Your reference:
Our reference:

MOORE STEPHENS

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Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75016 Paris
France

Moore Stephens International Limited
150 Aldersgate Street
London EC1A 4AB
T +44 (0)20 7334 9191
F +44 (0)20 7651 1637
E msil@moorestephens.com
www.moorestephens.com

Dear Sir/Madam

RESPONSE FROM MOORE STEPHENS INTERNATIONAL LIMITED ("MSIL", "WE") TO THE OECD PUBLIC DISCUSSION DRAFT "BEPS ACTIONS 8-10: FINANCIAL TRANSACTIONS

MSIL appreciates the work that has been undertaken by the OECD in this area to date and welcomes the opportunity to provide its comments and views on the complex area of the transfer pricing aspects of financial transactions. In doing so, we appreciate that the discussion draft acknowledges that there are a number of different views and policy approaches by different countries.

General remarks

There would be considerable merit in some separate policy guidance or recommendations that apply to regulated financial services businesses (“FS businesses”). There is little mention of such businesses in the discussion draft, yet they may often be fundamentally different in terms of their structure, purpose and transactions from non-FS regulated businesses. There is little consideration in the discussion draft, for example, of banks or insurance businesses, in contrast to other parts of the BEPS recommendations.

If the recommendations are intended to apply to banks and insurance businesses it would be useful to specify this, though what would be more useful would be separate guidance; precedent for which is provided by the permanent establishment profit-attribution guidance in Action 7. If separate guidance is not provided, then it would appear that such businesses would potentially be obliged to document every transaction from an Action 8 - 10 compliance perspective.

Given the difficulty in designating what constitutes an FS or FS-regulated business, it might be better to have additional guidance for “businesses for whom lending is a core business activity” or a similar type of definition. This would define a business by activity, which should reduce the problems associated with sector definition.

Identifying the commercial or financial relations

Question Box B.1 Article 25 /Article 9 / BEPS Action 4 report

We have concerns over the lack of consistency of approach between jurisdictions regarding the application of rules to questions of capital structure and interest deductibility. A situation where one territory applies an arm’s length test whilst the other does not risks double taxation in terms of a potential disallowance of interest for the borrowing entity and a taxable interest receipt for the lender. This may not constitute a complete disallowance of the interest deduction, depending upon the approach adopted by the tax administration in the borrower’s jurisdiction.

For example, a tax administration in the jurisdiction of a borrowing entity may disallow all or part of an interest deduction claim on the basis that the debt exceeds that which an independent lender would be willing to advance, or an unrelated borrower would be willing to borrow. If the lending country did not adopt a corresponding approach, then presumably 100% of the interest receivable would be taxable with no recourse to Mutual Agreement Procedure relief or similar. This runs contrary to the aims of BEPS, which are to improve the coherence of international tax rules and ensure a more transparent tax environment.

Question Box B.2 Re: Paragraph 17

In our view, delineating an entire amount of funding as equity where the amount either exceeds the amounts that an unrelated lender would lend or a unrelated borrower would borrow appears contrary to the spirit of Article 9 and the definition of the arm's length principle. It would seem to represent an unsophisticated approach that curtails the flexibility of the arm's length test, the intention of which is to provide comparable commercial delineations of a transaction between unrelated parties.

Re: Paragraph 19

Paragraph 19 (page 7 of the discussion draft) proposes that "Independent enterprises, when considering whether to enter into a particular financial transaction, will consider all other options realistically open to them…". This may be true up to a point, but our concern is whether a borrower would be expected to document such a process and the reasons for choosing the selected option and not the others. This would seem to impose a considerable and potentially unrealistic compliance burden on many businesses. It would be helpful if greater clarity could be included as to what would constitute reasonable compliance obligations in this regard.

As a general conclusion on Section B.1 (paragraphs 3 – 21), our request would be for recommendations that recognise the large variance in circumstances, transactions and sectors that may fall within the scope of the guidance. The final recommendations need to be sufficiently flexible to accommodate such differences.

Question Box B.3 Factors to be considered as part of the accurate delineation of the actual transaction

In our view, it is crucial to establish the context of the complex transaction in which the loan or funds are involved. In particular, the more complex the transaction (e.g. M&A or restructuring) the greater the need to analyse the situation from the investor's perspective, as this is the party that is willing to bear risk and wait for the profit to arise over time. In such cases, the risk is allocated to the lender with respect to the funds advanced; thus consideration should focus on allowing interest rates resulting from capital/equity investments rather than simply analysing from a borrower's perspective and increasing the capital of a local entity. It is probable that similar investment-related advanced funds would be considered either from a discounted-dividend perspective or as a loan depending on capital structure and the estimated profitability of the business.

The economically relevant characteristics of actual financial transactions

The discussion draft states at paragraph 22 (page 8) that financial transactions between associated enterprises may lack the detailed contractual arrangements found where similar transactions are entered into between independent parties. In practice this lack of detailed documentation is likely to extend to the key functions performed by a lender in relation to an advance to a related party as outlined in paragraph 24 (page 8). For many relatively small or medium-sized multinationals detailed documentary evidence regarding the functions mentioned in that section is unlikely to exist. To compile it solely for the purpose of compliance with transfer pricing obligations will impose a compliance burden on such businesses. Arguably, such documentation should already form part of the transfer pricing records of a multinational entity ('MNE') and so this would not create additional work. In practice, this may not be the case and our view is that materiality is crucial in this regard and should be made clear in the guidance. There will be many situations where BEPS is not an issue and it would seem disproportionate to impose a burden on businesses in relation to relatively small transactions that are low risk from a compliance perspective.

The discussion draft does not discuss in detail the disregarding of actual transactions between related parties that lack the commercial rationality that would be expected in arm's length transactions between independent parties. It refers to the principle that a transaction may be disregarded but fails to offer recommendations or examples in relation to financing transactions. The inclusion of such recommendations and/or examples would be welcome, as this has been a fundamental topic of contention for many years and has not been uniformly applied on a jurisdiction-by-jurisdiction basis. This reconstruction power, given its wide implications, needs to provide clarity on this issue.

Question Box B.4 Risk free rate of return

A significant proportion of the discussion draft is devoted to the issue of a risk-free rate of return. In focusing on this issue, the discussion draft misses the opportunity, presumably due to a lack of consensus, of seeking alignment on the related matter of excessive capitalisation of entities that are subject to low rates of tax. This has been the subject of BEPS discussions between tax administrations and MNEs for many years. The lack of constructive proposals or guidance may be seen as a missed opportunity in addressing key aims of the BEPS programme.

In particular, the original BEPS plan from 2013 highlighted the excessive capitalisation issue but the discussion draft focuses not on that but on allocation of risk. The problem in doing so is that in the absence of an agreed multilateral approach, tax administrations will presumably adopt their own policies or domestic legislation to tackle the excessive capitalisation issue. The result is unlikely to be a coherent international consensus that was the aspiration five years ago.

A potential solution that should be worthy of consideration would be an approach analogous to that applied for the attribution of profits to a permanent establishment, whereby capital could be calculated so as to be commensurate with the functions, assets and risks of an entity. This would have the advantage of coherence with other BEPS actions and is an approach that has been widely discussed and adopted.

Finally, but importantly, as a general comment, if a key BEPS policy concern is with cashbox-type structures, there is an argument as to whether the cashbox should receive *any* return rather than a risk-free return.

With respect to paragraph 4 of Box B.4, in our view the proposed approach does not correspond to the actual circumstances which may vary across the geographical markets in which the multiple lenders operate. The proposed approach would, in particular, put lenders located in economies characterised by significantly higher interest rates in a non-arm's length position, in that they would need to agree to lend money on conditions providing lower interest returns than those alternatively available to them in the open market.

With respect to paragraph 6 of Box B.4, in cases where no long-term investment exists but only prolonged operational financing, consideration should rather be given to a revolving loan, as a long-term loan needs specified maturity – which in the quoted case is extended to new periods.

Question Box B.5 Alternatives to government issued securities

We suggest a repo rate for an AAA issuer (from a selected geographical economy) as a potentially useful guide to a risk-free rate of return in all markets.

Pricing approaches to determining an arm's length interest rate

Question Box C.7 Internal CUP

There are a number of factors and circumstances in which an MNE group's average interest rate paid on its external debt could be considered as an internal CUP.

One of the most significant factors that support such a hypothesis is the common existence of highly integrated operations. In the case of highly integrated business operations, functional analysis including, but not limited to, the functions, risks, and assets of one party, cannot be reliably analysed in seclusion from those of one or more other affiliates of the MNE. Each affiliate receives and contributes to the implied benefit of group synergies and passive association that flow from being part of an MNE.

An interest rate paid by each affiliate based on its own independent credit rating associated with the functions, risks and assets of such an affiliate does not sufficiently represent the reality of the MNE's economic and financial position or the credit rating of a highly integrated business operation

A compilation of the credit rating of each of the affiliates and calculation of an average rate based on the pool of interest rates of all affiliates of the MNE closely exemplifies and closely aligns with the MNE's economic and financial position as an enterprise. This is especially true in the case of MNE groups with a vertical-integration operating model, resulting in significant interdependence.

As outlined above, the notion of interdependence and integration supports that the credit rating of the individual affiliate be closely aligned with the collective rating of the entire group, including the parent company. Each affiliate contributes to, and benefits from, being a part of a multiple-entity corporation. This inferred reliance on the related entities implies that these entities should lean towards a shared credit rating and that the average interest rate paid on an MNE group's external debt can be considered as an internal CUP.

We are grateful for the opportunity to provide our comments and would be pleased to discuss or clarify our response. In that event please contact any of the persons listed in the table below.

Yours faithfully,

On behalf of MSIL,

Ken Almand
Global Head of Transfer Pricing
Moore Stephens International Limited

Contact person	E-mail address
Ken Almand	ken.almand@moorestephens.com
Rita Chung	rchung@citrincooperman.com
Anthony Hayley	ahayley@moorestephens.com.au
Aleksandra Jaszczuk	a.jaszczuk@msca.pl

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