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EBF comments on the OECD Discussion Draft on BEPS Actions 8-10 regarding Financial Transactions

Preliminary remarks

The European Banking Federation (EBF), which is the voice of European banks, welcomes the opportunity to provide comments on the OECD Discussion Draft on BEPS Actions 8-10 regarding Financial Transactions.

Banks undertake intra-group financial transactions with the aim to segregate and manage risks and fulfil their regulatory obligations. The EBF would welcome that **the Discussion Draft** explicitly mentions that it **focuses only on financial transactions between related parties according to Art. 9 Para. 1 OECD Model Convention (MC)**. Consequently, all financial transactions between third parties (e.g. from a bank to its clients) are out of scope of the Discussion Draft**. The main purpose should be about improving the standard of non-banks treatment of financial transactions, and therefore the Discussion Draft should not replace or conflict with the OECD 2010 Report on the attribution of profits to permanent establishments of banks.**

The banking sector is subject to **extensive regulation**, for instance, capital, liquidity and leverage requirements, ability to transact with particular customers and reporting. Seeking to protect customers and ensure financial stability, regulation actively and constantly shapes and controls how banking business is undertaken. The EBF welcomes the acknowledgment of the importance of regulation and risk management in the Discussion Draft. In this respect, the EBF would also appreciate that the Discussion Draft mentions that **flexibility** should be given to Multinational Entreprises (MNEs) as far as the application of the separate entity approach for the risk assumption is concerned.

Banks undertake financial transactions in **huge numbers and volumes**. Financial transactions are effectively the stock in trade of banking businesses. Therefore, the EBF believes that the **accurate delineation of financial transactions** should not be subjected to higher scrutiny than other intra-group transactions. We refer in particular to our comments to Boxes B.1, B.2 and B.3 below. In this respect, the **transaction-by-transaction approach** suggested in the Discussion Draft would be **impractical** for both banks and tax authorities.

For **example**, the issues of association and implicit support in a banking group are more complex than in non-banking groups. This is because banking groups generally will not wish (reputation) and may not be allowed (regulation) to let their banking subsidiaries go bankrupt, which implies that banking subsidiaries will generally be able to fully rely on their banking parent's capital and liquidity support in any event. Furthermore, banking parents are actively engaged in steering and controlling their subsidiaries' risks, making their position very different from third party lenders that do not have the means to steer and control their borrower's risk. However, the regulator of a separately regulated subsidiary will require the subsidiary to be adequately and appropriately capitalised in its own right and to comply with its own capital requirements, independent of the parent's. Concerning systemically important banks, recovery and resolution plans are required, which will significantly influence the relationship between parent and subsidiaries in this regard. Great care is required in considering whether one may derive from this that the credit worthiness of subsidiaries of a banking group can generally be assimilated with that of the parent company and whether, as far as credit worthiness is concerned, the position of banking subsidiaries will generally be very similar to that of foreign permanent establishments of banking parents.

The **volume of activities**, the **extensive regulation** and the **international nature of banking operations** produced a number of pressing and interesting transfer pricing questions. This led to the creation of the **OECD 2010 Report** on the attribution of profits to permanent establishment addressing the allocation of risk and capital within banking and financial services groups (2010 Report – so called "Authorised OECD Approach" AOA). Bank groups are usually organised in the form of a legal entity with several dependent permanent establishments (PEs) – unlike industrial or services-sector groups with several independent subsidiaries. The reason for this is regulatory/supervisory requirements for their business activities. These concern the capital structure in particular. The Report takes into account the treatment of PEs as hypothetical separate and independent enterprises, particularly for banks and global trading in financial instruments (Parts II and III). The findings of the Report have been incorporated into the current version of Article 7 of the OECD Model Convention.

The 2010 Report is well-researched, thoroughly considering the manner in which such banking businesses are conducted. The 2010 Report considered all aspects of banking business including regulation and is respected by both banks and we believe tax authorities, addressing the transfer pricing challenges presented by cross-border banking businesses. We would urge that it be made clear that the Discussion Draft is not intended to override the existing transfer pricing rules applicable to banks in the profit allocation between a branch and its head office, nor the 2010 Report.

Where, in addition to PEs, bank groups operate subsidiaries that mostly conduct similar business activities under the same or similar conditions in the host jurisdiction, we would recommend that, in line with the AOA principles, financial transactions with affiliated subsidiaries should be treated equally for tax purposes with respect to their delineation and pricing. These principles are appropriate and transferrable.

Reasons for such reference to the AOA principles, elaborated for the banking sector, for bank PEs are:

- same regulatory/supervisory requirements for a bank group, no matter whether it is organised as an undertaking with dependent PEs and/or as a parent undertaking with subsidiaries;
- the hypothetical independence to be applied under the AOA to PEs, as well as the specificities of the business activities of PEs acknowledged thereunder;
- the comparability of the AOA requirements for, on the one hand, the banking sector in particular and, on the other hand, for financial transactions in general;
- the transferability of the reasons that led to the AOA principles for intra-bank loans (Part II);
- practical considerations, bearing in mind overall bank management that should enable banks to determine arm's length transfer pricing of financial transactions at reasonable effort (implementation as "best practices").

The proposed guidance should make clear that it first of all intends to target base erosion and profit shifting further to transfer pricing approaches regarding intra-group financial transactions, excluding regular regulated banking operations within banking groups that support commercial banking business. Such operations are not BEPS-driven, they should be excluded and are already subject to well-established transfer pricing approaches applicable to the trading activities. Banking groups fulfil an essential role as funding providers to the economy, which is an absolute key condition to enable economic growth. Banking groups and their activities are subject to extensive regulation to ensure the protection of customers and to protect financial stability. It is critical that regulation is not contradicted by taxation. For instance, if inconsistent and too stringent rules would be imposed to the pricing of intra-group financial transactions in the context of a banking group, this could directly affect the pricing of financial products to non-affiliated banking clients. Hence the importance to confirm that regular regulated banking operations in the context of a banking group are not targeted by the new guidance, but remain subject to the existing extensive and thoughtful work of the OECD so as to avoid that any new OECD transfer pricing guidance applicable to intra-group financial transactions has an adverse impact on the real economy.

Specific comments

B.1. Identifying the commercial or financial relations

General comments re boxes B.1, B.2 and B.3

As a general matter, we believe that the accurate delineation of financial transactions should not be subjected to higher scrutiny than other intra-group transactions. Opening up in this way for increased reclassification will likely lead to increased uncertainty and likely extensive tax audits. Due to the fact that the capital structure of banks is mostly determined by regulation, we generally do not see any potential debt/equity characterisation issues involving banks that could be relevant in the field of transfer pricing related BEPS risks: in other words, capital structure does not represent a decisive aspect to determine whether a financial transaction is priced at arm's length Consequently, any reclassification of financial transactions (e.g. from debt to equity) should be a rare exception in tax audits.

Please note however that debt/equity characterisation could be a concern to banks where mismatches arise between different country practices that give rise to double taxation; at present, this issue has always been left to the individual countries discretion and has not actually been dealt with in any official OECD guidance. More generally, it is not yet fully clear how the proposed guidance on the transfer pricing of intra-group financial transactions, which proposes an OECD acknowledged approach for debt/equity characterization for transfer pricing purposes only, would precisely interact with debt-equity characterization approaches in the context of hybrid mismatch and interest deduction measures, where possible approaches appear to have been left to the discretion of individual jurisdictions.

It should be ensured that the accurate delineation of financial transactions does not contradict current banking regulatory legislation (capital requirements etc.). The tax treatment of transactions should remain in line with the existing regulatory requirements.

Comment re box B.1

Regarding the interaction between Art. 25 OECD MC and Art. 9 Para. 1 and 2 OECD MC, we believe that the OECD should promote conclusion of double taxation treaties (DTTs) with Art. 9 Para. 2 OECD MC (Corresponding adjustment) during the implementation phase of BEPS measures. In our experience, corresponding adjustment presents a much faster remedy from (economic) double taxation than the mutual agreement procedure. However, we do acknowledge the value of a Mutual Agreement Procedure (MAP) if a DTT does not contain Art. 9 Para. 2.

B.2. The economically relevant characteristics or actual financial transactions

B.2.1.

We welcome it that accurate delineation of financial transactions should be in line with Chapter I, Section D.1 of the general OECD Transfer Pricing Guidelines. This means that contractual terms, functions exercised, assets used, risks assumed and characteristics of financial products or services should reflect the economic circumstances of the parties and the markets as well as the business strategies of the parties.

However, if the parent undertaking and the subsidiary of a bank group act within the limits of the regulatory requirements, there is no reason, bearing in mind the existing freedom of contract, to assess the contractual form differently for tax purposes. It should be made clear that the burden of proof lies with the tax authorities if they challenge the contractual form.

B.2.2.

Where bank groups are concerned, reference should accordingly be made as regards the function and risk profile, particularly the functions of the lender and the key characteristics of loan transactions, to the (detailed) Part II of the 2010 OECD Report.

B.2.4.

If, in the case of bank groups, an external comparison with bank lending rates to third parties and/or with similar or other benchmarks is to be taken as an economically relevant characteristic, it should be noted that, in view of the functional and risk analysis required and the cash pooling by banks for the entire group, a blanket transfer of external price comparisons to intra-group loans (without any adjusted calculation) is basically inappropriate.

Overall bank management is based on the bank group's overall leverage, not on a bank lending rate to third parties. If individual bank lending rates to third parties were taken as the basis, considerable adjustments would be needed to obtain a satisfactory price comparison for a bank group with affiliated subsidiaries.

B.2.4./B.2.5.

Generally speaking, an adjustment of the arm's length principle in terms of economic circumstances or business strategy is appropriate if an arm's length-based financial reorganisation measure is involved (see e.g. German Federal Fiscal Court (BFH) ruling of 9.6.1997, Grand Senate 1/94, Federal Tax Gazette II 1998, 307, by which the BFH rejects the tax classification of the waiver of a claim under financial reorganisation arrangements as a deposit). This applies particularly to the financial reorganisation of a bank subsidiary since, because of its business model as an intermediary, a bank group has to consider its reputation and cannot generally afford not to rescue a subsidiary and allow it become insolvent.

Over and above arm's length-based financial reorganisation measures, an adjustment of the arm's length principle appears called for in view of the overriding aspect of the parent undertaking's own economic interest in the commercial success of the subsidiary and its duty to assume a certain degree of responsibility as stakeholder for funding the subsidiary (see in this respect, European Court of Justice ruling of 11.5.2018, case C-382/16, Hornbach Baumarkt AG).

Box B4

Box B4 creates some confusion. Reference is made in this context to what we mentioned in the introduction, i.e. only related party financial transactions should be covered by the Discussion Draft

a. For example, does section 10 and 11 imply that a third country may be involved, if so this may lead to confusion.
b. Section 13 and 14 are bundling the funding transaction with development of an intangible, which also leads to confusion, when separating the two types of transactions and pricing both in accordance with the arm's length principle would be appropriate.
c. Please also see comment 3 above regarding country risk.

Re n° 4

A look at banking practice, where there is generally no risk-free finance, shows that taking government bonds as an example of (relatively) risk-free finance for price comparisons appears generally questionable. In addition, we regard such a benchmark as appropriate only for long-term finance in capital market business, but not for short-term finance in money market business. Bearing in mind the adjustments needed, further explanation of these benchmarks is required.

Re no. 6

We take a critical view of maturity transformation. The example of reclassification of the subsequent replacement of a short-term financial instrument with another (short-term?) financial instrument as a long-term financial instrument is, in our view, at odds with the arm's length principle (key term: risk analysis) and also appears too general.

Box B.5.

Realistic alternatives should be explained with the help of (further) examples.

Re no. 9

Given events on the ground in the eurozone, we oppose the idea of the tax administration of one country considering government bonds issued by a higher-rated country a basis for risk-free financing if both countries belong to the same currency zone (take, for instance, Greek vs. German government bonds).

Box B.6

Same remark as under Box B.1

C.1. Intra-group loans

Box C.1

In a bank group, the treasury function is highly important for the liquidity management of the bank as a whole. Depending on the business model of the group, this function can take (sometimes very) different forms, from highly centralised to more decentralised structures. As a result, treasury functions will be of varying importance with regard to function and risk analysis.

In view of this, we consider the distinction between a subsidiary with "full autonomy over its financial transactions" and a subsidiary where this is not the case to be inappropriate and too blunt. Further explanations are needed and, in particular, criteria for classification.

In any event, we would recommend making reference to the guidance on functional analysis in parts II and III of the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments (so called "Authorised OECD Approach", or AOA).

We agree that the treasury function should be regarded as a service.

Box C.2

Goes against the arm's length principle and this simplification will lead to more confusion. The process of trying to get an as right credit rating as possible (which is the current best practice) is aligned with the arm's length principle and how third parties would act. The suggestions in Box C2 will likely lead to more confusion also as tax authorities from two different sides may have different views.

If a subsidiary has a stand-alone rating, the option of using it should be provided for because this is consistent with the arm's length principle.

It would however always be appropriate, in the interests of practicability, legal certainty and with bank-wide risk management in mind, to use the group rating of a bank group as a basis when considering each individual subsidiary, even if the subsidiary has a rating assigned by a rating agency on a stand-alone basis, if this simplified approach is offered with no ability to rebut or adjust.

Boxes C.2/C.3

We agree that both perspectives should be taken into account when considering the economic and financial relations and analysing the economically relevant characteristics of transactions between associated borrowers and lenders.

It should nevertheless be borne in mind that intra-group loans in bank groups differ from those in industrial or service-sector groups when it comes to the management of business processes and, in particular, the treasury function in general. It is therefore open to question whether processes can be compared at all.

Boxes C.2 to C.6

In a financial institution with a centralized treasury function, one possible model for the parent company's pricing of long term loans towards it's international branches and subsidiaries which could be suitable for some groups is to split the price into two components: (i) a charge equal to the short term interbank rate (reference rate) calculated on the actual loan amounts and (ii) a liquidity premium. The liquidity premium should reflect the cost related to the need for the long term funding at group level that is created by the branch/subsidiary. For such purpose, the liquidity premium should be computed based on the net assets of the receiving branch/subsidiary, defined as the receiving entity's outstanding loans to third party customers less the entity's weighted deposits from third party customers.

Under this pricing model the need for long term funding created by the branch/subsidiary may deviate from the funding actually received by the branch/subsidiary. This is due to the fact that the contribution to the overall need for long term funding may deviate from the liquidity because the composition of outstanding loans to customers vs. weighted customer deposits in the branch/subsidiary may create a higher need for obtaining long term funding on a group level in order to stand behind the branch/subsidiary than what is actually needed for the branch/subsidiary to receive in terms of liquidity transactions in order to serve it's day-to-day obligations.

We welcome that WP6 presents in the subchapter C.1.7 pricing approaches to determine an arm's length interest rate that are widely spread in the practice. Due to the lack of Comparable Uncontrolled Prices ("CUPs") in practice and complexity of other pricing models, we would welcome, if safe harbours in the form of transaction volumes would be used. We would appreciate, if e.g. only financial transactions exceeding USD 50'000 p.a. would have to be comprehensively documented. Any transactions below the threshold should be considered as priced at arm's length.

As regards the pricing of intra-group financial transactions, transfer pricing rules must give sufficient regard to the essential role of regulated banks to the economy as highlighted above. As a necessary consequence, it must be clear that intra-group fund transfer pricing (and the pricing of any other financial transactions that support commercial banking business) should be consistent with regulatory policy and may not inadvertently affect the pricing to external, non-affiliated counterparts. This e.g. means that it must be possible for banks to choose the funding base rate of intra-group funding transactions from any appropriate and justifiable pricing curve, be it a publicly available or implied curve, as long as such curve appropriately reflects the specific features (tenor, creditor status, …) of each particular intra-group loan. In addition, as banks derive their funding from many different sources and do not usually attract funding to fund their subsidiaries on a 1 to 1 basis, transfer pricing approaches must allow that the pricing may be established taking into account the marginal average cost of funding.

It should also be clear from this that for bank groups, a blanket transfer (of pricing) of financial transactions with third parties to intra-group loans (without any adjusted calculation) is inappropriate. Overall bank management is based on the bank group’s overall leverage, not on a bank lending rate to third parties. If individual bank lending rates to third parties were taken as the basis, considerable adjustments would be needed to obtain a satisfactory price comparison for a bank group with affiliated subsidiaries.

It should be noted that in some cases the price of country risk is in some cases higher than differentiating the credit worthiness and will in such cases have a high impact on price. See comment 3 above.

Box C.5
Credit default swaps (CDSs):

CDSs can be a valuable means of determining a (comparable) interest rate for a loan.

Since the draft does not discuss the role of CDSs in more detail, we would welcome further explanation, especially in the form of examples.

Box C.6
Internal CUPs - Banks do not only have internal CUPs (inbound) from a borrowers point of view, but banks have external (outbound) CUPs as lenders, i.e. banks have extensive CUPs and also internal models for calculating the price for customers, which should be deemed relevant also when pricing loans to associated parties.

Box C.7
In bank groups, the approach of taking account of a premium when determining funding costs is one (general) method which, though it departs further from the concept of the arm’s length principle, is nevertheless practicable.

We would recommend in this context that the guidance on bank groups should make reference to the corresponding guidance on capital resources in part II of the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (so-called “Authorised OECD Approach”, or AOA).

Par. 63/64 – Credit rating methodology
The internal rating models used by bank groups have to comply with prudential and regulatory requirements. The use of internal rating models for determining ratings should therefore be permitted in the banking sector.

German tax courts have differing views on the effects of implicit support, such as financial support by the parent company (judgement of Münster Fiscal Court of 7 December 2016, 13 K 4037/13 K, F, appeal to the German Federal Fiscal Court ref. I R 4/17 vs. Cologne Fiscal Court of 29 June 2017, 10 K 771/16, appeal to the German Federal Fiscal Court ref. I R 62/17). The effect of such support with respect to the arm’s length principle is frequently overestimated, in our view, since third parties will not normally rely on support from the group without explicit guarantees.

We believe it can be inferred from the OECD Transfer Pricing Guidelines that support from the group can only be regarded as reducing interest rates if third parties in a comparable situation, i.e. in the absence of an explicit guarantee, lend to group companies on more favourable terms simply because they belong to a group. Empirical evidence shows that this is not normally the case. Implicit support should therefore not normally have to be regarded as reducing interest rates.

In addition, we would recommend that the guidelines on intra-group loans should make reference to the corresponding guidance in parts II and III of the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments (so-called "Authorised OECD Approach", or AOA).

Par. 73 – Stand-alone rating vs. group rating

If a bank group is involved, we do not agree that it may sometimes be appropriate to depart from the general approach and cap the stand-alone rating of a subsidiary at the level of the group rating. This is because the subsidiary's stand-alone rating will be based either on the findings of an external credit-rating agency or on criteria recognised by banking supervisors and regulators. There is therefore no reason to assume the existence of abuse or of anything that could "undermine" this rating.

Please also see our comments above on stand-alone ratings and boxes C 2./3.

Par. 75 - Covenants

Covenants are not a criterion when it comes to intra-group loans because of the lack of a comparable situation when lending to a third party. Our comments above on relevant economic reasons in the form of a restructuring measure or in the lender's own economic interests (see comments on Box B.3.) apply here too. The non-application, or lack, of covenants in intra-group loans justifies a departure from the arm's length principle and does not have the effect of increasing interest rates.

Par. 79 - Guarantees

Unlike implicit support within a group, which is discussed above, guarantees should be seen as reducing interest rates with respect to the arm's length principle (see our comments above on boxes C2./3.).

Par. 92/93 – Bank opinions

The draft guidance distinguishes between bank opinions and formal loan offers. The former are thought generally not to be indicative of arm's length conditions, while the latter are not explicitly said to provide evidence of arm's length conditions.

A bank's documents relating to the formal offer of a loan are rooted in the arm's length principle and should be explicitly recognised as evidence of arm's length terms and conditions.

In principle, the same goes for bank opinions, provided that they go beyond mere "letters". We reject any claim that a bank would issue such "letters" simply as a courtesy. Bank opinions are also firmly rooted in the arm's length principle, especially given that adjustments may be made in response to new interest rates or maturity adjustments.

Par. 132-136 - Hedging

In this context, too, we recommend that the guidance on bank groups should make reference to the corresponding guidance in parts II and III of the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments (so-called authorised OECD approach, or AOA).

D.1 – Financial guarantees

Reference is made to comments to Boxes C.2 to C.6 above. It is welcomed that the same reasoning is explicitly expressed under the Section on guarantees where the guidance states that "it is recognized that even an explicit guarantee by a related party may not provide the borrower any additional benefit beyond an acknowledgement that the group as a whole may suffer negative consequences by not supporting the borrower in honouring its debt" and that in such circumstances "no guarantee fee would be expected to be paid." We would recommend to explicitly emphasize in the guidance that this lack of additional benefits further to an explicit guarantee will commonly occur in the context of a banking group where strong regulatory requirements and high reputational care entail the highest degree of implicit support.

Guarantees – 141: a bank entity providing a guarantee to another entity will increase its risk weighed assets and will as such increase its cost for holding capital, which needs to be considered when pricing guarantees, which to some extent differs from other MNEs.

Guarantees 140 (same comment as 1): Will likely lead to increased uncertainty and likely extensive tax audits.

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About the EBF

The European Banking Federation is the voice of the European banking sector, bringing together 32 national banking associations in Europe that together represent a significant majority of all banking assets in Europe, with 3,500 banks - large and small, wholesale and retail, local and international – while employing approximately two million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that reliably handle more than 400 million payment transactions per day. Launched in 1960, the EBF is committed to a single market for financial services in the European Union and to supporting policies that foster economic growth.

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