG" or "we") welcomes the opportunity to engage with the Organisation for Economic Co-operation and Development ("OECD") regarding its draft guidance on financial transactions dated July 3, 2018 (the "Discussion Draft" or "guidance"). KPMG has considered input from non-U.S. member firms of KPMG International in developing our comments but submit on our behalf alone.

KPMG commends the OECD for engaging the transfer pricing and tax community in this project at an early stage.

Executive Summary

Our comments will directly address, and where relevant expand on, specific "questions to commentators" included in the Discussion Draft, reflecting the following major themes:

1. The accurate delineation of the actual transaction, as applied to financial transactions, must account for key differences in the nature of intercompany financial transactions and those involving tangible or intangible assets. This includes the fact that the financing function may be separable in tangible or intangible transactions, while it is at the core of a financial transaction. The OECD recognizes the importance of accurate delineation of the transaction, and therefore should take note that issues with such delineation based on misunderstanding of key features of financial transactions will lead to more disputes between taxpayers and tax authorities.

   KPMG recommends against specification of factors to be taken into consideration when delineating a financial transaction. Rather, guidance should allow taxpayers to characterize and defend the nature of their intercompany financial transactions according to their facts and circumstances. KPMG recommends specific edits to paragraph 11 of the guidance, as well as elimination of paragraphs 13-15.

   KPMG believes that an entity's capital structure should be respected unless there is evidence that it is outside the norm of market practices. The OECD should also clarify that any re-characterization of intercompany debt under an accurate delineation of the actual transaction approach is an arm's length issue subject to Article 25 procedures.

2. In most cases, the accurate delineation of a financial transaction should focus on comparing its terms, along with the financial capacities of the parties involved, to observable market benchmarks, largely respecting the contractual allocation of risks and responsibilities among the parties but for cases of clear and egregious distortions of those roles and the resulting pricing of the transactions.

   Where the terms of a related-party transaction depart significantly from market convention, or from the taxpayer's established policies when dealing with third parties, taxpayers may need to include in their transfer pricing documentation some justification for their terms and conditions. However, KPMG recommends against any rules that would automatically impose certain terms on transactions among related parties (e.g., covenants).

3. Consideration of implicit support in a lending or guarantee transaction, and its impact on arm's length pricing, should be based on the particular facts and circumstances of each taxpayer, and not follow from any "rebuttable presumptions" regarding the relationship between the MNE group's credit rating and that of an individual entity. Assertions of implicit support, by either taxpayers or tax authorities, should be based on thorough analysis or market evidence.

   KPMG recommends altering paragraph 67 and deleting paragraphs 68 and 69 of the guidance. We also suggest replacing paragraphs 70-74.

4. KPMG believes that there are many situations where opinions provided by third parties, such as banks or insurance brokers, can be helpful in determining arm's length pricing. Such indicators should not be pre-emptively ruled out. Rather, taxpayers should be allowed to advocate for such opinions on a case by case basis, based on the degree of rigour with which the opinions are established and the extent to which this approach can be shown to be more reliable under the facts and circumstances than alternative methods. Consequently, the OECD should consider revising paragraph 93 of the guidance.
5. Regarding cash pooling, the allocation of group synergy benefits is not typically taken into consideration when benchmarking deposit and lending rates. In most cases, the recommended approach would be excessively costly and data intensive, and should therefore be applied only in exceptional situations.
6. The OECD's draft guidance on captive insurance companies should be significantly revamped to better reflect the nature of risks that they tend to assume, the curbing role of regulators, and practically applicable pricing methodologies. Assessment as to whether or not a captive insurer exercises adequate control of risk should take into consideration unique features of the industry and market, as well as typical functional profiles for a captive.

The BEPS actions have helpfully renewed the focus on financing transactions in particular. The arms-length approach of the transfer pricing guidelines will overlap, and potentially conflict, with domestic rules on related party pricing as well as anti-hybrid and thin capitalisation rules. KPMG believes that the guidance in the Discussion Draft would in some cases increase the potential for disagreement with tax authorities. It is important that the guidelines provide clear rules and approaches to minimise differences and uncertainty. To the extent they arise, the guidelines should allow clear and speedy resolution of disputes.

Box B.1. Question to commentators

Commentators' views are invited on the guidance included in paragraphs 8 to 10 of this discussion draft in the context of Article 25 of the OECD Model Tax Convention ("MTC"), paragraphs 1 and 2 of Article 9 of the OECD MTC as well as the BEPS Action 4 Report.

Chapter I of the Transfer Pricing Guidelines discusses the role of risk in accurately delineating intercompany arrangements, including a functional analysis with respect to risk control and mitigation, the assumption of risk, and the financial capacity to bear it. KPMG agrees that accurate delineation of the actual transaction is relevant to financial transactions. However, any assessment of the management and control of risk, along with the accompanying key decision-making functions, must take into account the distinctive nature of these transactions.

Example 3 in the Transfer Pricing Guidelines (paragraph 1.85) describes a company which owns a valuable tangible asset while other group companies make key decisions regarding investment, utilization, exploitation, and disposition of the asset. The owner's contribution, therefore, is limited to financing the acquisition of the asset. Section D.1.1.6 of the Guidelines indicates that under these circumstances, the asset owner is entitled to no more than a risk free return. The returns on the business risks incurred in the transaction should be allocated to other group companies who control and manage that risk.

The risks incurred in a financial transaction are different from those pertaining to investments in tangible or intangible assets. The latter require a different sort of business decision making, throughout the life of the asset, with regard to commercial opportunities and strategies to exploit them, including marketing plans, delivery of the asset and associated services to customers, and eventually possible disposition of the asset or other resolution of the project. These key contributions can be separated from the financing role when the latter is only one aspect of the transaction. When it comes to loans, however, the financing role is at the core of the transaction, and that is where the key decisions are made. Further, a lender is usually able to avail itself of widely available, standardized, and disseminated market information when deciding on whether or not to extend financing, and at what terms. Those terms also govern the timing and circumstances of the asset's disposition (i.e., a

predetermined maturity date or prepayment option). Consequently, much of the decision-making responsibilities relevant to tangible or intangible assets is taken off a lender's hands. We cannot apply functional criteria relevant to risk management functions for non-financial assets to a purely financial transaction, and the guidance should explicitly recognize distinctions between financial transactions and those involving development, production, and exploitation of tangible or intangible assets. Accordingly, the OECD should consider altering paragraph 11 of the guidance to read:

11. *In determining the arm's length conditions of financial transactions, MNE groups and tax authorities should apply the principles of Chapters I-III of the OECD Transfer Pricing Guidelines ("TPG") in a way which reflects the commercial reality of these transactions as distinct from intercompany transactions involving tangible or intangible assets. Accurate delineation of a financial transaction should primarily concern the contractual terms of the transaction, compared with market instruments, and grant, for example, the ability of a related-party lender to outsource functions to the same extent as independent lenders in the marketplace without prejudicing its right to a market return.*

Paragraphs 13-15 can largely be eliminated.

KPMG does agree that a related lender should undertake certain risk management functions, appropriate to the facts of each case and the general nature of financial transactions.[1]

Even without key differences between financial and non-financial transactions, an accurate delineation approach for a financial transaction, particularly with respect to identification of economically relevant characteristics or comparability factors, is also limited by the availability of information on the relevant factors. For example, while the MNE group's business and funding strategies and the functions performed by the related lending entity may be discernible, the same is not likely to be true of any potential comparable transactions. If the comparable transactions are individual corporate loans, for example, we may be able to conduct some limited research into the funding strategies and other relevant economic circumstances pertaining to the borrower, but will likely have to rely on some conjecture regarding these factors due to lack of opportunity to interview the borrower's management. Similarly, we are not likely to have much visibility into specific functions performed by the lender. Such information will be even less available in the case of a standardized financing instrument such as a bond market issuance. Consequently, consideration of such factors in identifying comparable transactions will often not be possible, or will not lead to reliable results.

Even with sufficient information, the delineation features listed in the Discussion Draft are subject to varying interpretations by relevant parties, potentially leading to a divergence of conclusions stemming from the same set of facts. For example, companies and tax authorities are bound to disagree on the role and interpretation of industry life cycle, macroeconomic trends, or options realistically available to the borrower and lender. This risk is heightened if some countries deviate from the accurate delineation approach and evaluate capital structure under domestic legislation or practices.

KPMG therefore recommends against specification of factors, even in broad categories, to be taken into consideration when delineating a financial transaction. Instead, the guidance should allow taxpayers to characterize and defend the nature of their intercompany financial transactions according to their facts and circumstances, with a focus on readily observable attributes for which market comparability can be established, such as the contractual terms of the transaction and the financial capacity of the parties. The list of factors relevant to a comparability analysis will differ in each case; consequently, taxpayers should not be penalized for omission of any factor if they deem it not to apply to their circumstances (though of course a tax authority could disagree with such an assessment).

[1] Further to this point, the Discussion Draft acknowledges that financing transactions among related parties will often be characterized by functional profiles which differ from what would be observed among unrelated parties.

Finally, no matter what form the final guidance on accurate delineation takes, KPMG encourages the OECD to establish materiality thresholds for the guidance prescribed in the Discussion Draft. At present, the Discussion Draft seems to be geared towards a standardized and untailored approach requiring taxpayers to apply a series of complicated analyses and tests to all loans. We request the OECD to reconsider whether this is truly a practical approach; in particular, applying the guidance to the full extent as detailed in the Discussion Draft to relatively smaller loans, working capital, etc., would be overly burdensome to taxpayers. To potentially remedy this, we recommend that the OECD incorporate a 'prudent business management' type concept into the Discussion Draft, distinguishing the expected analysis required for different types and sizes of loans and acknowledging that the vast majority of financing activities between related parties may not warrant complicated or very detailed analysis (including regarding capital structure), which may be more relevant to larger loans (i.e., where borrowing capacity may be more of a factor).[2]

Risk of Double Taxation

Multiple views on arm's length capital structure are likely to lead to more double taxation situations, even if none of the relevant parties adopt an accurate delineation approach, and these disagreements may become intractable if Mutual Agreement Procedures under Article 25 of the OECD MTC are not applicable. Consequently, the OECD should reassert that capital structure is an arm's length issue subject to corresponding adjustments and mutual agreement procedures among relevant jurisdictions. While the Commentary to Article 9 of the MTC prescribes adjustments in "State B" to relieve double taxation when a transaction is "rewritten" by "State A" so as to increase taxable income,[3] the Commentary also suggests that an adjustment may not be due if State B does not agree that the adjusted profits in State A reflect arm's length dealings.[4] This question goes beyond the quantum of a potential adjustment, to the principle governing it. Consequently, OECD Guidance should clarify that re-characterization of intercompany debt under an accurate delineation of the actual transaction approach is an arm's length issue subject to Article 25 procedures.[5]

Similar clarification and assertions are needed with respect to national rules limiting interest deductibility under BEPS Action 4. Arm's length capital structure and interest rates remain highly relevant even as some countries adopt versions of Action 4 since any "fixed ratio" test can leave room for a significant amount of deductible interest payments, especially if paired with a group ratio test and the ability to carry over interest expense to future tax years. Formula-driven limitations on interest deductions are a separate and distinct issue from arm's length capital structure and interest rates, but may lead to disputes among taxing jurisdictions and double taxation of the corresponding income.

In this regard, it would be helpful to have a consensus on the effect of domestic safe harbour formulae. Some countries allow a safe harbour ratio for deductible interest. This tends to become a default maximum allowable debt and may or may not equate to an arms-length capital structure as envisaged by the draft guidelines. Although the two tests (an arms-length rate and allowable deductible interest) achieve different things, alignment of the two tests is at least desirable for consistency.

KPMG believes that a borrower's capital structure should be respected unless there is compelling evidence that it is outside the norm of market practices. In any transaction there are typically many

[2] We note it is very common for a large multinational group to borrow at the top parent level and then make the funding available to group entities. For such groups, there will inevitably be a multitude of intercompany funding arrangements, and significant compliance efforts would be required in order to apply the comprehensive analysis expected by the OECD.

[3] See paragraph 5 of the Commentary to Article 9 of the OECD MTC.

[4] Paragraph 6 of the OECD MTC Commentary.

[5] Some jurisdictions do not currently entertain tax disputes regarding capital structure, limiting their focus to the interest charge.

combinations of debt and equity that are consistent with arm's length behaviour, so capital structure cannot be policed by a one-size-fits-all approach or set of formulas.[6]

Box B.2. Question to commentators

Commentators' views are invited on the example contained in paragraph 17 of this discussion draft; in particular on the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow, or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than the total funding required for the particular investment.

KPMG agrees that a focus on the contractual terms of an agreement, the interaction of those terms with arm's length pricing, and a robust analysis of a borrower's ability to bear debt are necessary and appropriate. These are typical components of an intercompany financing transfer pricing analysis, and directly address the question of how much a lender would be willing to lend to a particular borrower on the basis of that borrower's credit worthiness.

The example in paragraph 17 prudently highlights good-faith financial projections of a borrowing entity over the life of an intercompany loan as a primary determinant of a lender's willingness to lend. Other measures of the borrower's creditworthiness, including a credit rating analysis, can also be useful. KPMG believes that any other consideration of a lender's willingness to lend, or a borrower's willingness to borrow, beyond an evaluation of a borrower's creditworthiness is bound to open the door to varying interpretations of the relevant facts. For instance, regarding the maximum amount that an unrelated borrower would be willing to borrow, alternative strategies for and sources of financing are not readily determined; two independent companies with similar characteristics can reach differing conclusions as to working capital needs, and optimal sources for that capital.

Similarly, evaluation of a lender's other investment opportunities is not likely to be fruitful. Investment opportunities are characterized by various combinations of risk and return. Every investor chooses where he wishes to be along that spectrum, and no one choice is objectively superior to any other as long as they are all on the "efficient frontier" of optimal risk/return combinations. If a related-party loan is priced at arm's length relative to the borrower's creditworthiness, with a return commensurate with the market's assessment of its risks, then it is by definition among the population of optimal investment choices for the lender (and acceptable to the borrower).

KPMG suggests that paragraph 17 of the Discussion Draft not include any reference to "the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow," while maintaining its focus on the lender's willingness to lend based on the borrower's ability to service the loan.

An emphasis on the borrower's ability to repay a loan, relative to comparable borrowers and market instruments, reduces the prospect that a transaction will need to be delineated as part debt and part equity. For example, a borrower's financial projections do not need to demonstrate an ability to pay off the full amount of a loan upon maturity, but rather a reasonable percentage of the principal. It is typically assumed in an arms-length scenario that the remainder of the loan amount can be refinanced. In situations where the analysis of a borrower's ability to service and repay a loan establishes a clear limit on borrowing ability, *partial* delineation as equity can be considered. For example, in their interagency guidance certain U.S. regulators (e.g., the Federal Reserve and the Federal Deposit Insurance Corporation) set expectations of borrower repayment at 50 percent of total

[6] The OECD should also consider the impact of a reclassification of debt to equity on other components of a company's capital structure. For example, how does such a reclassification impact *other* debt that may be *parri passu* with the impacted loan(s)?

debt over a five to seven year period.[7] This or a similar standard could be considered when evaluating debt characterization based on cash flow projections.

Box B.3. Question to commentators

Commentators' views are invited on the breadth of factors specific to financial transactions that need to be considered as part of the accurate delineation of the actual transaction.

Commentators' views are also invited on the situations in which a lender would be allocated risks with respect to an advance of funds within an MNE group.

Factors that need to be considered as part of the accurate delineation of the transaction should be largely limited to the contractual terms of the financing, along with the functions performed by the lender relative to uncontrolled lenders. Analysing debt capacity and pricing based on those terms will largely confirm that the actual transaction is accurately delineated.

A related lender would not necessarily be expected to undertake the same functions, at the same intensity, as an unrelated one (as the Discussion Draft notes – paragraphs 24 and 51) Much of the information that would need to be evaluated by an unrelated lender will be available to a related one due to its association with the borrower. Also, a lender that is part of an MNE group may have more opportunities to outsource certain functions to related parties (such outsourcing to be compensated on an arm's length basis, where appropriate). It is also possible for an unrelated lender to depend on an outside rating agency evaluation for a significant portion of its risk management functions, similar to the estimated credit analysis of the borrower that would typically be performed as part of a transfer pricing study.

While the Discussion Draft recognizes that a comparison of functions between related and unrelated lenders should take into account associations among MNE members, the allowance for lesser functionality expected of a related lender needs to be reconciled with the emphasis on KERT functions typical of an independent lender when accurately delineating a transaction.[8] KPMG believes that accurate delineation should emphasize the need for an affiliated lender to be in a position to, and actually make, informed decisions as to whether and on what terms to extend credit, while de-emphasizing certain support activities that might contribute to such decisions in an uncontrolled financing transaction (and could be outsourced by a third-party lender, for instance).

Whether or not an associated lender performs all of the functions of an independent lender, outsources some of those functions, or can circumvent them due to the availability of information within an MNE group, the lender should be attributed risks with respect to an advance of funds within an MNE group as long as it can be demonstrated, based on contractual terms and, where relevant, demonstrated behaviour, that the lender is the ultimate bearer of those risks. As discussed earlier, the criteria for adequate risk control functions are different for a purely financial transaction as compared to one involving a tangible or intangible asset, particularly so if the lender and borrower are related parties.

Relevant economic circumstances are normally taken into consideration when benchmarking a financial transaction. For example, taxpayers and transfer pricing practitioners should match or adjust for currency and timing of any comparable loans. In addition, comparables are usually identified for the same geographic region (or perhaps as part of a global financial market that is largely standardized). Where possible, industry/business sector are also matched, or relevant adjustments are applied. The reasons for the financing can influence the choice of comparables; for example, it

[7] Federal Reserve, et al. (2014) "Shared National Credits Program 2014 Leverage Loan Supplement", November 2014.

[8] Also, the examples of functions expected of a related-party lender appear to include non-KERT activities, e.g., organizing and documenting the loan (paragraph 24). Can these functions not be outsourced without impacting the accurate delineation of the transaction?

may make sense to benchmark loans used to finance acquisitions (or other similar projects) using market data on mezzanine debt.

Application of the accurate delineation approach to certain industries which tend to operate through branches merits careful consideration. The authorized OECD approach to computing business profits for a permanent establishment requires that it be treated as a functionally separate entity. Further guidance is requested as to whether this would obligate banks, for example, to determine the accurate delineation of transactions involving their branch operations, which could run afoul of strict regulatory standards in many jurisdictions. The OECD should consider an industry "carve-out" to the recommended approach, assuming it remains a part of the final guidance, for banking and other highly regulated industries.

Box B.4. Question to commentators

Commentators' views are invited on the guidance contained in this Box [regarding the risk free rate of return] 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.

KPMG disagrees with the Discussion Draft's assertion that, in cases where a funder lacks the capability or willingness to perform relevant decision-making functions to control the risk associated with investing in a financial asset, the funder would necessarily be entitled to "no more than a risk-free return," however determined. A lending entity, or indeed any entity that engages in transactions with other members of an MNE group, should be compensated for its functions and risks on an arm's length basis; however, there is no reason to believe that arm's length compensation will automatically equal a risk-free return as defined in Box B.4. Consider what would happen in the case of an actual default by a borrower; would any related entity other than the funder of a loan be directly impacted by the loss in principle, and therefore have a claim against the borrower? If that risk and responsibility fall to the funding entity, then a risk-free return would undercompensate it. Looked at from a different perspective, if the excess over the risk-free return is attributed to another entity, then that entity must also have the financial capacity to bear the risk of loss commensurate with risk-taking activities. Even if there is no risk of default, limiting a lending entity to a risk-free return may lead to perpetual losses there if the entity has to fund itself at higher than a risk free rate in the market.

It is more accurate to view a return based on a government security rate, for example, as a *reference rate* when benchmarking the total arm's length interest rate payable to a lender (one that adequately bears and controls the credit risk). That is, the arm's length interest rate would equal a risk-free rate plus a credit spread. The risk-free interest rate on its own is not, except by chance, equal to arm's length compensation for a funding entity which does not exercise sufficient control over risk.

With regard to identifying an appropriate risk-free return (as a first step in benchmarking an arm's length interest rate, not as compensation to a lender which does not perform risk management functions), KPMG offers the following observations:

- Currency risk can be eliminated by identifying a reference security issued in the same currency as the loan. If this is not available, then currency adjustments using swap market data can be helpful.
- Temporal proximity of the reference security to the tested transaction can allude to the date of issuance of a comparable security or of its pricing in the secondary market.
- We agree that the duration of a reference security should be matched to that of an intercompany loan to the extent possible, and note that duration, or time to maturity, can be adjusted using market yield curve data.
- A short-term financial instrument which is consistently replaced with a new instrument could under some circumstances be accurately delineated as a long-term loan, but it may be difficult to justify such a delineation unless the borrower and the lender are obligated to allow the replacement.

- In a case where more than one government issues securities denominated in the functional currency of the loan in question, the choice of risk-free instrument should reflect risk factors attributable to the borrowing entity, including relevant aspects of country risk, rather than always be equal to the lowest rate of return available.

Box B.5. Question to commentators

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.

Realistic alternatives to government-issued securities to approximate risk-free rates of return, i.e., rates that reflect overall market movement regardless of credit risk, include swap rates and the London Inter-Bank Offered Rates (LIBOR), to be used as reference rates in pricing loans (i.e., as a component of the risk-adjusted rate of return), depending on the tenors and other terms of the loans in question. The U.S. Prime Rate, or analogous indicators in other countries, are also sometimes used as a base to price loans.

Another alternative is the SOFR (Secured Overnight Financing Rate), a U.S. short-term borrowing rate which is expected to replace LIBOR by the end of 2021. For transfer pricing purposes, SOFR has the advantage of reflecting actual transactions, while LIBOR is determined through surveys of participating banks.

Box B.6. Question to commentators

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.

The scenario described illustrates the potential for double taxation of income associated with financial transactions due to divergent views held by the relevant jurisdictions, as well as the arbitrary grant of a risk-free return to the funding entity. Assume that the borrower is in Country A, the funder is in Country B, and a third related party which performs key risk management functions is in Country C. Assume further that the taxpayer follows the guidance of the Discussion Draft and takes the position that the funding entity is entitled to no more than a risk-free return. The balance of an arm's length interest rate, which compensates for bearing of the credit risk, would then go to the Country C provider of risk management functions. However, if the Country B tax authority disagrees with the taxpayer's delineation of the transaction, the whole of the interest payments could be taxed by Country B, partly duplicating the credit risk component taxed by Country C. Further, in case of default, the taxpayer's position would obligate the Country C entity to bear the losses, although the contractual funding entity is in Country B.

If the taxpayer instead assigns a routine return to the service provider in Country C, allocating a greater share of the total interest to the funding entity in Country B, the Country C tax authority could potentially apply the guidance of the Discussion Draft and impose an upward adjustment to Country C taxable income, perhaps with no offsetting downward adjustment for Country B.[9]

[9] If opposing perspectives on the functions and risks of the entities involved in the lending process call into question the beneficial ownership of the interest payments, issues outside of transfer pricing may be raised (e.g., withholding tax, anti-hybrid rules).

The risk of these types of distortions may be heightened by an accurate delineation approach applied to financial arrangements but reflecting business and economic realities of non-financial transactions. As we stated in our response to Box B.1., it is not clear that procedures under Article 25 of the OECD MTC will be available to address any resulting points of controversy arising among the jurisdictions involved.

Box C.1. Question to commentators

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.

Situations where each member of an MNE group has full autonomy over its financial transactions are not uncommon. KPMG interprets this to mean that each member makes autonomous decisions as to whether and how much to borrow/repay loans, and under what terms. Funds can be supplied by other individual MNE members with excess cash, but more likely from a centralized treasury operation (which sources its cash internally or externally).

For example, a group treasurer can administer a revolving credit facility, with each member making independent decisions as to how and when to utilize that facility. Borrowing terms would be agreed to, or set by the treasurer. The primary operating entities could enjoy a high degree of autonomy in how and when they use the facility, including the option to look to outside sources of capital for better terms. External financing policy would likely be set and managed by the treasurer, with varying degrees of input from the borrowing entities. Smaller or less important entities in the MNE structure may not be able or willing to assert the same level of independence.

A variation would be a notional or physical cash pooling system, though that would likely raise the level of interdependence (and reduce the degree of autonomy) among the MNE members in that the terms of the transactions would tend to be more uniform.

Considerations for Banking

It is important to note that treasury operating models vary widely from one group to another. One industry where treasury operations are complex is regulated financial services, in particular banking. The treasury function in a bank is closely integrated with nearly all other functions of the bank and plays a key role in managing some of the principal risks that the bank faces, such as interest rate risk and liquidity risk. Another circumstance to factor in is that regulators closely oversee the treasury function; their review ranges from approving internal models to agreeing to operational aspects of the function. It is therefore imperative that a detailed functional analysis be performed before concluding on the appropriate transfer pricing methodology, taking into account the specificities of the banking industry and the impact of government regulation, as required by paragraph 13 of the Discussion Draft.

Box C.2. Question to commentators

Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

- A rebuttable presumption that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate, subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member;
- A rebuttable presumption that tax administrations may consider to use the credit rating of the MNE group as the starting point, from which appropriate adjustments are made, to determine the credit rating of the borrower, for the purposes of pricing the interest rate,

subject to the right of the taxpayer or the tax administration to establish a different credit rating for a particular member.

Commentators' views are invited on the use of an MNE group credit rating for the purpose of tax certainty and tax compliance to determine the credit rating of a borrowing MNE.

Commentators are also invited to provide a definition of an MNE group credit rating, how an MNE group credit rating could be determined in the absence of a publicly-available rating, and how reliable such a group credit rating would be when not provided by a credit rating agency.

In the absence of explicit guarantees, from a parent company or perhaps through a system of cross guarantees involving at least the major operating entities in the MNE group, KPMG does not agree that there should be a *rebuttable presumption* that an independently derived credit rating at the group level should be applied to each group member, or used as a starting point. This approach would *start* with the assumption that each group member is equivalent, or nearly so, to the group as a whole, even though members can vary significantly in terms of revenues, assets, and other key financial measures, as well as their importance to the global business. Whether or not a group member's credit rating should be established by direct reference to the group rating can be determined by market evidence and/or careful analysis of the MNE's business and industry, as well as the relationships among the relevant members of the group.

Situations where the group rating can accurately be applied to individual members, or act as a meaningful starting point to determine the credit rating of an individual borrower, are possible and, in some cases, may be desirable, but should not be assumed as a norm. Specification of a rebuttable presumption may place undue onus on taxpayers to refute a position which does not accord with their facts. Instead, taxpayers should be allowed to base their analysis and conclusions on their specific circumstances, including if those circumstances support the OECD recommended approach.[10]

A stand-alone credit analysis for a borrowing entity, using commercial credit rating tools and leveraging rating agency views as appropriate, can in many cases provide the foundation to benchmark an arm's length rate for an intercompany loan. Factors which may indicate a degree of internal support meaningful enough to impact a credit rating, and therefore the pricing of a loan or other financial transaction, should be considered but are unique to each taxpayer and the MNE group members involved.[11]

KPMG suggests that paragraph 67 of the guidance be edited to read:

67. The question of implicit support due to group association is a difficult one, though worthy of consideration. In pricing an intra-group loan, the borrower is viewed as an independent enterprise. This does not mean that the presence of the rest of the group is necessarily ignored. Therefore, the potential impact of passive association on creditworthiness and other terms should be taken into account when there are compelling reasons to believe that an unrelated lender would consider it. These reasons could include, for example, pricing of previous loans from unrelated parties which reflected an enhanced credit status of the borrower, or of an affiliated entity, relative to what a stand-alone analysis would have produced. Similarly, the past behaviour of a group as regards providing support can be a useful indicator of future behaviour. It is also possible that a comprehensive economic analysis of the company, its strategies, and its markets, in the context of the industry in which it operates, can support a conclusion that an individual entity would be expected to benefit from a certain amount of support from the group, given that entity's functions and contributions to the overall business. Taxpayers are free to express and support such reasoning (as are tax authorities); otherwise, an assessment of the borrowing

[10] The principle of group support is accepted by some, not all, credit rating agencies.

[11] Guidance from rating agencies on parent-subsidiary links may be taken into consideration when applicable.

entity's capacity to service the debt and the contractual terms of the loan – such as term, currency, security, covenants, and so forth – should be determinative.

Paragraphs 68 and 69 of the guidance can largely be deleted.

An analysis such as that described in KPMG's proposed new paragraph 67 would ideally be a thorough one, taking into account all available information (potentially including informed and detailed bank opinions regarding interest rates that would be charged to individual entities[12]) Otherwise, determining interest rates under the assumption of some degree of implicit support when none is forthcoming raises the risk of undercompensating the lending entity, which may not be able to depend on anything beyond the financial resources of the borrower in times of economic distress, thereby potentially distorting the allocation of capital among an MNE group.

Nevertheless, the guidance should recognize that a high volume of intercompany lending activity, perhaps combined with limitations on available financial data at the entity level, may make application of a group rating approach unavoidable, at least for some borrowers, even without evidence or analysis indicating that an unrelated lender would take implicit support into consideration. In some circumstances, corporations might have frequent low value / short term loans, so some sort of notching down approach may be considered as a potential quasi safe harbour to reduce the burden of having to perform detailed analysis for numerous simple / uncomplicated loans. When it is impractical to perform credit analyses on a large number of borrowers or loans, taxpayers should have the option to focus their analyses on the largest transactions or most active borrowers, while applying notching concepts to 'fill in the gaps' in evaluating borrowers and loans for which the same level of analysis would be overly burdensome or not possible (e.g., due to lack of sufficient financial information). Credit ratings and loan rates for these entities can be calibrated against the larger transactions, if possible, through a combination of quantitative and qualitative factors, and the rationale for conclusions reached should be included in transfer pricing documentation. However, we do not consider that this should be an overriding concept that is mandated or applied to all loans.

The MNE group credit rating is most reliably assigned by an outside credit agency. If no public rating has been assigned, then, as with an individual entity, the group rating can be determined using a commercial tool or equivalent, applied to the financial results of the group as a whole. (See our response to Box C.3 below.)

Box C.3. Question to commentators

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

Commentators' views are invited on the effect of implicit support as discussed in paragraphs 68 to 74 of the discussion draft, and how that effect can be measured.

The stand-alone credit rating of an MNE is based on its ability to meet financial obligations with no help from another party, related or unrelated. The stand-alone credit rating can be determined using commercially-available tools, such as from Moody's and S&P, or is assigned by a public credit agency. A public credit rating is relatively rare for a single member of an MNE group; consequently, it is important to understand how a stand-alone credit rating analysis can be performed absent a credit rating by a rating agency. The work performed by rating agencies when assigning a credit rating to an issuer (or a particular instrument) is very different from the outcome of some of the tools in the market. However, practitioners have developed some best practices in estimating stand-alone credit ratings using available market tools in order to be able to judge whether the result is reasonably comparable to the outcome of a full blown rating analysis by agencies. Many tax authorities use these tools for their own analyses.

A rating agency analysis can focus on a particular issuance or on the issuer as a whole. In the first case, the analysis issues a view of how likely investors in a particular instrument are to recover their

[12] See our response to Box C.7.

investment and the agreed interest. The second case assesses the general credit worthiness of an issuer over all its outstanding debt obligations. In assessing the credit worthiness of a group or a company, the rating agencies undertake a combination of quantitative and qualitative steps. This generally involves an analysis of the financials of the company, including projections; stress test analysis of those projections; and key current and projected financial ratios. The process also involves interviews with management to understand a range of issues affecting the company from key markets, primary suppliers, strength of management team, etc.

Different agencies would have slightly different approaches, but some key areas worth considering are whether the agency allows for the rating of a company in a given country to be above that of the Sovereign issuer, and whether a group company can have a credit rating above that of the group. There is no consensus on those two points by the credit agencies so even with an independent rating we could see a wide range of results for a given company or debt issue, depending in part on whether those two constraints to the rating analysis are imposed or not.

Credit Rating Tools

The available tools in the market provide a good way of estimate the credit worthiness of a stand-alone company. It is worth nothing that some of them such as the ones licenced by Moody's and S&P are often used by banks to determine credit worthiness of companies that do not have an independent credit rating and where internal models cannot be applied. In broad terms, the credit rating tools work as follows:

- Financials of the company are input into a model;
- The model produces an estimate of the expected default frequency ("EDF") for that company. This result can be adjusted by reference to the economic cycle; and
- The EDF for that company is mapped against a credit rating.

The models used are generally based on detailed statistical analyses. Explanations of the models are available from the providers in a sufficient level of detail for users to understand that the output is based on solid economic and statistical principles.

It is best practice to perform a series of corroboratory checks to the output of the models, if data is available. Some high level statistics that allow a mapping of financial ratios to credit ratings are available from different sources, so it is possible to check that the results are reasonable. The tools also produce a detailed sensitivity analysis so that it is generally possible to see what variables have the most impact on the credit rating. It is also important that practitioners perform relevant adjustments to the company financials to ensure that all variables that are affected by transfer pricing are reflective of arm's length pricing.

A general observation: The scope of any such analysis applied to a particular entity or transaction depends on the availability of the needed data, required resources, and the materiality of the intercompany payments, among other factors. As mentioned earlier, the OECD should allow for practical approaches to analyzing and documenting financial transactions, including materiality thresholds, so as not to overburden taxpayers by obligating them to comprehensively cover all intercompany interactions even when profit shifting potential is relatively low.

As suggested in our response to Box C.2., the possible impact of implicit support on an MNE group member might be observed in situations where an MNE group member borrows directly from a third party without the benefit of a guarantee, i.e., by comparing the credit rating implied by the interest rate on the loan to the stand-alone credit rating of the borrower. The difference between the two ratings can then roughly be applied to each borrowing entity in the group. However, the impact of implicit support may vary materially from one affiliate to another, and even from one loan to another for the same affiliate depending on the facts. It is therefore problematic to impose a one-size-fits-all assumption regarding the credit rating of an individual entity (or loan) in relation to that of the group. This is where a company and industry analysis, as described in our response to Box C.2. (and our proposed new paragraph 67) could be helpful.

As we suggested earlier, paragraphs 68 and 69 of the Discussion Draft can largely be deleted.

Box C.4. Question to commentators

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

KPMG recommends that paragraphs 70-74 of the guidance be replaced with the following:

70. *Taxpayers should address the question of implicit support in good faith, reflecting and documenting their specific transactions and circumstances, with an emphasis on any market evidence to support an assertion of group support impacting the pricing of intra-group financial transactions. Transfer pricing documentation should include any information known by the taxpayer, and perhaps not available to tax authorities, pertinent to the taxpayer's conclusion as to the presence and impact of group support. Whatever evidence for group support is cited, taxpayers and tax authorities should consider whether that evidence reflects circumstances which no longer apply to the time period in which the tested transaction is entered into.*

Covenants

KPMG does not believe that it is appropriate to assume or impose the presence of incurrence or maintenance covenants in related-party loans if none are specified in the actual loan contracts. If we assume that, due to the relationship between the parties and/or the lack of information asymmetry, the equivalent of a prohibition against incurring additional debt exists, for example, that assumption can subsequently be contradicted if additional debt is indeed issued. The consequence is that the original loan would have been mispriced. In order for a loan covenant to be taken into consideration when pricing a loan, it should be specified from the start in a loan agreement, rather than assumed to exist due to the association between the parties. This would attest to the parties' intention to adhere to the restrictions of the covenants, which cannot be assumed simply because they are related parties. (Lack of information asymmetry does not reveal the intentions of the borrower and lender.)

Taxpayers should be able to structure internal loans as they wish, assuming the terms are reflective of market practices and can be reliably priced. Where the terms of a related-party transaction depart significantly from market convention, or from the taxpayer's established policies when dealing with third parties, particularly when such a departure has a meaningful impact on pricing, taxpayers may need to include in their transfer pricing documentation some justification for their terms and conditions. However, KPMG recommends against any rules that would automatically impose certain terms on transactions among related parties.

Paragraph 78 of the Discussion Draft can therefore be revised as follows:

78. *There may be less information asymmetry (that is, better visibility) in the intra-group context than in situations involving unrelated parties. However, the presence and impact of covenants (or other terms) in intra-group loans will not be assumed unless specifically included in the contract between the parties.*

Box C.5. Question to commentators

Commentators' views are invited on:

- the role of credit default swaps (CDS) in pricing intra-group loans;
- the role of economic models in pricing intra-group loans (for instance, interest determination methods used by credit institutions).

Unless we view the MNE group member's credit rating as equivalent to that of the group as a whole, CDS benchmarks may be of limited use in the absence of market data on CDS issued directly by the entity in question. Additionally, even if the applicable data exists, CDS spreads can be notoriously volatile and so may not be reliable indicators of underlying credit fundamentals. However, CDS spreads observed over a sufficiently long period, perhaps adjusted for business cycle, can be a useful indicator of the market's perception of risk for the MNE group as a whole, helping to identify a range relevant to their credit rating, currency, and tenor. This range may be useful for applying adjustments to market data pertaining to the borrowing entity, or as a floor for the spread to be applied to any individual group member.

Economic models can be reliably applied to intra-group loans, assuming that the correct inputs are available and accurately measured, and the models are specified in a way to mirror credit rating methodologies applied by rating agencies and/or corresponding commercial tools.

Box C.6. Question to commentators

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

For the identification of reliable comparable data, realistic alternatives to intra-group loans are mostly limited to i) loans between independent parties and ii) bond market investments. A member of an MNE group who borrows from a related party is not likely to also have loans from unrelated parties, as internal loans are usually the easier to obtain and administer. On the other hand, there is available data on loans between members of different groups (i.e., corporate loan data) from which arm's length pricing ranges can be derived. The difficulty with uncontrolled corporate loans is that they often include customized sets of covenants which can make them difficult to match or adjust to a particular intercompany loan.

Market bond yields reflect more standardized loan rates, for which differences having to do with tenor, currency, interest rate payment or reset schedules (e.g., fixed or floating rates), and embedded options can be adjusted to match the loan being analysed. Bond market data is often the most reliable way to reflect market rates in pricing an intercompany loan, but its relative anonymity hinders any effort to follow the OECD draft guidance and account for economic and business factors that impact accurate delineation of the transaction (another reason why consideration of such factors is impractical).

Box C.7. Question to commentators

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.

An MNE group's average interest rate paid on its external debt can, in theory, be considered as an internal CUP if we assume that each MNE member's credit rating is equivalent to, or at least closely aligned with, that of the group. As discussed above, however, the assumption of rating equivalence is a dubious one. Even if it were not, there would need to be adjustments for maturity and other differences in terms between the external and any internal debt. Moreover, average interest paid on external debt is often difficult to determine, particularly if attempting to apply that external cost to a specific intra-group loan whose terms and economic circumstances will usually differ from those pertaining to external funding.

However, if the proper adjustments are made, there could be situations where an MNE group's interest on specific components of its external debt can be used at least as a starting point for benchmarking rates on internal financing. One example is a cash pooling arrangement, particularly in the presence of parent or group cross-guarantees. Another example is the concept of a "financing club," wherein the affiliates of an MNE join forces and engage one company to source debt in the

market on behalf of all of them. In both these cases, significant adjustments need to be made when applying the external rate to transactions among affiliates.[13]

Alternatively, the cost of funds approach may be applicable in cases where a related party is acting as a conduit to an external lender, and the latter bears the credit risk.[14] If the credit risk is shared between an internal and external lender, however, then a cost approach is not likely to result in arm's length compensation for the internal party.

The Discussion Draft mentions the importance of "considering the lender's cost of funds relative to other lenders' operating in the market."[15] However, we are not likely to be able to determine the costs incurred by other lenders in the market, other than to assume that their cost of funds would be based on market rates. In that case, once we adjust for credit risk (including which party is bearing that risk), the cost of funds approach will largely reduce to a CUP methodology.

Bank Opinions

The extent of the Discussion Draft's admonishment against the use of bank opinions to price loans (paragraphs 92 and 93) needs to be refined. The quality of such an opinion can vary, depending on the extent of any analysis performed by the bank in support of it. A superficial opinion which does not consider the actual facts of a transaction, including the financial capacity of the borrower and any entity supporting it, is not likely to be indicative of market pricing. However, an opinion which does explicitly consider those facts and evaluates them according to broadly accepted standards of credit analysis may be the best indicator of arm's length pricing (including by providing a reliable quantification of the impact of group support). KPMG therefore suggests that, rather than impose a broad prohibition, the OECD should recommend that tax authorities allow taxpayers support their positions with such opinions, noting that the weight given to such evidence should be based on the degree of rigour and clarity of underlying evidence provided therein.

Consequently, the OECD should consider revising paragraph 93 of the guidance as follows:

93. A bank opinion may be a reliable indicator of arm's length pricing if it can be demonstrated that the opinion is based on a rigorous analysis of the facts and circumstances of an intra-group loan, including key elements of the due diligence process that the bank would follow in the case of an actual transaction. Evaluation of the reliability of such opinions relative to that of market data on actual transactions between unrelated parties should follow the criteria in Chapter III of the Guidelines.

Box C.8. Question to commentators

With respect to the operation of a physical cash pool, commentators' views are invited on the situations in which a cash pool leader would be allocated risks with respect to lending within the MNE group rather than as providing services to cash pool participants coordinating loans within the group without assuming risks with respect to those loans.

Commentators' views are also invited regarding the three possible approaches that are described in the draft for allocating the cash pooling benefits to the participating cash pool members, along with examples of their practical application. In particular,

- are there circumstances in which one or another of the approaches would be most suitable?;

[13] Cash pooling is discussed below.

[14] Paragraph 91 suggests that a related party acting as an intermediary to an external lender is entitled to the costs of that agency function, plus a markup, and not the costs of the "services." This confuses two different concepts, however; cost of external funds, which is relevant here, with costs incurred in providing underlying services which are facilitated by an agent.

[15] Paragraph 90.

- does the allocation of group synergy benefits suffice to arrive at an arm´s length remuneration for the cash pool members?;
- Whether, in commentators' experience, the allocation of group synergy benefits is the approach used in practice to determine the remuneration of the cash pool members?

Commentators are also invited to describe approaches other than the ones included in the discussion draft that may be relevant to remunerate the cash pool members.

The evaluation and pricing of risk in a cash pooling arrangement will depend on several elements of that arrangement, including 1) whether or not a third-party bank is involved; 2) if there is a third-party bank, whether it views the cash pool leader (CPL) or the individual entities as counterparties to loans; 3) the existence or absence of parental or cross guarantees (or possibly implied group support); and 4) the credit profiles of the cash pool participants.

To take a typical example, if a cash pool is administered with the involvement of a third-party bank, and that bank requires either a parental guarantee or a matrix of cross-guarantees from all participants in the pool, then the CPL is not ultimately responsible for net debit positions with the bank and so may be entitled to no more than an arm's length service fee. On the other hand, if the CPL is the sole counterparty to the bank, or if no bank is involved, then the leader would be entitled to a return commensurate with the credit risk that it bears vis a vis the pool participants. That return would mostly be reflected in the debit rates paid by cash pool participants, either equal for all participants (i.e., if guarantees are involved or implied,[16] or if the pool members have similar credit scores) or varying depending on individual credit ratings.

Cash Pooling Benefits

Whatever the risks and remuneration of the cash pool leader, the debit and credit rates may be impacted by group synergy benefits. As described in paragraph 125 of the Discussion Draft, cash pool benefits are based on 1) the deposit and borrowing rates credited/charged by the third-party bank, relative to the aggregate that would have been earned/paid by each cash pool member acting on its own (this is the "volume benefit"); plus 2) the group savings that result from netting the group's cash needs against internal surplus cash (the "netting benefit"). If quantifiable, this aggregate benefit may be allocale to each participant based on its contribution in generating it. A residual profit split approach could make sense, wherein routine functions are first rewarded, and the residual is allocated through a combination of premiums on deposit rates and discounts on borrowing rates.

Generally, pool benefits can arise from a combination of deposit and borrowing activities. Deposits make internal funds available to borrowing members, thereby reducing the need for external borrowing (netting benefit). On the other hand, borrowing from the pool contributes to the group's ability to access favourable rates from the outside bank on an aggregate basis (volume benefit). Note that pool deposits also contribute to the realization of volume benefits, for bank crediting rates, and pool borrowers aid in maximizing netting benefits by borrowing internally.

In practice, quantifying group benefits can be labour-intensive at best, and unreliable as well, since it requires determination of the deposit and borrowing rates that would be realized by each participant, at least the major ones, individually. Depending on the circumstances, this could in turn require individual credit analyses (along with consideration of the impact of implicit support). The Discussion Draft takes note of potential difficulties arising from a lack of needed information on the cash pool members (paragraph 108). In our experience, the allocation of group synergy benefits is not the approach used in practice to determine transfer pricing policy for a cash pool. Instead, deposit and

[16] The presence of cross-guarantees might lead a bank to view the cash pool participants as the ultimate counterparties to the loans, as opposed to the cash pool leader.

borrowing rates tend to be evaluated using more traditional pricing methods. Challenges in measuring pool benefits, including obtaining the needed information, likely contribute to this practice.[17]

Taxpayers should be allowed flexibility in supporting an alternative approach for allocating benefits, such as described in paragraphs 128 and 129 of the Discussion Draft, or in concluding that any allocation would be unnecessary or possibly distortive, depending on their particular facts and circumstances. For example, where the cash pool leader is largely responsible for generating the benefits, sharing those benefits among pool participants could lead to non-arm's length results. If benefits can be quantified and allocated, KPMG does not believe that it is necessary or practical to vary the proportion of benefit attributed to each pool member depending on the source of that benefit (e.g., run multiple allocation models), although individual taxpayers may want to adopt such an approach if it can be supported.

The challenges and costs involved in quantifying group benefits and adjusting individual pool deposit and lending rates accordingly should be taken into consideration in the OECD recommendations. Cash pools tend to operate on thin margins and are properly aimed at the most efficient transfer of cash within the pool. Requiring taxpayers to follow the recommended approach can generate costs that are significantly disproportionate to any countering of profit shifting. Consequently, the OECD could recommend that taxpayers address the potential impact of group benefits on their transfer pricing policies, including data and cost restrictions in taking those benefits into account, with application of the methodology described in the Discussion Draft reserved for cases where the benefits are likely to be significant and relatively easily quantifiable.

Pool Deposit Rates

In evaluating an arm's length deposit rates in a cash pooling arrangement, the concept of a so-called in-house bank risk premium could be adopted. This measures the effect of additional counter-party risk assumed by the intra-group depositor (e.g., with no guarantee protection) in comparison to depositing the funds with a regulated business bank (with a potentially higher credit rating). This in-house bank risk premium could be applied for deposit transactions to cash pool leaders with a poorer credit rating (e.g. if the MNE has a group credit rating in the speculative grade area).

Any deposit rates determined in this manner may or may not be adjusted for the impact of group benefits. (A significant deposit premium could significantly impact the presence and measurement of such benefits.)

Box C.9. Question to commentators

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.

If it can be shown that a particular MNE member is placed in a disadvantageous position by being compelled to participate in a cash pooling arrangement,[18] taxpayers and tax authorities can consider allocating a sufficient amount of pool benefits to that member so as to at least make it whole relative to reasonable alternatives for meeting its liquidity needs. This approach would have to be balanced against imposing unfavourable allocations of benefits to other group members, and can perhaps be partly justified by reference to the particular MNE member's contribution to the aggregate pool benefits (relative to the quantum of those benefits without its participation).

[17] As do the policies of individual countries when it comes to acceptable cash pooling debit and credit rates, policies which do not always reflect the overall nature and benefits of cash pooling arrangements.

[18] This may happen if the particular MNE member has a significantly higher stand-alone credit rating than the average pool participant, and there are no guarantees supporting the arrangement.

Alternatively, if a particular MNE group member is able to obtain more favourable rates on its own, outside of the cash pooling arrangement, and if allocating a sufficient amount of the benefits to it makes the arrangement uneconomical for other members, the taxpayer may need to consider excluding the particular MNE member from participation in the pool. In most cases, the existence of netting and volume effects will mean that the cash pool is beneficial to all members, and an MNE would not be expected to put in place a cash pooling arrangement unless there is a net benefit to the group.

The benefits to an individual taxpayer of the cash pool must be evaluated in a comprehensive manner. For example, it is sometimes the case that a cash pool member will have higher deposit rates available to it in the market, while it can take advantage of a lower borrowing rate within the pool. Consequently, evaluating its alternatives by looking only on the deposit side of the equation could miss the overall advantages of pool membership.[19] It is important to also note that pool benefits to any one member can vary over time.

Finally, KPMG agrees that situations where a cash pool member is always a depositor or lender call into question the accurate delineation of the arrangement. However, it may be important in such situations to consider alternatives reasonably available to the member. For example, a company may choose to maintain positive balances with a cash pool leader over a longer-than-usual period of time if it does not have access to higher returns in alternative investment vehicles. This behaviour may be more difficult to support with larger persistent cash pool balances.

Box C.10. Question to commentators

Commentators' views are invited on whether cross-guarantees are required in the context of cash pooling arrangements (physical or notional), and how they are implemented in practice, along with examples.

Commentators' views are also invited on whether cross-guarantees are, in effect and substance (even if not in written contractual form), present in cash pooling arrangements.

In KPMG's experience, third-party banks do often require guarantees to be put in place, either from the parent or through a system of cross guarantees by the pool participants, or both. Moreover, guarantees are increasingly being required under tightening bank regulatory frameworks such as Dodd-Frank and Basel III. This trend applies to both physical and, particularly, notional cash pools. As stated earlier, the likely presence of cross guarantees for notional cash pools could impact the characterization of the cash pool members as direct counterparties to the loans (as opposed to the cash pool leader).[20]

From a regulatory perspective, formal written guarantees will typically be required; implicit support by the group is not likely to be viewed as sufficient.

Box C.11. Question to commentators

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

[19] For this reason, KPMG believes that any kind of "floor" deposit rate is usually unnecessary. One possible exception could be to implement a 0% floor if the base rates are negative (as the Euribor has been in recent years). If the MNE can demonstrate that the contractual terms with its third party counterparties (e.g. banks) also have a floor, it would be reasonable to mirror these conditions also in the cash pool.

[20] If cross-guarantees are provided to third-party banks, some MNE have implemented via an intra-group agreement the order of liability if a credit event occurs. These would in a first step allocate the credit risk to the cash pool leader, and in a second step to the ultimate parent company. Only if these companies default, the other companies would be liable on the basis of their (cross) guarantees issued.

profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

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

If the group policy is to hedge all exposed positions, but that hedging is effectively accomplished through offsetting positions within the group (e.g., one MNE member long a position and another MNE member short the same asset), and assuming that the group hedging policy is set by other than the individual MNE group members (e.g., the parent), then accurate delineation of the transaction could impute intercompany payments between and among MNE group members to balance gains and losses (or between each entity and a centralized treasury operation) as the market value of the underlying asset fluctuates.[21]

If an exposed position remains for the MNE group as a whole after matching of internal positions, the treasurer could enter into a hedging contract externally to cover the risk, with the costs (including the treasurer's relevant internal expenses) spread among MNE members or allocated to the parent, based on an analysis of benefits.

On the other hand, if the policy is to not hedge all market exposure, then the consequences of movements in the value of the underlying assets accrue to an individual MNE member or to another entity in the group, depending on where that policy is set. For example, if an individual MNE member chooses to be exposed to market movements, and has the freedom to do so, then it should bear the risk of volatile markets. If instead the decision to bear risk is made on a group-wide basis by the parent, then the consequences of market movements belong there. In any case, accurate delineation of the transaction would impute corresponding intercompany payments to achieve financial results for all entities consistent with their functions, risks, and choices.

We encourage the OECD to consider what its expectations are – is the OECD requesting taxpayers to start employing very complicated financial modelling (e.g., Black-Scholes, options pricing) to price each hedge on an individual basis? We would consider this to be clearly inappropriate for most circumstances and overly burdensome, especially for mid-sized or smaller size companies lacking the resources for such efforts. Nonetheless, we do understand there might be ad-hoc cases that may call for bespoke analyses. As such, we request the OECD to state clearly its expectations on when more complicated approaches to hedging would be required and when more practical approaches (e.g., total return swaps) can be applied.

Box D.1. Question to commentators

Commentators' views are invited on

- how a related party financial guarantee should be accurately delineated in accordance with the guidance in Chapter I of the TPG (considering also, for example, situations where it could be considered as a provision of a financial service, the sale of a financial asset or as a simple treasury service associated with a loan);
- the circumstances in which a guarantee is likely to be insisted upon by an independent lender granting a loan to a member of an MNE group;

[21] Caution should be advised when recommending the imputation of payments given hedging gains and losses may be subject to specific tax rules (e.g., Treas. Reg. § 1.1221 in the United States) and the MNE member to whom hedging losses are imputed may not be able to deduct them.

- where guarantees are insisted upon by an independent lender who grants a loan to a member of an MNE group, how and why guarantees affect credit rating and loan pricing; and
- examples of the most frequent cases where borrowers obtain guarantees from independent guarantors when borrowing from independent lenders together with examples of the process or mechanism by which a price is arrived at.

A guarantee could be required by a third-party lender in situations where the loan is large relative to the perceived stand-alone financial resources of the borrower, and/or the lender does not detect an adequate level of implied internal support. A lender may also require a guarantee in order to reduce its calculated risk and regulatory capital requirements. If not required by the lender, a financial guarantee may be sought by a borrower (or imposed by the parent or another related party) in order to raise the borrower's credit rating (in effect, substituting the financial resources of the guarantor), thereby lowering the borrower's interest costs. It's also possible that a guarantee will help justify a larger loan (see below). [22]

A financial guarantee should be delineated and priced based primarily on how it would be priced in the market. In a related-party context, the pricing should reflect the benefits that it provides. For example, for a guarantee that results in interest savings for the borrowing entity, the fee can be benchmarked accordingly.[23] However, the benefits of a guarantee are not always measured by a reduction in interest expense. A borrower may pay the same interest rate with or without a guarantee, but is perhaps able to borrow a larger amount from a particular lender (as opposed to having to go to another lender(s)), or access capital in a different market (e.g., geographic or in terms of the financial product issued), or with less onerous information disclosure and administrative burden. In these situations, the financial guarantee confers tangible benefits which are not based on interest savings. Accurate delineation of a guarantee transaction generally requires determination of the compensation an unrelated guarantor would be entitled to given its costs and risks as well as the benefits realized by the opposing party. KPMG agrees that in some situations no benefits will be provided by the guarantee, though 'benefits' should be broadly defined.

Impact on Borrowing Capacity

A word about situations where a guarantee may be seen as increasing borrowing capacity beyond what would be "accurately delineated as a loan" (paragraph 140). KPMG believes that re-characterization of part of the transaction (e.g., as a loan to the guarantor followed by an equity contribution to the borrower) should be considered only as a last resort, i.e., if it can be demonstrated conclusively that the borrower would not have been able to obtain the full quantum of the loan under any circumstances, by accessing any global capital market, or through alternative financial products. A guarantee's benefit may be to provide the borrower with additional financing options, without increasing its overall borrowing capacity as determined by its financial wherewithal.

Implicit Support

KPMG agrees that, in theory, the value of the guarantee should be adjusted for the impact of any implicit support. (This may be particularly relevant for guarantees that raise credit scores and reduce interest expense.) However, as is the case with loan pricing, taxpayers should have the freedom to make a case for implicit support in a manner that is relevant to their business and circumstances. An important consideration is that a third-party guarantor would not necessarily give the same weight to affiliation as a third-party lender. When pricing a related-party guarantee, it is the perspective of a hypothetical unrelated guarantor that should count.

[22] It should also be noted that lenders will at times ask for parental guarantees as a matter of course, with no impact on the terms of the loan.

[23] As described in paragraphs 149-152 of the Discussion Draft.

Pricing

With respect to pricing methodologies for guarantees, we note that reliable market data on CUPs is unlikely to be available. The yield differential approach is typical and workable, assuming that the guarantee does result in interest savings. Taxpayers can determine, given their facts and circumstances, the portion of the interest savings that can be paid as a guarantee fee. (Tax authorities may want to consider providing safe harbours for this.) The cost, valuation of expected loss, and capital support methods can each be useful in some circumstance, though perhaps more likely to be hampered by data constraints.[24]

Finally, with respect to cross-guarantees, if the arrangements are pervasive throughout an MNE group, the impact might be to equate the credit rating of each individual member to the group rating. However, there may be tricky issues with respect to the benefits realized by each individual member versus their contributions.

Box E.1. Question to commentators

Commentators' views are invited on the following:

- when an MNE group member issues insurance policies to other MNE group members, what indicators would be appropriate in seeking to arrive at a threshold for recognising that the policy issuer is actually assuming the risks that it is contractually assuming;
- when an MNE group member issues insurance policies to other MNE group members, what specific risks would need to be assumed by the policy issuer for it to earn an insurance return, and what control functions would be required for these risks to be considered to have been assumed;
- 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; [and]
- 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.

KPMG appreciates that captive insurance transactions are among the financial transactions which the OECD set out to address as part of the BEPS project, and acknowledges that these transactions can raise specific transfer pricing issues for which guidance would assist both taxpayers and tax authorities. Section E of the paper would, however, be strengthened from substantial revision to ensure a proper application of the arm's length principle.

KPMG also notes that this section refers consistently to "MNE groups", which could in theory include insurance groups. The OECD has written extensively on the functions, risks, business strategies, etc., of the insurance and reinsurance industry in the Report on Attribution of Profits to Permanent Establishments Part IV (2008 / 2010). It does not appear to be its intention to address the industry again in this discussion draft, as it receives no specific mention. We recommend that the OECD clarify the extent, if any, to which the final guidance on captives should be applied to an insurance/reinsurance group. In our view, it should not be applied, and transactions between members of such groups should be dealt with under the general principles of the Guidelines and the

[24] Variations on these alternatives could be applicable to performance guarantees (which the Discussion Draft does not address).

specific guidance in Part IV, taking into account the regulatory approach to risk allocation in the industry as recommended by the footnote to Section D.1.2.1 of the Guidelines.

As a general observation, paragraphs 162 to 178 appear primarily concerned with documenting reasons why these transactions might be disregarded. The questions in Box E.1. continue the theme, being largely based on the implicit premise that there is an unusually significant hurdle to overcome before captive insurance can be recognised for transfer pricing purposes. Paragraph 163 refers to a captive as providing "insurance-type" services rather than insurance, paragraph 166 cites as a "frequent concern" whether the transaction is "genuinely one of insurance", and Section E.3. is entirely dedicated to the "existence of insurance." There are many more examples of this implicit challenge to the transaction itself.

This approach is not apparent for other financial or non-financial transactions, either in the current draft or the Guidelines, and does not appear to be necessary. The transactions should simply be considered on their own merits and logical conclusions drawn in the light of the Guidelines.

Scope

An insurance company provides a regulated financial service of insurance to policyholders. A captive insurance company is simply an insurance company whose main purpose is to insure members of the group of which it is a part, or their customers. It does not provide "insurance-type" services, it provides insurance. That is the legal form of the transaction, and to provide this service the captive insurer must obtain a regulatory licence from the country in which the insurer is domiciled and/or operates.

In our experience, such a definition is sufficient to identify the transactions and the companies with which guidance on captive insurance should be concerned. If unregulated intra-group transactions exist to which similar principles might usefully apply, that is a matter to be determined based on the facts and circumstances of those transactions, but they are not insurance.

Accurate Delineation

The steps required for accurate delineation are set out in the Guidelines at paragraph 1.60. Steps 1 and 2 should be relatively straightforward, as an insurance policy issued by a regulated insurer will define clearly the risks covered, the limits, deductibles, territory and many other relevant details.

Step 3 requires consideration of control of risk, including financial capacity, and the conduct of the parties. In the case of a regulated insurance transaction, a third party, the regulator of the captive's domicile, has a legally binding interest both in ensuring the terms of the policy are respected and that the insurer has adequate financial resources. A captive with insufficient capital to bear the risks it assumes, or which fails to honour its policies by paying claims, will lose its licence. (Further, we disagree with statements in paragraph 183 of the Discussion Draft that capital requirements of a captive are likely to be 'significantly lower' than an insurer writing policies for unrelated parties; as regulated insurers, captives will also be required to hold adequate capital to support their positions).

Furthermore, as in many areas of financial services, important insurance functions can be outsourced to third parties, both by captives and independent insurance companies. A professional captive manager will often be employed to handle claims payments, prepare regulatory returns and actuarial forecasts, etc., further ensuring the captive behaves as an independent insurance company would. The conduct of the parties is usually, in our experience, consistent with the policies written by the captive.

The key aspect of accurate delineation to be addressed is therefore control of risk, which is broadly the focus of the questions in Box E.1. KPMG believes the guidance in paragraph 166 of the Discussion Draft provides appropriate indicators for recognising control of risk in the captive. The board of directors and, in larger captives, the underwriting committee should understand the risks the captive is assuming and have access to the relevant information, for example. They should have the capability to perform decision-making functions relating to the insurance risks the captive assumes

under intra-group policies, and should actually perform those functions. Once again, it is likely to be a regulatory requirement that this is the case. The International Association of Insurance Supervisors states:

> "In the case of a captive that does not employ the services of an insurance manager, supervisors should require the board members and senior management of the captive to demonstrate that they have the required skills and experience to effectively carry out their roles, including appropriate underwriting and accounting skills.
>
> Supervisors should require that the captive's board of directors collectively possesses the skills, experience and knowledge to oversee effectively the insurance managers and any other outsourced service providers. The board should also demonstrate that it has a broad knowledge of the business being written and that the directors can individually properly exercise their responsibilities."[25]

A third-party captive manager may provide services and advice, and in some cases may conclude policies on behalf of the captive within pre-approved limits. If the board and its subcommittees where relevant perform the equivalent of the four risk control functions identified in chapter 1.70 of the Guidelines, they should be seen as exercising control in the same way as the fund in that example exercises control through those functions over the risks assumed on its behalf by the fund manager. The same logic applies where functions are outsourced to another group member.

Provided the captive exercises this degree of control, it should be treated as assuming the insurance risks under the policies it issues and therefore should earn an insurance return. Paragraph 1.97 of the Guidelines states "the test of control should be regarded as being met where comparable risk assumptions can be identified in a comparable uncontrolled transaction." Further, the insurance industry provides multiple examples of insurance risks being assumed on behalf of another entity by an independent third party; this is the case of Managing General Agents, for example, and, in the Lloyd's market, of Managing Agents and "Coverholders" on behalf of Syndicate members.

The effect on the treatment of claims, premiums and investment income of a determination that control is not exercised by the captive would be highly complex and potentially subject to conflicting assertions from tax authorities in multiple jurisdictions, depending on their view of where control is exercised or whether the transaction is recognised. MNE groups wishing to establish a captive do so in jurisdictions which have appropriate levels of supervision for such entities and local skills in the day-to-management and legal / regulatory requirements of captives. Many of these jurisdictions also have favourable tax regimes, with the result that the profits of the captive are taxed in the parent's jurisdiction under CFC rules or domestic law elections. If control of risk is asserted by a country which is neither that of the captive nor the parent, there is a significant risk of double taxation: once under transfer pricing in the country asserting control of risk, and again under CFC rules in the parent company. No relief under MAP would be available. This is a further reason why KPMG considers that control of risk should generally be recognised in the captive where it has met the standards required by regulators, with any valuable functions performed outside the captive jurisdiction being rewarded with an arm's length fee. We believe that there should be a high threshold for asserting that an externally regulated insurance company should be treated as lacking the level of control required by the Guidelines.

A related issue to recognise is that if claims are paid in return for premiums by another member of the group which is not a licensed insurance company, it is likely to breach multiple insurance laws in its territory. If other, non-licenced, group members participate in the captive's control of risk functions, they should therefore receive a commensurate reward for their functions but not be allocated the insurance risk and reward. This is consistent with paragraph 1.105 of the Guidelines, and with arrangements at arm's length for the services of third parties described above. We note, however, that at arm's length, Managing General Agents and others do not share in the 'downside' in the year

[25] Application Paper on the Regulation and Supervision of Captive Insurers, November 2015.

in which the insurer makes an overall underwriting loss; they may however have reduced income in future years under a 'claw-back' clause.

Role of Reinsurance

Reinsurers and direct insurers have different pools of diversified risk, and a different cost structure (being business-to-business enterprises), which can make it beneficial for a group to pool risk in a captive in order to access the reinsurance market. We also note that a captive which reinsures its risks remains liable to the policyholders in the event of failure of the reinsurer. It therefore assumes significant credit risk, for which it is required to hold capital. In the event that the risks are reinsured with a single reinsurer, capital requirements may be higher due to concentration risk. These factors are also recognised by insurance credit rating providers, and must be respected by those captives with an external rating. The reward of a captive which reinsures all its business should therefore not be limited to a services reward but should also reflect a reward for credit risk assumed.

Typically, however, the reinsurance will leave a higher level of deductible in the captive, i.e., the amount from the first dollar of loss to the level at which the reinsurer starts to pay claims, than the deductible each operating company would have to bear under a direct insurance policy. Captives typically provide direct insurance below this level in addition to the amounts covered by reinsurance, and necessarily retain that risk. 'Pure' reinsurance captives that reinsure 100% of the risk are less common than those that retain some risk themselves.

In addition, as insurance capacity varies in the market throughout the cycle, the captive may insure and retain risks for 'gaps' in the group's programme of insurance relating to the attachment points, as well as limits of the third party insurance or reinsurance cover or the number of 'reinstatements' allowed by third parties once a claims limit has been reached.

Where the captive insures and retains group risks for either of these reasons, KPMG believes the transactions should be respected and priced at arm's length, subject to the earlier comments on control of risk. It is therefore a concern that paragraph 173 suggests "the difficulty or impossibility of getting coverage for certain risks" should raise questions about the commercial rationality of the arrangement. We would suggest paragraph 173 makes this distinction clear, for example by referring to the difficulty of getting coverage for certain risks due to their nature, as opposed to difficulties relating to market capacity.

With respect to fronting companies and reinsurance captives, paragraph 177 states:

> "Captive insurers may not be able to deal with all risks in the same way as traditional insurance companies. For instance, certain insurance risks must be placed with regulated insurers as a legal requirement. This may lead to the use of a fronting arrangement…"

We disagree on two grounds: all insurance must be placed with a regulated insurer, not merely "certain risks", and 'traditional' insurers also use fronting arrangements. Fronting arises because many countries, or administrative sub-divisions, require certain risks to be placed with an insurer regulated in that country or sub-division, and do not allow insurers regulated in other territories to insure them directly. For example, a potential customer in Country A wishes to insure their property in Country A. An independent insurer, B Co, licenced in Country B wishes to offer insurance for the property. Under the law of Country A, Country A property can only be insured by a company licenced in Country A, but B Co only has a licence in Country B. A common solution is for B Co to arrange for an independent insurer in Country A to insure the property and reinsure 100% of the risk to B Co, retaining a commission or 'fronting fee'. Independent insurers can, in this way, assume insurance risks in far more countries than they have licenses, and regularly do so. 'Fronting' is in no way confined to captive insurance companies; they regularly rely on such an arrangement to satisfy the needs of the MNE of which they are a part, but this is also true of independent insurers with MNE clients. They are no more complex to price than intra-group insurance without a fronting company, contrary to the suggestion in paragraph 178.

Box E.2. Question to commentators

Commentators' views are invited on the relevance and the practical application of the approach described in paragraph 181 of this discussion draft.

Section E.5 raises a number of issues. Paragraph 180 refers to the availability of 'external comparables': insurance policies are generally private contracts and it is not at all clear where such external comparables could be found. Where, as is usually the case, internal comparables are not available, the most reliable price setting methods for intra-group insurance tend to be based on advice from professional brokers and insurers / reinsurers and actuarial methods. According to the facts and circumstances, these can then be complemented by TNMM methods as discussed below.

KPMG endorses an actuarial approach to pricing premiums, assuming the relevant data is available.[26] Actuarial methods are particularly relevant to life insurance and pensions, where premiums and benefits arise over long periods of time. They are also highly relevant to low-frequency, high-severity risks such as natural catastrophe, or risks such as cyber-crime and professional indemnity where pricing at arm's length is based on appropriate statistical distributions due to the limited number of data points on which to assess the risk. Actuarial approaches can also be important in modelling the impact of different limits and deductibles on the risks assumed by the captive.

It is important to note, however, that such approaches result in the 'technical' price for assuming the risk. Insurance transactions between third parties are also impacted by features of the market at any point in time, including the supply of capital to the insurance market and the insurance 'cycle'. For example, prices may rise ("harden") following severe losses in the market, as insurers attempt to recoup losses and insurance capacity is reduced. The arm's length price may therefore be higher than the technical price predicted by statistical models.

In many cases, MNE groups seek price quotes from insurance brokers when benchmarking captive premiums. These quotes are often based on deep knowledge of the risks and markets involved, supported by analysis of the captive's specific circumstances, including substantial data submissions by the insured of a kind and detail that would be required by a third-party insurer. They are often the most reliable indicator of arm's length pricing. Consequently, analogous to the case of bank opinions on loans (see KPMG's response to Box C.7.), we believe that the use of brokers' quotes should be explicitly recognized in the guidance among the benchmarking approaches available to MNE groups that include captive insurance entities. Taxpayers should be able to advocate for such opinions on a case by case basis, whether pricing loans or captive insurance premiums, based on the degree of rigour with which the pricing exercise is shown to be carried out and the extent to which this approach can be shown to be more reliable under the facts and circumstances than alternative methods.[27]

TNMM Method

Paragraph 182 suggests a comparable uncontrolled price can be arrived at by considering the captive's combined ratio and the investment return on its capital. This appears, in fact, to be the application of two TNMMs:

- the combined ratio compares a profit level indicator, underwriting profit, to a base which is premiums;
- investment return on capital compares a profit level indicator, the return to a base which is capital.

As noted above, a TNMM approach can be useful as a corroborative method, but this is not a CUP. KPMG agrees that return on capital can be a useful measure, and that this requires consideration of the level of capitalisation of the captive, while recognising that any insurance company necessarily

[26] If the captive is regulated, relevant data will be required and therefore should be available.

[27] A more general comment on the Discussion Draft – the OECD should clarify the extent to which guidance in one section of the paper applies to other sections or types of transactions.

requires a reasonable buffer in excess of regulatory minimum requirements. It should also be recognised, when considering the capital put at risk, that independent insurance companies generally underwrite a range of different classes of business, each with greater or lesser degrees of risk, i.e., volatility of claims volumes, but do not publish separate capital balances held against each line. Establishing whether a captive could reasonably hold less capital against the risks it has assumed therefore requires caution.

However, any approach based on the comparability of balance sheet or P&L ratios must take into account the nature and timing of the pattern of claims in the particular class of business underwritten. In insurance, an up-front premium is paid in return for the assumption of a risk, within certain financial limits, by the insurer. When that risk is realised, the insurer pays a claim, but the claim may well be in a future period: an example is third party liability insurance, where claims for injury may arise in the years following the period in which the premium is paid, sometimes after a period of dispute over the amount of the claim.

A further example is where insurance covers an event which is low-frequency but high severity in nature, such as a major fire in a factory or loss of control of an oil well. The captive may receive premiums for many years with no such incident arising. It will appear to have high profits and high return on capital in each of those years. A single incident, however, may give rise to claims equal or greater to all the profits in earlier years.[28]

Other types of insurance may give rise to large numbers of annual claims in a more predictable manner, known as 'attritional' business. Such business may have relatively stable ratios from one year to the next, with some variation due to market factors.

It is essential to determine the characteristics of the insurance underwritten with respect to the pattern of claims (as well as the reserves taken), and in most cases carry out a multi-year analysis. For low-frequency, high-severity claims, that analysis might extend over a longer period such as five to 10 years or more.

Group Synergies

Group synergies may arise where captives exist primarily to access the reinsurance market. These do not arise from collective negotiation. An insurer offered 10 similar factories to insure assumes considerably more risk than an insurer covering only one, other factors being equal, and there is no evidence to suggest that the premium would be discounted as might be the case in the bulk purchase of goods from a manufacturer. The price is affected by the impact on diversification for the insurer; it may in fact reduce diversification to assume the insurance of a large number of similar risky assets, making its portfolio of risks too heavily weighted toward a particular group of correlated risks.

In addition, any allocation of synergy benefits among insured entities runs the risk of inadequately compensating captives for the risks they assume, potentially running afoul of regulatory standards.

Terminology

The draft would benefit in a number of places from more careful use of language. In paragraph 162, a series of examples are given of ways in which an MNE group could "manage" risks. Some of these appear in fact to be alternative approaches to funding the consequences of the realisation of certain risks, e.g. "set aside funds in reserves", while "acquire insurance from third parties" is a way to mitigate risks. "Self-insure" is not defined, nor is it clear how it is distinguished from "simply elect to retain the specific risk" or indeed from "set aside funds" or "pre-fund potential future losses" (itself an obscure term).

[28] Reserves may be taken based on the probability of future losses. Depending on the jurisdiction, such provisioning may or may not be tax deductible.

The point of paragraph 162 is unclear. It appears to address policy at the group level, in which case the alternatives are to insure certain risks outside the group or retain these risks within the group.

Paragraph 176 refers to "risk distribution", a term closely associated with US case law around premium deductibility, where broadly it seems to designate whether group risks are combined with non-group risks. Otherwise, distribution refers to the statistical characteristics of a particular type of risk. The pooling of risks, as referred to in the definition in paragraph 166, is risk diversification and is recognised by regulators as giving rise to a diversification benefit. The same paragraph goes on to refer to risk diversification, arguing a captive insurer may lack it. Theoretically a captive insurer might lack risk diversification, for example if it writes a single policy covering one building, but if it pools multiple risks and those risks are not highly correlated, it achieves risk diversification in the same way as an independent insurer regardless of whether or not the risks are those of connected parties.

In general, the draft clearly shows the influence of domestic case law in a number of countries. This can be seen in the discussion on whether what captives provide is insurance at all, the section on 'agency sales', and other areas. While KPMG accepts that case law can sometimes provide useful insights, it necessarily concerns cases where taxpayer and tax authority have been unable to reach agreement. Often, it relates to extreme facts and circumstances and is not therefore representative of a majority of taxpayers' affairs. In the case of captives, we note that while tax authorities naturally wish to understand the substance of the captive and the commercial rationale for the transaction, in the majority of cases enquiries have focused on the pricing of premiums, and agreement has been reached. We would urge the OECD in its guidance to reflect this and place less emphasis on the extreme cases that are the subject of litigation.

Box E.3. Question to commentators

Commentators' views are invited on the example described in paragraphs 187 and 188 of this discussion draft.

Paragraphs 187 and 188 describe a scenario wherein Company A, a retailer of high value technology consumer goods, offers insurance policies to third-party customers. The carrier for the policies is a related party, Company B, which earns above-market profits while Company A retains arm's length commissions. The example concludes that Company A deserves the residual profits earned on the arrangement since they are largely generated through the advantage of customer contact at the point of sale; Company B should earn returns which are in line with those earned by independent insurers assuming similar risks.

If the functional analysis indeed confirms that customer relationships are the key drivers of profits, perhaps combined with Company A's acumen in jointly marketing the technology products with the insurance, as well as the relatively commoditized nature of the insurance, then the conclusion in paragraph 188 is probably correct. However, if the total premium charged to the customer is a third-party price,[29] Company A's excess profits would need to be sourced to point of sale or other marketing advantages. Further, assuming a competitive market for Company B's insurance products, Company A's advantages would have to be unavailable to Company B from other retailers.

Higher profitability in Company B could be justified if it offered non-standard insurance products which represent a significant share of the perceived overall value to customers (i.e., sales of the technology products would suffer appreciably without the ability to pair them with insurance protection that would be otherwise difficult to procure).

[29] Assuming the customer does not "overpay" for the insurance for the sake of convenience.

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