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

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EBIT's Members[1] are grateful for the opportunity to provide comments on the OECD's public consultation running from 3 July – 7 September 2018 with regard to the OECD's Public Discussion Draft ("Discussion Draft") on BEPS Actions 8-10 Financial Transactions. Below are a number of issues that EBIT believes are key for Working Party no. 6 of the OECD on the Taxation of Multinational Enterprises to do further work on.

Accurate delineation of the actual transaction

Application of the approach of accurate delineation of the actual transaction

In Chapter I of the Transfer Pricing Guidelines 2017, the OECD introduced the approach of accurate delineation of the actual transaction as one of the key aspects of a comparability analysis. The Discussion Draft in paragraphs 9-10 aims to provide guidance to countries that use the accurate delineation of Chapter I to determine whether a purported loan must be considered as a loan for tax purposes, in the context of the application of Article 9 of the OECD Model Tax Convention. The OECD does not however consider accurate delineation under Chapter I as the only approach for determining whether purported debt should be treated as debt, but rather explicitly allows application of other approaches.

EBIT notes that a cross-border misalignment on applicable approaches may result in double taxation. Such misalignment could ensue if the countries in which the transaction partners are located have different views on the debt recognised and subsequently the arm's length interest rate due to different approaches applied. It would therefore be useful if the OECD provided guidance on the appropriateness of other methods and how misalignment on debt recognition is to be treated from a tax perspective. In any event, in case of such misalignment between countries, the recharacterisation of the loan should remain eligible for a mutual agreement procedure and not be considered as unilateral anti-abuse measure. It would however be preferable if the OECD would stipulate that countries should implement the approach of accurate delineation of the actual transaction as the only approach. As a range of these proposals could have substantial implications for withholding taxes applied to debt interest, or to dividend payments (i.e. secondary transactions following recharacterisation), We would welcome acknowledgement of this and clarification of how treaties must be analysed to prevent inadvertent penalisation of taxpayers.

Practical simplification

While the approach of accurate delineation of the actual transactions provides a sophisticated framework for the estimation of arm's length practices, EBIT sees room for simplification in the area of financial transactions in particular with regard to the arm's length debt leverage level assessment and the determination of the safe harbour interest rates. Concerning the debt leverage EBIT would welcome two types of escape rules. First, we believe that a fixed ratio rule (e.g. debt to equity ratio) would be useful. Second, we suggest applying a group escape clause: if the leverage level of the entity is lower than the group leverage on the consolidated basis, one should consider that there is no abuse of debt structure.

[1] EBIT membership information is available on: www.ebit-businesstax.com; EBIT Member companies include: Airbus Group, BP, Caterpillar, C-Brands, Deutsche Lufthansa, Diageo, GSK, Informa Group, International Paper, Johnson & Johnson, JTI, Naspers, PepsiCo, Pfizer, P&G, RELX, Schroders, SHV Group, Tupperware, UTC.

As far as the interest rates are concerned, EBIT notes that some countries have their own safe harbour rules for interest rate determination. It would also be helpful if the OECD clarified how local safe harbour rules could be applied in a cross-border context (i.e. considered as at arm's length in the lender's country). EBIT Members would welcome safe harbour rules at OECD level for different types of loans (e.g. M.o.U. on low risk activities).

Debt servicing

EBIT is concerned about the prescriptive language used in paragraph 17 of the Discussion Draft, by which, if an entity is unable to service a loan it can be concluded that an unrelated party would not be willing to provide such a loan to the entity, and thus, such loan received from a related entity would be not recognised as debt. We would appreciate further clarification of the term "servicing of debt" as used in this paragraph. "Servicing of debt" in general describes the payment of the interest on the debt acquired as well as the subsequent repayment of the debt amount. However, from our experience, it is perfectly feasible for an entity to hold a structural amount of debt, which it cannot repay in full without a further raise of capital. The fact that an appropriate level of debt is an important part of an efficient capital structure is acknowledged by rating agencies by giving target net debt/EBITDA and leverage ratios for each rating notch. The capability of immediate repayment of the principal amount of a loan on maturity should not be a necessary requirement for receiving such loans.

Tax treatment of non-recognized amount of debt

With reference to the example in paragraph 17 of the Discussion Draft and the specific invitation for comment, EBIT understands that only the remainder of such an advance – over and above the maximum amount that an unrelated lender would have been prepared to advance or the maximum amount that an unrelated borrower in comparable circumstances would have been willing to borrow, would not be recognised as a loan. Can the OECD confirm that our understanding is correct? Where a portion of the lender's advance to the borrower is not recognised as a loan, specific guidance on the tax consequences of the non-recognition and the potential use of secondary transactions and their consequences is necessary.

EBIT considers that recasting debt as equity would be unnecessarily complicated to implement and would have many unintended consequences. We strongly believe that recharacterisations should take place only in very limited circumstances. The revised guidance should clearly define and limit the circumstances when this approach may be applied. EBIT would prefer guidance with practical examples on how to execute and reconcile conforming adjustments across jurisdictions if debt is recast as equity. To minimize unintended consequences, recasting the entire amount of debt (rather than simply a portion) at the time of the testing event can sometimes be more practical e.g.: determining the portion of indebtedness to be recharacterised as equity likely would result in significant disputes, not only between a taxpayer and a particular jurisdiction, but involving multiple jurisdictions as to the amount of such recharacterised equity. Additional equity could result in the purported lender becoming an equity holder subject to the direct tax consequences attendant to an equity holder, such as distribution withholding taxes and possible capital gains on the disposition of such interest, which would arise at the time the purported portion of the debt is retired. To be sure, EBIT considers that there are potentially serious knock-on consequences of debt being recharacterised as equity and this should therefore only be done in extreme circumstances.

The economically relevant characteristics of actual financial transactions

Contractual terms

EBIT considers that between associated enterprises the contractual arrangements may not always provide all detailed information that tax administrations might wish to obtain in practice. The OECD suggests consultation of "other documents" in order to identify the actual conditions of contractual arrangements between associated enterprises. EBIT however would prefer guidance on how to document intercompany loan agreements and specific examples of other documents that should be considered in the delineation process.

Functional analysis

EBIT Members would welcome clearer guidance regarding the consideration of the full range of activities performed by one party to the transaction (specifically when involving a group treasury company/function) when delineating the transaction. This is a point alluded to in Example 2 in paragraphs 119-123 in the context of cash pool pricing and the allocation of spread between borrowing and lending positions, but must also be a consideration for other types of transactions.

Practical applicability of characteristics of actual financial transactions in data comparability

Commercial databases are generally used for identifying uncontrolled financial transactions for benchmarking purposes in the context of Transfer Pricing analyses. Such commercial databases contain extensive, albeit ultimately limited, information on financial transactions and its characteristics. In particular, the information available may be limited to transactions having specific characteristics (e.g. country of origin. In practice, it is often not possible to obtain a sufficient number of comparable transactions if strict selection criteria are applied. In addition, in terms of transaction purpose, the information available is often limited or aggregated in such a manner that does not allow assessing whether the initial intent of the transaction is comparable with the tested transaction. EBIT is therefore concerned about the prescriptive language with regard to the economically relevant characteristics of financial transactions to be considered in the pricing process. We would welcome if the OECD acknowledges practical restrictions on the benchmarking process and allows for (reasonable) flexibility, acceptable to all parties concerned, with regard to the selection of comparables. The revised guidance should acknowledge and reiterate that if "perfect" comparable uncontrolled transactions are unavailable, it is often possible to make reliable adjustments to imperfect comparables and such adjusted comparables may be the most reliable means available to benchmark a tested transaction.

Timing of the comparable transaction

EBIT is concerned that in particular the timing of issuance of potentially comparable transactions, such as bonds, is not necessarily decisive for the assessment of the comparability of such transactions as long as the timing of the Transfer Pricing analysis is in line with the tested transaction characteristics. For example, in the case of bond transactions, the yield to maturity of otherwise comparable bonds derived at the timing of the issuance of the tested transaction provides indicators for arm's length interest rates applicable to the tested transaction. In fact, a liquid secondary bond market is likely to provide a better comparable than a new public debt issuance due to the new issue premium (i.e. additional return demanded by investors to compensate them for the dilution of that company's debt) included in the interest rate on a new issuance.

Risk free return

Risk free return rate

The risk-free rate of return is a purely hypothetical concept where the risk-free rate is generally approximated by the reference to the interest rate on certain government issued securities. OECD guidance stipulates that where a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it is entitled only to a risk-free return. In such circumstances, the risk is allocated to the enterprise which has control over the risk and the financial capacity to assume the risk associated with the financial asset. Although EBIT Members believe that there are mechanisms more suitable to address situations in which a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, such as CFC rules, a risk-free return approach requires more guidance on how to allocate the return in excess of a risk-free rate. A risk-free return should not be applicable in cases in which the funder retains ultimate oversight of the portfolio even though it transfers day-to-day risk mitigation to others.[2]

The OECD specifically invited comments on financial transactions that may be considered as realistic alternatives to government-issued securities to approximate risk-free rate of returns. Assuming that the risk-free rate is appropriately limited, as noted above, EBIT Members believe that Interbank Offered Rate (e.g. Euribor, Libor or their successors such as SOFR and SONIA) could be considered as a realistic alternative to approximate a risk-free rate of returns on short-term transactions. Alternatively, for long-term transactions the swap curves may be preferable as the market's forecast of what Interbank Offered Rates will be in the future could be considered. EBIT believes that this represents a reasonably practical approach also in terms of documentation process as evidence can be easily obtained. However, one should consider that while Interbank Offered Rates/Swap Curves are less exposed to the sovereign risk it is exposed to risks associated with a banking crisis (an exposure which the transition to SONIA/SOFR aims to mitigate). Thus, the choice should depend on the relevant market conditions. EBIT Members would also welcome the possibility to use a unique (i.e. fixed reference/maturity) safe-harbour risk free rate of return per currency in order to avoid practical difficulties in the determination thereof. Lastly, we would prefer additional guidance concerning the computation basis of the risk-free remuneration (i.e. to what exact basis should the risk-free rate be applied?).

Allocation of the risk-free rate of return

EBIT Members would welcome additional guidance from the OECD on how the risk-free rate of returns should be split between affiliated entities in case different entities have the control over the risks and the financial capacity to bear the risks.

Risk-adjusted rate of return

The OECD indicates that, under an approach based on the cost of funds, the controlled transactions would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower and that this mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in paragraphs 89 to 91. EBIT Members would welcome further clarification on how this mark-up should be computed in practice, as this is an issue groups are very frequently faced with. In particular, we would like to understand how leverage and credit risk considerations should be factored into the mark-up analysis. This is particularly relevant and applicable to the common situation where a group issues bonds through a financing company set up for the purpose, and that company on-lends the funds to elsewhere in the group. The bond issuing company is raising debt on behalf of the group, and should be remunerated only by a small turn reflecting functions performed. Though gross debt is high, the company has zero net debt, and can reply on the implicit or explicit support of the group to know that the on-lending will be repaid in order for the bond to be repaid on maturity.

We understand that the IRS has precedent for seeking to argue that the presence of a guarantee of the bond issue (required by the market for public debt issues) means the external bond debt should be recharacterised as an equity investment by the guarantor in the issuing company, simply because of the level of gross debt exceeds what could be borrowed without the guarantee – despite the fact that the net debt is zero. EBIT disagrees with the

[2] OECD BEPS Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, 1.70, OECD Publishing, Paris (Oct. 2015).

view that guarantees of subsidiaries that are used to facilitate the passing of third-party borrowings to group members should be viewed narrowly from the perspective of the gross amount of debt on the books of the subsidiary borrower merely because such debt is guaranteed when the subsidiary has offsetting positions with other related affiliates. In such a case, the subsidiary's net debt is the more appropriate position to be analysed".

Maturity of the financial instruments

Referring to paragraph 6 in Box B.4., a short-term loan that is consistently replaced with a new instrument may, in some circumstances, be accurately delineated as a long-term instrument. However, there may be situations when the use of short-term instruments over a longer period of time represents a reasonable management decisions that should not be recharacterised. However, EBIT believes that a long-term loan with a "periodic break" clause, which allows the borrower and lender to renegotiate the terms of the borrowing or terminate the agreement at set anniversaries, may provide a more appropriate recharacterisation basis compared to a straight long-term loan, which would be priced differently.

Treasury function

Centralized treasury centres operating as profit centres

The Discussion Draft states that different treasury structures involve different degrees of centralisation, where in the most decentralised form, each entity within the group has full autonomy over their financial transactions and, at the opposite end of the scale, a centralised treasury has full control over the financial transactions of the group. EBIT Members would welcome additional guidance on how such differences could affect the remuneration of the treasury function in practice.

Lender's and borrower's perspectives

Borrower preferences

Borrowers on the capital market generally have access to both fixed and floating rate debt and choose the financing instruments based on their preference regarding financing risk exposure. If the business model and strategy of a borrower resulted in a loan taken on fixed rate without a break clause, it indicates that the borrower has consciously chosen not to expose himself to such risk. (Even if there is a break clause, a borrower can choose to not renegotiate / refinance its loans because they may receive services or other benefits from the lender. Especially for entities with a large loan portfolio, the constant interest rate monitoring will lead to administrative burden). Consequently, such borrower should not benefit from the favourable changes of market conditions. The wording of paragraph 56 of the Discussion Draft however implies that borrowers should seek to renegotiate existing loans if market interest rates change. Borrowers have the ability to choose a mix of fixed and floating rate debt, balancing certainty versus the ability to benefit from reduced rates. If the business model and strategy of a borrower means they have taken on fixed rate debt, and not paid for a break clause, they have consciously chosen not to retain this flexibility. EBIT believes that changes in macro-economic circumstances should not automatically lead to the recharacterisation of transactions if such options are not part of the transaction characteristics due to reasons explained above.

EBIT is concerned about the prescriptive language used in paragraph 54 of the Discussion Draft, by which, the borrower would generally seek secured funding ahead of unsecured funding in case the business has suitable collateral to offer. From our experience, while it may be cheaper, secured funding may result in the imposition of potentially significant restrictions and control over the conduct of the company. Many companies, particularly higher rated ones, would actively seek unsecured lending in priority. EBIT also has concerns with some of the language in paragraph 52. We suggest deleting the following sentence in the proposed guidance: "If the assets of the business are not already pledged as security elsewhere, it will be appropriate to consider ... whether those assets are available to act as collateral for the otherwise unsecured loan and the consequential impact upon the pricing of the loan."

The preferences of borrowers with regard to characteristics of financing transactions in terms of interest rate structure and granting of security are both a result of the borrower's business decisions. A particular concern of EBIT is that the current wording of the Discussion Draft dismisses alternative business considerations, which can result in reclassification of such transactions by tax authorities. EBIT wants to emphasise that choosing deviating business strategies/preferences must at all times remain the prerogative of businesses themselves.

Documentation of the options realistically available

The Discussion Draft stipulates that independent enterprises, when considering whether to enter into a particular financial transaction, consider all other options realistically available, and only enter into the transaction in absence of alternative that offers a clearly more attractive opportunity to meet their commercial objectives. Documenting that such rationales were considered is complicated due to sheer number of opportunities theoretically available to enterprises. EBIT would therefore prefer more extensive, detailed guidance and examples. The guidance should clarify that a taxpayer cannot reasonably be expected to identify and rebut in advance every alternative that a tax authority may subsequently identify as something which could have been a "realistic" commercial option. Stated differently, the mere fact that a tax authority proposes an alternative is an insufficient basis for recasting a taxpayer's otherwise reasonable transaction if it has been priced appropriately.

In our opinion, a particularly reasonable method of the demonstration that other realistically available options of a financing transaction were considered would be quotes from unrelated banks, or consideration of typical deposit rates when analysing short-term intra-group facilities with comparable risk profiles (e.g. market yield curves publicly available). We request that the language in paragraph 49 be modified to eliminate this requirement that would be imposed on lenders, as it would allow tax authorities to raise additional questions such as why an entity made a deposit (with the central treasury), why it didn't deposit less (or more), which would lead to prolonged audits and increased compliance burden. The guidance should reflect proper deference to the commercial decisions of a company's management, as many factors are taken into account by the board of directors and management in operating the company's business, including a financial capital perspective. While the board and managers take the shareholders' perspective into account in making business decisions, good business governance practices and corporate fiduciary duties and responsibilities also dictate that the company operate in a commercial reasonable manner and not solely at the behest of a shareholder.

Ownership of subsidiaries

According to the Discussion Draft, in the case of a loan from the parent entity of an MNE group to a subsidiary, the parent already has ownership of the assets of the subsidiary and therefore, in evaluating the pricing of a loan between related parties it is important to consider the option where those assets are available to act as collateral for the otherwise unsecured loan and its impact upon the pricing of the loan (if the assets of the business are not already pledged as security elsewhere). EBIT urges the OECD to provide additional guidance on the treatment of the assets in the context of group ownership. In particular, it is unclear when or whether assets should be considered as pledged and find such reflection in the benchmarking process. For example, if the lender has to assume that the transaction is secured while he might not actually have the luxury of assuming that the assets can be used as security (e.g. in case of Joint Venture structures), it could lead to value leakage to 3rd party shareholders, which would not respect the arm's length principle.

As previously stated, we strongly believe that tax authorities should not interfere with business decisions. Further guidance is required on those situations for which taxpayers would need to document why a loan was pledged or not. We think such guidance should be rooted in market practices, such as the application of underlying assets as pledged in the case of financing a real estate transaction, in order to provide a clear message and eliminate uncertainty. Further guidance and standards are also required with respect to different local treatment of the "ownership concept". For example, countries may apply different shareholding thresholds when defining "ownership", resulting in different assessment of a shareholder relationship between parent entity and its subsidiary. In a loan from the parent entity to a subsidiary, the assets would be considered as pledged from the perspective of one country and disregarded from the perspective of other country, ultimately resulting in an assessment of different interest rates to be at arm's length.

Credit rating

In-house modelling Use of credit ratings

In practice, lenders often use in-house models or commercial tools to estimate the credit rating of a borrower. According to the Discussion Draft, where a reasonably reliable rating for a debt borrowing can be arrived at using such tools or models, these could be applied. However, the OECD questions the credit rating methodology used in commercial tools, as those use only a limited sample of quantitative data to determine a credit rating. EBIT Members consider that it would be helpful if the OECD would provide additional guidance on the input parameters necessary for the models to derive "reasonably reliable ratings". Moreover, credit rating methodologies used in commercial tools released by rating agencies closely follow the agencies' internal methodologies. In certain cases, such commercial models are only tools applicable with a reasonable effort. Thus, EBIT suggest that a reasonable degree of flexibility acceptable to all parties concerned should be allowed with regard to the application of in-house models or commercial tools. However, the guidance should also recognize the distinction between financial businesses and large companies that have the resources to employ in-house financial models and other businesses that do not have these resources or who determine that given the number of financial transactions decide not to allocate significant resources to in-house financial models.

Implicit support

Contrary to the considerations set out in paragraphs 69-74 of the Discussion Draft, none of EBIT's Members can think of a scenario in practice where they would allow a subsidiary to default on third party debt. Parent company guarantees may be required by lenders – but sometimes this is because it allows them to do their due diligence on a listed and rated entity.

The Discussion Draft acknowledges the potential impact of passive association with the group on creditworthiness of a lender. EBIT Members have concerns with the potential for misapplication of group support as an integral part of the Transfer Pricing analysis because the benefit of passive association often is overstated and consideration of passive association tends to detract from the normative stand-alone principle. We would welcome additional guidance on the concrete application on how such association would be taken into account in the credit rating determination. While we understand that this could be done on the basis of credit rating agency methodology papers, we would also welcome simplified approaches (e.g. notching-down from parent company rating (top-down approach)), as groups are normally also using those, while stand-alone ratings (bottom-up approach) could also be the starting point of the analysis according to some rating agency methodologies).

EBIT Members welcome the clarification by the OECD that no guarantee fee is due in the absence of a formal / legal guarantee, i.e. in the case of a "letter of comfort".

Credit rating update

In the financial markets, financial transactions with a prolonged maturity period may often be subject to regular reviews and reassessments of the credit rating estimation. Certain instruments such as pricing grids on syndicated loan facilities are typically applied. EBIT would welcome additional confirmation by the OECD on the appropriateness of such assessments and specific guidance regarding critical maturities and assessment intervals.

Interrelation between implicit support and financial guarantees

EBIT Members would like to get confirmation that implicit guarantees should usually not lead to any remuneration and would also like to understand better in what specific circumstances such remuneration might be required. More generally, additional guidance on the interactions between implicit support and explicit guarantees would be welcome.

Cash Pooling

Rewarding the cash pool leader

Paragraphs 119-123 of the Discussion Draft describe an example of a group treasury company acting as cash pool leader. Specifically, it cites its ability to control financial risks contractually allocated to it, and its financial capacity to bear those risks, as potentially supporting – under functional analysis – such company "earning part or all of the spread between the borrowing and lending positions which it adopts". In keeping with the language of the rest of the section, it may make sense to state explicitly that given such functionality, compensation for the cash pool leader may include part or all of the "netting benefit", as referred to in paragraph 125.

Cash pooling benefits

In the Discussion Draft, the amount of the group synergy benefit is to be calculated by reference to the results that the cash pool participants would have obtained had they dealt solely with independent enterprises. While the idea of synergy benefits has some intuitive appeal, from a practical standpoint EBIT Members have concerns. Identifying, measuring and apportioning synergy benefits will be difficult to execute, and subject to considerable discretion and disagreement. We are concerned that the cost and complexity of compliance will increase substantially because of tax authorities perceiving synergy benefits where no such benefits exist. To the extent there are synergy benefits, errors in measurement may exceed the synergies themselves. Traditional pricing based on comparable third-party transactions will in many cases produce more reliable outcomes with less dispute and uncertainty than complex exercises intended to apportion synergies. Unless the treasury function is located in a low tax jurisdiction, cash pooling is not a high-risk BEPS issue but a low risk allocation of taxing rights issue. Further guidance should balance the theoretical value of "absolutely correct" taxation estimation against the administrative burden placed on taxpayers and the likelihood of low value disputes and MAP issues.

We ask the OECD to provide guidance and examples of the computation of synergy benefits, with appropriate consideration of the practicalities of conducting such a calculation, in order to better understand under what circumstances and based on what criteria one approach should be preferred over the other ones. We also want to stress that, in practice, many cash pools have significant functionality above and beyond pooling of liquidity (e.g. payment on behalf of participants structures). Under such structures, the cash pool header will operate as a payment and receipts hub for the cash pool participants and will perform more than a co-ordination or agency function with the master account. EBIT would prefer less prescriptive wording regarding the limitation of cash pool leader's functions.

Rewarding the cash pool members

Given that cash pools are not operated between independent third parties and hence direct comparables for rewarding netting benefits to cash pool participants are not available, there is a need for a practical, pragmatic solution for taxpayers. EBIT would welcome acknowledgement by the OECD of the difficulty in calculating netting benefits and finding arm's length methodologies for allocating to participants, and clearer acknowledgement that offering participants a more favourable interest rate (on both borrowings and deposits) than they may otherwise earn (bearing in mind options realistically available and the risk profile of the tested transaction) does reflect an appropriate solution. EBIT would welcome practical guidance on how the netting benefit should be shared, given that the calculations and pricing can be very challenging.

Distinction between long-term and short-term debt

The nature of a financing transaction in terms of the loan maturity may be subject to uncertainties in advance. Companies utilize different durations of debt to ensure adequate financing of their operations over fixed time frames. EBIT Members believe however, that acceptable accounting principles could be used to determine whether a financial transaction is short or long term, and the term to maturity should be respected so long as the decision relating to loan to maturity has been made in a reasonable way based on information available to the taxpayer at the time. Hence, EBIT would like to better understand how the OECD views specific duration thresholds for the distinction between long-term and short-term debt, as well as detailed guidance under which circumstances the short-term debt, should be reclassified as long-term debt. We would welcome a discussion including on the consideration of fluctuating balances on the characterisation of the transaction as being short or long term in nature. Further, different scenarios should find consideration in such guidance. For example, typically, balances on a cash pool will build up through the year and then reduce on the payment of an annual dividend. Any delay or restriction in paying out a dividend could lead to deposit balances remaining at a significant level for prolonged period of time, potentially exceeding the short-term duration thresholds. EBIT recommends that such balances should not be subject to long term recharacterisation. Flexibility should be allowed based on specific facts and circumstances, which can be documented.

EBIT Members would like to highlight that how to deal with early repayment when accurately delineating the actual transaction is important in practice. We would like to better understand how this can be factored into the analysis (i.e. breakage fees or option valuation reflected in the interest rate). In the case of reclassification, it should be limited to cases of clear abuse and not to situations in which taxpayers have exercised sound business judgment to ensure adequate working capital. In addition, with respect to financing transactions subject to reclassification, the guidance should reflect the business judgment of the company in assessing the impact of the relevant commercial and economic environment, including prevailing interest rates, foreign currency exchange rates and currency controls, on the chosen duration for the financing transaction under review.

Hedging

General comments

Generally, EBIT believes that insufficient guidance on hedging transaction is provided by the OECD in the Discussion Draft. In particular, EBIT would appreciate guidance on back-to-back hedging instruments and on offsetting positions within the group as well as specific guidance on the computation of the remuneration of the centrally performed hedging activities for the individual group entities. In addition, it would be useful to understand, with examples, how foreign exchange rate changes appear on financial statements when transactions are appropriately hedged. Foreign exchange losses, in particular, should be carefully explained; losses are an inevitable consequence of an effective hedge when the functional currency appreciates relative to a non-functional currency. It is often the case that tax auditors see only one side of the hedging transaction, invariably the loss side, and miss the offsetting item otherwise hidden in the company's accounts, i.e., to the tax auditor, it appears as if the company has a one-sided foreign currency loss. Many times, this is due to timing issues that make it difficult to "unwind" the offsetting transaction and identify the offsetting gains and losses on a profit and loss statement. Therefore, it would be more appropriate to require that taxpayers have appropriate policies for executing hedge transactions, and that these policies are consistently applied.

Financial guarantees

Cross-guarantees in the context of cash pooling arrangements

A financial guarantee may aim to increase the borrowing capacity of a borrower – i.e. permit a borrower to borrow a greater amount of debt that it could in the absence of the guarantee. In such case, OECD suggests that a portion of the loan from the lender to the borrower, in excess of the borrowing capacity of a borrower, should be accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower). EBIT would welcome further guidance regarding the estimation of the loan amount to be delineated as a loan from the lender to the guarantor – i.e. the loan portion in excess of the borrowing capacity of a borrower. In particular, it should be clarified whether the recharacterized loan amount should equal the exact difference between the borrowing capacity of the borrower in absence of a guarantee and the situation in which a guarantee is provided by the guarantor, which also impacts the borrowing capacity. In some cases, it may be more appropriate to recharacterize an excessive loan by deeming it to be tranched, with amounts in excess of the identified borrowing capacity carrying a "junk" interest rate. These amounts could then be disallowed for tax purposes as not reflecting arm's length behaviour, but they are at least still being characterised as payments of interest on debt. Safe harbour rules are helpful as a means to provide such guidance, especially because the portion subject to recharacterised needs to be limited to the nominal borrower's greater borrowing capacity and not the improved interest rate resulting from the guarantee. In addition, the timing of any potential recharacterisation of a guarantee needs to be limited to certain testing periods, such as the time the guarantee is first extended or substantially modified. Having said this, a reiterated on page 2 of this paper, in EBIT's view there are potentially serious knock-on consequences of debt being recharacterised as equity and this should only be done in extreme circumstances.

Captive insurance

Generally, we consider that captive insurance deserves a separate paper as it is a highly specific activity and not a type of financial transaction *per se*. We also wish to note that captive (re)insurance structures respond to sound economic and financial rationale and that they should therefore not be earmarked.

EBIT Members trust that the above comments are helpful and will be taken into account.

Yours sincerely,

European Business Initiative on Taxation – September 2018

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