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Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
Paris
France

BY E-MAIL: TransferPricing@oecd.org

Dear Sir/Madam

COMMENTS ON THE PUBLIC DISCUSSION DRAFT BEPS ACTION 8-10 – FINANCIAL TRANSACTIONS

1. We herewith take the opportunity to present our comments on behalf of the South African Institute of Chartered Accountants (SAICA) Transfer Pricing Sub-committee (a sub-committee of the SAICA National Tax Committee) on the Public Discussion Draft paper under Base Erosion and Profit Shifting (BEPS) Action 8-10 dealing with Financial Transactions (the discussion draft) issued by Working Party 6 of the CTPA working group of the Organisation for Economic Co-operation and Development (OECD).
2. It is understood that the OECD is considering revised guidance in respect to the transfer pricing of financial transactions and is seeking comments from interested parties. Specifically, the OECD has requested comments in response to specific questions raised in the discussion draft.
3. We would like to thank the OECD for the opportunity to provide constructive comments in relation to the transfer pricing of financial transactions. SAICA believes that a collaborative approach is best suited in seeking actual solutions to complex problems.
4. Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

Christian Wiesener

Madelein Grobler

**CHAIRMAN: SAICA Transfer Pricing
Sub-committee**

PROJECT MANAGER: TAX (SAICA)

The South African Institute of Chartered Accountants



Contents

A. GENERAL.....	3
B. SECTION B - INTERACTION WITH GUIDANCE IN SECTION D1 OF CHAPTER 1	3
BOX B1 - DETERMINING THE CAPITAL STRUCTURE OF AN ENTITY	3
BOX B2 - RECLASSIFICATION OF DEBT TO EQUITY	4
BOX B3 - DELINEATING THE FINANCIAL TRANSACTION	6
BOX B4 - RISK FREE RATE OF RETURN	7
BOX B5 - ALTERNATIVES TO GOVERNMENT SECURITIES	8
BOX B6 - COMMENTS ON DOUBLE TAXATION RISKS WHERE ONE ENTITY IS ONLY ENTITLED TO A RISK FREE RATE OF RETURN.....	9
C. SECTION C - TREASURY FUNCTIONS.....	9
BOX C1 - COMMENTS ON DECENTRALISED TREASURY STRUCTURE	9
BOX C2 - COMMENTS ON TAX CERTAINTY PERTAINING TO CREDIT RATINGS	10
BOX C3 - CREDIT RATINGS AND IMPLICIT SUPPORT	10
BOX C4 - GROUP STRATEGY	11
BOX C5 - ROLE OF CREDIT DEFAULT SWAPS	12
BOX C6 - ALTERNATIVES TO INTRA-GROUP LOANS	12
BOX C7 - INTERNAL CUP	13
BOX C8 - CASH POOLING.....	13
BOX C9 - CASH POOLING.....	14
D. SECTION D – GUARANTEES	14
BOX D1 - DELINEATING THE TRANSACTION.....	14
E. SECTION E - CAPTIVE INSURANCE	14
BOX E1 - DELINEATING THE TRANSACTION	14



A. GENERAL

5. This submission has been prepared by the members of SAICA's Transfer Pricing sub-committee, which comprises transfer pricing specialists from different industries with difference specialisations.
 6. Given the distinct nature of the discussion draft, which focuses on financial transactions, this submission focuses on providing general commentary, but where appropriate, comments relating specifically to Financial Institutions (FI's) operating in South Africa and other African countries were added.
 7. Given the comments relating specifically to FI's, we deem it necessary to provide further detail regarding the environment in which FI's operate in Africa. FI's in Africa - similar to other developed markets - are subjected to stringent regulatory requirements, in particular with regards to capital, liquidity and leverage.
 8. One of the unique attributes of emerging markets (EM's) such as Africa, is that a typical organisational structure comprises legal entity subsidiaries (not branches) that include external local shareholders per local FI regulatory requirements. Albeit that such shareholders may represent a minority shareholding, the local boards of such legal entities are very much governed by an attitude of local in-country revenue maximisation. This in itself creates an overlay requiring FI's to not only comply with in-country FI regulations, but to prove to local, independent Boards that any transaction conducted with a related party complies with the arm's length principle.
 9. The majority of EM's FI's are governed by domestic Central Banking policies in relation to related party payments further limiting the ability of banks and other FI's to engage in activity which may cause concern in relation to BEPS.
10. Submission: We submit that this is an important feature of the financial services sector and we are pleased that this has been acknowledged by the OECD in several places in the discussion draft.¹
11. Our submission follows the structure of the discussion draft and address the relevant questions raised below.

B. SECTION B - INTERACTION WITH GUIDANCE IN SECTION D1 OF CHAPTER 1

BOX B1 - DETERMINING THE CAPITAL STRUCTURE OF AN ENTITY

12. *Commentators views are invited relating to the guidance contained in paragraphs 8-10 of the discussion draft pertaining to the capital structure of an entity and the alignment to Article 9 and Article 25 of the Model Tax Convention and BEPS Action 4.*

¹ For example, we note that in paragraph 3, the OECD states that "in the absence of other influences such as legal or regulatory constraints, the balance of debt and equity funding between independent enterprises will be the result of various commercial considerations...Thus, in an intra-group situation, other considerations such as tax consequences may also be present". Furthermore, in Paragraph 13, the OECD states that "the effect of government regulations" is acknowledged

13. It is noted that the OECD does not intend to provide prescriptive measures for determining what constitutes debt and equity and that this is largely left to individual countries to include in their domestic legislation.
 14. In South Africa we have specific rules which apply to hybrid instruments and will therefore provide guidance on whether an instrument is deemed to be debt or equity.
 15. Furthermore, South Africa has varied guidance relating to thin capitalisation which in its current draft form does not align to the OECD recommendations put forward in the final BEPS report on Action 4. Submissions have been made to the South African Revenue Services (SARS) Legal and Policy Division to consider adopting the OECD recommendations in finalising its draft guidance.
16. Submission: It is submitted that the above provides support that if countries adopt differing domestic guidance for hybrid instruments and thin capitalisation rules, there is a high risk of increased double taxation. The guidance put forward in both BEPS Action 2 and 4 should therefore form the basis for countries to legislate against these two aspects. The guidance provides comprehensive discussion on what should be acceptable from an arm's length perspective and therefore adhere to Article 9 of the Model Tax Convention.
 17. We therefore submit that countries adopting the OECD Model Tax Convention should be encouraged to legislate based on guidance already provided in the BEPS reports Actions 2 and 4.

BOX B2 - RECLASSIFICATION OF DEBT TO EQUITY

18. *Commentators comments on the example provided in paragraph 17 of the discussion draft are invited, notably the maximum level of debt that should be considered to be arm's length.*
19. There is a considerable amount of guidance globally both in terms of Rulings issued by Tax Administrations and Case Law as to how to distinguish between debt and equity. The OECD, in its guidance, should seek to consider this. Re-characterising debt instruments to that of equity should be approached with caution. Having a "shopping list" of factors which may indicate that an arrangement is more akin to the contribution of capital than that of a debtor-creditor relationship may be helpful, however, it should not be prescriptive to the extent that Tax Administrations rely on it to make re-characterisations without due attention to the economic conditions. There are many reasons that a group may seek to leverage its constituent entities other than for tax reasons. For instance, capital reductions in certain countries can be difficult, making debt financing the most practical form of funding an entity.
20. Two possible scenarios where it could be argued that independent parties would not enter into loan arrangements can be considered. The first is as outlined in the example in paragraph 17 of the discussion draft and is responded to below.
21. The second example is where a borrowing entity does not actually require capital funding based on its balance sheet. This scenario has been considered for the purposes of the draft guidance on thin capitalisation in South Africa. SARS' view in this draft is that where a borrowing entity has a healthy balance sheet and excess cash reserves, the arm's length



debt amount should be nil. It should be noted that many South African taxpayers, however, do not agree with this view.

22. Submission: It is submitted that the OECD working party should consider providing guidance in such circumstances as part of this project.

23. MNE's should be free to determine how to structure the working capital of entities within the group and the determination of an arm's length debt amount should be considered in light of broader transfer pricing provisions and commercial considerations. As indicated in the discussion draft, there are frequently many commercial reasons behind a company's decision to borrow funds other than its existing financial position and its ability to service the debt.

24. Considering the example provided in paragraph 17 of the discussion draft, care needs to be exercised in relation to testing the arm's length amount of debt an entity can service, other than based purely on financial projections.

25. Submission: We submit, for example, in the scenario where Company B was a recently acquired target by investors (such as in the case of a Private Equity deal), the acquired entity may require considerable working capital to turn around its business albeit that the financial projections are poor. We submit that account should be taken of the asset base of the company and its relative worth. Liquidity and solvency tests should also be considered in addition to interest cover and debt cover tests to determine whether the proposed lending arrangement is commercially reasonable.

26. Further concerns may also arise in scenarios where inter-group loans are granted on an unsecured basis to a South African subsidiary with a negative Earnings-Before-Interest-Tax-Depreciation-Amortization (EBITDA), making the use of the interest cover and the leverage ratios impossible. The question is then, if one has to assume that the subsidiary has no entitlement to any interest and that the subsidiary should be funded through equity only.

27. Submission: It is submitted that this would not be commercially fair seeing that when the EBITDA goes positive as a result of turning the business around or growing the business, then interest deductions are justified, but the subsidiary requires the loan to finance the cause of the negative EBITDA.

28. Guidance is therefore required on what is considered arm's length when no other person would lend money to the subsidiary until it turns its business around and the shareholder is the only one willing to provide loan financing. It cannot be that the shareholder must do so through equity only as one also needs to consider:

- The fact that the shareholder loan is actually a secured loan as the lender (or its shareholder) directly or indirectly holds the shares in the subsidiary borrowing, especially considering that the subsidiary's assets should not be used as security on the basis that no bank would lend it money in any case; and



- The arm's length test for the amount should then not be whether a third party would lend money to the subsidiary, but rather whether shareholders in general would support a subsidiary in similar financial distress.

BOX B3 - DELINEATING THE FINANCIAL TRANSACTION

29. *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.*
30. The key comparability factors should remain the base line factors for delineating the financial transactions. It is considered that even where there are no formal contracts in place allowing the determination of the contractual obligations of the parties, undertaking a comprehensive functional analysis should provide sufficient evidence of the parties' conduct to enable the transaction to be identified and delineated.
31. Submission: It is submitted that the specific economic circumstances in the country in which the borrower is situated should also be considered in any analysis. We recommend that the guidance go further in ensuring consideration is given to countries with high interest rates, unstable currencies and regulatory controls which restrict the free movement of capital.
32. For instance South Africa has a very volatile currency, which is impacted by global events outside of a borrowing entity's control. Furthermore, South Africa has high interest rates and Reserve Bank restrictions on the amount of interest which may be paid offshore on an inbound loan. The implications these factors may have do not always align to our thin capitalisation provisions.
33. However, care should be taken in labelling financial transactions. Often these are a combination of many different aspects and delineating parts of an aggregated arrangement could lead to absurd transfer pricing outcomes. For instance, a multinational parent company may be engaged in managing the cash pooling of the group which would involve providing loans to meet working capital requirements, providing bank guarantees for third party funding and managing foreign currency exposures. The parent company could be rewarded based on the fact that it holds funds for the group and can perhaps borrow on more reasonable terms than the individual subsidiaries. Thus, it is able to on lend on better terms and conditions to the subsidiaries as opposed to the terms and conditions applicable if the subsidiaries borrow locally.
34. Submission: We submit that if each aspect of the above is delineated into separate transactions with a stand-alone interest on the loans, a guarantee fee and a service fee, the result could be that a subsidiary benefiting from all three activities ends up in a worse position than if it had simply managed its cash position independently. Therefore commercial common sense needs to prevail when looking at delineating financial arrangements.
35. When considering the allocation of risk to a lending entity within the group, it will largely depend on whether the financial transactions involve a third party or are simply the advancing of funds from a parent company to its wholly owned subsidiary. In the latter instance it could be argued there is no real commercial risk as the relationship of the parties



ensures that the lending entity carries limited risk as it owns the assets of the borrowing entity. However, assuming there is a degree of independence relating to the day to day management of the subsidiary, there still remains a risk to the lender of a reduced investment value where the balance sheet of the borrowing entity is weakened as a result of the liability.

36. For other financial transactions, risks will be attributed to the lending entity where it is managing currency risk through lending in a different currency, or where it is assuming primary obligation over a third party debt through a guarantee arrangement.

37. Submission: We therefore submit that the OECD should consider the nature of risks and how these are allocated within the financial services sector. Such risks are regulated and may therefore present a challenge when considering the allocation of risk for the purposes of delineating a transaction.

38. The volume and complexity of activities undertaken by FI's implies that a transaction-by-transaction approach which has been suggested in the discussion draft is impractical for both FI's and Tax Administrations. Rather, the OECD has already considered the allocation of risk and capital within FI's when developing the 22 July 2010 *"Report on the attribution of profits to permanent establishments"* (the 2010 report). The 2010 report recognises the importance of Key Entrepreneurial Risk Taking (KERT) functions in a bank or financial institution (i.e. the creation of financial assets and management of the risk associated with those assets).

39. Submission: We submit that the 2010 report is widely regarded by both Tax Administrations and taxpayers as a reasonable and fair approach to taxing banking and finance businesses and should remain the principle source of guidance for the banking and financial services sector. We urge the OECD to make this clear in any further possible guidance.

40. In evaluating the factors specific to a taxpayer's ability to accurately delineate the financial transaction, system capabilities must also be taken into account. From a FI perspective, substantial sums of money are allocated to investment in infrastructure, inclusive of systems that support the processing of high volumes of transactions. These systems have limitations in terms of reporting transactions on an individual basis and in the event of a single related party transaction being part of a sum of many larger transactions (e.g. a related party Foreign Exchange (FX) Spot transaction which ultimately ends up being traded as a portfolio hedging transaction with a third party) it would not, by way of example, be possible to "delineate" the initial individual related party profit and loss on such original FX Spot trade.

BOX B4 - RISK FREE RATE OF RETURN

41. *Commentators comments are invited on the guidance put forward in respect of pricing debt transactions and specifically the use of a risk free rate of return.*
42. It is stated that if a lender lacks the financial capability or does not undertake any decision-making in respect of a loan, the lender should only be entitled to a risk free rate of interest on the loan. This could be benchmarked using a relevant government security rate.



43. Submission: It is submitted that the above broad statement may not be in line with commercial reality. It is highly unlikely that any lender would operate on this basis and risk free lending arrangements rarely, if ever, exist in the commercial world. It is further submitted that comparison could perhaps be drawn from a third party situation in terms of which one party instructs a bank to lend funds to a third party and assumes the obligation for payment. Arguably, the bank makes very limited decisions over lending the money, but would still go through the appropriate checks before advancing the funds, including a credit check of the guarantor. Thus, the bank is still taking some degree of decision-making and to some degree assuming a level of risk. It is considered that the example included is unrealistic.

44. A risk free rate of return is typically found in government securities, as well as between banks. The latter are regulated and required to maintain certain amounts of capital, thus shortfalls in cash are often met through inter-bank lending arrangements. The rate is normally linked to the availability of money in the market, on prevailing interest rates and dependent on the specific lending contract. This makes them similar in nature to government bonds and inherently less risky than any normal commercial loans.

45. A risk free rate of return could simply be used as a starting point for any interest rate analysis. However, any commercial lender would add risk parameters to get to a commercial interest rate, irrespective of the functions undertaken or the risks assumed by the lender. Furthermore, even a bank which may be provided government capital at a risk free rate would need to make a profit on its on lending. Therefore it is maintained that no third party lending institution would advance funds with an interest rate marked to a risk free rate of return. They may have a "base rate" which is the risk free rate with a profit margin added, to which various risk premiums are also added.

46. Currency risks, frequency of repayment of capital and the duration of the lending agreement would all comprise risk premiums which would be added to a base rate of interest. However, care should be undertaken in considering these. For instance, a longer duration loan may be considered to create less risks, but a commercial lender would generally provide a higher rate of interest if the money is provided on deposit as it provides additional investment capital for the lender for a longer term. However, if lent over longer periods, the lender may charge a lower rate of interest than a shorter term arrangement. Thus interest rates vary considerably depending on whether they are applied to deposits or loans which would impact any transfer pricing analysis in a group context where a treasury function is present.

47. Submission: It is submitted that country risk adjustments represent a significant challenge. Using government bond rates for the country in which the debtor is situated would present a reasonable starting point, however, as indicated above a third party lender would add to this a profit margin plus premiums to account for other risks associated with the borrowing entity.

BOX B5 - ALTERNATIVES TO GOVERNMENT SECURITIES

48. *Commentators are invited to describe financial transactions which offer a realistic alternative to government issued securities to approximate a risk free rate of return.*



49. As indicated above it is our view that the use of risk free returns represents only the starting point for determining an arm's length interest rate and would never be used in practice for commercial loan arrangements.

50. Submission: We submit that Government issued securities are one example of risk free returns which may be available, however as indicated above, the inter-bank lending rates between central banks and the commercial banks are also low risk rates of return and are readily available.

BOX B6 - COMMENTS ON DOUBLE TAXATION RISKS WHERE ONE ENTITY IS ONLY ENTITLED TO A RISK FREE RATE OF RETURN

51. *Commentators are invited to comment on the guidance provided in paragraph 11 pertaining to the double taxation risk which may arise.*
52. As indicated above we are of the view any transactions within a multinational where a risk free return is considered, the appropriate level of reward is not consistent with the arm's length principle for the reasons outlined above.
53. The comments on the risk adjusted rate of return are noted.

54. Submission: However, it is submitted that in any scenario where the funder is taking risk over a project undertaken by the borrowing entity, the arrangement would not have the same characteristics as a typical loan. Thus, adjusting for risk under a typical debtor-creditor arrangement would not apply.
55. Comparability would need to be sought from arrangements between third parties which have the same characteristics of the lending entity, having some degree of control over the risk on the underlying project or intellectual property (IP) being created by the borrowing party. This would be more akin to a venture capital or joint venture arrangement whereby one party is providing the capital funding and another undertaking the development. It would not be typical in a debtor-creditor arrangement.

C. SECTION C - TREASURY FUNCTIONS

BOX C1 - COMMENTS ON DECENTRALISED TREASURY STRUCTURE

56. *Commentators are invited to describe situations where, under a de-centralised treasury structure, each MNE member has full autonomy over its financial transactions.*
57. Where a MNE group operates a decentralised treasury structure, each entity would be responsible for managing its funding requirements and working capital requirements. The treasury operation within the group would simply operate as a centralised bank for the group providing for excess funds to be placed on deposit at the behest of the group entities, and providing funding were requested. The treasury operation would seek to manage the group funding balances including sourcing external funding where needed. Thus, the individual entities within the group would benefit through reduced cost of funding.



58. Submission: We submit that the treasury operation under a de-centralised model would not manage any of the risks associated by the individual entities in the group. It would only manage its own risk as the group banking entity.

59. With regards to FI's, It is important to distinguish between a FI whose core business and measure of success is to achieve a return on capital as opposed to a corporate whose measure of success may be to manage costs.

60. The legislative framework to be adopted by EM FI's regarding the Recovery and Resolution Planning (RRP)² will impact substantially on classifying the treasury function as indeed being a centralised or decentralised structure given explicit requirements for systemically important banks that have multiple points of entry and their need to be self-sufficient and not over-reliant on, for example, related parties advancing of funds (Note: treasury related services are deemed to be a critical shared service in accordance with current Guidance – page 7, paragraph 2.3).

61. The above referenced legislative framework would thus go against the principles contained in paragraph 52 of the discussion draft which states that *"the parent already has control of and ownership of the assets of the subsidiary which would make the granting of security less relevant to its risk analysis as a lender"*. The implications of the RRP referenced in paragraph 53 above may imply that shareholders are deprived of advancing funds as a result of protection afforded to other creditors.

BOX C2 - COMMENTS ON TAX CERTAINTY PERTAINING TO CREDIT RATINGS

62. *Commentators are invited to consider various approaches put forward in the discussion draft pertaining to providing tax certainty associated with determination of a credit rating.*

63. Submission: It is submitted that the rebuttable presumption should be that an independent credit rating for the group should be the starting point in determining the credit rating for a borrower in a specific debt transaction. This would ensure a consistency in the starting point in the analysis and mitigate the risk of double taxation as a result of differing approaches by individual countries.

64. In the absence of a publicly available independent credit rating, a credit rating can be established using reputable third party credit rating tools. These should take into consideration the country in which the parent company is located, the strength of its consolidated balance sheet and cash flow, as well as the industry in which the group is predominantly operating.

BOX C3 - CREDIT RATINGS AND IMPLICIT SUPPORT

65. *Commentators are invited to define a stand-alone credit rating of a MNE and the impact of implicit support.*

² FSB Key Attributes of Effective Resolution Regimes for Financial Institutions contained in the FSB Guidance on Arrangements to Support Operational Continuity in Resolution, 18 August 2016

66. Submission: We submit that recent case law³ has established when it could be considered appropriate to determine the credit rating of a borrowing entity within a group on a stand-alone basis and when the implicit support of the parent should be taken into account.

67. Where the borrowing entity is a "core" operating subsidiary for the group and plays a vital role in the supply chain, then there is an argument that the parent company would seek to ensure that the borrowing entity does not default on its debt obligations. In such a case therefore, implicit support should be taken into consideration in determining the credit rating of the subsidiary.

68. Where, however, the borrowing subsidiary does not play a significant role in the value chain, or is not considered "core" to the MNE, the level of implicit support provided by the parent company is inherently less and therefore plays a less important role in determining the subsidiaries credit rating. In such a case the subsidiary may have its credit rating determined on a stand-alone basis dependent on the terms and conditions of the loan arrangement.

69. Submission: However, we submit that care should be exercised in treating a non-core subsidiary as if it is not part of a broader group given the judgment in the Chevron case.⁴

70. We do recommend that acknowledgement should be made by the OECD regarding local banking regulations (e.g. Section 70 of the Banks Act of South Africa) that may specifically provide for the fact that the Parent company will essentially ensure that its subsidiaries' capital requirements are met in the event of default (i.e. local regulations depict an implicit level of support by the parent company).

71. Third party credit rating agencies' may factor in this "implicit support" in determining a stand-alone local entity credit rating and the relevant local Tax Administration would not look favourably on any implicit support cost or benefit being priced into related party transactions.

BOX C4 - GROUP STRATEGY

72. *Commentators are invited to comment on the example contained in paragraph 70 of the discussion draft.*

73. We address this in the preceding paragraphs. We would like to comment, however, on the capping of stand-alone credit rating.

74. Submission: Whilst the approach appears reasonable, we would request that careful consideration needs to be provided to capping credit ratings in a general manner.

75. Where the determined credit rating is extreme when considered in the context of the group, this may indicate that the arrangement is more akin to the contribution of capital than a loan transaction. It could lead to an increase in disputes if Tax Administrations adjust to a

³ Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation [2017] FCAFC 62; *General Electric Capital Canada Inc. v. The Queen*, Docket numbers 2006-1385(IT)G and 2006-1386(IT)G (December 4, 2009).

⁴ Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation [2017] FCAFC 62, at 44.



capped credit rating as a means to re-characterise a contribution to capital or quasi-equity arrangement to that of a loan arrangement with a view to imputing an interest charge.

BOX C5 - ROLE OF CREDIT DEFAULT SWAPS

76. *Comments are invited on the role of default swaps and economic models for pricing inter-company loans.*
77. Whilst it is recognised and fully supported that the comparable uncontrolled price (CUP) method is considered to be the most favoured method relevant to the pricing of intra-group loans, such third-party pricing information may be readily available for G10 currencies. However, in EM's such as Africa, there is no credit default swap (CDS) pricing information for bank debt. Local currency pricing information is thus simply not publicly available and may be "developed" by various data points collated by the relevant FI that may have traded at various preceding periods in the affected country in varying tranches. Such pricing information limitations imply that whilst a CDS may indeed inform the pricing of an intra-group loan, these instruments are only available in developed markets, for example, G10 currencies and a different pricing approach is generally required for other, EM currencies.
78. Economic models such as Moody's are indeed relied upon by FI's that simultaneously rely on such internal models for purposes of defending the arm's length nature of their very own intra-group loan pricing. The relevant EM FI would rely on the outcome (i.e. credit rating) of such economic model whilst simultaneously developing country specific data (i.e. an internally developed economic model) for purposes of incorporating a country risk premium relevant to the underlying loan to ensure such loan is priced at arm's length.
79. The issue at hand for taxpayers is that such data – per limitations referenced in the paragraph above – is (a) not publicly available and may be developed by the taxpayer itself that is attempting to validate the arm's length nature of the pricing of the loan and (b) the economic model itself used to determine the pricing may be interpreted and applied differently by different Tax Administrations or may even differ amongst credit institutions depending on the available pricing information (e.g. deals / transactions in which such credit institutions have recently participated in the underlying currency in order to develop some form of database / pricing repository) at the time the transaction was entered into and for which reasonable adjustments have been made to essentially represent a CUP for the underlying loan. Whilst paragraph 85 acknowledges that a loan to a member of a different group could be a valid comparable, one can appreciate the complexity that this brings up to 8 years post the event in defending the arm's length nature of such loan (very relevant to EM Tax Administrations in Africa that have limited data available to benchmark such transactions).

80. Submission: It is submitted that the OECD should commit to acknowledge the lack of suitable comparable data in EM's such as countries in Africa and to accept that there may be a range of arm's length pricing information due to a lack of consistency.

BOX C6 - ALTERNATIVES TO INTRA-GROUP LOANS

81. *Comments are invited on realistic alternative transactions to intra-group loans.*

82. It is submitted that an alternative to an intra-group loan may be a bond issued by a company to investors. Companies often issue bonds to investors because direct borrowing from a bank may be more restrictive and/or expensive. However, in such cases the maturity date is usually pre-determined/agreed, which is not necessarily the case in respect of intra-group loans. In addition, potential limitations of a bond issuance may be that the bond issuance would effectively represent a one-sided approach (i.e. from a borrower's perspective) and would not necessarily reflect the options realistically available to the lender.

BOX C7 - INTERNAL CUP

83. *Commentators are invited to comment on situations where the average interest rate paid on external debt can be used as an internal CUP.*

84. Submission: We submit that, whilst this could be used as a possible starting point to determining an arm's length interest rate, variances in the terms and conditions which exist between the external loan arrangements and the intra-group loan arrangements, should also be taken into account.

85. In the event the funds are on lent to a subsidiary operation, this could be an appropriate starting point.

86. Within the context of FI's in EM's and the cost of funds approach, the cost of liquidity together with a country risk premium is generally applied in pricing related party interest in lieu of the fact that it is extremely difficult to isolate specific costs relevant to specific entities together with the Group strategy that considers treasury to play a critical role in ensuring liquidity and managing assets and liabilities accordingly. Such function is thus not deemed to be a "profit centre" activity for which profit margins should be achieved in accordance with the Group's risk management framework. Acknowledgment of the Group strategy should also be considered by the OECD in relation to this section.

87. In relation to the OECD commentary contained in Paragraph 92 of the discussion draft regarding bank opinions, FI's themselves rely on bank quotes (referred to by the OECD as bankability opinions) in many instances for related party pricing purposes. This reliance is especially relevant in the context of EM's where pricing information is not readily available (e.g. subordinated debt in West Africa) and is also especially relevant where the underlying product is complex to price and highly competitive (e.g. trade finance in East Africa) and the relevant FI that has relationships with other FI's does not want to jeopardise their key relationship with another FI by not executing off the back of a formally drafted contract. We thus request that the OECD expand on why a bank opinion / quote would not be considered to be adequate and provide FI's with realistic, commercial alternatives when faced with the afore-mentioned market limitations.

BOX C8 - CASH POOLING

88. *Commentators are invited to provide examples where a cash pool manager is allocated risks relating to group lending. Commentators are also invited to comment on the examples put forward for allocating cash pooling benefits.*

89. Submission: It is submitted that a cash pool manager could assume risk in an intra-group lending arrangement where the pool manager assumes currency risk as a consequence of



using external borrowing in one currency to advance a loan to an operating affiliate in a less stable currency. Other circumstances where a cash pooling manager could assume risk is where it is on lending to an entity in a jurisdiction with regulatory restrictions which may impact the ability of the borrowing entity to repatriate the funds and/or interest. Commercial risks could be embedded into the loan arrangement which shelters the borrowing entity by allowing a roll-up of interest when, financially, it is unable to pay the interest due to requiring cash for operational reasons.

BOX C9 - CASH POOLING

90. *Comments are invited on how to treat the requirement for all members of the group to participate in a cash pooling arrangement.*

91. Submission: It is submitted that in a relationship between third parties, an entity would not have entered into a transaction which is clearly non-beneficial.⁵

D. SECTION D - GUARANTEES

BOX D1 - DELINEATING THE TRANSACTION

92. *Comments are invited on certain circumstances when a guarantee should be recognised and priced.*

93. Submission: We submit that the facts and circumstances relating to the guarantee arrangement should determine the nature of the transaction.

94. Where the guarantor is standing as primary surety on an external loan arrangement with a third party and the impact for the lender is to enable a more preferential interest rate, then there is an argument that the guarantee should be a financial service and measured in terms of an interest rate spread.

95. Where a guarantee is a requisite in order to provide lending and without that the borrowing entity would not be able to secure any external funding, it can also be argued that this is a financial service. The only other option the group would have is for another entity to borrow the funds and on lend to the entity requiring the funds. Pricing this would depend on the cost of the external borrowing that would be required as an alternative.

96. Submission: It is further submitted that most guarantees are used to obtain improved cost of borrowing. In such cases these are typically priced in accordance with an interest rate spread.

E. SECTION E - CAPTIVE INSURANCE

BOX E1 - DELINEATING THE TRANSACTION

97. *Comments are invited on the various issues pertaining to allocation of risk and the appropriate return for captive insurance arrangements.*

⁵ Refer paragraph 102 of the discussion draft



98. Submission: We agree that it would be helpful if an example was provided which illustrates the effect of outsourcing the underwriting function on the income allocated to the MNE group member that issues the insurance policies.

99. In South Africa, as in most African countries, external CUPs are not readily available. Actuarial methods to arrive at a price are used, but specialists are rare. The methodology suggested in the draft regarding how a CUP can be arrived at by combining two methods appears useful, but more guidance would be required.

100. Submission: Guidance regarding the use of actuarial methods as well as a combination of two methods, regarding application thereof, would be required.

101. It may also be useful to include guidance regarding the use of broker quotes, which would be common in the industry. The submission relating to the use of bank quotes (paragraph 87 above), and the underlying principles as set out above, is here referred to. Paragraph 166 of the discussion draft provides insightful and valid points in relation to “testing” an independent insurer for arm’s length comparability purposes. What would be of value is practical guidance as to how a taxpayer evidences such “capabilities” to Tax Administrations.