SwissHoldings
Verband der Industrie- und
Dienstleistungsunternehmen
in der Schweiz

Nägeligasse 13
Postfach
CH-3001 Bern

+41 31 356 68 68
info@swissholdings.ch
www.swissholdings.ch

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

Per Mail to: TransferPricing@oecd.org

Berne, September 7, 2018

BEPS ACTIONS 8 - 10 – Financial transactions

Public Comments by SwissHoldings, the business federation of Swiss-based multinational enterprises from the manufacturing and service sectors (excluding the financial sector).

Dear Madam/Sir

The business federation SwissHoldings represents the interests of 62 Swiss-based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the BEPS discussion draft on transfer pricing aspects of financial transactions:

A clear commitment to the arm's lengths principle also for financial transactions would be appreciated. Focus of the TPG should be the "right" pricing of financial transactions and not the right level of the capital structure as such. In order to avoid controversy in this complex area the burden of proof for potential re-characterization of transactions (e.g. loan to equity) should be on the side of the tax authorities and applied only in limited case. In order to minimize the compliance burden and risk of controversy, OECD should consider to introduce reasonable materiality thresholds and safe harbours for certain transactions.

The OECD seems to believe that tax payers have the possibility to access credit relevant data (e.g. at what conditions can a peer borrow money). For bonds, this data is public. But for loans or other financing instruments this data is not available, it is confidential and not shared.

Rating agencies do not have that information either. Instead, they rely on certain more or less sophisticated models which are usually derived from bond pricing models.

Tax authorities do have the advantage that they get access to the relevant data through their audits. Thus, they have a significant advantage compared to the tax payers.

Reliable data points can be collected for highly liquid bond markets such as e.g. "borrower in the healthcare industry, 1-year duration in EUR or USD". Loans however are often granted to borrowers in less liquid markets where comparables can hardly be found (e.g. a Latvian MedTech enterprise in EUR or a Malaysian speciality chemicals enterprise in Ringgit).

Conditions for long term loans are agreed at a certain point in time. In hindsight such conditions may look odd and potentially generate the impression that the financial transaction has been set up mainly for tax purposes. As a side note: In the context of Hard to Value Intangibles, OECD issued guidance in August 2018 and stated that ex post results can be used as presumptive evidence on ex ante pricing. The above is therefore not just a theoretic fear but reality. In practice, this leads to uncertainty and unpredictability for tax payers.

Ideally MNEs would have the possibility to access the relevant information at banks (e.g. conditions of loans granted to other MNEs, currency, duration and justification for the agreed interest rate). Alternatively, OECD could offer access to such an anonymised data base which it maintains for that purpose.

Specifically, we would like to provide comments on following questions and aspects:

Box B.1. –

Box B.2. Commentators views are invited on the example contained in para.17…

SwissHoldings comments: The example stated makes the overarching assumption that based on the facts and circumstances, no third party would provide a loan to Company B absent a clear demonstration of ability to repay principal amount through the good faith financial projections. This is not the case in many instances where refinancing as a likely outcome is acceptable, or a demonstration of ability to repay at least only partially repay principal. Furthermore, financial covenants may be inserted that require the lender under certain circumstance to liquidate certain assets in order repay principal amounts. Furthermore, the proposition that the 'excess' portion of the loan may be reclassified as equity is open to vast interpretation and will offer tax authorities a standardised way to challenge all financing arrangements. Additionally, this paragraph appears somewhat contradictory to statements made in B2 that question whether indeed the entire loan should be reclassified as equity (which it clearly should not).

Paragraph 19 rightly introduces the concept of the other "options realistically available" to both parties, as is now standard practice when considering other intercompany transactions involving sales of assets (e.g. IP). More guidance is needed however on whether the lender could have used the funds more profitably. This will not be the single determining factor, and the value of the return on the investment should be calculated also with reference to the lenders WACC or other such metrics.

Para. 20 introduces comparability analysis. This will rarely, if ever, be a practical option, largely due to large scale unavailability of what would be privately held data and facts and circumstance that would ever give a meaningful comparison.

Box B.3. Commentator views on the breadth of factors specific to financial transactions…

SwissHoldings comments: Para. 24 describes whether respecting a loan as debt should be influenced by the extent to which the provider of the funds performs the usual functions of a lender. This will not necessarily apply in common situations where a clean bond issuing SPV is established (for various reasons) operating purely under a parental guarantee which is, economically a substitute for capital at risk, in order to access the capital market.

Box B.4. –

Box B.5. –

Box B.6. –

Box C.1. Describe situations where, under a decentralised treasury structure…

SwissHoldings comments: Treasury lends itself to a centralised model, and this is generally adopted by many MNE's. However, whether centralised or not, the fundamental question has to be under general transfer pricing considerations, which itself will reflect the underlying treasury function strategy – provision of routine services and acting as a cost centre, or engaging in entrepreneurial risk taking, profit motivated speculative activity and putting at risk cost of capital. The rate of return should be tied back to the underlying activity, whether decentralised or not.

Box C.2. Commentators are invited to consider whether the following approaches would be useful for the purpose of tax certainty and tax compliance:

A rebuttable presumption that tax administrations may consider using 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 tax-payer 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.

SwissHoldings comments: The approach proposed in the first bullet above is considered unuseful for the purpose of tax certainty and tax compliance. This is why it has been crossed out. MNEs are not uniform and homogenous. Each group member must be individually assessed in terms of its business, its financials and other individual circumstances (e.g. special financing covenants, guarantees etc. and the country it operates in). The business profile for a short cycle consumer products MNE is drastically different to a large EPC capital intensive business and the financing needs are entirely different.

Any system should be as simple as possible. More sophisticated and more complex models do generally not lead to higher certainty or better results. To the contrary, models with greater complexity will generally lead to higher uncertainty.

It seems at odds that the starting position is that the rating of a subsidiary is equal to that of the parent. The rebuttable presumption should be that the subsidiary is rated on a stand-alone basis (as would be the case with an external rating agency) with a subsequent adjustment upward for implicit parental support.

Para. 52 deals with a loan from a parent entity to a subsidiary (without defining whether a Tier 1 or lower subsidiary and the absence of a contractual right over the assets of the borrowing company does not necessarily reflect the economic reality of the risk inherent in the loan. This is a controversial statement, which immediately diverts away from the separate independent enterprise approach and does not encapsulate very real situations when it comes to grading the level of financial parental support. The statement also fails to deal with structural subordination. A parent company lending to a subsidiary will not have access to that subsidiaries assets until such a time that the subsidiary has paid off its creditors and distributed the remaining equity to the shareholder. Thus conceptually, a lender to a parent company will be structurally subordinated than a lender who will lend directly to an operating subsidiary that is generating the operational cash flows to service the debt.

Box C.3. 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.

SwissHoldings comments: A relationship bank will always take an implicit support into consideration. There is in general no data point available for a stand-alone view.

The wording in nr. 68 is fine. However, the implicit support has only a value if the bank has detailed knowledge and insight into the MNE like in the case of a relationship bank. An independent third party bank will not invest time and effort into a fee quote which will unlikely materialize. Thus, the effect of implicit support cannot be reliably measured.

As already stated in the general comments above, OECD wrongly assumes that an MNE has or could have access to all relevant information and knowledge required for an arm's length pricing.

Box C.4. Commentators views are invited on the relevance of the analysis included in paragraph 70.

<u>SwissHoldings comments:</u> While the underlying principal behind para.70 may be true, there needs to be much greater discussion on how to identify, differentiate and price such differences between strategic and non-strategic entities. As the credit rating of a group company (top-down approach starting with a parental credit rating and notching down or bottom-up approach starting with a stand-alone credit rating and notching up) seems to be closely linked to the relative importance of the group company, we seek concrete guidance on how to measure the importance of group companies. This seems to have a significant impact on the credit rating and is very likely to trigger discussions with the tax authorities.

Box C.5. 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).

<u>SwissHoldings comments:</u> CDS are instruments comparable to insurance policies or simple bets. CDS and their pricing models are usually guided by bonds (standardized). Such standardized instruments should not be used for non-standardized bilateral and usually non-public contracts with specific covenants (e.g. subordinated vs non-subordinated etc.).

Running and maintaining economic models for the pricing of intercompany loans may be useful for banks where this is a core business and a core competence. For an industry MNE, this is not a core competence. It cannot be justified to invest significant amounts into systems and economic models if this is not a core competence. Moreover, it can be questioned if the result of such economic models is valuable and worth the investment given that (i) tax authorities usually still challenge the result and (ii) the MNE has the possibility to influence the result by influencing the business and the financials of its affiliates (type of business, provision of equity, collection of dividends, payment terms, subordination agreement etc.). After all, systems and economic models make more sense for banks and similar, as long as the credit business is a core competence of the tax payer concerned.

CDS are a wide used tool in large MNE's and the effect, shifting risk from a lender to a counterparty that is (likely) where the strategic treasury control lies should without question be a key component in pricing the loans, whether embedded in the pricing or priced based on the profile and probability of the borrower.

Box C.6. –

Box C.7. Commentators are invited to describe situations in which an MNE group's average interest rate paid on its external debt can be considered as an internal CUP.

<u>SwissHoldings comments:</u> Average interest rates paid on external debt should not be considered as an internal CUP for loans or similar as OECD guidelines will generally be applied to all sorts of situations. However, there are significant differences between e.g. guaranteed EUR or USD bonds in Europe and e.g. bank loans in Indonesia from a local bank to a local affiliate. The average interest rate paid does not reflect individual circumstances and covenants such as currency, duration, securities, country risks etc.

The average rate cannot be used as a CUP for internal borrowings. It does however offer a useful comparative when pricing parental guarantees.

Box C.8. Cash pooling…

SwissHoldings comments: It is worth emphasising in the this overall discussion that tax consequences are never the motive for cash pooling, and authorities should realise this when examining cash pooling arrangements. While the benefits can be fairly easily established, it is important to also incorporate the role of other arrangements in the pricing, such as intercompany guarantees. Again, pricing should follow accepted TP considerations, so the remuneration of the cash pool leader is commensurate with the functional risk profile of the pool leader. But authorities need to be cognisant of the fact that a pool with a large number of participants where cash is swept on a daily basis is burdensome and often expensive with sophisticated tools required in order to execute, manage and track – and rarely if ever tax driven.

Regarding the allocation of cash pool benefits, it is worth mentioning that this is a highly controversial issue and very likely to be challenged by tax authorities (which we have already experienced). We would appreciate clearer guidance on how the benefit is calculated and then allocated to cash pool participants.

Box C.9. –

Box C.10. –

Box C.11. In a situation where there are off-setting positions within an MNE group, commentators' views are invited on how accurate delineation of the actual transaction under Chapter I affects the profits and losses booked in separate entities within the MNE group as a result of exposure to risks.

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?

SwissHoldings comments: It is unreasonable to believe that affiliates of an MNE will enter into e.g. fx losses on purpose just because there are certain fx gains elsewhere in the MNE group. There is no total transparency and the information about off-setting positions alleged to be available is factually missing. This is why this is considered a theoretic approach not applicable in practice. Moreover, should this concept be further developed and implemented, there is a risk that e.g. fx losses may inherently as a presumption no longer be tax deductible while fx gains will continue to be taxable unless the MNE is able to prove that there are no off-setting positions in the group.

If the entity is setting the group policy and bears the entrepreneurial risk then the appropriate treatment would be the excess return/risk of loss is realised in that entity.

Additional Comment

Section 2.3 – Rewarding of the cash pool leader

The Discussion Draft should make clear that also treasury entities of non-financial MNE can be treated like a bank, if they have adequate substance/risks/functions/capital. The arm's length remuneration for such treasury entities would therefore be based – like for banks – on the spread between bid and ask for the financial transactions (including lendings/borrowings, F/X, hedging, etc.). For cash deposits with such treasury entities the deposit rates shall be considered as arm's length CUP as for corresponding deposits with banks (and not a borrowing rate).

Box D.1. –

Captive Insurance

In general we have the feeling, that the current draft paper is not appreciating enough the fact how regulated the insurance business is and the strict governance, risk management and compliance requirements which needs to be followed by all insurance companies.

Insofar, as it is a highly regulated business, we do not understand the general skepticism and "frequent concern" expressed in par. 166, i.e. whether there exist a genuine insurance transaction.

Comments in relation to bullet 1 – Box E.1:

Next to an effective risk transfer test, indicators should be based on risk pooling and risk diversification. The US IRS has developed a comprehensive criteria catalogue that provides guidance for qualifying a scheme as conforming to insurance.

Comments in relation to bullet 2 – Box E. 1:

Most regulatory regimes now specify the risks which drive a captive's capitalization requirements. We would refer to the Solvency II and equivalent systematics for non-life and life business. Classic risk categories to apply are Underwriting risk, Reserving risk, Credit risk, Catastrophe risk, Operational risk and Market risks. The control functions should mirror the various risk categories. The majority of applicable insurance regulations now require any insurer to have an appropriate risk and compliance management in place and foresee an independent responsible actuary function that continuously monitors risk taking governance and solvency adequacy.

Comments in relation to bullet 3 – Box E. 1:

National insurance regulations, under the influence of Solvency II and other equivalent or similar legislative initiatives, require strict protocols for outsourcing key functions, such as underwriting. The control over any qualified captive management service provider is within the scope of the responsibilities of the board of directors. The board must have the qualifications to exercise its control functions. Conceptually there should not be any impact on the income allocated to the MNE by the fact of captive management/underwriting outsourcing. Captive management costs will be incurred whether the entity is self-managed or managed partly by a third party. A quantitative example is not required to be included in Section E.

Comments in relation to bullet 4 – Box E. 1:

As indicated above, this scenario appears to be inconceivable as a captive is required to operate under a license granted by a qualified insurance regulation and regulator. If the captive deviates from its license framework or otherwise disregards its regulatory duties, it would first face regulatory intervention requiring remediation of shortfalls. In the extreme, the license is suspended or revoked. The captive owner risks a non-compliance situation and may ultimately need to liquidate. All national insurance regulations provide for insurance liquidation processes and governance.

Additional comments

Paragraph 166:

The categorization includes criteria which are remote from the standard use and setup of captives. Thus, accepting third party business is rather the exception than the rule and hence a poor indicator. Direct insurance captives are a minority; the majority of captives are reinsurance operations.

There would be merit to include fronting arrangements as a distinctive feature indicating a reinsurance captive setup.

Moreover, the requirement that *"the insured risk would be otherwise insurable outside the group"* is also not reasonable and in clear contradiction to *paragraph 173*. Hence, we would recommend to delete this criteria.

Paragraph 167:

It is not observed that local regulators are imposing "lighter" regulatory regimes to captives compared to the commercial insurance sector. Under Solvency II, the proportionality principle found little concrete application for relief from regulatory impositions. Other regulatory environments, in particular the ones of popular captive domiciles, do apply specific captive regulation, but in terms of governance and solvency requirements the gap to the commercial insurance and reinsurance sector is felt to be small. Hence, a clarification would be appreciated.

Paragraph 172 and 173:

We suggest to add the following additional commercial reasons for an MNE group to use a captive:

- Making available a consistent level of risk coverage throughout the world, which may otherwise not be accepted by local insurers on a local policy.
- Obtain a better understanding of and managing the cost of risks.
- Achieve higher risk coverage limits, since the third party insurer capital is not consumed by the risks covered by the captive.

Paragraph 177:

As already mentioned above, the majority of captives are reinsurance operations. Claims management of the fronter under the direct insurance is not impacted by the fact that a captive reinsurance is in place, since the captive will only accept valid claims from the fronter. It is not a common concept that claims handling and other administrative functions related to the fronter's direct insurance business are handled by a member of the same MNE group as the captive. Such outsourcing, if at all permissible, would need approval from the regulatory body.
It is not correct that a majority of the fronter's premium are passed to the captive. Actually only the premium related to the risk covered by the reinsurance contract is paid to the captive.

Paragraph 178:

The concerns raised in this paragraph do not reflect the fact that both the direct insurance contract between the fronter and a member of an MNE group as well as the reinsurance contract between the fronter and the captive of the same MNE group are subject to strict regulatory requirements and supervision and that the premiums payable under both contracts are subject to a professional underwriting process also regulated and supervised by the competent regulatory body.

Paragraph 183:

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The logic of the statements made under this section are difficult to understand and are generally disputable. It needs to be observed that captives are subject to rigorous solvency regulations. These are based on conservative assumptions leading to generally high capitalization levels compared to similar sized commercial (re)insurers which may profit from either a higher diversification or broader community of insureds. In this sense, the statement of “insurance regulators frequently set lower regulatory capital requirements for captives” is misleading and disregards facts. From a captive owner perspective, the practical experience with various local regulators differs from the statements made in 183. There are stringent actuarial requirements in place and corresponding reporting to regulators that assure captives operating at solvency ratios significantly higher than 100%. It would be recommendable that pertinent statistics are consulted to test 183 against facts. Hence, again also here a correction and clarification would be appreciated.

Paragraph 184/185:

The right allocation of group synergies depends on the specific facts and circumstances and in particular the function and risk profile of the captive insurance entity. Further guidance and clarification is required in order to avoid controversy.

Box E.1. –

Box E.2. –

Box E.3. –

We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

Dr. Gabriel Rumo	Martin Hess
CEO	Senior Policy Manager Taxation