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OECD
Centre for Tax Policy and Administration
Tax Treaties, Transfer Pricing and Financial Transactions Division
2 rue André Pascal
75016 Paris
FRANCE
Sent via e-mail to TransferPricing@oecd.org

To the kind attention of Mr. Tomas Balco

Re: **TPMinds International** - W**orking group on financial transactions**

Dear Mr. Balco,

Following your speech at TPMinds International on March 19, a group of participants (including delegates from both the business community and advisors) have met in order to discuss some topics relevant to financial transactions' transfer pricing. We understand that the aim of the OECD would be to finalize the relevant guidance by this year, the next meeting to discuss the topic is scheduled for April and the remaining issues to be addressed are the following:

- Need/possibility to identify an arm's length capital structure;
- Possibility to use the group credit rating for transfer pricing analyses.

The working group at TPMinds International focused mainly on the second item and discussed various reasons why the group credit rating should not be considered as a possible reference in transfer pricing analyses. These include, at least, the following:

- As a matter of fact, delegates from the banking industry argued that group credit rating is not considered as a standard practice in lending decisions. On the opposite, the starting point is represented by the stand-alone rating determined according to internal models, adjusted in order to take into consideration the implicit support, since the business and financial risk profiles (also defined as qualitative and quantitative credit characteristics) are different for subsidiaries than for the combined group. This view was also shared by delegates from the general industrial sectors. Using the group credit rating to price intra-group loans would, therefore, represent an approach not in line with the one followed in a third-party scenario;

- The delegates also mentioned that subsidiaries may have external ratings and, in certain cases, they obtain a credit rating higher than the group one (up to 2 notches above). This would create an evident inconsistency if the group rating is adopted for intra-group loans while the external one is used in third party transactions;

- If all the entities in the group share the same rating there would be no credit spread among them, therefore the group treasury company would not be able to obtain any remuneration for the credit risk assumed. This would undermine the role of in-house treasury companies as well as be inconsistent with the general guidance on risk assumption in the Guidelines and to the technical analyses prepared by rating agencies. As a result, increased controversy, rather than simplification, would be the likely outcome of a group credit rating approach;

- If all the entities in the group share the same rating, a group treasury company would have an incentive to fund only the more creditworthy and integrated entities (as the risk connected is lower) and to let third party lenders fund the others' (at a higher interest rate determined according to the actual risk connected). This, once again, demonstrates that an intra-group rate determined based on the group rating would be inaccurate;

- In the experiences of the participants to the working group, existing local rules in various countries and tax authorities' approaches are generally based on the stand-alone rating (with possible adjustments for the implicit support). The use of group rating has instead been adopted, in certain cases, by tax authorities as an opportunistic measure, therefore, in the participants' view, the guidance should take a clear position on the matter (e.g. in which cases the group rating may/has to be used, if any);

- An extreme consequence of the group credit rating approach would be the impossibility to remunerate financial guarantees, invalidating the relevant guidance on the matter. The group credit rating implicates, indeed, a complete support to all the subsidiaries that would leave no space for any explicit support in the form of a guarantee. As the participants interpret rating agencies' criteria as limiting the increase in credit rating due to implicit support to a maximum of three notches, the adoption of the group credit rating would require an even stronger support in case of subsidiaries with lower ratings.

Other topics on which the delegates would like to raise the attention of the OECD are the following:

- In terms of capital structures, it has to be pointed out that the use by the rating agencies and lenders of Debt-to-Equity ratios is limited. The key leverage statistic is represented by the Debt-to-EBITDA and other Cash Flow-to-Debt ratios. In fact, these ratios are usually adjusted to consider non-recurring income and expense items. On the other hand, Capital can be overstated due to acquisitions resulting in goodwill/intangibles;

- Special considerations for the financial industry, at least in terms of regulated capital structure and specific services/sectors (e.g. asset management);
- Performance guarantees, at least in the definition of what should be considered as a performance guarantee (as opposed to financial guarantees) and possible pricing models;
- Delineation of transactions and capital structure for specific industries (e.g. real estate, renewable energy plants, project finance) where subordinated/mezzanine debt is a standard practice in the market. For instance, in the infrastructure sector the subordinated debt is commonly found only in the special purpose vehicles, as the project finance is normally on a non-recourse basis and there is no comparable subordinated debt in the parent company. Given the limited availability of external comparable transactions, additional guidance on the matter would be welcome. The current text of the discussion draft only mentions subordination of a loan as a feature to be taken into account while the hybrid nature of mezzanine financing requires special care due to the possibility of re-qualifying a subordinated intra-group loan into senior debt and/or of notching down at one, two or even three notches the subsidiary stand-alone rating (with or without implicit support).

We believe that these comments may be of help in the future discussion and in reaching the final consensus on the matter.

We are of course at your disposal for further details on the above.

Yours faithfully,

Raffaello Fossati   Luca Romanelli

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For further clarifications you may reach us at the following email addresses:

rfossati@fantozzieassociati.it
lromanelli@fantozzieassociati.it