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Dear Sir/Madam

Comments on the Public Discussion Draft on BEPS Action 4 – Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

We welcome the opportunity to make this written submission in response to the OECD’s discussion draft on ‘Approaches to address BEPS involving interest in the banking and insurance sectors’ (“Discussion Draft”).

The Asia Securities Industry and Financial Markets Association Limited (“ASIFMA”) is an independent, regional trade association with over 90 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional service firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region’s economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

Context of this submission

We agree that the interest related BEPS concerns for the banking and insurance sectors should be considered separately given the significant differences in the business model and the regulatory environment these sectors operate under. In representing our members’ interests, our response to the Discussion Draft is made from a banking sector perspective and covers:

- Comments on the approach to exclude solo-regulated banking entities\(^1\) from the scope of application;
- Discussion of interest related BEPS risk associated with non-regulated entities in a banking group;
- Comments on the application of the modifications to the fixed ratio rule described in the Discussion Draft as it applies to non-regulated entities in a banking group; and
- Specific considerations for bank branches.

\(^1\) As referred to in paragraph 11 of the Discussion Draft, “solo-regulated banking entities” means entities engaged in banking business and subject to capital regulation at an entity level.
For the other concerns highlighted in the Discussion Draft which are not specific interest related BEPS risk, such as ‘hybrid’ regulatory capital issued in the legal form of equity but treated as debt for tax purpose and borrowing to invest in equity-funded vehicles in low tax jurisdictions, we believe these should be dealt with through domestic tax rules and/or other BEPS Actions (e.g. Action 2 for hybrid mismatches and Action 3 for controlled foreign company regimes).

Although this submission has not responded to all specific questions raised in the Discussion Draft, we are supportive of the concepts and responses set out in the submission by the Securities Industry and Financial Markets Association (“SIFMA”) and the joint submission by the British Bankers’ Association (“BBA”) and the Association for Financial Markets in Europe (“AFME”), which are consistent with our overall conclusion that banking groups as a whole should be excluded from the application of an Action 4 rule. We are also generally supportive of the concepts made in the cover letter and attached paper submitted by the Business and Investment Advisory Committee (“BIAC”). As such, we have not sought to duplicate certain detailed comments provided in those submissions.

1. Approach to exclude solo-regulated banking entities from the scope of application

We appreciate the recognition by the OECD of the unique role that interest expense plays in the banking entities (i.e. it is effectively ‘cost of goods sold’) and the acknowledgement of the specific regulatory requirements imposed on banking groups. We also agree with the OECD’s view, as expressed in paragraph 26 of the Discussion Draft, that excessive leverage in banking entities has not been identified as a key risk at this point in time and so it is anticipated that, in majority of cases, this risk will be low. As such, there should be less need to introduce tax rules aimed at dealing with a risk that does not exist or is already addressed.

On this basis, we support the approach as discussed in the Discussion Draft that a fixed ratio rule should not apply to solo-regulated banking entities, and we suggest that this approach should be broadened to all entities in a banking group (and related vehicles, e.g. a non-consolidated securitization company).

We consider, for the reasons set out below, that a narrow carve-out of only solo-regulated banking entities from the application of fixed ratio rule would result in inappropriate tax and economic outcomes, i.e. where tax deduction of interest expense in other non-regulated entities in a banking group is restricted under the operation of the modified fixed ratio rule. In particular, interest expense in most of these cases is incurred in the production of other taxable non-interest income and/or the banking group as a whole generates net interest income due to the existence of a banking entity which forms part of the group.

2. Interest related BEPS risk associated with non-regulated entities in a banking group

In considering whether any general interest limitation rules should apply to non-regulated entities in a banking group, it is important to assess whether such interest related BEPS risk exists in these non-regulated entities in a predominantly banking group.

Usually, banking groups are subject to consolidated supervision such that non-regulated entities are also within the scope of the group level capital adequacy and leverage requirements. This imposes restrictions on the levels of debt that can be held by these non-regulated entities as well as the banking group at a consolidated level. It is therefore important that any proposed approach under Action 4 should take this into account and appreciate the type and nature of activities conducted by these non-regulated entities in a banking group, which in majority of the cases, are integrated with the key banking business conducted by the solo-regulated banking entities as well as the group’s overall funding structure.

Notwithstanding that some of the non-regulated entities are not consolidated in the banking group for accounting purposes, as there is no apparent interest related BEPS risk exists in
these non-regulated entities, we recommend that all these entities should be excluded from the scope of the fixed ratio rule and group ratio rule prescribed under the Discussion Draft; hence we suggest a full exemption for banking groups from the application of the fixed ratio rule and group ratio rule. In order to better explain the aforesaid suggestion, we set out below the common types of non-regulated entity that usually exist in a banking group and, in each case, explain the reasons why we consider the interest related BEPS risk in these entities to be low.

i) **Holding companies/financing companies**

Some banking groups will have an ultimate parent company or holding company above their main licensed banking entity. Such holding companies/financing companies not only raise equity but also issue debt and borrow money on behalf of the banking group. On a stand-alone basis such companies may be in a net interest expense position. However, such interest expense is usually incurred by these entities for funding the net interest income in the solo-regulated banking entities within the group. Where only solo-regulated banking entities are carved out from the fixed ratio rule so that their net interest income is ignored, such treatment could put the banking group in an asymmetrical position, where the interest income is taxed in the hands of the banking entities and a portion of interest expense is disallowed to the banking group as a whole.

This issue is increasingly relevant given that as part of the recovery and resolution plan ("RRP"), the Financial Stability Board ("FSB") has introduced regulatory requirements for banks to introduce non-bank holding company structures as the single point of entry such that resolution action will be initiated at the top holding company level. The objective is to achieve an orderly resolution in the event of a bank failure. A group may have a single resolution group or multiple resolution groups depending on its structure. In either case, loss absorbing capacity must be allocated from the point of entry to the individual banks within the group to ensure that losses are passed up to the point at which resolution powers will be used.

On account of the conditions prescribed under the RRP, banking groups are encouraged to raise funds (which may or may not qualify as regulatory capital) at its holding company level and provide capital through various instruments to the relevant entities within the group by the holding company. This is another example where the choice of the financing/funding entity is driven by regulatory considerations. Under the resolution regime, the holding company is generally a purpose-built vehicle set up for the purpose of allowing an orderly resolution of a failed bank. As such, this type of holding company/financing company is highly integrated with the operation of a bank and we consider the interest related BEPS risk associated with such holding company/financing company is relatively low.

Our conclusion is it would be far simpler to exclude holding companies in general from the scope of the rules, rather than seek to implement a method of, say, tracing use of holding company onward lending, which would be administratively burdensome.

ii) **Securities companies**

While not subject to the same set of regulatory capital requirements, securities companies are generally also regulated entities and subject to capital adequacy standards in most countries. For instance, securities trading companies in Hong Kong are regulated by the Securities and Futures Commission and subject to, amongst other regulations, Securities and Futures (Financial Resources) Rules which provide for capital and other prudential requirements for certain securities trading activities. Given the regulatory environment in which securities companies operate, the interest related BEPS risk associated with securities companies are comparatively low.

Furthermore, to the extent securities companies do borrow funds (thus incurring interest expense), such interest remains akin to ‘cost of goods sold’ because the company invests the funds in assets that aim to generate a net income return. That income may be non-taxable
(e.g., an exempt dividend receipt arising from equity trading); however, there are already
domestic tax rules in place in key financial services jurisdictions (e.g., Singapore and Hong
Kong) that address this issue by allowing a tax deduction for interest expense only to the
extent that it is incurred in the production of taxable income (we refer to our general point on
this on page 6 below). Given that securities companies conduct high volume low margin
activities such as stock loan/borrow, repos, etc. in their capacity as financial intermediaries for
the borrowers and lenders in the financial market, imposing an Action 4 rule could increase
the cost of finance which could lead to closure of such activity or higher cost to the borrowers.
Surely this is not the intention of Action 4.

iii) Fund management companies

The activities conducted by fund managers are specifically confined to the provision of fund
management services and it would not be commercially feasible or viable for them to shift
profits to other entities via excessive leverage for the purposes of obtaining a tax advantage.
In addition, notwithstanding the challenges posed by various tax authorities from a transfer
pricing perspective, it is not uncommon for fund management companies to be remunerated
on a cost-plus basis. This means any interest expense incurred by the fund management
companies, like any other expenses, will add to the cost base and hence, be recouped as part
of the taxable income of the companies.

iv) Special purpose vehicles (“SPVs”) set up for the purpose of securitizations

The key objective of SPVs in a securitization transaction is to achieve tax neutrality and
certainty. Securitizations consist of bringing together a group of assets that produce a
predictable cash flow or grant the right to a future cash flow, transforming these assets into
securities (shares, bonds or other securities) which are issued to investors (who in turn expect
a predictable income stream on the securities). The use of SPVs in securitizations, as the
mechanism for holding the group of assets in question, allows banks to meet specific
objectives by way of obtaining finances, transferring risk and performing specific investment
activities.

The SPV’s taxable profit/loss is generally the difference between the yields on its assets and
the coupons on its issued securities. Typically, these are matched as closely as possible,
leaving the SPV with only a very small amount of retained profit. The investment objective of
SPVs in a securitization transaction is very confined and any investment returns generated
therefrom, net of any expenses and fees, would normally be circulated back to the investors
as distributions. As such, the SPV’s ability to incur debt is limited given its constrained
business activities; and hence, there should be little room for such SPVs to take on excessive
leverage despite that these SPVs may not be consolidated in the banking group for regulatory
and accounting purposes. For these reasons, they should also be excluded from the scope of
any Action 4 rule even if they are not in a ‘banking group’ as defined.

v) Leasing companies

Financial leasing companies engage in financing the purchase of tangible assets. Lease
transactions entered into by these leasing companies are often in substance in the nature of
lending, despite the legal form is not. Taking a basic example, in a sale and leaseback
arrangement, the leasing company may acquire the legal ownership of the asset for a
purchase consideration (effectively the loan principal) and then lease the asset back (as
lessee) to the seller (as lessee) in return for a rental income stream from the lessee
(effectively the interest return on the loan). The economic ownership of the asset is
effectively retained by the lessee, who incurs all benefits, costs and risks associated with the
ownership of the assets.

To reiterate, finance leasing is in substance a loan in a banking context. Accordingly, if such
a company incurs interest expense on funding used to acquire ownership of the asset (as in
the scenario above), that expense is again ‘cost of goods sold’ for the business. The only
difference is that lease arrangement generates net rental income; while a simple loan arrangement by a bank generates net interest income. As such, leasing companies are usually in a net interest expense position, though such financing arrangement aims to generate a net income return. For this reason, disallowing the net interest expense would be unjustified as it would make the economic return on the leasing arrangement uncommercial.

**vi) Structured finance companies**

Similar to securities companies, interest expense in many transactions entered into by structured finance companies is akin to ‘cost of goods sold’, as the financing is used to fund the structured finance transactions.

Where a structured finance company is construed as having excessive interest expense, such as if it generates a tax exempt return on income, we reiterate that many Asia-Pacific countries already have specific tax provisions in their domestic tax laws which seek to restrict excessive tax deduction on interest expense where funding is used to generate non-taxable or exempt income from investments.

Also, more often than not, the key tax concern associated with structured finance transactions is the use of hybrid instruments or hybrid entities to achieve mismatches in tax outcome, rather than the use of excessive leverage. As such, we believe the best way to deal with this is through Action 2 – Hybrid mismatch arrangements, rather than limiting the interest expense deduction via the operation of fixed ratio rule.

On this basis, we consider that the interest related BEPS risk for structure finance companies to be low.

**vii) Shared service companies**

Service companies within a banking group play an operational supporting role to the wider banking group. Banking groups typically centralize their support functions (e.g. IT, HR, legal, finance, etc.) into a single or multiple service entity/entities which then provide(s) support/administrative services to the group’s entities. Service companies within banking groups are usually remunerated on a cost-plus basis, in order to adhere to OECD arm’s length transfer pricing principles. Accordingly, interest expense incurred by these services companies will add to the cost base and be recouped as part of the taxable income of the company.

### 3. Comments on the application of modified fixed ratio rule

In addition to our view as set out in Section 2 above that non-regulated entities within a banking group generally do not pose a significant interest related BEPS risk, we set out below our comments regarding the application of the modified fixed ratio rule as proposed in the Discussion Draft.

**Fixed ratio rule remains applicable to non-regulated entities in a banking group**

Even where a jurisdiction does identify certain interest related BEPS risk within non-regulated entities in a banking group, in applying the fixed ratio rule, the narrow carve-out of solo-regulated banking entities from the group could result in an asymmetrical tax outcome as discussed above.

In the event where banking entities are carved out so that their net interest income is ignored, banking group as a whole could suffer a restriction on the tax deductibility of interest even where that interest expense is effectively funding taxable interest income or other taxable non-interest income rather than exempt income. It is because the allocation of interest expense within a banking group is largely driven by various commercial factors such as the level of activities undertaken by each entity and credit rating and does not necessarily align
with interest income as funding may be used to generate other forms of income (e.g. commission fee, services fee, investment income, trading income, etc.) which are subject to ordinary taxation rules. A perceived mismatch of interest income and interest expense within non-regulated entities in a banking group does not mean that interest related BEPS risk exists.

Also, an exemption that applies solely to the banking entities within a banking group is difficult to implement in practice.

**Exclusion of net interest income/expense in relation to regulatory capital**

While we appreciate the attempt to exclude interest income and expense in relation to regulatory capital in applying the fixed ratio rule as discussed in the Discussion Draft, we respectfully do not consider such exclusion renders enough protection for genuine borrowing activities conducted by banking groups.

It is recognized in Annex 2 of the Discussion Draft that globally systemically important banks (“G-SIBs”) will be subject to the total loss absorbing capacity (“TLAC”) requirements on top of those under the Basel III framework. While we consider that debt instruments issued for TLAC requirements serve the same purposes as regulatory capital, it is not entirely clear whether interest expense incurred on debt instruments issued for TLAC purposes would be excluded from the fixed ratio rule.

It is also practically difficult for banks to trace and hence exclude interest income/expense relating to regulatory capital as funding is largely fungible within a banking group. Taking the holding company example above, companies may raise regulatory capital that is on lent in the form of ordinary loans within the group, and vice versa.

The Discussion Draft suggests, in the circumstances where third party debt which does not qualify as regulatory capital is raised by another entity in a group to fund activities in a bank, it is expected that this debt will be on-lent to the bank on similar terms such that it does not pose an issue for the operation of the fixed ratio rule. This is based on the assumption that any third party debt will be on-lent on similar terms such that interest income generated therefrom will offset interest expense; and perhaps leaving an interest margin. However, we would like to highlight that while the arm’s length principle is to be respected, in a commercial world, the terms of on-lending would pretty much depend on various business considerations such as credit rating/financial position of the borrower, lending and borrowing capacity, etc., and do not necessarily mirror those terms agreed with the third party lenders. Therefore, where third party debts borrowed by non-regulated entities, albeit not qualifying as regulatory capital, are used to fund the banking activities, the inclusion of the related interest income/expense in the scope of the fixed ratio rule would not be appropriate.

**Existence of specific tax rules to prevent excessive interest deduction claim**

As noted above (see securities companies paragraph), many Asia-Pacific jurisdictions already have specific tax provisions in place in their domestic tax laws to scrutinize the deductibility of interest expense in both the bank and non-bank context. Taking Hong Kong and Singapore as examples, interest expense is generally tax deductible only to the extent to which it is incurred in the production of taxable income. Where interest expense is incurred to generate non-taxable income, the amount should not normally be tax deductible. Where the amount of non-taxable income is significant, tax authorities may even seek to attribute a portion of all expenses (including interest expense which is not incurred for specific purposes) to such non-taxable income and disallow any apportioned expenses.

Some other countries like Australia, Japan, New Zealand and Korea have thin capitalization rules in place to restrict excessive tax deduction on interest expenses. A number of them (including Australia and New Zealand) have even tightened their rules recently in light of the BEPS Action Plan.
Furthermore, some jurisdictions have specific deduction rules for certain types of companies. For example, for holding companies in Singapore, tax deduction for indirect expenses is capped at 5% of the companies’ gross chargeable investment income.

As such, many Asia-Pacific jurisdictions already have existing tax provisions under their domestic laws which constrain the deductibility of interest expense in both the bank and non-bank context.

4. Special considerations for bank branches

It is common for banks to operate through foreign branches (permanent establishments for tax purposes) for their overseas operations rather than subsidiaries. This is for a variety of reasons, including being able to rely on regulatory support of the head office jurisdiction, enhanced business capacity due to efficient use of capital within the same legal entity, ease of control and governance, reduced administrative and funding costs, etc.

As with a regulated banking company (see above), such branches are often the main licensed banking businesses of the group in the relevant jurisdiction, such that interest expense should again be the ‘cost of goods sold’ to generate net income return. Bank branches should therefore equally pose a low BEPS risk.

5. Conclusion

We would like to reiterate that as recognized in the Discussion Draft, the role of interest plays in the banking sector is different from that in other commercial and industrial companies. Funding and the sourcing and allocation of funds within a banking group are driven by various commercial and regulatory considerations, including the need to borrow to generate income (the ‘cost of goods sold’ analogy), the RRP and Basel III requirements which encourage centralization of capital raising activities through a holding company, and the underlying business activities of each subsidiary and branch. These are driven largely by regulatory and commercial considerations.

As explained in Section 2, the interest related BEPS risk associated with other non-regulated entities in a banking group is low, as evidenced by our examples of various types of non-regulated entity. Combined with the practical constraints in applying the modified fixed ratio rules to non-regulated entities in the banking group and the fact that many countries (particularly in the Asia-Pacific jurisdictions) already have targeted tax rules to disallow interest expense incurred in the production of non-taxable income, we believe the correct approach is to allow a full exemption for banking groups from the application of fixed ratio rule and group ratio rule. This will prevent unfair and arbitrary outcomes to the banking sector which may give rise to wider unintended consequences to the global economy as a whole. We would be happy to discuss any of the points raised in our response with you in further detail to assist with your consideration.

Yours sincerely,

Mark Austen
Chief Executive Officer
ASIFMA

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Email: mausten@asifma.org
Appendix – ASIFMA List of Member Firms

**Banks/Financial Institutions**

ANZ  
Bank of America  
Bank of China  
Bank of New York Mellon  
Barclays  
BNP Paribas  
China Construction Bank  
CICC  
CIMB Group  
Citi  
CLSA  
Commerzbank AG  
Crédit Agricole  
Credit Suisse  
Daiwa Capital  
DBS Bank  
Deutsche Bank  
Goldman Sachs  
HSBC  
ING Bank  
J.P. Morgan  
Liquidnet Asia  
Macquarie  
Morgan Stanley  
Mizuho Financial Group  
National Australia Bank  
Nomura  
Société Générale  
State Street  
UBS  
Wells Fargo  
Westpac

**Non-Banks**

Allen & Overy  
Ashurst  
Bloomberg  
Broadridge Financial Solutions  
Clearstream / Deutsche Borse Group  
Clifford Chance  
CLS Group  
Davis Polk & Wardwell  
Deacons  
Deallogic Asia Pacific  
Deloitte  
DTCC  
EBS BrokerTec  
Euroclear  
Ernst & Young  
Fitch Ratings  
Freshfields Bruckhaus Deringer  
Herbert Smith Freehill  
ICAP  
ITG  
King & Wood Mallesons  
Kirkland & Ellis  
KPMG  
Korea Securities Depository  
Latham & Watkins  
Lexcel Partners Attorneys at Law  
Linklaters  
Links Law Offices  
Markit Asia  
Mayer Brown JSM  
Moody's Investor Service  
Nasdaq Market Technology  
North Rose Fullbright  
PricewaterhouseCoopers  
Sanford C. Bernstein  
Skadden, Arps, Slate, Meagher & Flom  
Slaughter & May  
Standard & Poor's  
SWIFT  
Thomson Reuters  
Tradeweb  
White & Case
Asset Managers

AllianceBernstein
Baillie Gifford Asia (Hong Kong)
BlackRock
BNP Paribas Investment Partners
BNY Mellon Investment Management Asia Pacific
Capital Group
Eastspring Investments
Fil Investment Management (Hong Kong)
First State Investments
Goldman Sachs Asset Management
HSBC Global Asset Management

J.P. Morgan Asset Management
M&G Investments
Matthews Global Investors
Nikko Asset Management
Principal Global Advisors
Schroders
State Street Global Advisors
UBS Global Asset Management
Wellington Management Hong Kong
Dear Sir, dear Madam,

The Association Française de la Gestion financière ("AFG") represents the French asset management industry. Our 613 members include all market participants working for individual investors or collective investment schemes. 4 French asset managers are currently in the top 25 Global ranking. There are 3,000 billion in assets under management in France and 11,500 investment funds. AFG is also a member of both EFAMA and PensionsEurope.

AFG welcomes the opportunity to comment on the discussion draft entitled “BEPS action 4 Approaches to address BEPS involving interest in the banking and insurance sectors”.

We have questions concerning the scope of the “different approach”.

According to the discussion draft, the conditions which allow banks and insurance companies to benefit from an exemption are the following:
- they are key providers of debt finance either as lenders or as investors,
- interest income are operating items,
- they are subject to regulatory capital rules.

It seems to us that investment management companies as well as venture capital funds and securitization funds meet most of these conditions and therefore should also benefit from the exemption.

In the EU directive “against tax avoidance practices that directly affect the functioning of the internal market” (ATAD), investment management companies, securitization and capital venture funds are excluded from the interest limitation provided by article 4 because they enter into the definition of “financial undertakings”:
- investment management companies because they have the status of investment firm (article 2 (4) (a)
- securitization funds and capital venture funds because they are Alternative Investment Funds (article 2 (4) (e)

It seems to us that the OECD should extend the exemption to other players within the financial industry.

Yours sincerely,

Delphine Charles-Péronne
Directeur des Affaires Fiscales et Comptables
Rapporteur de la Commission « Titrisation »
Responsable de la relation avec les membres correspondants

AFG - Association Française de la Gestion Financière
31, rue de Miromesnil - 75008 Paris
The UK Insurance Industry

The Association of British Insurers (ABI) is the leading trade association for insurers and providers of long term savings. Our 230 members include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.9trillion.

The ABI’s role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

Introduction

1. The ABI continues to support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment and we are grateful for the opportunity to comment on the discussion draft1. Our comments reflect our desire to ensure that any rules are workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations. Responses to the questions raised in the discussion draft are included in the Appendix.

Executive Summary

2. We are pleased to note that paragraph 26 of the discussion draft acknowledges that “excessive leverage in an insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this [BEPS] risk will be low.”

3. We are also pleased that the discussion document acknowledges that the comprehensive regulatory rules act as a safeguard to BEPS activity by insurers. However, we believe the discussion draft does not fully acknowledge the full breadth of these comprehensive regulatory rules. In particular, the safeguards to BEPS activity that results from group regulation is not reflected in the proposals.

4. In view of the comprehensive regulatory rules and that insurance groups do not generally pose a BEPS risk, which appears to be accepted by the OECD following the further work it has undertaken, we would ask that consideration is given to excluding, from the interest restriction rules, groups whose activity is wholly or mainly of that of insurance or a combination of insurance and related activities.

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1 Discussion draft on OECD BEPS Action 4: Approaches to address BES involving interest in the banking and insurance sectors released 28 July 2016.
5. If an exclusion is not acceptable then we would strongly urge the OECD to avoid recommendations of having any special rules for insurance groups, including any modified versions of the fixed ratio rule.

6. We therefore suggest that the best approach would be to apply the general interest restriction rules to insurance groups. To have separate special rules for insurers, who pose a low BEPS risk, may give rise to unintended consequences and the potential for inappropriate restrictions. If there are particular structures that tax authorities believe pose a BEPS risk, that are not caught by the other BEPS initiatives or anti-avoidance rules, then our view is that targeted measures should be introduced.

7. We are concerned by the proposal to apply the fixed ratio rule to local insurance groups excluding insurance companies. Insurers often raise debt at the top company level to support group subsidiaries, either by passing this down as equity or to support the group regulatory capital requirement. The use of equity rather than debt would normally be a requirement of the local regulator who insists on the strongest possible capital. So the decision to fund a subsidiary by debt or equity is effectively taken outside of the control of an insurance group.

8. The consequence of the proposal to apply the fixed ratio rule to local insurance groups excluding insurance companies would be to exclude interest income and operating profit of insurers. Given the points made in paragraph 7 above, i.e. that debt is often raised by a non-insurer in an insurance group, this would effectively mean that many insurance groups would have a negative EBITDA and most interest would not be deductible, putting insurers in a worse position than most other industries. Excluding all third party interest expense on regulatory capital from the net interest expense subject to the rule as suggested in paragraph 56 of the discussion draft would help. However, for some of our members such an exclusion would mean that some insurers, who are not excessively leveraged, may still be subject to interest restrictions. Therefore, we believe that, if the general rules are not applied to insurers, then the recommendation in paragraph 56 of the discussion draft should be strengthened to automatically exclude all third party interest expense on all debt issued by a company or group/sub-group whose activity is wholly or mainly that of insurance or a combination of insurance and connected activities (i.e. asset management). If all third party interest expense is not excluded then we believe there would be inappropriate restriction of interest that is inconsistent with statements made in the consultation document concerning insurance groups.

9. The treatment of existing debt would need to be considered. A large proportion of this debt issued by insurance groups is long-term in order to comply with regulatory requirements. It would therefore be extremely difficult and costly to restructure the debt. If the new rules applied immediately it could lead to large interest restrictions for insurers and double taxation since the debt holders would still have interest income. So we believe at the very least, if full grandfathering is not possible, there should be a period of at least two years where all existing debt is grandfathered to enable the most efficient restructuring of that debt. Therefore, we
believe that the option, in paragraph 195 of the Report\textsuperscript{2}, of a country not having transitional rules should be dis-applied for all third party debt issued by insurance groups.

Association of British Insurers
8 September 2016

\textsuperscript{2}Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report
Appendix

The risks to be addressed through interest limitation rules
1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

As the discussion draft explains, insurers operate within comprehensive regulatory rules. In Europe there is consistency of the regulatory requirements as all European insurers are within the Solvency II regime. These requirements include strict limits on the amount of debt an insurance group can hold to meet its regulatory capital requirements at all three tiers of regulatory capital. These limits apply at both solo and group regulated levels i.e. it is necessary to measure tiering of capital at both the solo and group level and if limits are breached at either level then any excess is disregarded and would provide no capital benefit.

We believe that the regulatory constraints provide safeguards to BEPS activity by insurance groups and any BEPS risk is small. We are pleased that this has been partly acknowledged in paragraph 26 of the discussion draft which states “excessive leverage in an insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this [BEPS] risk will be low.” However, we believe that these comments apply equally to all companies in an insurance group that is subject to group regulation.

In addition to regulatory restrictions, the level of debt in an insurance group as a whole has a large impact on the group’s credit rating. Credit ratings are extremely important in the insurance market because most lines of business cannot be written if an insurance group cannot secure a high enough rating. In the market it is quite common for rating agency restrictions to be more of a binding constraint on insurance group leverage than government regulation. Rating agencies look at the leverage of the group as a whole, not just leverage in individual insurance companies.

Banks and insurance companies
2. Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?

We are not aware of any other considerations.

3. Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country’s regime.

As mentioned in our response to question 1, in Europe the regulatory rules include strict limits on the amount of debt an insurance group can hold to meet its regulatory capital requirements at both solo and group regulated levels i.e. it is necessary to measure tiering of capital at both the solo and
group level and if limits are breached at either level then any excess is disregarded and would provide no capital benefit.

Furthermore, the impact of the regulatory rules extends outside Europe. Although local regulatory rules can vary, the Solvency II regime will govern all European insurers and many other governments are developing new regulatory rules that follow the same fundamental concepts as Solvency II. Furthermore, European insurance companies who reinsure to locations outside Europe will need to demonstrate that the local regulations are ‘equivalent’ to Solvency II, or be sufficiently capitalised under Solvency II rules.

In addition, international standards for group wide supervision of insurance groups will be strengthened by the International Association of Insurance Supervisors (‘IAIS’) Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). This is still in the course of development but does focus on group supervision (including the activities of non-regulated entities). Group-wide regulatory oversight of internationally active insurance groups is therefore expected to increase.

4. **Are there any general issues related to the operation of the authorised OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?**

We are not aware of any other considerations.

5. **Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?**

We would ask that consideration is given to excluding, from the interest restriction rules, groups whose activity is wholly or mainly of that of insurance or a combination of insurance and related activities. If an exclusion is not acceptable then we would strongly urge the OECD to avoid recommendations of having any special rules for insurance groups, including any modified versions of the fixed ratio rule.

We therefore believe the better approach would be to apply the general interest restriction rules to insurance groups. To have separate special rules for insurance companies, who pose a low BEPS risk, may give rise to unintended consequences and the potential for inappropriate restrictions. If there are particular structures that tax authorities believe pose a BEPS risk then our view is that targeted measures should be introduced rather than widely drawn special rules, such as a modified fixed ratio rule that are applicable to insurance companies.

6. **What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a
country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

Some countries apply the Arm’s Length Principle to debt which applies to all sectors. This allows tax authorities in those countries to take a wider perspective e.g. on balance sheet debt levels etc. Also, CFC and anti-hybrid rules may deal with some of the concerns.

As excessive leverage in an insurance company has not been identified, it is unlikely there are any specific approaches being applied.

If a specific BEPS risk is identified, we suggest that targeted measures should be used rather than a widely drawn approach which has the potential to produce inappropriate interest restrictions.

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

We have serious concerns about this approach. The effect of excluding regulated insurers would be to remove the majority of the interest income (arising on the bond portfolios held by insurance carriers) and business profits (i.e. positive underwriting results) from the interest restriction rules, while potentially leaving the full amount of interest expense on debt issued at holding company level within the scope of the restriction calculation.

For commercial reasons such as securing higher ratings, managing liquidity, or reducing transaction costs, insurance groups generally raise debt at the holding company level to support group subsidiaries, either by passing this down as equity or to support the group regulatory capital requirement. The use of equity rather than debt to fund the insurance operating company is often a requirement of the local regulator.

So, excluding solo regulated insurers could result in a large interest restriction, where there are wholly commercial transactions, because the form of the investment (i.e. equity investment into the insurance operating company) has been dictated by a regulator. We believe a restriction of interest in these circumstances would be inappropriate. Excluding all third party interest expense on regulatory capital from the net interest expense subject to the rule as suggested in paragraph 56 of the discussion draft would help. However, for some of our members such an exclusion would mean that some insurers, who are not excessively leveraged, with the potential for interest restrictions. Therefore, we believe all third party interest expense on all debt issued by a company or UK group/sub-group whose activity is wholly or mainly that of insurance or a combination of insurance and connected activities (i.e. asset management), should be automatically excluded from the rule.

8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

We believe it is important to differentiate between borrowing that funds an equity investment that contributes to operating income of an insurer or bank and borrowing that is used to support group
subsidiaries. Insurers generally would not borrow to make an equity investment to fund operating income. The source of funds for this type of investment is the premium income received. However insurance groups do borrow to support group subsidiaries either by passing this down as equity or to support the group regulatory capital requirement. As mentioned in our response to question 7 above insurers often raise this debt at the holding company level. The use of equity rather than debt would normally be a requirement of the local regulator who insists on the strongest possible capital.

9. **What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.**

We are not aware of any approaches currently being applied other than Controlled Foreign Company rules by some countries which are not sector-specific.

10. **Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?**

We are not aware of any other considerations and agree that if a country applies the authorised approach, there may be no need for the country to apply additional tax rules to deal with an insurance company using interest expense to fund non-taxable income from an investment in a permanent establishment. We would also note that there are already extensive transfer pricing rules regarding the allocation of income to branches in the insurance context.

11. **Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?**

Where a country decides to have specific rules to address the BEPS risks identified in paragraph 43 of the discussion draft, it should ensure that it takes into account the regulatory environment in which insurers operate and that transactions may be undertaken as a requirement of the regulator.

**Entities in a group with a bank or insurance company**

12. **Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?**

Paragraph 46 of the discussion draft gives two examples of where insurers could engage in BEPS activity. The first is where an insurance group includes entities in more than one country or are taxed differently. The second is where an entity is part of the local group, but outside the regulatory group.

We believe there is no BEPS risk with the first example. Even where an insurance group includes entities in more than one country all the insurance companies will be subject to regulation. In Europe there would be regulation covering all entities in Europe from the home country. Where an
an entity is in a country outside Europe, then it would be subject to regulation in the country of residence. Furthermore, all companies beneath a European headquartered group or a European sub group will be effectively subject to Solvency II regulation irrespective of whether they are located in Europe or outside Europe as a result of Solvency II group regulation.

We believe that the most appropriate way for tax authorities to deal with the second example is by targeted rules. Using targeted rules would deal with the BEPS risk, but would avoid the inadvertent and inappropriate impacts that could be created by a general rule.

Please also see our answers to question 7.

13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company:

   a. application of the fixed ratio rule to the local group excluding banks and insurance companies

   We have the same concerns with the suggestion in paragraph 51 of the discussion draft of creating a second local group containing only solo-regulated insurance entities, to which the fixed ratio rule would be applied, as we do with the more straightforward option of applying the fixed ratio rule to a local group excluding insurance companies. The effect of creating a second local group would be to remove the majority of the interest income and business profits from the interest restriction rules, while potentially leaving the full amount of interest expense on debt issued at holding company level within the scope of the restriction calculation. Excluding all third party interest expense on regulatory capital from the net interest expense subject to the rule as suggested in paragraph 56 of the discussion draft would help. However, we understand that such an exclusion would still leave some insurers, who are not excessively leveraged, with the potential for interest restrictions. So we believe that all third party interest expense on all debt issued by a company or UK group/sub-group whose activity is wholly or mainly that of insurance or a combination of insurance and connected activities (i.e. asset management), should be automatically excluded from the rule.

   b. the treatment of interest expense on debt supporting banking or insurance activities

   We believe that the recommendation in paragraph 56 of the discussion draft should be strengthened. Excluding all third party interest expense on regulatory capital from the net interest expense subject to the rule as suggested in paragraph 56 of the discussion draft would help. However, we understand that such an exclusion would still leave some insurers, who are not excessively leveraged, with the potential for interest restrictions. So we believe that all third party interest expense on all debt issued by a company or UK group/sub-group whose activity is wholly or mainly that of insurance or a combination of insurance and connected activities (i.e. asset management), should be automatically excluded from the rule.
c. other issues?

We are unaware of any other issues.

14. **Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?**

We are unaware of any other issues that should be considered.

15. **Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?**

Yes. If the group ratio rule is applied to an insurance group excluding insurance companies, similar issues arise as they do for the fixed ratio rule. The effect of excluding insurance companies would be to remove the majority of the interest income and business profits from the interest restriction calculation, while potentially leaving the full amount of interest expense on debt issued at the holding company level within the scope of the restriction calculation. Excluding all third party interest expense on regulatory capital from the net interest expense subject to the rule as suggested in paragraph 56 of the discussion draft would help. However, we understand that such an exclusion would still leave some insurers, who are not excessively leveraged, with the potential for interest restrictions. So we believe that all third party interest expense on all debt issued by a company or UK group/sub-group whose activity is wholly or mainly that of insurance or a combination of insurance and connected activities (i.e. asset management), should be automatically excluded from the rule.

16. **Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?**

We believe the best approach is to apply the group ratio rule to the insurance group as a whole, including insurance operation companies.

17. **Do you have any other comments on any of the issues raised by this discussion draft?**

The treatment of existing debt would need to be considered. A large proportion of this debt issued by insurance groups is long-term in order to comply with regulatory requirements. It would therefore be extremely difficult and costly to restructure the debt. If the new rules applied immediately it could lead to large interest restrictions for insurers and double taxation since the debt holders would still have interest income. So we believe at the very least, if full grandfathering is not possible, there should be a period of at least two years where all existing debt is grandfathered to enable the most efficient restructuring of that debt. Therefore, we believe that the option, in paragraph 195 of the Report, of a country not having transitional rules should be dis-applied for all third party debt issued by insurance groups.
**BEPS Action 4**

*Discussion draft on approaches to address BEPS involving interest in the banking and insurance sectors*

**ABI comments**

8th September 2016
The Italian Banking Association (hereinafter ABI) welcomes the opportunity to comment on the OECD’s Discussion Draft: “Approaches to address BEPS involving interest in the banking and insurance sectors”, issued on July 28th, 2016.

ABI represents and promotes the interests of its member banks and financial intermediaries (about 800 Associates).

1) General comments

i) The Discussion Draft

The report on Action 4 of the BEPS project establishes a common approach to tackle BEPS involving interest¹, but highlights that a different perspective could be required to address risks posed by entities in the banking and insurance sector, taking into account their particular features. Therefore, according to the Action 4 Report, countries may exclude entities in banking and insurance sectors from the scope of such a common approach.

The same reasoning is now followed at the European Union level. In fact, the anti-tax avoidance directive² allows the EU Member States to exclude financial undertakings (including banks) from the scope of its interest limitation rule.

Against this background, the Discussion Draft aims at identifying (i) the potential BEPS risks involving interest deductions posed by entities in the banking and insurance sectors and (ii) approaches to address such risks.

In order to contribute to this discussion, our comments are focused mainly on the Italian banking sector and the relevant Italian tax and regulatory rules that are applicable in this sector.

¹ I.e. the fixed ratio rule and group ratio rule. The fixed ratio rule restricts an entity’s net interest deductions to a fixed percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA) calculated using tax principles. The group ratio rule allows an entity in a highly leveraged group to deduct net interest expense in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of its worldwide group.

² Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
As a starting point, we cannot but support the conclusions already achieved both at the international and EU level that constraints and specificities of the banking sector – from a market, regulatory and tax perspective – need to be considered in addressing possible BEPS risks involving interest.

Accordingly, we believe not only that there are strong arguments to justify that a different approach is to be adopted in the banking sector, but also that an interest limitation rule is not effective in addressing BEPS risk in the banking sector. This is a fundamental point, taking into account that these rules may reduce the effectiveness of regulatory requirements which were introduced to deal with the financial crisis.

ii) The Italian experience

For a better understanding of our position, it is worth mentioning the Italian discipline of interest expenses in order to underline the importance attributed by Italian banks to the subject.

In particular, our banks have experienced – and still will be experiencing till to the end of 2016 – the negative effects of the special provision introduced in 2008 that limits to 96% the amount of interest that can be deducted by banks for the purposes both of the corporate income tax (IRES) and the regional tax on productive activities (IRAP).

It has to be stressed that this rule does not apply to industrial and commercial companies, which have been subject – since 2008 – to a deduction formula substantially in line with the criteria established by OECD Action 4. In other terms, only for banks and other financial institutions, together with insurance companies, the percentage of 4% of interest is definitely non-deductible, since no carry forward is admitted. Differently, for other businesses, the interest expenses exceeding interest income (i.e. net interest expenses) may be deducted each year up to 30% of the company’s gross operating margin (essentially a type of EBITDA), but the amount non deducted is not definitely “lost”.

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3 Interest that is not deductible in a particular year may be carried forward indefinitely for offsetting against available 30% EBITDA in subsequent years. Also, where EBITDA exceeds
As shown by a paper published by the Bank of Italy ("The tax burden on banks over the period 2006-2014")\(^4\), such a restriction of the deductibility of the interest paid contributed, along with other tax measures affecting the Italian banking industry, to a shrinking in the net income, with a non-negligible effect both on the financial stability and on the profitability of the banking sector during the tax years considered by the paper.

Finally, after almost 10 years, the above described rule is due to expire with effect from the tax year 2017 (for the fiscal year 2016 Italian banks are still subject to the 4% interest non-deductibility threshold limitation). The last Italian stability law (Law No. 208 of 28 December 2015) abolishes such a rule, thereby ending a period of competitive disadvantage for the Italian banking sector.

This referred experience dramatically enhances the awareness of the Italian banking sector about the adverse effects brought by the potential adoption of tax measures, which - limiting the deductibility of interest - may impact on their ability to provide credit to the market and may be detrimental to their core business activity.

2) The specific features of the banking sector

Obviously, the above expressed concerns do not imply a lack of support for the BEPS plan main objectives. Indeed, we totally agree with the stated needs of aligning tax rules with the location of economic activity and value creation, of improving coherence between domestic tax systems and international rules, and of promoting greater transparency.

Nevertheless, we believe that "base erosion and profit shifting" risks connected to interest expenses are not to be envisaged with reference to the banking activity, due to a number of reasons.

the net interest in a given year, the balance may be carried forward to increase the deductible limit for subsequent years.

\(^4\) https://www.bancaditalia.it/pubblicazioni/qef/2016-0314/QEF_314_16.pdf?language_id=1
More specifically:

a) banks typically have net interest income rather than net interest expense;

b) interest plays a different role in the business of the banking sector compared with other sectors, and

c) banks are subject to strong regulatory capital requirements.

2.a. Banks typically have net interest income rather than net interest expense

As mentioned in the Action 4 Report\(^5\) and in the Discussion Draft, banks typically have net interest income rather than net interest expense.

Third-party interest income is vitally important to ensure group’s profitability and liquidity. The banking activity aims at making profits and does so by lending money at a higher rate than the rate at which it borrows.

Therefore, assuming that there would be a risk of BEPS involving interest (which is not the case), the fixed ratio rule and the group ratio rule, which are at the heart of the common approach established in the Report and limit the level of an entity’s net interest expense, would not be effective in addressing such a risk and would make the system unnecessarily complex.

From a compliance perspective, it would be illogic to oblige banks to fulfil specific and more than probably complex rules just in order to be able to prove the lack of the pre-requisite itself for the interest restriction. In this perspective, excluding banks from any restriction on the tax deductibility of interest expenses would be coherent with the more general need to eliminate unnecessary administrative burdens.

2.b. Interest plays a different role in the business of the banking sector compared with other sectors

\(^5\) See paragraphs 188 to 190 of the Report.
Although the Discussion draft itself acknowledges the distinctive features of the banking sector, we would like to emphasize once again that the raw material of the banking activity is represented by interest expenses.

Banks borrow from depositors or in the wholesale market to provide lending activities to individuals, SMEs, corporates and governments at a margin over cost of funds to the bank.

Because financial institutions borrow and lend as part of their core activity, limiting the interest deductibility for them would be equivalent to limiting the deduction of the cost of goods produced by a manufacturing businesses.

3.c. Banks are subject to strong capital requirements

The Discussion Draft clearly states that banks are subjects to prudential regulation, thereby diminishing the BEPS risk related to interest expenses, and therefore advocates a different treatment for them, taking into account the risks posed and the role interest plays in banking businesses.

However, the role played by the aforementioned prudential regulation seems to be underestimated in the assessment in Annex II: as a matter of fact, regulation and supervisions provide more significant constraints on interest related BEPS risks than the discussion draft suggests.

In order to bolster our point above, we would like to emphasize some features of the Italian banking system and of the European one.

Italian banking groups are subject to capital requirements that restrict their ability to place debt in certain entities. These regulatory requirements provide protection against excessive leverage for tax purposes: they limit de facto any BEPS risk involving interest in the Italian banking sector.

In this respect, as mentioned in paragraph 20 of the Discussion Draft, one could say that the Italian regulator and the Italian tax authorities may adopt a different view as to the nature of some specific interest-bearing instruments which, although they are treated as debt from a tax perspective, qualify as ordinary shares for regulatory capital purposes (AT1 and AT2 instruments) because they include certain characteristics which mean they are able to absorb losses.
By way of example, article 2 paragraph 22 of the Law Decree No. 138 of 13 August 2011 provides that financial instruments which are neither shares nor assimilated into shares - issued as of 20 July 2011 by financial intermediaries subject to prudential supervision by the Bank of Italy and in compliance with the capital requirements set out by EU regulations and Italian prudential regulations - are treated for Italian tax purposes as bonds or securities similar to bonds. This tax treatment entails the tax deductibility of the interest due under these instruments within the ordinary limits applicable to the issuing bank\(^6\) irrespective of their accounting and regulatory treatment. It is worth noting that this tax provision was introduced to tackle the financial crisis.

Nevertheless, we would like to underline that the use of “hybrid” instruments is inconvenient and expensive for Italian banks because, from a regulatory perspective and particularly the CRD IV Directive, there are very strict conditions to be satisfied to meet a proportion of the minimum requirements through non-equity capital requirements (Alternative Tier I capital). Accordingly, the use of these instruments is rather low. In any case, issues linked to and caused by hybrid instruments should be a target of the work under BEPS Action 2 and not under Action 4.

Furthermore, with regard to the risk related to the deductions for interest funding equity investments, which give rise to non-taxable income - as remarked in par. 39 of the Discussion Draft - it must be observed that, when a bank is required by regulatory capital rules to deduct the investment from its own equity capital, such investment should be treated as funded wholly using equity, with consequently no need of any tax limitation to interest deduction.

Turning our attention to the EU, we would like to point out that the EU authorities have adopted in several areas stricter rules than the minimum standards prescribed

\(^6\) In this respect, in addition to the above described rule, that limits to 96% interest deduction for banks (operative till the end of tax year 2016), Italian tax law requires, as a general rule, that the remuneration is not linked to the performance of the issuer (or other entities considered by the law). Otherwise, i.e. when the remuneration is linked to the performance of the issuer (or other entities considered by the law) no deduction is admitted.
by Basel, thereby simplifying or generalizing an approach in ways that often results in more rigorous requirements than the Basel standards. For an overview of such areas see the following box.

**Scope of application of Basel capital standards**
In terms of scope, the contribution of the CRR (Capital Requirement Regulation) and CRD IV (Capital Requirement Directive) to financial stability is not confined to large internationally active banks. The scope of Basel III is officially limited to internationally active banks. The EU authorities believe that restricting its scope to this category leaves the risk of major gaps in prudential coverage. Consequently, the EU legislation implementing Basel III also applies to all other banks in the EU and investment firms. As a result, it applies to around 40% of total world banking assets, which means an additional 20% of world banking assets are effectively subject to Basel III requirements.

While Basel III applies to internationally active banks at a consolidated level and to each internationally active bank at each tier within a consolidated group, European legislation applies at the level of each legal entity, except for clearly defined exceptions. Consequently, EU authorities believe that EU legislation is more effective in promoting the financial soundness of individual subsidiaries.

**Capital buffers**
EU legislation also foresees a range of other powers for national authorities to use in responding to the emergence of localised systemic risks in their jurisdictions by raising capital requirements beyond the regulatory minima and capital conservation buffer. This includes scope for imposing a countercyclical buffer or a systemic risk buffer, and measures intended to limit system-wide exposure to real estate overheating. These are in addition to the Basel requirements to provide for buffers for systemically relevant institutions. For example, through the "systemic risk buffer", Member State authorities can increase CET1 (Common Equity Tier 1) capital to cover "structural systemic risk" by up to 3% of risk-weighted assets (until end-2014) and by up to 5% (as from 2015).

**Credit risk**
The EU has strengthened the treatment of real estate collateral relative to Basel III. First of all, there are additional qualitative standards, for instance relating to the quality of collateral. Member State authorities are also required to monitor the quality of mortgage loans on an ongoing basis and are required to tighten eligibility standards when necessary.

**Other measures**
EU authorities believe that remuneration policies can encourage excessive risk-taking behavior and can therefore undermine sound and effective risk management and the stability of credit institutions at least as much as inadequate levels of capital. EU legislation therefore sets standards for remuneration that EU authorities believe go beyond current international agreements. It contains an express obligation for credit institutions to establish and maintain, for categories of staff whose professional activities have a material impact on the risk profile, remuneration policies and practices that are consistent with effective risk management. In particular, a maximum ratio between the fixed and the variable component of the total remuneration has been established. Under Pillar 2, supervisory authorities are allowed to require institutions to limit variable remuneration as a percentage of net revenues where it is inconsistent with the
As a result, we propose that the OECD recognises the principle that regulation can effectively eliminate interest related BEPS risk, and that it should be down to each jurisdiction to determine whether their domestic implementation of globally and regionally agreed regulation eliminates the risk.

Additionally, it is worth underlining the view encompassed in the Draft according to which any approaches adopted should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis. In other words, this implies a careful and continual coordination between the supervision rules and the fiscal ones, where the latter must always be consistent with the former.

In this light, we hold the view that the final approach on the subject of interest deductions should be more determined that the one adopted in the Discussion Draft. The notion of a “low” BEPS risk connected to interest expenses for banks should be replaced by the notion of a “non-existing” BEPS risk as a principle, due to the constrains posed by the capital regulation. Nevertheless, possible loopholes arising from peculiarities of a single national tax system, which in principle cannot be excluded, should be amended by the single national tax system itself.

4) Potential BEPS risks already dealt with by Italian tax law

In this regard, Italian tax system, similarly to many other jurisdictions, provides a number of examples of specific rules suited to avoiding the main BEPS risks that the Discussion Draft connects to interest expenses.

Below there are examples of the solutions given by the Italian legislator to some of these risks.

4.1. Interest expense funding tax-exempt income

The Discussion Draft (paragraphs 34 to 40) identifies a potential BEPS risk in relation to entities claiming deductions for interest funding equity investments, which give rise to non-taxable income.
In our opinion, in this situation no BEPS risks is to be envisaged as a matter of principle, because – as also mentioned by the Discussion Draft itself – there are significant regulatory and commercial considerations – relevant also in Italy – that reduce the attractiveness of these arrangements and make them functionally useless.

Anyway, it should be recalled that the aim of the participation exemption regime is not the double exemption of the income. Even though the income received by the beneficiary entity is exempt (provided the relevant conditions are met), this does not mean that such an income was not previously subject to corporate taxation at the level of the entity which generated it.

In this perspective, if the aim is that of tackling the use of low tax jurisdictions, then the solution should not be the introduction of an interest limitation rule but either the implementation of CFC (controlled foreign companies) rules or the full or partial taxation of dividends deriving from non-cooperative jurisdictions. This is the approach followed by Italian tax law, through the specific anti-abuse rules disallowing the exemption when the participated company is located in the so-called Black List countries.

The same rule has been generalised by the recent EU Directive 2016/1164, that establishes a strict CFC rule, re-attributing the income of a low-taxed controlled subsidiary to its parent company. As stated by Article 7 of the Directive, the parent company must include in its tax base the income of the permanent establishment which is derived, among other items, from dividends and income from the disposal of shares.

Therefore, no BEPS risk can be envisaged neither in Italy (on the basis of present law) nor in Europe (on the basis of the above mentioned Directive) for investments through incorporated vehicles operating in low tax jurisdictions.

Moreover, also the following features of Italian tax system are able to contrast possible BEPS risks:

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7 Point (a) (iii) of paragraph 2.
- No full participation exemption regime is provided by our law, since the exemption of dividends and capital gains is limited to 95% of their amount;
- with specific reference to investments in shares held for trading, banks are subject to full taxation, without the reduction, which as a consequence applies only for shares booked as financial fixed assets.

4.2. Free capital requirements of foreign permanent establishments

The Discussion Draft (paragraphs 22 to 25), identifies a potential BEPS risk involving interest in relation to the level of free capital attributed by the head office to its foreign permanent establishments (PE). Even though the first OECD report on the “Attribution of Profits to Permanent Establishments” was released in 2008, in most countries there is no legislation in place requiring a minimum capital to be allocated to the PE, entailing the possibility for a PE to claim an interest deduction – fiscally deductible at the level of the PE – for all of its funding costs without limitation. Therefore, in some specific circumstances, BEPS risks may exist.

However, such a risk cannot occur from an Italian perspective, due to the tax regime applicable thereto which requires foreign banks to allocate a minimum free capital to their Italian PEs by using one of the methods recommended by the OECD in its 2010 Report on the Attribution of Profits to Permanent Establishments.

In particular, according to the recent Measure of the Commissioner of the Revenue Agency of 5 April 2016, where a permanent establishment is to be considered under-capitalized according to such OECD methods, a portion of the funding provided by the relevant head office may be re-assessed as figurative free capital, and, consequently, passive interests arising from such re-determined part of the funding are not deductible. This way, once again, a specific internal rule gives solution to the theoretical BEPS risk, in line with the OECD principles for permanent establishments, without necessity of further provisions aimed at limiting the deduction of interest expenses.

Similar criteria have been established also for the purposes of the calculation of free capital of foreign exempted Permanent Establishments of Italian companies.

Rather, the theme of the tax treatment of Permanent establishments raises, in our opinion, a different kind of concern, taking into account the possible risk of double
taxation in those cases where the domestic requirements - related to the free capital to be allocated to the Permanent establishment for tax purposes - would be different in the head office country and the Permanent establishments country. As an example, if it happens that the minimum free capital threshold in the head office country is higher than the one applicable in the Permanent establishment country, this may imply that the tax credit granted in the head office country will allow the head office to recover only partially the foreign taxes. The solution to double taxation caused by different “free” capital attributions suggested in the OECD Commentary (para. 47-48 of the OECD Commentary to art. 7) – i.e. to follow the attribution of capital derived from the application of the approach used by the State in which the permanent establishment is located – should be implemented in a way that has legally binding force (and not through the mutual agreement procedure).

5) Other observations

Some words can be added with reference to the theme of the treatment of other entities within a banking group.

The idea behind the Discussion Draft seems to carve out solo-regulated entity from the fixed ratio rule while supporting the application of the fixed ratio rule to the remaining group.

In our opinion this approach may lead to illogical results (e.g. when the group has loss making holding companies) which may put financial groups at a disadvantage to other sectors.

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In conclusion, ABI comments can be summed up as follows:
1. banking regulatory constraints effectively eliminate interests related BEPS risk. Therefore, for banks, there should be a full exemption from any action on interest restrictions that might be taken in response to BEPS Action 4.

2. in any case, the alignment of the tax rules with the regulatory capital ones should be considered ad as prerequisite, both at national and international level. As mentioned before, it is crucial that tax rules do not conflict with or reduce the effectiveness of regulatory capital rules intended inter alia to reduce the risk
of a future financial crisis. This principle, already acknowledged by the Discussion Draft, should play a fundamental role in the finalization of any OECD position.
06 September 2016

International Co-operation and Tax Administration Division
OECD/CTPA

By email: interestededucations@oecd.org

Dear Sir/Madam

Public Discussion Draft: BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

The Australian Bankers Association (ABA) welcomes the opportunity to comment on the proposals in the OECD’s Public Discussion Draft – BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors (Discussion Draft) released in July 2016.

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry’s contribution to the economy and to ensure Australia’s banking customers continue to benefit from a stable, competitive and accessible banking industry.

Summary of this submission

1) Part 1 develops further the reasons underlying the conclusion (already in the Draft) that the banking sector is not an area where BEPS concerns arise or are likely to arise and outlines our submission on the implication of this conclusion for the scope of any general interest limitation rules.

2) Part 2 addresses some aspects of the proposals for targeted rules to address specific BEPS risks.

3) Part 3 addresses the issue of the treatment of banks located within larger corporate groups.

4) Part 4 responds to some of the ‘Questions for consultation’ set out in the Discussion Draft.

1. The extent and effects of regulation of the banking sector

The ABA welcomes the clear acknowledgement in the Discussion Draft that –

... excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low ...

[para 26]

We agree with that observation; it matches our own experience.
The ABA’s submission of 6 February 2015 on the Public Discussion Draft, BEPS Action 4: Interest Deductions and other Financial Payments (2015 submission) drew attention to the significance of the regulatory environment for the banking industry as an important constraint that mitigates against BEPS concerns, and again this position is confirmed in Annex 2 of the Discussion Draft:

One of the main goals of Basel III is to strengthen the capital base of banking groups to protect the solvency of banks, and this has a direct impact on the ability of banks to be over-leveraged [para 69].

It is worth restating the explanation in our 2015 submission about why this comes about:

- The regulatory environment in which banks operate is directed to ensuring that banks (both as a group and on a stand-alone basis) have significant levels of non-deductible capital, typically ordinary equity and retained earnings. This is especially so as a result of the Basel III capital adequacy rules introduced after the 2007-2009 global financial crisis, and this incentive for banks maintaining high levels of equity will only increase as a result of Basel IV.

- Many kinds of regulatory capital are not treated as debt under domestic law and therefore do not generate deductions. The regulatory capital of a bank will typically consist of ordinary equity (Common Equity Tier 1), retained earnings/reserves and funds raised through various kinds of hybrid financial instruments (Additional Tier 1 instruments). The bank will also have ordinary debt instruments on issue. In many countries just the cost of servicing Tier 2 instruments (and only some Tier 2 instruments) and ordinary debt will be deductible. The other kinds of instruments raise no BEPS concerns.

- Banking regulators will seek to ensure that debt is not disproportionately reallocated to particular entities by inter-group transactions. For example, in Australia, the Australian Prudential Regulation Authority (APRA) has issued the Prudential Standard APS 222 – Associations with Related Entities which mandates that:

  an [authorised deposit-taking institution – a bank] must:

  - Monitor, manage and control potential contagion risk between the ADI and other members of a conglomerate group of which the ADI is a part.

  - Meet minimum requirements with respect to dealings with related entities and certain related matters; and

  - Comply with prudential limits on intra-group exposures.

  In particular, the institution must limit its exposure to related entities to ‘the level of exposures which would be approved for unrelated entities of broadly equivalent credit status’ without the benefit of any implicit guarantee of the risk from other group entities [APS 222, para 11].

Set out in the Appendix to this submission is a more detailed explanation of the extent of the regulatory regime to which banks are subject.

These factors – that higher levels of regulatory capital must now be held, that this loss-absorbing regulatory capital is not typically debt and involves no deductions, that there are already controls on the total level of debt in each entity, and that regulators limit inter-group dealings which control the possibility of reallocating debt disproportionately to one entity – explain the conclusion that, ‘excessive leverage in a bank or insurance company has not been identified as a key risk …’ [para 26].

Indeed, this is such a pivotal observation that it should be more prominent, and shape all the OECD’s work in this area: the OECD should state much more clearly that the absence of evidence about BEPS-related concerns means the banking sector can and should be outside the scope of any specific national actions that might be taken in response to BEPS Action 4. Similarly, the OECD should state more clearly that governments can have confidence that excluding banks from any national response is not problematic for those reasons and the reasons set out below.
The ABA makes this suggestion because the tenor of the Discussion Draft gives the impression that the main point of the Discussion Draft is to assist the OECD to devise a better interest limitation rule (whether a fixed ratio rule or a group ratio rule) tailored just for banks. For reasons explained below, a more profitable approach for the follow-up work undertaken after the release of the OECD’s report *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report* in October 2015, *(Final Report)*, and for the shape of any further report flowing from this consultation, would have been to frame the project rather differently: assessing the viability of allowing banks and banking groups to remain outside the scope of any national BEPS-inspired interest limitation regime altogether and the circumstances in which that can be allowed to occur.

We say that because the observation that ‘excessive leverage in a bank or insurance company has not been identified as a key risk’ *(para 26)* has profound ramifications: it leads to the presumption the banking sector can, and probably should, be entirely outside the scope of any tax-specific domestic interest limitation rules that might be enacted in response to BEPS Action 4.

**Multiple regulators and multiple regulated.** Given that the concern of Action 4 is, the ‘use of interest [as] one of the simplest profit-shifting techniques available in international tax planning’ *(para 2)*, it is an important observation that the regulatory framework will already, ‘restrict [banks’] ability to place an excessive level of debt in particular entities’ *(para 6)*.

There are other important matters which do not feature prominently in the Discussion Draft about (i) just how much of a banking group is subject to regulation, (ii) how many regulators are potentially scrutinising the operations of multinational banks, and (iii) how precise and detailed that regulation is. Annex 2 does not give a complete picture of the extent of regulatory oversight.

Some passages in the Discussion Draft give the impression that in the modern banking industry it is just the entity which conducts banking operations which will be subject to control by the banking regulators although the Discussion Draft does refer to:

> *Regulators [which] require capital ratios to be met at the level of a worldwide group, a regional group (e.g. in the European Union) and/or a local group (e.g. including all group entities in the same country) [para 146]*

It is important to note that:

- While banking regulators will insist on adequate capital levels for the bank within a corporate group, they will also generally insist on sufficient equity for non-bank entities within a corporate group once it includes a bank. Clearly, banking regulators care about the possibility that a non-bank entity within a group could produce spill-over effects causing the collapse of the bank and so, not surprisingly, it is often the case that a non-bank entity in a group will have its own specific capital adequacy requirement in effect imposed by the banking regulator.

- For banking groups that operate cross-border, levels of capital adequacy in these entities are often assessed by regulators in two countries, not just one. It is not the case that national banking regulators will simply accept compliance with foreign capital rules as satisfying local requirements as well; and

- Local regulators will look to foreign holding companies (as well as the local entity) in deciding whether the local entity is sufficiently well capitalised. Clearly, the existence and feasibility of parental support is an important matter in assessing the adequacy of loss-absorbing capital in the local bank.
The diagram below shows these points:

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Listed Holding Entity

Domestic Bank  Non-bank Subsidiary

Country A

Offshore Bank

Country B
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**Country A regulator:** Listed Holding Entity, Domestic Bank, Offshore Bank and Non-bank Subsidiary will all be subject to scrutiny and control by the banking regulator in Country A.

**Country B regulator:** As well as the direct regulation of Offshore Bank, Listed Holding Entity and Domestic Bank will also be subject to scrutiny by the banking regulator in Country B.

**Divergences between countries and national regulators.** The ABA makes this point because the Discussion Draft gives the impression that the regulatory environment has limitations or deficiencies which qualify the confidence that tax authorities might otherwise place in it to control potential BEPS behaviour:

- *by ensuring that a bank or insurance company is capitalised with an appropriate level of equity, these rules may also to some extent provide protection against excessive leverage for tax purposes and in many countries this will be the case. However, there are a number of factors that mean this may not always happen ... [para 18]*

The Discussion Draft suggests two limitations:

- Because regulatory rules are enacted in national law, they differ cross-border and do not ‘provide the same level of protection against excessive leverage for tax purposes in all countries and in all cases’ [para 19]; and
- Banking regulators may treat as loss-absorbing equity some instruments which tax authorities treat as debt [para 20].

Neither of these observations is compelling.

As was noted above, the capital adequacy of banking groups that operate cross-border is assessed by regulators in two countries, not just one, and this means in effect that the stricter of the two regimes will actually be the one which controls. Annex 2 already notes that, ‘in some cases countries may “gold-plate“ their regimes by applying stricter rules’ [para 72]. So the observation that the regulations will not be identical is not really relevant where it is the stricter rule that has to be met.

Further, there is reason to be confident that discrepancies between national regimes will gradually disappear in the future. While Annex 2 notes that the Basel III standards, ‘have not yet been fully implemented by countries’ [para 72], it also notes that, ‘most countries [do] apply rules based on a framework established by the Bank for International Settlements’ [para 68]. In reality, most developed and many developing countries do subscribe to these norms, and are in the process of moving their national regulatory regimes toward the requirements of Basel III, and soon they will need to meet the requirements of Basel IV which will set more stringent uniform norms.

Secondly, while at the margins there will be disagreements between the tax and regulatory authorities about the classification of some instruments, for most instruments, the classifications are clear and common: the treatment of Common Equity Tier 1 (CET1), current year retained earnings and reserves will typically align for tax and regulatory purposes. There can be discrepancies between the tax and regulatory treatment of Additional Tier 1 (AT1) instruments, but their ability to be used to generate BEPS outcomes is unlikely to be sizeable as the amount that can be raised at AT1 capital is often capped by the regulatory environment.
In short, tax authorities should have a high degree of confidence that the regulatory environment is adequate to control potential BEPS behaviour in the banking sector.

**Additional aspects.** In fact, the observation that the banking sector is not a location for BEPS concerns also follows for other reasons.

One is, what might be termed, the ‘add-on costs’ of debt. The regulatory regime requires banks to hold liquid (i.e. readily realisable) assets against their liabilities, and generally, the higher the level of debt, the greater the value of liquid assets that must be held. For example, the Australian banking regulator requires banks to maintain a high ‘liquidity coverage ratio’.

‘...to ensure that banks have an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30 calendar day liquidity stress scenario.’

Liquid assets (sometimes in domestic markets but more often in Australia, the RBA committed liquidity facility) have a ‘negative cost of carry’ – that is, they pay a small return because of the liquidity feature, and this rate of return is invariably below the cost of servicing the liability. Again, this add-on cost is a further disincentive to excessive borrowing.

**Giving priority to banking regulation.** The ABA’s 2015 submission also drew attention to the important observation that the regulatory regime is the appropriate place to locate rules about capital structure, outbound cash flows, and so on. Both tax and banking regulators have the same interest in ensuring that excessive amounts of funds do not flow offshore, that amounts (which might be available to meet claims on the bank) are not retained offshore, and that there are adequate levels of equity in each segment of the group in each country in which it operates. Handling any base erosion concerns through the regulatory regime ensures there is no conflict between competing regimes and regulators, and minimises the compliance cost for banks and thus the dead-weight loss to society.

**Location and allocation of debt and equity.** Paragraph 3 of the Discussion Draft refers to the focus of Action 4 as directed to the ‘use of interest [as] one of the simplest profit-shifting techniques available in international tax planning’ [para 2]. We think it important to repeat the observation made in our 2015 submission that the sourcing and the allocation of funds within a banking group is driven by circumstances that do not apply for commercial and industrial firms.

While commercial firms have a great deal of flexibility about how and where to source funds for their operations, banks generally do not. This mitigates against BEPS concerns:

- It is especially important in the banking industry for an institution to centralise its capital raising activities and then disburse funds to related entities – banks typically wish to present ‘one face to market’, so that the group is able to obtain funds most cheaply. This practice inevitably means that funds will be disproportionately raised in one jurisdiction by the head of the group, or a small number of locations and not by each of the various operating entities; and

- ‘Lumpy’ allocations of that capital within a banking group are not abnormal. Banks will often need to allocate significant amounts of capital to one permanent establishment or subsidiary, rather than another, for reasons other than tax – the different risk profiles of the customers in each jurisdiction, the different business products being offered in each jurisdiction, the different levels of maturity of the bank’s operations in each jurisdiction, the different views of the regulators in each jurisdiction of the required level of capital, and so on.
The Discussion Draft gives examples of exactly this kind of scenario, where banking regulation drives both the form of funding, the location where funds are raised and the location where funds are put to use:

*Some regulators require foreign headed groups to establish a local holding company, which must issue regulatory capital instruments to support the activities of banks and insurance companies in that country. These instruments will typically be issued intragroup, for example to a top-level holding company which issues regulatory capital instruments to third party investors [para 58]*

As stated in the ABA’s 2015 submission, tax motivations do not drive these practices. Rather, commercial and regulatory considerations dictate that funds are commonly raised centrally and disbursed to related entities, and that funds are placed in different amounts with particular PEs or subsidiaries. More importantly, tax rules should not interfere with these practices whether by design or by accident or insist on practices which could run counter to the imperatives of bank regulation.

**The overlay of tax constraints.** Finally, it is worth noting that the regulatory regime does not operate alone. For example, Australian tax law adds many extra barriers to potential base erosion activity through:

- Thin capitalisation rules (Australia’s version of an interest limitation rule)
- Transfer pricing rules
- Controlled foreign company (CFC) rules
- Withholding taxes on interest payments leaving Australia
- Specific anti-avoidance rules, including rules in our treaty network, surrounding measures directed at non-residents
- A recently-announced UK-style ‘diverted profits tax’ measure, and
- A robust and pervasive general anti-avoidance rule (GAAR).

In summary, the further work undertaken in the Discussion Draft demonstrates that the case for including banks (and corporate groups containing banks) in a general interest limitation rule – whether a fixed ratio rule or a group ratio rule – has not been made out:

- The empirical observation that, ‘excessive leverage in a bank … has not been identified as a key risk’ [para 26] is correct, and stems from the structural features of the regulatory system which have proven themselves more than adequate to meet BEPS concerns.
- The constraints imposed by the regulatory system are then usually buttressed by existing anti-abuse measures in the domestic tax regime; and
- There are observations in the Discussion Draft already that ‘there are a number of potential benefits from excluding banks [entirely] … from the scope of the rule’ [para 32].

If there is no evidence of harm, and there are benefits from not including them in the rule, the final report should reflect that and recommend leaving banks and banking groups outside the scope of any BEPS-inspired general interest limitation rule.

2. **Targeted anti-avoidance rules**

While para 26 of the Discussion Draft acknowledges that, ‘in the majority of cases, this [BEPS] risk will be low’ for banks, two particular concerns are singled out:

- ‘banks … using third party or intragroup interest to fund equity investments giving rise to income which is non-taxable or is taxed in a preferential manner’; and
• ‘entities in a group ... incurring excessive third party or intragroup interest expense, which may be set against taxable interest income in the bank or insurance company’ [para 9].

On reflection, neither concern appears to us sufficiently cogent to warrant departing from our main submission, that including banks in a general interest limitation rule is not necessary.

**Interest funding tax exempt/tax-preferred income**

One issue which was mentioned in the Final Report and in the Discussion Draft is whether banks should be allowed to deduct interest expense which is (somehow) related to earning either non-taxable distributions on equity investments in subsidiaries [para 35-40] or non-taxable foreign branch profits [paras 41-42].

**Distributions from subsidiaries.** With regard to the treatment of interest connected with earning tax-free distributions, we agree with the observations in the Discussion Draft that there are, ‘regulatory and commercial considerations which impose costs or other down-sides as a result of it doing so, reducing the attractiveness of such arrangements in most cases’ [para 35].

The Discussion Draft refers to three matters: the fact that equity investments in subsidiaries will be deducted from the bank’s own equity when assessing capital adequacy ratios [para 36]; the market preference of regulators and ratings agencies for banks not to fund subsidiaries with equity [para 37]; and the commercial imperative for a bank not to have equity trapped in offshore subsidiaries [para 38].

There are other factors which reinforce the unattractiveness of funding offshore subsidiaries with equity. Paragraph 36 notes that there are situations where an equity investment in an offshore subsidiary will not be deducted from the bank’s own equity when assessing capital adequacy ratios, but para 36 does not acknowledge that where an equity investment is not a capital deduction, the underlying assets of the subsidiary are required to be risk-weighted for capital adequacy purposes. In effect, the parent bank has to have equity in either case; to offset the capital reduction which occurs in one situation, or to support the risk-weighted assets now appearing in the other.

From an Australian perspective, this outcome comes about this way: equity investments in other entities (depending on whether they are financial entities) would be either treated as a capital deduction or a risk-weighted asset under APRA’s *Prudential Standard APS 111: Capital Adequacy: Measurement of Capital*. One situation where no deduction from equity may be required from a regulatory perspective is for equity injected into a subsidiary, where the entity is an extended licence entity (ELE). An ELE is treated as part of the Level 1 entity of the bank, but in this case, the assets of the ELE would be required to be included in the risk-weighted assets of the Level 1 bank, hence, there may also be a capital impact for the bank.

In so far as problems still remain (for example, the profits of a subsidiary are untaxed because it is located in a low or no tax jurisdiction [para 39]), the more appropriate solution is to invoke properly formulated CFC rules: the problem which needs to be solved is not the treatment of the interest expense, but rather the failure which allowed profits diverted into a CFC to remain unattributed back to the parent company.

**Foreign branch profits.** With regard to the treatment of interest attributable to foreign branches, the ABA agrees again with the approach in the Discussion Draft [para 42]. The solution is relatively straightforward: the approaches to the attribution of profits to permanent establishments (PES) detailed in the *2010 Report on the Attribution of Profits to Permanent Establishments* directly addresses the issue of attributing capital to branches and there is, ‘no need for the country to apply additional tax rules to deal with a bank or insurance company using interest expense to fund non-taxable income from an investment in a permanent establishment’ [para 42].
Interest expense applied against non-interest income

Much of the Discussion Draft is concerned with issues arising from spill-overs and the potential for shielding: the potential impact on the design and functioning of an interest limitation rule of (i) single entities with multiple activities, or (ii) corporate groups with multiple subsidiaries.

The two problematic situations envisaged are:

- A single entity which conducts operations that generate both interest income and non-interest income [for example para 30 refers to banks earning, ‘trading profits, dividend income, commissions and fees’ and refers to ‘the interest expense funding these activities [exceeding] the bank’s interest income’]; and
- A corporate group which has both banking subsidiaries (which generate interest income) and non-banking subsidiaries (which generate non-interest income) [Part IV and the Examples in Annex 3].

We take it that this is the concern behind the second point in paragraph 9: ‘entities in a group with a bank or insurance company incurring excessive third party or intragroup interest expense, which may be set against taxable interest income in the bank or insurance company’. The suggestion is to keep the banking business operations or banking entities separate because they will typically generate net interest income, but then to apply the interest limitation rule to portions of a single entity’s operations, or just to some entities in a corporate group.

The ABA will address the treatment of banks within larger corporate groups below.

With regard to mixed incomes being earned within a single entity, the Discussion Draft notes ‘there are a number of potential benefits from excluding banks [entirely] ... from the scope of the rule’ [para 32]. The potential benefits identified are not benefits; they are simply instances where drawbacks implicit in the fixed ratio rule will not be exposed.

There are real benefits from excluding banks entirely from any interest limitation rule: in the acknowledged absence of BEPS risk, such an approach will eliminate one additional, expensive and probably unnecessary compliance obligation. The ABA doubts that there will be instances where a bank would be permitted by regulators to undertake extraneous activities which are highly leveraged (say, a mine) and can shield these operations from scrutiny under an interest limitation rule because the bank has net interest income, rather than expense. This situation can be imagined, but it is not realistic.

It is worth pausing to note that the concern expressed in paragraph 30 is driven by the notion that an interest limitation rule must operate by comparing interest receipts and interest payments – the rule attaches to a taxpayer’s ‘net interest expense’. This is understandable as it is the design set out in the Final Report and the rule makes some sense for, say, industrial firms: interest income can reduce interest expense, but income from sales of widgets cannot – sales income is extraneous. But the Discussion Draft is taking a view about the scope of what constitutes, and does not constitute, banking that is ill-conceived: it implies that fee income or trading profits earned by banks are somehow extraneous, and akin to income from the sale of widgets. In reality, the interest expense allows the bank to earn the loan establishment fee and the monthly account fee, as well as the interest receipt from the customer.

Modern day banking is more than simply taking deposits and making loans; it is integral to the industry that a banking institution will earn ‘trading profits, dividend income, commissions and fees’ [para 30]. The Discussion Draft acknowledges elsewhere that, ‘modern banks are engaged in providing a broad range of financial services to individuals and businesses’ [para 14].

Once that proposition is accepted, there seems little point in attempting to differentiate between (i) the interest expense attributable to earning interest income, and (ii) the interest expense attributable to earning account fees, fees for financial advice, profits from accepting currency and interest risk, commissions on underwriting public offerings, and other kinds of income.
This is not to say that a financial institution should be, for tax purposes, an umbrella which can immunise any activity from scrutiny under an interest limitation rule. But if the banking regulator accepts, for example, that providing financial advice, acting as nominee to hold clients’ investments, investing and trading in portfolio securities, or offering safe custody services are appropriate activities for a regulated deposit-taking institution to undertake, this should suffice for tax purposes as well. It should not be necessary for the bank to differentiate the interest expense incurred to earn interest income from interest, and other expenses incurred to earn profits that arise from activities that are part of the modern banking industry and acceptable to banking regulators. In this area as well, the judgment of the regulator about permissible and impermissible activities provides a real constraint on BEPS opportunities.

3. Corporate groups which include a bank [Part IV of the Discussion Paper]

As was noted above, much of the Discussion Draft appears to be concerned with the problem of designing either a fixed ratio rule or a group ratio rule which is effective where a corporate group has both banking and non-banking subsidiaries: how to apply the fixed ratio approach [or the group ratio approach] to an entirely domestic group [or a group with foreign operations] if a bank is included in the group [excluded from the group] for purposes of the interest limitation rule.

The approach the ABA has advocated above is much more straightforward: given the acknowledged absence of BEPS activity in the banking sector, banks can and should remain outside the scope of an interest limitation rule. We argued above that this is a sensible and workable rule for banks that operate through PEs in foreign jurisdictions. It is also a sensible and workable approach for groups that include a bank, including corporate groups that operate cross-border.

Again, this is not to say that including a minor bank in a group should immunise all subsidiaries from scrutiny under an interest limitation rule, but the presumption should be that all the entities in a group which includes a deposit-taking institution, regulated by the banking regulator, should be outside the scope of the rule. A broad exclusion along these lines is unlikely to result in a loophole which would undermine the thrust of the Action 4 project.

In the ABA’s experience, banks will generally be part of groups of companies all of which are involved in the finance industry. We have yet to see banks which own and operate mines or factories, or entities which operate as banks being owned by telecommunications companies. Certainly, many industrial and commercial groups provide finance to their retail clients (many automobile manufacturers have a related consumer finance company), but these entities do not typically accept deposits from the public, which we take to be one of the core features of an entity properly described as a bank. Given that corporate groups which include banks will most likely be connected mainly with other companies engaged in finance activities, an exclusion for the entire group is workable and likely to prove sufficiently robust.

To insist that banking entities be separated from the rest of the group would create obvious compliance problems. For example, some financial services groups are structured as a listed holding entity that holds shares in a separate corporation which runs the banking operations. This structure may exist so that the group can also contain an insurance subsidiary, an aircraft leasing company, a credit card business, a funds management subsidiary, and so on. (There may also be a geographic overlay with a single listed head company and separate subsidiaries operating both banking and other financial businesses in different countries.) The HSBC Group, JP Morgan Chase and the Sumitomo Mitsui Financial Group display this type of structure. The regulatory regime may preclude the bank owning these entities directly, but they can be included in one group under the umbrella of the holding entity. Assuming the banking regulators are content with this structure, it ought to be accepted for tax purposes as well for the reasons we noted above: the banking regulator is also concerned with the capital adequacy of the insurance, leasing and funds management operations and will be keen to ensure that these entities are not so capitalised with debt that they could bring down the entire group, including the bank.
The exclusion for the entire group is likely to be robust for a rather more mundane, but nevertheless significant, practical reason: submitting to banking regulation is, in our experience, not something that is to be lightly undertaken. Any corporation which wishes to take deposits from the public faces a laborious, costly and lengthy process to gain approval, and must submit to ongoing rigorous scrutiny. These practical difficulties make it unrealistic to suspect that this is a plausible route to avoidance.

As we noted above, our submission is that the exclusion of the entire group should be a presumption. It may be that some additional form of protection is thought warranted, though that is not our preference – perhaps along the lines of a requirement that the bank is of a sufficient size when compared to the rest of the group’s operations, provided that the measurement is one that can be undertaken easily and from readily observable data.

4. Questions for consultation

Our earlier comments have outlined our general submission on the approach that should be taken in the Final Report on this issue, so far as banks and banking groups are concerned. In doing so, we have already addressed a number of the questions in the Discussion Draft.

This part of the submission addresses more succinctly some of the other questions posed in the Discussion Paper:

**Question 5.** Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

The recognition that ‘excessive leverage in a bank or insurance company has not been identified as a key risk’ leads to the presumption that the banking sector can remain entirely outside the scope of any tax-specific domestic interest limitation rules that might be enacted in response to BEPS Action 4.

**Question 8.** Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

**Question 10.** Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

As noted above:

- An appropriate and adequate solution is to invoke properly-formulated CFC rules to obviate the treatment of tax-free dividends from subsidiaries in offshore low or no tax jurisdictions; and
- An appropriate and adequate solution to the treatment of interest attributable to foreign branches is to implement the approaches to the attribution of profits to PEs detailed in the 2010 Report on the Attribution of Profits to Permanent Establishments.

**Question 15.** Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

The presumption should be that all the entities in a group which includes a deposit taking institution, regulated by the banking regulator, should be outside the scope of an interest limitation rule. This is a sensible and workable approach and, for the reasons given above, is unlikely to result in a loophole which would undermine the thrust of the Action 4 project. If additional protection is thought necessary, a requirement that banking activities are of a sufficient size compared to the rest of the group may add integrity.
5. Concluding remarks

The ABA wishes to take this opportunity to conclude with a more fundamental concern about the Action 4 project.

From its outset in 2013, the driving force behind the BEPS project was to challenge, ‘arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.’ OECD, Action Plan on Base Erosion and Profit Shifting (2013) [p.10].

But by the time the Final Report had been concluded in 2015, the focus had shifted dramatically. Rather than focus on base erosion, the main recommendation was directed largely to restricting leverage per se: ‘the recommended approach is based on a fixed ratio rule which limits an entity’s net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation’. This formulation omits the key ingredient which turns mere leverage into base erosion – namely, that there is an arrangement designed to shift income out of a jurisdiction and into the hands of related parties located in low or no tax jurisdictions. Leverage and base erosion are not synonymous, but the Action 4 Final Report treats them as if they are.

Omitting that key feature has created the very problem which the Discussion Draft now has to grapple with: how to make the recommended design of an interest limitation rule work when applied to banks; being entities which (i) have high levels of interest expense, but for reasons that have nothing to do with base erosion, and (ii) have a capital structure that is largely dictated by regulators. A much more promising approach to Action 4 would be to reinstate the critical notion – that any interest limitation rule which might be enacted should only ever be applied to transactions between related parties designed to shift profits away from the jurisdiction where the profits have been earned. Or to put this the other way, Action 4 should never have evolved to a situation where the deductibility of interest paid by a bank on borrowings from its customers is being put in jeopardy.

Please do not hesitate to contact me if you would like to discuss any of these matters further.

Yours faithfully

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Appendix - Regulation of banks

Banks are required to hold minimum levels of capital

Banks operate with minimum levels of total regulatory capital. Banking regulators determine prudential capital requirements (PCRs) for banks. The minimum PCRs that a banking group should maintain are as follows (expressed as a percentage of total risk-weighted assets held by the banking group):¹

a) Common Equity Tier 1 (CET1) Capital of 4.5 per cent.
   CET1 comprises ‘tangible’ equity such as shareholders’ common equity, retained and current year earnings, and accumulated reserves. It is the primary defence against insolvency and bank failure.

b) Tier 1 Capital ratio of 6.0 per cent.
   Tier 1 Capital comprises CET1 and AT1 capital. AT1 primarily refers to other forms of equity capital, such as preference shares, as well as some kinds of debt instruments with similar characteristics. Under the Basel framework, AT1 capital must be available to absorb the losses of a troubled institution by converting into equity or written off on the occurrence of a non-viability trigger event.

c) Total Capital ratio of 8.0 per cent.
   Total capital comprises CET1, AT1 and Tier 2 capital. Tier 2 Capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital but nonetheless contribute to the overall strength of a banking group and its capacity to absorb losses. Tier 2 capital primarily includes subordinated debt that has the same ‘non-viability’ clause, meaning it must be converted to equity or written off on the occurrence of a non-viability trigger event.

The banking group must maintain risk-based capital ratios above its PCRs at all times.

In fact, banking groups generally hold capital in excess of these minimum PCRs, by incorporating required buffers particular to their circumstances. Buffers are held for capital conservation and countercyclical reasons. These buffers can be used in times of stress and as losses are incurred. For example, a bank is required to hold a capital conservation buffer of 2.5 per cent and may be required to hold a countercyclical buffer of up to 2.5 per cent, and a systemic risk buffer of up to 3.5 per cent.

A combination of the domestic regulatory and tax rules ensures that capital is held in jurisdictions that require funding and/or level of capital for regulatory purposes.

Currently, in many countries (including Australia), the cost of servicing CET1 and Tier 1 capital is not deductible, whilst only the cost of servicing Tier 2 capital would be allowed as a tax deduction. Potential anti-hybrid rules are the subject of domestic focus following the OECD’s Final Report on BEPS Action Item 2.

Large exposure limits and intra group exposure

Banks are subject to regulatory large exposure limits, which seek to ensure that banks are not overly exposed to individual counterparties. These rules apply for both related and unrelated parties.

Banking regulators seek to ensure that debt is not disproportionately reallocated to particular entities by intra-group transactions. For example, in Australia, APRA has issued the Prudential Standard APS 222 – Associations with Related Entities which mandates that banks:

- Monitor, manage and control potential contagion risk between the banking group and other members of a conglomerate group of which the bank is part.

¹ In Australia expressed in prudential standard APS 110
Strong banks – strong Australia

- Meet minimum requirements with respect to dealings with related entities and certain related matters; and
- Comply with the prudential limits on intra-group exposures.

Broadly, banks must not have unlimited exposure to related entities either in aggregate or at an individual entity level. Banks must limit their exposure to related entities to a level consistent with that approved for dealings between unrelated entities.

In particular, an institution must limit its exposure to related entities to ‘the level of exposures which would be approved for unrelated entities of broadly equivalent credit status’ without the benefit of any implicit guarantee of the risk from other group entities [APS 222, para 11].

The general effect of the large exposure limits is that banking groups are limited in their intra-group dealings and restricted from disproportionately re-allocating debt to one entity, further mitigating BEPS risks.

Regulation of intragroup flows

In addition to large exposure limits, many regulators also place limits on the flow of funds between head office and branches/subsidiaries. The regulators want the local balance sheet to be stable and predictable, with limitations on the ability of funds to be transferred to parts of the group in other jurisdictions – particularly in times of crisis.

Banks are required to hold a minimum amount of high quality liquid assets

Regulators also require banks to maintain sufficient liquidity (at all times) to meet their obligations as they fall due, and hold minimum level of high quality liquid assets (HQLAs) to survive a severe liquidity stress.

Under the Liquidity Coverage Ratio (LCR) imposed by regulators, banks are required to maintain an adequate level of unencumbered HQLAs to meet their liquidity needs for a 30 calendar day period under a severe stress scenario. The LCR must be >100 per cent, and the test is represented by:²

\[
\text{Stock HQLAs} \quad \frac{\text{Total net cash outflows over next 30 calendar days}}{\text{total demand liabilities}} \quad > \quad 100\%
\]

Under the Basel LCR framework, banks are expected to be able to meet their liquidity needs in each currency and maintain HQLA to support their liquidity needs by currency. The regulators require international banks, in calculating the LCR, to take into account restrictions on the ability to transfer liquids across borders. The regulators generally only allow liquid assets held offshore to be included in the Group LCR to the extent they match the outflows in that jurisdiction, with surplus liquids held offshore only able to be included in the Group LCR in limited circumstances. These requirements have the effect of obligeing international banks to hold liquid assets in the jurisdiction where the funding is raised.

This aspect was raised on page 5.

Banks are required to maintain an appropriate net stable funding ratio

The net stable funding ratio requires banks to maintain sufficient stable funding to fund their assets and off-balance sheet activities. Broadly, it requires banks to match the maturity profile of their funding to the maturity profile of their commitments. This is intended to reduce the likelihood that disruptions to a bank’s regular funding sources will cause liquidity issues, increase the risk of its failure and potentially lead to broader systemic stress. As a result, the requirement to hold longer term funding can adversely impact the net interest position of a bank given that long term funding is more expensive.

² In Australia, expressed in prudential standard APS 210
I. Introduction

These comments are being submitted to the OECD by the Banking and Finance Company Working Group (the “Working Group”) on Base Erosion and Profit Shifting (BEPS)\(^1\) in response to the public Discussion Draft released on 28 July 2016 by the OECD entitled “BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors (the “Draft”).” The Working Group appreciates the opportunity the OECD has provided since the outset of the BEPS project to explain the nature of the banking business,\(^2\) how it is uniquely regulated, the critical role that debt plays in the business, and the necessity to carefully evaluate potential BEPS relating to interest expense within these important parameters. Throughout the Draft, these factors are recognized and taken into consideration. In fact, the Draft recognizes that BEPS relating to interest is a “low risk” issue for regulated banking groups.

However, the Working Group is very concerned with the direction that the OECD is taking in its recommendations on Action 4 for the banking sector, essentially to apply a modified fixed ratio rule. We have set out below a summary of our key points of concern together with our view on the position that the OECD ought to recommend, and included further supporting analysis and commentary after this summary.

II. Executive Summary

In developing our view on the appropriate recommendation that should be made for the banking sector, we consider that the following key points need to be taken into account:

1. The Working Group firmly believes that consolidated regulation, including capital requirements, leverage ratio limitations, and changes to the structure and business of banking groups caused by resolution planning, creates constraints on over-leverage and on interest expense that are equal to or more rigorous than application of the fixed ratio rule in the final Action 4 report as applied to non-financial services groups.

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1 The Banking and Finance Company Working Group comprises members of the Securities Industry and Financial Markets Association (including Citigroup, T.D. Bank, JPMorgan Chase & Co., Bank of America, Jefferies, Credit Suisse and Goldman Sachs), and Barclays and American Express. The Securities Industry and Financial Markets Association (SIFMA) is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raise over $2.5 trillion for businesses and municipalities in the U.S., serve clients with over $20 trillion in assets and manage more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

2 When this submission refers to the “banking group,” “banking industry,” or “banks and other similarly regulated financial services groups,” we are referring to banks, broker dealers, investment banks, and finance company groups that are regulated by an independent prudential regulator typically established by statute, or a subgroup of a larger business that is regulated as such and that includes financial services entities that are regulated as well by a local regulator (referred to as solo-regulated). These group and subgroups also include entities that are not subject to local regulation but are integral to the financial services group or subgroup that is subject to consolidated regulation, such as holding companies and services companies.
Fundamentally we therefore consider that application of the fixed ratio rule, or indeed any other rule, to banking groups is unnecessary from a BEPS perspective because the regulatory environment significantly constrains banking groups from engaging in activity that may pose a potential BEPS risk arising from the tax deductibility of interest expense;

(2) We are concerned that these business and regulatory realities, and the roles they play in preventing banking groups from engaging in BEPS related to debt and interest expense, remain less than fully understood in the context of tax policy and tax administration, and that the recommendations for the banking sector are therefore not coherent from a policy perspective (see also (4) below).

(3) The proposed application of the fixed ratio rule, with adjustments that seek to isolate interest expense in non-solo regulated entities within regulated banking groups subject to consolidated regulation, fails to recognize the integrated operations and funding requirements of entities within a banking group and will create undue harm for such groups that is disproportionate to any perception of such BEPS activity in regards to the group as a whole.

(4) Furthermore, the implementation of the modified fixed ratio rule recommendation would leave banking groups in a comparatively worse position to non-financial groups. This is because while non-financial groups’ gross taxable income represents EBITDA that would provide capacity for allowable interest expense, for banking groups the capacity that would be provided by the solo-regulated operating entities would no longer be available to offset the interest expense of the modified group suggested by the draft. Further, the gross operating income of banking groups comprises largely interest income, which the proposals would, in effect, entirely carve out from consideration in the application of the fixed ratio rule. A modified fixed ratio rule would therefore be discriminatory to the banking sector.

(5) Critically, interest income is gross income from the active trading of a banking group, and interest expense is a direct cost of sales, or cost of goods sold for a banking group, and limitations on the deductibility of interest expense against corresponding financial income will affect the cost of finance (and financial intermediation). Furthermore, any restriction on the tax deductibility of a banking group’s cost of sales would be fundamentally different from the approach taken by the OECD in other aspects of the BEPS Project, where (rightly) there has been no recommendation for an artificial restriction on the tax deductibility of a business’s cost of sales.

(6) The disproportionate implications for a banking group through the application of the fixed ratio rule are amplified by the fact that the group ratio rule, which is designed to allow some amount of interest to be deducted beyond the amount provided by the fixed ratio rule where a group naturally operates with a higher degree of leverage, does not provide such additional relief for banking groups, as the Draft acknowledges.

Accordingly, the Working Group strongly urges the OECD to recommend as a best practice that regulated banking groups and subgroups whose operations are predominantly of a banking, broker-dealer, investment banking or financing business in nature not be subject to the fixed ratio and group ratio rules or to any adjustments to these rules.

Our rationale for recommending this approach is based on the following:
Such groups, which are predominately engaged in the banking, financing or similar business, will generally be regulated both by a prudential regulator in the headquartered jurisdiction and by prudential regulators in other jurisdictions (for example, where the local subsidiary or sub-group carries on banking activity), and do not pose a potential BEPS risk arising from the tax deductibility of interest expense. Such groups must be differentiated from non-financial groups that have regulated captive financial entities embedded within their structures but are not subject, as a group or subgroup, to consolidated regulation. Therefore, such non-financial groups are not subject to the same limitations and regulation that are imposed on the banking group.

The Working Group disagrees with the assertion in the Draft that differences between regulatory capital rules in different jurisdictions may permit BEPS activity, and that such differences in regulatory coverage may be justification for regulators and tax authorities viewing excess leverage differently. We also think that it is fundamentally problematic if tax authorities take the view that they should or could impose limitations on tax deductibility because they may disagree with the amount of leverage permitted by regulators. Tax policy making should be coherent with regulatory policy objectives in the approach to the banking sector.

Furthermore, the Working Group disagrees with the basic premise that appears to be the basis for the OECD’s further work in this area, namely that there is tax base erosion through interest expense when a banking group, subject to both arm’s length transfer pricing and existing anti-avoidance legislation, earns taxable net interest income in a country – when the interest expense is fungible and a key component of the cost of sales.

The Working Group also disagrees with two other reasons given in the Draft for why special tax rules should apply to banks. These are sections of the Draft dealing with the attribution of capital to permanent establishments (PEs), and sections addressing the possibility that BEPS is created through the use of interest expense to fund non-taxable income in a bank. We have set out in the detailed analysis below further comments on our disagreement on these two points.

Finally, the Draft discusses banking and insurance groups together, though it does acknowledge that debt and interest play vital but different roles in these two types of financial services businesses. As a general matter, the Working Group believes that a final report should carefully address banking and insurance groups based on the distinct business models of the two industries.

III. Supporting Analysis and Detailed Commentary

(1) Potential BEPS risks related to the banking industry as identified in the Draft

This submission is structured first to address the areas of potential BEPS that are identified in the Draft, and then to discuss the suggested options for remedies that are included in the Draft. For banking groups, the Draft states that countries identified the following financing structures as posing BEPS risk under the final Action 4 report:
• The use of third party or intragroup interest to fund equity investments giving rise to income that is non-taxable or is taxed in a preferential manner.
• Incurring excessive third party or intragroup interest expense, which may be netted against taxable interest income.

(2) Suggestions that banking regulation does not protect against excess leverage

While identifying the above financing structures as posing BEPS risk, the Draft notes that countries distinguished between two sets of groups: on the one hand, the risks posed by banks subject to capital regulation at a solo level (meaning that an operating business entity is subject to local country regulation and, broadly speaking, subject to individual capital requirements); and on the other, the risks posed by other entities within a bank group, including holding companies and other entities that are not subject to solo level regulation. As a general matter, we believe this distinction is misplaced in the context of banking groups that are regulated in their entirety by home country prudential regulators, or regulated as such at the sub-group level. The Working Group believes that the manner in which such groups are regulated in terms of the level of capital they must maintain, debt/equity ratios with which they must comply, and other aspects of banking regulation globally and at the local country level create a limitation on leverage and interest expense that is on par with or even more rigorous than the fixed ratio rule as it applies to non-financial groups.

In fact, the Draft acknowledges that regulatory capital requirements provide protection against excessive leverage for tax purposes. Notwithstanding such acknowledgment, paragraphs 19, 20, and 21 of the Draft go on to list reasons why it is believed that regulatory capital requirements may not prevent BEPS by banking groups. These reasons include the following: that regulatory capital rules may differ between countries and the type of regulated activity undertaken; that there are differences between how regulators and tax authorities may view the excessive leverage; and that there are differences in the economic environment or legal frameworks in different countries in which banking groups operate.

We disagree with these assertions as they do not reflect the reality of the implementation of regulatory capital standards around the world, and we are concerned that banking regulation remains less than fully understood in the tax policy making context.

For example, paragraph 19 of the Draft states that there are material differences in how Basel III has been implemented globally. In fact, implementation of the Basel standards has been remarkably consistent. The Basel Committee on Banking Supervision (BCBS) reviews, on an ongoing basis, the extent to which domestic regulations are aligned with the minimum Basel requirements to help identify any material gaps. This assessment program has shown that the implementation of Basel III capital and liquidity standards at the jurisdictional level has been generally consistent with the globally agreed Basel standard. Therefore, we recommend that the OECD make a closer investigation of how the Basel standards are indeed being implemented. Such an investigation will demonstrate that in large part the regulatory capital rules are providing a level of protection against excessive leverage that, again, is equal to or more stringent for global banking groups than that of the fixed ratio rule as it might apply to non-financial services groups.
While some jurisdictions continue to work on implementing key elements of the post-crisis regulatory framework, the BCBS and G-20 expect key jurisdictions to be broadly compliant with minimum global standards. Jurisdictions can be reprimanded during the G20 process if they are perceived to be creating opportunities for regulatory arbitrage. In addition, regulators continue to develop other key elements of the post-crisis regulatory framework, which will further enhance minimum, comparable global capital standards. The BCBS continues to work on a final calibration of the leverage ratio. In January 2016, the BCBS’s Oversight Committee, comprising Central Bank Governors and Heads of Supervision (GHOS), agreed that the leverage ratio should be based on a Tier 1 definition of capital, should comprise a minimum level of 3% and discussed the possibility of additional requirements for global systemically important banks. The GHOS will finalize the calibration in 2016 to allow sufficient time for the leverage ratio to be implemented by 1 January 2018. Additionally, by the end of 2016, the GHOS will review the BCBS’s proposal on the design and calibration of capital floors, involving setting the baseline minimum requirements that would apply to all jurisdictions.

The OECD seems to be arguing that firms are utilizing regulatory arbitrage opportunities for tax purposes; however, this is inconsistent with the reality as described above for banking groups.

Paragraph 20 states that there are differences between how tax authorities and regulators may view the issue of excessive leverage, and suggests that while regulators are concerned with the overall level of debt in a group, tax authorities are focused on earnings stripping and other base erosion techniques in which “excessive” levels of debt is “pushed into an entity” to reduce the amount of profits subject to tax. The Draft goes on to note that some jurisdictions allow certain interest-bearing instruments to be treated as capital for regulatory purposes, subject to prescribed limits. Where these instruments are treated as debt for tax purposes, “a bank or insurance company’s leverage for tax purposes may be higher than its leverage for regulatory purposes.” As an initial matter, we disagree with this statement. Such debt instruments are additions to, not substitutes for the equity required to meet the tier 1 Common Equity ratio, which is the prime determinate of the requisite amount of capital a regulated bank must hold.

In addition, while we agree that it is possible that some regulatory capital instruments may be treated as debt for tax purposes, this should not be viewed as a problem that creates a BEPS opportunity for regulated banking and similar groups. All sophisticated jurisdictions pay tax policy attention to the distinction between debt and equity. Regulatory capital instruments by their nature receive consideration in this regard due to factors such as subordination, convertibility, write-off of principal, discretionary coupons, perpetuity, high rate, coupons accounted for as distributions, etc. This issue is also covered by the hybrid rules. We do not believe, therefore, that it is necessary for the OECD to separately address this issue under Action 4.
(3) The Draft identifies branches and the attribution of free capital to PEs of banks companies as potentially problematic

The Draft identifies branches and the attribution of free capital to PEs of banks companies as potentially problematic. The Draft states that in most countries there is no regulatory requirement for capital to be allocated to a permanent establishment. Therefore, the Draft indicates that while regulatory requirements may sufficiently address BEPS in entities, these rules would not necessarily prevent a PE of a bank claiming an interest deduction for all of its funding costs without limitation. Moreover, the Draft points out that the approaches taken into account in the 2010 Report on the Attribution of Profits to Permanent Establishments (the 2010 report) include appropriate approaches for the attribution of profits to PEs of banks and insurance companies and a PE should be attributed an arm’s length amount of free capital. However, as these approaches take into account capital requirements in the home country or the host country, the Draft maintains that concerns that regulatory capital rules in different countries may not provide the same level of protection against excessive leverage for tax purposes are also valid in the case of a PE.

The Working Group believes these assertions represent a misunderstanding of the 2010 Report and its implementation. Local tax authorities can attribute capital of the entity to the local branch in accordance with the arm’s length principle as provided in the Authorized OECD Approach (AOA) outlined in the 2010 report. Additionally, by adopting this approach where a branch is considered to have been allocated excess capital, we would expect the local tax jurisdiction to make adjustments to the tax computation that would increase the amount of taxable profits to those that would be achieved by similar banking activities carried out by a standalone bank in the same or similar circumstances. The effect of this approach is that a bank’s permanent establishment has an appropriate amount of interest expense attributed to it for tax purposes, as does the head office. There is no need for an interest restriction in the head office simply because there is a foreign PE.

Lastly, the concerns included in the Draft run counter to prior OECD statements recognizing that the 2010 report provided a complete and satisfactory resolution to the attribution of profit issues relating to a PE in the context of the banking industry. As noted above, the 2010 report provides tax authorities with the tools they need; if anything, the final report on this matter should reinforce the application of the 2010 report rather than suggest alternative tools.

(4) Interest funding non-taxable income from an equity investment

Paragraph 35 of the Draft states that countries have identified BEPS risks “which concern a solo-regulated entity using deductible interest expense to fund non-taxable income” and typically involve a bank receiving a non-taxable return on an equity investment. The report accurately points out that these concerns are mitigated by “a number of regulatory and commercial considerations” including regulatory capital and other constraints against the use of double leverage in a group that relate to using debt to fund equity investments and regulatory constraints against “trapping” capital in subsidiaries. Yet, the Draft upholds that countries are still concerned about BEPS risks in this area and, in particular, suggests banks might “incorporate equity funded vehicles in low tax jurisdictions, which are used to invest in portfolio investments.”
We agree that these concerns are significantly mitigated by regulation, which continues to evolve and strengthen, and we would respectfully suggest that concerned countries examine carefully whether their concerns are historic and precede the regulatory developments since Basel III, and/or whether their concerns are better addressed by measures outside of the scope of Action 4.

As remedies, the Draft suggests, in paragraphs 39 and 40, addressing these concerns by (i) disallowing interest expense for debt used to fund non-taxable income; (ii) reducing or eliminating the amount of income that might benefit from a participation exemption regime; or (iii) tying tax rules to regulatory capital rules so that if regulatory capital rules require that an equity investment be reduced for regulatory capital purposes, then tax rules should treat the funding amount as equity and not debt, thereby eliminating interest deductions. Attempting to tie regulatory and tax rules together in the manner outlined is likely to be very difficult to achieve given that the regulatory environment does not necessarily achieve its objectives in that way. Meanwhile, applying controlled foreign corporation (CFC) type rules is appropriate and more directly targeted than the alternative approach of applying the fixed ratio rule, to the extent that countries find that a BEPS problem exists in regards to regulated banking and similar groups, notwithstanding the changes that have occurred and the robust nature of the regulatory environment that applies to these groups.

(5) The fixed ratio rule should not be applied in a modified manner to banking groups

The OECD’s recommended best practices approach in the October 2015 final Action 4 report is to limit the deduction of net interest expense to a fixed ratio (10-30%) of the EBITDA of the taxpayer, which may be a consolidated group or may be a single entity depending on the particular country’s consolidation rules and the particular group’s circumstances. This general test is subject to a possible worldwide group ratio safe harbor that would allow full deduction if the taxpayer’s net interest expense level is not disproportionate to the worldwide group’s net third-party interest expense level.

The Draft, rather than suggesting a best practices approach similar to the fixed ratio rule included in the October final Action 4 report, states in paragraph 51 that countries “should consider applying the rule to the local group excluding banks and insurance companies . . . To the extent that a country intends to apply the fixed ratio rule to banks and insurance companies, these could be included in a second local group containing only solo regulated entities.” We have grave concerns with this approach, along with the assumptions and examples in the Draft relating to the potential impact of applying this approach. As explained below, we believe the implementation of the modified fixed ratio rule would leave banking groups in a comparatively worse position to non-financial groups and is not justified.

Paragraph 52 states that net interest expense in the remaining entities in the group would be deductible up to the benchmark fixed ratio threshold. However, this statement and examples 1 and 2 assume these remaining entities would include a combination of entities with interest income and interest expense. In this regard, all of the examples suffer from this flaw of assuming there is a substantial non-financial entity in the group that will have EBITDA. This fact pattern does not exist for any members of our Working Group. In Appendix 1, we include both the examples contained in the Draft as well as an example of what we believe to better illustrate the impact of the fixed ratio rule as suggested in the Draft. While such an approach may adequately address potential BEPS for a manufacturer or a retailer
with a financing arm, any issues that may arise there should be analyzed separately from banking and other financial groups such as the firms in our Working Group.

We don’t believe Example 2 accurately portrays the outcome of the application of the fixed ratio rule, as it indicates a relatively small portion of the group’s interest expense is disallowed through application of the fixed ratio threshold separately to the groups. In reality, this regrouping of financial services entities into regulated and non-solo-regulated entities for purposes of the application of the fixed ratio rule will result in the EBITDA threshold being negative, so no interest deduction would be allowed in these cases. This is a fundamental concern because those expenses are part of the cost of sales of the banking group’s financial services business carried out through those other entities.

To reiterate, in many cases, a holding company will issue debt on behalf of the group and, on a stand-alone basis, may be in a net interest expense position, even though effectively the interest expense in the holding company is funding net interest income in a solo-regulated operating company. Therefore, if the regulated operating companies are carved out of the fixed ratio rule so that their net interest income is ignored, banks and insurance groups may find themselves suffering a restriction on the tax deductibility of interest even where that interest expense is effectively funding taxable interest income rather than exempt income. We are therefore concerned that the proposed narrow carve-out only of solo-regulated entities is simply not an appropriate approach, and furthermore is likely to put financial groups at a disadvantage to other sectors.

As noted above in the discussion of banking regulation, the Working Group believes that alternative applications of the fixed ratio rule would ignore the fact that such groups use entities that are not subject to solo regulation such as holding companies, treasury companies, special purpose companies (such as debt issuing or financial repacking entities) and asset management companies for a variety of commercial purposes. Since the activities of such entities usually are closely aligned to the core bank/broker dealer/finance company business of the group and, as described below, impact the consolidated regulation of the banking group separating, these linked entities from a business and regulatory perspective for tax purposes defies economic, business and regulatory reality.

While not all entities are subject to solo “functional regulation,” (i.e., individual capital requirements and other restrictions that apply to a bank or securities firm) it is important to stress that a banking group is subject to consolidated capital requirements that cover all of its assets and liabilities. All third-party assets and liabilities are rolled up into the consolidated entity, and all of these assets and liabilities are subject to capital requirements. As such, separating these entities within a country simply because they are not subject to solo entity regulation ignores the fact that consolidated capital requirements apply to the entire group, and therefore leverage ratios apply to the entire group. Parent holding companies, for example, are prudentially regulated, and are required to serve as a source of strength for their subsidiaries. From a resolution planning perspective, separating these entities by interjecting tax considerations into the capital planning/distribution process is problematic. This is particularly of concern as regulators are requiring Total Loss Absorbing Capital (TLAC) to be issued by a parent as debt into the market, and a bank/broker dealer subsidiary will issue debt to the parent. Applying the fixed
ratio rule in the manner suggested by the draft could undermine financial stability objectives and could lead to a need to restructure a group that would provide a distraction from, and run contrary to, critical regulatory considerations.

Thus a tax authority can only create distortions in the economics of a banking operation by viewing entities in an isolated way. Regulators focus and place limitations on inter-company lending within a group (e.g., limitations on large exposures), all to the point of furthering resolution planning and ensuring the financial soundness of each individual regulated entity. Each country’s regulator watches over the particular entity’s leverage ratios, and will also be concerned about the interest rate being paid on inter-affiliate loans. Regulation thus puts significant limits on leveraging up entities, while ensuring that interest charges are calculated on an arm’s-length basis. In addition, regulators look at inter-affiliate exposures broadly, including limiting credit exposures (use of loans and derivatives) between banks and other entities.

Financial services groups and non-financial services groups are very different businesses, and therefore efforts to manipulate the fixed ratio rule to apply to financial services groups in order to produce results comparable to those when the rule is applied to non-financial services groups simply will not work (nor is it necessary from a tax policy perspective). Paragraph 52 reads that, “it is expected that excluding banks and insurance companies from a local group should in most cases remove the main operating entities which earn interest income as a primary activity. The impact of the rule on an entity in a group with a bank or insurance company should thus be closer to that on entities in other groups.” Presumably, this means that the aim of applying the fixed ratio rule in this way to financial services groups is to make the operation of the fixed ratio rule comparable and proportionate to the manner in which it applies and the impact the disallowance of interest expense would have upon non-financial services groups. However this approach is not appropriate, it is not proportionate, it is unwise, and it does not produce a result that is comparable to the application of the fixed ratio rule to non-financial groups, because it completely carves out core operating income of the banking group from consideration alongside related interest expense.

Paragraphs 54 to 60 discuss the potential limitation of interest expense that could occur when entities issue third-party debt, including debt that counts as regulatory capital, to support operating banking and other similar entities in a group, and the fixed ratio rule is applied to some but not all entities in a country. Paragraph 56 states that the limitation on interest expense that would occur may not be appropriate and the remedy should be that some or all of the third-party interest expense on regulatory capital should be excluded from the net interest expense subject to the rule. We agree with this recognition in the Draft that interest expense related to such regulatory capital instruments should not be subject to limitation as part of the application of the fixed ratio rule, as doing otherwise would distort the outcome assumed by regulators. As noted above, however, most countries have adopted or will adopt tax rules relating to such instruments that are consistent with their approaches to defining debt and equity, based on the characteristics of the instruments and in consultation with banking regulators. We consider this to just be an example of the problems that would be caused by interest expense in non-solo regulated entities being separated from operating income in regulated entities. The suggestion to give special treatment to regulatory capital instruments does not address this fundamental concern.

Therefore, the Fixed Ratio Rule (or any version thereof) should not be applied to separate entities or subgroups within such a banking group. In fact, we believe that the final report should go further than the Draft in making clear that concerns regarding the risk of BEPS related to interest expense by a
banking group are likely to be unusual, and should include a clear note of caution as to the extent to which it is desirable to introduce modifications or variations of the fixed ratio rule to address such perceived concerns. It would be undesirable for the final report to appear to be advocating a fragmentation in the international approach where that is not generally necessary.

(6) Application of the group ratio rule will not provide relief

As noted in paragraph 62, the group ratio rule is intended to permit the deduction of more interest expense beyond that limited by the fixed ratio rule, to the extent the amount of interest expense being deducted is in line with net third-party interest of the group as compared with the EBITDA of the group.

Paragraph 63 points out, accurately we believe, that if the fixed ratio rule is applied on an entity-by-entity basis, or applied to exclude regulated banks and insurance companies from a group, the group ratio rule will likely “not provide any relief.” Paragraph 67 identifies practical issues in this regard.

The fact that the group ratio rule, which is intended to provide additional relief to non-financial services groups that are limited in their ability to deduct interest expense using the fixed ratio rule, “breaks down” when applied to financial services groups if the fixed ratio rule is applied in the targeted manner described by the draft is another reason why the potential application of the fixed ratio rule as described in the Draft is unworkable. The group ratio is aimed at ensuring that the fixed ratio rule does not cause unintended commercial damage in industries with substantial amounts of third-party debt finance. The fact that this approach is not workable for a regulated banking group – which is naturally an industry involving substantial amounts of third party debt finance, given that taking on debt is fundamental to the business operations of a banking group – is further reason to dispense with suggestions that countries apply the fixed ratio rule in alternative ways, and also argues for a broader exemption from the fixed ratio rule for MNC groups for which banking, financing and similar activities are their ordinary course of business.

(7) Working Group Recommendations

The Working Group strongly believes that applying the fixed ratio rule or modified versions of the fixed ratio rule to banking groups is not justified by the low level of BEPS risks posed by such groups, and that to take either route risks causing unintended problems. We support the statement in paragraph 26 that, “In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk is low.” The Draft goes on, in paragraph 27, to state that “there is no need at this time to develop a single common approach to deal with this risk.” We fully agree with this conclusion and would suggest that the OECD’s final report should simply and concisely conclude as such. If no common approach is required, then we would see further commentary as to potential approaches to be unnecessary and inconsistent with the BEPS program, as such commentary could be interpreted by individual countries as representing OECD-endorsed minimum standards. In particular, we disagree with the suggestion that regulated banking and similar groups be broken into two groups in order to apply the fixed ratio rule. The creation of two groups not only excludes the net interest income of the bank group but also the income of the bank for purposes of computing EBITDA. This would put a bank at a disadvantage compared with a non-bank whose operating entities income is used to compute the
allowable interest expense (and would seek to arbitrarily limit the tax relief for a banking group’s cost of sales, again quite unlike the approach taken with non-banks).

Therefore, for purposes of financial services groups that are predominantly engaged in a banking, financing or similar business, we recommend that, as a best-practices approach, countries applying the fixed ratio rule as described in the final Action 4 report expressly exempt such groups. Various definitions could be applied to target the exemption to banking groups and subgroups, including whether the group or subgroup itself is subject to prudential regulation in its headquartered country. Such an exemption is necessary and appropriate both because (i) consolidated regulation of banking groups creates constraints on over-leverage and on interest expense that make application of the fixed ratio rule (or modifications thereof) unnecessary and would potentially cut against regulatory limitations while creating serious harm to the business; and (ii) interest expense has a fundamentally different role in banking groups, i.e. as a vital component of the cost of sales, and we believe it is inappropriate to place an arbitrary limit on the tax relief available for an expense of that nature. Countries that are concerned that, despite the reach and robust nature of banking regulation and capital requirements, some amount of BEPS is occurring in their jurisdictions by such banking groups should be encouraged to look to other guidance produced by the final BEPS reports, including Action 2 (hybrid mismatches), Action 3 (effective CFC rules), Action 6 (treaty abuse), and Actions 8-10 (transfer pricing).

Finally, if the fixed ratio rule is to be applied in any manner that does not exempt regulated banking groups, taxable dividends and other financial services operating income of entities within such groups should not be carved out, and should be treated as equivalent to interest income. To do otherwise would distort the taxation of financial trading profits (i.e., the ordinary income and expenses of a financial institution) and treat debt differently from the manner considered appropriate for the purposes of financial regulation. This is recognized in paragraph 14 of the Draft, which points out that groups with significant investment banking activities in a country, including securities trading, etc., may be funded with debt but produce non-interest income.

There are numerous examples in which this does and will occur, because debt capital can be utilized by regulated entities within a financial group in different financial businesses. Such businesses include: fixed income trading (which generates interest income and trading profit), equities trading (which will generate trading income and dividend income) and derivatives trading. Debt employed in the regulated financial institution’s equities and derivatives business creates an expense in the net interest calculation, but the non-interest trading, dividend or derivatives income generated in such businesses will not offset the interest expense to eliminate any net interest expense if a narrow definition of interest is taken when assessing whether there is net interest expense.

It is worth noting that even for a banking group, it is possible to have a broker dealer and investment bank in a country that does not include a deposit-taking bank. In addition, local market conditions may be such that a banking group’s interest income is suppressed while it may not be able to entirely refinance itself in the prevailing interest environment (for example, some funding may be locked in for a longer term at higher rates than currently applicable). In addition, a country’s definition of interest may
contain elements that would produce unexpected results, leading to net interest expense arising, when applied to a banking business. For example, the UK's recent consultation considers the inclusion of debits and credits on a range of derivative contracts in the determination of interest, as well as impairment losses, which risks causing banks to have net interest expense when there is no policy need for a restriction on interest deductibility.

In all the above cases the extent of debt in the capital structure of the regulated entity is governed by the applicable regulatory regimes, which guard against base erosion through interest. The effect of attempting to apply the generally applicable fixed ratio rule in such circumstances, without including dividend or other related income as equivalent to interest, would create a distorted reflection of the financial profits of the group.
Appendix

The examples given in the Draft set out the fixed ratio rule as it would apply to a local group including banks and insurers and also to a local group excluding banks and insurers. This illustrates the impact of a disallowance applying where the rules require a carve-out for banks and insurers. The OECD example is reproduced below.

OECD Example:

Assume A Co is a holding company with two subsidiaries: B Co, which is an operating company carrying on non-financial activities, and C Co, which is a solo-regulated bank or insurance company. Assume also that A, B and C Co are all entities tax resident in Country X, which applies the fixed ratio rule using a benchmark fixed ratio of 25%.

Scenario A: Applying the fixed ratio rule to a local group including banks and insurers

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co (operating co)</th>
<th>C Co (operating co)</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>10</td>
<td>70</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td>26</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>25%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>(25)</td>
</tr>
<tr>
<td>Net interest income/(expense) of local group</td>
<td></td>
<td></td>
<td></td>
<td>26</td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Interest taxable/(deductible)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, there is no disallowance because the local group has net interest income. Therefore the group is taxed on 26 of interest income.
### Scenario B: Applying the fixed ratio rule to a local group excluding banks and insurers

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co (operating co)</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>10</td>
<td>70</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td>(24)</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>25%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>(20)</td>
</tr>
<tr>
<td>Net interest income/(expense) of local group</td>
<td></td>
<td></td>
<td>(24)</td>
<td></td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td>(0.5)</td>
<td>(3.5)</td>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td>Interest taxable/(deductible)</td>
<td>(2.5)</td>
<td>(17.5)</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, the local group now excludes the operating banking/insurance company and therefore has net interest expense. The interest capacity is capped to 25% of EBITDA, therefore there is a disallowance of 4, which is allocated between A Co and B Co (the example assumes allocation on the basis that neither A Co nor B Co has net interest deductions in excess of 25% of EBITDA). Therefore the group is taxed on 30 of interest income.

However, the OECD example does not take into account a scenario where the group has holding companies that mainly produce losses, which could have a greater negative tax impact on banking and insurance groups.

**Working Group Example:**

Assume HoldCo A and HoldCo B are holding companies in a banking group that have no income other than dividend income and incur interest and management expenses. Assume also that Operating Co is a solo-regulated bank tax resident in the same jurisdiction as HoldCos A and B, that jurisdiction having a 20% tax rate.
Scenario A: Applying the fixed ratio rule to a local group including banks

<table>
<thead>
<tr>
<th></th>
<th>HoldCo A</th>
<th>HoldCo B</th>
<th>Operating Co</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>(20)</td>
<td>(10)</td>
<td>80</td>
<td>50</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(35)</td>
<td>(25)</td>
<td>150</td>
<td>90</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>30%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>(15)</td>
</tr>
<tr>
<td>Net interest income/(expense) of local group</td>
<td></td>
<td></td>
<td></td>
<td>90</td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Interest taxable/(deductible)</td>
<td>(35)</td>
<td>(25)</td>
<td>150</td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, there is no disallowance because the local group has net interest income. Therefore the group is taxed on interest income of 90 (at the 20% rate of tax, this leads to a tax liability of 18).

Scenario B: Applying the fixed ratio rule to a local group excluding banks

<table>
<thead>
<tr>
<th></th>
<th>HoldCo A</th>
<th>HoldCo B</th>
<th>Operating Co</th>
<th>Local group (excl. banks)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>(20)</td>
<td>(10)</td>
<td>80</td>
<td>(30)</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(35)</td>
<td>(25)</td>
<td>150</td>
<td>(60)</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>30%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>
In this scenario, there is no interest capacity because HoldCo A and HoldCo B have negative EBITDAs. Therefore, the group is taxed on 150 of interest income (at the 20% rate of tax this gives a tax liability of 30) and the local group’s interest expense is disallowed.

The additional tax impact under the carve-out is therefore an increase in the liability of 12. It is common in banking groups for holding companies to incur interest expense management expenses and little or no other income, therefore resulting in a negative EBITDA position. As illustrated by the scenarios above, the proposed carve-out rules could fully restrict relief for interest expenses in a local banking group.
8 August 2016

Dear Sir/Madam

Approaches to address BEPS involving interest in the Banking and Insurance sectors

The BBA and AFME welcome the opportunity to make this written submission in response to the OECD's discussion draft published on 28 July 2016 entitled ‘Approaches to address BEPS involving interest in the Banking and Insurance sectors’.

The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in 50 countries, with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA.

The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions.

Key considerations in the application of these rules to banks

We are grateful for the OECD’s recognition set out in the discussion draft that care is needed in targeting the approach of Action 4 to the banking sector. However, we believe that this needs to be more strongly stated in the final recommendations.

In offering our comments on the discussion draft, we have been guided by the following considerations:-

- **Interest is a fundamental part of a bank’s business** – Banks are substantively different to other businesses (i.e., those which are not regulated), and interest paid by banks is equivalent to the ‘cost of goods sold’ by non-banking businesses. Great care is needed in applying rules to banks to restrict the deductibility of interest paid to make sure that the proposals fulfil their aims without resulting in unintended consequences or an unnecessary compliance burden on ordinary business. Since debt is taken on, and hence interest expense incurred, as a central part of a bank’s core operating business we have significant concerns about the policy rationale for seeking to restrict tax relief for that cost of sales when a bank is earning taxable net interest income in a given territory.

- **Banks are already highly regulated** – There is a risk that these proposals could result in tax consequences that contradict regulatory requirements that are out of a bank’s control.

- **Regulation also constrains the perceived risks** – the base erosion and profit shifting (BEPS) risks identified in the OECD’s final recommendations on Action 4 are substantially mitigated by the globally and regionally co-ordinated regulatory environment in which banks operate.
- **The impact of regulation applies beyond just regulated entities themselves** - Regulatory supervision typically applies to banking groups, not just to banking companies. Even where this is not the case, the effect of regulation on banking companies within groups which are predominantly banking groups will have an indirect impact on the activities of the entire group. It is therefore important that measures address banking groups on a holistic basis.

**There should be a presumption that effective regulations will eliminate interest-related BEPS risks**

We are pleased that the OECD recognises the regulatory requirements placed on banks. However, we believe that these factors are underestimated in the assessment in Annex II of the discussion draft. We believe that regulatory supervision provides more significant constraints on interest-related BEPS at both a solo-regulated and group level than the discussion draft suggests. We have provided more detail on the regulatory environment applying to banks in our response to Question 3 and in Appendix A.

We note that the discussion draft states that the OECD cannot take a view that regulation is sufficient to eliminate interest-related BEPS risks in all countries in all cases. We acknowledge that and we would not expect that the OECD could conclude that the regulatory environment would always preclude interest-related BEPS both now and in the future.

We therefore believe that the OECD should recognise the general principle that regulation can (and indeed does, when it is in line with current international standards) effectively constrain interest-related BEPS risks at least as well as the general fixed ratio rule, and that it should be down to each jurisdiction to determine whether there are instances where that general principle does not fully apply in their country.

We believe that the OECD should frame this approach with a clear statement of the importance of developing policy carefully in this area, both because of the risk of creating incentives which are misaligned with regulatory policy objectives, and also because any rule which seeks to restrict tax relief for a business’ cost of sales by reference to an arbitrary and subjective percentage of a given attribute (let alone an attribute which does not seem applicable in this context for banking) has the potential to cause unintended consequences.

Although the discussion draft reflects on the implementation of interest deductibility rules for both banks and insurers, in practice the regulatory and commercial environment in which banks and insurers operate differs significantly (and the role of interest is different, as the discussion draft recognises). Therefore, we would encourage the OECD to treat each sector separately in its considerations, and make recommendations that are specific to the needs of each sector to ensure that they are appropriately aligned with the respective regulation.

**Applying that approach for banking groups**

Where a tax authority concludes that their domestic implementation of globally and regionally agreed regulation appropriately addresses the interest-related BEPS risks, countries should be permitted to apply a full exemption for banking groups which recognises that there should be limited interest-related BEPS risk in the banking sector.

If further protection is then considered necessary, we would propose that carefully targeted rules, which are co-ordinated with regulators, are more appropriate than a heavily modified general rule.

We believe that an exemption that applies solely to the banking entities within a group is difficult to implement in practice and should not be the recommended approach. We have discussed this further
in our responses to Questions 13 and 14 below. Further, there are many entities in a multi-national banking group which carry out activities closely related to the activities of the solo regulated entities (where again any interest expense is part of the cost of sales), and we believe it is not appropriate from a policy perspective to separate such entities in applying any form of the fixed ratio rule.

The introduction of these rules should be proportionate to the interest-related BEPS risks that exist. We believe the best way to achieve the required degree of proportionality is to ensure that measures are specifically targeted to BEPS risks, and to move away from a general rule which does not address specific and identified risks, and which was designed with non-financial services businesses in mind. Nonetheless the final report should make clear that care is needed to make sure that any targeted rule has the effect intended, given the risk of unintended consequences.

Finally, as the 2010 OECD Report on the Attribution of Profits to Permanent Establishments addresses BEPS risks which may exist in the context of permanent establishments, banks should be exempted from any general or specific rules as existing rules will already address any risks (we have set out more detail in our response to Question 6).

**The need for consistency**

Paragraph 27 of the discussion draft states that most countries will likely not find banks and insurance companies creating significant BEPS risk relating to interest expense and, therefore, “... there is no need at this time to develop a single common approach to deal with this risk. Instead, the final report on approaches to address BEPS involving interest in the banking and insurance sectors will include a summary of the approaches currently applied by countries.”

Whilst we agree with the initial statement, we would be concerned that not recommending a common approach may result in a proliferation of different restrictions in countries could lead to substantial complexity for global groups, and raise the risk of double taxation due to conflicting tax systems. As many banks are large global organisations, divergent approaches in applying these rules to banks could be unnecessarily complex and costly for banks to comply with.

Accordingly, we would welcome a clear and consistent view to be set out by the OECD, which standardises the considerations for tax authorities whilst permitting some flexibility to reflect any differences in the local implementation of regulatory standards.

**Proposed recommendations for the banking sector**

Given the points above regarding the effect of regulation and recognising the need for global consistency in applying these rules, we have set out below a proposed approach which we believe would give effect to the OECD’s under Action 4 and which may be applied to banks in a proportionate and appropriate way:

- **Step 1.** There is a presumption that effective regulation of banking will mitigate interest-related BEPS from taking place at least as well as the general fixed ratio rule.

- **Step 2.** Tax authorities should review their domestic regulatory regimes to identify whether there are any interest-related BEPS risks that are not addressed and appropriately constrained by regulation (bearing in mind the significant development of the regulatory regime in recent times).

- **Step 3.** Where no interest-related BEPS risks are identified, there should be a full exemption for banking groups from any interest restrictions. That exemption should apply to the
full group, where the group is predominantly banking. The exemption could reference regulatory supervision or oversight of the group as a whole.

Step 4. If an interest-related BEPS risk is identified, tax authorities should first engage with regulators to understand why that risk is not constrained, and whether any tax rules proposed would conflict with the aims of regulators.

Step 5. Tax authorities should then apply proportionate targeted anti-avoidance rules to any interest-related BEPS risks which remain.

Such rules might include restrictions explicitly tied to the oversight of regulators (such as a finding that a group is excessively “double leveraged”) or a review process which allows them to work with regulators and industry to consult on and introduce targeted tax rules for banking groups in the future if an interest-related BEPS risk emerges which has not been identified. The effect of rules should be consistent in principle with the fixed ratio rule applied to non-banks, albeit different in form.

The reasons for these steps are considered in more detail in our response to individual questions below. We would also highlight that we have included (in Appendix A) a more detailed overview of the regulatory environment which applies to banking groups.

We are grateful for the opportunity to provide comments on the OECD’s discussion draft. We would be happy to discuss any of the points raised in further detail to assist with your consideration.

Yours faithfully,

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Approaches to address BEPS involving interest in the Banking and Insurance sectors

1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

We do not have any risks to add which are not already been identified in the discussion draft.

We note that paragraph 9 of the discussion draft lists as a specific risk that banks may incur "excessive third party or intragroup interest expense". We do not believe that this is a general BEPS risk due to the regulatory considerations which govern a banking group's operations. We have outlined those points in detail in response to Question 3.

2. Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?

Whilst we agree with this aspect of the summary in the discussion draft, we believe that greater consideration needs to be given to the following key factors which are critical in considering the application of any rules to banks, alongside the matters raised in the opening remarks of this response.

i. Banks fundamentally deal in interest as a product and a cost of sales.

Interest is a fundamental part of the banking business model, acting as a key component of both revenue and cost of sales.

Applying a restriction on the tax deductibility of interest expense for a banking group is similar to a restriction on the deductibility for tax purposes of the cost of raw materials for a manufacturing business, or the cost of paying employees for a service business. The rules could restrict a tax deduction for the bank’s cost of sales which could have a consequent adverse impact on the flow of finance, and provision of financial intermediation, to the wider economy.

As a bank’s core business involves borrowing and investing, it is likely that any rules applied to banks would be onerous to implement from a compliance perspective, and could result in a substantial administrative exercise to prove that a bank is not subject to an interest restriction.

The application of a number of the general recommendations under Action 4 is likely to give rise to inappropriate results for banking businesses, and we have highlighted below some particular concerns with the application of these rules. Any difficulties in applying these rules, particularly those defining interest and EBITDA for the purpose of the fixed income ratio rule, will likely be carried over to the group ratio rule.

Banking is a business which involves taking on significant amounts of debt, both customer deposits and wholesale finance, and that needs to be recognised with an appropriate
safeguard in the final recommendations. We propose an exemption approach to deal with this, with the regulatory environment providing the safeguard against the tax policy risks.

ii. **Banks will not always be in a net interest income position**

There is an understandable presumption that banks would likely be out of the scope of these rules as they should find themselves in a net interest receivable position. There are however a number of circumstances, some examples of which are set out below, in which banks may find themselves in a net interest expense position, such that tax relief for the cost of ordinary business could be disallowed. It should be noted that in the examples below we assume that interest takes its ordinary meaning. However there are various aspects of the proposed approach to determining interest and EBITDA which could exacerbate these concerns.

*Investment and institutional banking*

Not all regulated banking activity involves lending money or holding assets which give rise to an interest return but there are a range of activities which are nonetheless an integral part of a banking trade. Broker/dealer activities may still rely on debt that is used to generate other non-interest financial trading income for the bank, such as equities, or derivatives. For a range of financial activity with a bank or broker/dealer, interest expense is an integral cost of sales which generates a wider range of financial income, such as dividends or derivative receipts. This position may be temporary, or a permanent feature of the bank’s business.

*Banks during economic downturns*

Banks’ borrowing and lending activities are not directly matched, and that may mean that banks borrow and lend on different maturity profiles, and a combination of fixed and floating rates linked to different markets. This may mean that changes in the local interest rate environment, for example low interest rates introduced in response to economic conditions, result in a bank’s income being reduced relative to interest expense raised previously on a longer term basis.

At the same time, banks are required not to recognise interest income on non-performing loans, so interest income will be depressed as a result.

During difficult financial times for borrowers generally, there is potential for a restriction on interest deductibility to cause a bank to be restricted from deducting the expenses that are central to their core business. Such a limitation could push banks further into a loss making position in situations where that could run counter to wider economic and regulatory interests.

*Leasing*

Banks with substantial leasing businesses could find themselves in a position where they pay more interest than they receive in a particular year. This may occur because leases have irregular interest profiles, or where there is a mismatch between finance leases and operating leases.
iii. **Regulation does constrain interest-related BEPS, but more importantly the interest profiles of banks are dictated in large part by their capital structure.**

As a result of the regulatory environment, banks and banking groups are restricted in their ability to engage in interest-related BEPS. Banking groups will typically be subject to both specific regulation of the banks in the group, and regulatory supervision of the overall group. This results in restrictions on the type, quality and the location of capital within a global group. Regulation imposes requirements on banks’ capital and constrains their leverage, which limits the risks of over leverage, while commercial pressures mean that over-capitalisation is not sustainable in the long run.

Banks are further constrained by factors including commercial pressures, capacity within the capital markets for new issuances, and investor appetite. In addition, credit ratings agencies also impose their own expectations on banks’ capital requirements, including on the extent of any “double leverage”.

As a result, the funding of banks and their capital structures will be determined by these regulatory and market requirements. Therefore, opportunities for a bank to engage in interest-related BEPS are significantly constrained in a manner consistent with, and in practice further than, the OECD’s general recommendations under Action 4.

Furthermore, we expect that the rules would in general encourage companies facing an interest restriction to seek to restructure their funding profiles to minimise or eliminate excess interest paid. That approach cannot apply to banking groups which are already constrained in their choice of capital structures by the regulated regime in which they operate. Banking groups within the scope of the rules could therefore suffer restriction on tax relief for their cost of sales, and may not be able to alter their financing structures in order to reduce that restriction.
3. Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country’s regime.

We note that Annex II of the discussion draft primarily discusses the restrictions on regulatory capital as they apply to banks. In practice, there are a larger number of restrictions which apply globally which govern the debt taken on by a bank, or the interest earned by them. We have set these out in further detail in Appendix A, which we believe is a useful supplement to Annex II of the discussion draft.

In light of the comprehensive regulatory environment detailed in the following pages, we have the following specific comments in relation to the risks identified in paragraphs 19-21 of the discussion draft. We have also sought to reflect the impact of these concerns and our responses in developing our proposed approach, which is detailed in our response to Question 5.

**Paragraph 19** of the discussion draft notes that “there is no accepted international standard for capital regulation” and therefore “it is not possible to reach a conclusion that regulatory capital rules provide the same level of protection against excessive leverage for tax purposes in all countries and all cases.”

We would note that in many cases, globally agreed standards, which include Basel III and the Capital Requirements Directive IV in the EU, set minimum standards for regulation, and those regulations cover more than just regulatory capital (as set out below). We do not believe it is appropriate for these global measures to be lightly dismissed in approaching this discussion draft.

We would not expect that the OECD could conclude that the regulatory environment would always preclude interest-related BEPS both now and in the future. That said, the general fixed ratio rule does not eliminate the risk of interest-related BEPS for non-banks. We believe that the approach taken to banking groups should be proportionate to that taken with respect to other businesses, and that the regulatory environment does provide a suitable and equivalent safeguard which is likely to be at least as effective at mitigating interest-related BEPS as the general fixed ratio rule.

Given the wide range of regulatory considerations outlined below, we recommend that the OECD recognises the principle that regulation can effectively mitigate interest-related BEPS risk, and that it should be down to each jurisdiction to determine whether their domestic implementation of globally and regionally agreed regulation eliminates the risk.

However, we believe that the OECD should frame this approach with a clear statement of the importance of developing policy carefully in this area, both because of the risk of creating incentives which are misaligned with regulatory policy objectives, and also because any rule which seeks to restrict tax relief for a business’ cost of sales by reference to an arbitrary and subjective percentage of a given attribute (let alone an attribute which does not seem applicable in this context for banking) has the potential to cause great damage.

We would also suggest that to the extent that individual countries nonetheless identify a future interest-related BEPS risk, targeted rules developed in conjunction with regulators are best placed to address any residual issues.

**Paragraph 20 and 21** of the discussion draft indicate that there are some concerns that the aims of regulators and tax authorities may differ, and that may mean that regulation does not constrain
interest-related BEPS risks. At a macro level, we believe that both tax and banking regulators have
similar interests in ensuring that adequate levels of equity are held, that both equity and debt are held
in the right jurisdictions to be available to meet claims on the bank and that debt taken on is not
excessive.

We note that notwithstanding the concerns above, paragraph 26 of the discussion draft explicitly
states that excessive leverage in the banking sector has not been identified.

In the first instance, we believe that tax authorities and regulators should engage and discuss any
differences in their approaches, and seek to agree a position which eliminates rather than propagates
differences. Handling any interest-related BEPS risks through the regulatory regime ensures there is
no conflict between competing regimes and regulators, and delivers an approach in which the aims of
regulators and tax authorities are aligned.

Proposed approach

Given the points raised above, and the detailed summary of the regulatory environment in Appendix
A, we believe that the OECD should endorse a view that regulation can effectively eliminate interest-
related BEPS risk.

To address the concerns raised in the discussion draft in paragraphs 19-21, we would propose that
the first step for tax authorities in applying these rules to banks should be to assess whether there are
any remaining interest-related BEPS risks which are not addressed through regulation.

In that context, we believe that the aims of Action 4 as applied to banks could best be achieved
though the adoption of the following recommendations for all countries:

Step 1. There is a presumption that effective regulation of banking will mitigate interest-
related BEPS from taking place at least as well as the general fixed ratio rule.

Step 2. Tax authorities should review their domestic regulatory regimes to identify whether
there are any interest-related BEPS risks that are not addressed and appropriately
constrained by regulation (bearing in mind the significant development of the
regulatory regime in recent times).

Step 3. Where no interest-related BEPS risks are identified, there should be a full exemption
for banking groups from any interest restrictions. That exemption should apply to the
full group, where the group is predominantly banking. The exemption could reference
regulatory supervision or oversight of the group as a whole.

Step 4. If an interest-related BEPS risk is identified, tax authorities should first engage with
regulators to understand why that risk is not constrained, and whether any tax rules
proposed would conflict with the aims of regulators.

Step 5. Tax authorities should then apply proportionate targeted anti-avoidance rules to any
interest-related BEPS risks which remain.

Such rules might include restrictions explicitly tied to the oversight of regulators (such
as a finding that a group is excessively “double leveraged”) or a review process which
allows them to work with regulators and industry to consult on and introduce targeted
tax rules for banking groups in the future if an interest-related BEPS risk emerges
which has not been identified. The effect of rules should be consistent in principle with
the fixed ratio rule applied to non-banks, albeit different in form.
The proposed approach should also include the recognition that these rules should not be applied to permanent establishments as interest-related BEPS risks in branches are addressed by the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (discussed further in our response to Question 4 below).

4. Are there other any general issues related to the operation of the authorised OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?

For regulatory and commercial reasons, banks rely on permanent establishments (commonly referred to as branches) in very different ways to most businesses. Banks often use permanent establishments of a single legal entity, including in major financial hubs. For example, within the EU, regulatory permissions mean that a permanent establishment of a bank can rely on the permissions granted to it by the home country regulator to operate across the EU through permanent establishments.

Transfer pricing rules in general apply to banking groups, which mean that both interest expense and income are allocated to follow the underlying economic activity of banks. In this case, the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments is particularly relevant, and specifically deals with the attribution of profits to permanent establishments in the banking sector.

Capital Attribution Tax Adjustments (CATA) will be required where a bank’s permanent establishment is deemed to have excessive interest when compared to the parent company operations. The calculation requires a nominal calculation based on the level of equity which would be expected to exist within the branch as if it were a standalone entity. In practice, this typically requires a comparison to be made to the head office and restricts the interest deduction if it is deemed to be excessive. Therefore, the application of transfer pricing rules to the permanent establishments of banks ensures that the permanent establishment is allocated the appropriate interest deductions.

We do not therefore think that it should be necessary to apply the interest deductibility rules to inbound branches (which are effectively subject to similar rules already).

Equally, we do not see any need to apply any interest restriction in the head office country in respect of the overseas branches of banks. As set out above, the effect of the transfer pricing approach specifically applied to banks under the 2010 rules is that the relevant interest expense is allocated to the foreign operation.

We believe that it is imperative that any recommendation should specifically exempt banking branches from applying these rules and that the existence of outbound bank branches should not affect any application of the fixed ratio rule in the head office country – in both cases given the potential for double taxation.

We note that paragraph 22 of the discussion draft raises the concern that not all countries have adopted the OECD’s 2010 proposals, or impose minimum capital requirement for branches. However, we believe that the approach outlined in answer to Question 3 above can be applied by these countries as well. Should those countries identify that an interest-related BEPS risk exists in relation to a permanent establishment, we believe that the targeted rule to tackle that risk would be the adoption of the OECD’s 2010 proposals for banking branches.

If branches are not to be excluded, then significant further work will be required in relation to situations where there is a net allowable CATA deduction and the allocation of tax-EBITDA and tax-interest to branches for these purposes. In addition, where the legal entity as a whole is either not
subject to a restriction or in a country which does not apply Action 4, the double tax credit rules should not restrict the tax relief given which could result in double taxation.

We believe that a mechanism for excluding double taxation should be a mandatory precondition of enacting rules applicable to branches under Action 4.

5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

As noted previously, we expect that many countries should be in a position where no interest-related BEPS risk arises in relation to banking groups because of the following factors:

i. The risk of interest-related BEPS in a banking group is already heavily constrained by regulation. The establishment of debt within a banking group is governed by regulation, rather than being freely available to be located for the purposes of tax planning (i.e. the concern which seems to have driven the OECD’s original recommendations on Action 4)

ii. The existing tax environment in which banks operate also reduces any risk of interest-related BEPS

Therefore, we believe that it is appropriate to recommend countries to provide a full exemption from the rules for banking groups from the rules. If specific risks are identified, we believe that proportionate, targeted rules should be introduced.

6. What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

In practice, we expect that it is unlikely for a bank to be materially overleveraged because of the regulatory environment (as detailed in our response to Question 3) and also many commercial pressures that influence the banks raising of funds in the market. The commercial pressures will affect the type of instrument involved, its term, its amount, the timing of the issue and indeed which entity within a group has best access to the market. The commercial pressures apply directly to banks’ issuing entities (generally the parent or holding company) and this helps to make capital a scarce and valuable resource within a banking group. Therefore, there are strong commercial reasons for banks not to engage in activity which may pose a risk of interest-related BEPS.

In addition to regulatory and commercial considerations, a number of existing anti-avoidance rules will already operate to constrain some specific risks. As interest is fundamental to the business of a bank, these measures have a greater effect in addressing interest-related BEPS risks.

In particular, the application of transfer pricing rules which address both price and quantum of debt and Capital Attribution Tax Adjustments to branches (discussed above) will apply to the intra-group allocation of debt. This should ensure that, in cases where there is net interest income in a country, the interest expense is an appropriate amount from a tax policy perspective. Existing controlled foreign companies (CFCs) rules (enhanced by the OECD’s own recommendations on CFCs under Action 3) prevent certain BEPS-related risks where low tax jurisdictions are exploited.

In addition, general anti-avoidance rules and the OECD’s recommendations regarding hybrid mismatch rules will also address a number of the interest-related risks.
Some countries apply a fixed ratio type restriction to all businesses uniformly, which generally operates so as not to restrict the tax deductibility of interest expense for banks on the basis that a bank may typically have net interest income. Whilst such a policy approach rightly recognises that cases where there is net interest income do not present a policy risk, we believe a more explicit exemption for banking groups is preferable, given the examples we have provided earlier of situations where a bank may have net interest expense (See answer to Question 2 (in particular section ii)).

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

If the fixed ratio rule were to apply to banks, appropriate definitions of interest and EBITDA will be needed.

Banks pay and receive interest as a result of their funding structures and in relation to a wide range of transactions across a bank’s trading book. Too broad a definition of interest would require a bank to disaggregate interest from derivative transactions, prime brokerage and numerous other transactions across the organisation. Some interest expense, for example that which arises under repos, may currently be integrated into the calculation of an entity’s financial trading returns, rather than being itemised as an interest item.

Whichever approach is taken, if there is no exemption for banking groups, there will be a need to address these issues in order to make the application of these rules practicable from a computational perspective and, more importantly, to prevent the distortions and potentially serious consequences which could arise from treating part of the cost of sales of the relevant financial trading activity from being deductible for tax purposes.

In the case of derivatives, we note that the OECD’s recommendation under Action 4 seeks to include notional interest amounts under derivative instruments or hedging arrangements related to an entity’s borrowings. That may be appropriate for a non-financial services business, but does not seem workable for a bank unless the definition of interest is broadened as set out above.
Q.8-9 Non-taxable income

8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

9. What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

As noted previously, we believe that in the majority of countries, the risks identified in paragraphs 34-40 of the discussion draft, will be constrained by regulation and that our recommended approach detailed in our answer to Question 5 is the best way to address these risks in a proportionate manner. Such an approach also appears to be under consideration in paragraphs 39 and 40 of the discussion draft, and we welcome the OECD's recognition of the need to target specific risks only.

In addition, we note that for a number of the risks identified, measures that constrain the risk itself, or seek to tackle the issue, are already in place.

- We note that the risks associated with double leverage are discussed in paragraph 36 of the discussion draft. As noted in our answer to Question 3, we believe that such risks are constrained in many countries.

- We note that CFC risks are identified in paragraphs 39-40 of the discussion draft. We believe that such risks should be effectively addressed by the recommendations under Action 3 of the BEPS project (rather than as a part of the OECD's recommendations under Action 4).

- If income is exempt because it is taxed overseas, we believe that that should be a matter of allocation of taxing rights (under DTTs) not BEPS.

- In the examples set out in the discussion draft, there is an underlying theme of borrowing to fund exempt income. In general, it is unlikely that a bank could be said to have borrowed an amount in order to fund non-taxable income. Borrowing will typically be carried out on an aggregated basis to cover a group's funding requirements. Given the regulatory and commercial concerns involved, new borrowing will be subject to careful consideration and review before it is taken on. That borrowing is fungible, and is deployed in the bank's business.

When that leads to taxable net interest income arising in a country, we do not believe that there is a risk that interest-related BEPS is present – certainly not to any material degree – given the other safeguards both from a tax policy perspective (such as transfer pricing) and the regulatory environment. Paragraph 39 of the discussion draft refers to rules that disallow interest expense used to fund non-taxable income. It is not clear what rules are envisaged, and we are concerned that this could result in a recommendation which restricts that tax relief for the funding deployed in the bank's business in the territory, when that interest expense is actually a cost of earning the taxable financial income arising in the same territory.

In addition, to the extent that income has been specifically exempted under a jurisdiction's tax code, the key consideration is the not the borrowing to fund the income (if it could be identified) but the exemption from tax of the income stream generated. That should be a matter for the local tax authority to consider, rather than a matter for the OECD to consider under Action 4.
10. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

Please see the response to Question 4 above.

11. Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

As noted above in our response to Question 5 above, we believe that proportionate targeted rules to address BEPS risks may be appropriate where a tax authority concludes that regulation does not already eliminate interest-related BEPS risks.

It is critical that any specific risks addressed by a territory introducing a targeted rule are genuine risks, in practice rather than in theory, and we would encourage tax authorities to work with regulators in considering whether any risk exists in country and how to address them in a manner which is co-ordinated.

12. Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?

There will be a need to appropriately define a banking group for the purposes of the exemption discussed in Question 5, and for the assessment of interest-related BEPS risks by the tax authority. We have considered in more detail in answer to Question 13 the wide ranges of issues which would need to be addressed if some group entities were to be included in the general rule.

We therefore believe that a common set of principles should exempt from the rules groups which are predominantly banking groups from applying a fixed ratio-type restriction.

If that is considered to be too wide, we would suggest that an alternative approach could be adopted which would exempt both solo regulated entities and any group companies that are closely associated with the banking activities of a banking group.

This approach could be defined in legislation and supported by guidance and would exempt all holding and funding companies associated with the banking company, including companies responsible for securitisation and leasing businesses, service companies, property holding companies which provide services to or hold property on behalf of a banking company, and other closely related investing, financial repackaging and operating entities.
**Fixed Ratio Rule**

13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company -
   a. application of the fixed ratio rule to the local group excluding banks and insurance companies
   b. the treatment of interest expense on debt supporting banking or insurance activities
   c. other issues?

14. Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?

We believe that there are a significant number of issues with the introduction of a ‘modified’ fixed income ratio rule for banks that mean that this should not be a recommended approach by the OECD. (We also note that the group ratio rule is unlikely to be a safeguard in this respect (please see below)).

As noted above, we are of a view that banks should not be subject to a fixed ratio-type restriction from a policy perspective, and that the risks of not including banks are minimal. In addition, we believe that it is likely to be more proportionate for any risks to be mitigated by the future introduction of a TAAR if a specific risk is identified.

If these rules are to be applied to banks, then the final rules will need to address a number of specific concerns that relate to banking businesses.

**Banking specific problems with a modified fixed ratio rule**

i. **Funding structures outside the banking company funding the banking company**

   A banking group may hold funding and capital at the level of a holding company or funding company which would not meet the definition of a banking company, and would therefore not be included in the calculation. This would apply in particular where capital is held in a holding or funding company for the purposes of banking activity rather than held within the banking company.

ii. **Other group companies**

   Within a regulated group, non–solo regulated entities are likely to be subject to the group regulator’s supervision. As a minimum, regulators are likely to exercise informal oversight over such entities and in practice they may be subject to more rigorous supervision. All such entities will be subject to group-wide supervision by regulators which will look at the position of the group as a whole. Critically, the group position could result in additional capital requirements being imposed on a banking entity or parent of a banking entity.

   The exclusion of the non-solo regulated entities brings with it the risk of dislocating sources of funds from revenue generating activities.

iii. **Allocation methodology**

   We note that paragraph 60 of the discussion draft suggests an allocation methodology could resolve certain issues regarding the funding of banking operations from group companies which are not themselves banks.
Tracing the debt established by a banking company is likely to be difficult since funding will largely be fungible.

Allocating on a pro-rata basis is very unlikely to provide a result which is either just and reasonable or proportionate and will present tax positions which differ from the views of regulators and on which the business is driven. We believe that this would not be consistent with the approach adopted for non-banking businesses.

iv. Other operations within a banking group

An exclusion for banking companies would leave non-bank entities in a banking group to apply the fixed ratio rule either to the remaining entities or to the remaining sub-groups. This would capture a variety of different group companies including service companies, property holding companies, leasing entities and companies which carry out investing, financial repackaging and other operating activity closely related to the group’s banking activity (for example companies created to hold distressed debts and other receivables). In addition, it may capture debt factoring and other receivables businesses where these are held outside a main banking entity. In reality these entities are closely associated with a banking entity’s operations, where interest remains a cost of sales.

If those companies do exceed the fixed ratio rule, it is unlikely that the group ratio rule would offer protection as the overall banking group is likely to be in a net interest income position and those companies are therefore potentially penalised relative to the equivalent operations held by non-banks.

Where the non-banking entities are funded from the solo regulated bank in the same country, there will also be double taxation within the banking group, as interest which is paid to the bank or an excluded funding company may be caught within these rules and a corresponding restriction on interest deductions applied. Under this modified approach, this may apply even though the interest would not have been excessive if the full group was in scope, and does not in fact represent a BEPS risk since it is paid within the domestic tax net, with the bank remaining fully taxable on the corresponding income.

Segregating a group in this way would impose a standard higher than that under Action 4 and would be inconsistent with the approach applicable to other industries.

Other issues to be addressed

For the reasons indicated above, we would argue strongly that a ‘modified’ fixed ratio rule should not be recommended. If a modified fixed ratio rule is deemed necessary in any particular country, then we would encourage ongoing consultation and engagement between tax authorities and industry.

As well as the general and specific issues discussed above, further consultation might consider:

i. A possible gateway test that could be applied by banking groups which could eliminate the compliance burden of calculating tax interest for a business in which interest is a cost of sale.

ii. An election to disapply these rules. We believe that entities should be permitted to elect out of a modified fixed ratio rule and into the general rules where any modified rules prove too onerous or produce unintended results. Since such an election would only put an organisation
into the same position as other groups, there should be limited risk to the implementing tax authority in allowing such an election.

**Group Ratio Rule**

15. *Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?*

16. *Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?*

In practice, the calculation of the group ratio rule as it applies to banks is likely to raise similar issues to those identified for the fixed ratio rule. In particular, the definition of interest in this context, and the resulting calculation of EBITDA, is likely to be complex. In practice, we do not believe that the group ratio rule itself offers a significant safeguard for banking groups. However, we believe that an equivalent safeguard is required, given that banks are naturally leveraged businesses, and that this is best achieved by applying a general exemption from the fixed ratio rule (or any modification thereof), with reliance on the regulatory environment to mitigate the tax policy concerns.

17. **Do you have any other comments on any of the issues raised by this discussion draft?**

Banks may support commercial and corporate customers during times of financial distress by converting outstanding debt into equity. That may in practice mean that the bank owns more than a 50% share of the company, and the company may therefore be viewed as being part of the bank’s group under the standard definitions of grouping for Action 4 purposes. If that company is treated as part of the banking group for the purposes of rules addressing interest-related BEPS, the result may be unpredictable and could result in a company that was previously suffering a restriction on interest falling out of scope due to the net interest income position of the bank, or being brought into scope if the opposite fact pattern applies.

That result is likely to be undesirable for tax authorities, debtor companies and for banks, and we would therefore propose that any definition of a banking group should exclude such shareholdings.
Appendix A: The regulatory environment for banks

In most countries which have adopted Basel III or higher standards, banking companies are subject to solo regulation, and banking groups are subject to consolidated supervision, so that non-solo regulated group entities are within the scope of the group level capital adequacy and leverage requirements. The combination of solo regulation and group level requirements impose constraints on the level of debt held by non-solo regulated entities and therefore reduce the risk of BEPS activity being undertaken by non-solo regulated entities.

In addition, any entity within such a regulated banking group is subject to oversight by the group regulatory authority both directly and indirectly (e.g., in its dealings with other regulated group companies, through “large exposure” limits, etc.).

Critically, these rules, limits and requirements must be applied continuously, the effect of which is to constrain a bank’s ability to alter its regulatory capital structure, or the location of external loans and thus restricts interest-related BEPS.

Overview of regulatory constraints

<table>
<thead>
<tr>
<th>Regulatory constraint</th>
<th>Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Capital requirements</td>
<td>As noted in Annex II of the discussion draft, capital requirements applied to banks set a standard for the level, form and quality of equity and debt which a bank can issue. The net effect of the requirements below effectively constrains a bank’s ability to alter its regulatory capital structure, or the location of external loans.</td>
</tr>
<tr>
<td>B. Large exposure limits</td>
<td>These rules govern transactions between group entities and effectively constrain the ability of banks to enter into the intragroup transactions which are envisaged in paragraph 8 of the discussion draft.</td>
</tr>
<tr>
<td>C. Regulation of intragroup flows</td>
<td></td>
</tr>
<tr>
<td>D. Allocation of Total Loss Absorbing Capital (TLAC)</td>
<td>These rules govern the allocation of debt and equity in a banking group to subsidiaries. Again, these rules constrain the ability of banking groups to enter into the intragroup transactions which are envisaged in paragraph 8 of the discussion draft.</td>
</tr>
<tr>
<td>E. Double Leverage</td>
<td></td>
</tr>
<tr>
<td>F. Banks are required to hold minimum amount of High Quality Liquid Assets</td>
<td>The effect of the liquidity coverage ratio is to depress the level of interest income which a bank receives due to the economic cost of holding liquid assets. The Net Stable Funding Ratio increases the interest expense which a bank must pay. Both measures make a banking group more likely to breach interest restrictions which are considered in Action 4, yet are outside of a bank’s control. There is a risk that banks could be penalized through the tax system for complying with key regulatory requirements.</td>
</tr>
<tr>
<td>G. Commercial Pressures</td>
<td>There are strong commercial reasons for banks not to engage in interest-related BEPS, not least the cost of capital buffers in excess of the minimum standards mandated by regulators which mean that such buffers are unlikely to be held or used for tax planning purposes.</td>
</tr>
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</table>
**A. Capital requirements (covered in Annex II of the discussion draft)**

The key regulatory focus in recent years has been to strengthen the capital requirements placed on banks to reduce the probability of bank failures.

These capital requirements also act as a restriction on a bank’s ability to issue debt and push this down to subsidiaries as equity (known as ‘double leverage’). This is because a bank subscribing for equity in a subsidiary must deduct that investment from its own capital resources when calculating its own regulatory capital that is eligible to be taken into account when calculating capital adequacy under the solo regulatory regime. In other words, a bank which provides capital to a subsidiary reduces its own ability to undertake business, as its own capital base is reduced.

It is also worth highlighting that the capital requirements allow banks to meet a limited proportion of the minimum requirements through non-equity capital instruments. These instruments include Alternative Tier 1 instruments (AT1), such as contingent convertible bonds, which have the characteristics of both debt and equity. However, we note that any BEPS risks posed by such instruments are specifically addressed by the hybrid mismatch rules.

We note that regulation, particularly for large multinational banks, is complex. While the internationally agreed standards apply to all banks, regulators will approach each bank on its own exact circumstances based on an assessment of the risks faced, and that means that each bank is likely to face differing pressures.

The net effect of the requirements below effectively constrains a bank’s ability to alter its regulatory capital structure including the location of external loans.

**Capital structure – Going concern through resolution**
B. Large exposure limits

In addition to the restriction in A above, banks are also subject to regulatory large exposure limits, which seek to ensure that banks are not overly exposed to individual counterparties. These rules apply for both related and unrelated parties.

This has the effect of ensuring that debt is not disproportionately re-allocated to particular entities by intra-group transactions. The regulations mandate that a bank must:
- monitor, manage and control potential contagion risk within the banking group and other members of a conglomerate group of which the bank is part;
- meet minimum requirements with respect to dealings with related entities; and
- comply with the prudential limits on intra-group exposures.

Broadly, international banks are constrained in their exposure to related entities either in aggregate or at an individual entity level, by reference to their own capital resources. Banks must limit their total exposure to related entities to a level similar to that allowed for dealings between unrelated entities.(when the related entities are subject to consolidated supervision, they may be exempted from this requirement by their competent authority upon satisfying relevant conditions stipulated in the Capital Requirements Regulation (CRR), Article 113(6).)

Non-exempt exposures, including to a subsidiary that has not satisfied the relevant conditions stipulated in CRR, Article 113(6), are restricted to a 25% limit of eligible capital resources i.e. capital net of any equity investment in subsidiaries and other undertakings. In practice, banks’ individual exposures are likely to be further restricted, and do not come close to the 25% limit as this would give rise to single name concentration risk, which would prompt regulators to require banks to hold additional capital against that risk.

We note that there are variations in the approach to large exposure limits between jurisdictions, for example they may be waived to some degree or even entirely in relation to intra-group exposures.

Nonetheless, the general effect of the large exposure limit is to place restrictions on the ability of banking groups to issue debt and push this down to subsidiaries as equity as well as the use of intra-group loans from banks in low taxed jurisdictions to high tax jurisdictions.

C. Regulation of intragroup flows

In addition to large exposure limits, many local banking authorities regulate flows between the head office and foreign branches/subsidiaries. For example, regulators often impose their own limits on funds that can be transferred between branches/subsidiaries in their jurisdiction to the head office. Local regulators want the local balance sheet to be stable and predictable, with limitations on the ability of funds to be transferred to head office, especially in a crisis.

Banking groups are restricted from engaging in intragroup transactions which might otherwise pose a risk of interest-related BEPS.
**D. Allocation of Total Loss Absorbing Capital (TLAC)**

Accessing public markets to raise capital is subject to many commercial constraints. Additionally, regulation directs the amount and types of funding. Regulators are increasingly focused on the distribution of specific types of funding within global banking groups, to support resolution requirements, facilitate increased financial sector resilience and strengthen financial stability of the economy.

Incoming regulation will require banks to be structured to have resolution groups whereby resolution action will be taken only at the top level. A group may have a single or multiple resolution groups depending on its structure. In either case, loss absorbing capacity must be allocated from the point of entry to the individual banks within the structure to ensure that losses are passed up to the point at which resolution powers will be used.

This will require a banking group to take on liabilities through its holding company and provide capital through specific instruments to particular group companies. These requirements are designed to allow the orderly resolution of a failed bank. This is another example where the nature, quantum and location of funding are driven by regulatory considerations. Whilst there may be tax consequences as a result of this structuring, in practice the identification of resolution groups and allocation of funding is driven by regulatory concerns.

**E. Double Leverage**

We understand that some tax authorities have concerns in relation to the scope of double leverage within banking groups and the potential for interest-related BEPS that may result. This is also discussed in paragraph 36 of the discussion draft.

This concern relates to debt taken on by a parent and invested through equity into subsidiaries. This type of borrowing, or “double leverage”, is seen as a key consideration for investors and credit rating agencies when assessing the position of banking groups, as it has the potential to constrain the issuer's ability to make the scheduled payments on its debts.

In essence, double leverage measures the ratio of equity issued by a bank (or holding company) to equity invested by the bank (or holding company). There are a range of calculations in respect of double leverage. Each calculation seeks to ensure that the issuer to the public is able to soundly support and service the capital raised and the subsidiary is capitalised in a reliable and appropriate manner, which it can in turn be expected to service. If the double leverage ratio is considered excessive, access to markets will be impacted and the holding company's credit rating may be reduced to reflect the perceived reliance on discretionary dividends to fund the interest obligations of the holding company, or its potential inability to realise its assets and repay its debt. The commercial pressure to retain a high credit rating therefore acts as a market incentive to limit double leverage to be excessive.

In addition, such double leverage is constrained by the regulatory environment, particularly in relation to holding companies and sub-holding companies. A regulator will seek to promote the safety and soundness of the firms they regulate, which includes holding companies such as ultimate parent companies or regional holding companies (for example the European holding company of non-EU headquartered groups). Specific features of the regulatory environment, as well as the overarching regulatory objective, require that holding companies of solo regulated entities are themselves stable, resolvable (in effect can be liquidated without adversely affecting other parts of the banking group) and are able to fund solo regulated subsidiaries appropriately. Whilst this does not result in the
deduction from capital approach seen in the solo regulatory regime, the factors outlined nonetheless result in an effective constraint.

Therefore, whilst some degree of double leverage may be accepted within a non-solo regulated holding company, the regulatory environment constrains its extent.

The risk of double leverage is constrained by both access to capital markets and by regulators. To the extent that double leverage is specifically recognised in a bank’s capital requirements, we do not believe that tax rules should contradict or be misaligned with wider regulation.

**F. Banks are required to hold minimum amount of High Quality Liquid Assets**

Regulators require banks to maintain sufficient liquidity (at all times) to meet their obligations as they fall due and hold a minimum level of high quality liquid assets (HQLAs) to survive a severe liquidity stress.

Under the Liquidity Coverage Ratio (LCR), banks are required to maintain an adequate level of unencumbered HQLAs to meet their liquidity needs for a 30 calendar day period under a severe stress scenario.

Under the Basel LCR framework, banks are expected to be able to meet their liquidity needs in each currency and maintain HQLA to support their liquidity needs by currency. Regulators require international banks, in calculating the LCR, to take into account restrictions on the ability to transfer liquid assets across borders. The regulator generally only allows liquid assets held offshore to be included in the Group LCR to the extent that they match the outflows in that jurisdiction, with surplus liquidity held offshore only able to be included in the Group LCR in limited circumstances. These requirements have the effect of requiring international banks to hold liquid assets in the jurisdiction where the funding is raised. They also mean that bank holding companies may be required to hold additional liquidity centrally which can increase the effects.

The result of this regulation is that banks are required to hold assets/HQLAs which generate a low rate of return, depressing their interest income in relation to their interest expense. This will contribute negatively to the net interest position of any bank as a result.

Another Basel III measure, the Net Stable Funding Ratio, also requires banks to match the maturity profile of funding to the maturity profile of their commitments. This will require banks to hold a greater level of long-term funding than they might otherwise choose to do. Longer term funding is likely to be more expensive to service, increasing a bank’s interest expense and again, contributing negatively to the net interest position of any bank as a result.
G. Commercial Pressures

We would note that there are strong commercial reasons for banks not to engage in activity which may pose a risk of interest-related BEPS.

In particular, we note that there are commercial pressures which influence the ability of banks to raise funds in the market. For example, there are market constraints on the degree and pricing of capital such as equity, AT1 and subordinated debt. These commercial pressures apply directly to banks’ issuing entities (generally the parent or holding company) and this helps to make capital a valuable resource within a banking group. Once raised, the capital then has to be subscribed to the operating entities in such a way so as to meet all regulatory demands.

In addition, we note that Banks may operate with internal management ‘buffers’ (which may be prescribed or held proactively) to ensure that they do not fall foul of the minimum regulatory requirements, which are measured on a continuous basis and are effectively again governed by regulation. The regulatory rules and constraints noted above, including the associated economic costs, mean that any such buffers are unlikely to be maintained primarily for tax planning purposes.
William Morris  
Chair, BIAC Tax Committee  
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Achim Pross  
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September 8, 2016

Ref: DISCUSSION DRAFT: BEPS ACTION 4 – “APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS”

Dear Achim,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 4 – Approaches to Address BEPS Involving the Banking and Insurance Sectors (“the Discussion Draft”). BIAC was pleased that the Action 4 Final Report published in October 2015 acknowledged it would be inappropriate to apply its main recommendations to the banking and insurance sectors and that further analysis was required.

While we welcome the reinforcement in the Discussion Draft of the uniqueness of financial services businesses and recognition of the fact that debt is not a significant BEPS risk for this sector, we are disappointed that the Discussion Draft did not develop a best practice recommendation. The BEPS Project has always sought to introduce consistency between different tax systems, and an overlapping system of different optional rules, as set out in the Discussion Draft, will frustrate that aim. It will also create additional uncertainty and complexity for business and tax authorities alike, with no particular impact on reducing actual BEPS activity.

The attached BIAC paper suggests a best practice rule. In summary, prudential regulatory constraints on the banking and insurance sectors already restrict the use of debt in these businesses. For banking and insurance groups predominantly engaged in the active conduct of banking and insurance businesses that are globally regulated (referred to in the attached paper as Regulated Finance Groups or “RFGs”), prudential regulation is substantial and increasing. BIAC’s view is that the primary option in the Discussion Draft of disaggregating solo-regulated entities from all other entities in RFGs and applying the fixed ratio limit to the other entities is misguided. It would create the potential for tension with regulatory considerations even though the Discussion Draft itself found little BEPS risk. As a consequence, BIAC advises, as a best practice recommendation, that RFGs be exempted from Action 4.
The attached BIAC paper explains there are existing tax rules in different jurisdictions that adopt the notion of financial services groups. The attached paper also mentions different countries’ approaches to prudential regulation of financial services groups and thus builds on the Discussion Draft’s Annex 2 description of capital regulation in the banking and insurance sectors. The BIAC comments that follow make the point that to be considered “globally regulated” a financial services group would either be subject to global “umbrella” regulation by the regulator of the home country of its ultimate shareholder, or would have the substantial majority of its gross income earned from entities subject to prudential regulation within the financial services group.

The attached BIAC comments also observe that the EU Anti-Tax Avoidance Directive elevates Action 4 to a minimum standard and therefore EU Member States are legally obliged to implement interest limitation rules. The move towards a legally binding (albeit not fully harmonised) approach at EU level is to be contrasted with the Discussion Draft where there is a movement away from a best practice approach to a series of flexible options for the banking and insurance sectors to be considered by countries. BIAC is hopeful this will be changed in the final the Discussion Draft recommendations. BIAC believes it sets a better international standard for global guidance for the OECD to adopt a best practice rule for RFGs.

For completeness, the attached BIAC comments will also address the attribution of free capital to permanent establishments of banks and insurance companies, and the issue of interest expense funding non-taxable income, both of which are raised in the Discussion Draft.

We would welcome the opportunity to discuss our comments with you or assist in any other way that you would consider helpful.

Sincerely,

Will Morris, Chair BIAC Tax Committee
Background and Introduction

1. BIAC welcomes the opportunity to comment on the OECD’s discussion draft on BEPS Action 4 on Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors (“the Discussion Draft”), released on July 28, 2016. BIAC observes that the Discussion Draft is required because of the conclusions reached in Chapter 10 of the OECD’s October 2015 Final Report on Action 4 (“Chapter 10”).

2. The OECD/G20 consensus in the Action 4 Final Report at paragraph 183 was that “a number of particular features of groups in the banking and insurance sectors need to be taken into account” and, further at paragraph 190, that more work was to be done “to identify best practice rules to deal with potential base erosion and profit shifting risks posed by banks and insurance companies, taking into account the particular features of these sectors.”

3. BIAC’s own comments of February 6, 2015 (in response to the Discussion Draft on Action 4 released on December 18, 2014) applauded the development of best practice rules stating at the very beginning of its comment letter that “BIAC supports the development of tax rules based on ‘best practices’ as a general matter.”

4. BIAC also cautioned that while it “agrees that efforts to develop best practices ... should minimise distortions in investment and competition, minimise administrative/compliance costs to tax authorities and taxpayers, avoid double taxation, promote economic stability and provide certainty of outcomes, in addition to addressing BEPS concerns. Tax rules that create significant collateral economic damage should not be considered as ‘best practice’ rules.”

5. BIAC continues to hold these views and it is against this background that the following comments are submitted.

Preliminary Points and Overview

6. BIAC commends the Discussion Draft for acknowledging that interest expense for the banking and insurance sectors “is broadly comparable with ... cost of sales for entities in non-financial sectors” (page 5). BIAC also appreciates the Discussion Draft’s recognition of the significant role of prudential regulation and regulatory capital requirements imposed on these sectors (page 5 and Annex 2).

7. BIAC is however disappointed that the Discussion Draft has deviated from developing best practice rules as directed in Chapter 10. Instead, as stated in the OECD’s press release of July 28, 2016, the Discussion Draft takes an approach where “flexibility is provided for a country to take into account the particular features of its tax law and policy... [where] stakeholders [are provided] with substantive options ... .” Paragraph 27 of the Discussion
Draft states, in contradiction with Chapter 10 just seven months earlier, “there is no need at this time to develop a single common approach ... .”

8. BIAC is concerned that adoption by different countries of flexible, and thus different, options that derived from the fixed ratio and group ratio rules will create confusion, complexity and uncertainties for tax administrators and MNEs in the banking and insurance sectors. Such flexibility will also result in double taxation and critically risks providing fiscal incentives that could contradict regulatory oversight and control.

9. One of the options described in the Discussion Draft is to disaggregate banking and insurance groups into solo regulated entities and other entities for purposes of the fixed ratio rule (paragraphs 48 to 53) with knock on effects for the group ratio rule (paragraphs 62 to 67 with examples in Annex 3). This disaggregation option, if adopted mandatorily by countries, would run the risk of conflicting with regulatory and prudential requirements that seek to constrain debt in relation to equity. This is because the fixed ratio and group ratio rules of Action 4 favour consistent leverage among group companies. This could result in some group members having more leverage than regulators may deem prudent.

10. Mandatory disaggregation would also increase tax complexity and thereby increase administrative and compliance costs for tax authorities and taxpayers. Further, disaggregation introduces the possibility that interest on third party debt raised by a holding company could be disallowed as the EBITDA of the holding company may be low or even negative. It is also important to note that disaggregation with an exception for only solo-regulated entities could have unintended consequences with different outcomes as between different participants in the banking sector depending on the geographic and other mix of business and entities.

11. We do not believe that mandatory disaggregation of banking and insurance groups of companies should be included as an option under the Discussion Draft’s flexible approach for those banking and insurance groups that are (i) predominantly engaged in the active conduct of banking and insurance businesses in multiple jurisdictions and (ii) are subject to global regulation either because (a) there is a home country prudential regulator of the shareholder of the financial services group of companies or (b) the greater part* of gross income is from regulated entities in the financial services group (hereafter referred to as Regulated Financial Groups or “RFGs”).

12. RFGs are different from groups of MNEs primarily engaged in non-financial activities that have regulated financial entities embedded within such MNEs. RFGs make extensive use

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* This implies 50%, but BIAC acknowledges that a different threshold may be appropriate. Additional analysis could be undertaken to identify what the appropriate threshold percentage should be. BIAC would welcome the opportunity to assist in this analysis if this would be helpful to the OECD.
of debt, both intercompany throughout the group and third party debt, for valid commercial reasons and to be compliant with regulatory obligations.

13. Disaggregating RFGs to impose Action 4’s fixed ratio and group ratio rules on parts of the RFGs would interfere with the ordinary course of business of RFGs and would not reflect regulatory constraints within which RFGs operate. Further, disaggregation could have the effect that banks and insurers are put in a worse position in relation to the group ratio rule than other sectors when it is generally acknowledged that BEPS risk for banks and insurers is low. We believe that best practice, as directed by Chapter 10, would be to not subject RFGs to Action 4’s fixed ratio and group ratio rules.

14. If best practice is not adopted in the final recommendations, then additional options should be provided in the final report. One such option countries could adopt would be that RFGs not be subject to the fixed ratio and group ratio rules given the operations of RFGs and the protection from BEPS already afforded by the regulatory environment. Another option would be to broaden the exception for solo-regulated entities so that, in addition to solo regulated entities being excluded from the fixed ratio and group ratio rules (a current option in the Discussion Draft), holding companies, service companies and other entities that are core entities in the RFG must also be excluded.

15. The impact of the EU’s Anti-Tax Avoidance Directive, (“ATAD”) should also be considered. ATAD includes provisions based on (although not wholly in line with) the BEPS Action 4 interest fixed ratio and group ratio recommendations for EU members. These are thus no longer “best practices” for EU states, rather they are “minimum standards”. Accordingly, it should be considered how the flexibility in proposals put forward by the OECD in relation to this ongoing work on Action 4 will interact with the ATAD requirements placed on EU member states.

16. For completeness, our comments below will also address the attribution of free capital to permanent establishments of banks and insurance companies, and the issue of interest expense funding non-taxable income, both of which are raised in the Discussion Draft.

Why Best Practice is Preferred

17. BIAC recognises some might think excluding banking and insurance entities from the Action 4 recommendations would be a “free pass”. It is not. The regulatory rules faced by the banking and insurance sectors are unique and substantial. They have been put in place for important systematic reasons and impose meaningful and serious constraints on the banking and insurance sectors. While BIAC agrees with the Discussion Draft at paragraph 20 that “differences exist in how regulators and tax authorities may view the issue of excessive leverage[,]” these differences must be judged in light of (i) the finding at paragraph 26 that excessive leverage in the banking and insurance sectors has not been found, and (ii) the significant international efforts to provide a consistent global framework for prudential regulation.
18. Further, BIAC understands there can be a place for targeted rules, and supports the Discussion Draft statement at paragraph 43 that targeted rules should be considered to address BEPS risks. BIAC observes that the risks listed in paragraph 43 as BEPS risks cover all industries and sectors, and the risk enumerated in that paragraph are not specific to the banking and insurance industries.

19. BIAC also agrees with paragraph 44 of the Discussion Draft that targeted rules applied across all industries “may have an unintended or excessive impact if applied to a bank or insurance company without modification” and also agrees that if targeted rules are applied to banks and insurance companies such targeted rules should take into account the particular characteristics of banks and insurance companies ... .” Critically, any specific targeted measures must be informed by and coordinated with regulatory rules. If an interest-related BEPS risk is found by a taxing authority to exist, then the tax authority should engage with the regulators, when seeking to develop targeted tax rules, to ensure that tax rules and regulatory rules are not in conflict. Tax authorities should be encouraged to be proactive in avoiding conflict with regulatory rules and financial system objectives.

20. The Discussion Draft accepts that the risk of BEPS activities in banks and insurance companies from excessive leverage is low. Paragraph 26 explains: “In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low.” BIAC understands this is, in large measure, attributable to regulatory supervision of the banking and insurance sector with the objective of financial stability and soundness, and this is acknowledged at various places in the Discussion Draft, including Annex 2.

21. Even though the Discussion Draft concludes that the risk of BEPS is low, it diverges from its terms of reference found in Chapter 10 to “identify best practice rules.” Instead, the Discussion Draft describes a variety of approaches and invites countries to use the information to address the risks of BEPS as specifically determined by each country. Thus, if the Discussion Draft is finalised in its present form, then different countries would be encouraged to adopt different rules that implement Action 4’s fixed ratio and group ratio rules in different ways.

22. While different countries have a wide range of reasons for implementing different tax rules, the adoption of tax laws by countries based on different options that derive from the fixed ratio and group ratio rules clearly creates the potential for confusion, complexity and uncertainties for both tax administrators and MNEs in the banking and insurance sectors. Adoption of consistent international tax rules aligned with prudential regulation should be the goal.
23. The OECD / G20 consensus on Action 4 voiced in Chapter 10 was that common approaches and best practices should be adopted in this area. Chapter 10’s mandate to identify best practice for the banking and insurance sector was and continues to be prudent in the base case and is even more so given the significant multijurisdictional, cross-border business activities of a major portion of the banking and insurance industries.

24. BIAC therefore suggests that the mandate set forth in Chapter 10 be followed and that it be followed based on the facts that have been found as set forth in the Discussion Draft. Given there is a low risk of BEPS by banking and insurance sectors from excessive leverage, the best practice rule should be that this sector not be subject to the fixed ratio and group ratio rules of BEPS Action 4.

What Are RFGs?

25. As mentioned at the outset of these comments, Chapter 10 (at paragraph 183) stated that “a number of particular features of groups in the banking and insurance sectors need to be taken into account.” (Emphasis added.) BIAC realises that the best practice suggested above needs to be put within parameters and, building on Chapter 10’s paragraph 183, BIAC suggests it be limited to groups that have particular features (i.e., groups of companies meeting certain criteria).

26. The rule to be designed would, in our view, be limited to (i) groups of companies predominantly engaged in the active multijurisdictional conduct of banking and/or insurance businesses and (ii) regulated by a regulator with a global mandate and global scrutiny, or where more than half of the group’s gross income is from regulated entities in the group. A definition would thus be needed for this purpose of “group” and understandings would be required of what the active conduct of multijurisdictional banking and/or insurance businesses means, as well as what “predominantly engaged” in such businesses means. Further, definitions of “global regulation by a prudential regulator” and “a group that derives the greater part of its financial services income from entities that are regulated” would be required.

27. These criteria and definitions can be designed with reference to the actual operations and structure of groups that make up the banking and insurance sectors. Much work has already been done in this regard as evidenced throughout the Discussion Draft. Also, as explained below, these criteria and definitions can be adopted (and tweaked) from rules already in place in various jurisdictions for tax and regulatory purposes.
28. As an example of rules that are instructive, tax rules in the US (in the context of foreign tax credit limitation rules) provide that if a group of companies meets the test of being predominantly engaged the in active conduct of financial services business (and thus a “Financial Services Group”), then every member qualifies. See Section 904(d)(2)(C) of the Internal Revenue Code of 1986 and Treas. Reg. Section 1.904-4(e)(3).*

29. Likewise, in the UK, a similar concept is employed in the worldwide debt cap rules of the Taxation (International and Other Provisions) Act 2010 (“TIOPA 2010”). The worldwide debt cap rules don’t apply to qualifying financial services groups under section 261(2) of TIOPA 2010 and a group is a qualifying financial services group if, broadly, all or substantially all of the UK trading income, or the worldwide trading income of the worldwide group for the period is derived from lending activities (and activities ancillary thereto), insurance and insurance-related activities, and relevant dealing in financial instruments.

30. BIAC is not suggesting these are the only rules, or necessarily the best rules, but merely that these rules contemplate these issues and are thus informative.

31. On the regulatory side, there are examples of regulators with global “umbrella” regulatory reach. Again, as examples, in the US the Bank Holding Company Act provides for consolidated supervision by the US prudential regulators of US banking groups headed by a Bank Holding Company; in the EU Article 11 of the Capital Requirements Regulation similarly requires consolidated supervision of EU banking groups at the level of the top EU holding company; and in Japan similar requirements are established under Article 52-25 of the Banking Act, and Announcement 20, Standards on Regulatory Capital for Bank Holding Companies. Likewise, the Solvency II regime in the EU is informative in this regard for insurers in the EU. Insurers headquartered outside the EU could be considered globally regulated if the great part of their financial services income is generated by regulated companies within the group.

32. These instructive rules, many of which already exist, could be used to design a best practice rule to define RFGs that would be excluded from the fixed ratio and group ratio rules of Action 4. BIAC would be pleased to assist in this effort.

* Section 904(d)(2)(C) provides: “Financial services income shall be treated as general category income in the case of ... a member of a financial services group [and] ‘financial services group’ means any affiliated group ... which is predominantly engaged in the active conduct of a banking, insurance, financing or similar business. ‘Predominantly engaged’ is defined in Treas. Reg. Section 1.904-4(e)(3) to require that 80 percent of gross income be derived from the active conduct of a financial business.
33. Given there are rules in various countries to define financial service groups and global umbrella regulation, RFGs need to be distinguished from MNEs that are primarily engaged in other business activities, but have regulated entities embedded within them. While MNEs in other industries use debt to finance their core businesses (or to assist their customers to finance the purchase MNE goods), debt is the core of an RFG business. This is encapsulated in the Discussion Draft statement that interest expense for the banking and insurance sectors “is broadly comparable with ... cost of sales for entities in non-financial sectors” (page 5).

Summary of Suggested Best Practice Rule

34. Given the points made above, BIAC suggests a best practice rule which has three prongs. First, RFGs should be exempted from the fixed income and group ratio rules of the Action 4 Final Report. Second, MNEs that are not RFGs, but have regulated entities embedded in them, would be subject to the fixed income and group ratio rules but should be permitted to elect out of the disaggregation rule found in the Discussion Draft.† Third, targeted rules should be considered to address identified BEPS risks, but any targeted rules should take account of the characteristics of RFGs and the impact and consequences of regulation to avoid unintended or excessive impact.

Impact of EU’s ATAD

35. On July 12, 2016, the Council of the European Union (“EU”) adopted the Anti-Tax Avoidance Directive (“ATAD”).‡ The ATAD entered into force, as binding European Union law, on August 8, 2016, and compels EU members to adopt and publish rules necessary to comply with the ATAD (with some derogations) by December 31, 2018 and apply those rules from January 1, 2019. Article 4 of the ATAD provides for an interest limitation rule, reflecting (with some differences) the OECD’s Action 4 on the limitation of deduction of interest. EU Member States are, in essence, therefore legally obliged to implement interest limitation rules. Thus, the ATAD has effectively elevated Action 4 from its best practice status in the OECD October 2015 Final Report on Action 4 to a “minimum standard” that must be adopted into law by EU members.

36. BIAC notes that paragraph 7 of Article 4 of ATAD permits (but does not oblige) Member States to exclude “financial undertakings” (which includes regulated banks and insurers)
from the scope of the interest limitation rules, including where such financial undertakings are part of a consolidated group for financial accounting purposes). The ATAD does not however provide currently for any alternative approach to be applied to financial undertakings. Subject to the point below, Member States must either apply interest limitation rules to financial undertakings or not apply such rules. There are no other alternatives.

37. BIAC also notes that paragraph 6 of Article 11 of ATAD permits EU Member States which have national targeted rules preventing BEPS risks at August 8, 2016, and which are equally effective to the interest limitation rule set out in Article 4 of the ATAD, to apply those rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on its official website on a minimum standard with regard to BEPS Action 4, but no later than 1 January 2024. It would appear necessary for such Member States to be able to demonstrate to the European Commission the equivalent effectiveness of such rules.

38. The move towards a mandatory and legally binding (albeit not fully harmonised) approach at EU level may be contrasted to that in the Discussion Draft. In the latter case, there is a movement away from a best practice approach to a series of flexible options for the banking and insurance sectors to be considered by countries. While BIAC is hopeful this will be changed in the final recommendations, BIAC is concerned that the mandatory nature of the ATAD and its exemption of defined financial entities from the interest limitation rules will cause undue confusion and complexity for RFGs and EU tax administrators if the Discussion Draft is adopted in its current form.

39. The EU itself could adopt the 3-pronged best practice rule suggested by BIAC above; however, BIAC believes it sets a better international standard for the OECD to adopt the 3-pronged best practice rule for global guidance. The EU could then interpret its exemption from the fixed ratio and group ratio rules for defined “financial undertakings” taking into account the OECD’s final recommendations from the Discussion Draft.

Additional Options if Best Practice Not Adopted

40. If best practice is not adopted in the final recommendations emanating from the Discussion Draft and instead the flexible approach is used, then one of the options included in the flexible approach should be that different countries could adopt a rule

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§ Paragraph (9) of the preamble to the ATAD provides the following rationale: “Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. As the discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.”
that RFGs are not subject to the fixed ratio and group ratio regime (namely, our suggested best practice above). BIAC strongly prefers that this rule be made the best practice rule, but, if it cannot be, then it needs to be included as a preferred option that could be prudently adopted by countries for the reasons explained above.

41. Another option that could be considered is to broaden the exemption from the fixed and group ratio rules for solo-regulated entities to include (a) holding companies, (b) service companies and (c) core entities in the RFG that are not subject to solo-regulation so that these entities would, like solo-regulated entities, not be subject to the fixed ratio and group ratio rules. To expand on each of these:

A. We do not believe that the Discussion Draft fully addresses the potential impact on holding companies that issue debt-bearing instruments at a “single point of entry” and, in turn, supply regulatory capital to subsidiaries. See paragraphs 55 and 56 and Example 3 and 4. Given the importance of holding companies in providing funds to subsidiaries that are solo-regulated in a RFG, the Discussion Draft’s approach of differentiating them from solo-regulated entities would, in BIAC’s view, create disproportionate results and could, in certain cases, lead to interest expense becoming non-deductible.

B. Resolution and recovery (“R&R”) plans are required of certain banks by regulators with the aim of solvency and orderly resolution in the case of a financial crisis. R&R plans will often separate the service activities into a separate entity. Given this regulatory requirement and given the integral nature of service companies to the functioning of the overall enterprise, service companies should be combined with solo-regulated entities and holding companies under this option.

C. Core entities that are not solo-regulated but are engaged in activities integral to the RFG should likewise be included. Situations exist where entities that are not solo-regulated are, nevertheless, engaged in activities that generate active financing income, the activities of which are integral to the RFG. While BIAC strongly suggest the adoption of the 3-pronged best practice rule, if it is not adopted, then BIAC would be pleased to assist in developing alternatives that address the OECD’s concerns.

**Attribution of Free Capital to Permanent Establishments (“PEs”)**

42. BIAC believes that the concerns in paragraphs 22 to 25 of the Discussion Draft can be better addressed by encouraging countries to adopt the Authorised OECD Approach (“AoA”) found in the OECD’s *2010 Report on the Attribution of Profits to Permanent Establishments* (“2010 Report”). Not all countries have adopted the AoA, and encouraging countries to do so would be preferred as compared to countries creating different methods of attributing “free” capital to permanent establishments to address Action 4 concerns, thereby undermining the carefully considered consensus of the 2010 Report.
Interest Expense Funding Non-taxable Income

43. Paragraphs 35 and 39 of the Discussion Draft state that some countries have expressed concern that solo-regulated entities claim deductions for debt that is in turn used to invest in equity of companies incorporated in low tax jurisdictions that pay dividends that are not subject to tax in the hands of the solo-regulated entities. BIAC commends the Discussion Draft for discussing at some length in paragraphs 36 to 38 that prudential regulation of regulated entities guards against this concern.

44. Despite these regulatory limits, the Discussion Draft suggests at paragraphs 39 and 40 that countries with this concern should consider enacting measures that either (i) disallow interest expense for debt used to fund non-taxable income, (ii) reduce or eliminate participation exemptions or other benefits attributable to such debt or (iii) would tie tax rules to regulatory capital rules so that if regulatory capital rules require that an equity investment be reduced for regulatory capital purposes, then the tax rules would treat the funding amount as equity and not debt, thereby eliminating interest deductions.

45. BIAC observes that tying tax rules to regulatory capital rules in this way would be a substantial exercise. Further, disallowing interest expense or limiting participation-type exemptions in this limited context is a non-proportional response, especially given the points made by the Discussion Draft at paragraphs 36 to 38. Instead BIAC suggests that CFC rules are more appropriate and should be used. BIAC notes that the OECD /G20 consensus on CFCs reflected in the Final Report on Designing Effective Controlled Foreign Corporation Rules (released on October 5, 2015) is apropos to the concern raised. BIAC further notes that Action 3 Final Report is a report of best practices / common approaches, as is the Action 4 Final Report.

CONCLUSION

46. In summary, BIAC suggests a three-pronged best practice rule set forth in paragraph 34 of these comments. This suggestion, if adopted, would adhere to the Action 4 Final Report mandate for best practices in this area and provide a path to minimize potential conflicts between the EU’s ATAD and the OECD’s Action 4.

47. BIAC thanks the OECD for providing this opportunity to comment and would be happy to assist as the OECD thinks appropriate.
Mr. Achim Pross  
Head, International Co-operation and Tax Administration Division  
Organization for Economic Co-operation and Development  
Centre for Tax Policy and Administration  
2 Rue André Pascal  
75775 Paris Cedex 16, France

Via e-mail to interestdeductions@oecd.org

Dear Mr. Pross:

The Canadian Bankers Association welcomes the opportunity to submit comments on the Discussion Draft on BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors issued by the OECD on July 28, 2016 (the “Discussion Draft”).

EXECUTIVE SUMMARY

First and foremost, we wish to thank the OECD for acknowledging and recognizing the following:

- The significant regulatory environment that banking groups face and the challenges that this imposes on banks.
- That the regulatory environment that banking groups operate within "restricts their ability to place excessive debt in regulated entities or use debt to fund equity investments in subsidiaries".
- That excessive leverage in Banks has not been identified as a key risk and that there is no need at this time to develop a single common approach to deal with this risk.

We are however disappointed that the OECD having recognized the foregoing has sanctioned the "potential use" by a country of a general interest limitation rule applicable to banks and insurance companies. Specifically, we think it is appropriate for the banking industry to be excluded from the general interest limitation as discussed below. We also believe that it is relevant to note that in Canada the parent entity of a banking group is a regulated bank. We also believe for clarity that the rules should define interest expense as only including true interest expense, and not other items such as bad debts, swap expense etc.

EXCLUSION FROM GENERAL LIMITATION

While the Discussion Draft acknowledges that "it was noted (in the Action 4 Report) that any approaches adopted should not conflict with or reduce the effectiveness or regulatory capital
rules intended to reduce the risk of future financial crisis", no steps or recommendations have been advanced to ensure appropriate safeguards are taken to prevent any regulatory conflicts that could arise should any country chose to introduce a general interest limitation rule.

In view of the very real potential conflict that any interest limitation rule could have on the prudential regulatory environment in which banking groups operate we strongly urge the OECD to formally exclude banking groups (which covers all regulated entities in a banking group) from the application of a general interest expense limitation rule.

Paragraph 32 of the Discussion Draft highlights that in poor market conditions (economic downturn) interest income will be significantly reduced or eliminated through loan losses such that even a financial institution could have net interest expense potentially subject to the fixed ratio rule which "could seriously hinder an entity's ability to survive financial shocks". More importantly the last bullet of this paragraph correctly highlights that "any disallowance that is incurred under the fixed ratio rule is likely to be permanent". Clearly this would be a completely unintended and punitive outcome.

It is worth highlighting that much of the perceived or potential abuses that may arise in the financial services industry are likely already dealt with through the guidance produced in Action 2 (Hybrid Mismatch) Action 3 (Effective CFC Rules) and Action 6 (Treaty Abuse) and as such there is no need for further action through any interest expense limitation rules which are very difficult to target with any degree of precision and could have significant unintended consequences.

The Canadian Bankers Association appreciates the OECD’s recognition that the banking industry is unique. Consequently, we believe that these unique attributes may result in unintended consequences to the bank groups should they be subject to general limitations without due recognition of their inherent differences. While the regulatory environment is a key differentiator, two other key relevant differences are net interest and the capital and funding functions as discussed in further detail under these headings below.

We urge the OECD to specifically exempt financial institutions from the fixed ratio rule and the group ratio. As a major role of financial institutions is to provide liquidity in the global economy, any restrictions of interest deductibility would endanger that liquidity role with potentially large consequences for the global economy.

Should a country decide to keep the banking industry included in the general interest limitation, we feel strongly that the OECD should be clear in its guidance that the rules be modified to accommodate the interest component as discussed below. Furthermore, we strongly encourage any country considering an interest expense limitation rule that could apply to banking groups to undertake extensive consultations with their banking/insurance regulatory groups as well as resident banks and banking associations before considering any interest expense limitation rules that could apply to financial institutions.

**NET INTEREST**

As noted above, if the OECD feels that it must sanction the “potential use” of a general interest limitation rule applicable to banking groups, then we support the OECD’s conclusion as reflected in the Discussion Draft that any limitations on the deductibility of interest should key off net interest rather than gross interest. We want to underscore the importance of this fundamental point.
The largest operating expense of banks and other financial intermediaries is their interest expense, and it is of pivotal importance. The core business of the financial industry is financial intermediation. In the case of banks, this would include the transmission of funds from lenders to borrowers, intermediating between them, engaging in the purchase and sale of financial assets or commodities, etc. Money is the inventory, the stock in trade of a financial group. Interest expense is the equivalent to cost of goods sold for non-financial businesses. Interest expense on borrowing permits banks and other financial intermediaries to earn interest income on their lending activities. For example, the interest paid to depositors enables banks to earn interest income from lending to mortgage borrowers. While all businesses earn some interest income from their cash and treasury functions, the role of financial intermediation is to earn a net interest spread for the functions, services and risks undertaken from concurrently borrowing and lending.

The use of net interest as the starting point for any new limitation rules is critically important for financial institutions, because most of the profit of banks and financial intermediaries comes from the net interest margin from borrowing and lending. In many cases, a tax on gross interest income or a denial of a tax deduction for gross interest expense could result in tax cost that exceeds the net interest margin from the transactions. Paragraph 32 of the Discussion Draft is particularly helpful in that it highlights that in poor market conditions (economic downturn) as interest income is reduced or eliminated through loan losses a financial institution could have net interest expense which could be subject to a fixed ratio rule and this "could seriously hinder an entity's ability to survive financial shocks". More importantly, the last bullet of this paragraph correctly highlights that "any disallowance that is incurred under the fixed ratio rule is likely to be permanent". Clearly this would be extremely punitive from a tax policy perspective and would be completely unintended.

It is equally important that the computation of net interest be done to appropriately capture a true "net" number. In this regard, we are concerned about the Discussion Draft's use of the word "entity." A net interest rule that applies on an entity basis would be overly narrow and would not appropriately calculate net interest expense and related interest income. Rather, net interest should be determined on a modified basis taking into account all entities within the group in a jurisdiction, or on some other aggregate basis. This is necessary to ensure that the interest expense of a holding company that is used to raise financing for an operating business is properly netted against the interest income of its wholly owned operating company. Given the critical importance of this point, we urge the OECD to make clarifications in a revised discussion draft contemplating this issue further discussed below.

Furthermore a net interest rule that applies on an entity basis would be overly narrow and would not appropriately consider the net interest expense and related interest income of related entities within the group. As recommended above, we believe net interest should be determined on a modified basis taking into account all entities within the group in a jurisdiction, or on some other aggregate basis.

OTHER CONSIDERATIONS - CAPITAL AND FUNDING FUNCTIONS

Financial institutions capital and funding functions are often centralized at the parent level or in a dedicated treasury group as this (1) reduces the overall cost of funds/capital, (2) provides an important risk management function, and (3) manages regulatory capital considerations which apply both at an entity level and on a consolidated group level.

A global banking group cannot operate, effectively and efficiently without the ability to employ funds between jurisdictions and between members of the group through intercompany loans and other transactions treated as debt. In the ordinary course of their businesses, members of a
global banking group will need to engage in intercompany debt transactions rather than equity contributions and distributions. In addition, banks and their regulated subsidiaries are subject to wide-ranging regulatory regimes and rules that constrain and affect virtually every aspect of their businesses, including the use and terms of their intercompany debt. These regimes and rules operate to limit the extent to which the group can engage in intercompany debt transactions and require allowable intercompany debt transactions to have terms that are at arm’s length. In fact in certain circumstances the regulatory rules require and encourage the use of intercompany debt.

Centralized borrowing, by its nature will result in related-party interest expense as the funds raised are passed along to the various operating entities of the group throughout the world. The Discussion Draft seems to call into question the Arm’s Length Principle and all of the excellent work done by the OECD in developing the 2010 Report on the Attribution of Profits to Permanent Establishments (the 2010 Report)\textsuperscript{iv}. To the contrary, we believe that the arm’s length test is a valuable tool that should be central to any related party analysis. The data and the experience show that transfer pricing for debt is well established. The determination of an arm’s length transfer pricing interest charge for a lending transaction typically involves a series of components for which information is available, principally:

- Internal or external credit rating of the borrower;
- Yield curve in the marketplace for comparable lending transactions;
- Duration of the lending transaction;
- Options to renegotiate or prepay; and
- Amount of securitization.

We urge the OECD to recognize that multinational financial institutions will often centralize their funding and capital raising operations and that this will by its nature result in related party debt and that this related party debt should be considered in any net interest expense calculation. We caution the OECD not to create additional uncertainty by undermining the longstanding OECD Guidance of the 2010 Report as this excellent work has already dealt with the arm’s length test and transfer pricing analysis necessary to address any potential risk of BEPS in related party leverage and interest expense. As noted above, in a regulated financial services environment the regulators closely monitor related party transactions and demand that related party transactions occur at "market rates or better."

Bank group subsidiaries can often be funded by collateralized borrowings. In a collateralized borrowing, the borrower supports its obligation to repay the lender by posting collateral (debt or equity securities) that is approximately equal to the amount of cash borrowed. Thus, collateralized borrowings result in generally equivalent increases to both the asset and liability side of a balance sheet. Collateralized borrowings, by their nature, give rise to debt and gross interest expense levels for banking and other financial services intermediaries that can be many times the levels for businesses that are engaged in manufacturing or other types of services. However, it is not the gross amounts that are of real relevance to the business or economics of financial intermediation. Rather, what is relevant is the spread between the income generated by the collateral and the interest expense on the borrowing.

Another significant source of funding for subsidiaries of a banking group is unsecured loans from the parent bank, which in turn is responsible for obtaining funds from the market. Centralizing a worldwide group’s external unsecured borrowings at the parent level provides a lower overall cost of funds, and provides an important risk management function, because it permits the parent to monitor more closely the activities of the businesses that are being funded. While, centralized borrowing, by its nature, results in related-party interest expense, this expense is associated with an important business function.
Above-average leverage ratios of financial intermediaries, compared to other industries, simply reflect their unique business model of borrowing in order to lend to businesses, households and governments. Financial intermediaries are already subject to comprehensive financial regulations, which include leverage and risk-adjusted minimum capital requirements, such as the international regulatory framework for banks developed by the Basel Committee on Banking Supervision (Basel III) as well as individual countries’ banking regulations. Banking capital requirements are specifically designed to ensure that banks are well-capitalized and not over-leveraged. If interest expense tax deduction rules attempt to address over-leverage concerns, they would be redundant and could potentially be in conflict with the bank regulatory capital requirements. The OECD should encourage each country’s tax policy division to consult with their banking/insurance regulators, resident banks and banking associations before considering any interest expense limitation rules that could apply to financial institutions.

SUMMARY

Banking groups and other financial intermediaries have long been recognized as playing a central role in countries’ economies and serving as a critical driver of economic development. Financial intermediaries provide important services to borrowers and lenders, investors, and insurance policyholders that go beyond what individual players could achieve directly in the capital markets.

The Canadian Bankers Association recognizes that many of the identified issues are in part dealt with through alternative guidance (as noted above). However, we feel strongly that additional bank specific guidance should be added to BEPS Action 4, clearly outlining that should a country decide to adopt a general interest limitation rule, that the rules be modified to accommodate the peculiarities of the industry. We believe if individual countries are left without specific guidance from the OECD, there is a risk of different rules across many different jurisdictions that will result in a patchwork environment for global banks to operate in. We believe this is contrary to the OECD’s fundamental objective of consistently applying fair tax policy globally. We strongly believe the potential uncertainty and risk that could otherwise result far outweigh the costs of the exclusion of the banks from the general limitations and/or the refinement to the application to “net interest” for banking groups.

We appreciate the opportunity to provide these comments on key issues with respect to the Action 4 Discussion Draft. We would be happy to respond to questions or to provide any further information that would be useful as the OECD continues its work in this important area.

Sincerely,

[Signature]

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i Paragraph 5 of Discussion Draft
ii Paragraph 28 of Discussion Draft
iii Paragraph 6 of Discussion Draft
iv Paragraph 25 of Discussion Draft
CLHIA Response to OECD Discussion Draft "BEPS Action 4 Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors"

The Canadian Life and Health Insurance Association ("CLHIA") is pleased to provide comments on behalf of its members on the Discussion Draft "BEPS Action 4 Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors".

The CLHIA is the national trade association for life and health insurers in Canada. Our member companies account for 99% of Canada’s life and health insurance business and provide a wide range of financial security products such as life insurance, annuities and supplementary health insurance to 28 million Canadians. Canadian life insurers operate in over 20 countries around the world and three Canadian life insurers rank among the top 15 global life insurers by market capitalization. A quarter of the CLHIA’s members operate as subsidiaries or branches of foreign insurers or reinsurers from the United States and Europe. The CLHIA is also a member of the Global Federation of Insurance Associations (GFIA) based in Brussels.

The CLHIA supports the OECD’s broad objectives in combating aggressive tax planning, including through commercially excessive leverage and inappropriate interest deductions. However, any measures adopted by the OECD need to be proportionate and well-targeted such that they do not result in inappropriately restricting interest expenses, which could negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers. In addition, it is critical that, as noted by the OECD in paragraph 6 of the Discussion Draft, any approaches adopted by the OECD "should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis".

We strongly recommend that the OECD’s proposed measures reflect the following considerations with respect to life insurance companies and groups:
• the important role of the strong and comprehensive regulatory system within which the life insurance industry operates which:
  • requires financial institutions to hold minimum amounts of equity, and
  • restricts their ability to place an excessive level of debt in regulated entities (see paragraphs 5 and 18 of the discussion draft)
• commercial constraints which require life insurers to maintain high credit ratings and adequate long-term or permanent capital, thereby limiting debt leverage that is commercially excessive
• the low level of BEPS risk - paragraph 26 of the discussion draft states “excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this [BEPS] risk will be low.”.

Responses to the questions raised by the OECD are included in the attached Appendix. The CLHIA’s recommendations:
• are intended to ensure the OECD’s proposed measures are proportionate, and targeted, to the BEPS risks
• preserve the safety and soundness of the life insurance sector, and
• address only life insurance groups where life insurance and related activities (such as asset management) are the primary activities of the group.

Our recommendations may be summarized as follows:
• in the absence of specific BEPS risks arising from insurance structures (for which insurance specific rules may be indicated), countries should apply the general interest restriction rules to insurance groups
• all third party interest on debt that qualifies as regulatory capital (or on debt used to fund regulatory capital) should be excluded from the net interest expense subject to the rule.

Original signed by:

Noeline Simon
VP, Taxation and Industry Analytics
Responses to the specific questions in the Discussion Draft are as follows:

The risks to be addressed through interest limitation rules

1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

As the discussion draft notes in paragraphs 5 and 18, insurers (and banks) are subject to comprehensive regulatory capital rules which:

i) require them to hold minimum amounts of equity, and
ii) restrict their ability to place an excessive level of debt in regulated entities.

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) regulates financial institutions (including many financial institution holding companies) at a consolidated worldwide level and at a “solo” or non-consolidated insurance entity level. Canada's financial institutions regulatory system is widely regarded as being one of the most stringent regulatory systems in the world.

In addition, commercial constraints, such as the need to maintain high credit ratings to attract customers and investors, further limit the ability of insurers (and banks) from taking on excessive debt levels. These commercial constraints mean that Canadian life insurers generally hold regulatory capital that is well in excess of the required minimum capital without excessive debt leverage. High credit ratings are vital from a marketing perspective, since customers look to the financial strength of their financial institution, as do investors. High credit ratings are particularly important for the life insurance industry, given the very long term nature of life insurance contracts, which often extend 50 or more years.

We believe that these regulatory and commercial constraints sufficiently restrict life insurance groups from having excessive debt such that any BEPS risk is small. The OECD acknowledges this in paragraph 26 of the discussion draft which states “excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this [BEPS] risk will be low.” We believe this low risk assessment also applies to all companies in a Canadian life insurance group that is subject to regulation at the consolidated level.
Banks and insurance companies

2. Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?

We are unaware of any other considerations that should be taken into account.

3. Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country’s regime.

As previously mentioned in our response to question 1, in Canada, life insurers are regulated at a consolidated worldwide level and at a non-consolidated entity level, under what is widely recognized as one of the most stringent regulatory systems in the world such that there is no evidence of any material BEPS risks involving interest on excessive debt. In addition, most other countries also subject insurers to stringent capital regulation.

4. Are there other any general issues related to the operation of the authorised OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?

We are unaware of any other issues that should be taken into account.

5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

If a country has established that insurers do not represent a BEPS risk, we believe the lack of any specific interest restrictions for insurers does not raise any concerns. In fact, we would have real concerns with any specific rules for insurers where no material BEPS risk exists given the:

• possibility of unintended consequences, and
• risk of inappropriate restrictions on interest deductions which could negatively impact the financial strength of the institution (which would also be a concern to regulators, customers and other stakeholders).
Given these concerns, any specific rules should be targeted to address specifically identified BEPS risks. In the absence of specific BEPS risks, countries should apply the general interest restriction rules to insurance groups on a consolidated basis.

6. What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

Some countries, such as Canada, have thin capitalization rules, which generally apply to restrict the deductibility of interest where the debt/equity ratio exceeds a specified limit. In addition, some countries apply the Arm’s Length Principle to debt in all sectors, which allows for the debt to be re-characterized as appropriate based upon the actual facts and circumstances, as opposed to interest restrictions based upon a mechanical mathematical formula.
We are not aware of any insurance sector specific rules to address BEPS risks which is consistent with the fact that excessive leverage in insurance companies has not been identified as a significant risk. In the event that an insurance specific BEPS risk is identified which is not addressed by the general interest restriction rules, we recommend that targeted measures be used which would reduce the risk of unintended consequences and inappropriate interest restrictions.

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

As described below, we have serious concerns about the OECD’s suggestion that, where a country applies the fixed ratio rule to the net position of a local group, it should consider applying the rule to the local group excluding banks and insurers.

Historically, and because of efficiencies in accessing the capital markets, Canadian life insurance groups have generally raised debt at the holding company level to support group operations, either to invest in equity of subsidiaries (including the insurance operating company) or to meet regulatory capital requirements. Local regulators often require the use of equity rather than debt to fund the insurance operating company.

Under this funding structure, the interest expense resides in the holding company while the income and business profits from the invested capital reside in the insurance operating
company. Excluding the regulated insurers would exclude their income and business profits from the interest restriction calculation but would include the full amount of the interest expense on the debt issued at the holding company level and potentially subject that interest expense to the restriction. As a result, excluding insurers from the local group to which the fixed ratio is applied could result in a large interest restriction, in a situation that does not raise any BEPS risks. This is inappropriate and would penalize insurers for maintaining and increasing regulatory capital through the proceeds of debt issued by a holding company.

In paragraph 56, the OECD suggests that where a country applies the fixed ratio rule to a local group excluding banks and insurance companies, it should consider excluding some or all of the third party interest expense on regulatory capital from the net interest expense subject to the rule. Consistent with promoting high capital levels to ensure the safety and soundness of financial institutions, we strongly recommend that ALL third party interest on regulatory capital (or on debt used to fund regulatory capital, as described below) be excluded from the net interest expense subject to the rule.

This approach is supported by the OECD's comments in paragraph 60 of the discussion draft which states that:

"There may also be circumstances where third party debt which does not qualify as regulatory capital is raised by another entity in a group to fund activities in a bank or insurance company. In many cases, it is expected that this debt will be on-lent to the bank or insurance company on similar terms, and so it does not pose an issue for the operation of the fixed ratio rule (i.e. interest income will offset interest expense, perhaps leaving an interest margin). However, there may be some cases where this debt is used to fund an equity investment, for example as acquisition finance to fund part of the purchase price of a bank or insurance company, and in this case the entity raising the debt will have a net interest expense. Where the entity with the net interest expense and the bank or insurance company are in the same country, the country should consider permitting an adjustment to exclude the net interest expense from the scope of the fixed ratio rule. This is on the basis that the net interest expense is funding activity which is taxable in the same country and so does not pose a BEPS risk. Where an entity has non-regulatory capital debt funding equity investments in a number of banks or insurance companies, this may involve an allocation of net interest expense between equity investments in banks or insurance companies in the same country and those in other countries".
8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

As mentioned in our response to question 7, insurance groups borrow to support group subsidiaries, either passing the borrowed funds down as equity or using the funds to meet the group's regulatory capital requirement. This debt is often raised at the holding company level, particularly where local regulators require the use of equity rather than debt to fund the insurance operating company.

9. What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

We are unaware of any approaches currently being applied by countries.

10. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

We are unaware of any other considerations that should be taken into account.

11. Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

At this time, we do not expect there would be any different implications for life insurance companies from applying any targeted rules to address the specific risks identified in paragraph 43 of the discussion draft.

Entities in a group with a bank or insurance company

12. Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?
We are not aware of any other general issues. As noted, we believe that the level of BEPS risk involving interest posed by entities in a life insurance group is low, due to regulatory requirements and restrictions as well as commercial considerations.

13. **Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company:**

   a. application of the fixed ratio rule to the local group excluding banks and insurance companies

   Our concerns are the same as those outlined in our response to question 7.

   b. the treatment of interest expense on debt supporting banking or insurance activities

   As suggested by the OECD in paragraph 56 of the discussion draft, ALL third party interest on regulatory capital (or on debt used to fund regulatory capital, as described in our response to question 7) should be excluded from the net interest expense subject to the rule.

   c. other issues?

   At this time, we are unaware of any other issues.

14. **Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?**

   At this time, we are unaware of any other modifications that should be considered.

15. **Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?**

   At this time, we are unaware of any additional practical issues that should be taken into account.
16. *Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?*

We recommend applying the group ratio rule to the insurance group as a whole, including insurance operating companies.

17. *Do you have any other comments on any of the issues raised by this discussion draft?*

In the event that any new BEPS rules apply to restrict the deductibility of interest expense for life insurers, the restrictions should either not be applied to existing debt or an appropriate transition period should be provided taking into account any inability of the insurer to restructure or refinance the debt without a significant cost or penalty. A large proportion of life insurers' existing debt is long-term which is very costly and difficult to restructure. This issue is particularly significant for life insurers given the long-term focus of the life insurance industry. Lack of an adequate transition period will result in significant costs to the industry with the potential for negative regulatory and market access repercussions.
I. Introduction

These comments are being submitted to the OECD by the Banking and Finance Company Working Group (the “Working Group”) on Base Erosion and Profit Shifting (BEPS)\(^1\) in response to the public Discussion Draft released on 28 July 2016 by the OECD entitled “BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors (the “Draft”).” The Working Group appreciates the opportunity the OECD has provided since the outset of the BEPS project to explain the nature of the banking business,\(^2\) how it is uniquely regulated, the critical role that debt plays in the business, and the necessity to carefully evaluate potential BEPS relating to interest expense within these important parameters. Throughout the Draft, these factors are recognized and taken into consideration. In fact, the Draft recognizes that BEPS relating to interest is a “low risk” issue for regulated banking groups.

However, the Working Group is very concerned with the direction that the OECD is taking in its recommendations on Action 4 for the banking sector, essentially to apply a modified fixed ratio rule. We have set out below a summary of our key points of concern together with our view on the position that the OECD ought to recommend, and included further supporting analysis and commentary after this summary.

II. Executive Summary

In developing our view on the appropriate recommendation that should be made for the banking sector, we consider that the following key points need to be taken into account:

1. The Working Group firmly believes that consolidated regulation, including capital requirements, leverage ratio limitations, and changes to the structure and business of banking groups caused by resolution planning, creates constraints on over-leverage and on interest expense that are equal to or more rigorous than application of the fixed ratio rule in the final Action 4 report as applied to non-financial services groups.

\(^{1}\) The Banking and Finance Company Working Group comprises members of the Securities Industry and Financial Markets Association (including Citigroup, T.D. Bank, JPMorgan Chase & Co., Bank of America, Jefferies, Credit Suisse and Goldman Sachs), and Barclays and American Express. The Securities Industry and Financial Markets Association (SIFMA) is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raise over $2.5 trillion for businesses and municipalities in the U.S., serve clients with over $20 trillion in assets and manage more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

\(^{2}\) When this submission refers to the “banking group,” “banking industry,” or “banks and other similarly regulated financial services groups,” we are referring to banks, broker dealers, investment banks, and finance company groups that are regulated by an independent prudential regulator typically established by statute, or a subgroup of a larger business that is regulated as such and that includes financial services entities that are regulated as well by a local regulator (referred to as solo-regulated). These group and subgroups also include entities that are not subject to local regulation but are integral to the financial services group or subgroup that is subject to consolidated regulation, such as holding companies and services companies.
Fundamentally we therefore consider that application of the fixed ratio rule, or indeed any other rule, to banking groups is unnecessary from a BEPS perspective because the regulatory environment significantly constrains banking groups from engaging in activity that may pose a potential BEPS risk arising from the tax deductibility of interest expense;

(2) We are concerned that these business and regulatory realities, and the roles they play in preventing banking groups from engaging in BEPS related to debt and interest expense, remain less than fully understood in the context of tax policy and tax administration, and that the recommendations for the banking sector are therefore not coherent from a policy perspective (see also (4) below).

(3) The proposed application of the fixed ratio rule, with adjustments that seek to isolate interest expense in non-solo regulated entities within regulated banking groups subject to consolidated regulation, fails to recognize the integrated operations and funding requirements of entities within a banking group and will create undue harm for such groups that is disproportionate to any perception of such BEPS activity in regards to the group as a whole.

(4) Furthermore, the implementation of the modified fixed ratio rule recommendation would leave banking groups in a comparatively worse position to non-financial groups. This is because while non-financial groups’ gross taxable income represents EBITDA that would provide capacity for allowable interest expense, for banking groups the capacity that would be provided by the solo-regulated operating entities would no longer be available to offset the interest expense of the modified group suggested by the draft. Further, the gross operating income of banking groups comprises largely interest income, which the proposals would, in effect, entirely carve out from consideration in the application of the fixed ratio rule. A modified fixed ratio rule would therefore be discriminatory to the banking sector.

(5) Critically, interest income is gross income from the active trading of a banking group, and interest expense is a direct cost of sales, or cost of goods sold for a banking group, and limitations on the deductibility of interest expense against corresponding financial income will affect the cost of finance (and financial intermediation). Furthermore, any restriction on the tax deductibility of a banking group’s cost of sales would be fundamentally different from the approach taken by the OECD in other aspects of the BEPS Project, where (rightly) there has been no recommendation for an artificial restriction on the tax deductibility of a business’s cost of sales.

(6) The disproportionate implications for a banking group through the application of the fixed ratio rule are amplified by the fact that the group ratio rule, which is designed to allow some amount of interest to be deducted beyond the amount provided by the fixed ratio rule where a group naturally operates with a higher degree of leverage, does not provide such additional relief for banking groups, as the Draft acknowledges.

Accordingly, the Working Group strongly urges the OECD to recommend as a best practice that regulated banking groups and subgroups whose operations are predominantly of a banking, broker-dealer, investment banking or financing business in nature not be subject to the fixed ratio and group ratio rules or to any adjustments to these rules.

Our rationale for recommending this approach is based on the following:
Such groups, which are predominately engaged in the banking, financing or similar business, will generally be regulated both by a prudential regulator in the headquartered jurisdiction and by prudential regulators in other jurisdictions (for example, where the local subsidiary or sub-group carries on banking activity), and do not pose a potential BEPS risk arising from the tax deductibility of interest expense. Such groups must be differentiated from non-financial groups that have regulated captive financial entities embedded within their structures but are not subject, as a group or subgroup, to consolidated regulation. Therefore, such non-financial groups are not subject to the same limitations and regulation that are imposed on the banking group.

The Working Group disagrees with the assertion in the Draft that differences between regulatory capital rules in different jurisdictions may permit BEPS activity, and that such differences in regulatory coverage may be justification for regulators and tax authorities viewing excess leverage differently. We also think that it is fundamentally problematic if tax authorities take the view that they should or could impose limitations on tax deductibility because they may disagree with the amount of leverage permitted by regulators. Tax policy making should be coherent with regulatory policy objectives in the approach to the banking sector.

Furthermore, the Working Group disagrees with the basic premise that appears to be the basis for the OECD’s further work in this area, namely that there is tax base erosion through interest expense when a banking group, subject to both arm’s length transfer pricing and existing anti-avoidance legislation, earns taxable net interest income in a country – when the interest expense is fungible and a key component of the cost of sales.

The Working Group also disagrees with two other reasons given in the Draft for why special tax rules should apply to banks. These are sections of the Draft dealing with the attribution of capital to permanent establishments (PEs), and sections addressing the possibility that BEPS is created through the use of interest expense to fund non-taxable income in a bank. We have set out in the detailed analysis below further comments on our disagreement on these two points.

Finally, the Draft discusses banking and insurance groups together, though it does acknowledge that debt and interest play vital but different roles in these two types of financial services businesses. As a general matter, the Working Group believes that a final report should carefully address banking and insurance groups based on the distinct business models of the two industries.

III. Supporting Analysis and Detailed Commentary

(1) Potential BEPS risks related to the banking industry as identified in the Draft

This submission is structured first to address the areas of potential BEPS that are identified in the Draft, and then to discuss the suggested options for remedies that are included in the Draft. For banking groups, the Draft states that countries identified the following financing structures as posing BEPS risk under the final Action 4 report:
• The use of third party or intragroup interest to fund equity investments giving rise to income that is non-taxable or is taxed in a preferential manner.
• Incurring excessive third party or intragroup interest expense, which may be netted against taxable interest income.

(2) Suggestons that banking regulation does not protect against excess leverage

While identifying the above financing structures as posing BEPS risk, the Draft notes that countries distinguished between two sets of groups: on the one hand, the risks posed by banks subject to capital regulation at a solo level (meaning that an operating business entity is subject to local country regulation and, broadly speaking, subject to individual capital requirements); and on the other, the risks posed by other entities within a bank group, including holding companies and other entities that are not subject to solo level regulation. As a general matter, we believe this distinction is misplaced in the context of banking groups that are regulated in their entirety by home country prudential regulators, or regulated as such at the sub-group level. The Working Group believes that the manner in which such groups are regulated in terms of the level of capital they must maintain, debt/equity ratios with which they must comply, and other aspects of banking regulation globally and at the local country level create a limitation on leverage and interest expense that is on par with or even more rigorous than the fixed ratio rule as it applies to non-financial groups.

In fact, the Draft acknowledges that regulatory capital requirements provide protection against excessive leverage for tax purposes. Notwithstanding such acknowledgment, paragraphs 19, 20, and 21 of the Draft go on to list reasons why it is believed that regulatory capital requirements may not prevent BEPS by banking groups. These reasons include the following: that regulatory capital rules may differ between countries and the type of regulated activity undertaken; that there are differences between how regulators and tax authorities may view the excessive leverage; and that there are differences in the economic environment or legal frameworks in different countries in which banking groups operate.

We disagree with these assertions as they do not reflect the reality of the implementation of regulatory capital standards around the world, and we are concerned that banking regulation remains less than fully understood in the tax policy making context.

For example, paragraph 19 of the Draft states that there are material differences in how Basel III has been implemented globally. In fact, implementation of the Basel standards has been remarkably consistent. The Basel Committee on Banking Supervision (BCBS) reviews, on an ongoing basis, the extent to which domestic regulations are aligned with the minimum Basel requirements to help identify any material gaps. This assessment program has shown that the implementation of Basel III capital and liquidity standards at the jurisdictional level has been generally consistent with the globally agreed Basel standard. Therefore, we recommend that the OECD make a closer investigation of how the Basel standards are indeed being implemented. Such an investigation will demonstrate that in large part the regulatory capital rules are providing a level of protection against excessive leverage that, again, is equal to or more stringent for global banking groups than that of the fixed ratio rule as it might apply to non-financial services groups.
While some jurisdictions continue to work on implementing key elements of the post-crisis regulatory framework, the BCBS and G-20 expect key jurisdictions to be broadly compliant with minimum global standards. Jurisdictions can be reprimanded during the G20 process if they are perceived to be creating opportunities for regulatory arbitrage. In addition, regulators continue to develop other key elements of the post-crisis regulatory framework, which will further enhance minimum, comparable global capital standards. The BCBS continues to work on a final calibration of the leverage ratio. In January 2016, the BCBS’s Oversight Committee, comprising Central Bank Governors and Heads of Supervision (GHOS), agreed that the leverage ratio should be based on a Tier 1 definition of capital, should comprise a minimum level of 3% and discussed the possibility of additional requirements for global systemically important banks. The GHOS will finalize the calibration in 2016 to allow sufficient time for the leverage ratio to be implemented by 1 January 2018. Additionally, by the end of 2016, the GHOS will review the BCBS’s proposal on the design and calibration of capital floors, involving setting the baseline minimum requirements that would apply to all jurisdictions.

The OECD seems to be arguing that firms are utilizing regulatory arbitrage opportunities for tax purposes; however, this is inconsistent with the reality as described above for banking groups.

Paragraph 20 states that there are differences between how tax authorities and regulators may view the issue of excessive leverage, and suggests that while regulators are concerned with the overall level of debt in a group, tax authorities are focused on earnings stripping and other base erosion techniques in which “excessive” levels of debt is “pushed into an entity” to reduce the amount of profits subject to tax. The Draft goes on to note that some jurisdictions allow certain interest-bearing instruments to be treated as capital for regulatory purposes, subject to prescribed limits. Where these instruments are treated as debt for tax purposes, “a bank or insurance company’s leverage for tax purposes may be higher than its leverage for regulatory purposes.” As an initial matter, we disagree with this statement. Such debt instruments are additions to, not substitutes for the equity required to meet the tier 1 Common Equity ratio, which is the prime determinate of the requisite amount of capital a regulated bank must hold.

In addition, while we agree that it is possible that some regulatory capital instruments may be treated as debt for tax purposes, this should not be viewed as a problem that creates a BEPS opportunity for regulated banking and similar groups. All sophisticated jurisdictions pay tax policy attention to the distinction between debt and equity. Regulatory capital instruments by their nature receive consideration in this regard due to factors such as subordination, convertibility, write-off of principal, discretionary coupons, perpetuity, high rate, coupons accounted for as distributions, etc. This issue is also covered by the hybrid rules. We do not believe, therefore, that it is necessary for the OECD to separately address this issue under Action 4.
The Draft identifies branches and the attribution of free capital to PEs of banks companies as potentially problematic.

The Draft states that in most countries there is no regulatory requirement for capital to be allocated to a permanent establishment. Therefore, the Draft indicates that while regulatory requirements may sufficiently address BEPS in entities, these rules would not necessarily prevent a PE of a bank claiming an interest deduction for all of its funding costs without limitation. Moreover, the Draft points out that the approaches taken into account in the 2010 Report on the Attribution of Profits to Permanent Establishments (the 2010 report) include appropriate approaches for the attribution of profits to PEs of banks and insurance companies and a PE should be attributed an arm’s length amount of free capital. However, as these approaches take into account capital requirements in the home country or the host country, the Draft maintains that concerns that regulatory capital rules in different countries may not provide the same level of protection against excessive leverage for tax purposes are also valid in the case of a PE.

The Working Group believes these assertions represent a misunderstanding of the 2010 Report and its implementation. Local tax authorities can attribute capital of the entity to the local branch in accordance with the arm’s length principle as provided in the Authorized OECD Approach (AOA) outlined in the 2010 report. Additionally, by adopting this approach where a branch is considered to have been allocated excess capital, we would expect the local tax jurisdiction to make adjustments to the tax computation that would increase the amount of taxable profits to those that would be achieved by similar banking activities carried out by a standalone bank in the same or similar circumstances.

The effect of this approach is that a bank’s permanent establishment has an appropriate amount of interest expense attributed to it for tax purposes, as does the head office. There is no need for an interest restriction in the head office simply because there is a foreign PE.

Lastly, the concerns included in the Draft run counter to prior OECD statements recognizing that the 2010 report provided a complete and satisfactory resolution to the attribution of profit issues relating to a PE in the context of the banking industry. As noted above, the 2010 report provides tax authorities with the tools they need; if anything, the final report on this matter should reinforce the application of the 2010 report rather than suggest alternative tools.

Interest funding non-taxable income from an equity investment

Paragraph 35 of the Draft states that countries have identified BEPS risks “which concern a solo-regulated entity using deductible interest expense to fund non-taxable income” and typically involve a bank receiving a non-taxable return on an equity investment. The report accurately points out that these concerns are mitigated by “a number of regulatory and commercial considerations” including regulatory capital and other constraints against the use of double leverage in a group that relate to using debt to fund equity investments and regulatory constraints against “trapping” capital in subsidiaries. Yet, the Draft upholds that countries are still concerned about BEPS risks in this area and, in particular, suggests banks might “incorporate equity funded vehicles in low tax jurisdictions, which are used to invest in portfolio investments.”
We agree that these concerns are significantly mitigated by regulation, which continues to evolve and strengthen, and we would respectfully suggest that concerned countries examine carefully whether their concerns are historic and precede the regulatory developments since Basel III, and/or whether their concerns are better addressed by measures outside of the scope of Action 4.

As remedies, the Draft suggests, in paragraphs 39 and 40, addressing these concerns by (i) disallowing interest expense for debt used to fund non-taxable income; (ii) reducing or eliminating the amount of income that might benefit from a participation exemption regime; or (iii) tying tax rules to regulatory capital rules so that if regulatory capital rules require that an equity investment be reduced for regulatory capital purposes, then tax rules should treat the funding amount as equity and not debt, thereby eliminating interest deductions. Attempting to tie regulatory and tax rules together in the manner outlined is likely to be very difficult to achieve given that the regulatory environment does not necessarily achieve its objectives in that way. Meanwhile, applying controlled foreign corporation (CFC) type rules is appropriate and more directly targeted than the alternative approach of applying the fixed ratio rule, to the extent that countries find that a BEPS problem exists in regards to regulated banking and similar groups, notwithstanding the changes that have occurred and the robust nature of the regulatory environment that applies to these groups.

(5) The fixed ratio rule should not be applied in a modified manner to banking groups

The OECD’s recommended best practices approach in the October 2015 final Action 4 report is to limit the deduction of net interest expense to a fixed ratio (10-30%) of the EBITDA of the taxpayer, which may be a consolidated group or may be a single entity depending on the particular country’s consolidation rules and the particular group’s circumstances. This general test is subject to a possible worldwide group ratio safe harbor that would allow full deduction if the taxpayer’s net interest expense level is not disproportionate to the worldwide group’s net third-party interest expense level.

The Draft, rather than suggesting a best practices approach similar to the fixed ratio rule included in the October final Action 4 report, states in paragraph 51 that countries “should consider applying the rule to the local group excluding banks and insurance companies . . . To the extent that a country intends to apply the fixed ratio rule to banks and insurance companies, these could be included in a second local group containing only solo regulated entities.” We have grave concerns with this approach, along with the assumptions and examples in the Draft relating to the potential impact of applying this approach. As explained below, we believe the implementation of the modified fixed ratio rule would leave banking groups in a comparatively worse position to non-financial groups and is not justified.

Paragraph 52 states that net interest expense in the remaining entities in the group would be deductible up to the benchmark fixed ratio threshold. However, this statement and examples 1 and 2 assume these remaining entities would include a combination of entities with interest income and interest expense. In this regard, all of the examples suffer from this flaw of assuming there is a substantial non-financial entity in the group that will have EBITDA. This fact pattern does not exist for any members of our Working Group. In Appendix 1, we include both the examples contained in the Draft as well as an example of what we believe to better illustrate the impact of the fixed ratio rule as suggested in the Draft. While such an approach may adequately address potential BEPS for a manufacturer or a retailer
with a financing arm, any issues that may arise there should be analyzed separately from banking and other financial groups such as the firms in our Working Group.

We don’t believe Example 2 accurately portrays the outcome of the application of the fixed ratio rule, as it indicates a relatively small portion of the group’s interest expense is disallowed through application of the fixed ratio threshold separately to the groups. In reality, this regrouping of financial services entities into regulated and non-solo-regulated entities for purposes of the application of the fixed ratio rule will result in the EBITDA threshold being negative, so no interest deduction would be allowed in these cases. This is a fundamental concern because those expenses are part of the cost of sales of the banking group’s financial services business carried out through those other entities.

To reiterate, in many cases, a holding company will issue debt on behalf of the group and, on a stand-alone basis, may be in a net interest expense position, even though effectively the interest expense in the holding company is funding net interest income in a solo-regulated operating company. Therefore, if the regulated operating companies are carved out of the fixed ratio rule so that their net interest income is ignored, banks and insurance groups may find themselves suffering a restriction on the tax deductibility of interest even where that interest expense is effectively funding taxable interest income rather than exempt income. We are therefore concerned that the proposed narrow carve-out only of solo-regulated entities is simply not an appropriate approach, and furthermore is likely to put financial groups at a disadvantage to other sectors.

As noted above in the discussion of banking regulation, the Working Group believes that alternative applications of the fixed ratio rule would ignore the fact that such groups use entities that are not subject to solo regulation such as holding companies, treasury companies, special purpose companies (such as debt issuing or financial repacking entities) and asset management companies for a variety of commercial purposes. Since the activities of such entities usually are closely aligned to the core bank/broker dealer/finance company business of the group and, as described below, impact the consolidated regulation of the banking group separating, these linked entities from a business and regulatory perspective for tax purposes defies economic, business and regulatory reality.

While not all entities are subject to solo “functional regulation,” (i.e., individual capital requirements and other restrictions that apply to a bank or securities firm) it is important to stress that a banking group is subject to consolidated capital requirements that cover all of its assets and liabilities. All third-party assets and liabilities are rolled up into the consolidated entity, and all of these assets and liabilities are subject to capital requirements. As such, separating these entities within a country simply because they are not subject to solo entity regulation ignores the fact that consolidated capital requirements apply to the entire group, and therefore leverage ratios apply to the entire group. Parent holding companies, for example, are prudentially regulated, and are required to serve as a source of strength for their subsidiaries. From a resolution planning perspective, separating these entities by interjecting tax considerations into the capital planning/distribution process is problematic. This is particularly of concern as regulators are requiring Total Loss Absorbing Capital (TLAC) to be issued by a parent as debt into the market, and a bank/broker dealer subsidiary will issue debt to the parent. Applying the fixed...
ratio rule in the manner suggested by the draft could undermine financial stability objectives and could lead to a need to restructure a group that would provide a distraction from, and run contrary to, critical regulatory considerations.

Thus a tax authority can only create distortions in the economics of a banking operation by viewing entities in an isolated way. Regulators focus and place limitations on inter-company lending within a group (e.g., limitations on large exposures), all to the point of furthering resolution planning and ensuring the financial soundness of each individual regulated entity. Each country’s regulator watches over the particular entity’s leverage ratios, and will also be concerned about the interest rate being paid on inter-affiliate loans. Regulation thus puts significant limits on leveraging up entities, while ensuring that interest charges are calculated on an arm’s-length basis. In addition, regulators look at inter-affiliate exposures broadly, including limiting credit exposures (use of loans and derivatives) between banks and other entities.

Financial services groups and non-financial services groups are very different businesses, and therefore efforts to manipulate the fixed ratio rule to apply to financial services groups in order to produce results comparable to those when the rule is applied to non-financial services groups simply will not work (nor is it necessary from a tax policy perspective). Paragraph 52 reads that, “it is expected that excluding banks and insurance companies from a local group should in most cases remove the main operating entities which earn interest income as a primary activity. The impact of the rule on an entity in a group with a bank or insurance company should thus be closer to that on entities in other groups.” Presumably, this means that the aim of applying the fixed ratio rule in this way to financial services groups is to make the operation of the fixed ratio rule comparable and proportionate to the manner in which it applies and the impact the disallowance of interest expense would have upon non-financial services groups. However this approach is not appropriate, it is not proportionate, it is unwise, and it does not produce a result that is comparable to the application of the fixed ratio rule to non-financial groups, because it completely carves out core operating income of the banking group from consideration alongside related interest expense.

Paragraphs 54 to 60 discuss the potential limitation of interest expense that could occur when entities issue third-party debt, including debt that counts as regulatory capital, to support operating banking and other similar entities in a group, and the fixed ratio rule is applied to some but not all entities in a country. Paragraph 56 states that the limitation on interest expense that would occur may not be appropriate and the remedy should be that some or all of the third-party interest expense on regulatory capital should be excluded from the net interest expense subject to the rule. We agree with this recognition in the Draft that interest expense related to such regulatory capital instruments should not be subject to limitation as part of the application of the fixed ratio rule, as doing otherwise would distort the outcome assumed by regulators. As noted above, however, most countries have adopted or will adopt tax rules relating to such instruments that are consistent with their approaches to defining debt and equity, based on the characteristics of the instruments and in consultation with banking regulators. We consider this to just be an example of the problems that would be caused by interest expense in non-solo regulated entities being separated from operating income in regulated entities. The suggestion to give special treatment to regulatory capital instruments does not address this fundamental concern.

Therefore, the Fixed Ratio Rule (or any version thereof) should not be applied to separate entities or subgroups within such a banking group. In fact, we believe that the final report should go further than the Draft in making clear that concerns regarding the risk of BEPS related to interest expense by a
banking group are likely to be unusual, and should include a clear note of caution as to the extent to which it is desirable to introduce modifications or variations of the fixed ratio rule to address such perceived concerns. It would be undesirable for the final report to appear to be advocating a fragmentation in the international approach where that is not generally necessary.

(6) Application of the group ratio rule will not provide relief

As noted in paragraph 62, the group ratio rule is intended to permit the deduction of more interest expense beyond that limited by the fixed ratio rule, to the extent the amount of interest expense being deducted is in line with net third-party interest of the group as compared with the EBITDA of the group.

Paragraph 63 points out, accurately we believe, that if the fixed ratio rule is applied on an entity-by-entity basis, or applied to exclude regulated banks and insurance companies from a group, the group ratio rule will likely “not provide any relief.” Paragraph 67 identifies practical issues in this regard.

The fact that the group ratio rule, which is intended to provide additional relief to non-financial services groups that are limited in their ability to deduct interest expense using the fixed ratio rule, “breaks down” when applied to financial services groups if the fixed ratio rule is applied in the targeted manner described by the draft is another reason why the potential application of the fixed ratio rule as described in the Draft is unworkable. The group ratio is aimed at ensuring that the fixed ratio rule does not cause unintended commercial damage in industries with substantial amounts of third-party debt finance. The fact that this approach is not workable for a regulated banking group – which is naturally an industry involving substantial amounts of third party debt finance, given that taking on debt is fundamental to the business operations of a banking group – is further reason to dispense with suggestions that countries apply the fixed ratio rule in alternative ways, and also argues for a broader exemption from the fixed ratio rule for MNC groups for which banking, financing and similar activities are their ordinary course of business.

(7) Working Group Recommendations

The Working Group strongly believes that applying the fixed ratio rule or modified versions of the fixed ratio rule to banking groups is not justified by the low level of BEPS risks posed by such groups, and that to take either route risks causing unintended problems. We support the statement in paragraph 26 that, “In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk is low.” The Draft goes on, in paragraph 27, to state that “there is no need at this time to develop a single common approach to deal with this risk.” We fully agree with this conclusion and would suggest that the OECD’s final report should simply and concisely conclude as such. If no common approach is required, then we would see further commentary as to potential approaches to be unnecessary and inconsistent with the BEPS program, as such commentary could be interpreted by individual countries as representing OECD-endorsed minimum standards. In particular, we disagree with the suggestion that regulated banking and similar groups be broken into two groups in order to apply the fixed ratio rule. The creation of two groups not only excludes the net interest income of the bank group but also the income of the bank for purposes of computing EBITDA. This would put a bank at a disadvantage compared with a non-bank whose operating entities income is used to compute the
allowable interest expense (and would seek to arbitrarily limit the tax relief for a banking group’s cost of sales, again quite unlike the approach taken with non-banks).

Therefore, for purposes of financial services groups that are predominantly engaged in a banking, financing or similar business, we recommend that, as a best-practices approach, countries applying the fixed ratio rule as described in the final Action 4 report expressly exempt such groups. Various definitions could be applied to target the exemption to banking groups and subgroups, including whether the group or subgroup itself is subject to prudential regulation in its headquartered country. Such an exemption is necessary and appropriate both because (i) consolidated regulation of banking groups creates constraints on over-leverage and on interest expense that make application of the fixed ratio rule (or modifications thereof) unnecessary and would potentially cut against regulatory limitations while creating serious harm to the business; and (ii) interest expense has a fundamentally different role in banking groups, i.e. as a vital component of the cost of sales, and we believe it is inappropriate to place an arbitrary limit on the tax relief available for an expense of that nature. Countries that are concerned that, despite the reach and robust nature of banking regulation and capital requirements, some amount of BEPS is occurring in their jurisdictions by such banking groups should be encouraged to look to other guidance produced by the final BEPS reports, including Action 2 (hybrid mismatches), Action 3 (effective CFC rules), Action 6 (treaty abuse), and Actions 8-10 (transfer pricing).

Finally, if the fixed ratio rule is to be applied in any manner that does not exempt regulated banking groups, taxable dividends and other financial services operating income of entities within such groups should not be carved out, and should be treated as equivalent to interest income. To do otherwise would distort the taxation of financial trading profits (i.e., the ordinary income and expenses of a financial institution) and treat debt differently from the manner considered appropriate for the purposes of financial regulation. This is recognized in paragraph 14 of the Draft, which points out that groups with significant investment banking activities in a country, including securities trading, etc., may be funded with debt but produce non-interest income.

There are numerous examples in which this does and will occur, because debt capital can be utilized by regulated entities within a financial group in different financial businesses. Such businesses include: fixed income trading (which generates interest income and trading profit), equities trading (which will generate trading income and dividend income) and derivatives trading. Debt employed in the regulated financial institution’s equities and derivatives business creates an expense in the net interest calculation, but the non-interest trading, dividend or derivatives income generated in such businesses will not offset the interest expense to eliminate any net interest expense if a narrow definition of interest is taken when assessing whether there is net interest expense.

It is worth noting that even for a banking group, it is possible to have a broker dealer and investment bank in a country that does not include a deposit-taking bank. In addition, local market conditions may be such that a banking group’s interest income is suppressed while it may not be able to entirely refinance itself in the prevailing interest environment (for example, some funding may be locked in for a longer term at higher rates than currently applicable). In addition, a country’s definition of interest may
contain elements that would produce unexpected results, leading to net interest expense arising, when applied to a banking business. For example, the UK’s recent consultation considers the inclusion of debits and credits on a range of derivative contracts in the determination of interest, as well as impairment losses, which risks causing banks to have net interest expense when there is no policy need for a restriction on interest deductibility.

In all the above cases the extent of debt in the capital structure of the regulated entity is governed by the applicable regulatory regimes, which guard against base erosion through interest. The effect of attempting to apply the generally applicable fixed ratio rule in such circumstances, without including dividend or other related income as equivalent to interest, would create a distorted reflection of the financial profits of the group.
Appendix

The examples given in the Draft set out the fixed ratio rule as it would apply to a local group including banks and insurers and also to a local group excluding banks and insurers. This illustrates the impact of a disallowance applying where the rules require a carve-out for banks and insurers. The OECD example is reproduced below.

OECD Example:

Assume A Co is a holding company with two subsidiaries: B Co, which is an operating company carrying on non-financial activities, and C Co, which is a solo-regulated bank or insurance company. Assume also that A, B and C Co are all entities tax resident in Country X, which applies the fixed ratio rule using a benchmark fixed ratio of 25%.

Scenario A: Applying the fixed ratio rule to a local group including banks and insurers

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co (operating co)</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>10</td>
<td>70</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td>26</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>25%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>(25)</td>
</tr>
<tr>
<td>Net interest income/(expense) of local group</td>
<td></td>
<td></td>
<td></td>
<td>26</td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Interest taxable/(deductible)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, there is no disallowance because the local group has net interest income. Therefore the group is taxed on 26 of interest income.
**Scenario B: Applying the fixed ratio rule to a local group excluding banks and insurers**

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co (operating co)</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>10</td>
<td>70</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td>(24)</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>25%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>(20)</td>
</tr>
<tr>
<td>Net interest income/(expense) of local group</td>
<td></td>
<td></td>
<td></td>
<td>(24)</td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td>(0.5)</td>
<td>(3.5)</td>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td>Interest taxable/(deductible)</td>
<td>(2.5)</td>
<td>(17.5)</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, the local group now excludes the operating banking/insurance company and therefore has net interest expense. The interest capacity is capped to 25% of EBITDA, therefore there is a disallowance of 4, which is allocated between A Co and B Co (the example assumes allocation on the basis that neither A Co nor B Co has net interest deductions in excess of 25% of EBITDA). Therefore the group is taxed on 30 of interest income.

However, the OECD example does not take into account a scenario where the group has holding companies that mainly produce losses, which could have a greater negative tax impact on banking and insurance groups.

**Working Group Example:**

Assume HoldCo A and HoldCo B are holding companies in a banking group that have no income other than dividend income and incur interest and management expenses. Assume also that Operating Co is a solo-regulated bank tax resident in the same jurisdiction as HoldCos A and B, that jurisdiction having a 20% tax rate.
**Scenario A: Applying the fixed ratio rule to a local group including banks**

<table>
<thead>
<tr>
<th></th>
<th>HoldCo A</th>
<th>HoldCo B</th>
<th>Operating Co</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>(20)</td>
<td>(10)</td>
<td>80</td>
<td>50</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(35)</td>
<td>(25)</td>
<td>150</td>
<td>90</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>30%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>(15)</td>
</tr>
<tr>
<td>Net interest income/(expense) of local group</td>
<td></td>
<td></td>
<td></td>
<td>90</td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Interest taxable/(deductible)</td>
<td>(35)</td>
<td>(25)</td>
<td>150</td>
<td></td>
</tr>
</tbody>
</table>

In this scenario, there is no disallowance because the local group has net interest income. Therefore the group is taxed on interest income of 90 (at the 20% rate of tax, this leads to a tax liability of 18).

**Scenario B: Applying the fixed ratio rule to a local group excluding banks**

<table>
<thead>
<tr>
<th></th>
<th>HoldCo A</th>
<th>HoldCo B</th>
<th>Operating Co (excl. banks)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>(20)</td>
<td>(10)</td>
<td>(30)</td>
</tr>
<tr>
<td>Net interest income/(expense)</td>
<td>(35)</td>
<td>(25)</td>
<td>(60)</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td>30%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>
Dear madam, sir,

The Dutch Banking Association ("NVB") welcomes the invitation from the Committee on Fiscal Affairs to comment on the Discussion Draft on approaches to address BEPS involving Interest in the banking and insurance sectors as published on 28 July 2016. We are happy to provide our comments on the Discussion Draft and trust our input will help to get an even better understanding of the specific situation of regulated banking groups which makes excessive leverage a remote risk.

**Banking groups are highly regulated (Questions 1, 3, 5, 17)**

The Discussion Draft on various occasions clearly and rightly notices that banking groups are highly regulated which means that the risk of excessive leverage in a bank or insurance group is low. We agree that there is less, or even better no, need to introduce tax rules aimed at dealing with a risk that does not exist or is already addressed. The Discussion Draft recognizes that regulators require banks to hold minimum amounts of equity which by definitions limits the opportunities for them to engage in BEPS activities. The required minimum level of equity has different definitions for different purposes and banks must meet them all. The Regulatory capital requirements know only one direction and that is towards higher capital both on a consolidated as well as a stand-alone basis. As there is little risk on excessive leverage in a regulated banking group, we are of the opinion regulated banking groups can remain out of the scope of Action 4.

If the BEPS working group nevertheless still feels the need for interest limitation rules for banking groups as well, we strongly request to take our comments into account.

**Interest expenses to fund non-taxable income (Questions 6, 8, 9, 10)**

Although the Discussion Draft recognizes that the risk on excessive leverage is remote for regulated banking groups, it still has concerns on allocation of deductible interest expenses to fund non-taxable income. The Discussion Draft correctly points out regulatory and commercial constraints for the use of equity but nevertheless fears that banks may excessively allocate their funding to assets

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1 The Nederlandse Vereniging van Banken ("NVB") is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.
generating non-taxable income, e.g. equity participations. We feel that the Discussion Draft insufficiently recognizes that BEPS Action 3 CFC rules and Action 2 Hybrid Mismatches already deal with the BEPS risk relating to non-taxable income from qualifying equity participations and we encourage OECD to notify countries to be careful for overkill if they intend to introduce both Action 2, 3 and Action 4 tax rules.

Further the Discussion Draft fails to recognize situations where banks are forced to acquire equity participations in its clients, such as in default situations where debt is swapped into equity. It goes beyond the objective of Action 4 to apply anti BEPS tax rules to funding allocated to non-taxable income arising from these situations.

**Different rules for non-bank entities in a banking group (Questions 2, 7, 11, 12, 13, 14, 15, 16)**

The Discussion Draft notices that a regulated banking group likely includes nonbanking entities such as Holding Companies and finance SPV’s and that the BEPS risk involving excessive leverage and interest for those entities is similar to that of other non-banking entities. The Draft includes various alternatives and examples for applying the fixed or group ratio rule with exclusions. We advise OECD to encourage countries not to apply different rules to non-banking entities included in regulated banking groups as this may result in unreasonable limitations, administrative and practical burdens and the impossibility for tax consolidation within a banking group. Inherent to being part of a banking group, both regulated and non-regulated group entities enter into all kind of intragroup transactions which cannot without unreasonable effort be eliminated for the purpose anti BEPS calculations.

The Discussion Draft includes various examples where the fixed or group ratio rule is applied with exclusions for interest on bank debt funding. In particular the examples that include Holding Companies earning positive EBITDA are not realistic and it is more likely that the EBITDA of holding companies is negative or close to nihil. We advise to amend the examples accordingly. In your example 2 “Applying the fixed ratio rule to a local group excluding banks and insurance companies” you assumed that Holdco A is in a positive EBITDA position of 10. We amended your example into a scenario where Holdco’s are included with negative EBITDA.

**Example with Holdco’s with negative EBITDA applying the fixed ratio rule excluding banks and insurers**

<table>
<thead>
<tr>
<th>EBITDA</th>
<th>Holdco A (10)</th>
<th>Holdco B (20)</th>
<th>C Co (operating) 70</th>
<th>Local group (30)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest income/(expense)</td>
<td>(3)</td>
<td>(21)</td>
<td>50</td>
<td>(24)</td>
</tr>
<tr>
<td>Benchmark fixed ratio</td>
<td></td>
<td></td>
<td></td>
<td>25%</td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Net interest income/ (expense) of local group</td>
<td></td>
<td></td>
<td></td>
<td>(24)</td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td>(3)</td>
<td>(21)</td>
<td></td>
<td>(24)</td>
</tr>
<tr>
<td>Interest taxable/ (deductible)</td>
<td>0</td>
<td>0</td>
<td>50</td>
<td></td>
</tr>
</tbody>
</table>

We are of the opinion that regulated banking groups should fully remain out of the scope of Action 4 but if the BEPS working group nevertheless prefers to apply different rules for non-banking entities
La Fédération Bancaire Française (FBF), organisme professionnel regroupant l’ensemble des établissements de crédit en France, est heureuse de l’opportunité qui lui est offerte de présenter ses observations dans le cadre de la consultation organisée par l’Organisation de Coopération et de Développement Économiques (OCDE) sur l’action 4 du plan « BEPS », « Approaches to address BEPS involving interest in the banking and insurance sectors ».

Nous avons fait un certain nombre d’observations que vous trouverez dans la note ci-jointe, établie en anglais afin d’en faciliter la diffusion auprès des différents membres de l’OCDE et parties intéressées.

Nous restons à votre entière disposition pour tout renseignement complémentaire dont vous auriez besoin. Vous pouvez me joindre au 33 148 00 50 73.

Je vous prie d’agréer, Madame, Monsieur, l’expression de mes salutations distinguées.

Blandine LEPORCQ
Directrice du département fiscal
COMMENTS FROM THE FRENCH BANKING FEDERATION ON THE APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS (ACTION 4)

We welcome the initiative of the OECD to complete its work on rules for the financial services sector in relation to Action 4 and would like to thank you for the opportunity to comment on the approaches to address BEPS involving interest in the banking and insurance sectors.

It is important for us that a close dialogue be maintained with companies, including on the practical implementation of the measures decided by the states within the OECD.

1. Executive summary and proposed approach

We welcome and acknowledge the position of the OECD in the Discussion Draft, that states that "...excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low ... [para 26]".

Banks are heavily regulated, and the regulatory environment for the banking industry is an important constraint that highly mitigates BEPS risks involving interest deduction in this sector.

We propose that the following approach be adopted:

1. The OECD should endorse a position stating that:

   - interest is the primary raw material upon which is built the banking activity: interest paid by banks is equivalent to the cost of goods sold by non-banking businesses. Introducing global rules limiting the deduction of interests would be counterproductive and could even trigger collateral effects that could be detrimental to some banking activities;

   - the regulatory constraints, that apply both locally and globally to the banking sector can effectively eliminate interest related BEPS risk;

   - so-called "non-regulated" activities carried out by banking groups — that are marginal as a general rule— are either actually specifically regulated -because regulators look toward tainting risks for the banking activities- or indirectly regulated through regulatory constraints that apply to banking groups globally. There is therefore no basis for considering these activities separately.

2. This situation justifies a full exemption for banking groups from any global action on interest deduction limitation in BEPS Action 4.

3. Instead, if a specific situation creating BEPS risk through interest deduction happened to be identified by a country within a banking group, this country after having assessed the situation with local regulators, may introduce an anti-avoidance rule targeted at the specific risk/behaviour identified. Such targeted rules, if any, would have anyway to be adapted to the banking activity (e.g. EBITDA as defined today is not applicable), to consider banking activities that may face a net interest expense -as could for instance be the case for corporate and investment banking activities where revenues are not always
interests but also trading and commission revenues, to be consistent with local regulatory rules and across jurisdictions for the sake of clarity.

4. Finally, as far as attribution of profits to permanent establishments is concerned, this should also be exempted from any general or specific rules, as the 2010 OECD Report addresses any BEPS risks which may exist in the context of permanent establishments.

2. General comments

2.1. Banking industry first specificity: interest is our raw material

Interest is the primary raw material upon which is built the banking activity: banks borrow from depositors or in the wholesale market to provide lending to individuals, SMEs, corporates and governments at a margin over cost of funds to the bank, or to carry-out other banking activities. The interest expense is a cost of sales for the bank, a key resource involved in a bank’s products. Because financial institutions borrow and lend as their core activity, limiting the interest deductibility for them would be comparable to limiting the deduction of costs of acquisition of fruits and vegetables for greengrocers.

2.2. Banking Industry second specificity: regulation

It is of the utmost importance to remind the regulated environment in which banks operate.

- The regulatory environment in which banks operate is directed to ensuring that banks (both as a group and on a stand-alone basis) have significant levels of non-tax-deductible capital, typically ordinary equity and retained earnings. This is especially so as a result of the Basel III capital adequacy rules introduced after the 2007-2009 global financial crisis. The need for banks to maintain high levels of equity will also increase under Basel IV rules.

- Many types of regulatory capital are not treated as debt under domestic law and therefore do not generate tax deductions. The regulatory capital of a bank will typically consist of ordinary equity (Common Equity Tier 1), retained earnings/reserves and funds raised through various kinds of hybrid financial instruments (Additional Tier 1 instruments). The bank will also have ordinary debt instruments on issue. In many countries, only the cost of servicing Tier 2 instruments (and only some Tier 2 instruments) and ordinary debt are deductible.

- Banking regulators will seek to ensure that debt is not disproportionately re-allocated to particular entities by intra-group transactions.

- For banking groups that operate cross-border, levels of capital adequacy in these entities are often assessed by regulators in two countries and not just one only. It is not the case that national banking regulators will simply accept compliance with foreign capital rules as satisfying local requirements as well.

These different factors explain the OECD conclusion –to which we concur with- that, ‘excessive leverage in a bank or insurance company has not been identified as a key risk ...’ [para 26].

This is a key observation that should be more prominent and shape all the OECD’s work in this area: the OECD should much more clearly state that the absence of evidence about BEPS-related concerns means the banking sector should be outside the scope of any specific national actions that might be taken in response to BEPS Action 4.
Similarly, the OECD should state more clearly that governments can have confidence that excluding banks from any national response is not problematic for those reasons and the reasons set out below.

We make this suggestion as the Discussion Draft gives the impression that the main point is to assist the OECD to devise a better interest limitation rule (whether a fixed ratio rule or a group ratio rule) tailored for banks only.

We consider, on the contrary, that the project should have been framed differently: assessing the viability of allowing banks and banking groups to remain outside the scope of any national BEPS-inspired interest limitation regime altogether and the circumstances in which that can be allowed to occur.

Some passages in the Discussion Draft give the impression that in the modern banking industry, it is just the entity which conducts banking operations which will be subject to control by the banking regulators although the Discussion Draft does refer to “Regulators [which] require capital ratios to be met at the level of a worldwide group, a regional group (e.g. in the European Union) and/or a local group (e.g. including all group entities in the same country) [para 146]”

2.3. Case of “non-regulated” entities included in regulated banking groups

As far as “non-regulated” entities included in regulated banking groups are concerned, it should be noticed that:

- Banking regulators will insist on adequate capital levels for non-bank entities within a banking group. As a matter of fact, banking regulators care about the possibility that a non-bank entity within a group could produce spill-over effects causing the collapse of the bank and so it is often the case that a non-bank entity in a group will have its own specific capital adequacy requirement in effect imposed by the banking regulator.

- Local regulators will look to foreign holding companies (as well as the local entity) in deciding whether the local entity is sufficiently well capitalised, as the existence of parental support is an important matter in assessing the adequacy of loss-absorbing capital in the local bank.

- All these entities, as a result of their inclusion within a regulated banking group, are *de facto* indirectly regulated through global capital adequacy requirements. Furthermore, these activities are very often marginal within a banking group when assessing their part in revenues.

- Other arguments against separate consideration of “non-regulated entities” are given in § 2.5. below.

2.4. Full exemption of any global measure for Banks and Banking groups

To this extent it is of the utmost importance to give priority to banking regulation: the regulatory regime is the appropriate place to locate rules about capital structure, outbound cash flows, and so on. Both tax and banking regulators have the same interest in ensuring that excessive
amounts of funds do not flow offshore, that amounts (which might be available to meet claims on the bank) are not retained offshore, and that there are adequate levels of equity in each segment of the group in each country in which it operates. Handling any base erosion concerns through the regulatory regime ensures there is no conflict between competing regimes and regulators, and minimises the compliance cost for banks.

The sourcing and the allocation of funds within a banking group is driven by circumstances that do not apply for commercial and industrial firms. While commercial firms have a great deal of flexibility about how and where to source funds for their operations, banks generally do not.

In practice it is unlikely for a bank to be materially overleveraged because of the regulatory environment and also of the many commercial pressures that influence banks raising funds in the market. These commercial pressures apply directly to banks' issuing entities (generally the parent or holding company) and this makes capital a scarce and valuable resource within a banking group. Therefore there are strong commercial reasons for banks not to engage in activity which may pose a risk of interest related BEPS. General anti-avoidance rules and the OECD action on hybrids will also complement a number of these risks.

In summary, the further work undertaken in the Discussion Draft demonstrates that the case for including banks (and corporate groups containing banks) in a general interest limitation rule – whether a fixed ratio rule or a group ratio rule – has not been made out, especially when we read the following OECD remarks:

- "excessive leverage in a bank ... has not been identified as a key risk" [para 26]
- "there are a number of potential benefits from excluding banks [entirely] ... from the scope of the rule" [para 32]!

Without evidence of harm and considering benefits from not including them in the rule, the final report should reflect that and recommend leaving banks and banking groups outside the scope of any BEPS-inspired general interest limitation rule.

Given the protection provided by the regulatory environment (already recognised by the OECD in its final report on interest limitation rules published in October 2015) and by transfer pricing principles which govern the interest rates that can be charged on loans, we favour an exemption from the general fixed ratio rule for regulated banking groups, and we do not believe that further restrictions on the tax deductibility of interest expense for banks and regulated banking groups are required. That exemption should apply to the full group, where the group is predominantly banking. Such a definition could reference regulatory supervision or oversight of the group as a whole.

Introducing a tax rule which would limit the deduction of financial expense would not only be unnecessary but counterproductive: it would create tension with the extremely complex regulatory prudential framework and would potentially trigger collateral detrimental effects to some activities.

2.5. Targeted anti-avoidance rules may be more appropriate

Instead of setting global rules, we do think that tax authorities should review their domestic regimes to identify whether there can be interest related BEPS risks that are not addressed and appropriately constrained by regulation.
Should an interest related BEPS risk be identified, tax authorities should first check with regulators if and why that risk is not constrained, and whether any proposed tax rules would conflict with the aims of regulators the applicable banking regulation.

Tax authorities should then apply case-by-case targeted anti-avoidance rules to remaining interest related BEPS risks, if any.

Such rules would have to be very carefully designed, in order to avoid collateral effects that may be detrimental to some activities. Among others, the following points would have to be carefully taken into account:

- The presumption that banks would likely be out of the scope of interest deduction limitation rules as they should find themselves in a net interest receivable position should not be overestimated. Indeed, there are a number of circumstances in which banks may find themselves in a net interest expense position (for instance corporate and investment banking activities for which revenues are not only interests but also gains on financial instruments, commissions, and so on). A limitation rule that would not take into account this situation would result into a detrimental outcome for some activities.

- The application of a fixed ratio rule to banks would entail specific problems. Indeed, as far as EBITDA is concerned, its current definition appears to require a bank to disaggregate interest from derivative transactions, prime brokerage and numerous other transactions. Also, other type of income such as dividends or capital gains which represent trading income for banks should be taken into account which altogether with the interest represent the NBI (net banking income) of a bank. Appropriate definitions of interest and EBITDA as it applies to banks would be needed.

- Potential targeted anti-avoidance rules would have to consider the situation of a banking group as a whole, and the so-called “non-regulated” and holding entities should not be considered separately. To that extent, the following should be considered:
  
  - A banking group may hold funding and capital at the level of a holding or funding company which would not meet the definition of a banking company, and would therefore not be included in the calculation.
  - Within a regulated group, non-solo regulated entities are likely to be subject to the group regulators’ supervision as explained above. Such entities will be subject to group-wide supervision by regulators who will look at the position of the group as a whole. The group position could result in additional capital requirements being imposed on a banking entity or a parent of a banking entity. The exclusion of the non-solo regulated entities brings with it the risk of dislocating sources of funds from revenue generating activities.
  - Tracing the debt established by a banking company is likely to be difficult since funding is fungible. Allocating on a pro-rata basis is very unlikely to provide a result which is either fair and reasonable or proportionate and will present tax positions which will differ from the views of regulators and on which the business is driven, and will not be consistent with the approach adopted to non-banking businesses.
  - Excluding banking companies and their funding structures would leave non-bank entities in a banking group to apply a fixed ratio rule to the remaining entities or to the remaining sub-groups. If those companies do exceed the fixed ratio rule, it is unlikely that the group ratio would offer protection as overall banking group is likely to be in a net interest income position; they would therefore be potentially penalised in a way inconsistent with equivalent operations held by non-banks.
  - Where the non-banking entities are funded from the banking business, there will also be double taxation within the banking group, as interest which is paid to the funding entity may be caught within these rules, even though it would not have been caught if
the full group was in scope, and does not in fact represent a BEPS risk since it is paid within the domestic tax net, with the bank remaining fully taxable on the corresponding income. Segregating a group in this way would impose a standard higher than that under current Action 4 and would be inconsistent with the approach applicable to other industries.
OECD Public Discussion Draft - BEPS action 4: Approaches to Address BEPS involving interest in the Banking and Insurance Sectors. Reaction from Febelfin, the Belgian Financial Sector Federation

Febelfin (Belgian Financial Sector Federation vzw/asbl)
Lobbyist Identification number : 1938561921-91
Organisational Unit: corporate tax
Line of Activity: Tax Affairs
Contact: Clio Célis – cc@febelfin.be ; Rodolphe de Pierpont – rp@febelfin.be

Febelfin vzw/asbl (non-profit association) is the Belgian Financial Sector Federation. It tries to reconcile the interests of its members with those of the policy makers, supervisors, trade associations and pressure groups at the national and European level. Febelfin vzw/asbl defends the interests of all its members: large banks, small and medium-sized banks, niche players, providers of infrastructure, etc. It speaks on behalf of the financial sector as a whole (except for the insurance companies). Febelfin’s mission consists of the following:

- defining positions held by and on behalf of its members
- lobbying at the national and European level and taking part in social negotiations
- providing services: providing information, comment and counsel as well as training via Febelfin Academy
- Communicating with its members and the public at large and taking part in the debate on professional, political, social and educative matters.

First, Febelfin welcomes this opportunity to comment on the OECD Discussion Draft on BEPS, action 4 “Approaches to Address BEPS involving interest in the banking and insurance sectors”, issued on 28 July 2016. This is a major issue and concern for the sector.

Febelfin understands the importance of the Base Erosion and Profit Shifting (aka BEPS) project and the OECD’s expectation which are in line with the legitimate objective of combating tax evasion.

In our opinion, the measures proposed within the framework of BEPS should remain as consistent as possible and as commensurate as possible with the aim which has been set, and with the real risks of international tax evasion. The specific character of the banking and finance sector must be taken into account, given the fundamental differences with the other ‘traditional’ production or services provision sectors.
On the one hand, this has directly to do with the sources of funding for financial institutions, which rely on these in addition to the obligatory or legal capital ratios. Any unwise limitation would affect the stability of the financial system.

On the other hand, interests are a ‘core-business’ of the financial sector, because the balance sheet assets consist, to a large extent, of claims corresponding with lending to companies, private persons and public authorities. The balance sheet assets of financial institutions also include participating interests in several companies which are also active in the field of corporate lending.

As a matter of principle, mechanisms for aggressive tax planning are out of the question, be it as for the sources of funding or as for the assets.

One should also bear in mind that the sector must comply with extensive regulation and supervision, at the international level when it comes to groups which are active in various countries. Consequently, Febelfin is in favour of an adequate carve-out aimed specifically at the financial sector institutions.

Furthermore, Febelfin pleads for maintaining the current exception as for the banking sector, the funding of which by means of debts has no link whatsoever with an international tax evasion scheme.

Given those regulatory supervision of the banking sector with the objective of financial stability and soundness, in the majority of cases, the BEPS risk in our view will be rather low, if any.

For further observations and details, we refer to the headlines of the BIAC and IBFED responses we endorse for the biggest part. Anyhow, additional serious and fine-tuned analysis obviously will be necessary.

As for the situation of the insurance companies as well as a number of technical details, please find more specific comments below:

a. We think it is necessary to provide solutions which correspond with the activities and specific character of the financial sector. There is indeed a kind of resemblance, but also a fundamental difference between the insurance and banking sector, which may justify a different approach for both sectors. We think that there is a need for looking into this aspect more in detail.

b. The place and role of some branches and subsidiaries of financial groups such as the leasing and factoring companies should also be carefully examined.
Leasing and factoring are both very important sources of funding for companies, with a rather different legal and accounting treatment. As such, they can be perceived as playing a similar role as banks in the funding of the economy. Most of the times, those activities are organized in Belgium within a separate legal entity. So, just like banks and insurance companies, leasing and factoring companies are providers of (indirect) debt finance to groups in other sectors. The own funding of these activities could be jeopardised by an approach which is too limitative.

We think that, given their nature, leasing and factoring companies should be treated in order to avoid unintended consequences and any kind of unlevel playing field. No distinction should be made between companies that are part of a banking group and companies that are not.

Hence we propose to include leasing and factoring companies, either as part of a banking group (group approach) or, for non-bank related leasing companies, based on their status as regulated activity.

c. This consultation clearly calls for additional technical efforts and reflection in the field. For that purpose, Febelfin can easily ask the field workers for their counsel in order to make an analysis of the special characteristics of the situation.

It goes without saying that other considerations may be added to this list, all the more because there is still a need for a more comprehensive analysis of the field situation for the purpose of identifying the specific situations which would lie outside the context of tax evasion.

It would also be wise to take time for looking into the special character of the financial entities and the funding by lending activities, such as leasing, so as to avoid a future situation in which problematic and unwanted consequences must be rectified.

We would like to point out that the implementation period by all means should be realistic.

The OECD recommendations definitely should take into account the comments from the financial sector, because the avoidance issues should not be solved by unintended negative treatment nor by a distortive double taxation situation.

Attachment : links to the BIAC and IBFed responses
Dear Sirs

Response from FTI Consulting to the OECD public discussion draft on BEPS Action 4 “Discussion Draft on Approaches to Address BEPS Involving Interest in The Banking and Insurance Sectors”

We welcome this opportunity to present our comments on the OECD public discussion draft on “Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors”.

Thank you for this opportunity and we hope that our comments are helpful.

Yours faithfully,

Marvin Rust

Additional Contributors:

- Ruth Steedman
- Ben Tausig
BEPS Action 4 “Discussion Draft on Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors”

Introduction

Thank you for this opportunity to respond to the discussion draft on the Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors.

While key questions about the regulatory status of banks and insurers have been considered in some detail in the discussion draft, and this is warmly welcomed, we would start by noting that it may be worth revisiting four key points which are not expressly addressed.

i. Many of the difficulties addressed by the discussion draft start from the assumption that the aim is to adapt the Action 4 rules in the context of banking and insurance groups. However, for reasons cogently explained at paras 13-15 of the discussion draft, the fixed income ratio and group income ratio rules centre on EBITDA. However, this is an inappropriate starting point for banks and insurers. Interest is core and not incidental to their business and therefore basing BEPS controls on measures which start by stripping interest on either side of the balance sheet will, with few exceptions, be inappropriate. There is a risk of individual countries being unable to devote sufficient time and expertise to coming up with workable alternative models. A more detailed OECD working group to evaluate alternative starting points would be likely to be a better approach: while it is recognised that it may not be possible to arrive at consensus, providing more detailed implementation options, based on more detailed analysis and scenario modelling would make a very positive difference. There is significant risk that if the jurisdictions are required to work out individually a suitable method of modifying the fixed ratio rule and group income test, or providing exceptions to these, a complex, elaborate and internationally inconsistent set of rules will result.

ii. The extent to which interest is core to the business of banks and insurance companies means that in general, even leaving formal regulatory requirements aside, other factors are likely to be more important than tax in determining funding structures – specifically market conditions and overall business opportunities, the requirements of rating agencies and the need to match funding profiles. EBITDA is widely regarded as a relevant factor for non-financial companies in a broader economic context: it is equally well established that it is not an appropriate measure of banks’ and insurance companies’ performance. Specifically, in a stressed situation where impairments or claims mean there is no net interest income, they risk increasing stress on an institution because of unexpected disallowance of tax relief on a key element of its operating costs. Particularly given the absence of strong evidence of BEPS in regulated groups, a better targeted approach is required. It is not clear why this cannot be provided through the combination of regulatory restrictions, appropriate CFC rules and Action 2. A more extensive working group programme would also enable it to be established whether BEPS remains a significant concern for regulated entities after the effect of the other BEPS actions is taken into account, particularly on action 2 and CFC changes.
iii. The current low/negative interest rate environment is imposing significant pressures in many jurisdictions on traditional banking and insurance business models, particularly in markets such as the UK where universal free personal banking is an established expectation. As groups try to readjust both their business and funding models to deal with this, a transitional period to implement the new Action 4 requirements would be particularly welcome.

iv. There is a need for solutions to be workable, and not to impose disproportionate compliance burdens. The examples in the discussion draft demonstrate effectively both the complexity and potentially arbitrary results which may arise across jurisdictions without a clearer framework.

Specific questions raised by the discussion draft have been addressed below, but some of these are based on assumptions about approach which we believe should be re-evaluated. We recognise that there will be pressure from different jurisdictions to accommodate existing national approaches where these are considered to work well, and the proposal to publish details of specific jurisdictional provisions at para 40 is particularly welcomed, but we would strongly advocate an approach which provides international consistency, possibly allowing jurisdictions a choice between two options available to allow for local sensitivities.

Answers to questions

Please note that where questions are grouped in the discussion draft we have followed the grouping and discussed the issues together.

1. Categories of BEPS risk not identified

The summary here appears to presuppose only two types of group for categorisation of risk – solo regulated bank and insurance companies and other entities within a group, including holding companies. It is recognised that groups involving multiple businesses, some of which are and some of which are not banks and insurers present special difficulties. However, many jurisdictions, including the EU, apply regulatory requirements not only at a solus entity level but also to consolidations. Normally such consolidations will be at the level of a topco (by determined criteria) or a topco within a specified jurisdiction and therefore include some or all holding companies.

It might be more useful and appropriate to think of groups in the following way

1. Single jurisdiction groups (there are still many smaller banks and insurers which are local), which could be excluded

2. Groups where all entities are either solo regulated or within a regulated group subject to consolidation rules

3. Groups which are not single jurisdiction groups but where there are significant entities (say more than 5% of group profits/balance sheet) which are not either solo regulated or part of a regulatory consolidation.
If artificially high amounts of debt were pushed into an entity in a high tax jurisdiction which
was itself a non-regulated entity or holding company, a tax consolidation or grouping regime
could allow (as para 9 notes) offset of the interest expense against bank/insurance profits, but
this should not arise where consolidated capital rules apply. Similarly, regulatory controls
should be sufficient to prevent this for single jurisdiction groups (regulators would restrict
exposure to non-regulated parts of groups as well as third parties/other jurisdictions). This is
acknowledged at para 16 of the discussion draft but it would be helpful if at the next stage the
implications of this could be followed through.

2. Other considerations in relation to the role of interest in banking and insurance

As noted above, in many jurisdictions we are currently in a low/negative interest environment
without recent precedent. The outcome for traditional banking and insurance models is still
uncertain, and therefore transitional period before the adoption of new restrictions on interest
deductibility would allow for further evaluation of likely impact, given impact on margins.

While the objective in general for both banking and insurance would be to achieve net interest
margin factors which mean this may not be achieved include

- Mismatch between different currency interest rates

- Impairments, claims profiles or other core business outcomes which may
  disproportionately affect a particular jurisdiction

- Forex exposures

- For investment banking
  - Fee based business (including advisory)
  - Equities broking/trading outturns

- Start up or business transition/restructuring costs

- Funding profile mismatches (where long term debt, for example, at higher fixed interest
  rates, funds short term lending/deposits on which rates have decreased)

Additionally, funding HQLA has a negative overall effect on margin for banks: this may combine
with any of the factors above to exacerbate this effect. Further, the treatment of collateralised
repos and stock loans is not addressed. Some more detailed research and modelling across
jurisdictions would be helpful here before solutions are determined. We note that due to
different economic conditions and business mixes, all these factors may – and frequently will -
have significantly different effects within different jurisdictions for a multinational group,
etirely absent tax considerations.
Therefore, while it is agreed that there could be situations involving BEPS through interest where the general Article 4 approach does not address the problem at all because the group has net interest income, it seems likely there will be a larger number of cases where, in the absence of net interest income, applying the fixed ratio role would give a wholly inappropriate outcome in the light of normal levels of gearing for banking and insurance groups.

3. **General issues related to the impact of regulatory capital rule on the level of leverage in a bank or insurance company**

As noted above, in many jurisdictions these restrictions apply on a consolidated basis and not just to solus entities. Adapted approaches are therefore required for entities within a consolidated group.

While it is recognised that of course the regulatory constraints are driven by what regulators consider will protect the banking system, not tax issues, as noted at paragraph 20, regulators are also seeking to ensure that levels of debt are not excessive. In effect, by comparison with risks that banks might take without regulation, post-crisis regulators are already imposing strict funding limits. It is recognised that approaches will vary by jurisdiction, as noted at para 19, but the document does not identify evidence that the variations extend to allowing levels of debt which would create BEPS risk. While certain classes of regulatory capital may be debt (typically tier 2 and a very limited slice of tier 1) this is a separate issue: such instruments will almost invariably be hybrids and CFC and anti-hybrid rules should offer sufficient protection against BEPS risk.

A key problem with the proposal that individual jurisdictions should design their own modifications to the standard Action 4 measures is that it is likely to result in complexity and arbitrary differences between the treatment in different jurisdictions which result in a lack of overall relief for appropriate group funding costs. The concern addressed by Article 4 is the distortion or dilution of taxable profits through interest diversion and, while there are complexities around non-banking/insurance entities in mixed groups, there does not appear to be evidence supporting the need for additional measures for solus regulated entities. Rather, as paragraph 26 notes, the risk with such entities is low.

Further, if the measures adopted involve subjective criteria or tests the outcome of which may be uncertain, in the absence of an effective dispute resolution mechanism, international groups may be presented with real difficulty and unacceptable costs in achieving an appropriate outcome. It would be helpful if more detailed guidelines or recommended approaches could be provided through further working group exercises.

4. **Operation of the authorised OECD approach and the impact on level of free capital**

There is already significant difficulty operating with the actual allocation/arm's length test for PEs and this can give rise to particular complications for entities with multiple branches – a structure often chosen for regulatory efficiency or to avoid unnecessary administrative costs. Different regulatory and tax approaches between jurisdictions mean that some entities are already unable to obtain deductions for overall financing costs. It is crucial in policy terms (and in some cases a legal requirement) to ensure a level playing field between PEs and entities, so
that the choice between type of establishment is not distorted by tax discrepancies, and we would therefore suggest that further complications in calculating allowable deductions for PEs should be avoided in the absence of evidence of BEPS risk.

5.  **Concerns and approaches adopted; and**

6.  **Existing approaches where BEPS risks identified**

Again, the main concern here is workability: the paper falls short of recommending an approach and this suggests it will be left to countries to determine individual approaches, including applying general article 4 tests for other sectors which, for reasons noted elsewhere in the discussion draft, is not appropriate for banks and insurance companies.

7.  **Other considerations re application of fixed ratio rule to banks or insurance companies**

The difficulties noted at para 31 depend on the approach adopted to grouping. The potential implications of disallowance noted at the second bullet of para 32 are significant and non-sustainable. Both are clearly inappropriate in policy terms, and could lead, in a year involving a major claim event or series of events or impairments on major loans or sector loans, to an entity finding that complete interest disallowance exacerbates the group position and to tax charges being completely divorced from both economic and accounting profits. The uncertainty around this may also impact deferred tax recognition in some circumstances.

The assumption inherent in the document is that the fixed ratio test represents the baseline to apply to banks and insurance companies, and the question is how this is to be applied or modified. However, from a strategic perspective, for the reasons set out above and generally accepted in the discussion document, EBITDA is not an appropriate proxy to use in testing for interest disallowance for banks and insurers. From a policy perspective it would be preferable to work from a baseline which involves testing actual interest deductions against a reasonable arm’s length test for interest in a context where decision making as to the amount and location of debt is not distorted by tax considerations.

We would suggest that for banks and insurers this means either accepting that current post-crisis regulatory standards impose sufficiently stringent tests or

- Identifying an internationally appropriate debt:equity level appropriate for each of banking and insurance, different from non-financial entities (perhaps an adapted level based on Basel III with an additional buffer inbuilt)

- defining the elements to be taken into account (probably also relying on regulatory definitions, which has the additional benefit of reducing the compliance burden and ensuring that tax authorities have an alternative way of checking calculations)

- providing for a carry forward regime appropriate for shock events.
8. **Other considerations re using interest to fund non-taxable income;** and

9. **Current approaches by countries to funding non-taxable equity income**

In some cases this is a point of limited relevance for banks and insurers as dividend income (for example in the UK) will be treated as taxable where it forms part of a financial trade. In policy terms, there is therefore no reason to make special provision for the treatment of interest. A similar approach might be workable in other jurisdictions, although it can create some practical difficulties in determining the status of particular income streams. Rather than introduce further complexity, a CFC regime that would include the income of the subsidiary in the low-tax jurisdiction unless there was sufficient substance, might be an appropriate approach.

An alternative is some form of interest allocation rule, or anti avoidance test. If applied in a banking/insurance context, this would need however to allow for two situations:

- Complex and dynamic transaction patterns within a regulated entity which would make an allocation rule difficult to apply: it would be preferable to rely here on regulatory constraints

- A context where a holding company for a regulated group takes on funding which in the entity itself is matched by equity holdings and not pushed down as debt, but which funds taxable activities in a banking or insurance subsidiary, and forms part of the consolidated regulatory group. This is particularly common given regulatory focus in many jurisdictions on a “single point of entry” structure. Regulators are requiring funding to be taken in at topco level: and external funding at topco level is also common for practical reasons with some public issues and private placements.

10. **Funding non-taxable equity income on an investment in a permanent establishment;** and

11. **Targeted rules to address specific risks**

Again, the main concern here is workability: the paper falls short of recommending an approach and this suggests it will be left to countries to determine approaches individually. It would be helpful to individual countries to provide suggested approaches and evaluate these: this would also be likely to result in greater level of consistency for international groups and reduce the likelihood of double taxation. The position for PEs will need to correspond to that for entities, but will be more complicated to determine because of the different approach to regulation. Specifically, with PEs, the regulatory position will in some cases be determined by the entity jurisdiction rather than the PE jurisdiction, so as noted at 4 above, an appropriate measure of arm’s length attribution will be required.

12. **Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account**
We agree that the key issues have been identified: concerns relate to giving more guidance on preferred, practicable and workable solutions which manage BEPS risk while not risking denial of deductions for a core business expense because of a formulaic approach which is not adapted to FS businesses.

In our view, for local groups subject to consolidated regulation where substantially all of the activity is banking or insurance, a broad carve out for the entities subject to consolidated regulation from the fixed ratio would be more appropriate.

We do however recognise that the question of “mixed” groups is particularly complex. It would be worth assessing whether a “ring fence” between non-financial and financial activities would be a more workable solution than the Appendix examples. For holding companies, assessing whether the company is part of a consolidated regulatory group should in most cases provide an appropriate solution.

13. Additional practical issues arising from the modification to the fixed ratio rule?

We agree with the points flagged at 55-56 in relation to regulatory capital – at a practical level these issues are likely to be important for a number of groups and excluding regulatory capital would provide a partial solution. However, where debt is appropriate on an arm’s length basis and interest is fully taxed in the recipient, the fixed ratio/group ratio rule may still give inappropriate results if this is applied to banks and insurers. Annex 3 Example 5 assumes disapplication of the fixed ratio rule and exclusion of net interest on regulatory capital, but it will be important that such disapplication is available, as the example illustrates.

14. Should any other modifications be considered in applying the fixed ratio rule?

See comments above, particularly at 12 and 13. Again, the main concern here is workability: the paper falls short of recommending an approach and this suggests it will be left to countries to determine individual approaches.

The examples in Annex 3 all assume a significant level of EBITDA excluding the interest income of the financial services entities. However, in practice, this is unlikely to be the case; indeed many groups will have holding companies that incur expenses but do not have significant income and thus are in a negative EBITDA position. Using that fact pattern to modify example 2 outlined in Annex 3, there would be an additional £20m restriction in the deductions claimed for the interest expense.

As noted above, it would be helpful for the next stage of evaluation to involve a more appropriate framework than metrics based on EBITDA. We would also recommend that jurisdictions are encouraged to adopt a wider carve-out is applied to all entities subject to consolidated regulation in a jurisdiction, reflecting the constraints that consolidated regulation imposes.
15. Additional practical issues arising from approach to applying group ratio rule for entity in a group with a bank/insurance company; and

16. Other approaches

For some groups a “ring fencing” approach where the outcomes and rules applicable for banks and insurers are separately applied from other elements in the group would be helpful, and would allow recognition of the specific factors.

The first three of the approaches suggested at para 65 to dilute or qualify the Action 4 requirements for non-FS groups would involve contrasting levels of operational complexity for different groups. Further, it is difficult to see that the first (group ratio rule) or third (higher benchmark fixed rate, but without a suggested level or clear articulation of the basis for this) would be particularly helpful. The third approach might work for a group with a small FS business which has limited support role for the rest of the group (e.g. sale of insurance to support group product sales, or a bank to provide finance supporting product sales), because the overall impact on the group would be limited. However, for groups which are complex financial services groups involving banking, insurance and non-banking FS activities (advisory, investment management, consumer credit etc.) this would be most unlikely to provide outcomes which are defensible in policy terms by reference to arm’s length norms.

Option 2 which is a kind of ring fencing, might operate more successfully as noted above but requires jurisdictions generally to provide a general exclusion for regulated entities and regulatory capital. For the reasons indicated, we would suggest it would be important also to exclude holding and other companies within the consolidated regulatory group and not merely solus regulated entities.

Option 4 involves disregarding all the factors identified which make it inappropriate to apply a fixed ratio rule to banks and insurers. It is difficult to see how it could produce an appropriate result.

17. Other comments

For the reasons noted above, a further working group exercise to arrive at clearer recommendations before proposals are finalised would be a necessity in our view in ensuring both practicality and consistency, and to give time to consider how the proposals on action 4 interact with other elements of BEPS.

End of response.
Draft GFIA response to the OECD Discussion Draft on BEPS Action 4
Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

Summary

- GFIA supports the OECD’s broad objectives in combating aggressive tax planning through excessive leverage and inappropriate interest deductions. However, it is critical that any measures adopted by the OECD are workable, well targeted, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers. In addition, as noted by the OECD in paragraph 6 of the Discussion Draft, any approaches adopted by the OECD “should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis”.

- GFIA's recommendations below are consistent with promoting high capital levels to ensure the safety and soundness of financial institutions.

- GFIA welcomes the fact that the OECD recognises in paragraph 26 of the Discussion Draft that “excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this BEPS risk will be low”. The OECD also correctly states that existing regulation acts as a safeguard for any insurance BEPS risk. In addition, other factors restrict excessive leverage in the insurance industry including:
  - financial strength is a critical requirement from a marketing perspective, as consumers look to purchase insurance from sound strong insurers
  - commercial constraints (eg. credit rating agencies) require insurers to hold more than just the minimum required amounts of equity and restrict their ability to hold excessive debt (as the OECD notes in paragraph 5 of the Discussion Draft).

- GFIA therefore recommends that any general rules to address BEPS should apply to insurance groups as a whole (insurance and noninsurance entities combined) without excluding stand-alone insurance companies in that group. Where tax authorities identify specific insurance structures that may require special rules from a BEPS perspective, any such special rules to address those specific structures should be created only after consultation with the industry and should complement the general rules. GFIA believes this would be the most effective way to address any specific issues with insurance structures.

- In the Discussion Draft, the OECD proposes a different solution: a fixed ratio rule which would apply to groups but exclude stand-alone insurance companies from that group. GFIA has strong concerns with this approach because such a calculation of the fixed ratio would exclude the interest...
income and operating profit of insurers but would include the full amount of interest expense on
debt issued at the holding company level. This would likely lead to an inappropriate interest
restriction because, under such a calculation of the EBITDA, the EBITDA of many insurance
groups would be negative and most interest would not be deductible.

Therefore, GFIA believes that this approach is flawed and would unduly affect many insurers that
have a non-financial holding company which issues debt and uses the proceeds of the debt to
subscribe for equity in the insurance company. The use of equity rather than debt to fund the
insurance company is in this case generally a requirement of insurance regulators who prefer the
most permanent, loss-absorbing form of capital. As such, it is certainly not a decision which is
made by the insurance group for BEPS purposes. Excluding the operating profit of the insurer in
applying the fixed ratio rule is clearly inappropriate in such circumstances.

When the activities of an insurance group consist mainly of insurance-related activities, there are
very limited or no earnings in the non-insurance part of that insurance group. This differs
significantly from non-financial groups for which the main source of earnings that constitutes the
basis for determination of the interest deductibility will be included under the fixed ratio rule. GFIA
believes that applying a fixed ratio rule to the non-insurance part of an insurance group only (or
separately) is not appropriate.

The OECD recognizes that non-deductibility of interest may not be appropriate in the case of
instruments that support regulated banking or insurance activities. The OECD proposes a way to
address this in paragraph 56 which is only partially effective because, while it provides in principle
an exclusion for third party interest on regulatory capital, it still includes other third party interest.
Including non regulatory debt within the scope of the rules could result in inappropriate interest
restrictions even where an insurance group is not excessively leveraged.

Finally, GFIA strongly recommends that insurers' existing debt should be excluded entirely or at
least benefit from a transitional period for the remaining term of the debt to allow for the most
efficient restructuring of the debt, a big part of which is long-term debt that cannot be repaid or
renegotiated before the end of that remaining term without cost or penalty.

Answers to consultation questions

1. Are there any categories of BEPS risk involving interest posed by banks or insurance
   companies, or entities in a group with a bank or insurance company, not identified in the
discussion draft which should be focused on as part of this work? If so, what are these risks
   and how could they be addressed (either through the approaches set out in this discussion
draft or otherwise)?

3. Are there other any general issues related to the impact of regulatory capital rules on the
   level of leverage in a bank or insurance company that should be taken into account? It
   should be clearly identified where these are issues relevant to all or a large number of
countries or where they concern a particular country’s regime.

In all jurisdictions, insurers are subject to prudential regulation which acts as a safeguard for any insurance
BEPS risk. In Europe, this is Solvency II and in other major jurisdictions, this refers to frameworks which are
Solvency II equivalent. Such frameworks cap the amount of debt an insurer can hold to meet its regulatory
capital requirements while also providing adequate safeguards to prevent or significantly minimize any
BEPS activity.
5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

GFIA recommends that general rules to address BEPS should apply to insurance groups as a whole (insurance and noninsurance entities combined) without excluding stand-alone insurance companies in that group. Where tax authorities identify specific insurance structures that may require special rules from a BEPS perspective, any such special rules should be created only after consultation with the industry and should complement the general rules. GFIA believe this would be the most effective way to address any specific issues with insurance structures.

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

The OECD proposes a fixed ratio rule which would apply to groups but would exclude any stand-alone insurance companies in that group. GFIA has strong concerns with this approach, because such a calculation of the fixed ratio would exclude the interest income and operating profit of insurers but would include the full amount of interest expense on debt issued at the holding company level. This would likely lead to an inappropriate interest restriction because under such a calculation of the EBITDA, the EBITDA of many insurance groups would be negative and most interest would not be deductible.

Therefore, GFIA believes that this approach is flawed and would unduly affect many insurers that have a non-financial holding company which issues regulated debt and uses the proceeds of the debt to subscribe for equity in the insurance company. The use of equity rather than debt to fund the insurance company is in this case generally a requirement of insurance regulators who prefer the most permanent loss-absorbing form of capital. As such, it is certainly not a decision which is made by the insurance group for BEPS purposes. Excluding the operating profit of the insurer in applying the fixed ratio rule is clearly inappropriate in such circumstances.

When the activities of an insurance group consist mainly of insurance-related activities, there are very limited or no earnings in the non-insurance part of that insurance group. This differs significantly from non-financial groups for which the main source of earnings that constitute the basis for determination of the interest deductibility will be included under the fixed ratio rule. GFIA believes that applying a fixed ratio rule to the non-insurance part of an insurance group only (or separately) is not appropriate.

The OECD recognizes that non-deductibility of interest may not be appropriate in the case of instruments that support regulated banking or insurance activities. The OECD proposes a way to address this in paragraph 56 which is only partially effective because, while it provides in principle an exclusion for third party interest on regulatory capital, it still includes some third party interest.
8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

Many insurers have a non-financial holding company which issues regulated and/or general debt and uses the proceeds of the debt to subscribe for equity in the insurance subsidiary. The use of equity rather than debt to fund the insurance subsidiary is in this case a requirement of insurance regulators who prefer the most permanent loss-absorbing form of capital. As such, it is certainly not a decision which is made by the insurance group for BEPS purposes as demonstrated by the fact that insurance groups are not excessively leveraged.

13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company:

a. application of the fixed ratio rule to the local group excluding banks and insurance companies. GFIA has strong concerns with the OECD’s proposed fixed ratio rule which would apply to groups excluding stand-alone insurance companies in that group. In this situation, the majority of income and business profits would effectively be removed from the interest limitation rules while leaving the full amount of interest expense on debt issued at the holding company level within the scope of the restriction calculation, which would result in inappropriate interest restrictions. GFIA has similar concerns with the suggestion to create a second local group containing only insurance subsidiaries and to apply the fixed ratio rule to that group.

b. the treatment of interest expense on debt supporting banking or insurance activities. The OECD recognizes that non-deductibility of interest may not be appropriate in the case of instruments that support regulated banking or insurance activities. However, GFIA has concerns as explained above with the OECD’s proposal to address this issue through the fixed ratio rule as it may lead to inappropriate interest restrictions. As we recommend above, we believe the general rules should be applied to an insurance group as a whole.

15. Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

16. Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

In GFIA’s view, applying the group ratio rule to an insurance group while excluding insurance subsidiaries would result in similar concerns as when the fixed ratio rule is applied: it would exclude the interest income and operating profit of insurers but would include the full amount of interest expense on debt issued at the holding company level. This would likely lead to an inappropriate interest restriction because, under such a calculation of EBITDA, the EBITDA of many insurance groups would be negative and most interest would not be deductible.
17. Do you have any other comments on any of the issues raised by this discussion draft?

GFIA recommends that insurers’ existing debt should be excluded entirely since most of it is long-term debt and it would be very difficult and costly to repay or restructure it before the end of its remaining term. In the event that insurers’ existing debt is not entirely excluded, then, at the very minimum, it should benefit from a transitional period for the remaining term during which it cannot be repaid or restructured without cost or penalty to allow for the most efficient debt restructuring.

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About GFIA
Through its 41 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 60 countries. These companies account for around 87% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.
Grant Thornton UK LLP welcomes the opportunity to respond to the Public Discussion Draft on BEPS Action 4 Approaches to address BEPS involving interest in the banking and insurance sectors.

We trust that this response contains useful commentary. If you would like to discuss any of these points in more detail then please contact Howard Jones, Head of Insurance Tax, Grant Thornton UK LLP at howard.jones@uk.gt.com or by telephone on +44 (0)207 7184 4568.

Responses to specific questions

Question 1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion or otherwise)?

We have not identified any further categories of BEPS risks related to banks and insurance companies. Action 4 identifies BEPS risk in respect of banks and insurance companies using interest to fund equity investments, or banks and insurance companies incurring excessive interest expense which is set against taxable interest income. However, as stated in paragraph 5 of the Draft, regulatory rules and commercial constraints require banks and insurance companies to hold minimum levels of equity which restrict their ability to place excessive debt in particular entities or to use debt to fund equity investments in subsidiaries. Furthermore, excessive levels of debt would have a negative effect on credit rating with a resultant increase in costs and operational risk. In light of these observations, we question whether the risk of BEPS involving interest in banks and insurance companies that are significant enough to require blanket remedial action by tax authorities.

Question 2: Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?

We have not identified any other considerations which should be taken into account.

Loans, funding, interest, etc. are central to the operation of banks and to a lesser degree insurance companies and together with Corporate and Government debt represent liquidity / financing in today's business environment. If abusive tax practices are identified they should be targeted with specific anti-avoidance measures rather than systemic measures.

Question 3: Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country's regime.
The risk of excessive leverage is an area that continues to be considered by the European Banking Authority (EBA) in conjunction with their impact assessment and calibration of the Leverage Ratio. Disclosure requirements are likely to help reduce the risk of excessive leverage in banks as competent authorities will be monitoring these ratios and comparing with similar institutions to assess the risks arising.

Where countries have adopted Capital Requirements Directive IV (or equivalent) or Solvency II (or equivalent) we consider the differences to be insignificant compared with differences arising from different tax regimes or the anticipated differences arising from the implementation of the BEPS Actions.

Regulatory capital, including interest bearing instruments, is already subject to stringent regulation and there is no requirement for leverage for regulatory purposes to be the same as leverage for tax purposes. Any interest restrictions that might be introduced to address such differences are likely to interfere with regulatory rules and drive the behaviour of a bank to either avoid issuing such instruments (which are often necessary to raise capital) or to pass any additional tax costs on to investors. As stated by the OECD in paragraph 6 of the Draft, any approaches adopted should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crises. We therefore believe that it should be for regulators to take a view on the level of leverage which is acceptable in a bank or insurance company rather than tax authorities.

Furthermore in many countries regulators apply "group supervision" rules to ensure that group actions and other group entities should not compromise the governance or solvency of the bank or insurance company.

**Question 4: Are there any other general issues related to the operation of the authorised OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?**

In order for branches or permanent establishments to trade in regulated sectors, they must ensure compliance with local regulatory and solvency requirements. Entities may also be subject to Group Supervision.

In many countries, transfer pricing adjustments to attribute capital to these permanent establishments is a frequent way to counter a lack of investment income. There are also transfer pricing rules to address inter-group lending. In addition, there is also sufficient transfer pricing legislation which if monitored properly would negate the need for the fixed ratio and group rules to apply. We would recommend that such international tax laws should be applied diligently and rigorously by all authorities, minimising the need for Action 4 to apply.

In the UK, permanent establishments of non-EU banks and insurance companies are required to hold and report regulatory capital to the Prudential Regulation Authority (PRA), using essentially the same framework as would be required for a stand-alone company in the UK. For permanent establishments of EU banks and insurance companies however, the parent company is required to report and hold regulatory capital on behalf of the permanent establishment. Due to transfer pricing adjustments to attribute capital to these permanent establishments, as explained above, tax risks arising are already addressed.

**Question 5: Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?
As stated in paragraph 27 of the Draft, it is not expected that excessive leverage will be an issue for most countries and consequently, we would expect that most countries will not introduce specific tax rules to deal with this risk.

We are concerned with countries that do introduce tax rules if, as expected, a minority do as this will lead to a lack of consistency and comparability. This will however depend on the extent to which regulatory rules differ between countries.

**Question 6: What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks/and or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.**

For permanent establishments of foreign banks and insurance companies, transfer pricing adjustments to attribute capital and income to these permanent establishments is often effective.

In addition, the UK has existing rules in place towards targeting unacceptable arrangements with respect to intra-group debt and lending, some of which include:

- Unallowable purpose rules
- Counteractions in the loan relationship regime, and
- General Anti-Avoidance Rule (GAAR)

**Question 7: Are any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?**

The Draft suggests the fixed ratio or group ratio rules could be applied to banks and insurance companies, and these rules rely on limiting net interest deductions to a fixed percentage of EBITDA. However, EBITDA is not a relevant measure for banking and insurance groups and does not provide a reliable basis on which to calculate a restriction. Other ratios are used to gauge the performance of such companies.

As explained in the Draft, the fixed ratio rule is unlikely to have an impact on a bank or insurance company as these entities are by and large net interest recipients. Where the rule is implemented and has an impact on a banks or insurance company, the rule could interfere with regulatory rules or it could have an unfair impact on certain businesses. Examples of the latter include start-up banks or insurance companies, non-traditional business models, or banks/insurers in financial difficulty. In all of these instances, a fixed ratio rule would be unwelcome, and compounded by potentially resulting in a permanent disallowance of the interest.

In addition, lending by banks provides liquidity; therefore, to retrospectively apply a rule at the time the tax return is prepared, eliminates the ability to have any certainty on a normal business transaction. Furthermore, in order to counter the uncertainty, interest rates could be pushed up, penalising borrowers with consequential impact on the economy.

**Question 8: Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?**

The decision on how to fund a subsidiary is first and foremost a commercial decision rather than a tax one. However, where debt is used to fund an equity investment, no tax leakage will occur where both entities are resident in the same country. Where the same investment is made across a border however, transfer pricing rules should apply which result in the investing entity being properly rewarded for the level of investment risk taken, or controlled foreign company rules should apply such that profits are recorded in the investing entity's tax return. These tax rules more accurately reflect the commercial reality of the investment.
Restricting interest deductions for such investments should be unnecessary if other tax rules are effective, particularly as regulatory rules and Regulators already provide a significant deterrent in most countries.

**Question 9:** What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

Please see the answers to questions 6 and 8.

**Question 10:** Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

Please see the answer to question 4 in respect of the capital requirements of a permanent establishment.

Any risks arising with respect to permanent establishments should be addressed through OECD guidance on permanent establishments and attributing profits to permanent establishments, and transfer pricing.

**Question 11:** Where a country introduces targeted rules to address specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

In applying targeted rules, one should look at the types of transactions and structures that are considered to be abusive. These structures would be abusive regardless of the industry in question.

Furthermore, OECD recommendations on mandatory disclosure rules should help tax authorities to identify arrangements giving rise to specific BEPS risks, such as those outlined at paragraph 43 of the Draft. In addition, in the UK, the Disclosure of Tax Avoidance Scheme (DOTAS) rules provide mandatory disclosure rules of such arrangements, and the Code of Practice on Taxation for Banks and Code of Practice on Taxation for Large Businesses provides voluntary disclosure rules with the former including a naming and shaming element.

**Question 12:** Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken in account?

In discussing entities in a group with a bank or insurance company, the OECD does not distinguish between financial sector groups and non-financial sector groups. These two categories of groups should be considered separately with respect to how any interest restrictions may apply to the non-regulated entities in the group. Considering both as one ignores the following key aspects of a financial sector group: the impact of regulation on a group level, the number of entities in the group that rely upon or support the regulated entities, whether after the removal of the banking/insurance entities and the entities supporting the banking/insurance entities there is a coherent group left, whether the main trading activities take place in the regulated entities leaving fewer activities in the non-regulated entities which could find the interest restrictions have an unfairly effect.

**Question 13:** Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company: -

a) Application of the fixed ratio rule to the local group excluding banks and insurance companies
b) The treatment of interest expense on debt supporting banking or insurance activities
c) Other issues?
In the same way that it is considered that all banks and insurance companies within a financial or non-financial group should be excluded from the scope of any potential interest restriction, any entities in these groups that support the regulated entity should also be excluded from the scope of any potential interest restriction.

Where the OECD has identified issues with respect to regulated entities or regulated groups raising or issuing debt, externally or internally, for reasons that do not support the regulatory position of the group, the regulatory rules in place and capital requirements should still apply to naturally curtail the risk of excessive amounts of debt being issued/raised.

Consideration should also be given as to whether, absent the targeted avoidance rules, financial groups should be excluded in full from the potential interest restrictions.

**Question 14:** Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?

Please see the answer to question 13, this has already been considered and discussed.

**Question 15:** Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

Please see the answer to question 13, this has already been considered and discussed.

**Question 16:** Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

Please see the answer to question 13, this has already been considered and discussed.

**Question 17:** Do you have any other comments on any of the issues raised in the discussion draft?

The Draft accepts that banks and insurance companies are key providers of debt finance to groups in other sectors and will traditionally have net interest income rather than expense. Regulatory capital rules require banks and insurers to hold minimum amounts of equity and restrict the ability to place excessive debt into the entities or to use debt to fund equity investments in subsidiaries. Furthermore, the approaches to address BEPS risks in these entities should not conflict or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis.

We appreciate the desire to exclude a bank or an insurer from the fixed ratio and group tests but this only serves to put them at a disadvantage compared to other taxpayers. No other groups are being stripped of their main profit or EBITDA generating entities. Banks and insurers generate significant income from many other sources such as fees, commissions, administration, premiums, brokerage etc. The exclusion of this EBITDA from group calculations puts banking and insurance groups at a disadvantage compared to other taxpayers.

We would expect greater definition of terms such as 'bank', 'insurance company', or 'entities in a group containing a bank or insurance company'. Without guidance it is difficult to determine the scope of the measures and how widely the OECD intends for them to be applied. For example, UK legislation defines a bank as an authorised person that has regulatory permission to accept deposits, and an investment bank as an authorised person with a minimum capital requirement that has certain regulatory permissions, most prominently to deal in investments. The Draft however refers to banks and insurance companies in a more general sense. While it should be for tax authorities to determine how widely the measure apply to certain industries, for consistency purposes it would help if the OECD were to consider how Action 4 measures apply to companies in the financial sector that are considered to be similar to banks and insurance company but which do not operate as banks and insurance companies in the traditional sense.
The Draft provides a number of examples of BEPS involving interest. However it is not clear how an interest restriction would necessarily address such risks any more effectively than existing tax and anti-avoidance measures, including OECD recommendations in other BEPS Actions. There are regimented international tax laws already in place designed to counteract such risks. These include transfer pricing rules, anti-hybrid rules, arbitrage rules, thin capitalisation, controlled foreign company rules, worldwide debt cap rules, and rules attributing capital or expenses to permanent establishments or income from permanent establishments. These measures together with the intense regulatory scrutiny that banks and insurers are subject to already minimise the BEPS risk.
Submission to the OECD on the Action 4 Discussion Draft on BEPS Involving Interest Expense in the Insurance Sector

By The Insurance Company Working Group on BEPS

Introduction and summary of recommendations

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS),¹ a group of global insurance and reinsurance companies, in response to the public Discussion Draft released on 28 July 2016 by the OECD entitled “BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors” (the “Draft”). This Draft follows the October 2015 final Action 4 report on BEPS and interest expense, which included a common approach to addressing interest-related BEPS, focusing on restricting net interest expense.

The Working Group very much appreciates the opportunity the OECD has provided since the outset of the BEPS project to explain the nature of insurance business, how it is uniquely regulated, the critical role that debt plays in the business, and the necessity to carefully evaluate potential BEPS relating to interest expense within these important parameters. However, the Working Group believes that these business and regulatory realities and the role they play in preventing insurance groups from engaging in BEPS related to debt and interest expense need to be more fully understood and recognized in the context of tax policy and tax administration.

Most importantly, insurance groups that are subject to prudential regulation at the headquarter level and are thus predominantly engaged in the insurance business should not be subject to special limitations on interest expense deductibility. At a minimum, countries wishing to apply the fixed ratio rule to such groups should do so without change. We are particularly concerned, therefore, that the Draft’s discussion of targeted rules seeking to isolate interest expense in non-insurance entities within a regulated insurance group will create undue harm for such groups that is disproportionate to any perception of such BEPS activity in regards to the sector as a whole and will cause significant differences to regulatory positions for insurance groups. Mechanisms that seek to isolate interest expense in non-solo regulated entities within regulated insurance groups fail to recognize the integrated operations and

¹ The members of the Working Group are AIA Group Limited; American International Group, Inc.; MetLife, Inc.; Prudential Financial Inc.; Prudential plc; Swiss Re, and XL Catlin. Note that references to the “insurance sector” and “insurance groups” in this document include reinsurance & reinsurers.
funding requirements of entities within an insurance group. Such rules will be difficult and burdensome to apply to large, complicated insurance groups and seem to outweigh any perceived risk.

Generally, we believe the application of the fixed ratio rule to global insurance groups is unwarranted and unnecessary given the low level of leverage in such groups generally, and the commercial and regulatory realities that combined to lead the OECD to conclude that the risk of BEPS related to interest expense for our industry is low, but under no circumstances should the OECD signal to countries that it is appropriate to apply targeted rules, or variations on the fixed ratio rule, to insurance companies.

Specifically, the Working Group takes issue with and looks forward to further discussions with the OECD on the following, which are explained in more detail later in this submission:

- The Working Group disagrees with assertions that differences between regulatory capital rules in different jurisdictions may permit BEPS activity. We do not believe there is any justification or merit in the view that tax authorities should or could impose limitations on tax deductibility because they may disagree with the amount of leverage permitted by regulators. As regulators are rapidly moving towards a level of increasing coordination and cooperation globally in the manner in which they supervise insurance groups, more and more groups are regulated at both a group (i.e. parent) level and also a sub-group (regional holding company) level, as well as at the solo individual insurance company level. Thus, regulation affects the activities that can be undertaken by any entity within an insurance group. This stringent regulation applied to the group as a whole causes insurers to be significantly restricted in the way they can invest in subsidiaries.

- The Working Group disagrees with the section of the Draft dealing with the attribution of capital to a permanent establishment (PE) and the suggestion that special tax rules should be considered because current practice does not appropriately consider the work that OECD concluded in 2010 relating specifically to the insurance industry.

- The Working Group also disagrees with sections addressing the possibility that BEPS is created through the use of interest expense to fund non-taxable income in an insurance company.

Potential BEPS related to the insurance industry as identified in the Draft

This submission is structured to first address the areas of potential BEPS that are identified in the Draft. It then discusses the suggested remedies that countries may employ. For insurance groups, the Draft states that countries identified the following financing structures as posing BEPS risk to be identified under Action 4:

- The use of third party or intragroup interest to fund equity investments giving rise to income that is non-taxable or is taxed in a preferential manner

- Incurring “excessive” third party or intragroup interest expense, which may be netted against taxable interest income
It is unclear, however, what the drafters mean by “excessive” interest expense in the context of an insurance group. Specifically, are the drafters implying that interest expense is excessive by reference to industry standards, regulatory requirements, or some other measure? As the OECD concedes in the document, insurance groups are not typically heavily geared and this is due to the significant restrictions on overall leverage placed on groups as well as insurance entities. In this context, we recommend that references to “‘excessive’” leverage should be removed.

**Suggestions that insurance regulation does not protect against excess leverage**

The Draft states that BEPS risks could exist because regulatory capital rules do not necessarily provide adequate protection against such risks. Paragraphs 18, 19 and 20 list reasons why regulatory capital requirements may not prevent BEPS by insurance companies. Accordingly, the Draft states that varying country regulatory capital rules, the type of regulated activity undertaken, and the differing approaches that regulators and tax authorities may take in viewing excessive leverage are factors that may create BEPS risk.

We disagree with these assertions. In the European Union, for example, Solvency II has now been introduced (we also note that the Swiss regulatory regime has “equivalent” status to Solvency II, and it is expected that the UK will retain either Solvency II or an equivalent regime post-Brexit). This means that in the case of an insurance MNE with significant operations in more than one EU member state, the national insurance regulators for each of the relevant EU member states will consult together and may agree on one national regulator as the primary regulator for the MNE’s EU group. This may be the regulator in the EU member state where the MNE has its largest operations, regardless of whether the EU group is held by a holding company in a different EU member state. The primary regulator of the EU group will scrutinize all of the EU entities in the group; at the same time, local regulators in other EU member states will be looking at the local group entity or entities in their respective countries. In addition, all regulators where the group has significant operations (both in the EU and outside the EU) will participate in a College of Supervisors. Colleges of Supervisors refer to multilateral groups of relevant supervisors that are formed for the collective purpose of enhancing efficient, effective and consistent supervision of financial institutions operating across borders. The Colleges of Supervisors provide a platform for the gathering and dissemination of relevant or essential information, developing a common understanding of the risk profile of the groups, achieving coordination of supervisory review and risk assessment at a Group level, as well as establishing supervisory plans for the mitigation of risks at Group level. This process does operate globally so, for example, an insurance group with headquarters in Hong Kong would likely have as its lead regulator the Hong Kong regulator, but all the regulators from countries in which the company operates will meet regularly as part of this College of Supervisors.

It is worth noting that the structure of the group in Europe may be driven in part by the requirements and preferences of the regulator that ultimately becomes the group regulator. In addition, it is likely that an inbound group would only have one holding company for insurance operations in Europe due to
Solvency II. If an inbound group had multiple holding companies in the EU, the group regulator would be expected to require consolidation into a single holding company.

In the United States, the U.S. National Association of Insurance Commissioners (NAIC) adopted changes to its Model Laws in 2010 to allow (and encourage) state regulators to similarly participate in supervisory colleges to coordinate the regulation of insurance holding company systems with other regulators. In order to assess the overall insurance group’s business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance processes, and as part of the examination of individual insurers, an insurer’s domestic state regulator may participate in a supervisory college with other regulators charged with supervision of the insurer or its parent, affiliates, or subsidiaries, including other state, federal, and international regulatory agencies. In addition, for larger, global U.S.-based insurance groups, the Federal Reserve has proposed regulations that will also provide for uniform capital and other standards that will apply to the group as a whole.

Paragraph 19 states: “First and most simply, regulatory capital rules differ between countries and the type of regulated activity undertaken. This in particular is the case for insurance companies where there is no accepted international standard for capital regulation.” As noted above, however, developments in the regulation of insurance groups demonstrate coordination, or a forceful movement towards coordination by regulatory bodies globally. In a landscape where it is common for the top regulator of a multinational insurer to monitor and strongly influence the capital position of the group as a whole, the combination of group supervision and solo entity regulation means that unregulated “gaps” within an insurance group are very limited. Just as important is the fact that regulation of insurance groups may differ from company to company and from regulator to regulator in terms of the amount of capital required and the amount of leverage allowed, but those differences will be due to the particular underwriting risks of the group in question and the perception of the group by its regulator in general, and is in no way indicative of differences that will allow for “excessive” leverage by a group, or particular types of arbitrage in relation to debt.

**The attribution of free capital to PEs of insurance groups may be problematic**

The Draft also identifies branches and the attribution of free capital to PEs of banks and insurance companies (paragraphs 22-25) as potentially problematic.

The Draft states that in most countries there is no regulatory requirement for capital to be allocated to a permanent establishment. Therefore the Draft indicates regulatory requirements do not sufficiently address BEPS in entities as these rules would not necessarily prevent BEPS in a PE unless there is some limitation on the interest deductions.

The discussion draft points out that the approaches taken into account in the 2010 Report on the Attribution of Profits to Permanent Establishments (“the 2010 report”) include appropriate approaches for the attribution of profits to permanent establishments of insurance companies, and that PEs should be attributed an arm’s length amount of free capital. However, “as these approaches take into account...
capital requirements in the home country or the host country,” concerns that regulatory capital rules in
different countries may not provide the same level of protection against excessive leverage for tax
purposes are also valid in the case of a PE.

The Working Group believes these assertions are inaccurate. In the first instance it is important to note
the extensive work undertaken by the OECD in developing the framework for the 2010 report. The
underlying principle is that permanent establishments should be hypothesized as separate legal entities.

Furthermore, the above assertions fail to take into account the way in which branches are actually
regulated in insurance groups worldwide. The assertion that there is no regulatory requirement for
capital to be allocated to permanent establishments is only the case for European branch structures
which, as detailed above, are now within the scope of the stringent pan-European Solvency II regulatory
framework. Only in this case is it possible to pool capital at the head office level and only with the
consent of the relevant regulators. An EU framework has been in place for many years that enables
insurers to conduct business across the European Union on either a Freedom of Establishment (FoE) or
Freedom of Services (FoS) basis. A similar framework exists for reinsurers under the Reinsurance
Directive. The FoE and FoS provisions mean that operations with a head office in Europe are permitted
to conduct insurance and reinsurance business in other EU member states (either directly or through
branches) but are only required to be regulated and authorized in their home State (this is known as “EU
Passporting”).

This has generated an ability to hold a single pool of capital and assets to cover operations across the
whole European Union, a methodology that is capital efficient and operationally efficient and subject to
stringent regulatory supervision pertaining to the quantum, quality and type of core capital held as debt.
This is supervised not only by the regulators but also by ratings agencies. Therefore it would not, in our
view, be possible for insurance groups to structure capital to result in BEPS.

It should be noted that with the UK vote to separate from the EU (known as Brexit), the future ability of
UK-based insurance groups to take advantage of EU Passporting is in question, and the outcome could
be that these branches would have to be separately capitalized. However it is seen as highly likely that
the UK would retain Solvency II or equivalent status for insurance regulation.

U.S. tax rules make it virtually impossible to have foreign branches of a U.S. life insurance company, but
U.S. groups are able to operate throughout Europe through branches of a European-based insurance
company, for example, and do so for the reasons noted above. In Asia and Latin America, there is no
ability to hold a single pool of capital to support branch operations in different countries. Therefore,
regulators will require each branch to hold capital in the same way that a subsidiary would be required
to hold capital in that jurisdiction. Given that the capital requirements of the regulator in the
headquarter country for the group as a whole — including branches -- may be even more robust than
those of local regulators relating to specific branches, the headquarter regulator could require the group
as a whole to hold more capital in relation to a branch operation than would be the case if the relevant
business was operated as a subsidiary.
Given the above, the Draft’s statement contending that, for most countries, there is no regulatory requirement for capital to be allocated to a permanent establishment is inaccurate.

The OECD has already spent considerable time and effort to understand the functions, assets, risks and value chains of the insurance industry in developing bespoke guidance for the allocation of risk and capital within insurance groups. The OECD had extensive discussions with the industry during the development of guidance on Article 7 of the OECD Model and preparation of the OECD Part IV report. This applies the separate legal entity approach in order to allocate capital to the respective parts of an insurance group by reference to people functions. OECD Part IV, and its subsequent adoption into domestic laws and tax treaties, is widely regarded by both tax authorities and insurers as a reasonable and fair approach to taxing insurers.

Because regulators simply do not allow risk to be borne in an insurance company unless it has the appropriate capital and people functions, the arm’s-length principle will cause income to be allocated for tax purposes to the appropriate entity within an insurance group. Moreover, the Draft reflects a failure to consider the fact that a branch is subject to capital requirements of the larger entity of which it is a part, and runs counter to prior OECD statements recognizing that the 2010 Report provided a complete and satisfactory resolution to the attribution of profit issues relating to a PE in the context of the insurance industry.

As noted above, the 2010 Report provides tax authorities with the tools they need; if anything, the final report on Action 4 relating to insurance companies should reinforce the application of the 2010 report rather than suggest an alternative methodology.

**Interest funding non-taxable income from an equity investment**

Paragraph 35 of the Draft states that countries have identified BEPS risks “which concern a solo-regulated entity using deductible interest expense to fund non-taxable income,” typically involving an insurance company receiving a non-taxable return on an equity investment. The report accurately points out that these concerns are mitigated by “a number of regulatory and commercial considerations,” including regulatory capital and other constraints against the use of double leverage in a group that relate to using debt to fund equity investments and regulatory constraints against “trapping” capital in subsidiaries. Double leverage, in regulatory parlance, is the ability of a parent company, or a holding company, to use debt to fund equity investments in subsidiaries.

Given the above, for the Draft to maintain that countries still are concerned about BEPS risks in this area and, in particular, to suggest insurance companies might “incorporate equity-funded vehicles in low-tax jurisdictions, which are used to invest in portfolio investments,” does not appear to follow.

We take issue with the notion that Insurance companies do not face a number of regulatory, business, and rating agency constraints on their ability and willingness to borrow at the holding company level in...
order to invest in equity in operating subsidiaries. Some of these constraints are similar to those faced by banks but many are different, due to the different business models being considered.

Starting with regulation, insurance regulators that supervise insurance holding companies (either as part of a regulatory group or at a solo level) are concerned about debt at a holding company being invested as equity in operating subsidiaries for the same reason bank regulators care about this – dividends are needed to fund the repayment of the debt, which takes funds away from the operating companies and their obligations to their customers, although there are of course differences between insurance and banking regulators’ perspectives and experience. The different business models between banking and insurance and the role of rating agencies are also important factors in considering this issue.

Because the business models and risk factors are different, the focus of regulators in the two sectors is somewhat different, but that does not necessarily mean that the existence of double leverage in the insurance context is less frowned upon by insurance regulators. Banking regulators are very focused on liquidity risk, as they need to ensure that the banks can address a tightening of credit markets and potential runs on retail deposits. Insurance regulators are focused on there being sufficient capital to pay policyholders’ claims, with access to funds being less immediate than may be the case for banks. Thus, the two sets of regulators focus on different sides of the balance sheet, but the resulting protections are quite similar and robust.

In most cases, if policyholders stop paying premiums, their coverage ends and the insurer does not have any further obligation. For certain life policies, policyholders can get at the cash surrender value of their policies, but that may come with a surrender charge. Where insurance coverage continues, for life business, the obligation to pay is generally very far in the future. For P&C companies, although the obligation to pay could be more immediate, the insurer generally will not receive claims from every policyholder.

This is all recognized in the OECD’s 2010 paper on attribution of profits to a permanent establishment (Parts I-IV). An insurer takes on liabilities and must hold assets to cover them, but the law of large numbers means it is unlikely that the insurer will have to pay customers’ claims in correlation to amounts received.

Where group regulation is applied to insurers, it involves looking at the overall group balance sheet and how much capital is needed, as well as the liquidity, financial resources and capital of the top holding company. In a Solvency II context, where capital is held in overseas operating companies or regional holding companies, the parent company must be able to demonstrate that it could remit that surplus capital back to the group holding company within a certain number of months in order for that overseas capital to be regarded as being sufficiently fungible. For an insurance group that is wholly within the EU, one might well find the debt raised at the top level being pushed down to have similar debt-equity ratios at both operating company level and group level if such funding is required. However, because most large insurance groups are operating across a number of regulatory regimes, a different debt-equity profile is going to exist at group and solo levels because at the solo operating company level, the local regulator may still be operating a regime or approach that only allows equity.
In the United States, the NAIC supervisory colleges, as noted above, coordinate the regulation of insurance holding company systems with other regulators. In order to assess the overall insurance group’s financial position and risk exposure, an insurer’s domestic state regulator will convene an annual supervisory college with other regulators charged with supervision of the insurer or its parent, affiliates, or subsidiaries, including other state, federal, and international regulatory agencies. Additionally, an “own risk assessment” conducted by the home state regulator reviews the insurer’s corporate group, including detailed analysis of all intercompany transactions, particularly those relating to funding, reinsurance and liquidity.

A holding company may choose to borrow and push down the proceeds as equity, even if there is no tax benefit to the holding company. This would be because raising debt is cheaper than equity even without a tax deduction. This is a commercial decision, not an attempt at tax minimization. Regulators, like shareholders and analysts, understand the need to see a reasonable return on equity capital. While they will likely demand more equity capital at the regulated entity level, they understand cost pressures and have no reason to unduly restrict borrowing at the parent level to fund such equity, when borrowing/lending is not the core activity of the group, provided that the mix for the group is reasonable.

The role of credit rating agencies is also critical. The higher the leverage in the group, the lower the rating is likely to be, which will impede the ability of the group to write certain lines of business.

Nevertheless, because policyholders’ claims, in both a life and non-life insurance context, may not be made for many years, insurance regulators prefer that most, if not all, of an insurance company’s capital be in the form of equity.

Moreover, insurance regulators place a limit on dividends. Generally, a dividend can only be paid up to a certain percentage of surplus or some other metric. Dividends, or return of capital, often require notification or approval of the regulator, while anything above a certain distribution or that reduces surplus below certain levels needs specific approval. Importantly, regulators generally will not permit the payment of a dividend that puts an insurance company at risk of not being able to pay policyholder claims, even if it means the holding company could default on its debt. Although a default at the parent level might put an insurer at risk in terms of the ability to write new business, particularly where this has a negative impact on the rating of the group’s securities, it would not mean that the insurer is unable pay claims, which is the primary concern of the insurance regulator.

Many of the above considerations are identified in paragraphs 35-38 of the Draft, yet the Draft goes on to note that, “Despite these considerations, a number of countries involved in the work on Action 4 have identified cases where solo-regulated entities claim deductions for interest funding equity investments which give rise to non-taxable income.” The Working Group urges the OECD to consider other options, rather than suggesting to member states that they adopt special targeted rules to limit the interest deductibility of insurance companies, to address this rather vague concern in the Draft. In fact, in paragraph 39, the Draft adopts in our view a more appropriate position, suggesting that countries consider other options, including limiting the benefits of a participation exemption in such cases. We
also support the statement that “where a bank or insurance company has been required by regulatory capital rules to deduct the value of an equity investment from its own equity capital, a rule may treat this investment as funded wholly using equity. In this case, there may be no need to apply a tax rule to address interest funding non-taxable income.”

Suggestions for applying the fixed ratio rule in a targeted manner to insurance groups

The OECD’s recommended general approach in the October 2015 Action 4 final report is to limit the deduction of net interest expense to a fixed ratio (10-30%) of the EBITDA of the taxpayer, which may be a consolidated group or may be a single entity depending on the particular country’s consolidation rules and the particular group’s circumstances. This general test is subject to a possible worldwide group ratio safe harbor that would allow full deduction if the taxpayer’s net interest expense level is not disproportionate to the worldwide group’s net third-party interest expense level. The Draft notes the special role that interest plays in the operation of an insurance group, and that such groups generally will have net interest income rather than interest expense.

To reiterate, interest is taxed as trading receipts / expenses in an insurance company. This has been a long-standing principle in most tax regimes and reflects the fact that the investment of premiums is fundamental to the business of an insurance company. Insurance groups are almost always net lenders. Insurance companies seek to invest company capital and customer premiums in (i) assets that will match the term and the risk of liabilities (various types of debt instruments meet that need), and (ii) assets constituting solvency capital (i.e., capital to provide a buffer against losses). By far the most common investments are in cash, treasury bills, government bonds and corporate bonds, with the income generated therefore being largely in the form of interest. In addition, insurers are increasingly key investors in long-term infrastructure projects, the investments into which often involve debt funding that enables the insurers to manage inflows from investments with outflows on maturing policies. Hence, insurance groups typically have net interest income.

However, a holding company within an insurance group may very well be a net borrower (either at the parent level or a sub-group level). That is why a targeted fixed ratio rule that would exclude solo regulated entities is not appropriate, because the capital to support those regulated entities is usually in a top holding company that is not regulated. Capital in the form of debt, rather than equity, is issued by the holding company mainly because the cost of such capital is significantly less than the cost of equity, approximately 3% per annum post-tax compared to approximately 10% to 15% per annum, varying by company and type, for equity. Therefore, a holding company on a standalone basis will typically have interest expense and no or very little interest income.

The Draft also notes that the Action 4 final report allows countries the flexibility to apply the fixed ratio rule on an entity-by-entity basis and, in paragraph 50, notes circumstances in which such application may not be appropriate for insurance groups. Nevertheless, the Draft details several approaches to apply the fixed ratio rule to a local insurance group by excluding the entities in the group that perform insurance operations, or to apply the fixed ratio rule by artificially combining solo regulated entities in a
country into one group to which the fixed ratio rule would apply, while applying the rule separately to the non-regulated entities.

We have grave concerns with this approach. While the Draft suggests ways in which disallowed interest expense might be apportioned among entities in the group so as to potentially reduce the impact of this approach, we believe these mechanisms are not workable, mainly because there will, in reality, be little or no interest income that could be utilized to minimize the negative effects of any restriction. To suggest that any version of the fixed ratio rule can be applied to separate entities within such an insurance group, or applied to artificial groups that isolate solo regulated insurance businesses from core support entities, fails to recognize the importance of these support entities to the insurance business and the business and regulatory reasons why such entities are operated separately from an insurance or reinsurance business. Moreover, we are not aware of instances in which a country has decided to diverge from a general rule relating to interest expense in order to apply targeted rules to regulated insurance groups. Germany, for example, which is the model for the OECD’s fixed ratio rule and has a mature market for insurance headquartered groups, does not impose targeted rules on insurance companies (and we understand is also not planning to do so following the publication of the Action 4 report).

There are a variety of reasons why insurance groups will have regulated and unregulated entities in the same jurisdiction. For reasons of administrative and legal simplicity, as well as regulatory requirements, it is common to use service companies, which employ staff and procure external services for the benefit of the wider group, rather than have these activities undertaken by insurance companies themselves. EU regulations, as implemented in some countries (e.g., the UK) prevent employees of regulated insurers from performing any services for an affiliated company, so employees are typically employed by a service company to avoid duplication of costs. These companies will have little or no income but will have administrative expenses, so when combined with a holding company that may have interest expense, these services entities will have no income to offset that expense if the non-solo regulated subgroup were subject to the fixed ratio rule on its own.

In addition, many regulatory regimes penalize insurance companies holding subsidiaries; where there are multiple operating companies within such jurisdictions, it is common for these to be consolidated under a single holding company. Such a company may well also hold capital itself to maximize fungibility, rather than risk it being “trapped” within a single company and unavailable to sister entities. If such a jurisdiction were to apply the fixed ratio rule in the manner suggested by the Draft, insurance groups would clearly be penalized as the holding company would have little or no income to offset interest expense.

Treasury companies are often not subject to solo regulation as well, on the basis that they do not have any liabilities to policyholders. Treasury companies are used to manage surplus cash within an insurance group, to ensure that it is invested in a way that maximizes return while preserving liquidity, so that funds can be allocated around the group if needed. Such a structure is operationally more efficient than having companies manage surplus cash positions individually, and enables the group to obtain better rates from third-party banks due to the larger deposits placed. Again, we are concerned that application
of the fixed ratio rule to a subgroup of entities, such as a Treasury company in a jurisdiction, would result in the disallowance of interest expense for no justifiable reason, relating to entities that are supporting operating companies that are generating interest income.

As a general matter, we believe it is not accurate to refer to entities that may not be subject to insurance regulation in a local country by a local regulator (generally referred to as solo regulation) as “unregulated,” because the balance sheet and risk exposures of these entities are taken into account by the group regulator in determining the group’s compliance with regulatory capital requirements and so regulation is applicable to such entities in that manner. As noted above, with the move towards group regulatory approaches such as Solvency II and Systemically Important Financial Institution (SIFI) type regulation, more and more groups are regulated at both a group (i.e. parent) level and also a sub-group (regional holding company level) as well as at the solo individual insurance company level. Regulation affects the activities that can be undertaken by any entity within an insurance group. Furthermore, the regulators supervising the regulated insurance operating companies will closely monitor credit risk arising from counterparty risk (i.e. insurers would not receive full capital credit for concentrating borrowing with one counterparty). Thus, artificially separating these entities for tax purposes that are linked from a business and regulatory perspective defies economic and business reality. If a regulator would not look at entities in an isolated way, a tax authority can only create grave distortions in the economics of a banking operation by doing so.

Statements in paragraph 51 and 52, and the examples in Annex 3 are oversimplifications and ignore business and economic reality. Paragraph 52 states that net interest expense in the remaining entities in the group would be deductible up to the benchmark fixed ratio threshold. However, this statement, along with examples 1 and 2, assumes these remaining entities would include a combination of entities with interest income and interest expense. This generally will not be the case as these remaining non-solo-regulated entities will in most cases not be operating business entities.

In example 2, a relatively small portion of the insurance group’s interest expense is disallowed through application of the fixed ratio threshold. In reality, under the approach outlined in the Draft, insurers would receive little to no deduction on debt raised by a holding company. This is because by only excluding the solo regulated entities, all interest income used to support regulated insurance activities would be excluded while the externally sourced regulatory debt, held in the top holding company, would be included in the calculation. This effectively gives insurers a negative EBITDA.

Finally, financial services groups and non-financial services groups are very different businesses, and therefore efforts to amend the fixed ratio rule to apply to financial services groups in order to produce results comparable to those when the rule is applied to non-financial services groups will not be effective. We therefore disagree with Paragraph 52, which states: “it is expected that excluding banks and insurance companies from a local group should in most cases remove the main operating entities which earn interest income as a primary activity. The impact of the rule on an entity in a group with a bank or insurance company should thus be closer to that on entities in other groups.”
Application of the group ratio rule

As noted in paragraph 62, the group ratio rule is intended to permit the deduction of more interest expense beyond that limited by the fixed ratio rule, to the extent the amount of interest expense being deducted is in line with the net third-party interest of the group as compared with the EBITDA of the group. Paragraph 63 points out, accurately we believe, that if the fixed ratio rule is applied on an entity-by-entity basis, or applied to exclude regulated insurance companies from a group, the group ratio rule will likely “not provide any relief.” Paragraph 67 identifies practical issues in this regard.

The group ratio rule is intended to and should provide additional relief to non-financial services groups that are limited in their ability to deduct interest expense when the fixed ratio rule is applied. The fact that the group ratio rule does not work in the context of an insurance group means that applying the fixed ratio rule in a targeted manner is particularly unfair for an insurance group, which would suffer disproportionately as compared with a non-financial services group.

Working Group Recommendations

Since early 2014, the Working Group has been committed to providing the OECD with background and education on the operations and regulation of global insurance and reinsurance companies. This submission in many ways summarizes much of the information and many of the issues that have been the subject of our discussions with the OECD over this period. Due to the nature of our business and how debt is utilized, the commercial realities of the business, and the increasing global conversion of insurance regulation, we believe a final report should:

- Emphasize and reiterate the low risk of BEPS for insurance groups relating to interest expense.
- Eliminate recommendations to apply any special rules for insurance groups, including any modified versions of the fixed ratio rule.
- Indicate that application of the fixed ratio rule to insurance groups may not be necessary given the relatively low leverage ratios of insurance groups, the potential volatility of insurers’ profitability due to their reliance on investment markets and the impact of natural disasters, the significance that regulators place on the use of separate holding companies and other non-solo regulated entities, and the focus of regulators and rating agencies on the level of capitalization and the functionality of these companies.
Introductory comment

Insurance Europe welcomes the opportunity to comment on this Organisation for Economic Co-operation and Development (OECD) discussion draft on approaches to address Base erosion and profit shifting (BEPS) involving interest in the banking and insurance sectors. Insurance Europe supports the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment, as well as the OECD’s reflections on how interest limitation rules can be designed to take into account the particularities of the financial sector in general and of insurance in particular.

Summary

The OECD recognises in paragraph 26 of the Discussion Draft that “excessive leverage in an insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this BEPS risk will be low”. In addition, the OECD acknowledges that existing regulation acts as a safeguard for any insurance BEPS risk. Insurance Europe agrees with and welcomes these statements.

Therefore, Insurance Europe believes that general rules should apply to insurers, and in particular to entire insurance groups when relevant. If tax authorities are concerned about specific insurance structures from a BEPS perspective, targeted rules can complement the general interest limitation rules and would be the most effective way to address these issues. Otherwise, applying special rules regardless of the very low BEPS risk in insurance would result in inappropriate restrictions.

However, the OECD proposes a fixed ratio rule which, while applicable to local groups, would not apply to insurance companies which are part of this group. Therefore, the application of the fixed ratio rule is limited to the non-insurance companies of an insurance group and the OECD suggests that this is done by excluding insurance-related revenue and debt. The OECD is right that excluding banks or insurance companies would
have the same effect as applying a fixed ratio rule to these entities, but Insurance Europe does not agree with how the OECD proposes to implement this rule.

The consequence of the OECD’s proposals would be that the interest income and operating profit of insurers would be excluded whereas the full amount of interest expense on debt issued at holding level would remain under the scope of the rules. Insurance Europe believes that this approach is flawed. Where typically the activities of an insurance or banking group are predominantly insurance-related, this approach leaves very limited or no EBITDA in the non-insurance part of an insurance group. As a result, non-insurance companies (including holdings) that are part of an insurance group could be faced with an unintended interest limitation. This situation differs from non-financial groups for which, under a consolidated approach, the main source of earnings that constitutes the basis for determination of the interest deductibility is included when applying the fixed ratio rule.

While for other industries consolidated approaches in any form are appropriate, applying a fixed ratio rule to the non-insurance part of an insurance group is not. Only where the insurance activities of a group are less than predominant could such a rule be suitable. So, as a first step, prior to applying any fixed ratio rule, it would need to be determined whether the activities of the group predominantly consist of insurance activities. Only if not, the modified fixed ratio rule could be applied.

Many European insurers have a non-financial holding company. Insurers often issue regulated debt out of this holding company and may use the debt to subscribe for equity in the insurance undertaking (as equity is considered higher-quality capital by regulators). Furthermore, the company in which the equity has been invested could be in the same territory as the holding company that has raised the debt. Carving out the insurance undertaking would remove the interest income and operating income from the EBITDA calculation, which Insurance Europe believes could lead to inadvertent interest restriction. Specifically, many insurance groups would have a negative EBITDA and most interest would therefore not be deductible.

If general rules are not applied to insurers as suggested above, Insurance Europe believes that this risk of inadvertent interest restriction can be partially mitigated by strengthening paragraph 56 of the Discussion Draft. The recommendation in paragraph 56 should automatically exclude all third-party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities. This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related.

**Answers to consultation questions**

**Question 1:** Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

**Question 3:** Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country’s regime.

The OECD acknowledges that existing regulation acts as a safeguard for any insurance BEPS risk. In Europe, this refers primarily to the Solvency II Directive which applies to all insurers. Solvency II limits the amount of debt an insurer can hold to meet its regulatory capital requirements. These limits apply to all capital tiers at both group and subsidiary level. If any limits imposed by Solvency II are breached, the excess debt would provide no capital benefit. Insurance Europe believes that Solvency II also provides adequate safeguards to BEPS activity and welcomes the OECD’s recognition that the potential BEPS risk in insurance is low. Insurance
Europe believes that these considerations apply to all companies in an insurance group which is subject to group regulation.

While the above refers primarily to the regulatory environment in Europe, it should also be noted that many other jurisdictions are developing regulatory rules that follow the principles of Solvency II and that will therefore most probably be considered equivalent to Solvency II. In addition, European insurers who reinsure in non-EU jurisdictions are asked to demonstrate that regulation in those jurisdictions is equivalent to Solvency II.

While the OECD acknowledges that existing regulation acts as a safeguard for any insurance BEPS risk, it also states that this role is limited by inconsistent regulatory frameworks between various jurisdictions. Insurance Europe would point out that there is a significant effort ongoing to harmonise regulation internationally and regionally, for both banks and insurers. Therefore, this concern is unfounded.

The OECD’s Discussion Draft also raises the issue of “hybrid” capital which can be treated as equity for regulatory purposes and as debt for tax purposes and which could escape interest limitation rules. Insurance Europe would point out that regulation such as Solvency II places an upper cap on the amount of hybrid capital which can be issued for regulatory purposes, so this effectively restricts any BEPS risk. In any case, it should be acknowledged that hybrid regulatory capital is not designed to create tax mismatches and its use does not constitute a harmful tax practice.

**Question 5:** Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

Insurance Europe believes that, if it is accepted that insurers pose a low BEPS risk, general rules should apply to insurers rather than no rules at all. If tax authorities are concerned about specific insurance structures from a BEPS perspective, targeted rules can complement the general interest limitation rules and would be the most effective way to address these issues. Applying special rules regardless of the very low BEPS risk in insurance would result in inappropriate restrictions.

**Question 6:** What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

Insurance Europe is unaware of existing specific rules for insurers in any jurisdiction. This is probably because excessive leverage in an insurance company has not been identified. As explained above, if tax authorities are concerned about specific insurance structures from a BEPS perspective, targeted rules can complement the general interest limitation rules and would be the most effective way to address these issues. Applying special rules regardless of the very low BEPS risk in insurance would result in inappropriate restrictions.

**Question 7:** Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

Insurance Europe has serious concerns with this approach.

The fixed ratio rule would apply to groups but would not apply to regulated insurance companies which are part of these group. The consequence of this proposal would be that the interest income (from the bond portfolios held by insurers) and operating profit (from the positive underwriting result) of insurers would be excluded, whereas the full amount of interest expense on debt issued at holding level would remain in scope.
Insurance Europe believes that this approach is flawed. Where typically the activities of an insurance group predominantly consist of insurance-related activities, this approach leaves very limited or no EBITDA in the non-insurance part of an insurance group. As a result, non-insurance companies (which includes holdings) that are part of an insurance group could be faced with an unintended interest limitation. This situation differs from non-financial groups for which - in a consolidated approach - the main source of earnings that constitute the basis for determination of the interest deductibility is included when applying the fixed ratio rule. Therefore, while for other industries consolidated approaches in any form are appropriate, applying a fixed ratio rule to the non-insurance part of an insurance group is not. Only where the insurance activities of a group are less than predominant could such a rule be suitable. So, as a first step prior to applying any fixed ratio rule, it would need to be determined whether the activities of the group predominantly consist of insurance activities. Only if not, the modified fixed ratio rule could then be applied.

Many European insurers have a non-financial holding company. Insurers often issue regulated debt out of this holding company and may use the debt to subscribe for equity in the insurance undertaking (as equity is considered higher-quality capital by regulators). Furthermore, the company in which the equity has been invested could be in the same territory as the holding company that has raised the debt. Carving out the insurance undertaking would remove the interest income and operating income from the EBITDA calculation, which Insurance Europe believe could lead to inadvertent interest restriction. Specifically, many insurance groups would have a negative EBITDA and most interest would therefore not be deductible.

**Illustration:** In this example, the two holding companies of an insurance group have negative EBITDA (which is not uncommon in insurance, as they incur management expenses and have no income but dividend income). Under the proposed carve-out of insurance companies, the local group will have net interest expense of EUR 60 million but no positive EBITDA. As a consequence, the entire interest expense of 60 will be disallowed, while without a carve-out the positive EBITDA of the operating group could be used in applying the fixed ratio rule, if the group would be in a net interest expense position.

<table>
<thead>
<tr>
<th>EUR (million)</th>
<th>Holding Company 1</th>
<th>Holding Company 2</th>
<th>Operating company regulated insurer</th>
<th>Local group</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>-25</td>
<td>-5</td>
<td>100</td>
<td>-30</td>
</tr>
<tr>
<td>Net interest income/expense</td>
<td>-45</td>
<td>-15</td>
<td>200</td>
<td>-60</td>
</tr>
<tr>
<td>Fixed ratio</td>
<td></td>
<td></td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Interest capacity</td>
<td></td>
<td></td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Net interest income/expense of local group</td>
<td></td>
<td></td>
<td>-60</td>
<td></td>
</tr>
<tr>
<td>Total interest disallowance</td>
<td></td>
<td></td>
<td>-60</td>
<td></td>
</tr>
<tr>
<td>Allocation of disallowance</td>
<td>-45</td>
<td>-15</td>
<td>-60</td>
<td></td>
</tr>
<tr>
<td>Interest taxable/deductible</td>
<td>0</td>
<td>0</td>
<td>200</td>
<td></td>
</tr>
</tbody>
</table>

If general rules are not applied to insurers as suggested above, Insurance Europe believes that this risk of inadvertent interest restriction can be partially mitigated by strengthening paragraph 56 of the Discussion Draft. The recommendation in paragraph 56 should automatically exclude all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities and services (including asset management). This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related.

**Question 8:** Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?
While insurers do not usually borrow to make an equity investment, it is certainly the case that many insurance groups often raise debt at holding company level to support a subsidiary of the group (by way of passing down equity or boosting the group regulatory capital requirements). The use of equity rather than debt would in this case be a requirement of the regulator which would insist on using equity (i.e. the strongest, most loss-absorbing, type of capital).

**Question 12:** Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?

The discussion draft gives two examples in paragraph 46 of instances in which insurers could engage in BEPS activity.

- **Where an insurance group includes entities in more than one country or are taxed differently.** European insurers are all subject to Solvency II regardless in which EU country they have entities. When European insurers have entities in non-EU jurisdictions, they are asked to demonstrate that regulation in those jurisdictions is equivalent to Solvency II. Therefore, Insurance Europe believes that no BEPS risk can arise in such situations.

- **Where an entity is part of the local group, but outside the regulatory group.** As explained above, this would be a situation best addressed through targeted rules, which would avoid any inadvertent impacts of a special rule for insurers.

**Question 13:** Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company:

**Application of the fixed ratio rule to a local group excluding banks and insurance companies.** Just as Insurance Europe is concerned by the application of a fixed ratio rule to a group while excluding the insurance companies of this group, it has similar concerns about the suggestion to create a second local group containing only insurance subsidiaries and to apply the fixed ratio rule to that group. In this case as well, the majority of interest income and business profits would be removed from the interest limitation rules while leaving the full amount of interest expense on debt issued at holding level under the scope. As explained above, all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities should be automatically excluded.

**The treatment of interest expense on debt supporting banking or insurance activities.** Although the OECD recognizes that non-deductibility of interest may not be appropriate in case of instruments that support regulated banking or insurance activities, the suggested mechanism to remedy this seems too narrowly calibrated because:

- Only interest on regulatory capital is excluded, while other types of debt may also support the banking and insurance activities.
- Only external interest is included.
- For non-regulatory instruments, the OECD suggest that BEPS should not be an issue if funds are lent on similar terms. However, in practice this may not necessarily be the case.
- The allocation approach as described in paragraph 60 seems discriminatory and would likely result in something that BEPS is trying to limit, namely tax-motivated behaviour.

Insurance Europe believes that this discrepancy can be remedied by strengthening paragraph 56 of the Discussion Draft. The recommendation in paragraph 56 should automatically exclude all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities and services (including asset management). This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related.
Question 15: Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

Question 16: Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

Applying the group ratio rule to an insurance group while excluding insurance subsidiaries would yield a similar result as when the modified fixed ratio rule is applied (i.e. the majority of interest income and business profits would be removed from the interest limitation rules while leaving the full amount of interest expense on debt issued at holding level under the scope). Insurance Europe believes that the recommendation in paragraph 56 should automatically exclude all third party interest expense on all debt issued by a European company whose activity is mainly or entirely insurance or related activities. This recommendation should also apply in the same conditions to groups where insurance entities and bank entities are related. The best approach would be to apply the group ratio rule to the insurance group including insurance subsidiaries.

Question 17: Do you have any other comments on any of the issues raised by this discussion draft?

Insurance Europe believes that existing debt should benefit from grandfathering or at least from a transitional period which would allow for the most efficient restructuring of the existing debt, a big part of which is long-term.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe’s economic growth and development. European insurers generate premium income of €1 200bn, directly employ over 975 000 people and invest nearly €9 800bn in the economy.
Dear Mr. Mark Johnson,

Public Discussion Draft – BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

The International Banking Federation (IBFed) is the representative body for national and international banking federations from leading financial nations around the world. This worldwide reach enables the IBFed to function as the key international forum for considering legislative, regulatory and other issues of interest to the banking industry and its customers.

The IBFed understands the importance of the Base Erosion and Profit Shifting (BEPS) project, and the OECD’s expectation that the final outcome will deliver fair, certain, predictable, sustainable and principled rules that taxpayers can easily apply and tax authorities can easily administer.

The IBFed would like to express its gratitude for this opportunity to comment on the OECD Discussion Draft on BEPS Action Item 4, Approaches to Address BEPS Involving Interest in The Banking and Insurance Sectors issued on 28 July, 2016 (the Discussion Draft). We respectfully submit the following comments on this issue for your consideration.

Endorsement of Other Submissions

Set out below is a summary of our key points, some of which are explained in more detail in the submissions made by the Australian Bankers Association, the British Bankers Association and Fédération Bancaire Française. We have reviewed those submissions and agree with and endorse them.

Executive Summary and Proposed Approach

We welcome and acknowledge the position of the OECD in the Discussion Draft, that:

… excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low … [para 26]

Banks are highly regulated, and the regulatory environment for the banking industry is an important constraint that mitigates against BEPS concerns.
It is important for the Banking industry that the regulatory capital and tax rules are aligned. Therefore, we propose that the following approach be adopted:

1. Banks and insurance companies should be treated separately for BEPS purposes. Whilst there are some similarities, they are different types of organisations and are regulated differently.

2. The OECD should endorse a view that the regulatory constraints on banks can effectively eliminate interest related BEPS risk, and that the first step in applying these rules to banks should be for the tax authorities to assess whether there are any interest related BEPS risks which are not addressed and appropriately constrained by regulation in their jurisdictions.

3. Where no interest related BEPS risks are identified, there should be a full exemption for banking groups from any action on interest restrictions that might be taken in response to BEPS Action 4.

4. If an interest related BEPS risk is identified, then the specific country should introduce anti-avoidance rules that:
   a. are targeted at the specific risk/behaviour, and have limited application;
   b. have regard to (and be consistent with) the local regulatory rules;
   c. be consistent across jurisdictions (it becomes too complex for international banks to deal with different rules in different jurisdictions); and
   d. recognise the complexity of the banking business and are not so complex and cumbersome that appropriate administration of the rules is not possible for either taxpayers or tax administrators.

5. Finally, the attribution of profits to permanent establishments should be exempted from any general or specific rules. The 2010 OECD Report comprehensively addresses any BEPS risks which may exist in the context of permanent establishments.

**Regulation of Banks**

The regulatory constraints on Banks are more extensive than covered in the Discussion Draft.

In most countries that have adopted Basel III, banks are subject to individual regulation and banking groups are subject to consolidated supervision. These rules constrain a Bank’s ability to alter its regulatory capital structure, or the location of external loans, for tax reasons and therefore restrict interest related BEPS issues.

The primary regulatory and commercial constraints on Banks that eliminate interest related BEPS risks include the following:

1. **Capital requirements**

   Banks are required to hold minimum levels of capital. Post Basel III, the minimum prudential capital requirement (PCR) a Bank is required to hold is [4.5%] core equity and [8%] total regulatory capital (TRC). In fact, banks hold capital in excess of these minimum PCRs, by incorporating buffers particular to their circumstances. It is not uncommon for a bank to hold in excess of [8%] core equity and [11.5%] total regulatory capital1.

   Core equity is comprised of shareholder capital, retained earnings and current year profits. Return under core equity is non-deductible, so banks already effectively take a hair-cut for certain proportion of their funding costs. TRC also includes AT1 and Tier 2 funding. AT1 is also non-deductible in a number of jurisdictions.

   There is an increasing trend for the banking regulators to increase the amount of core equity held by banks, so this non-deductible funding component will likely increase over time.

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1 Ratios will differ between jurisdictions, as the local regulators may differ on implementation of calculation for risk weighed assets.
2. Large Exposure Limits

Banks are subject to large exposure limits (LEL), which is to ensure that banks are not overly exposed to individual counterparties – both related and unrelated. Broadly, the rules require Banks to:

- monitor, manage and control potential contagion risk between banking group and other members of a conglomerate group of which the bank is part;
- meet minimum requirements with respect to dealings with related entities and certain related matters; and
- comply with prudential limits on intra-group exposures.

The general impact of these rules are to place restrictions on the ability of banking groups to issue debt and push this down to subsidiaries as equity and also limits the possibility of re-allocating debt disproportionately to one entity (e.g. in a high tax jurisdiction).

3. Regulation of Intragroup flows

Many regulators also place limits on the flow of funds between head office and branches/subsidiaries. The regulators want the local balance sheet and income statement to be stable and predictable, with limitations on the ability of funds to be transferred to parts of the group in other jurisdictions – particularly in time of crisis.

4. Liquids and High Quality Liquid Assets (HQLAs)

Banks are required to hold liquids to meet their obligations, and hold a minimum level of HQLAs to survive a severe liquidity stress. Under the Liquidity Coverage Ratio (LCR) imposed by the regulators, banks are required to maintain an adequate level of unencumbered HQLAs to meet their liquidity needs for a 30 day period under a severe stress scenario. HQLA’s have a negative cost of carry (i.e. the return earned on these liquids is less than their funding cost).

This means that Banks are not able to simply leverage themselves with any kind of debt. Some of the debt raised will likely be used to acquire the HQLAs, and there will be an associated cost - being the negative cost of carry.

Further, under Basel III, international banks are generally required to hold liquids in the jurisdiction where the funding is raised. This is because Banks are expected to hold liquids by currency, and the regulators effectively restrict the ability of Banks to transfer liquids across jurisdictions.

Other Comments and Considerations

Other comments and considerations that we would like to make on the Discussion Draft are as follows:

Existing Tax Laws

All of the jurisdictions have existing tax laws in place that deal with some of the specific BEPS risks raised in the Discussion Draft, such as domestic thin capitalisation, transfer pricing and Controlled Foreign Corporation (CFC) rules.

Interest Funding Non Taxable Income on an Equity Investment

We agree with the observations in the Discussion Draft that there are ‘regulatory and commercial considerations which impose costs or other down-sides as a result of [holding equity investments and receiving non-taxable income], reducing the attractiveness of such arrangements in most cases’ [para 35].

To the extent that income has been specifically exempted under a jurisdiction’s tax code, the key consideration is the not the borrowing to fund the income (if it could identified) but the exemption from
tax of the income stream generated. That should be a matter for the local tax authority to consider, rather than a matter for BEPS Action 4.

In so far as problems still remain (for example, the profits of a subsidiary are untaxed because it is located in a low or no tax jurisdiction [para 39]), the more appropriate solution is to invoke properly formulated CFC rules: the problem which needs to be solved is not the treatment of the interest expense but rather the failure which allowed profits diverted into a CFC to remain unattributed back to the parent company.

Corporate Group That Includes Both Banking and Non-Banking Subsidiaries

A presumption should be that all the entities in a corporate group which includes a deposit taking institution, regulated by the banking regulator, be outside the scope of an interest limitation rule. This is a sensible and workable approach, and is unlikely to result in a loophole which would undermine the thrust of the BEPS Action 4 project.

If additional protection is thought necessary, a requirement that banking activities are of a sufficient size compared to the rest of the group may add additional integrity.

If there is a large corporate group that includes a small bank, then the bank should be outside the interest limitation rule but the larger corporate can still be included.

We welcome the opportunity to discuss with you the comments raised in this paper.

Yours sincerely,

Hedwige Nuyens
Managing Director, IBFed

Michael Barbour
Chair of Tax Working Group, IBFed
Comments on Discussion Draft on BEPS Actions 4
“Approaches to address BEPS involving interest in the banking and insurance sectors”

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the “BEPS Action 4: Approaches to address BEPS involving interest in the banking and insurance sectors” released on July 28th, 2016.

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC’s Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

* * *

We would appreciate the effort of the OECD to address the risks of base erosion and profit shifting by aggressive tax planning involving excessive interest deduction which undermine a fair competition.

Various considerations are made in this discussion draft as to whether regulated banks and insurance companies should be excluded from the scope of the fixed ratio rules as well as the group ratio rules and instead a different approach should be applied thereto. It is also considered as to whether the targeted rules to address specific risks should be applied to the regulated banks and insurance companies with more flexibility.

The paragraph 5 of the discussion draft states the backgrounds of the above considerations including “entities engaged in banking or insurance business will typically have net interest
income rather than net interest expense” and “it is essential that the nature, extent and impact of regulatory capital requirements such as minimum amounts of equity and minimum capital ratios are understood”. In this regard, it should be noted that regarding the former, non-regulated group finance companies may also be in a similar position, and regarding the latter, any entities borrowing money from unrelated parties are also subject to implicit capital requirements irrespective of whether the regulatory requirements are applied and which sectors they belong to, such as a limitation on credit lines based on the credit analysis conducted by the lenders and regular examinations by credit rating agencies.

Therefore, it should be considered by the OECD that entities with sufficient capital in view of the thin capitalization rules which focus on debt/equity ratios be excluded from the scope of the fixed ratio rules, having regard to the similarity to the regulated banks and insurance companies. We note that the paragraph 17 of the final report issued in October 2015 states that the thin capitalization rules should not be included in a best practice approach since there are disadvantages such that it allows significant flexibility in terms of the rate of interest expenses on the debt, and the debt/equity ratios may be manipulated by increasing the level of equity under these rules. However, thin capitalization rules should be respected as it has an effect to restrict the debt/equity ratios to a certain level, which is a similar outcome achieved by the regulatory capital requirement applied to the banks and insurance companies.

It should also be taken into consideration that a fair competition may be undermined if the regulated banks and insurance companies are excluded from the scope of the fixed ratio rules and group ratio rules. In other words, in that case, regulated banks and insurance companies with net interest expenses will not be subject to a disallowance which logically should be made, whereas non-regulated entities such as group finance companies with similar net interest expenses may be subject to a disallowance irrespective of whether the fixed ratio rules are applied on an entity-by-entity basis or to the local group’s net interest position, which will result in a competitive disadvantage on the non-regulated entities compared to the regulated banks and insurance companies. Thus, sufficient care should be taken in this respect in considering a different approach to the regulated banks and insurance companies as this may undermine the fair competition which is one of the targets of the BEPS project.

Furthermore, though the final report prescribes that the fixed ratio rules would also be applicable to the interest expenses paid even to domestic companies and unrelated parties, given that the purpose of these rules are to prevent the base erosion and profit shifting by aggressive tax planning involving excessive interest deduction, we would like to reiterate that the interest expenses subject to the restriction on deductions under the fixed ratio rules should be limited to only those payable to foreign related parties.
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Comments on Discussion Draft on BEPS Action 4 – Approaches to Address
BEPS Involving Interest in the Banking and Insurance Sectors

KPMG International (‘KPMG”) welcomes the opportunity to comment on the Organisation for Economic Co-operation and Development’s (‘OECD”) discussion draft on BEPS Action 4 – Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors, dated 28 July 2016 (the “Discussion Draft”).

As acknowledged in the Discussion Draft, the issues raised by interest deductibility in the banking and insurance sector are complex, and made more so by the differences among jurisdictions’ existing tax and regulatory environments. These differences mean that there is unlikely to be a “one size fits all” solution, and we commend the acknowledgement in the Discussion Draft that countries will need to tailor any new rules for their specific tax and regulatory environments.

Our comments do not address all of the questions posed in the Discussion Draft, but focus on questions 13 and 14:
As noted in the Discussion Draft, regulatory constraints limit the possibility of BEPS for banking and insurance companies, and in any event banking and insurance companies are often net recipients of interest income, rather than net payers of interest expense. For that reason, we agree with the view expressed in paragraph 26 of the Discussion Draft that excessive leverage in banking entities has not been identified as a key risk at this point in time. We also generally support the view, expressed in the Discussion Draft, that a fixed ratio rule (“FRR”) should not apply to banking or insurance entities.

Specifically, paragraphs 31 and 32 of the Discussion Draft suggest that jurisdictions might apply the FRR either on an entity-by-entity basis (which, in practice, would exclude banks or insurance companies with net interest income) or by excluding banks and insurance companies from the scope of the FRR. Paragraph 32 suggests that the FRR may be applied more effectively to other entities in a group, without taking into account the net interest income or EBITDA of banks or insurance companies in the group.

In our view, however, limiting the carve-out to the FRR only to solo-regulated entities would result in inappropriate results and unnecessary complexity, as we discuss in more detail below. Instead, we suggest that, where a group or sub-group within a jurisdiction is wholly or mainly engaged in banking and/or insurance activities, consideration be given to excluding all companies within that group or sub-group from the application of the FRR and group ratio rule (“GRR”). This approach, of exempting all entities in a banking or insurance group, seems to be supported in paragraph 6 of the Discussion Draft, but is not further developed.

The alternative to applying an exclusion to all entities in a group that is wholly or mainly engaged in banking and/or insurance activities would be to exclude solo-regulated entities
and to have supplementary rules to take into account debt that is related to the activities of those entities.

**Interest on Debt that Supports Banking or Insurance Activities**

In the case of a group that is wholly or mainly engaged in banking or insurance activities, excluding only the banking or insurance companies often would mean applying the FRR or GRR to a residual group that includes only holding companies and/or companies that provide group services. As discussed in paragraph 67 of the Discussion Draft, applying the FRR or GRR to such a group would appear illogical, especially where the activities of the holding company or non-regulated entity are related to the banking or insurance activities of the group.

For example, applying the FRR or GRR to a holding company of a group that is wholly or mainly engaged in banking or insurance activities is likely to result in different treatment of taxpayers depending solely on whether or not debt is incurred at the holding company level or in a solo-regulated entity. The position of debt, and whether or not debt can be pushed down to a solo-regulated entity, is often dictated by regulatory requirements, with the motivation being nothing to do with tax or BEPS activity.

The Discussion Draft recognizes these concerns in paragraphs 54 through 60, suggesting that, if banks and insurance companies (and their interest income) are to be excluded from the group, then interest expense on debt incurred to support banking or insurance activities should also be excluded. While we support this general concept, we do not think that the Discussion Draft adequately addresses these concerns.

In particular, we support the suggestion in paragraphs 54 through 58 of the Discussion Draft that “regulatory capital” issued by non-regulated entities be excluded from the rules. Example 4 of the Discussion Draft reflects a straightforward way to implement this approach.

Groups also issue non-regulatory capital to support the banking or insurance activities of the group, as noted in paragraph 60 of the Discussion Draft. We support the suggestion in paragraph 60 that interest expense on debt that funds the income of the bank or insurance company be excluded, regardless of whether the debt qualifies as regulatory capital and regardless of whether the holding company’s investment in the bank or insurance company is in the form of debt or equity, at least when the entity with interest expense and the bank or insurance company are in the same country.

We note, however, that none of the examples in the Discussion Draft illustrate this “same country” exception, and indeed Example 2 seems to suggest a very different approach. Example 2 involves three entities that are all resident in Country X: A Co (a holding company), which owns B Co (a non-financial operating company) and C Co (a solo-regulated bank or insurance company). In Example 2, the EBITDA and net interest income of C Co are excluded from the group for purposes of applying the FRR, and the example concludes that the outcome is the same as if A Co and B Co had been entities in a different sector and had not been part of the same group as a bank or insurance company.
Example 2 appears to neglect, however, the fact that the capital of A Co – including its debt – supports the banking or insurance activity of C Co. Under the approach in Example 2, the income of C Co is subject to tax in Country X, but the interest expense of the rest of the group is not adjusted to reflect the fact that some of that interest expense supports the income of C Co.

Example 2 does not provide details of intragroup payments, and some of the income of C Co might be paid to A Co in the form of interest that would reduce A Co’s net interest expense. Even in that case, however, some of A Co’s equity investment in C Co is properly viewed as funded by part of A Co’s debt, and the same country exception should take that into account.

The same country exception therefore requires rules to determine when debt of a non-regulated entity is used to fund banking or insurance activity. Paragraph 60 suggests a tracing rule that would exclude interest expense on an instrument the proceeds of which are actually invested in a debt or equity investment in the bank or insurance company. This type of tracing approach has the benefit of providing a bright line rule, and of being relatively simple to compute, at least in relation to new funding. On the other hand, it is likely to be very difficult to apply to historic structures, and it also ignores the fact that capital is fungible, so in some sense all of the capital of the holding company supports all of the debt and equity investments of the holding company.

An alternative approach may be to ignore any interest income of the holding company from the bank or insurance company, and then exclude from the FRR a percentage of the group’s interest expense. Given the fact that EBITDA is not a meaningful measure of income in the banking and insurance sector, as noted in the Discussion Draft, it would be necessary to use a measure other than EBITDA to determine how to allocate the interest expense of the holding company.

Alternative allocation measures pose significant challenges. For example, jurisdictions might consider an asset-based approach, such that a proportion of the group’s debt would be excluded based on the proportion of the group’s assets represented by the banking or insurance companies. We note, however, that the U.S. foreign tax credit rules include one version of an allocation approach based on asset values, and those rules might be viewed as raising a number of complicated issues, including valuation (especially of intangible assets) and the treatment of interest income and expense of fiscally transparent entities.

We submit, therefore, that jurisdictions may wish to consider excluding from the application of the FRR and GRR all of the entities (including holding companies and group services companies) of a group that is wholly or mainly engaged in banking and/or insurance activities. These kinds of groups do not appear, in our view, to justify the administrative complexity created by the types of allocation rules that would be necessary to exclude interest expense on debt that supports the banking or insurance activities of the group.

**Debt Owed by Non-Regulated Entity to a Related Regulated Entity**

Our experience also suggests that non-bank/insurance subsidiaries are often funded by related regulated entities in the same jurisdiction. In that case, excluding the regulated
entities from the FRR would ignore the interest income (which is taxed locally) while potentially limiting the interest expense of the non-regulated entity.

To address this concern, a supplementary rule would be required to exclude from the FRR interest expense on debt owed to a related bank or insurance company in the same country, where the bank or insurance company is otherwise excluded from the FRR or GRR. If the borrower has taxable domestic income, the interest deduction by the borrower and the interest income of the bank offset, and there should be no BEPS risk. Targeted rules could be developed to address circumstances in which the debt funds an investment that generates tax-exempt or deferred income, though these rules may add considerable complexity.

Exclusion for Banking and Insurance Groups

Given the complexities of applying the FRR or GRR to non-regulated entities in a group that includes banking or insurance entities, we suggest that jurisdictions may wish to consider excluding from the FRR and GRR all entities in a group that is wholly or mainly engaged in banking and/or insurance activities. Each jurisdiction could define, using principles relevant in its existing tax and legal system, when a local group or sub-group is wholly or mainly engaged in banking and/or insurance activities (or substantially all of the group’s activities consist of banking and/or insurance). Such a definition could presumably be based on a combination of ratios looking at assets, revenues, and employees or officers, over a period of time.

In determining whether a group or sub-group meets the wholly or mainly (or substantially all) activities test, consideration might be given to treating the financial services activities of regulated group entities other than banks or insurers in like manner to those of the regulated bank and insurance group members. The European Union's (“EU”) definition of Financial Undertakings, which are excluded from the scope of the EU interest limitation rule, includes a number of non-bank/non-insurance entities also subject to regulation, e.g., certain regulated fund managers and investment firms. This appears to recognize that the regulatory environment in which these firms operate imposes restrictions that limit the opportunities for BEPS due to debt, because these regulated entities need to meet certain capital adequacy requirements in order to protect stakeholders including investors and customers.

For example, the capital requirements for a regulated investment firm in the EU are driven by the type of service undertaken and an analysis of business risk. Each investment firm is required to formulate an internal capital adequacy assessment process (i.e., ICAAP) as a means of determining that they have an adequate level of capital required to cover the business’s risk. The “own funds” requirements for firms subject to the EU’s Markets in Financial Instruments Directive (i.e., MiFID) provide a regulatory capital framework:

In order to ensure that firms are able to organize an orderly winding down or restructuring of their activities, they should hold sufficient financial resources to withstand operational expenses over an appropriate period of time. During the winding down or restructuring, a firm still needs to
continue its business and be able to absorb losses which are not matched by a sufficient volume of profits, to protect investors.¹

The requirement imposed on investment firms to meet these ongoing capital adequacy requirements might be considered to limit the opportunity to reduce profits using debt.

Applying an exclusion from the FRR and GRR to all entities in a group that is wholly or mainly engaged in banking and/or insurance activities would greatly simplify a jurisdiction’s limitations on interest deductibility, and would not preclude a jurisdiction from adopting targeted rules to address BEPS concerns in such a group. For example, the Discussion Draft suggests that some jurisdictions may be concerned about the use of leverage in such a group to fund investments that give rise to tax-exempt or deferred income, and those jurisdictions could develop appropriately tailored rules that address those concerns.

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About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

Memo

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To The International Co-operation and Tax Administration Division,
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From Ramona Jurubiță
  Teodora Alecu
  Mastacaneanu Ionut

Date 12 September 2016

Comments on Public Discussion Draft on approaches to address
BEPS Action 4 involving interest in the banking and insurance
sectors

Dear Sir or Madam,

Please find below our comments on the discussion draft on approaches to
dress BEPS involving interest in the banking and insurance sectors. Our
comments below refer to the specific case of emerging countries which rather
have a traditional banking system.

As a general comment, we believe that emerging countries that do not have
sophisticated lending, financial investments and insurance sectors, might be
unfairly/disproportionately affected by the proposed rules and one might
question whether the cost of implementing such rules would not exceed the
potential benefits.

Also, there may be differences between the debt-to-equity ratio concepts from
a fiscal perspective versus the prudential approach under the domestic
regulatory framework, as well as the proposed Public Discussion Draft in
question. Thus, we consider that it would be necessary introducing extensive
rules on this concept, if intended to be applied in the banking and insurance
sector.
We address below the specific points of the discussion draft:

**Point 9**
It is not clear to us which would be the risk of BEPS in the banking and insurance sector of emerging countries with a banking system dominated by traditional retail and commercial banks. For example, we find that the risk raised at the first bullet point in the Draft Discussion Paper is rather marginal in the case of retail and commercial banks whose activities, consisting mainly in taking up debt for the purpose of lending, lack the complexity of those of investment banks and are thus less prone to the BEPS risk mentioned here (as their equity investments do not represent a significant portion of their balance sheet).

We think that by introducing the set of rules stated by the Draft Discussion Paper would give rise to a substantial burden for the taxpayers in the field, in comparison to the benefit that the tax authorities may have by preventing and/or identifying potential cases of BEPS. In order to secure the buy-in of the stakeholders in this project, we think that the tax risks intended to be addressed under this BEPS approach should be explained in more detail.

**Point 13**
It may be necessary to also refer to non-banking financial institutions. Such entities are usually subject to a less restrictive prudential supervision from the Regulatory Body, which raises the question of whether such entities should be included under this particular approach or under the general approach set in Action 4 Report.

**Point 15**
Insurance companies and banks are very much different in terms of activity and business model. Wouldn’t it be needed to settle a separate set of rules?

**Point 19**
There are cases where certain financing is needed under the regulatory capital requirements. There are 2 aspects in this sense:

- (i) If receiving funds of a certain nature is required and compulsory under the prudential supervision regulations (such as Tier 2, Tier 3), we think that it would be not reasonable to disallow the deductibility of the related interest expenses, solely because the group chose not to increase the share capital but to put in place subordinated loans arranged within the conditions compliant with prudential requirements;

- (ii) If certain intra-group transactions are carried out, as an option to continue and expand the business, under the constraints of the prudential supervision requirements, it would be unfair to disallow the deductibility of related interest expenses.
Comments on discussion draft on approaches to address BEPS involving interest in the banking and insurance sectors
12 September 2016

Point 27
With respect to identifying material BEPS risk from excessive leverage in banks and/or insurance companies, we think that care should be taken as currently there is no harmonization with the concepts and terms used in the fiscal legislation.

In taxation, substance over form is more and more used, the approach being also intensively recommended by the OECD BEPS Action Plan.

Due to the lack of harmonized definitions of the items which qualify as quasi-equity under the prudential supervision requirements and the items traditionally considered as debts or equity for tax purposes, the scope of this Public Discussion Draft may be susceptible to interpretations and thus to a potential arbitrary approach from tax authorities.

Point 28
Given the business profile of the banks and insurance companies in emerging countries, which is a traditional financing based one rather than an investment based one, we think it would not be appropriate to apply such standard ratio based limits to interest expenses of banks and insurance companies?

Point 46
Bank and insurance groups may be engaged in BEPS without preventing the group as a whole from meeting its regulatory capital requirement – what if the capital requirements imply the group entities engaging in the transactions/BEPS?

Point 56
Equity reclassified debt with zero interest expenses would result in a negative net interest position at the level of the lender. But, given the qualifying regulatory capital (see also point 60), it may be considered as unfair.

Yours faithfully,

Ramona Jurubiţă
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By email to: interestdeductions@oecd.org

8 September 2016

Dear Mr. Pross,

**BEPS Public Discussion Draft: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors**

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD’s *Public Discussion Draft BEPS Action 4: Approaches to address BEPS Involving Interest in the Banking and Insurance Sectors* (the “discussion draft”).

Our comment letter contains four sections:

I. An executive summary setting out our primary comments and recommendations.

II. A more detailed commentary on the principles which we consider relevant to BEPS involving interest in the banking and insurance sectors which we believe support our primary recommendations.

III. Our responses to the questions for consultation contained in the discussion draft.

IV. A detailed analysis of global bank regulation which in our view bolsters our primary recommendation to exempt regulated financial groups from Action 4 and responds to the request that interested parties offer additional comments on the issues raised in the document.

I. Executive Summary

Our principal comments and recommendations may be summarised as follows:

1. The discussion draft acknowledges that there is limited scope for BEPS risks arising in regulated banking and insurance groups due to the limits on leverage imposed through the prudential regulatory regimes which apply to groups operating in these sectors. We agree with this assessment.
2. Applying the fixed ratio rule under Action 4 to banking and insurance groups (or entities within such groups) would impose a significant compliance burden on such groups, may give rise to tension with prudential regulatory policy objectives (e.g., in relation to resolution) and could lead to double taxation. These risks will likely increase to the extent that alternative approaches are adopted by territories in relation to the application of Action 4 to banking and insurance groups. In view of this, we believe it is important that the OECD recommend a preferred single approach for member countries to adopt.

3. Given the limited BEPS risk coupled with significant potential downsides of applying the fixed ratio rule, we believe the preferred approach would be to exclude groups engaged primarily in banking and insurance activities (referred to in this paper as “Regulated Financial Groups”) from Action 4 entirely. Further work will need to be performed to determine an appropriate definition of Regulated Financial Group for this purpose although there are precedents elsewhere which may be adopted as a starting point from a banking perspective. We comment on these further below.

4. The discussion draft considers an alternative option being the exclusion of regulated entities from Action 4 with the fixed ratio rule applying to non-regulated entities. We consider this approach would be problematic and could potentially put banking and insurance groups in a worse position than non-banking groups. In view of this, to the extent that an exclusion of banking and insurance groups entirely is not considered optimal, we believe the preferred alternative approaches would be: (a) application of the standard fixed ratio and group ratio rules to banking and insurance groups as a whole (i.e., consistent with other industry sectors), or (b) exclusion from Action 4 of both the regulated entities within a banking or insurance group and those entities conducting activities which are integral to the core banking or insurance business of the groups but which for regulatory or other commercial reasons are conducted in separate legal entities (e.g., group holding companies, group service companies, financing vehicles, etc.).

5. The discussion draft highlights the BEPS risk associated with debt funding being used to finance equity investments which give rise to income which is not taxed or taxed at a preferential rate. We believe it is more appropriate to address such risks through appropriate CFC measures rather than through Action 4.

6. On a more general level, given the fundamental importance of financing and interest in the banking and insurance sectors, it is vital that any approach recommended in relation to Action 4 is consistent with measures taken under other BEPS actions relating to financing activities (e.g., hybrids, CFC, etc.) such that banking and insurance groups have an appropriate level of certainty in relation to the tax treatment of a core element of their business. We believe an exclusion from Action 4 entirely would be the preferred means of achieving this.

7. While the primary focus of this letter is to recommend an exclusion for RFGs, we also recommend regulated banks (and their transactions) within non-banking groups be excluded from Action 4.
II. General comments

Banking and Insurance Groups

We recognize and compliment the OECD in the final report in understanding the need for further analysis in developing rules with respect to debt-equity issues and the deductibility of interest on debt for the banking and insurance sectors.¹

Our primary recommendation is to exempt from Action 4 banks and insurance companies at a group level since in the current regulatory environment, these RFGs not just individual entities, are subject to a number of regulatory rules that govern and constrain virtually every aspect of their business, including the use of debt.

The discussion draft acknowledges the BEPS risk related to overleverage for banks and insurers is relatively low and our recommendation is consistent with that observation. Prescribing nuanced rules which may be more complicated than the rules in the final Action 4 report for non-regulated entities would seem to contradict the risk analysis. Moreover, it would increase costs and complexity to a sector which is already subject to stringent regulation with respect to its borrowings.

The discussion draft describes, in paragraph 9, the two structures (“risk one” and “risk two”) “used by banking and insurance groups which pose the types of BEPS risk intended to be addressed under Action 4. The main BEPS risks involving interest that have been identified include –

1. banks or insurance companies, and entities in a group with a bank or insurance company, using third party or intragroup interest to fund equity investments giving rise to income which is non-taxable or is taxed in a preferential manner;

2. entities in a group with a bank or insurance company incurring excessive third party or intragroup interest expense, which may be set against taxable interest income in the bank or insurance company.

We have two recommendations listed below regarding the two BEPS risks identified in paragraph 9 of the discussion draft.

1. Risk one related to debt funding of certain equity investments should be dealt with via a BEPS Action 3 CFC regime. Most existing CFC regimes already contain a requirement that passive income is included at the parent level. For the banking and insurance industry, the existing CFC regimes, with the requirement for key entrepreneurial risk taking (“KERT”) functions to be performed in the CFC jurisdiction (UK model) or that the CFC have employees that perform substantial activities to generate income (U.S. active financing model) are more effective. This solution is preferred in comparison to a rule which would limit the interest expense deduction. The backwards tracing of interest expense may be difficult to isolate, comply with and administer particularly due to the fungibility of money. Moreover, using formula to allocate or any other apportionment type method than a direct tracing can result in interest limitations which diverge from economic reality. We

recommend that the OECD, and participating BEPS jurisdictions, focus on the preferential income, and if needed amend their CFC regime.

2. Risk two related to groups with bank and non-bank entities is difficult to address, as we do not agree that third party interest expense poses a BEPS risk. When the subjective term “excessive” is added, it presumes someone other than the bank and the third party know the level of debt that is excessive. The rate of interest will be arm’s length between third parties, and the rate of tax of the payor and the payee is not an indication of BEPS, so this concern should simply be dropped. As discussed in further detail in Section IV below, the financial regulators are already performing the function to monitor and limit the regulated financial group’s leverage.

We believe, based upon the two recommendations above, and the current regulatory environment that encompasses the group, not just bank and insurance entities, our primary recommendation is that there should be a group wide exemption for RFGs. Section IIIV of our letter explains in detail how global regulation operates using a U.S. bank example (other countries have substantially similar rules pursuant to Basel III), and why RFGs should be exempt from an additional complex tax regime under Action 4 due to the financial regulatory regimes they operate under.

**Groups that Include a Bank or Insurance Company**

Rules to address the risks posed for a group that includes other entities with a bank or insurance company will clearly be a challenge to implement, comply with and administer. However, similar to potential BEPS risk two mentioned above, the inclusion in Example 5 whereby all of the debt funding is external, and therefore presumably at arm’s length, we do not believe poses a BEPS risk.

The discussion for these groups centred on how best to apply the EBITDA ratio to a group that includes a bank or insurance company to ensure the net interest income of these entities is not used to reduce or eliminate the effectiveness of the fixed ratio rule for entities operating other types of businesses. While BEPS risks in regulated banks and insurance companies might be mitigated by reliance on the non-tax regulatory regime, as discussed above, the BEPS Action 4 risks in holding non-regulated entities may not be easily mitigated, or they certainly present a higher hurdle. We do believe regulated banks and their transactions should be excluded from BEPS Action 4 even if they are within a non-bank group.

The discussion draft acknowledges that, in the context of the fixed ratio rule, the exclusion of interest income and expense from EBITDA could create significant issues for insurance and banking entities where interest is a key source of income. Somewhat helpfully, the draft suggests that excluding regulatory capital might be a possible approach, on the basis that if the capital had been issued by the regulated entity, it would be either excluded or unlikely to suffer a disallowance.

The discussion draft, at paragraph 67, discusses the practical difficulties of extracting the data necessary to properly produce a group ratio calculation, especially if certain items are excluded, such as regulated entities and regulatory debt funding. However, the paper doesn’t address the question of whether it is fundamentally correct to be excluding interest income and expense from the EBITDA calculation where interest forms a central part of ‘earnings’. The examples in Annex 3 show how this would work; however they are hypothetical, and assume significant levels of EBITDA excluding the
interest income of the financial services business. It remains to be seen how realistic the examples actually are.

We understand the final October 2015 report did view as a BEPS risk higher levels of third party debt in high tax countries. That said, the Example 5 in the draft Annex 3 did not disclose the tax rates in the borrower and lender jurisdiction, and arguably without this rate differential, and only arm’s length third party debt involved, there should be no BEPS Action 4 issue present in Example 5. In addition, going back to the 1998 Harmful Tax Competition report, merely having different tax rates was not an indicia of harmful competition, and we believe that should still be the case.

III. Comments on the Questions For Consultation

The risks to be addressed through interest limitation rules

1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

We do not believe so; the OECD has done a thorough job in identifying potential risks. As discussed in our submission, we believe these risks, specifically those for RFGs, do not require addressing in Action 4.

Banks and insurance companies

2. Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?

As the OECD has noted, interest income and expense are the result of ordinary course activities for banks, which is why our primary recommendation is that any BEPS Action 4 limits should not apply to interest on debt issued by any member of a RFG.

To the extent that the primary recommendation is not accepted, at a minimum, we would recommend a more nuanced approach should be taken, although this increases tax complexity and costs. As mentioned above, we believe this would not be consistent with the OECD’s objectives or risk assessment for this sector. One area of perceived leverage, when there may be no leverage at all due to over collateralization, is in the area of secured financing conducted by banks and securities dealers. It might make more sense to distinguish, and remove the collateralized securities based financing activities of banks and dealers a part of an Action 4 analysis. The GAAP rules generally require a balance sheet gross up of both assets and liabilities, despite the general over-collateralization provided in securities loans and repos.

Removing the collateralized securities based financing would significantly reduce the leverage in both banks and dealers, and avoid interest expense getting caught inadvertently in a BEPS Action 4 crossfire. These transactions, like deposits, including intercompany deposits among affiliates, are ordinary course activity for RFGs. Bank entities and broker-dealers obtain a significant portion of their debt funding through transactions directly with customers, in the form of repos or repo-like financing transactions rather than deposits. The broker-dealers also rely on longer-term intercompany
debt that reflects a portion of the debt issued by the top-tier parent entity in the capital markets. In addition to this longer-term debt, other intercompany debt transactions arise on a daily basis among the broker-dealer subsidiaries, reflecting the need to move cash and assets among them. For regulatory and customer preference reasons, a customer will typically establish a customer relationship with a single broker-dealer entity within a RFG (i.e., the prime broker) for all of its transactions. However, the natural home for the security that is the subject of a customer lending transaction may be in a different jurisdiction as a result of various factors, most importantly, where the market for that security is most liquid. The disconnect between the customer location and the location of the securities being purchased or financed frequently results in the creation of an intercompany debt obligation between two affiliated broker-dealers in different jurisdictions, but under the same global regulatory umbrella. For example, assume a U.S. client of a U.S. broker-dealer wishes to borrow cash against its holdings of gilts, the securities issued by the British government. In order to increase liquidity and for other business needs, the customer enters into a repo transaction under which it sells the gilts to the U.S. broker-dealer, which is its prime broker and with which it has a customer relationship, and agrees to repurchase the gilts at the conclusion of the repo. The group’s U.K. broker-dealer can more easily use gilts in its ordinary course of business because the natural market for gilts is located in the United Kingdom (where gilts are issued and traded in the secondary markets). Accordingly, to satisfy the customer’s desire to borrow against its gilt position, the U.S. broker-dealer will typically enter into a back-to-back transaction with the U.K. broker-dealer, such as an intercompany repo, to hedge the customer facing repo, and then the U.K. broker-dealer will use the gilts in its ordinary course of business.

Another consideration, absent an exemption for RFGs, would be the removal from an interest deduction limitation for any negative carry associated with the need to maintain high quality liquid assets (“HQLA”) in a liquidity buffer. The regulated bank or dealers’ cost of funding the HQLA will have a negative impact on the net interest margin, but such a negative carry is driven by a regulatory mandate, not a desire to base erode. A challenge to this approach, and a reason for our primary recommendation, is how to determine the negative carry due to the fungibility of the funding – direct tracing, an allocation or apportionment method? Whether to use an average or blended rate, how to treat currency impacts and derivatives used to hedge currency as well as interest rate and duration risk.

3. Are there other any (any other?) general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country’s regime.

The discussion draft at paragraphs 18-21 is concerned with different countries regulatory regimes being different in type, different in implementation dates, and also different from the local tax rules. This in inevitable as each jurisdiction seeks to implement what works best for that jurisdiction and for to address the goal of the particular regulator. Our view is there is no Action 4 risk for RFGs emanating from these differences, and that whatever works for the regulator of the home country should be sufficient for the tax authority in that jurisdiction, and that any globally regulated group should also have very limited BEPS Action 4 risk due to the combination of the global / umbrella regulation and the stand alone regulation of subsidiaries. At the very least, the tax authorities should not be at odds with the rules of another governmental agency. We believe that if the OECD attempts to step in and
cherry pick some of the debt and accompanying interest as “good” or “bad” they will inevitably create inconsistencies with the goal of the financial regulator.

We would like to provide more comment and context to the impact of the regulatory capital rules in order for the OECD to get more comfortable with our primary recommendation to exempt RFGs. The regulation and regulatory capital environment has a significant impact on intercompany and downstream funding for banks and insurance groups that would be RFGs, both forcing and restraining the use of debt. For RFGs, the top-tier parent entities (in the U.S. and elsewhere, known as financial holding companies) and each of the banking and broker-dealer subsidiaries are heavily regulated by multiple governmental agencies in order to ensure the country’s financial soundness and protect the depositors, customers and counterparties, as well as the financial system.

The RFG is regulated on a consolidated or umbrella basis, and the banks and broker-dealers are also regulated on a standalone basis. In the current environment, the regulators oversee every aspect of the business of an RFP, including monitoring the debt issued and the loans made. The prudential banking regulations impose regulatory capital requirements, meaning a minimum amount of common equity and certain preferred stock and subordinated debt funding (collectively referred to as regulatory capital) relative to assets, on both a risk-weighted and absolute basis. The regulatory framework also requires limits on leverage, limits on large exposures or risks, and resolution planning, including a capital structure designed to facilitate the orderly resolution of the parent corporation and its material legal entities in the event of future material financial distress or failure.

The regulatory capital rules recognize that debt and leverage are necessary to the operation of a financial services group in its role as a financial intermediary, but place limits on the extent to which a RFG may utilize leverage in order to preserve the safety and soundness of the individual institution and the financial system as a whole (systemic risk). In certain contexts, intercompany debt is encouraged or even required by regulation or supervisory guidance, because it can serve as a tool to enable the RFG’s movement of assets within the group in times of stress. For example, regulators require long-term debt as a component of capital.

The net effect of this regulatory framework is that regulated entities cannot take on excessive intercompany debt and, secondly, that regulatory compliance dominates the planning for the capital structure of a RFG in a way that essentially forecloses tax planning with debt in regulated entities.

In relation to insurance, there are solvency rules (Solvency II) which impose restrictions on the amount of debt which is permitted to count towards regulatory capital requirements. These restrictions exist at the solo and group level. Solvency II applies to European insurers, but similar rules exist or are being developed outside the European Union (“EU”), including for example equivalence requirements. We believe the BEPS risk is low because of the stringent regime in which insurers and other companies in their groups (such as service companies and holding companies) are subject to. The view of rating agencies also places limits commercially on the amount of debt which can be raised by insurance groups. Moreover, it is commonplace for insurers to raise debt at the holding company level and pass this as equity to subsidiaries, an approach which is driven by regulatory constraints. We also note it is accepted in the discussion draft that the BEPS risk within an operating entity is considered to be low, and we believe that the same principle applies where the debt is raised outside the operating entity, which is common practice for insurance groups.
4. Are there any general issues related to the operation of the authorized OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?

In general, it is our experience that tax authorities have limited experience in the practical application of the treatment of free capital for banks and insurance companies. The 2010 Report on Attribution of Profits to Permanent Establishments (which outlines how to deal with free capital through a couple of alternatives) does structurally limit the BEPS risk. However, the Authorized OECD Approach (AOA) outlined in the 2010 Report is not overly prescriptive in determining how to mechanically adjust the balance sheet and resulting interest expense after the attribution of capital which can lead to varying interpretation and results. It also gives effect to interbranch transactions which are transactions presumably not of concern to financial regulators, nor sometimes to tax authorities in jurisdiction that have not adopted the AOA. For example, while the U.S. has adopted the AOA, it has done so in only seven of its income tax treaties to date, even for companies who are residents of those 7 countries, it may nonetheless utilize its domestic law for capital attribution. The U.S. domestic laws still provides for a safe harbour of 5% capital and it allocates global interest expense to the PE which is not subject to the arm’s length standard. The U.S. presumably allows its domestic rules to be used to attribute capital because the AOA’s recommended methods for allocating capital were not prescriptive enough for the U.S. to enforce or administer. This general comment is not targeted at BEPS Action 4, rather pointing out that it may be premature, one way or the other, to determine whether the AOA attribution to free capital has achieved its goals, and that more time to analyse the impact of the 2010 AOA should be provided before altering it, since that project took 15 years or so.

5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?

Based upon our recommendation and the points in this comment letter, we believe this would be the enlightened jurisdictional approach, the best practice approach.

6. What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

If a tax authority believes banks or insurance companies are over leveraged, the most effective first point of contact should be their fellow governmental financial regulator. Query what the comparator that the tax authority is comparing a bank to in order to make this “over-leverage” determination? If it is a local, success technology company, the assessment would be accurate yet meaningless, the proverbial apple to an orange comparison. Curiously, if the tax authority compared local banks leverage to the leverage ratio of most central banks, the local banks would likely appear over capitalized.

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?
We believe that the fixed ratio bears no relevance to the banking or insurance industry, and its application would do affirmative harm while increasing complexity.

8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?

The discussion draft captured the considerations well. We make no additional comment on question 8.

9. What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

As mentioned in our general comments, we believe the best practice to deal with this concern would be the application BEPS Action 3, a CFC regime that would include the income earned by the subsidiary in the low tax jurisdiction into the taxable income of the parent jurisdiction, unless there were sufficient substance and people functions in the low tax jurisdiction responsible for the generation of the income. The OECD 1998 Report on Harmful Tax Competition has as its primary recommendation the use of a CFC regime. At the time only 17 of the 30 OECD members had CFC regimes. In our view, this is the most useful tool in the tax tool kit to deal with the BEPS concern of banks or insurance companies using debt to generate tax advantaged income.

The draft put forth options including (1) disallowing the interest expense at the bank parent level used to fund non-taxable income, (2) reducing the income which benefits from a participation exemption or other beneficial tax regime to reflect the value of the interest funding the income, (3) turning off the participation exemption or beneficial regime in certain circumstances, and (4) looking to link up the regulatory capital rules to inform the tax treatment. Each alternative described in the report would add additional complexity to an already overly complex international tax regime. Disallowing the interest expense at the parent level raises the question of how? Direct tracing, some pro-rata test, what to include / exclude from a pro-rata test any source of limitation becomes problematic as discussed above in our recommendation on addressing risk one. We recommend a CFC regime.

10. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

We believe any other concerns are addressed in the OECD’s Public Discussion Draft BEPS Action 2: Branch Mismatch Structures. We make no additional comment on question 10.

11. Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

Yes, there are several, discussed in our replies to questions 1 to 10, as well as in Section IV of our comment letter. Our primary recommendation is to carve out RFGs.

2 The UK CFC regime use of KERT principles as the measurement for deferral or the US Subpart F Active Financing regimes are 2 examples of CFC regimes that allow deferral but only when sufficient substance occurs in the (lower taxed) jurisdiction.
Entities in a group with a bank or insurance company

12. Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?

We have no comments on question 12.

13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company

a. application of the fixed ratio rule to the local group excluding banks and insurance companies

b. the treatment of interest expense on debt supporting banking or insurance activities

c. other issues?

We have no comments on question 13.

14. Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?

We have no comments on question 14.

15. Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

We have no comments on question 15.

16. Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

We have no comments on question 16.

17. Do you have any other comments on any of the issues raised by this discussion draft?

If RFGs are not provided a carve-out from Action 4, it is very important, if rules are introduced for insurers or banks, that existing debt is considered. We believe it is important to grandfather existing debt or introduce a period during which restructuring may be undertaken. This is particularly important in the case of third party debt issued by insurers, and there should be no option for a country to opt out of transitional rules.

IV. Reasons for an Exception for Regulated Financial Group

Our primary recommendation is to exempt RFGs from BEPS Action 4 is based on two main arguments: (i) borrowing money has been a vital part of the financial services industry since its
inception and (ii) governments have sought to protect the creditors of financial institutions (such as bank depositors or insurance policy holders) from the risks of borrowing too much money in relation to capital. This recommendation is also consistent with the assessment that the BEPS Action 4 risk is low for this sector. Moreover, there is no compelling reason for tax regulators to overlay additional rules on the existing regulatory processes especially ones that could conflict with another arm of the same government. One of the advantages of this approach would be that it would achieve regulatory capital instrument conformity: amounts that are treated as debt for regulatory purposes would have the same treatment for tax purposes, and likewise for equity instruments.

Whilst much of the philosophy of this section is relevant to insurers, the detail relates to the regulatory regime applicable to banks. As noted above, insurers are also subject to stringent regulatory regimes at individual and group levels, and detailed work would be required to ensure RFGs would be defined appropriately so an exemption would align with the relevant policy objectives.

The definition of a RFG for purposes of the exclusion can start by including “G-SIFIs” as well as any other substantially similar financial institutions. We are happy to continue to work with you to come up with a viable definition, and/or to meet with you to detail our reasoning for this request. The use of interest income and expense of RFGs has accurately been described as being inventory or part of cost of goods sold, and in our view, comparisons to non RFGs are not overly relevant. The definition of an RFG can also look to certain OECD member states existing rules for recognizing the uniqueness of a group with is predominantly a financial services group. The U.S. has a financial services group definition in its foreign tax credit rules provided the group is predominantly engaged, meaning 80% of its income is derived from the active conduct of a financial business. The UK worldwide debt cap rules do not apply to qualifying financial services groups if all, or substantially all of UK trading income, or worldwide trading income of the group is derived from lending, insurance and insurance related activities, and dealing in financial instruments.

Our discussion on bank regulation uses a U.S. based bank with non-U.S. operations as the example to describe the overlapping umbrella effect of global regulation, as well as being subject to multiple domestic regulators.

**Bank Regulation**

Financial regulators are not focused on tax impacts of debt, but rather on solvency and soundness of the institutions that they regulate. When financial regulators reach a conclusion on the required amount of capital, they are validating an institution’s capacity to borrow. There is no industry in which the composition of one’s balance sheet is more carefully reviewed and stress-tested than the financial services industry. A business does not choose to be regulated. Rather, it must comply with the complex regulatory regime which comes at a great costs both from actual compliance costs, and opportunity costs. The regulation is nonetheless required based on government policies that are intended to protect depositors, policyholders, and the economy as a whole from the possibility of insolvency, default, and the possible domino effect of multiple failures on the economy as a whole.

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3 See the Financial Stability Board 2015 list of 30 global systemically important banks (G-SIBs) at [http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf](http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf). This could be used as a starting point, there are clearly other banks, and global insurance companies that can, and should be included in a regulated financial group (RFG) excluded from the application of Action 4.
Regulators want to validate the soundness of institutions both at the consolidated level and at the separate company level (taking into account of both foreign and domestic subsidiaries). Complying with the standards of the applicable regulator is as compelling a business purpose as there can be because, in the end, a non-compliant institution cannot operate, and is either seized by the regulator or merged into a compliant institution pursuant to government order. One could argue that there is always a business purpose for banks to borrow money (within reasonable bounds of scale): money is their inventory. It enables them to enter into revenue-generating transactions, and if they can make more money on those transactions than it costs to borrow, the result is a profit.

The OECD October 2015 final report on Action 4 was on the correct path when pointing out in paragraph 184: “An important consideration is that the role interest plays in a banking or insurance business is different to that in other sectors. Banks and insurance companies hold financial assets and liabilities as an integral part of their main business activities. In addition financial sector business in most countries are subject to strict regulations which impose restrictions on their capital structures”. . . .

While paragraph 190 stated that “It is not intended that entities operating in the banking and insurance sectors, or regulated banking or insurance entities within non-financial groups, should be exempted from the best practice approach to tackle base erosion and profit shifting involving interest. Instead, in order to tackle base erosion and profit shifting by groups in all sectors, it is essential that a best practice approach include rules which are capable of addressing risks posed by different entities.” Moving from the global or umbrella regulatory discussion, we believe discussing the role of intercompany debt and interest within RFGs would be useful to the OECD as it continues to focus on Action 4.

**Intercompany Debt and Interest in the Banking Business**

Banking is about financial intermediation – receiving cash from depositors around the world and making it available to other customers. In effect, cash is a bank’s inventory, and the interest it pays to obtain that cash is its cost of goods sold. Debt is the means by which cash is transmitted; both from external sources in the form of customer deposits and loans, and within the organization, from one banking subsidiary or branch to another. For a banking organization, the ability to move cash via debt is not merely a matter of convenience, it is essential from a regulatory perspective and for profitability and survival. These transactions create genuine liabilities: they involve fixed sums and creditor claims, rather than a sharing of profits.

Historically, most banking subsidiaries and branches fund themselves primarily through the deposits they take in from customers. They supplement their deposits with longer-term intercompany debt that reflects a portion of the debt raised in the capital markets by the top-tier parent entity. While this represents the basic pattern of debt funding for many banking operations, at any given time there will be a need to move cash from one place to another among the banking entities and branches.

On a daily basis, subsidiaries and branches make hundreds of intercompany deposits in order to manage risk, including liquidity, interest rate exposures and currencies among the various entities. These transactions are centralized in geographical hubs, with each hub receiving deposits from bank branches and subsidiaries and placing deposits with other bank branches and subsidiaries as
necessary. The transactions are largely formulaic, driven by processes designed to optimize worldwide management of risk within the risk governance framework established by the bank’s management.

**Intercompany Debt and Interest in the Broker-Dealer Business**

Similar to banking subsidiaries, a RFG’s broker-dealer affiliates obtain a significant portion of their debt funding through transactions directly with customers, but in the form of repos or repo-like financing transactions rather than deposits. The broker-dealers also rely on longer-term intercompany debt that reflects a portion of the debt issued by the top-tier parent entity in the capital markets. In addition to this longer-term debt, other intercompany debt transactions arise on a daily basis among the broker-dealer subsidiaries, reflecting the need to move cash and assets among them. We detailed an example in our reply to question 2 above.

**Regulation and its Impact on Intercompany Debt and Interest**

Regulated financial groups, starting with the top-tier parent entities (as a financial holding company) and each of their banking and broker-dealer subsidiaries are heavily regulated by multiple governmental agencies in order to ensure the financial soundness of the company, its stakeholders, and the capital markets more broadly. We detailed this more in our response to question 3 above.

**Regulatory Constraints on Intercompany Debt – Example in U.S.**

U.S. banks are subject to regulation and supervision by a number of bank regulatory agencies. The top-tier parents of large U.S. commercial banks are registered bank holding companies that have elected to be treated as a financial holding company under the Bank Holding Company Act. Accordingly, these banks are regulated and supervised on a consolidated basis by the Federal Reserve Board. National banks are regulated and supervised by the Office of the Comptroller of the Currency (“OCC”). The Federal Deposit Insurance Corporation (the “FDIC”) also has examination authority for all banking subsidiaries whose deposits it insures. Overseas branches of U.S. national banks are regulated and supervised by the Federal Reserve Board and OCC and overseas subsidiary banks by the Federal Reserve Board. These overseas branches and subsidiary banks are also regulated and supervised by regulatory authorities in the host countries, as discussed further below. In addition, the Consumer Financial Protection Bureau regulates consumer financial products and services. While most non-U.S. “G-SIFIs” have a primary regulator in their home jurisdiction, and not the multiple regulators as exists in the U.S., the non-U.S. bank largely follow similar regulatory edicts emanating from the BIS in Basel.

The bank regulatory agencies impose many regulatory limitations on the banks, including requirements for banks to maintain reserves against deposits, restrictions on the types and amounts of loans that may be made and the interest that may be charged, and limitations on investments that can be made and services that can be offered. U.S. banks are also subject to regulatory capital requirements issued by the Federal Reserve Board, referred to as the U.S. Basel III rules. These rules establish an integrated capital adequacy framework, encompassing both risk-based capital ratios and leverage ratios.4

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4 See generally 12 C.F.R. part 217. The U.S. Basel III rules implement in the United States the framework of capital standards published by the Bank for International Settlements’ Basel Committee on Banking Supervision and known as the
In addition, there are restrictions on loans and other transactions between the U.S. subsidiary banks and their non-bank affiliates. Specifically, Section 23A of the Federal Reserve Act prohibits U.S. subsidiary banks from lending more than 10% of their capital and surplus to a single non-bank affiliate, and more than 20% to all affiliates, and requires that most such transactions be on a secured basis. Section 23B of the Federal Reserve Act requires that all such transactions be on arm’s length market terms.

U.S. broker-dealers are registered under the Securities Exchange Act of 1934 (the “Exchange Act”). Their primary regulator is the Securities Exchange Commission (“SEC”). They are also members of, and subject to the oversight of, the Financial Industry Regulatory Authority. Certain subsidiaries are also swap dealers and Future Commission Merchants (“FCMs”) registered with the Commodity Futures Trading Commission (“CFTC”). These regulated entities are members of, and subject to the oversight of, the National Futures Association. Each of these bodies administers a complex set of rules designed to protect customers and ensure the safety of the U.S. securities and derivatives markets as a whole. SEC-registered broker-dealers must maintain a minimum ratio of net capital to measures of indebtedness specified by regulation (which are measures of the broker-dealer’s own indebtedness or, alternatively, customer-related receivables). In addition, as discussed above and below, broker-dealers that are part of large banking organizations are indirectly subject to requirements applicable to their holding company parent, such as consolidated capital requirements that effectively limit their use of leverage, and to resolution planning requirements that drive a need for intercompany debt. To comply with these requirements, SEC-registered broker-dealers must abide by initial, ongoing minimum and excess net capital requirements. Minimum net capital depends on the nature of the SEC-registered broker-dealer’s business. There are notification requirements for, and potential restrictions on the timing of, any reduction in excess net capital below certain levels.\(^5\)

Non-U.S. regulators also limit the debt of a bank or broker-dealer. Each non-U.S. subsidiary or branch that conducts banking or dealing operations is subject to the relevant host country bank or broker-dealer regulatory regime and the oversight of that country’s regulatory body, in addition to the oversight of the Federal Reserve Board. These host country regulators, and the relevant local laws, have a general objective of ensuring the soundness of that particular entity or branch in order to protect local depositors and customers. While all the regulators have a general interest in ensuring the viability of the group of entities as a whole, each local regulator necessarily monitors the branch or entity for which it bears primary responsibility. As a consequence, each of these branches and entities generally must be able to demonstrate that it is financially strong – by meeting local capital requirements – on a standalone basis.

For example, the U.K. subsidiaries are subject to the EU Capital Requirements Directive (2013/36/EU), as transposed into U.K. law, and the Capital Requirements Regulation ((EU) No. 575/2013) (collectively, “CRD IV”), which together represent the EU’s implementation of the international Basel III capital accords.\(^6\) A two-step regulatory capital analysis is required to determine

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\(^5\) FCMs are similarly subject to net capital requirements. Swap dealers that are also banks prudentially regulated by a banking regulator must comply with the capital requirements already applicable to them as banks. While the specific capital requirements for non-bank swap dealers that are not also FCMs have not yet been finalized, these entities will be subject to regulatory capital requirements.

\(^6\) While all of the regulatory consequences to banks of the U.K.’s anticipated departure from the EU are not yet known, we do not expect that it will affect the obligation to comply with Basel III.
the regulatory capital requirements with which a U.K. bank or investment firm must comply. The first step is a formulaic calculation of its minimum capital requirements. The second step involves the bank or firm carrying out the Internal Capital Adequacy Assessment Process (the “ICAAP”). In the ICAAP, the RFG will determine whether its particular risk profile and the level of its exposures mean that it should hold capital beyond the minimum required level. The relevant regulator must then perform a supervisory review of the ICAAP and can require the bank or firm to hold more capital if the regulator believes risks have not been adequately addressed.

We hope this letter provides you with relevant comments and context around the global regulatory regimes for RFGs and provides ample explanation for our recommendations. We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the discussion draft.

Yours faithfully,

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Basel, 8 September 2016  
A.149/JBR

Public Discussion Draft – BEPS Action 4: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

Dear Mr. Pross,

The Swiss Bankers Association (SBA), founded in 1912 in Basel, is the leading professional organisation of the Swiss financial centre. Its main purpose is to maintain and promote the best possible framework conditions for the Swiss financial centre both at home and abroad.

The SBA would like to thank the OECD for the opportunity to comment on the present discussion draft.

The discussion draft recognizes that interest plays a particular role for banks and in this respect, the banking sector differs from the other sectors of the economy. Further, it is also noted that the banking industry, unlike other economic sectors, is highly regulated, which considerably restricts any room for manoeuvre.

1. General remarks – particular features of the banking industry

Overall, we remain concerned about the risk of unintended consequences, especially from measures designed to combat specific and contrived avoidance strategies which take insufficient account of the potential impact on ordinary commercial transactions. For instance, imposing a “one size fits all” rule on interest deductibility would be completely inappropriate if it fails to take account of the very different circumstances in the financial services sector, where borrowing and lending are integral to the commercial operations and interest plays a different role than in other industries (i.e. interest paid is equivalent to the “cost of goods sold” by non-banking businesses).

The banks’ asset and liability structure is determined by the local and global regulatory requirements, giving little leeway for banks to structure their activities. Banks conduct
business with special purpose vehicles which facilitate intermediation. Vehicles resident in low tax jurisdictions are chosen to ensure tax neutrality, e.g. reducing double taxation, but not to secure tax advantages.

In addition, we would like to underline that the discussion draft ignores arm’s length tests on interest deductions. We regret that such a basic and well established principle is simply not considered. For a company, the consequences of ignoring arm’s length tests are straightforward: deductions might be disallowed even though the related payments fully reflect market conditions. The Arm’s length principle meets the concerns of the BEPS project.

2. Questions for consultation

We limit ourselves to answer some of the questions, which we consider of particular relevance for us. For the other questions, please refer to our general remarks above.

**Question 3:** Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country’s regime.

As mentioned in the discussion draft, banking groups are subject to regulatory capital requirements that restrict their ability to place debt in certain entities. By ensuring that a bank or insurance company is capitalized with an appropriate level of equity, these rules may also to some extent provide protection against excessive leverage for tax purposes. The capital requirements, as defined and implemented by the Basel capital framework, reduce the leeway for optimizing the structure of debt instruments for tax purposes.

Due to the preference of local regulatory authorities for higher local capital buffers, there are indications that capital requirements for subsidiaries are often higher than the minimum requirements defined for the group, thus limiting the scope for balance sheet optimization for tax purposes on a group level.

As a specific example, the new international standards, which were developed by the Financial Stability Board (FSB) require that global systemically important financial institutions (G-SIFIs) must issue and maintain Total Loss Absorbing Capital (TLAC) on the top level of their holding company. The goal of TLAC is to ensure that G-SIFIs have enough equity and additional loss-absorbing capital in the form of bail-in bonds for a potential resolution without the use of taxpayers' money. The Swiss capital ordinance requires that such instruments be issued by the top-holding company in Switzerland. This requirement is to ensure the legal enforceability of any processing and conversion of the bail-in of bonds, which is in line with the FSB directives and requirements of international authorities assessing the resolution plans of G-SIFIs. Therefore, Swiss head-quartered G-SIFIs are required to issue and hold large amounts of subordinated debt in Switzerland (approximately CHF 80-100 bn in total for the two Swiss G-SIFIs to
be built up in the coming years). Apart from the regulatory requirement to issue such instruments in Switzerland, which already reduces the scope of tax optimization, the issuance of such funds and the necessity to allocate them within the group in line with regulatory requirements, may lead to increased (profit) tax burden for Swiss-G-SIFIS due to additional income from investments, which are not fully deductible under current Swiss corporate tax rules.

Moreover, liquidity requirements provide for an additional layer of constraints to a bank’s asset and liability management, thus increasing the protection against excessive leverage for tax purposes further. A banks' liquidity risk management aims to maintain a sound liquidity position to meet all liabilities when due and to provide adequate time and financial flexibility to respond to a firm-specific liquidity crisis in a generally stressed market environment, without incurring unacceptable losses or risking sustained damage to the businesses. Similar to capital requirements, there are indications that requirements from local regulators often exceed the requirements applicable on a group level, thus reducing the scope for (tax) optimization with interest-bearing instruments:

- The liquidity coverage ratio (LCR) measures the short-term resilience of a bank’s liquidity profile by comparing whether sufficient high-quality liquid assets are available to survive the expected net cash outflows from a significant liquidity stress scenario, as defined by the relevant regulator. Therefore, the LCR is a key metric used by banks and regulators within a liquidity management framework. In addition to the international standard (Basel Committee on Banking Supervision), systematically important banks in Switzerland are subject to local liquidity requirements. The calculation of the relevant metrics are prescribed by Switzerland’s financial-markets regulator (FINMA), based on the standards stemming from the Bank for International Settlements (BIS).
- The net stable funding ratio (NSFR) framework is intended to limit over-reliance on short-term wholesale funding to encourage a better assessment of funding risk across all on- and off-balance sheet items, and to promote funding stability.

**Question 13:** Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company –

- a. application of the fixed ratio rule to the local group excluding banks and insurance companies
- b. the treatment of interest expense on debt supporting banking or insurance activities
- c. other issues?

**Question 14:** Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?

Interest rates may vary widely across jurisdictions, between currencies, over time not to mention the negative interest that banks have to pay for deposits they hold at a number of central banks. Furthermore, interest rates related to debt financing may vary within the same group because of different ratings that entities belonging to the group may have. These factors, with the exception of the negative interest only imposed on
banks, may impact other economic sectors as well. Given the particular role played by interest for banks however, banks are more sensitive to developments in this area than other sectors.

In our submission of 6 February 2015, we had already indicated that rules referring to measures of earnings such as EBIT or EBITDA are not appropriate for the banking industry since in general, interest is a key source of a bank's profitability, which can be compared with revenue and cost of goods sold in other industries. We think that even a modified fixed ratio rule, taking into account that EBIT or EBITDA as such are not appropriate for the banking sector, would be difficult to implement for the banks and for the tax administrations to assess. The risk that banks are confronted with conflicting rules might increase exponentially and therefore create additional uncertainty. This would be true in general, but in particular for banking groups with international presence: these would face a real risk to have to comply with a number of different domestic rules applying to their entities, which could not be reconciled at group level.

We therefore think that a fixed ratio rule should not apply to any entity of a banking group. Such rules might be overly restrictive and might not be applicable in an appropriate manner (by banks and by the tax authorities). Considering that the constraints imposed on the regulated entities of a banking group impact the unregulated entities as well, BEPS risks are very low or non-existent in the case of banking groups.

Question 15: Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?

Question 16: Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?

As mentioned above, we think that a fixed ratio rule is not appropriate for the banking sector. We are also of the same opinion as far as a group ratio rule is concerned.

Moreover, one has to consider for banking groups with international presence that tax rules differ across jurisdictions, local GAAPs differ across jurisdictions (definitions differ and financial ratios might not be comparable, consolidation rules might not lead to the same outcome), timing mismatches can occur (different periods for accounting and taxation periods). Group-wide approaches might lead to double taxation if the matching of third party interest expenses with intra-group loan agreements is not possible. We recognize that the challenges represented by a group ratio rule are also faced by other sectors, however, a combination of those rules with the rules that are specific for the banking industry would considerably add complexity to the implementation, for no benefit as far as BEPS is concerned.

The SBA is therefore of the opinion that limitation on interest deductions should not apply to the banking industry, since the banking industry is highly regulated and even non-regulated entities of a banking group cannot fully ignore the requirements set by prudential regulators. Banks’ operations and requirements to hold debt instruments or debt-like capital instruments is constrained by liquidity, funding and capital requirements, that are generally governed by the BIS, with implementation governed by the
home regulators. As such, there is limited possibility for tax evasion / optimization. Separate requirements from a tax perspective would likely collide with the already existing requirements.

The SBA thanks the OECD for taking due account of these comments.

Yours sincerely,
Swiss Bankers Association

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Jean Brunisholz
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Per e-mail: interestdeductions@oecd.org  

Zurich, 8 September 2016  

BEPS ACTION 4 – APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS  

Dear Mr. Pross,  

The Swiss Insurance Association SIA welcomes the opportunity to comment on this Organisation for Economic Co-operation and Development (OECD) discussion draft on approaches to address Base erosion and profit shifting (BEPS) involving interest in the banking and insurance sectors.  

The discussion draft recognizes that interest plays a particular role for insurances and in this respect, the insurance sector differs from the other sectors of the economy. Further, it is also noted that the insurance industry, unlike other economic sectors, is highly regulated, which considerably restricts any room for manoeuvre. The Discussion Draft acknowledges that there is a very low risk for insurance groups, and therefore our view is any further restrictions should be by exception only.  

We would like to make some more general comments, which would fall under question 17:  

1. Whilst the perceived BEPS risks for insurance groups are identified in paragraph 9 of the Discussion Draft, we consider this is far too widely drawn (particularly with respect to the second bullet of that paragraph) and should be more specifically defined at the OECD and / or country level.
2. With regard to the use of debt to fund equity investments and the risk identified, we believe this should not unilaterally apply to M&A transactions. M&A transactions will not be tax motivated but rather driven by commercial and strategic imperatives. For acquisition of insurance targets solvency requirements will ensure the debt funding (and therefore the related interest expense) is limited to largely prevent BEPS activity. Moreover in numerous instances purchasers will be unable to fund the entire purchase consideration through equity so restricting interest relief may substantially limit investment.

3. We believe that no interest limitation rules should apply to interest payable on third party debt. Interest income is fully taxable at investors’ level and therefore interest expense should also be fully tax deductible. There is no real reason to disallow the cost of external debt as it is a genuine business cost and it can not be contemplated as base erosion or profit shifting. Finally, interest may also be subject to withholding tax.

4. The regulatory environment in most countries already largely governs how insurers’ capital is managed, and leaves little scope for BEPS through deductible interest expense. Therefore if there are any special measures for insurance these should be commensurate with the risk identified. More specifically:

   i. The regulatory framework does not allow an extensive use of debt financing because of the strong capital requirements to be fulfilled. Regulation usually requires a minimum amount of equity and includes limits on regulatory eligible capital, which would incur interest expenses.

   ii. Furthermore, Swiss life insurance companies – as well as foreign life insurers - are obliged to credit for the benefit of their policy holders so called technical interests rates (e.g. technical interest rate on insurance benefits claims of 2nd pillar products). It is important to recognize that these credited actuarial technical interests, which are one base for the change of the technical provisions in the balance sheet, don’t qualify as a debt interest rate. As consequence the OECD is requested to define that these technical interest rates are out of scope in the further work.

   iii. In some countries insurance solvency requirements need to be fulfilled not only at the level of the regulated financial entity (incl. branches), but also on Group level and on Sub-Group level and therefore apply for Holding, Financing and Investment subsidiaries.
iv. The amount of eligible regulatory capital is restricted to a certain percentage of equity for regulated entities, Groups and Sub-Groups. The strict regulation framework and thresholds for regulatory capital do not give room for tax planning and BEPS. The regulatory requirements in terms of total required capital as well as quality of capital (loss absorption) have been increasing considerably after the global financial crisis. In particular the requirements regarding loss absorption are increasing (“bail-in”). Additionally, the International Association of Insurance Supervisors (IAIS) is developing group-wide global capital standards for all internationally active insurance groups as well as additional High Loss Absorbency requirements to apply for Global Systemically Important Insurers (G-SII’s). Due to these increasing requirements investors are ready to subscribe regulatory capital only at higher interest rates which increase the financial costs for insurance companies.

v. Insurance groups raise debt to reduce their cost of capital as the cost of debt is significantly less than the cost of equity. Capital is key to insurers, without which they cannot underwrite business, so it’s akin to plant and machinery in manufacturers. Matters that make debt less attractive will therefore push insurers costs, and ultimately premiums to policyholders up. There's no equivalent BEPs measure to deal with tax planning concerning plant and machinery.

vi. In addition it should be considered that life insurance companies have an important function in a number of European national social security systems (e.g. 2nd pillar). Thus, interest deduction restrictions affecting life insurance companies could have an adverse impact for the insured persons.

5. In many territories there are already extensive tax rules, which potentially restrict deductions for related party and may be third party interest. Overlaying additional legislation on these existing rules risks unduly burdensome tax regimes and more critically denying tax deductions for interest expense which is clearly not BEPS. Again we would urge that if there are any special measures for the insurance sector, these should be commensurate with the specific risk identified.

6. The Swiss Federal tax authorities, as an example, have introduced safe harbour thin capitalization rules with an asset base test. These rules determine the maximum of debt and accordingly the maximum of tax deductible interest expense. Furthermore, the participation exemption rules require a disallowance of interest expense based upon a proportional allocation of interest expense to dividend income and therefore lead to a non-deductible portion of interest expense.
7. As a further example, in Germany earnings stripping rules are in place which limit the
deductibility of net interest expenses to 30 percent of EBITDA for tax purposes. This
restriction applies to any kind of interest expense, irrespective of whether it is derived
from intercompany financing or third-party debt. Any interest in excess of the 30 per-
cent threshold is non-deductible. Germany has had earning stripping rules for many
years, but despite a large insurance sector has never felt the need for specific rules.

8. In the Discussion Draft there are a number of comments pertaining to permanent es-
tablishments (‘PEs’) and also the 2010 Report on the Attribution of Profits to Perma-
nent Establishments (the 2010 Report) on which we would comment:

   i. Paragraph 22 states that “... in most countries there is no regulatory requirement
      for capital to be allocated to a permanent establishment.” This does not accord
      with our understanding. We believe the default in most countries is that there will
      be a regulatory requirement to allocate capital to PEs and only within the EU
      where FoS/ FoE rules (freedom of services and establishment) apply do branch-
      es not have separate capital requirements.

   ii. The 2010 Report in our view potentially provides considerably less flexibility for
      PEs than companies to engage in BEPS activity. The 2010 Report has a clear
      aim to attribute an arms length amount of interest to the PE. So for example there
      are requirements for a full functional and factual analysis and two main methods
      (capital allocation and thin capitalisation) are prescribed to attribute assets to the
      insurance PE. This gives tax authorities more ability to counter any perceived
      BEPS activity.

   iii. A consequence for insurance companies operating through PEs is that there is
      considerable scope for unrelieved double taxation due to the problem of triangu-
      lation in a PE context, especially where the insurance company has multiple PEs.
      In our view this would make it potentially more punitive for an insurance company
      with a PE structure to engage in BEPS activity and so the 2010 Report effectively
      provides a disincentive to even consider BEPS activity around interest expense.

9. Grandfathering of tax relief for interest on existing loans is key, should any special rules
for insurers apply. Much external debt is subordinated or senior and cannot be repaid
without penalty payments (i.e. a premium above the NPV of future cash flows has to be
paid to convince external lenders to repay). Regulators require for both group and
subsidiary subordinated debt to be long-term in nature to ensure it provides a solid cap-
ital base should there be a large volume of claims, and hence such debt has to be long-term in nature.

Grandfathering of existing debt would be consistent with what the European Commission has proposed within its Anti Tax Avoidance Directive.

10. Any rules that divide of insurance and non-insurance activities would be artificial. Many "non-insurance" activities, e.g. asset managers, service companies, treasury companies have a major purpose of supporting the insurer and are often separated for non-tax purposes e.g. regulatory necessity. Most of those activities, e.g. service companies earn relatively low margins, and therefore existing thin capitalisation rules restrict the debt and interest that can be allocated to such entities.

In summary we believe that the existing BEPS proposals combined with existing national tax rules (national and OECD) and the specific regulatory regime for insurers are very largely adequate to address the very low level of risk attaching to insurers. Therefore we would urge that any additional rules for insurers are by exception only in countries where perhaps the tax and regulatory environment does not already place substantial limitations on interest expense deductibility.

Yours sincerely

Swiss Insurance Association SIA

[Signatures]

Lucius Dürr
CEO

Marc Chuard
Head of Finance & Regulation
Re: USCIB Comment Letter on OECD’s Discussion Draft on BEPS Action 4 – Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

Dear Mr. Pross,

USCIB appreciates the opportunity to provide comments on the discussion draft concerning approaches to address BEPS involving interest in the banking and insurance sectors.

USCIB supports the comments of BIAC. We write separately to emphasize that because there is a low risk of BEPS by banking and insurance sectors from excessive leverage, the best practice rule should be that these sectors not be subject to the fixed ratio and group ratio rules of BEPS Action 4.

USCIB recognises some might think this suggestion would be a “free pass” for the banking and insurance sectors. It is not. The regulatory rules faced by the banking and insurance sectors

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1 USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policymakers and regulatory authorities worldwide, and works to facilitate international trade and investment.
are unique and substantial. They have been put in place for important systematic reasons and impose meaningful and serious constraints on the banking and insurance sectors.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)
BEPS ACTION 4 – APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS

Dear Mr. Pross

Zurich Insurance Group ("Zurich") welcomes the opportunity to respond on the OECD Public Discussion Draft on the above topic issued on 28 July.

By way of introduction, Zurich is a leading multi-line insurer that serves its customers in global and local markets. With about 55,000 employees, it provides a wide range of general insurance and life insurance products and services. Zurich’s customers include individuals, small businesses, and mid-sized and large companies, including multinational corporations, in more than 170 countries. The Group is headquartered in Zurich, Switzerland, where it was founded in 1872. The holding company, Zurich Insurance Group Ltd (ZURN), is listed on the SIX Swiss Exchange and has a level I American Depository Receipt (ZURVY) program, which is traded over-the-counter on OTCQX. Further information about Zurich is available at www.zurich.com.

Whilst Zurich is supportive of the BEPS initiative and the underlying rationale for BEPS Action 4, we do however have concerns that the latest proposals could lead to unfair restrictions on interest deductions for insurance groups. The Discussion Draft acknowledges that there is a very low risk for insurance groups, and therefore our view is any further restrictions should be by exception only. We would also like to make some more general comments, which would fall under question 17:

1. Whilst the perceived BEPS risks for insurance groups are identified in paragraph 9 of the Discussion Draft, we consider this is far too widely drawn (particularly with respect to the second bullet of that paragraph) and should be more specifically defined at the OECD and / or country level.
2. With regard to the use of debt to fund equity investments and the risk identified, we believe this should not unilaterally apply to M&A transactions. M&A transactions will not be tax motivated but rather driven by commercial and strategic imperatives. For acquisition of insurance targets solvency requirements will ensure the debt funding (and therefore the related interest expense) is limited to largely prevent BEPS activity. Moreover in numerous instances purchasers will be unable to fund the entire purchase consideration through equity so restricting interest relief may substantially limit investment.

3. We believe that third party debt should not be unilaterally included. Third party interest will in the vast majority of instances be a genuine expense of the business, and whilst it made lead to a reduction in tax for the paying entity (as with any other legitimate business expense) this is not a valid reason to restrict deductibility. If the interest is paid to a third party in the same country there is clearly no overall base erosion or profit shifting. If paid to a third party in a different country it may erode the overall tax revenues of that territory (in the same way as third party expense) but there is no base erosion or profit shifting as the OECD would contemplate it.

4. The regulatory environment in most countries already largely governs how insurers’ capital is managed, and leaves little scope for BEPS through deductible interest expense. Therefore if there are any special measures for insurance these should be commensurate with the risk identified. More specifically;

i. The regulatory framework does not allow an extensive use of debt financing because of the strong capital requirements to be fulfilled. Regulation usually requires a minimum amount of tangible equity and includes limits on regulatory eligible capital, which would incur interest expenses.

ii. Furthermore, Swiss insurance companies are obliged to credit certain types of interest for the benefit of their policy holders (e.g. technical interest rate on insurance benefits claims of 2nd pillar products). These credited actuarial technical interests, which are one of the elements for the change of the technical provisions in the balance sheet, do not qualify as debt interest in the sense of BEPS 4.

iii. In some countries insurance solvency requirements need to be fulfilled not only at the level of the regulated financial entity (incl. branches), but also on Group level and on Sub-Group level and therefore apply for Holding, Financing and Investment subsidiaries.

iv. The amount of eligible regulatory capital is restricted to a certain percentage of equity for regulated entities, Groups and Sub-Groups. The strict regulation framework and thresholds for regulatory capital do not give room for tax planning and BEPS. The regulatory requirements in terms of total required capital as well as quality of capital (loss absorption) have been increasing considerably after the global financial crisis. In particular the requirements regarding loss absorption are increasing.
("bail-in"). Additionally, the International Association of Insurance Supervisors (IAIS) is developing group-wide global capital standards for all internationally active insurance groups as well as additional High Loss Absorbency requirements to apply for Global Systemically Important Insurers (G-SII's). Due to these increasing requirements investors are ready to subscribe regulatory capital only at higher interest rates which increase the financial costs for insurance companies.

v. A limitation of interest deduction would further increase the funding costs and therefore also increase the insurance premium cost for the policyholder. Moreover, the tax deductibility of the interest adds to the attractiveness of bail-bonds that eventually supports economic stability and vulnerability to financial crisis.

vi. In addition it should be considered that life insurance companies have an important function in a number of European national social security systems (e.g. 2nd pillar). Thus, interest deduction restrictions affecting life insurance companies could have an adverse impact for the insured persons.

5. In many territories there are already extensive tax rules (see paragraphs below relating to UK, Switzerland and Germany), which potentially restrict deductions for connected and maybe third party interest. Overlying additional legislation on these existing rules risks unduly burdensome tax regimes and more critically denying tax deductions for interest expense which is clearly not BEPS. Again we would urge that if there are any special measures for the insurance sector, these should be commensurate with the specific risk identified.

6. Taking the UK as a specific country example of existing tax rules on interest deductibility, the corporate tax-payer will have to consider at least the following in relation to interest and loans. It is worth noting that with the exception of vi. below (which will be repealed), all other tax rules limiting interest deductions will remain in place after the UK implements proposed BEPS driven changes.

i. ‘Thin capitalisation’ rules – embodied in transfer pricing rules to consider connected part debt.

ii. An ‘unallowable purpose’ rule, broadly denying a deduction where the interest is not for a commercial purpose.

iii. A GAAR (general anti-avoidance rule) to deter tax-payers from entering into abusive tax avoidance arrangements.

iv. A TAAR (targeted anti-avoidance rule) to counteract tax advantages arising from interest.

v. Other rules around restrictions relating to exchange movements on loans not at arm’s length, tax advantage on resetting interest rates, disposal of lender rights not fully recognised for accounting.
vi. A "worldwide debt cap" to restrict corporation tax deductions for interest and other finance expenses claimed by UK members of a large group, by reference to the group's consolidated finance costs.

7. The Swiss Federal tax authorities have introduced safe harbour thin capitalization rules with an asset base test. These rules determine the maximum of debt and accordingly the maximum of tax deductible interest expense. Furthermore, the participation exemption rules require a proportional allocation of interest expense to dividend income and therefore lead to a non-deductible portion of interest expense.

8. In Germany earnings stripping rules are in place which limit the deductibility of net interest expenses to 30 percent of EBITDA for tax purposes. This restriction applies to any kind of interest expense, irrespective of whether it is derived from intercompany financing or third-party debt. Any interest in excess of the 30 percent threshold is non-deductible.

9. Within the EU there is an emerging process to strengthen corporate tax rules to address BEPS. An anti-tax avoidance package of proposals was published at the start of 2016 and most recently a directive has been issued which covers five areas including interest limitation rules. It is clear there will be a very large overlap if not duplication between the EU directive and the OECD work. Of particular significance to note are:

   i. One of the other five areas is a general anti-abuse rule to cover any gaps in specific anti-avoidance rules.
   ii. The directive applies to all corporate taxpayers in a member states, including subsidiaries of companies based in non-EU countries.
   iii. Six of the EU member states to whom the rules will apply are not OECD members.
   iv. The directive will need to be enacted in members’ domestic tax rules by the end of 2018.
   v. Where member states already have avoidance rules that are equally effective to the interest limitation rules, these may continue in force until the end of 2023 (or until the OECD reaches agreement on a minimum standard).

10. In the Discussion Draft there are a number of comments pertaining to permanent establishments (PEs) and also the 2010 Report on the Attribution of Profits to Permanent Establishments (the 2010 Report) on which we would comment:
i. Paragraph 22 states that “… in most countries there is no regulatory requirement for capital to be allocated to a permanent establishment.” This does not accord with our understanding. Whilst in some instances this may be correct – the obvious example being within the EU where FoS / FoE rules (freedom of services and establishment) permit this for EU PEs – we believe the default in most countries is that there will be a regulatory requirement to allocate capital to PEs.

ii. The 2010 Report in our view potentially provides considerably less flexibility for PEs than companies to engage in BEPS activity. The 2010 Report has a clear aim to attribute an arm’s length amount of interest to the PE. So for example there are requirements for a full functional and factual analysis and two main methods (capital allocation and thin capitalisation) are prescribed to attribute assets to the insurance PE. This gives tax authorities more ability to counter any perceived BEPS activity.

iii. A consequence for insurance companies operating through PEs is that there is considerable scope for unrelieved double taxation due to the problem of triangulation in a PE context, especially where the insurance company has multiple PEs. In our view this would make it potentially more punitive for an insurance company with a PE structure to engage in BEPS activity and so the 2010 Report effectively provides a disincentive to even consider BEPS activity around interest expense.

In summary we believe that the existing BEPS proposals combined with existing tax rules (national and OECD) and the specific regulatory regime for insurers are very largely adequate to address the very low level of risk attaching to insurers. Therefore we would urge that any additional rules for insurers are by exception only in countries where perhaps the tax and regulatory environment does not already place substantial limitations on interest expense deductibility.

Yours sincerely

Zurich Insurance Group Ltd

[Signatures]

Carl Emanuel Schillig
Group Tax Director

Guido Fritschi
Head of Tax Switzerland