Comments received on Public Discussion Draft

BEPS ACTION 4: ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE

25 August 2016
TABLE OF CONTENTS

Association of Real Estate Funds (AREF) 2
Federation of German Industries (BDI) 6
Business and Industry Advisory Committee to the OECD (BIAC) 10
British Property Federation (BPF) 19
BusinessEurope 32
Confederation of British Industry (CBI) 37
Confédération Fiscale Européenne (CFE) 38
Confederation of Swedish Enterprise 44
Commercial Real Estate Finance Council Europe (CREFC Europe) 49
European Business Initiative on Taxation (EBIT) 55
European Public Real Estate Association (EPRA) 59
Fédération Bancaire Française (FBF) 65
Grant Thornton UK LLP 69
International Chamber of Commerce (ICC) 73
IFAGrupo Mexicano 76
International Alliance for Principled Taxation (IAPT) 82
Japan Foreign Trade Council, Inc. (JFTC) 139
Keidanren 143
KPMG LLP 147
NERA Economic Consulting 154
PricewaterhouseCoopers International Limited (PwC) 157
Royal Institution of Chartered Surveyors (RICS) 166
United States Council for International Business (USCIB) 172
Dear Sir/Madam,

OECD consultation: BEPS Action 4 Elements of the Design and Operation of the Group Ratio Rule

The Association of Real Estate Funds (AREF) welcomes the opportunity to respond to the OECD’s consultation on BEPS Action 4 Elements of the Design and Operation of the Group Ratio Rule.

Investment funds serve an important purpose by pooling capital from a variety of sources in order to finance economic activity. Capital is provided via pensions and other savings vehicles used by individuals, as well as by life insurance companies, endowments and charities. The capital raised may be used to support development and investment in both residential and commercial property, and this is crucial to growth and economic prosperity. Investment capital may also be provided to infrastructure, private equity and small and medium-sized enterprises. As the volume of traditional lending has declined, the need for alternative sources of financing has correspondingly grown.

From an investor’s point of view, funds are an essential savings vehicle and provide benefits over direct investment. By pooling their funds with other investors, funds allow investors to gain the benefits of economies of scale even if they have relatively little invested. They also provide access to markets that might be closed to the small investor. The importance of funds as a vehicle for long-term saving is all the more relevant today, when individuals are increasingly being called upon to make their own provision for retirement. It is critical that fund structures provide investors with equivalence in tax treatment compared with direct owners of assets.

The Association of Real Estate Funds (AREF) represents the UK real estate funds industry. It has about 65 members with a collective net asset value of around £65 billion under management on behalf of investors. This includes around £20 billion in UK authorised retail funds and similar amounts in various forms of UK unregulated collective investment vehicles (CIVs) and in offshore domiciled funds. Member funds represent about two-thirds of UK commercial real estate held in CIVs.
Property funds are often highly leveraged. Any adverse tax treatment of property investment could have adverse ramifications for the long-term financing of commercial and residential development and investment.

We have two key concerns which we explore more fully in the appendix.

First, the definition of group for the purposes of applying the group ratio rule means that certain property funds will find themselves part of a broader group primarily outside property investment. The two parts of the group are likely to have very different borrowing needs and this will lead to an interest restriction for the property fund. The lower returns will adversely affect both property development and investment themselves, and the investors looking for diverse investment opportunities.

Second, a group ratio rule as suggested does not reflect the commerciality of third party lending in the context of property funds. Third parties provide finance based on loan-to-value parameters and lending is secured on particular properties. As such, income from property is automatically aligned with interest costs and there can be no or minimal BEPS risk.

We would welcome the opportunity to discuss the impact of the consultation proposals on property funds in more detail. I am available at your convenience to discuss anything in this letter.

Yours faithfully

John Cartwright
Chief Executive
The Association of Real Estate Funds
APPENDIX

Question 14: Do you have any other comments on any of the issues covered by this discussion draft?

Definition of group

For the purposes of applying the group ratio rule, a group includes a parent company and all entities that are fully consolidated on a line-by-line basis in the parent’s consolidated financial statements. This definition of group is problematic for certain property funds as a property fund may form part of a broader group that is not predominantly engaged in property investment. There are two scenarios where this is relevant:

1. A property fund may be owned within a life insurance group (in order to support liabilities to policyholders).
2. A property fund requires a minimum size at launch in order to purchase properties, to ensure that a level of diversification exists, and to ensure that administration costs do not deter investors. This means that a property fund is often ‘seeded’ by an initial investor of sufficient size so as to ensure the fund has critical mass on launch. The result may be that the fund forms part of a wider group.

Due to the unique characteristics of property fund investment, we think it would be inappropriate to apply a group ratio rule to the interest relief of a property fund, where the group may be engaged primarily in activities outside property investment. The borrowing needs of the property fund are likely to be vastly different from the borrowing needs of the rest of the group. As such, the net third party interest expense/EBITDA ratio for the wider group would be significantly less than for the property fund alone. This would result in an interest restriction for the property fund with a knock-on detrimental effect for the investors who may be individuals, pension funds, life insurance companies (and their policyholders) etc. This goes against the premise that investment in funds should be tax neutral compared with direct investment.

Commerciality of third party lending on property

A group ratio rule as suggested also contrasts with the commerciality of third party lending in the context of property funds. Third parties are willing to provide finance which is secured on particular properties. Lending is generally based on loan-to-value parameters. If a third party is prepared to finance a real estate transaction or project, then there would seem to be no reason to restrict deductibility of interest for tax purposes as there is no BEPS risk. This point is reinforced by the way in which real estate is typically taxed. Almost all, if not all, treaties give
taxing rights over income from real estate to the state in which the real estate is situated. This means that taxation of income from property is automatically aligned with deductions for interest on a loan secured on the relevant property.

A group ratio rule should ensure that there is no restriction on the deductibility of interest paid to third parties. This is contemplated in the discussion draft in the context of losses. Both where a group has a positive group-EBITDA but includes entities with a negative-EBITDA and where a group has a zero or negative group-EBITDA, the discussion draft says that an entity with positive EBITDA could be allowed to utilise interest capacity up to the group’s net third party interest expense. Whilst we understand that groups with losses pose particular problems where a rule depends on a proportion of earnings, there seems to be no rationale for treating such groups more favourably than other groups.
Dear Sir or Madam,

We highly appreciate the opportunity to comment on the public discussion draft “BEPS Action 4 Elements of the design and operation of the group ratio rule”. We thank the authors for the work they have done, and also we would like to thank the OECD for continuing the work on this topic.

Just as the OECD the BDI considers the group ratio rule being an important supplement to the fixed ratio rule to ensure a deductibility of interest for high leveraged companies. To achieve this political goal the provisions of the group ratio rule shouldn’t unnecessarily restrict the deduction of interest. At the same time the calculation of the group ratio rule should be as simple as possible.

Therefore it’s basically straightforward to calculate the group ratio based on unadjusted figures from the group’s financial statement as argued by the OECD in Approach 1. However, as the OECD correctly points out accounting standards actually do differ. Then the question arises whether these differences should be aligned and if so to what extend? Any overstatement or understatement of net third party interest expenses as mentioned in paragraph 9 requires a reference value which doesn’t exist up to now. As a result comparable groups will have a different net third party interest expense as well as basically comparable groups do have different tax liabilities when not doing business in the same countries.

In consequence we suggest to limit the application of approach 2 and 3 and the discussed amendments mainly to achieve greater flexibility and to compensate for very limited opportunities in national tax law to deduct interest expenses. That’s why we strongly support the opportunity of an
uplift to the net third party interest expense as mentioned in paragraph 22/Example 1. However, we do not understand why this uplift is limited to 10 percent since the OECD gives no comprehensible reason for this value. Since reporting standards differ to various extends we suggest to give national authorities full flexibility how to dimension the uplift.

The treatment of non-deductible payments as described in paragraph 24 ff./example 2 is in our opinion a good example why any adjustments should be handled with care. If country A allows for a deduction and country B for exactly the same kind of payment does not it’s by definition unclear which country shall be the reference treatment. Thus we suggest not to give any recommendation for an adjustment.

In paragraph 27 f./example 3 the OECD argues “that entities may use interest paid to related parties outside a group to increase the group’s net third party interest expense and inflate the interest capacity of all entities in the group”. To prevent this happening the OECD recommends “to exclude net interest expense paid to related parties from the definition of net third party interest expense” as a possible measure. As an example how this could happen the OECD gives in paragraph 89 the example that investors replace part of the group’s equity with shareholder debt.

The BDI strongly disagrees with this line of reasoning since the process described is associated with very far reaching non-tax consequences for the group. It can be expected that an exchange of equity against debt leads to a change of the group’s equity as a whole. This will also have consequences for the credibility at the capital market and normally will induce a change in ownership structure.

Additionally e.g. in Germany according to paragraph 8c corporate income tax law the described process would in most cases be associated with an at least partly loss of a loss carry-forward if existing. Even an increase of the group’s equity by a related party to finance a new investment would have the same consequences. This can be a good reason to finance an investment of a related group with debt instead of equity. Another reason for debt-financing could be the limitation of risk.

In consequence we reject OECD’s recommendation to exclude net interest expense paid to related parties from the definition of net third party interest expense. Instead we ask to stick to the treatment as given in the financial statement. Notwithstanding we concede that a replacement of equity by debt can be used to perform BEPS. However, for the reasons given above we don’t expect this to be the case outside of groups. Thus to achieve the intended policy goal of the group ratio rule there should be no exclusion of any kind of third party interest unless there is empirical evidence that it is used to perform BEPS.

Correspondingly we reject any kind of adjustment for interest income and expense when calculating the group-EBITDA as described in paragraph 39/example 6. Again we recommend to stick to the financial statement.
We agree with OECD’s proposal in paragraph 43 ff./example 7 that fair values shouldn’t be used for the calculation of EBITDA or third party net interest payments even if permitted or required under accounting standards. Since fair values incorporate unrealised gains or losses – the latter not depreciated from the book value – they’re associated with a certain degree of uncertainty which should be avoided.

For the treatment of dividend income as discussed in paragraph 50 ff./examples 8 to 12 we ask to calculate EBITA in all cases with respect to the treatment in the tax laws. That means taxable dividends should be included and tax exempt dividends should be excluded. This treatment should hold for each entity – as recommended by the OECD BEPS Action 4 final report – and the group as well. Otherwise part of the third party interest expenses falls short of deduction as demonstrated in example 9.

In general we ask for an identical treatment of entities and group in all cases – that means also when calculating EBITDA in connection with Joint Venture Entities (examples 12, 13, 14, 15). We can’t reconstruct the reason given by the OECD for a different treatment: “This is to ensure that the group ratio rule effectively apportions a group’s net third party interest expense across all of its sources of income.” (paragraph 52)

If entities and group shall necessarily be treated differently we suggest that similar solutions as described in example 16 should be applied. In this case part of the joint venture entity’s net third party interest expense is attributed to the group. By this operation the group’s EBITDA becomes again exactly the sum of the EBITDAs of the group’s entities.

When dealing with loss making entities in the group the loss reduces the EBITDA of the group which is the denominator of the net third party interest expense / EBITA ratio. In consequence this ratio can increase significantly which gives the group’s entities very high capacity for interest deduction. However, the OCD considers the recognition of negative interest capacity in loss-making entities not as part of the best practice approach (paragraph 143). We fully agree with that. However, we disagree with the conclusion that the loss making entity shall not have any interest capacity at all under the group ratio rule. In example 17 this problem becomes irrelevant because the loss making entity receives net interest revenue. We urge the OECD to develop a solution for this problem.

The treatment described above results in a very high unused interest capacity as shown in example 17. Subsequently the OECD discusses various measures to limit this effect. In example 18 the entity with negative EBITDA is excluded from the calculation of the group’s EBITDA. While this limits the interest capacity significantly there is no reason given why this should be the superior approach.

In example 19 an upper limit for the interest deduction of each entity is applied which is the consolidated net third party interest payment of the group. This also limits the interest capacity significantly. Additionally the interest capacity of all entities is restricted to zero – regardless of the
amount of third party interest expenses actually paid by an entity – if the group has no consolidated net interest expenses but a net interest surplus. Therefore we consider this alternative not to be best practise.

The third way to reduce the unused interest capacity presented by the OECD is a cap (example 20). That means the interest capacity of every entity is limited to a certain percentage of her specific EBITDA if the group’s actual net third party interest expense / EBITDA ratio is higher. We consider this being the superior approach, however there are any but political reasons for the value of the cap. Since example 21 is a combined application of examples 19 and 20 the comments hold respectively.

The last case discussed is a negative EBITDA of the group. We agree that now it’s impossible to calculate a meaningful net third party interest expense/EBITDA ratio. We strongly back up the OECD’s position that even now interest should be deductible under the group ratio rule. For this the OECD suggests the same approach as in example 19 which is an upper limit that equals of the amount of the consolidated net third party interest expenses of the group. In example 22 this leads to a huge amount of disallowed interest expenses. In our opinion this approach should be reconsidered because in particular loss making groups shouldn’t be faced with the risk of income tax payments due to non-deductible expenses. Since there’s no scientific reason for the upper limit chosen it could as well be twice the consolidated net third party interest expenses of the group.

Please do not hesitate to contact us if you have any questions.

Yours sincerely

Berthold Welling  Ralph Brügelmann
Ref: DISCUSSION DRAFT: BEPS ACTION 4 – “ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE”

Dear Achim,


It is understood that deductibility of interest payments is a key component of the BEPS project and BIAC was pleased that the Action 4 report published in October 2015 had a clear recommendation that the proposed common approach should be a fixed ratio rule supplemented with a group ratio rule.

BIAC previously noted substantial concerns about the appropriateness and practicality of global group-wide tests, which have the potential to create significant complexity and difficulties for taxpayers and tax authorities alike. However, as an optional supplement to a fixed ratio rule, and if implemented in a consistent and practicable way, the group ratio rule has the potential to be a useful tool. It can, in those circumstances, help to ensure that a fixed ratio rule does not unduly and adversely impact highly leveraged businesses, particularly when operating in jurisdictions which have adopted a lower fixed ratio restriction.

Although we found many aspects of the Discussion Draft welcome, we would still suggest more concrete and prescriptive recommendations in certain areas. The BEPS Project has always sought to introduce consistency between different tax systems, and an overlapping system of different rules in respect of a global test would frustrate that aim. It would also create a substantial amount of work in multiple jurisdictions for some taxpayers, with no particular benefit to tax authority revenues.

Again, we thank you for the opportunity to comment on this discussion draft. We would welcome the opportunity to discuss our comments with you at a public consultation meeting, or assist in any other way that you would consider helpful.

Sincerely,

Will Morris,
Chair BIAC Tax Committee
Approaches to calculate a group’s net third party interest expense

Comparison of the three approaches

1. Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

1. BIAC’s primary position in respect of the three approaches is that, after considering the various issues, the OECD should recommend that all jurisdictions adopt approach 1, i.e. a multinational corporation (MNC) would use their interest income and expense figures from their consolidated income statements without adjustments to calculate global net interest. As noted in the draft, this would be the most straightforward approach and the easiest for business to comply with (and for tax authorities to audit).

2. Although it is recognised that there would be some differences under different accounting standards\(^1\) that may cause the net interest figure to be slightly under or overstated as compared to an adjusted figure, we consider that the shortcomings of approach 1 are overstated in the discussion draft. On the whole, the simplicity and administrative feasibility of approach 1 make it the preferred alternative.

3. Notwithstanding this general recommendation, we note that there are differences in local tax and accounting rules (including particularly Fair Value movements). These could (in a minority of cases) result in significant timing differences if taxpayers were forced to use approach 1 (which may or may not reverse before they have expired). We therefore also recommend that taxpayers should be given the option to apply the more administratively complex approach 2 or 3.

4. We disagree with the assertion that under approach 1 groups’ net interest expense could be manipulated to ensure that income items are not accounted for as interest (para 9). An MNC’s interest line is scrutinised by independent accountants as part of the financial audit process and there is therefore minimal scope to understate interest income. Further, as noted in the discussion draft, this could be addressed with the inclusion of an anti-avoidance rule (which we are not clear why the discussion draft dismisses out of hand as difficult to apply in practice, particularly given the complexities of the alternative approaches offered). In particular, publicly traded companies go through extremely rigorous processes to obtain assurance over their income statements and therefore ought to be permitted to use approach 1.

5. If it is not possible for approach 1 to be applied universally, our second preference is that groups are permitted to choose themselves whether they will apply approach 2 or 3. As the discussion draft notes either approach should give rise to the same figure for a group’s net third party expense (para 11) and therefore we see no reason why one of these approaches

\(^1\) For example, the difference in the treatment of derivatives under US GAAP and IFRS.
should be favored over the other from a policy perspective, but the administrative burden
could be less severe if groups are given an option of how to arrive at the figure.

6. The worst situation would be if different countries were able to choose different approaches to
calculate a group’s net third party interest expense on a country by country basis. Each
calculation under approach 2 or 3 represents a substantial compliance cost to taxpayers and,
given there is no anticipated difference in tax revenues, a requirement to use a different
method of calculation that produces the same result would offer no benefit to tax authorities.
The application of any a global rule inevitably requires some local work on the part of
taxpayers. However, if the group ratio rule were to be implemented differently in different
jurisdictions the administrative cost of compliance would mean that some MNEs will simply
lack the resource to apply the rule at all.

7. If the calculation method is to be different across jurisdictions, the OECD could instead
recommend that where the country of residence of an MNC’s parent company has adopted a
fixed ratio/group ratio approach to interest expense disallowance, other countries should
follow the calculation of net interest expense, minus any uplift if the local jurisdiction does not
allow that. If such a recommendation is made, then the same principle should apply to the
calculation of EBITDA. This would remove the risk that a group would have to recalculate the
interest expense in a number of different ways to take into account each jurisdiction’s
permutations to the rule.

8. Per para 6 the third party interest expense “calculation should be based on a group’s
consolidated financial statements, prepared using International Financial Reporting Standards
(IFRS), Japanese GAAP or US GAAP, or other accounting standards as permitted by the relevant
country”, which we understand to mean that all group ratio calculations should be driven from
the parent company’s accounting standards. It is, therefore, a natural next step to further
ensure that adjustments to net interest expense (and EBITDA) are in line with the relevant rules
in the parent company jurisdiction.

Adjustments to a group’s net third party interest expense

3. It is important that a country’s tax policy goals can be taken into account in determining net third
party interest expense. Are there any practical issues raised by any of the adjustments described in
the discussion draft that are not highlighted in the draft?

4. Are there any areas where a country’s tax policy goals should be taken into account in
determining net third party interest expense which are not set out in the discussion draft?

5. Are there any other circumstances where a group’s net third party interest expense should be
adjusted to include the group’s share of the net third party interest of an entity outside the group?

Practical issues that may prevent a group aligning net interest expense and EBITDA

9. BIAC appreciates recognition from the OECD that in some cases there will be practical or legal
constraints that make aligning location of net interest expense with economic activity difficult
or impossible (para 22). We agree and strongly support in principle allowing an entity to apply
an uplift to its group net third party interest expense. It is disappointing that the draft implies the uplift should be limited to a maximum of 10%.

10. The rationale behind this suggested flexibility in the group ratio is to enable groups to receive a deduction for all of their net third party interest expense, recognising that debt may not be spread exactly in line with EBITDA. For many groups, the 10% uplift will not be enough to cover third party interest expenses in some jurisdictions (and will be an unusable excess in others). The assumption appears to be that adjusting the mix of debt and equity, at least within a margin of 10%, in a group of companies is straightforward. In a minority of situations this might be so, but in many typical group scenarios this does not reflect the process that groups undertake in order to raise finance for investments.

11. Where a controlled entity has a commercial requirement for additional funding, the split between debt and equity financing will often be dictated by external structural issues such as minority interests, existing creditors, exchange controls / other local regulatory constraints and foreign exchange (including currency restrictions in certain countries). It is incorrect to assume that debt can always be shared and “pushed around” within the group such that it aligns with economic substance. Even where it can, this is unlikely to equate to an alignment with EBITDA in any given year; EBITDA fluctuates for a number of reasons, not least macroeconomic changes outside of the group’s control.

12. BIAC would propose that (at the very least), where a group can demonstrate that there is a genuine non-tax reason that debt cannot be shared between entities in line with EBITDA as a proxy for economic substance, such as regulatory capital restrictions, that there should be in-built flexibility to the application of the group ratio rule.

**Preventing interest capacity being increased by non-deductible payments**

13. The discussion draft suggests that interest expenses which are non-tax deductible could be used to increase a group’s net third party interest expense and therefore, under the rules of a particular country, may pose a material BEPS risk (para 26) if included in the net third party interest expense figure.

14. Given the payments are non-deductible in the concerned jurisdiction in any case, BIAC fundamentally disagrees that these payments should properly be considered a BEPS risk.

15. Suggesting different countries introduce their own amendments to the calculation of their relevant group ratio is unhelpful for taxpayers and would create unnecessary complexity with no material impact on tax revenues.

16. To be clear, BIAC finds it difficult to understand why any business would (or could, even if they wished to) manipulate the group ratio rule to obtain a tax benefit by incurring payments which are economically equivalent to interest but non-deductible. Introducing a debt like cost in order to get a slightly higher ratio of allowable interest deductions, the cash benefit of which would be at the marginal tax rate, would not be commercially viable.

17. If this is an issue which countries are concerned about, we suggest that the OECD makes clear the problem, as well as the exact definition of the categories of payments that will be included in the net third party interest expense.
Addressing risks posed by interest paid to related parties outside the group

18. It is not entirely clear what BEPS risks are being targeted in respect of payments to related parties outside the group, other than structured financing arrangements. If this is the case, we believe that restricting all interest payments by reference to related party non-group borrowing in all cases is excessive and BIAC would strongly suggest a more targeted recommendation is adopted.

Net third party interest of associate or joint venture entity

19. BIAC agrees with the OECD’s proposals regarding the necessary adjustments for a group’s share of net third party interest for joint venture enterprises (JVEs). If they have the available resources to do so, taxpayers should be able to make adjustments for the net interest expense in a JVE in proportion to their interest in the entity. We do not consider there to be a BEPS risk (by not making such adjustments), so bearing in mind the potential complexity of the calculations and the corresponding compliance burden, we believe that this should be explicitly recommended as an option of taxpayers rather than countries.

Definition of group-EBITDA

20. The key for groups who are applying these rules is consistency in the operation of them in the different countries in which they operate. BIAC is supportive of the OECD’s suggestions regarding group-EBITDA and hopes that they will be presented in a prescriptive way in the Final Report so that no countries will deviate from them.

Items to be included in the adjustment for interest and income expense

6. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

21. Business values simplicity and agrees with the approaches as outlined in the discussion draft as follows:
   - The treatment of capitalised interest should follow a group’s accounting treatment, as this would be the most straightforward approach.
   - Where an adjustment for net third party interest expense is required to bring it into line with the actual net interest expense funding the group’s earnings, the adjustment should also be reflected in the figure for interest income and expense removed in calculating group-EBITDA.
   - Where an adjustment to net third party interest expense is required to achieve any other tax policy goal, the figure for interest income and expense removed in calculating group-EBITDA should not reflect these adjustments.
   - Fair value adjustments should be excluded in order to reduce volatility and the OECD should make a clear recommendation on this rather than leaving it open for countries to interpret.
Net interest on defined benefit pension schemes should be excluded for all calculations as the Action 4 Final Report recommends that there is no restriction of this expense.

**Items to be included in the adjustment for depreciation and amortisation**

7. *Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?*

22. BIAC supports the approach suggested by the OECD (i.e. treating other fixed asset costs such as impairments/write-off of fixed assets in the same way as depreciation for the purposes of the group-EBITDA calculation).

**The treatment of dividend income and a group’s share of earnings of an associate or JVE**

8. *Are there any practical issues raised by including all dividend income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?*

23. We are not aware of any practical issues that would arise if all dividend income was included in group EBITDA, particularly if para 56 is followed and all dividend income in the group’s consolidated income statement is included in group-EBITDA without adjustment.

9. *Are there any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?*

24. We are not aware of any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA. However, we refer to our comment in paragraph 19 above concerning interest payable by joint venture entities. It would appear inequitable to include income without including the appropriate expense. We would therefore suggest that the inclusion of income should be on the same basis as the inclusion of the related expense.

**The treatment of non-recurring items**

10. *Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?*

25. BIAC would like first and foremost an approach which "can be applied easily and consistently in all countries” (para 64).

26. This could be achieved through recommending a rule that non-recurring items should be included in the calculation of group-EBITDA, or, alternatively by including adjustments for certain material “clearly defined and identifiable non-recurring items” (para 65).
27. If adjustments are required, it is important that there is a sensible materiality threshold to ensure it targets only those items which create volatility.\(^2\)

28. Groups should not be required to prepare a separate EBITDA calculation in each country in which they operate. This would be inefficient for taxpayers, to the point where compliance would be extremely challenging, and would not generate any significant additional tax revenues. This can be avoided in one of two ways; either, the adjustments required to EBITDA in respect of non-recurring items should be universally agreed and recommended by the OECD such that they do not vary from country to country; or, groups should be able to apply the rules set by the jurisdiction of their parent company to work out their EBITDA and this calculation should be respected by tax authorities in all of the jurisdictions in which they operate.

29. We agree with the discussion draft that if particular items must be stripped out of the group-EBITDA calculation in a particular country, this should be done consistently (i.e. in cases that would both increase and decrease a taxpayer’s global group ratio).

**Approaches to deal with the impact of losses on the operation of the group ratio rule.**

**The treatment of entities where a group has a positive group-EBITDA**

11. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

12. If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

30. As noted in paragraph 69, calculation of entity-EBITDA for the purposes of excluding those entities with a negative EBITDA from the group EBITDA calculation would be complex and impose a significant additional burden on groups. BIAC therefore cautions strongly against this approach.

31. Instead, our preferred approach would be that, for those entities whose EBITDA is negative, an upper limit is placed on the amount of net interest that can be deducted under the group ratio rule, determined by reference to an amount equal to the group’s net third party interest expense (after applying any permitted uplift).

32. The discussion draft proposes a cap which should not exceed 100% of EBITDA (para 72), and it appears that any restriction would be based on finding a level that results in some kind of restriction, rather than by reference to the amount of identified and targeted BEPS activity. We would therefore propose that no cap is imposed and, if there must be a cap, it should be at 100% rather than any lower percentage of EBITDA.

\(^2\) We would need more information on what exactly these clearly defined and identifiable non-recurring items in respect of which any adjustments would be required in order to comment more specifically. BIAC would suggest that the significant non-recurring items that could be targeted are: gains/losses from the sale of a business; impairments; and legal/environmental settlements. It would also be useful for the OECD to provide guidance on how items that are presented separately from the main P&L, e.g. income from discontinued operations under some accounting standards, should be treated for this calculation.
33. Para 73 proposes an additional entity level restriction so that entities cannot claim deductions for amounts that exceed the total net third party interest expense of the group, and this would apply to all entities regardless of their EBITDA. However, in practice, there are commercial reasons why certain entities may have levels of interest that exceed the group’s total net interest expense in some circumstances. For example, if cash must be ringfenced for regulatory reasons (e.g. in the extractive sector) or cannot be repatriated from the country in which it has accumulated (e.g. exchange controls), it will earn interest which cannot be used to fund the group’s taxable activities, and this interest will offset the group’s third party borrowings which are being used to fund other (taxable) activities.

34. Whilst it may be appropriate in many circumstances to restrict an entity’s interest expense in line with the amount of the group’s global net interest, we do not believe that this should be a “recommended best practice”. BIAC suggests that this area should be discussed in more detail to highlight what the BEPS concerns are and to highlight the potential issues that may arise where such restrictions are imposed, so that participating countries can implement appropriate and consistent rules that address these concerns whilst also taking account of all group’s debt profiles.

The treatment of entities where a group has a zero or negative group-EBITDA

13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

35. It would not be practical to exclude the earnings of entities with a negative EBITDA from group EBITDA. As noted above, this would require complex calculations and place a significant additional compliance burden on groups.

36. The most practicable solution would be that entities are subject to a cap on their interest deductions set at the lower of actual entity interest or, alternatively, a percentage of entity EBITDA (using the same percentage as a restriction for losses where there is a positive group EBITDA).

14. Do you have any other comments on any of the issues covered by this discussion draft?

37. BIAC’s main concern is that the group ratio rule should be as straightforward to apply as possible, such that it does not create an unnecessary and inefficient compliance burden for business (and tax authorities) and that it does not include areas of subjectivity, which leave room for disputes between tax authorities and taxpayers.

38. The rules should, therefore, be simple to apply and enacted as uniformly as possible across jurisdictions. To the extent they are not implemented uniformly and consistently there should be a recommendation that if the parent of a MNE is in located in a jurisdiction that has adopted a fixed ratio/group ratio approach to interest expense disallowance, other countries should follow the calculation of net interest expense and EBITDA adopted by the parent’s jurisdiction.

39. We understand from the OECD that the calculation of the group ratio should be based on a group’s consolidated financial statements, and that the reporting standard under which the
consolidated accounts are prepared can be used for the whole group. BIAC supports this approach; however, it does raise a question about how audits will work.

40. There are number of potential complexities in the auditing of a group ratio rule and it would be useful to understand how the following aspects will work:
   a. whether each country will audit net interest expense and group EBITDA under its own principles or if they will accept the principles of a parent company’s jurisdiction (or another agreed set of principles);
   b. which tax authority(ies) would sign off a group-wide allocation computation; and
   c. how to manage uncertainty arising from the knock on effects of any tax audit adjustment (which could be many years later) to one of the entities in the group to all the others in the group. Under group wide rules there could be some interdependency between the ultimately agreed tax positions of each entity – a change in one has a “ripple” effect on all the others in a group.

41. We note that where individual companies or worldwide groups may have net interest income, the Fixed Ratio Rule and Group Ratio Rule may not result respectively in meaningful restrictions nor reliefs. We also note that the Action 4 recommendations in respect of Financial Services and Insurance Sector is still under consultation, and that depending on the results of this consultation, such groups may have to apply different rules to different entities within their group. We recommend that the conclusions of both of the current Action 4 consultations are aligned in this respect.
Elements of the design and operation of the group ratio rule

Introduction

1. The BPF represents the UK’s commercial real estate (CRE) sector. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them.

Background

2. The functioning of business in the wider economy relies on investment into commercial real estate. It provides high quality accommodation for businesses and allows them the flexibility to adapt and relocate with changing economic conditions. We are keen to ensure that any proposals aimed at tackling perceived tax abuse do not inadvertently stem the flows of capital into real estate, as that would ultimately harm the quality and availability of business infrastructure.

3. Because real estate is a physical asset, its investment and maintenance is relatively labour intensive compared to other investment asset classes such as equities or bonds. The construction industry in particular benefits from investment in commercial real estate but there are significant benefits for auxiliary services such as property and facilities management, surveyors, lawyers, accountants and many others.

4. Commercial real estate investment is also very capital intensive, and the amounts of money involved with individual projects can be enormous, particularly in the context of the transformation or regeneration of entire neighbourhoods. The total value of the UK’s commercial property is nearly £900bn\(^1\). Given the values involved, the availability of debt finance to supplement sources of equity capital is crucial to the healthy functioning of the real estate market. If it were not easily accessible the stock of commercial buildings would be significantly lower than it is and business’s costs of occupation would be considerably higher, to the detriment of the economy as a whole.

5. Restricting the tax deductibility of debt will increase its overall cost to real estate borrowers. This is likely to reduce the amount of debt capital that the industry can deploy, which will undoubtedly have a negative and incalculable impact on investment in towns and cities.

6. In preparing our response, we have had the benefit of reviewing the response to be made by the Commercial Real Estate Finance Council (CREFC) Europe, which promotes a sustainable and successful CRE debt market in Europe. We strongly agree with the views expressed in that response, particularly as regards the challenges that the group ratio rule (GRR) may cause for lenders to CRE.

Key points

7. We understand the aim of the GRR to be to provide tax relief for interest costs in excess of that afforded by the fixed ratio rule (FRR) in the context of groups that for commercial reasons may be

\(^1\) IPF size and structure of the UK commercial property market 2015
more highly leveraged. In other words, it is recognition that on its own, an FRR will not deliver a fair outcome for more highly leveraged or capital intensive industries like real estate and infrastructure.

8. If investment in those industries is not to be undermined by an increase in the post-tax cost of debt capital, the design of the GRR is of critical importance. The aim should be to not restrict the tax deductibility of interest costs beyond that needed to counter BEPS risks. Sadly, the OECD’s proposed approach to the GRR will not achieve that outcome, but may instead punish low-BEPS risk groups for using debt capital and will lead to significant complexity for both businesses and tax authorities.

9. Our key points are as follows:

9.1. The OECD’s GRR framework should explicitly provide significant flexibility to individual countries in implementing its recommendations. Countries will have widely differing tax systems and while we appreciate the OECD’s desire for consistency in the application of its recommendations, the reality is that their practical implementation will differ widely. As long as individual countries are satisfied that BEPS risks are adequately mitigated, we do not see these differences as bad things. For instance, the UK will need additional flexibility to address distortions arising from tax-to-book differences in an accounts based GRR test. This is in contrast to a number of other countries (e.g. France, Germany) where local GAAP accounts are closely aligned with local tax calculations.

9.2. The GRR as proposed will disproportionately affect groups with diverse businesses. Where a group carries on activities with very different debt profiles, the more highly leveraged activities will always suffer a restriction on their third party interest costs, even where a group is based wholly in one country and therefore poses absolutely no BEPS risk. This is a clearly unfair outcome and the GRR framework should allow countries the scope to rectify this result.

9.3. A group ratio based on earnings and income does not provide fair outcomes for taxpayers where their costs and income arise in different periods, such as in the case of real estate development projects. We therefore welcome the proposals to allow a GRR based on balance sheet measures such as a debt:equity ratio or – in a real estate context – a loan to value (LTV) ratio, as this could go some way to mitigating that unfairness.

9.4. We agree that fair value movements on derivative contracts should be excluded from the definition of ‘group net third party interest’. We would also propose that amounts representing rental payments under the new IFRS16 accounting standard (lease accounting) be excluded from that definition. Failure to do so will lead to a business’s rent payments potentially becoming restricted for tax purposes.

9.5. The definition of ‘group EBITDA’ should exclude fair value movements arising from the revaluation of investment property assets. These amounts represent unrealised gains, can be highly volatile and unpredictable and are often entirely outside the control of a business. This can lead to massive fluctuations in group ratios that introduce considerable uncertainty into tax liability forecasting. Ultimately this makes real estate investment and development a more uncertain proposition, with harmful implications for the real economy if the supply of business space is affected.

9.6. The GRR must work for joint venture (JV) arrangements. Due to the large sums of money involved, real estate investors often seek to share risks by partnering with others through a variety
of different legal arrangements. As the UK is finding out, applying the GRR to such structures is fiendishly complicated and risks favouring tax transparent JVs over tax opaque ones.

10. As you know, the UK is currently in the process of implementing the OECD’s recommendations in respect of BEPS Action 4. The consultation process for that implementation has made it clear that the GRR has the potential to significantly increase cash flow uncertainty for those businesses that will rely on it in order to obtain tax relief for their third party interest expenses.

11. This by-product of the GRR should not be seen as merely an inconvenience for taxpayers to deal with; the price to pay for a safer corporation tax system. Uncertainty is the nemesis of investment, particularly long term investment into the sort of real estate and infrastructure projects that can transform whole areas of cities. We worry that productive investment is being put at risk by uncertainty created by the tax code.

12. In our response we propose ways of mitigating that uncertainty within the confines of the GRR, but ultimately we do not feel that the GRR strikes the right balance between protecting against interest-driven BEPS and ensuring that low BEPS-risk businesses receive adequate tax relief for their genuine third party interest costs.

More detailed consideration of the above and of individual consultation questions is set out in Appendix 1. Further elaboration of some of these points is contained within Appendix 2 and Appendix 3.

We remain at your disposal should you wish to discuss the contents of this response in more detail.

Ion Fletcher  
Director of Policy (Finance)  
British Property Federation  
St Albans House  
57-59 Haymarket  
London SW1Y 4QX  
020 7802 0107  
jonfletcher@bpf.org.uk
Appendix 1 – detailed responses to selected consultation questions

Q1: Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

1. IFRS 16, a new accounting standard due to take effect in 2019, will require all businesses that lease properties to recognise the value of that lease on their balance sheets. In addition, payments in respect of property leases, which are currently recognised as rental expense in a company’s income statement, will be split into two components: amortisation of the lease asset and the financing cost of entering into that lease.

2. The commercial nature of property rental agreements will not change, but the way they are recognised in business’s financial statements will be very different – income statements will effectively no longer show rental expenses as a separate line item. The accounting treatment of all leases will move to that which currently applies to finance leases.

3. Unless the GRR makes special provision for it, businesses may under the new rules face a restriction on the amount of rental expenses on which they are able to obtain tax relief. The financing cost component of a property lease will – unless specifically excluded – be included in the definition of ‘net third party interest’ as a result of its accounting treatment.

4. We cannot see a justification for restricting the tax deductibility of property rental expenses. Indeed doing so could lead to double taxation where lease rentals are not wholly deductible in the hands of the lessee but are taxed in full in the hands of the landlord. Rents on property assets are almost invariably subject to tax in the jurisdiction in which the property is located. As a result, no BEPS risk exists and we see no reason to restrict a tax deduction for the lessee.

5. It should therefore be clear that the financing cost component of a property rental lease does not form part of a group’s net third party interest expense for the purposes of the GRR. We note this issue will arise in the context of all leases currently treated as ‘operating’ leases for accounting purposes – not just real estate.

Q2: What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest?

6. No comments.

Q3: It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

7. No comments

Q4: Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?
8. We do not identify any additional areas where a country’s tax policy goals should be taken into account in determining net third party interest, but this does not mean that they do not exist. As a general point, we would encourage the OECD to provide countries with as much flexibility as possible in the interpretation and application of the GRR, including for the purposes of reflecting tax policy goals. Any list of such goals provided by the OECD should not be exhaustive.

Q5: Are there any other circumstances where a group’s net third party interest expense should be adjusted to include interest income or expense of an entity outside the group?

9. In a CRE context, this is most likely to be the case for joint ventures (JVs). See our response to Question 9 below.

Q6: Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

10. See our response to Question 9 below.

Q7: Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

11. See our response to Question 9 below.

Q8: Are there any practical issues raised by including all dividend income in group EBITDA? If so, what are these issues and how could they be addressed by a country?

12. See our response to Question 9 below.

Q9: Are there any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

13. Given the large scale of certain CRE investments it is very common for investors to seek to pool risk, capital and expertise through JVs or some other form of co-investment arrangement. The legal form of these arrangements varies depending on (among other things) the purpose of the JV and the characteristics of the investors. JVs are generally funded through a mixture of debt and equity capital, where the debt may be provided by either a third party lender, such as a bank, but just as often it is provided by the JV investors (shareholder debt).

14. There are many strong commercial reasons for using shareholder debt. Often it will be cheaper for JV investors to source third party debt – relying on their scale and the fact that they are established businesses – than it will be for the JV entity itself. Indeed, sometimes a lender will not be willing to provide debt finance at all to a JV entity, as these are usually special purpose vehicles (SPVs) newly created for a JV project and will have no track history of performance.
corporate has a special tax status – e.g. REIT) the investors are treated for tax purposes as owning shares in another company.

16. Where shareholder debt is used in a JV, applying the GRR to different types of JV arrangement will generally result in a more favourable outcome for tax transparent JVs than for opaque JVs. This is because opaque JVs will be subject to interest restrictions in line with the FRR (if all of their debt comes from the JV partners, it will all be treated as related party debt and therefore disregarded for the GRR), whereas transparent JVs are in effect ignored for tax purposes and the group ratio(s) that applies to the income arising in it will be those of the JV investors.

17. In other words, an opaque JV may see its interest deductions restricted to 30% of EBITDA whereas in a transparent JV the interest deductions will accrue to the JV investors to the extent of their individual group ratios, which in CRE will most likely be higher than 30%.

18. This result means that tax opaque JV arrangements will become more expensive from a tax perspective than tax transparent JVs and will no doubt influence the way that future JVs are structured. Perhaps more importantly, unless countries adopt grandfathering for existing financing arrangements (and the UK looks unlikely to do so), existing tax opaque JVs will be punished vis-à-vis tax transparent JVs.

19. The Discussion Draft makes no reference to this disparity; perhaps because JVs (and particularly tax transparent JVs) are less commonly used outside of the real estate and infrastructure sectors. However, the OECD should be aware that its recommendations regarding interest restrictions could have unintended consequences for commercial activity. We therefore recommend that the OECD provides countries with the necessary flexibility to rectify or mitigate discrepancies arising from the application of the GRR.

Q10: Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

20. IFRS requires groups owning investment property to report the fair value of that property in the group’s balance sheet and to recognise any movement in that fair value from the preceding period in the group’s income statement. The fair value of an investment property at any one time will depend on a number of factors including its condition, the extent to which it is let and the general state of the real estate market, reflecting strength of investor confidence.

21. Some of these factors (e.g. market sentiment, the construction of a competing building nearby) are often unpredictable, are totally outside of the control of a particular investor and can lead to significant fluctuations in a group’s EBITDA. Movements in the fair value of investment property represent unrealised gains and losses and can reverse within a short space of time.

22. Such movements are therefore akin to the type of non-recurring item identified in the discussion draft. Although they happen every year, their size and direction is unknowable and can have a material impact on a group’s income statement. If they were to be included within ‘group EBITDA’ for the purposes of the GRR the result would be highly volatile group ratio figures and therefore highly volatile and uncertain tax relief on interest costs. Appendix 2 illustrates this by reference to an existing real estate investment business.
Elements of the design and operation of the group ratio rule

23. Not only would this be difficult from an administrative perspective for those groups affected, it would also make budgeting for the tax cost of a given investment almost impossible. This raises the level of uncertainty associated with a particular project, which ultimately makes that project less likely to go ahead. Were this to happen at sufficient scale, we are concerned that the supply of new business space could be negatively affected with a deleterious (for occupiers – and the economy more generally) impact on the rental cost of that space.

24. While the application of carry forward or carry back of unused interest capacity may mitigate some of the ill effects described above, it does not eliminate them. This is particularly the case when countries – like the UK – choose not to permit carrying-back unused interest capacity.

25. We therefore strongly recommend that movements in the fair value of investment property are not included within group EBITDA for the purposes of the GRR. Alternatively, groups could be given the ability to elect to calculate their group ratio by reference to some form of ‘tax EBITDA’. While this may be complicated for multinational groups, it would reduce the potential volatility of the group ratios of businesses based wholly in one country.

Q11: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so what are they?

26. Where a group has a very high group ratio, providing tax relief for this level of interest would appear to be in line with the policy objective, even where this creates an overall taxable loss. If a group has (at a global level) suffered an overall economic loss because external interest expense exceeds its profits, we do not see why it would be appropriate to penalise it. If countries are minded to introduce a cap, this should be at the level of the gross third party interest expense of the group, to ensure that loss making entities are not further penalised by these restrictions.

Q12: If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

27. Whether an expense is tax deductible or not should not be subject to an arbitrary cap. If the OECD were to recommend such a cap, it would need to be reflective of the industry that each entity operates in. In a real estate context, it is not uncommon to see interest at 60%-80% of earnings, particularly in a higher interest rate environment. For infrastructure projects, it is typically even higher.

28. A cap based on third party interest expense would be more appropriate. However, the OECD should allow countries to permit a deduction for gross third party interest expense where appropriate. In a real estate context, it is typical for interest expense to be matched against rental income in the same country; it will not necessarily be matched against interest income in the same country. If the same group earned interest income in another country, the net interest expense of the group would reduce, which would inappropriately restrict the interest deduction available against the rental income.

Q13: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and if so what are they?
29. The GRR is not designed for businesses with life cycles spanning more than one accounting period, and as such, the rules will be particularly inappropriate for real estate developers.

30. In order to ensure that loss making entities are not penalised, we would agree that that safeguards should be introduced. As noted in response to question 12, where the GRR has not resulted in an appropriate outcome, entities should be allowed to deduct up to the gross third party interest expense of their group (and it would be fair to cap the deduction to this amount). An alternative safeguard in a real estate context would be to allow a full deduction for third party interest in respect of debt which is secured against assets in that country. Given the interest deduction is naturally matched against the profits or income from the real estate, this debt poses negligible BEPS risk and as such, should not be restricted.

Q14: Do you have any other comments on any of the issues covered by this discussion draft?

31. While the GRR is designed to provide more highly capital intensive businesses with a higher (and more appropriate) level of tax relief on their interest costs than the FRR, there are still instances in which the GRR will deny such groups a deduction for *bona fide* third party interest – even where there is no BEPS risk involved. This is particularly the case where a group carries on activities with different financing needs and therefore different debt profiles.

32. For instance, where a business carries on a lowly leveraged property management business alongside a more highly leveraged property investment business, the group’s ratio would reflect an average of those two very different activities. Applying the GRR on an entity by entity basis in such situations would always result in a restriction of interest in the more highly leveraged entities. Where a group is based wholly in one country this feels like entirely the wrong outcome, as the group is being penalised and yet poses no BEPS risk whatsoever.

33. The OECD’s final recommendations on the GRR should allow countries to counteract this sort of unfair outcome in whatever way best suits their particular tax system. This may include applying the GRR at a national group level rather than on an entity by entity basis.

34. Appendix 3 provides further detail on this problem.
Appendix 2 – case study of UK CRE business with overseas operations

1. This appendix illustrates how the group ratio rule will often result in tax outcomes that are very different from commercial reality. The charts below are based on a real UK real estate business with overseas operations.

Graph A:

2. The following graph illustrates the earnings and interest expense of a real estate business over an 8 year period. The green line illustrates the earnings of the group, including realised and unrealised gains and losses. The blue line strips out the realised and unrealised gains and losses, which shows that the underlying rental income arising in the business is relatively stable over time. The interest expense (the yellow line) is also relatively stable over time.
Elements of the design and operation of the group ratio rule

Graph B:

3. Graph B shows what the group ratio for this business would be over the same 8 year period; the different lines represent different amounts being included within the group earnings figure in calculating the ratio. The green line, which includes realised and unrealised gains and losses, creates the most volatile group ratio. The volatility is reduced when unrealised gains and losses are excluded (represented by the yellow line); and the volatility is further reduced when all gains and losses are excluded (the blue line).

4. Graph B shows that where realised and unrealised gains are included within the group ratio calculation it becomes significantly more volatile; ranging from 10% to 100% (green line).

5. The volatility decreases when realised and unrealised gains and losses are removed from EBITDA; decreasing the Group Ratio range from 45% to 75% (blue line).

6. If we consider how stable the underlying businesses is – represented by the blue line in graph A; it seems inappropriate for the group ratio to impose such volatility on the amount of interest that can be deducted by the UK business.
Why is there still volatility in the group ratio after realised and unrealised gains are removed?

7. The group ratio is a factor of anything that impacts on the total earnings and interest expense of the worldwide group, including:
   
   7.1. A recession, and resulting void periods in properties.
   
   7.2. Development activity with limited earnings for a period.
   
   7.3. Different debt markets and interest rates around the world.

8. The larger the group, the more countries in which it operates, and the more diverse its activities and the debt profile, the harder it will be to predict what tax relief will be due on their interest costs. This would be an extraordinary amount of uncertainty to impose on businesses and more importantly, it does not result in a fair or appropriate outcome.

9. Debt secured against real assets in the UK that derive rental income in the UK is appropriately based in the UK. If the group ratio rule cannot achieve a deduction for this interest in all cases; a safeguard must be introduced as part of these new measures.
Elements of the design and operation of the group ratio rule

Appendix 3:- when would a GRR not be appropriate?

1. The following scenario illustrates that the GRR is not appropriate for groups with diverse debt profiles.

Example 1: application of the group ratio rule – inappropriate outcome

Scenario A: a high yielding activity and a low yielding activity within the same group
A property investor has a fully let property (Office block X) in country A and a property under development (Shopping centre Z) in country B. Each property has third party debt which is secured against the relevant building. We assume that the interest expense is the same on both buildings (say £50 interest expense). Office block X has rental income of £100, while Shopping centre Z has minimal rental income at this stage as we assume the development is partially complete with only some units let.

Office block X (country A) - interest/earnings ratio: 50/100 = 50%
Shopping centre Z (Country B) – interest/earnings ratio: 50/40 = 120%
Group Ratio = 85% - Country B does not receive a full deduction for third party interest

Scenario B: a highly leveraged activity and less leveraged activity in the same group
Assume that the same group still owns Office block X, but now also carries out a service sector business (Property Management Co. Y) in Country C. Assume that the property management arm also has earnings of £100, but has very little debt (say interest of £10).

Office block X (country A) - interest/earnings ratio: 50/100 = 50%
Property Management Co. Y (Country C) – interest/earnings ratio: 10/100 = 10%
Group Ratio = 30% - Country A does not receive a full deduction for third party interest
What does this example show?

2. The example illustrates that a GRR – on its own and if no further provision is made – will not provide a full deduction for third party interest in all cases.

3. Although it seems reasonable for debt secured against a building in a country to obtain a tax deduction in that same country (in which the rental income in respect of that building is also taxed); the GRR will not always give an appropriate result.

4. Furthermore, the example shows that a GRR would generate significant uncertainty for taxpayers given that interest expenses related to the same investment (Office Block X) would give rise to very different tax outcomes depending on the debt profile of the other businesses or activities in the same group.

5. While this example uses an earnings based group ratio measure; there will be situations where neither a balance sheet nor an earnings based measure would provide an appropriate outcome.

6. Other factors that might skew the group ratio calculation include:
   
   6.1. Interest rates (these can vary considerably in different countries);
   
   6.2. Lending terms (including loan to value ratios) - these can also vary depending on the nature and location of the asset, how strong the tenant’s covenant is, the outstanding period on the lease etc.
   
   6.3. The state of the local economy is which the building is based in. E.g. in a recession, a building may suffer a void period and gain no income for a period of time (similar example to the development asset).

7. There are many variables which will impact on the group ratio and may give rise to an inappropriate or unfair result. It is impossible to predict and account for all of these examples, therefore a suitable safeguard test should operate when the GRR has not provided a full deduction for third party interest. This safeguard will provide certainty to real estate borrowers and lenders at the point the finance is arranged.

Why is certainty important to real estate?

8. Investment thrives on certainty. However, if the tax outcome of an investment depends on the debt profiles of different parts of the group, lenders and borrowers will find it very difficult to find certainty over whether the rental income alone is sufficient to cover the interest expense.

9. While certainty is important for all businesses, it is particularly important for real estate business because the investments horizons and associated debt maturities can be very long term. Leverage levels are also typically much higher than other industries, so the amounts involved will generally be more material to the business.

Dear Dr. Achim Pross,

Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled “BEPS Action 4: Elements of the Design and Operation of the Group Ratio Rule” (hereinafter referred to as the Draft).

BUSINESSEUROPE’s view on the three proposed approaches to determining net third party interest expense is that the simplest and easiest to administer and control would be for all jurisdictions to adopt approach 1. Under approach 1 a multinational corporation (MNC) would use their unadjusted interest income and expense figures from their consolidated income statements to calculate global net interest. For publicly traded companies, the requirements of GAAP reporting are subject to detailed scrutiny by independent auditors and financial reporting authorities. This should provide sufficient comfort for tax administrations that the concerns expressed in the draft at paragraph 9 about income items not being accounted for as interest are effectively addressed.

While preferring that the audited consolidated income statement interest and expense data are used without adjustment for the determination, if there are specific concerns about manipulation, then a targeted anti-avoidance rule could be drafted to address these precise issues.
If approach 1 is not recommended in the final report, BUSINESSEUROPE would propose that groups are permitted to choose themselves whether they will apply approach 2 or 3. As the discussion draft notes at paragraph 11, either approach should give rise to the same figure for a group’s net third party expense. Therefore we see no reason why one of these approaches should be favored over the other. We would strongly recommend that the choice of approach should not be left to individual countries, as there is no anticipated difference in tax revenues between the approaches and there could be significant additional compliance costs for MNCs in preparing different calculations in each jurisdiction.

In paragraph 4, the Draft proposes that group ratio rules based on other relevant financial ratios of an entity’s worldwide group could be applied by countries and specifically refers to equity/asset or interest/earnings ratios. BUSINESSEUROPE considers that this option deserves more attention, as some of the alternative ratios could avoid some of the drawbacks identified for the EBITDA approach and notes that the recently adopted European Anti-Tax Avoidance Directive (COM/2016/026) implements at Article 4(3) an equity/total assets group ratio. It would be preferable for worldwide groups to be able to apply a consistent group ratio to reduce compliance costs.

BUSINESSEUROPE welcomes the acknowledgement from the OECD that in some cases there will be practical or legal constraints that make it difficult or impossible aligning the location of net interest expense with economic activity. We therefore strongly support the principle of allowing an entity to apply an uplift to its group net third party interest expense. However, it is not explained in the draft why the uplift should be limited to a maximum of 10%.

For many groups, a 10% uplift would not be enough to cover third party interest expenses in some jurisdictions, and would be an unusable excess in others. Where a controlled entity has a commercial requirement for additional funding, the split between debt and equity financing will often be dictated by external structural issues such as minority interests, existing creditors, exchange controls / other local regulatory constraints and foreign exchange (including currency restrictions in certain countries). It is incorrect to assume that debt can always be shared or moved within the group such that it aligns with economic substance. Even where it can, this is unlikely to equate to an alignment with EBITDA in any given year, EBITDA fluctuates for a number of reasons, not least macroeconomic changes outside of the group’s control. As a consequence of these practical restrictions on the freedom of groups to align the level of indebtedness with entity or country EBITDA, BUSINESSEUROPE would suggest that the uplift should not be limited to 10%.

BUSINESSEUROPE would propose that there should be in built flexibility to the application of the group ratio rule, including an increase in the uplift, where a group can demonstrate that there is a genuine non-tax reason that debt cannot be shared.
between entities in line with EBITDA as a proxy for economic substance, such as regulatory capital restrictions.

The discussion draft suggests, at paragraph 26, that interest expenses which are non-tax deductible could be used to increase a group's net third party interest expense and therefore, under the rules of a particular country, may pose a material BEPS risk if included in the net third party interest expense figure. As these payments are non-deductible in the concerned jurisdiction in any case, BUSINESSEUROPE can see no justification for the conclusion that these payments could properly be considered a BEPS risk.

If this is an issue which countries are concerned about, we suggest that the OECD makes clear the exact definition of the categories of payments that create the risk and would therefore be included in the net third party interest expense.

It is not entirely clear what BEPS risks are being targeted in paragraphs 27-28 in respect of payments to related parties outside the group other than structured financing arrangements. Restricting all interest payments by reference to related party non-group borrowing in all cases is excessive and creates significant administrative burdens in relation to non-consolidated entity transactions. BUSINESSEUROPE would strongly recommend a more targeted recommendation is adopted in the Final Report.

BUSINESSEUROPE agrees with the OECD's proposals regarding the necessary adjustments for a group's share of net third party interest for joint venture enterprises (JVEs) in paragraphs 29-30. If they have the available resource to do so, taxpayers should be able to make an adjustment for the net interest expense in a JVE in proportion to their interest in the entity.

BUSINESSEUROPE appreciates the OECD's helpful suggestions regarding the definition of group-EBITDA and would recommend that that they form the basis of clear guidance in the Final Report so that all countries will be urged to adopt them in full.

BUSINESSEUROPE supports simplicity and certainty in the guidance on adjustments for interest and income expense, and in particular agrees with the approaches as outlined in the discussion draft:

- The treatment of capitalized interest should follow a group's accounting treatment, as this would be the most straightforward approach.
- Where an adjustment for net third party interest expense is required to bring it into line with the actual net interest expense funding the group's earnings, the adjustment should also be reflected in the figure for interest income and expense removed in calculating group-EBITDA.
- Where an adjustment to net third party interest expense is required to achieve any other tax policy goal, (e.g. non-deductible interest expense for tainted acquisition or excessive interest) the figure for interest income and expense removed in calculating group-EBITDA should not reflect these adjustments.
• Fair value adjustments should be excluded (unless, for consistency where both legs of an inter group transaction such as a hedge should be treated equally) in order to reduce volatility and the OECD should make a clear recommendation on this rather than leaving it open for countries to interpret.

• Net interest on defined benefit pension schemes should be excluded for all calculations as the Action 4 Final Report recommends that there is no restriction of this expense.

BUSINESSEUROPE supports the approach suggested by the OECD, regarding adjustment for depreciation and amortization, including treating other fixed asset costs such as impairments or the write-off of fixed assets in the same way as depreciation for the purposes of the group-EBITDA calculation.

BUSINESSEUROPE supports the general principle that non-recurring items, other than impairment or write-off, should be included in the calculation of group-EBITDA. The draft suggests that some countries may require variations from this approach, without providing further detail. We would request, in order to comment further on this proposal that clearly defined and identifiable non-recurring items in respect of which any adjustments would be required are carefully explained in the draft. We would also prefer that these were limited as far as possible, and applied in a consistent manner across countries. We agree with the discussion draft that, if particular items must be excluded from the group-EBITDA calculation in a particular country, this must be done consistently (i.e. in cases that would both increase and decrease a taxpayer’s global group ratio).

As noted in paragraph 69, calculation of entity-EBITDA for the purposes of excluding those entities with a negative EBITDA from the group EBITDA calculation would be complex and impose a significant additional burden on groups. BUSINESSEUROPE therefore urges the OECD against this approach, but would propose that, for those entities whose EBITDA is negative, an upper limit on the amount of net interest that can be deducted under the group ratio rule is limited to an amount equal to the group’s net third party interest expense (after applying any permitted uplift), or a group ratio rule based on equity/total assets is permitted.

Paragraph 73 proposes, in addition to the 100% or lower limit to be adjusted by countries to limit interest capacity for entities with positive EBITDA, an entity level restriction so that the entity cannot claim a deduction for an amount that exceeds the total net third party interest expense of the group. It would apply to all entities regardless of their EBITDA. This appears a surprising recommendation as it is not consistent with the final recommendations of the Action 4 report released in October 2015 which clearly proposed a fixed ratio rule with a supplementary group ratio provision plus other targeted rules. As this additional rule does not appear to be so targeted, BUSINESSEUROPE suggests that this provision should not be included in the final recommendations.
BUSINESSEUROPE does not consider that it would be practical to exclude the earnings of entities with a negative EBITDA from group EBITDA, as this would require complex calculations and impose a significant additional compliance burden on groups. Instead, we believe that the most practicable solution is that entities are subject to a cap on their interest deductions set at the lower of actual entity interest or, alternatively, a percentage of entity EBITDA (using the same percentage as a restriction for losses where there is a positive group EBITDA). To reduce the number of situations with negative EBITDA, BUSINESSEUROPE would suggest that, for countries where there is a legislative concept of a tax unity, the limitation is applied at the level of the tax unity, and not the individual entity.

Yours sincerely,

[Signature]

James Watson
Director
Economics Department
CBI RESPONSE TO THE OECD DISCUSSION DRAFT ON ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE

As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

The CBI has supported the OECD BEPS project since its inception and recognises the need to update international tax rules to address base eroding and profit shifting activity.

We have reviewed the response prepared by BIAC in respect of the OECD discussion draft on elements of the design and operation of the group ratio rule and agree with the key points and conclusions set out in the BIAC response. In addition, we have set out below a specific comment to the UK businesses:

The UK suffers by comparison as there are many book to tax differences and the response to the UK consultation on interest deductibility (closed on 4 August 2016) included comments on inclusion of property and derivative revaluation movements distorting the outcome so that wholly UK groups could not deduct all third party interest. Additionally, groups would have items going through the interest expense in the P&L each year that are not taxed as interest on the same basis (e.g. swap valuation movements). The impact of all of this is to distort the group ratio calculation for UK groups.

- As set out in section “Definition of group-EBITDA” in BIAC’s response, net interest on defined benefit pension schemes should be excluded for all calculations as the Action 4 Final Report recommends that there is no restriction of this expense. We would propose that as well as pension contributions, share based payments should also be excluded in determining tax-EBITDA to avoid large and volatile movements in tax EBITDA.
Opinion Statement FC 11/2016

on the OECD Public Discussion Draft (BEPS Action 4)

Elements of the design and operation of the group ratio rule

Prepared by the CFE Fiscal Committee

Submitted to the OECD in August 2016

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.

The CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, CFE Tax Policy Manager, at brusselsoffice@cfe-eutax.org.
1 Introduction

This Opinion Statement by the CFE Fiscal Committee relates to the OECD Discussion Draft “BEPS Action 4: Elements of the Design and Operation of the Group Ratio Rule” (hereinafter the “Discussion Draft”), released for public consultation on 11 July 2016.

Please note that this is a preliminary version which is still pending approval by the CFE bodies. The final version will soon be made available on http://www.cfe-eutax.org/node/5507.

2 General remarks

Reference is made to the Opinion Statements submitted previously, i.e.

i. Opinion Statement FC-5/2015 of February 2015 on interest deductions and other financial payments (BEPS Action 4),

ii. Opinion Statements FC 4a-4f/2016 of 5 October 2015 on the OECD Final Recommendations on BEPS Actions 1, 4, 5, 8-10, 12 and 14, and

iii. the OECD BEPS Final Recommendations of 5 October 2015.

The comments below are based – and further expand – on the following comments and recommendations made in the aforementioned Opinion Statements.

2.1 As a general point, the concern was raised that the rules to limit the deduction on interest might lead to situations (i) in which not all third party interest will be tax deductible, (ii) in which the rules will lead to double taxation, and (iii) in which the rules will limit the deductibility of interest even though it concerns bona fide business situations in which the taxpayer can demonstrate that the objective to attract loans evidently was not to avoid or reduce corporate income taxes. In this respect, it was observed that the rules leave much space for different interpretation and discretion of the countries that adopt these rules, thus increasing the risks summarized above.

With respect to the group ratio rule, the hope was expressed that it would help to eliminate double taxation and to achieve a fairer system, while special attention was requested for the interaction of loss-making entities on the operation of the group ratio rule.

In view of the foregoing, CFE recommends that the group ratio rule meets the following conditions:

(i) if and to the extent that in the first round the implementation of the group ratio rule does not result in all interest on third party debt to be deductible for CIT purposes, there should be a corrective adjustment/compensating mechanism resulting ultimately in all third party interest being deductible;

(ii) the fact that dividends and/or capital gains from equity investments are exempt from CIT in the hands of the relevant group company should either not affect the deductibility of interest

2 http://www.cfe-eutax.org/node/4175.
due by such company, or, if it is allowed to limit such deductibility, find compensation elsewhere (see (i) above);

(iii) to the extent the group ratio rule provides for exceptions to the generic principles justified by “policy” considerations of the jurisdiction(s) involved, this should only be acceptable if (i) it concerns policy considerations specifically aimed at combatting base erosion and profit shifting, and (ii) the rights of the taxpayers are protected in that the aforementioned exceptions do not apply if they can demonstrate that base erosion and profit shifting was not the underlying motive for the third party borrowing.

2.2 Taking into account these recommendations, in the CFE’s view, the Discussion Draft apparently does not endeavour meeting the aforementioned conditions. This observation is in particular based on the following:

(i) the discretion of a country to deviate from the rules on the basis of tax policy considerations.

In numerous cases the Discussion Draft states that countries may not apply a group ratio rule, or a different group ratio rule based on “policy” considerations. See, for example, par. 4: “The option for a group ratio rule described in the Action 4 Report and this discussion draft represents an approach that should be suitable for most countries. However, countries may also apply a different approach to suit their domestic circumstances”. In addition, par. 21 states the following: “So long as the adjustments [to a group’s net party interest expense] required or permitted by a country are in accordance with the goals set out in the Action 4 Report, the fact that countries may make different policy choices on these issues is not inconsistent with common approach”.

In this respect it is unclear which goals specifically the Discussion Draft is referring to, taking into account that the Action 4 Report seems to be extremely “permissive” insofar it concerns the acceptability of a country’s policy. See for example par. 31 of the Action 4 Report: “It is also recognized that a country may have interest limitation rules that carry out broader policy aims such as reducing the tax bias in favour of debt finance...”. Query whether such policy is in accordance with the Action 4 Report. If it would, this would allow countries to make any adjustment they like at their full discretion. It would be very helpful if the OECD could explain in which circumstances a country’s “policy” would go beyond, and therefore no longer be in accordance with, the goals set out in the Action 4 Report.

By way of illustration, it is also worth noting that in the interest limitation rule of the recently adopted EU Anti-BEPS Directive all of the OECD’s recommendations with respect to adjustments to the Group Ratio Rule have been ignored.

(ii) the approaches available to calculate net third party interest expense and group-EBITDA.

The Discussion Draft provides for a number of approaches to calculate net third party interest expense. Approach 2 and 3 as described in the Discussion Draft allow for adjustments to the calculation of net third party interest expense to include and exclude certain items in accordance with whether they fall within the definition of interest and payments

---

5 Directive (EU)2016/1164 of 12 July 2016: link
economically equivalent to interest as described in the Action 4 Report. The CFE acknowledges the need for adjustments in certain cases as a group’s consolidated financial statements alone (i.e. Approach 1) may not be appropriate to reflect the actual third party interest income paid by the group due to different accounting standards. However, the CFE notes that if flexibility were given to countries to apply any of approaches 1 through 3, this could result in (large) variances in calculations of net third party interest expense between countries. It is therefore of utmost importance that a single standardised approach is taken if such adjustments are made. The absence of a single approach could result in not all third party debt being deductible. Similarly, if the “adjustment” approach described above is accepted to bring the net third party interest expense in line with the actual third party interest paid, any corresponding adjustments made to the group-EBITDA should also take such a single standardised approach.

(iii) inclusion of non-taxable dividend income in the calculation of group-EBITDA.

The Discussion Draft provides that all dividend income, including non-taxable (exempt) dividend income, should be included in the calculation of group-EBITDA but that exempt dividend should be excluded from the relevant taxpayer’s EBITDA. This approach may restrict an entity’s ability to fully deduct third party interest expenses. The CFE therefore favours the approach described in par. 55 of the Discussion Draft which proposes to exclude dividend income which is not subject to tax from group-EBITDA calculation. Although the compliance burden should be considered, the CFE believes the additional burden of this approach to be limited. As the Discussion Draft correctly notes, information on received dividend income and its tax treatment will be available to the group’s finance department. At the same time, information on a country’s treatment of dividend income should be readily available for the tax authorities as well in this ever more globalised world. In this context, the CFE wonders why on the one hand the Discussion Draft favours adjustments to the calculation of net third party interest expenses to ensure the proper operation of the group ratio rule (see par. 19 of the Discussion Draft), but on the other hand considers adjustments to the calculation of group-EBITDA to be too burdensome and complex (see par. 55 of the Discussion Draft).

(iv) the treatment of groups with zero or negative group-EBITDA.
The CFE shares the OECD’s concerns that there could potentially be a significant difference between the tax treatment of a group having a very low group-EBITDA and a group having a zero or negative group-EBITDA. To address the above issue, the Discussion Draft contains two proposals, i.e. excluding entities with negative EBITDA from the calculation of group-EBITDA (see par. 76 of the Discussion Draft) or allowing an entity with positive EBITDA in a group with negative group-EBITDA to deduct interest expenses up to the lower of the entity’s actual net interest expense, the group’s net interest expense and a set percentage of entity EBITDA (see par. 78 of the Discussion Draft). The CFE favours the option of excluding entities with negative EBITDA.

With respect to the issue of the carry forward that is raised in par. 79, the CFE refers to the recommendations made in the Action 4 Report, which it fully supports. As a general principle, the CFE believes that carry forward of disallowed and unused interest capacity under the group ratio rule is an important tool that would adequately address the issue of volatility in the outcome of the group ratio rule over different years due to fluctuations in a group’s income and net interest expense and should therefore be allowed where possible.

Given the importance, the CFE wonders why the mechanics of the carry forward of both disallowed interest and unused interest capacity in relation to the group ratio rule have not been addressed by the Discussion Draft.

In the context of carry forward of unused interest capacity specifically, the CFE notes the following observation made in par. 79 of the Discussion Draft: “On the other hand, where a group has negative group-EBITDA, this approach [i.e. the approach of paragraph 78 of the Discussion Draft] would prevent an entity which has deducted all of its net interest expense in the current period from carrying forward unused interest capacity...”. The meaning of this statement is unclear to the CFE. One would think that, if a group has zero or negative group-EBITDA, the group ratio rule cannot be applied and hence there will be no unused interest capacity to carry forward. To clarify this point, the CFE recommends to illustrate the mechanics of carry forward of unused interest capacity in an additional example, including an example of the alternative proposed in the last sentence of par. 79 of the Discussion Draft.

3 Responses to specific questions

The Discussion Draft poses a number of “questions for consultation” in regard to the proposed approaches to the outline of key elements of the design and operation of the group ratio rule, i.e. (i) the calculation of the group’s net third party interest expense, (ii) the definition of group-EBITDA, and (iii) the impact of losses on the operation of the rule. All issues to which the questions relate, and on which the CFE would like to comment have been addressed above as follows:

(i) Questions for consultation in regard to the calculation of the net third party interest expense: We refer to the comments made under paragraph 2.2, (i) and (ii) above.

(ii) Questions for consultation in regard to the Definition of Group-EBITDA: We refer to the comments made under paragraph 2.2, (ii) and (iii) above.
(iii) Questions for consultation in regard to the impact of losses on the operation of the group ratio rule: We refer to the comments made under paragraph 2.2 (iv) above.
The Confederation of Swedish Enterprise is Sweden’s largest business federation representing 49 member organizations and some 60,000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled “Elements of and design and operation of the group ratio rule” 11 July 2016 (hereinafter referred to as the Draft).

General Comments

The discussion draft is divided into three parts. The first part dealing with the calculation of net third party interest expense, the second definition of group-EBITDA and the third the impact of losses on the operation of the group ratio rule. Before we go into specific comments regarding these three parts, we would like to emphasize the need for a straightforward application of the group ratio rule in a consistent way across different countries. Some highly leveraged groups will be hit hard by the fixed ratio rule. The group ratio rule will be very important for such groups. In order to make the group ratio rule usable it must be easy to apply. The group ratio rule should not be more complex than absolutely necessary. Otherwise there is a risk that the group ratio rule will be too burdensome to comply with for some groups, leaving them unable to deduct most of their interest expense. Every element of the group ratio rule which increase the complexity of the rule should be carefully considered. If the element is not found to stop a clear BEPS-risk, it should not be included in the group ratio rule.

While the Confederation of Swedish Enterprise appreciates the efforts by the OECD to develop recommendations regarding the design and operation of the group ratio rule, we must also realize that it will take time before a well-functioning group ratio
rule is in place. And even when a group ratio rule is in place, it will most likely be complex and costly to comply with. With this in mind, the importance of the fixed ratio rule cannot be understated. The fixed ratio rule must be easy to apply and, especially for small open economies such as Sweden, the fixed ratio rule must be competitive. Otherwise investments will end up in other countries, with a more competitive fixed ratio rule. In this regard, we note that several large economies in Europe allow, or intend to allow, for interest deductions at the maximum prescribed EBITDA-rate (30%) as a response to the discussions of the Anti-Tax Avoidance Directive in the EU. These choices made by larger countries exert downward pressure on the statutory tax rates in other Member States, in particular in smaller economies in the periphery of Europe, to compensate for not being able to allow for more extensive allowable deductions than provided for in the larger economies.

In the following the Confederation of Swedish Enterprise leave specific comments on the different parts of the draft.

**Calculation of a group’s net third party interest expense**

The Draft contains three approaches on how to calculate a group net third party interest expense. Approach 2 and 3 are however different ways to come to the same conclusion. The main question to be answered is weather adjustments should be made or not. Approach 1 means no adjustments to the interest income and expense figures in the consolidated income statement, while approach 2 means that expense that are economically equivalent to interest should be added to the figures from the consolidated statement. Expense that are not economically equivalent to interest shall in the same adjustment be removed from the figures in the consolidated statement. Approach 3 is not based on the consolidated income statement but will include the same adjustments as approach 2. In the Draft, approach 2 and 3 are recommended. According to the Draft approach 1 risks leading to substantial differences in presentation of interest income and expense in income statements. This would lead to that the net interest figure could be underestimated or overestimated. Concerns are also mentioned that approach 1 could lead to manipulation so that items are not accounted for as interest in the income statement.

The Confederation of Swedish Enterprise believes that approach 1 should be the recommended approach. Although there are some concerns with approach 1, as mentioned in the Draft, we believe these concerns to be greatly exaggerated. The figures in the income statement have been audited and manipulation should therefore not be easy. The Draft states that approach 2 and 3 will lead to a consistent figure for a group’s net third party interest expense. Approach 1 would on the other hand lead to under- or overestimation of the interest figures. We are not convinced that this is correct and it is not clear how to measure what is an under- or overestimation. From economic theory, we know that it is notoriously difficult to disentangle the interest component form other cost components.
The consolidated income statement for a group is prepared in accordance with Generally Accepted Accounting Principles (GAAP) (e.g. US GAAP, IFRS or national GAAP). IFRS is applied in more than 100 countries for listed companies and US GAAP in the US for US companies. IFRS is mandatory for listed companies in the EU. IFRS and US GAAP are based on high quality financial reporting standards covering thousands of pages. While there are some differences between IFRS and US GAAP, it should also be pointed out that to a great extent the principles are similar or identical for financial reporting. The standards that govern financial reporting have thus reached far longer both in quality and in harmonization between different countries than tax legislation have. IFRS is e.g. applied in a consistent manner in different countries, while tax rules on the other hand can have greatly widespread interpretation and application depending on the country applying it.

One example can perhaps illustrate why tax adjustments will give rise to different interpretation in different countries. In the Draft, it is stated that the following item should be excluded from net third party interest expense:

“non-interest income and expense, to the extent this is not economically equivalent to interest”.

This is a broad and vague definition and would probably be interpreted and applied differently in different countries for tax purposes. One could say that the same definition already applies to financial reporting. But the difference is that the application of such a definition is already far more developed in financial reporting standards such US GAAP and IFRS and also national GAAP compared to where tax legislation is today. We therefore consider approach 1 superior to approach 2 and 3. Further, we are not convinced that approach 2 and 3 will actually lead to a more consistent application than approach 1. Taken into account the greatly increased complexity that approach 2 and 3 entails compared to approach 1, we cannot see a reason to recommend approach 2 or 3. Hence, we find approach 1 to be preferable.

As the Draft states, there will be some differences in the presentation of items in financial income statements depending on which financial reporting standard is applied. This should however not lead to a recommendation to apply approach 2 or 3, since the differences apply not only to the interest component but to all items.

If the OECD finds that approach 2 and 3 are the approaches to be recommended, the Confederation of Swedish Enterprise would like to highlight the need for limited and clearly defined adjustments. It is important that the group ratio rule is implemented in the same way in different countries. If jurisdictions implement the group ratio rule differently, it will mean increased complexity and uncertainty for taxpayers.
The Draft recognizes that groups may have issues aligning net interest expense and EBITDA. Therefore an entity may apply an uplift to its group’s net third party interest up to 10%. While the possibility for an uplift is welcomed by the Confederation of Swedish Enterprise, we believe that the limit to 10% is too low. Groups can have great concerns with aligning debt with EBITDA within the group, and the margin of error might be much higher than 10%. Therefore, if there should be a cap on the uplift, it should be higher than 10%.

The Confederation of Swedish Enterprise agrees with the Draft’s recommendation to allow groups to adjust their net third party interest to include the group’s share of the net third party interest income or expense of an associate or joint venture entity. It should however be clearly recommended that it is up to the group to decide whether or not to include such adjustments. Whether a group chose to include its share of a JVE or associate entity in their net third party interest should not give rise to any BEPS-risk. Therefore the decision to make adjustments or not should be up to the group.

**Definition of group-EBITDA**

Much of what have been mentioned above about the definition of third party interest expense can also be applied to the definition of group-EBITDA. It is important to ensure a uniform implementation which leads to a consistent application and in the end lower compliance costs for taxpayers. A good example of a more straightforward approach is the recommendation to completely exclude capitalized interest from the adjustment for interest income and expense. This is a clear recommendation that could easily be implemented and applied consistently by all countries. The same can be said about fair value movements on income instruments and net interest on a group’s defined pension liability. However, in the Draft it is mentioned a possibility for countries to require adjustments for the above-mentioned items. We believe that the final report should not include such flexibility.

As to non-recurring items, we share the view that they should be included in the group-EBITDA without adjustment. We are however concerned about the possibility stated in the Draft that countries may require specific categories of non-recurring income and expense to be removed from group-EBITDA. The Confederation of Swedish Enterprise see a risk of increased complexity if such requirements are permitted. If the OECD finds that this possibility must be kept in the final report, it should be clearly defined in the final report for what categories of non-recurring items adjustment requirements can be made.

**The impact of losses on the operation of the group ratio rule**

The Confederation of Swedish Enterprise shares the view that excluding entities with negative EBITDA from the calculation of group-EBITDA would impose a
significant additional burden on groups. There will also be difficulties for tax authorities to confirm that a group has such entities and ensure their losses have been removed. These negative effects will occur both in the event that the group has a positive or negative group-EBITDA. We are therefore of the view that the approach to exclude entities with negative EBITDA should not be applied in either scenario.

In a scenario where the group-EBITDA is positive, the Draft proposes a cap on a group’s ratio so that an entity’s interest capacity cannot exceed a set percentage of EBITDA. It is proposed that the limitation should not exceed 100 %. The Draft does also propose a limitation on an entity’s interest capacity so that it cannot exceed the total net third party interest expense of the group as a whole. Both of these limitations should according to the Draft be applied to all entities making use of the group ratio rule and not only to those in groups which include entities with negative EBITDA. In this context, we would like to emphasize the importance of having appropriate rules allowing for full carry forward and possibly carry back rules for disallowed interest payments to ensure that companies are treated in a neutral way irrespective of earnings profiles over time and the number of entities in the group. The suggested ceilings in the Draft easily impose non-neutralities which are not desirable from an economic efficiency point of view.

On behalf of the Confederation of Swedish Enterprise

August 16, 2016

Krister Andersson
Head of the Tax Policy Department

The Commercial Real Estate Finance Council (CREFC) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (CRE) debt market in Europe that can support the real economy without threatening financial stability. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance.

The functioning of business in the wider economy relies on investment into CRE. It provides the accommodation businesses need, with the flexibility to adapt and relocate with changing economic conditions and commercial requirements. As a capital intensive and long-term business often involving very large, valuable and illiquid assets, CRE is dependent on the ready availability of debt finance. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital. A typical CRE funding is likely to involve a mix of equity and senior debt (from third party finance providers), and may also involve mezzanine and/or junior debt (which could be from either a third party provider or a related party). Restricting the tax deductibility of debt will increase its overall cost to CRE businesses, in turn impacting on the deployment of equity capital and the viability of investment in the real economy.

It is important to remember that secured third party CRE debt poses very low BEPS risk. This kind of finance is commonly non-recourse, and a third party lender will generally want to lend to (and take security from) the entity that owns the collateral, and receives the rental income it generates.

For capital-intensive businesses, a sensible and fully developed GRR is essential to preserving the possibility of third party interest deductibility, because the fixed ratio rule will not ensure that straightforward third party debt expense is relieved. It is important (at both a practical and technical level) that there is a broad international consensus as to how the GRR should work across jurisdictions. We therefore welcome the opportunity to respond to the questions raised by the OECD in its Discussion Draft on Elements of the Design and Operation of the Group Ratio Rule (the DD).

In preparing our response, we have had the benefit of reviewing the response to be made by the British Property Federation (the BPF), which represents the views of those businesses in the UK that own, manage and invest in property. As a general matter, we firmly agree with the views expressed by BPF in its response to the DD: in particular we share with the BPF the concern that the GRR, as currently envisaged, is not capable of guaranteeing the deductibility of straightforward third party interest expense for CRE borrowers in situations where there is little or no BEPS risk.

We set out our key points and specific responses below. Please contact me if you would like to discuss.

Yours faithfully

Peter Cosmetatos
CEO, CREFC Europe
pcosmetatos@crefceurope.org
+44 20 3651 5696
Key points

The GRR must work for commercial real estate (CRE)

The OECD has been clear that the BEPS4 measures should not prevent businesses from raising the debt finance necessary for their business. However, the GRR risks doing this. As the BPF illustrates in Appendix 2 to its response, the GRR does not reflect commercial reality for CRE businesses, so could distort behaviour and capital allocation.

The typical form of CRE finance involves negligible BEPS risk. This is because it generally involves non-recourse financing, secured on the underlying CRE asset: it is a specialised form of asset-backed finance, not traditional corporate lending, and the quantum and location of third party debt reflects that, leaving very little scope for BEPS. It is the cash flows from the underlying CRE asset (from third party tenants) that determine borrowing capacity, not the earnings of the borrower’s group.

Like the BPF, we are concerned that the GRR may not be capable of striking the right balance between protecting against interest-driven BEPS and ensuring that low BEPS-risk businesses receive adequate tax relief for their genuine third party interest costs. Unless the GRR can be made to work sensibly within a CRE context, an additional safe harbour should be built into the proposals for non-recourse third party debt secured against immovable property. Otherwise, the CRE industry will be disproportionately and inappropriately affected by measures conceived as a means of combating MNE profit-shifting.

Volatility is best managed within the GRR

The GRR is based on accounting principles. This means that unrealised profits and losses could potentially result in significant movement in the GRR from one period to the next. Such volatility could lead to arbitrary results under the GRR, given the impact on a group’s ability to claim deductions for the same amount of interest cost in different period.

While the OECD’s BEPS 4 recommendations suggest measures to manage such volatility (through a mix of carry forward and carry back measures), both the optionality of these measures and their nature means that they are unlikely to enable companies to offset fully the effects of significant movements, whether in ‘group net third party interest’ or ‘group-EBITDA’, on their (tax) borrowing capacity.

It is important that the risk of volatility is adequately managed within (in such a way as to be effectively excluded from) the GRR itself. Fair value movements on derivative contracts should be excluded from the definition of ‘group net third party interest’, and the definition of ‘group EBITDA’ should exclude fair value movements arising from the revaluation of investment property assets. CRE businesses generally operate – and borrow – on the basis of stable and predictable cash flows. Their funding model should not be put at risk by material tax, or even administrative, costs resulting from tax rules intended to prevent avoidance by MNEs.

The importance of ensuring fair outcomes

The GRR is based on a seemingly simple idea: comparing interest cost with EBITDA. But the nature and number of adjustments the DD envisages within the GRR show that, in practice, the GRR will be far from straightforward. Balancing international consistency with fair outcomes may be very difficult.

We would encourage the OECD to set out a mandatory basic framework for the GRR but allow countries flexibility in its detailed interpretation and application. That flexibility should include allowing countries to find ways mitigating potentially unfair outcomes, including, for example, by applying a tax (rather than accounting) based EBITDA GRR, a balance sheet (debt:equity) rule or allowing specific safeguards for particular types of third party debt where BEPS risk is demonstrably low.
Appendix: detailed responses to selected consultation questions

Q1: Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

The DD notes that an approach based on items in consolidated accounts may give rise to variances, whether because of differences between accounting standards or because of the way those standards are applied in particular circumstances. Ultimately, the difficulty with approach 1 is that a degree of control over the tax status of financing items is effectively ceded to accounting standards boards.

Q2: What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest?

We agree with the comment made in paragraph 5 of the DD that there are benefits in countries taking a consistent approach in how they apply the GRR, particularly given that a cross-border group is likely to find itself subject to the GRR in more than one jurisdiction. However, OECD member states have widely differing tax systems: consistent implementation of the BEPS4 measures in practice is not a realistic goal.

If countries have the ability to determine which approach should apply within their national GRR – which is probably inevitable – groups may be subject to different levels of restriction across their business, notwithstanding the constancy of underlying facts. In the DD, the OECD states that approaches 2 and 3 “should give rise to the same figure for a group’s net third party interest expense”. Even if this is correct in all cases (which is doubtful), it clearly would not be the case if one jurisdiction applies approach 1, and another approach 2.

Differences would even be likely to arise if, say, approach 2 were mandatory. This is because any adjustments required to accounting items in calculating the GRR under a particular country’s rules are likely to be influenced by that country’s own domestic tax rules (see for example the adjustment suggested at paragraph 39(ii) of the DD), particularly given the optionality inherent within certain aspects of the proposals. This could result in different interpretations of the amounts to be included/excluded as interest income or expense across jurisdictions.

We therefore concur with the OECD’s recommendation to prefer approaches 2 and 3. We would however ask that the OECD’s final recommendations on the GRR emphasise the importance of consistency in factual “inputs” used in a GRR calculation across different countries (and thus encourage acceptance of a single calculation of net third party interest expense as referred to in paragraph 20).

Q3: It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

We would ask that the OECD’s final recommendations on the GRR provide meaningful guidance on the factors relevant to allowing an entity to apply an uplift and setting the amount of that uplift, with a view to encouraging consistency.

Q6: Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

The DD recommends that countries “should” take measures to exclude related party debt from the GRR. From a third party lender perspective, it is key that any definition of related party must be clear, unambiguous and easy to apply. This is particularly important within CRE finance given the nature of the
financial models on the basis of which lending decisions are made: models which take account of rental income, interest, other property related costs and tax throughout the proposed loan term.

**Q10: Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?**

We agree with the BPF that movements in the fair value of investment property should not be included within group EBITDA for the purposes of the GRR. If such movements were to be included, there would be increased volatility within the GRR, rendering unpredictable a group’s ability to obtain a tax deduction for economically predictable interest costs, simply because of an unrealised profit or loss.

While the measures proposed by the OECD to manage volatility may partially address these concerns, they do not eliminate them. With countries permitted to choose which of these measures will be available to taxpayers, some may choose to curtail businesses’ ability to manage the volatility problem created by the OECD’s rules.

An example of an unhelpfully flexible approach is the EU’s new Anti-Tax Avoidance Directive. This Directive is intended to set a minimum standard across EU member states for implementation of the OECD’s recommendations in relation to BEPS Action 4. However, in terms of measures to manage volatility, the Directive allows member states to choose between (a) indefinite carry forward of restricted interest; (b) indefinite carry forward, plus a time-limited carry back (of up to 3 years), of restricted interest or (c) indefinite carry forward of restricted interest, and a time-limited carry forward of unused capacity (of up to 5 years). This “pick’n’mix” approach means that a EU based group cannot guarantee that it will have the tools available to it to manage volatility appropriately across the EU as a whole.

The OECD’s mandatory basic framework for the GRR should therefore provide for volatility to be managed within the terms of the GRR itself. This should also help to ensure consistency between countries in their approach to the GRR and, as a result, fairness.

**Q11: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so what are they?**

In para 20 of its Final Report on BEPS Action 4, the OECD commented:

“This approach [the best practice approach set out in the Final Report] should provide effective protection for countries against base erosion and profit shifting involving interest, but should not prevent businesses from raising the debt finance necessary for their business and commercial investments.”

This principle should underlie the operation of the GRR, both generally and specifically in the context of the approach to including entities with negative EBITDA.

We therefore agree with the BPF that, where a group has a very high group ratio, tax relief for this level of interest should be allowed, given that this would appear to be in line with the policy objective. If a group has (at a global level) suffered an overall economic loss because external interest expense exceeds its profits, we do not see why it would be appropriate to penalise it.
Q12: If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

The GRR seeks to provide a safe harbour for third party interest and so (in summary) takes account of the “real” third party borrowing capacity of a group, rather than imposing an arbitrary limit. It is therefore counterintuitive and inappropriate to apply a pre-determined cap to the group ratio.

We agree with the BPF that, if any cap were to be imposed, it would be more appropriate for it to be on the amount of third party expense (in effect allowing countries to permit a deduction for gross third party interest expense in specified circumstances where the GRR would produce an inappropriate result).

In the context of the largely non-recourse, asset-financed CRE sector, it is common for interest expense to be matched against rental income in the same country, rather than against interest income, which may (as the BPF points out) arise in a different country. If the same group earned interest income in another country, the net interest expense of the group would reduce, which would inappropriately restrict the interest deduction available against the rental income.

Q13: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and if so what are they?

We agree with the BPF that safeguards should be introduced to ensure that loss making entities are not penalised through the operation of the GRR.

In particular, we support the BPF’s suggestion that, in the real estate context, a safe harbour should be provided allowing full deduction for third party interest in respect of non-recourse debt secured against assets in the same country. Given the interest deduction is naturally matched against the profits or income from the real estate, this debt poses negligible BEPS risk and, as such, should not be restricted.

Q14: Do you have any other comments on any of the issues covered by this discussion draft?

The GRR is based on comparing interest cost with EBITDA. On the face of it, this approach has similarities with the types of interest/debt service cover tests that lenders apply when making lending decisions and in financial covenants used in loan surveillance. However, those similarities are superficial, because CRE lending focuses on the cash flows generated by the asset, rather than on the borrowing group’s accounts. Adjusted EBITDA metrics used by the fixed ratio rule and the GRR are therefore very unlikely ever to be reflected in the commercial arrangements between lender and borrower.

There is therefore a real disconnect between what happens commercially and the proposed form of the GRR. That is likely to create practical difficulties for lenders using financial models to assess a proposed CRE financing – even though such financings pose negligible BEPS risk owing to their asset-based and non-recourse nature. The lender’s model will generally test the borrower’s ability to pay (through interest or debt service coverage tests) by reference to the rental income of the CRE collateral: the profitability of the corporate group of which the borrower is part is generally much less important. This is third party financing of real estate assets, not traditional corporate lending.

These difficulties are compounded because the GRR looks at the position of the broader group, whereas a CRE lender would tend to look just at that of the borrower. In practice, it will therefore be difficult for a secured CRE lender to feel confident about the tax assumptions in any model prepared based on expected cash flows: there are too many unknown, unpredictable – and commercially irrelevant – variables.
With the GRR so key to the ability of the borrower to obtain a deduction for its third party finance costs, it is therefore critical that the “final” GRR is as clear and simple as possible. The OECD will have failed in its policy goal if third party lenders and borrowers in respect of secured, non-recourse financings are unable quickly and easily to confirm that financing costs will be fully recoverable throughout the life of the loan. The GRR must unambiguously work as intended – such that parties to transactions can have a valid expectation that third party interest expense will be deductible.

As the BPF points out in its response, even though the GRR is intended to enable capital intensive businesses, such as those in the CRE sector, to obtain tax relief for the cost of straightforward third party debt, it is by its nature a blunt instrument. As a result, there could be instances in which the GRR, as currently proposed, fails to allow such groups full deduction for bona fide third party interest in circumstances where BEPS risks are negligible. Even where relief is not restricted, a considerable administrative burden risks being placed on businesses that are not be the target of BEPS 4.

The OECD’s final recommendations on the GRR should be very clear in prioritising fair outcomes for low risk sectors, while allowing countries the flexibility to fine-tune the rules in whatever way best suits their particular tax system. The priority here is not to allow counties to take account of their tax policy goals in setting their GRR, but rather to ensure that the rules work fairly and appropriately in practice. This is essential if the GRR is to allow firms to raise the debt finance necessary for their business and commercial investments.

Most importantly, unless the GRR can deliver essentially the same outcome for CRE businesses, an additional safe harbour should be built into the proposals to preserve full deductibility of interest on non-recourse third party debt secured against a specific immovable asset in the same jurisdiction.
European Business Initiative on Taxation (EBIT)

Comments on the OECD Discussion Draft on BEPS Action 4: Elements of the Design and operation of the Group Ratio Rule
Dear Achim,

EBIT is grateful for this opportunity to comment on the OECD’s Discussion Draft on BEPS Action 4: Elements of the Design and Operation of the Group Ratio Rule (the “Discussion Draft”) dated 11 July 2016.

There are a number of questions raised in the discussion draft concerning the detailed impact of the proposals. Many of these will depend on the key decisions reached on some of the principal issues. Therefore, we focus here on the issues we see of greatest potential significance to EBIT.

**Consistent approach to a group ratio rule**

The Discussion Draft encourages countries to adopt a group ratio representing net third party interest expense to EBITDA and for there to be consistency between countries in their interpretations of the components. However, it also states the case for countries using domestic policy concerns to adjust the components and choosing another financial ratio to suit their domestic circumstances.

EBIT notes that a standard approach by territories would enable businesses to apply the ratio quickly and easily across all those territories in which they are subject to tax and have a potential interest restriction. The compliance burden of applying a group ratio rule is a critical factor which should be taken into account.

EBIT also notes the differences in the resulting treatment of interest, or items equivalent to interest, between territories due to domestic policy rules. A straightforward example might involve two territories applying an IFRS accruals basis of accounting for a component where for tax purposes one territory follows that accruals basis while the other follows a paid basis. Timing differences would arise in the second territory which would not arise in the first territory. Another example might involve specific derivatives that include an interest equivalent, say hedging debt movements, treated differently for tax purposes in the two countries (as well as potentially for accounting purposes). If there were indefinite carry-forward (and potentially some carry-back) of unrelied amounts the impact of those differences over time may be significantly reduced. However, EBIT is concerned about countries applying relatively short time constraints which may result in substantial differences becoming permanent through factors other than BEPS. There is also the possibility that companies will be discouraged from entering into hedging arrangements that have generally been regarded from a policy perspective as a suitable response to limiting risk in the financial system.
Therefore, there may be a trade-off between criteria that allow a rule to be applied simply and that provide the appropriate amount of relief.

EBIT also recognises the range of different options which territories are likely to adopt (and are permissible under the Discussion Draft) which will add complexity and, at best, result in an internationally more coordinated but not one international standard approach.

EBIT would like to see the number of differences between approaches in territories kept to a minimum but, where differences are proposed, for the impact on businesses to be recognised and artificial constraints on relief minimised.

**Determination of amounts equivalent to interest**

There are practical difficulties in determining items which are equivalent to interest. Businesses have previously identified some of these concerns in relation to the scope of BEPS Action 4 as a whole. They are exacerbated by the need to include consolidated amounts emanating from countries where interest restrictions may not be a problem per se. For example, identifying the interest element of some derivatives dealing with operational issues may be particularly complicated.

There will be further issues where accounting standards change. For example IFRS16 is expected to come into force in 2019, and will require operating leases to be accounted for as if they were loans in the hands of the lessee, and this will result in amounts of interest accruing in the accounts in respect of such leases.

EBIT thinks that a sensible compromise might be to require the inclusion of interest equivalents only in relation to underlying instruments which are in the nature of hedges against debt movements.

**Related party debt**

The Action 4 proposals as a whole disallow interest expense in a borrower without preventing taxation of interest income in a lender. This may be manageable for groups where borrower and lender are in the same consolidated group, as we would assume it is expected that the group will be in a position to restructure such financing (though this is not necessarily the case in some circumstances).

However, if related party interest is excluded from the group ratio rule, it follows that it is likely to be disallowed in a situation where the lender and borrower are not in the same economic group. The parties are unlikely to be able to restructure the financing, because, by definition such restructuring would significantly alter the commercial arrangement. The most common situation where this might occur is in joint ventures, but there may be other situations in which this could occur. Such structures would therefore be taxed less favourably than wholly owned investments, despite the debt having wholly commercial purposes.

The most common situation in which this could occur is probably in joint ventures, but there may be other circumstances in which it might occur.

EBIT considers that more targeted rules which require adjustments in cases of perceived abuse of the group ratio rule would be more appropriate. It may be possible, for example, to restrict the limitation on connected party interest to situations where there are further indicators that the interest payment is motivated by tax considerations.
Entities with negative EBITDA

Adjusting the group ratio for entities with negative EBITDA also might give rise to potential mismatches between companies in the group involved in the same or similar activities and transactions.

EBIT thinks that the concern that negative EBITDA could result in aggregate interest capacity of all group entities far exceeding the actual net third party interest expense of the group, establishing a large excess which could distort the position in other years would be better dealt with via a suitable cap on the amount carried forward. As noted above, EBIT is concerned about restrictions which are not clearly targeted at BEPS, so the cap ought to reflect what is commercially reasonable (which might be more than the actual net third party interest expenses in any particular period). EBIT does not think that setting a cap otherwise on the group ratio as a whole is warranted.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this important area. EBIT is committed to a constructive dialogue with the OECD and is always happy to discuss.

Yours sincerely,

European Business Initiative on Taxation – August 2016

For further information on EBIT, please contact its Secretariat via Bob van der Made, Telephone: +31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com.

Disclaimer / Copyright: This document contains the collective views of the EBIT business working group and is provided to you courtesy of EBIT. PwC acts as EBIT’s secretariat but PwC is not a Member of EBIT. Nothing in this document can be construed as an opinion or point of view of any individual member of EBIT or of PwC. Any reproduction, in part or in total, of this document, in any form whatsoever, is subject to prior written authorisation of EBIT. Such authorisation can be obtained by EBIT’s Secretariat via: bob.van.der.made@nl.pwc.com. EBIT Joint EU Transparency Register number: 26231733692-35. For more info on EBIT, please see: www.ebit-business-tax.com/
International Co-operation and Tax Administration Division, OECD/CTPA

**Elements of the design and operation of the group ratio rule**

**Introduction**
Real estate plays a critical role in all aspects of our everyday lives. Property companies serve businesses and the society by actively developing, managing, maintaining and improving the built environment; where we all live, work, shop and relax. They also play a crucial part in providing retirement security to millions of people, by offering pension funds stable and highly competitive assets to invest in.

EPRA, the European Public Real Estate Association, is the voice of the publicly traded European real estate sector. With more than 220 members, covering the whole spectrum of the listed real estate industry (companies, investors and their suppliers), EPRA represents over EUR 365 billion of real estate assets and 90% of the market capitalisation of the FTSE EPRA/NAREIT Europe Index.

EPRA’s mission is to promote, develop and represent the European public real estate sector. We achieve this through the provision of better information to investors and stakeholders, active involvement in the public and political debate, improvement of the general operating environment, promotion of best practices and the cohesion and strengthening of the industry.

**Key points**
We understand the aim of the group ratio rule (GRR) to be to provide tax relief for interest costs in excess of that afforded by the fixed ratio rule (FRR) in the context of groups that for commercial reasons may be more highly leveraged. In other words, it is recognition that on its own, an FRR will not deliver a fair outcome for more highly leveraged or capital intensive industries like real estate and infrastructure.

If investment in those industries is not to be undermined by an increase in the post-tax cost of debt capital, the design of the GRR is of critical importance. The aim should be to not restrict the tax deductibility of interest costs beyond that needed to counter BEPS risks. Sadly, the OECD’s proposed approach to the GRR will not achieve that outcome, but may instead punish low-BEPS risk groups for using debt capital and will lead to significant complexity for both businesses and tax authorities.
Our key points are as follows:

1. The OECD’s GRR framework should explicitly provide significant flexibility to individual countries in implementing its recommendations. Countries will have widely differing tax systems and while we appreciate the OECD’s desire for consistency in the application of its recommendations, the reality is that their practical implementation will differ widely. As long as individual countries are satisfied that BEPS risks are adequately mitigated, we do not see these differences as bad things.

3. A group ratio based on earnings and income does not provide fair outcomes for taxpayers where their costs and income arise in different periods, such as in the case of real estate development projects. We therefore welcome the proposals to allow a GRR based on balance sheet measures such as a debt:equity ratio, as this could go some way to mitigating that unfairness.

4. We agree that fair value movements on derivative contracts should be excluded from the definition of ‘group net third party interest’. We would also propose that amounts representing rental payments under the new IFRS16 accounting standard (lease accounting) be excluded from that definition. Failure to do so will lead to a business’s rent payments potentially becoming restricted for tax purposes.

5. The definition of ‘group EBITDA’ should exclude fair value movements arising from the revaluation of investment property assets. These amounts represent unrealised gains, can be highly volatile and unpredictable and are often entirely outside the control of a business. This can lead to massive fluctuations in group ratios that introduce considerable uncertainty into tax liability forecasting. Ultimately this makes real estate investment and development a more uncertain proposition, with harmful implications for the real economy if the supply of business space is affected.
Appendix – detailed responses to selected consultation questions

Q1: Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

IFRS 16, a new accounting standard due to take effect in 2019, will require all businesses that lease properties to recognise the value of that lease on their balance sheets. In addition, payments in respect of property leases, which are currently recognised as rental expense in a company’s income statement, will be split into two components: amortisation of the lease asset and the financing cost of entering into that lease.

The commercial nature of property rental agreements will not change, but the way they are recognised in business’s financial statements will be very different – income statements will effectively no longer show rental expenses as a separate line item. The accounting treatment of all leases will move to that which currently applies to finance leases.

Unless the GRR makes special provision for it, businesses may under the new rules face a restriction on the amount of rental expenses on which they are able to obtain tax relief. The financing cost component of a property lease will – unless specifically excluded – be included in the definition of ‘net third party interest’ as a result of its accounting treatment.

We cannot see a justification for restricting the tax deductibility of property rental expenses. Indeed doing so could lead to double taxation where lease rentals are not wholly deductible in the hands of the lessee but are taxed in full in the hands of the landlord. Rents on property assets are almost invariably subject to tax in the jurisdiction in which the property is located. As a result, no BEPS risk exists and we see no reason to restrict a tax deduction for the lessee.

It should therefore be clear that the financing cost component of a property rental lease does not form part of a group’s net third party interest expense for the purposes of the GRR. We note this issue will arise in the context of all leases currently treated as ‘operating’ leases for accounting purposes – not just real estate.
Q10: Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

IFRS requires groups owning investment property to report the fair value of that property in the group’s balance sheet and to recognise any movement in that fair value from the preceding period in the group’s income statement. The fair value of an investment property at any one time will depend on a number of factors including its condition, the extent to which it is let and the general state of the real estate market, reflecting strength of investor confidence.

Some of these factors (e.g. market sentiment, the construction of a competing building nearby) are often unpredictable, are totally outside of the control of a particular investor and can lead to significant fluctuations in a group’s EBITDA. Movements in the fair value of investment property represent unrealised gains and losses and can reverse within a short space of time.

Such movements are therefore akin to the type of non-recurring item identified in the discussion draft. Although they happen every year, their size and direction is unknowable and can have a material impact on a group’s income statement. If they were to be included within ‘group EBITDA’ for the purposes of the GRR the result would be highly volatile group ratio figures and therefore highly volatile and uncertain tax relief on interest costs.

Not only would this be difficult from an administrative perspective for those groups affected, it would also make budgeting for the tax cost of a given investment almost impossible. This raises the level of uncertainty associated with a particular project, which ultimately makes that project less likely to go ahead. Were this to happen at sufficient scale, we are concerned that the supply of new business space could be negatively affected with a deleterious (for occupiers – and the economy more generally) impact on the rental cost of that space.

While the application of carry forward or carry back of unused interest capacity may mitigate some of the ill effects described above, it does not eliminate them. This is particularly the case when countries choose not to permit carrying-back unused interest capacity.

We therefore strongly recommend that movements in the fair value of investment property are not included within group EBITDA for the purposes of the GRR. Alternatively, groups could be given the ability to elect to calculate their group ratio by reference to some form of ‘tax EBITDA’. While this may be complicated for multinational groups, it would reduce the potential volatility of the group ratios of businesses based wholly in one country.
Q11: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so what are they?

Where a group has a very high group ratio, providing tax relief for this level of interest would appear to be in line with the policy objective, even where this creates an overall taxable loss. If a group has (at a global level) suffered an overall economic loss because external interest expense exceeds its profits, we do not see why it would be appropriate to penalise it. If countries are minded to introduce a cap, this should be at the level of the gross third party interest expense of the group, to ensure that loss making enteritis are not further penalised by these restrictions.

Q12: If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

Whether an expense is tax deductible or not should not be subject to an arbitrary cap. If the OECD were to recommend such a cap, it would need to be reflective of the industry that each entity operates in. In a real estate context, it is not uncommon to see interest at 60%-80% of earnings, particularly in a higher interest rate environment. For infrastructure projects, it is typically even higher.

A cap based on third party interest expense would be more appropriate. However, the OECD should allow countries to permit a deduction for gross third party interest expense where appropriate. In a real estate context, it is typical for interest expense to be matched against rental income in the same country, it will not necessarily be matched against interest income in the same country. If the same group earned interest income in another country, the net interest expense of the group would reduce, which would inappropriately restrict the interest deduction available against the rental income.
Q13: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and if so what are they?

The GRR is not designed for businesses with life cycles which span more than one accounting period, and as such, the rules will be particularly inappropriate for real estate developers.

In order to ensure that loss making entities are not penalised, we would agree that safeguards should be introduced. As noted in response to question 12, where the GRR has not resulted in an appropriate outcome, entities should be allowed to deduct up to the gross third party interest expense of their group (and it would be fair to cap the deduction to this amount).

Q14: Do you have any other comments on any of the issues covered by this discussion draft?

While the GRR is designed to provide more highly capital intensive businesses with a higher (and more appropriate) level of tax relief on their interest costs than the FRR, there are still instances in which the GRR will deny such groups a deduction for bona fide third party interest – even where there is no BEPS risk involved. This is particularly the case where a group carries on activities with different financing needs and therefore different debt profiles.

For instance, where a business carries on a lowly leveraged property management business alongside a more highly leveraged property investment business, the group’s ratio would reflect an average of those two very different activities. Applying the GRR on an entity by entity basis in such situations would always result in a restriction of interest in the more highly leveraged entities. Where a group is based wholly in one country this feels like entirely the wrong outcome, as the group is being penalised and yet poses no BEPS risk whatsoever.

The OECD’s final recommendations on the GRR should allow countries to counteract this sort of unfair outcome in whatever way best suits their particular tax system. This may include applying the GRR at a national group level rather than on an entity by entity basis.
Madame, Monsieur,

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 », « Elements of design and operation of the group ratio rule ».

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 1 48 00 50 73.

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

Blandine LEPORCQ
Directrice du département fiscal
We would like to thank you for the opportunity to comment on the elements of the design and operation of the group ratio rule as part of the implementation of Action 4 (limiting base erosion involving interest deduction and other financial payments). 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.

However, we first wish to underline that the European Union has already, through the adoption of the Anti-Tax Avoidance Directive (ATAD)\(^1\), decided to put in place the BEPS action plan, without taking into consideration the outcome of the additional work that is currently conducted by the OECD especially on action 4, nor the specificities of the banking activities. We are therefore extremely worried of how the Member States of the European Union will include the conclusions of these further considerations necessary to improve the general set up.

As a preliminary remark, we welcome the initiative of the OECD to complete its work on rules for the financial services sector in relation to Action 4. Considerable care is needed in considering any rules that could apply for the banking industry as regards the treatment of debt. 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. 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 part of 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. Given the protection provided by the regulatory environment (already recognised by the OECD in its final report\(^2\) 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 are required.

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.

As a second remark, we would like to emphasise on the fact that the limitation of interest deductibility for banks’ customers would also inevitably increase the costs of borrowing and could ultimately have a negative impact on the economy as a whole. A proper assessment of these potential implications should be conducted and discussed with the industry.

---

\(^1\) Adopted on July 12\(^{th}\) by the Economic and Financial Affairs Council

\(^2\) See OECD Final report on Base Erosion and Profit Shifting: “Limiting Base Erosion Involving Interest Deductions and Other Financial Payments” – paragraph 184, page 75
Indeed, the recommendations included in BEPS Action 4 apply to external counterparties. Such devices seem far to exceed the goal of inspiring original "anti-abuse" and would stigmatize systematically and therefore unjustly, the recourse to borrowing.

It seems important to react against the background trend in international tax with regard to the "debt bias": external financing is a powerful engine of investment, growth and hence employment. Since the credit institutions financing activities operate in a fully competitive environment (the latter being also exacerbated internationally), they are market conditions that are necessary. The interest rates and the amount of funding granted are based on the constraints and market risks. The decision whether to grant financing by credit institutions is a rational decision and based on very strong analysis (credit institutions being also subject to strong prudential requirements for granting of credit).

The recommendations of the OECD meet only a tax purpose that severely disrupts the economic logic: it is not appropriate to use as a working hypothesis that the only viable economic model should be based on a capital / minimum corporate debt. Non-compliance of this ratio would then, under this premise, an indicator of an abusive tax position of the company. It is essential to keep the borrowing since it is more effective than growth by capital.

Multiple factors can justify the recourse to loans: raise loans may especially be justified according to the type of investment, the life of the financed goods, but also the financial profile and supported the company's growth strategy, the relevant market the transboundary nature of funding, but not only.

If the borrowing allows tax leverage once the investment of economic profitability is higher than the cost of borrowing, this should not in itself constitute an abnormal situation since equity is sufficient depending on the personal situation of the company. From an economic point of view, since this method of financing is more profitable than development by equity and therefore generates wealth, there is no objective reason to institute a widespread presumption of “abnormality”.

Targeted anti-abuse clauses all have their usefulness only in intra-group financing situations. But this is not the spirit of the recommendations of BEPS to establish systematic mechanisms challenging the borrowing as a whole. It is therefore imperative that the safeguard clauses allow companies to easily demonstrate that their debt/ capital ratio is "market" irrespective of any standard set by lawmakers. In this regard, it is essential that the calculation of net financial expenses can be done at the tax groups for each of the EU countries of operation as it is already practiced in certain countries.

Our general comments are the following:

On the first set of questions on the calculation of net third party interest expense, we would recommend to use the consolidated accounts. Indeed, as banks when granting loans to our clients, should a limitation of interest rule exist, it will be taken into account as part of a risk to evaluate. The referential which is the more secured to estimate such a limitation is the IFRS consolidated accounts as they are audited and commonly used for the companies to raise funding through capital or debt.
Any other referential, different from one company to another, from one country to another will not be as reliable and may create distortion of competition.

On the adjustments to a group’s net third party interest expense, we are surprised by the reference to a 25% threshold to define a related party. Indeed, 25% does not give the control of an entity to the shareholder. Rules of action 4 are designed to prevent tax avoidance mechanisms especially by shifting interest expense: a shareholder which has not the control of an entity will not be able to carry out operations in order to optimise tax wise the result of this specific entity. Therefore only controlled companies should be specifically addressed.

On the questions relating to EBITDA, we would just like to remind that banks cannot calculate this intermediate line as interest products and interest expenses represent their turnover, the net banking income.

For non-financial companies the basic formula for EBITDA, even if the calculation may vary from company to company, is operating income, which is net revenue less operating expenses and cost of goods sold, with depreciation and amortization added back in. EBITDA aims to establish the amount of cash a company can generate before accounting for any additional assets or expenses not directly related to the primary business operations.

Again as banks granting credits to clients, we would like to insist on the necessity to have a harmonised definition worldwide of this measure especially if used as a universal measure on which is based the calculation of interest limitation.
Grant Thornton UK LLP response to the OECD's BEPS ACTION – Elements of the Design and Operation of the Group Ratio Rule

1.1 Introduction
Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to respond to the consultation on the design and operation of the group ratio rule, published the OECD on 11 July 2016.

We trust that this response contains useful commentary. If you would like to discuss any of these points in more detail then please contact Liz Hughes, Director, Grant Thornton UK LLP at elizabeth.hughes@uk.gt.com or by telephone on +44 (0)207 728 3214

1.2 Responses to specific questions

Calculation of net third party interest expense

Question 1 – Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

Approach 1 is attractive in its simplicity (and the low associated compliance cost as a result) but variances in the way that net interest could be calculated under different accounting standards is an issue. This could be managed to some extent, by identifying a short list of accounting standards under which net interest could be calculated.

Question 2 - What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

We understand that one of the fundamental pillars of the OECD’s BEPS project was to introduce coherence into the domestic rules that affect cross-border activities. If countries were given flexibility to apply any of Approaches 1 to 3 to determine net third party expenses, it might be difficult for multinational groups to maintain consistency, as they might have to apply Approach 1 in Country A, and approach 2 in Country B.

We would encourage the OECD to suggest only one approach that can be applied by all countries. This will reduce the compliance burden for multinational groups and also ensure that the results are applied consistently.
Question 3 – It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

Taxpayers tell us that consistency and certainty are important characteristics in a tax regime. We would therefore discourage the making of one-off adjustments in order to meet a country’s tax policy goals as this could introduce tax volatility and uncertainty for multinational groups.

Question 4 – Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

See response to question 3 above.

Question 5 – Are there any other circumstances where a group’s net third party expense should be adjusted to include group’s share of the net third party interest of an entity outside the group?

We consider that it is reasonable for tax authorities to pursue information about the net interest position of an entity outside the group through exchange of information provisions allowed by tax treaties. However, given the need to comply with accounting rules and pass auditor scrutiny we do not consider that there is a high risk of businesses seeking to secure additional tax deductions by virtue of net interest expenses arising in entities outside the group.

**Definition of group-EBITDA**

Question 6 - Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We are concerned that a business with a volatile group EBITDA can face varying levels of interest deduction even though the underlying financing arrangements remain stable over the same period. The inclusion of say, fair value movements on derivatives or unrealised gains or losses more generally may amplify the volatility of group EBITDA leading to a disconnect between the interest relief allowed and the underlying trading strength of the business. We therefore suggest that exchange gains and losses and fair value movements on derivatives and hedging agreements are removed from the group EBITDA calculation.

Question 7 - Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

No comment.

Question 8 - Are there any practical issues raised by including all dividend income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The inclusion of all dividend income into group EBITDA is confusing as any dividend income is typically excluded when calculating an entity’s EBITDA. Dividend income economically reflects the return of equity investment and should be completely excluded when determining the costs/return of debt in the capital structure.
Question 9 - Are there any practical issues raised by including a group's share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We are concerned that in the case of equity accounted associates or JVEs, the different tax authorities of the JV partners could treat the earnings arising from these types of 'co-owned' businesses in different ways, hence leading to inconsistent outcomes for the JV partners applying these rules.

Question 10 - Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

See response to question 6.

The impact of losses on the operation of the group ratio rule

Question 11 - Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

We appreciate the practical difficulties of eliminating loss-making entities from the group EBITDA calculation. However, there is increasing economic uncertainty in many countries at the moment and an increasing possibility that group entities (or the entire group) will become loss making. Consequently, rules regarding negative EBITDA businesses need to be applied consistently between countries. To the extent that a cap is introduced, we suggest that it is set at least 100% to minimise the risk that third party net interest is left unrelieved.

Question 12 - If a country does introduce a cap on a group's net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

No comment.

Question 13 - Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

Whilst all the approaches set out in the discussion draft have their pros and cons, allowing a positive EBITDA entity in a negative EBITDA group to deduct interest up to the lower of its actual net interest expense, the group's net third party interest or a set percentage of the entity's EBITDA, appears reasonable because it removes the 'cliff-edge' described in the discussion draft.

We note that there are concerns with this approach regarding the carry-forward of excess net interest expense but if this proved to be an issue, there could be either a time limit on the carry-forward of that interest or a limit to carrying forward unused interest capacity to amounts arising under the fixed ratio rule.
Question 14 - Do you have any other comments on any of the issues covered by this discussion draft?

Both of Approaches 2 and 3 may have negative impact on groups operating in highly leveraged sectors, such as real estate and construction. The projects currently in progress may have been started many years ago and with decades to run, so it seems unfair to impose rules without sufficient time to adjust the financing of such projects. We therefore suggest a 10 year grandfathering period for these large real estate and infrastructure projects.

We would suggest the OECD considering how the group ratio rule may be amended to take into account the variance in leverage profiles across a multinational group. Some groups will operate in both capital intensive and non-capital intensive industries, which results in different debt profiles. We suggest that consideration is given to allowing such groups to operate these calculations as if they were two separate groups.

Grant Thornton UK LLP, London

16 August 2016
Comments to the OECD Discussion Draft on Action 4
“Elements of the design and operation of the group ratio rule”

ICC welcomes the opportunity to comment on the new draft document on BEPS Action 4 pertaining to the “elements of the design and operation of the group ratio rule”. ICC is in overall agreement with the detailed comments submitted by BIAC. Nevertheless, ICC would like to further highlight points that we believe to be particularly important.

General comments

ICC perceives the group-wide interest allocation rule as very complex. The facility for countries to specify particular limitations could result in a great deal of inconsistency. It is, moreover, a fundamental systematic change. It would replace the traditional international tax system based on the arm’s length principle with a formulary system, with an allocation of the tax base following the “economic activity” or other factors that are deemed to be appropriate. We believe that such a formulary system on a global scale is neither desirable nor easily feasible.

Since the start of the discussion on Action 4, business has emphasized that one important condition of a group-wide interest deduction rule is to implement the rule consistently throughout the world. Inconsistent implementation would lead to double taxation as well as an increase in the administrative burden for companies. We would therefore like to reiterate that participating countries should align their respective rules on group-wide interest allocation, should they wish to introduce such a new and disruptive system.

In addition, the draft document only focuses on the net third party interest /EBITDA ratio of a consolidated financial reporting group. However the Action BEPS 4 Report mentions the option to apply different group ratio rules (e.g. “equity escape” rule as applied in certain countries and, more recently, included in the Anti Tax Avoidance Directive⁴). We suggest that other group ratio rules should be optional for countries, in particular those providing a simpler and consistent calculation whilst reducing administrative burdens for companies.

Specific comments

Calculation of net third party interest expense

ICC firmly believes that the first approach is by far the most preferred of the three approaches described by the OECD in the draft document. It is a very simple and pragmatic solution to take the numbers from the group’s financial statements. Although there should be differences between these numbers and adjusted numbers, these differences would be negligible.

If approach 1 should be rejected by G20/OECD or the member states involved, we advise the following regarding approaches 2 and 3. The OECD states in the draft document that

---

⁴ 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.
both methods should come to the same result. Therefore, from a fiscal point of view, it would not matter, which method companies employ and ICC urges OECD to avoid establishing rules that would be too burdensome. In our view, it would be reasonable for businesses to be given the option of which approach they wish to apply. Otherwise, companies would be obliged to apply two different calculation methods. It would not be desirable – either for companies or for tax administrations – to have two complex calculation methods in place which have to be applied in parallel. The aim should be to have one calculation method that is being applied throughout the whole group on a worldwide basis. One solution to achieve this aim could be to declare the method introduced by the headquarter country as the leading method for all other countries where the group operates.

With respect to the adjustment of third party interest expenses, we have difficulty understanding why these would be necessary. The discussion draft suggests that non-deductible payments can be a BEPS risk. In our view this is not the case as those payments have already been neutralised by being treated as non-deductible. In this case, there is no clear justification for a second adjustment in respect of these payments by reducing the capacity to deduct interest. Furthermore, we would like to highlight the concern that diverging adjustment rules on a national level would result in a very complex and burdensome set of rules for companies.

It is, in principle, very helpful that the OECD suggests introducing an uplift for entities to the group’s net third party interest expense. This reflects that economic activity (being represented by the parameter of EBITDA) and interest are not always aligned, for reasons that very often are not within the control or influence of the respective entity or group. We also believe that the recommended uplift of 10% in the discussion draft is too low for many companies or entities and should be raised to at least 20%.

**Definition of group-EBITDA**

The number of options and adjustments included in the report (up to 22 Examples) leads to practical difficulty in determining the appropriate approach and potentially substantial compliance cost and legal uncertainty for taxpayers. For companies it is of utmost importance to have uniform rules throughout national jurisdictions that are easy to comply with. To this end, we would recommend that the EBITDA be taken from the group accounts. Stripping capitalized interest out of depreciation and amortization as suggested in the Final Report on Action 4 would be highly complex. At the same time, we would like to encourage you to make adjustments in order to reduce the volatility of EBITDA, which is not controllable by the respective entity or group (e.g. fair value adjustments).

**The impact of losses on the operation of the group ratio rule**

The ideas set out in the discussion draft are, as also stated in the draft, very complex and burdensome for both companies and tax administrations alike. We therefore urge the OECD to consider adopting a more pragmatic approach as outlined in the BIAC comment letter.
The International Chamber of Commerce (ICC) Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

Founded in 1919, and with interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.
Via email
interestdeductions@oecd.org

Mr, Achim Pross
Head of the International Co-operation
and Tax Administration Division OECD/CTPA

On behalf of IFA Grupo Mexicano, A.C. (Mexican branch of the International Fiscal Association), below you will find our comments on the Public Discussion Draft on the BEPS Action 4 – “Elements of the design and operation of the group ratio rule”. Comments appear in italics.

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

In case that countries were given flexibility to apply any of the approaches 1 to 3, and entities decide to apply approach 1, considering that it is the easiest approach to comply with and taking into account that it is not necessary to adjust the interest income and expense figures and payments economically equivalent to interest, this may lead to some important distortions.

The above considering that the consolidated financial statements of the group may include items additional to those included in the definition of interest and payments economically equivalent to interest, described in Chapter 2 of the Action 4 Report, derived from the particular accounting policy applied in each country.

Additionally, under approach 1, entities could manipulate the amount of their net third party interest expense, and as a consequence the net third party interest expense/EBITDA ratio could be overstated or understated.

Considering the above, it is important that the Public Discussion draft emphasize the importance to discourage the application of the approach 1, whenever the application of approach 1 causes distortions like the overstated or understated net third party interest expense/EBITDA ratio described in the previous paragraph.
Regarding approaches 2 and 3, although these are two different approaches, according to the Public Discussion Draft, after their application the same result would be obtained. Notwithstanding, considering that approach 2 is determined from the information shown in the consolidated financial statements and the approach 3 is determined from the individual accounting records of each entity to recognize the net third party interest expense, we believe that the procedure that should prevail is approach 2.

Approach 2 seems the most efficient in order to make a review of how the net interest expense with third parties is obtained, this because the information used comes from the consolidated financial statements of the group with certain adjustments.

Taking into account that under Action 4 countries may allow entities to choose one of the three different approaches, we believe that it is important that once the entity elects an option in order to determine net third party interest expense/EBITDA ratio, this must be used during the following years, in order to avoid taking advantages by changing the approach from one year to another. Alternatively, a time limit could be established (for example five years should elapse for changing the approach).

4. Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

The Public Discussion Draft establishes the guidelines to determine the group’s ratio, through which it is possible to determine the net interest that will be deductible for each one of the entities of the group, considering the group’s net third party interest expense/EBITDA ratio.

Considering the above, each one of the entities that are part of a group shall apply the group’s ratio taking into account their individual EBITDA, in order to determine the deductible limit of the interest expenses.

However, the domestic tax legislation of some countries establishes rules in order to limit the deduction of interest, like thin capitalization rules. In the case of Mexico, the Income Tax Law establishes a limit for deducting interests derived from loans from one or more persons resident abroad and deemed as related parties, provided that the annual average of debts is greater than three times the net worth equity shown on the taxpayer’s financial statement, in which case the interest corresponding to the average debt of foreign related parties in excess of the referred threshold would be nondeductible.
In the case of Mexico, the thin capitalization rules only limit the interest paid to foreign related parties, but it is possible that the foreign holding of the group obtains loans from third parties and at the same time grants loans to its Mexican subsidiaries.

Considering what is stated in the previous paragraph, in case that a subsidiary which qualifies as Mexican resident for tax purposes receives a loan from its holding which qualifies as resident abroad, the interest derived from such loan may not be deductible in Mexico according to the thin capitalization rules contained in the Mexican Income Tax Law; however, if the rules contained in Action 4 are applied, specifically the group’s ratio, then such interest may be deductible.

It is important to mention that countries which implement the rules established in this Public Discussion Draft, should adjust rules from their domestic tax legislation related to the deduction of interest, in order to make sense with the rules included in Action 4. In case that the countries do not make this adjustment to their domestic tax legislation taxpayers could be affected by this situation, since a double tax limit on the deduction of interests (local limit and BEPS limit) could be applied.

Regarding the above, Action 4 establishes that the ultimate decision as to the order in which to apply interest limitation rules is left to the countries, taking into account the design of their rules and the risks they are intended to address. Nevertheless, we believe that it is important to consider the stated in the previous paragraph.

5. Are there any other circumstances where a group’s net third party interest expense should be adjusted to include interest income or expense of an entity outside the group?

In addition to the case of an associate or JVE, in the case of an entity participating in a trust which carries out business activities, and has interest expenses/ income, the group’s net third party interest expense should be adjusted to include said interest.

This, since the investment in the trust is regularly registered as an asset and the profits /losses it generates are recorded in the equity of the entity, without identifying interests (expenses or income).

Therefore, if the interest expense/ income of the trust is not included in the group’s net third party interest, the figures would be distorted, since the profit of the trust would be included in the entity’s EBITDA, and consequently in the group’s EBITDA.

However, each particular case shall be carefully analyzed in order to determine if the interest/expense of the trust shall be included in the group’s net third party interest expense, considering the accounting rules of each country.
12. If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

As the Public Discussion Draft establishes, it is necessary to consider that the group’s net third party interest expense/EBITDA ratio is distorted in the case of companies members of a group with negative EBITDA or low EBITDA.

In those cases, according to what is stated in the Public Discussion Draft, an alternative could be to exclude entities with negative EBITDA in order to determine the group’s net third party interest expense/EBITDA ratio or establish a cap on the deductibility of interest of the entities with positive EBITDA.

In this regard, in case that countries apply a cap on the deductibility of interest of the entities with positive EBITDA, we believe that such cap should attend to the activity in which the entity is engaged.

In this manner, one solution would be to define the economic activity in which the entity is engaged and based on it determine a cap for each entity part of the group. For example, for investment in projects that require significant leverage, establish a higher cap, for example for infrastructure projects such as oil and gas and power, residential developments, etc.

Considering the above, we believe that the cap to be set for the deductibility of interest of entities with positive EBITDA, shall be based on the economic activity in which the entity is engaged. Establishing an overall cap would be unfair considering that there are certain economic activities that require higher leverage.

13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

In the case of entities in a preoperative period, their EBITDA would be negative, since no income would have been received by them.

Therefore, it could be established as a general rule that the figures of entities with negative EBITDA, that are under a preoperative period, shall be excluded from the calculation of the group EBITDA.

This, in order to enable a group’s net third party interest expense/EBITDA to be calculated and the group’s net third party interest expense to be allocated among profitable entities in the group.

14. Do you have any other comments on any of the issues covered by this discussion draft?
a) Apply an uplift to the group’s net third party interest expense of up to 10%

According to the Public Discussion Draft, in some cases, there will be practical or legal constraints that make difficult to align the location of net interest expense and EBITDA. This situation can cause distortions that do not allow the total deduction of the net third party interest expense.

The Public Discussion Draft sets out an option for countries to allow an entity to apply and increase of the net third party interest expense up to 10%, in order to consider this amount to determine the group’s net third party interest expense/EBITDA ratio.

Although we consider that the option mentioned in the previous paragraph is a good mechanism to solve the problem, we believe that the fact that only certain countries may allow entities to apply the increase of the net third party interest expenses up to 10% to determine the group’s net third party interest expense ratio, could result into an unfair situation for entities depending on the country in which they are tax residents.

In this sense, we believe that one possible solution is to establish as a general rule that all countries increase the net third party interest expenses paid up to 10% to determine the group’s ratio, otherwise there would be countries that allow to applying such 10% and those where it is not allowed which may result inequitable.

b) Carry forward and carry back

In the case of carry forward and carry back of disallowed interest and unused interest capacity, rules providing the transmission of these items in the case of mergers and spin-offs could be incorporated.

This, in order to limit the transfer of such items in each particular case and considering the following premises:

- The merger is carried out between entities of the same group
- The merger is carried out with a third party
- The entity that spins off disappears derived from such corporate act
- The entity that spins off gives rise to one entity or more, etc.

Considering the above, it could be established that a country may impose limits on the transmission of the referred items in the case of mergers and spin-offs or other possible corporate acts that could derive in the transfer of such items.

Such limits shall be established in those cases which clearly derive in a BEPS risk.
The Action 4 2015 Final Report establishes in paragraph 165 certain time and value limits on carry forwards and carry backs that could be included, such as reset carry forwards to zero where a company changes ownership and also changes the nature of its economic activity.

However, in the case of mergers and spin-offs the ownership could be maintained as well as the economic activity of the entity.

Therefore, specific rules addressing the limit on the transfer of carry forward and carry back of disallowed interest and unused interest capacity, could be incorporated.

* * *

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA branch and in no case in the name, or on behalf, of Central IFA or IFA as whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.
August 16, 2016

VIA E-MAIL

Mr. Achim Pross
Head of the International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75116 Paris
France
interestdeductions@oecd.org

Re: Comments on Discussion Draft on BEPS Action 4: Elements of the Design and Operation of the Group Ratio Rule

Dear Mr. Pross:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, telecommunications, oilfield services, computer technology, energy, health care, beverages, software, IT systems, publishing, management consulting, and electronics.1 The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

---

1 The current membership of the IAPT is made up of the following companies: Accenture plc; Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; Cisco Systems, Inc.; The Coca-Cola Company; Exxon Mobil Corporation; Hewlett Packard Enterprise Company; Johnson & Johnson; Microsoft Corporation; Procter & Gamble Co.; REXL Group plc; TE Connectivity Ltd.; Thomson Reuters Corporation; Transocean Ltd.; Tupperware Brands Corporation; Vodafone Group plc; and Yum! Brands, Inc.
The Alliance appreciates the opportunity to provide input to the OECD with respect to its Discussion Draft on BEPS Action 4: Elements of the Design and Operation of the Group Ratio Rule released on July 11, 2016. Our comments are set forth in the Annex to this letter.

To date, the OECD has not scheduled a consultation for this Discussion Draft. We urge you to hold a hearing on the topic, and would like to participate if such a hearing is held. We also stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Joshua Odintz
Baker & McKenzie LLP
Counsel to the Alliance
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON THE JULY 11, 2016 DISCUSSION DRAFT

ACTION 4: ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE

AUGUST 16, 2016
IAPT Comments on the July 11, 2016 Discussion Draft

Action 4: Elements of the Design and Operation of the Group Ratio Rule

1. Introduction

1. The IAPT appreciates the opportunity to comment on the continuing work being done on BEPS Action 4, and in particular on the July 11, 2016 Discussion Draft on Elements of the Design and Operation of the Group Ratio Rule (Discussion Draft). There are several points that were raised in our prior submission\(^2\) that affect the design and function of a group ratio rule, and we take the opportunity to repeat such comments here.

2. We note that the Discussion Draft reiterates statements from the Action 4 Final Report that while a best practice is to include a group ratio rule based on a net third party interest expense / EBITDA ratio, countries are free to use no group ratio rule at all or to use a group ratio rule based on a different financial ratio, such as a different net interest / earnings ratio or an equity / total assets ratio. We appreciate that there may be constraints in changing existing group ratio rules, in the handful of countries where those exist, to conform to a newly prescribed BEPS best practice. For countries that are contemplating new rules on the limitation of interest deductions, however, we would certainly hope that adherence to a harmonized approach to a group ratio rule could be established as a best practice. This would be in keeping with the avowed purpose of the group ratio rule (i.e., to allow highly leveraged groups to deduct all of their third party interest expense) and with the objective of minimizing the burden on MNE groups. A lack of harmonization could mean that MNE groups operating in dozens of countries around the globe could face dozens of different sets of requirements for how to do the computations necessary, on both the group-wide and local elements, to determine their interest cap in each country.

3. Moreover, neither the Action 4 Final Report nor this Discussion Draft provide for a uniform definition of interest. The purpose of the group ratio rule is to permit a highly leveraged company a full deduction for its third party interest expense. It will be difficult for a group to obtain a full deduction where the definition of interest varies by jurisdiction. Some jurisdictions could significantly narrow the definition, which could result in double taxation without treaty relief.

4. In designing a group ratio rule, all jurisdictions should adopt uniform rules to permit the deduction of the full net third party interest expense. Uniform definitions and modifications will be essential to allow a full deduction for third party interest and to avoid double taxation. Further, jurisdictions should not enact unilateral rules that would limit the ability of the group to fully deduct net third party interest expense.

5. Because the Discussion Draft does not address the above issues, the IAPT recommends that the final guidance confirm that the group ratio rule should effectively be elective on the part of the taxpayer. In other words, as indicated at paragraph 117 of the Action 4 Final Report, the primary fixed ratio rule

\(^2\) The IAPT filed comments on Action 4 on February 6, 2015, which are attached as Appendix 1.
would apply first, and if an entity sought to claim additional interest expense deductions, it could elect to apply the group ratio rule. However, an entity should not be required to apply the group ratio rule as an independent limitation on deductions because of the potential costs associated with applying different iterations of the rule in different jurisdictions.

2. **Calculation of net third party interest expense.**

**OECD Question 1:** Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

**OECD Question 2:** What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

6. The Discussion Draft considers three potential starting points for calculating net third party interest expense. The first is to use interest income and expense from the consolidated financial statements, without adjustment (Approach 1). The second is a top down approach that would use interest income and expense amounts but make adjustments to reflect items included in the definition of interest and payments equivalent to interest as per the Action 4 Final Report (Approach 2). Under Approach 2, the following expenses would be included in net third party interest expense: capitalized interest, interest income on financial instruments carried at fair value, and interest included within other categories. Other items would be excluded, such as fair value gains or losses on financial instruments, gains and losses on the sale or redemption of financial instruments, and foreign exchange gains or losses (all to the extent that these are not economically equivalent to interest), net interest on a group’s defined benefit pension liability and similar post-retirement benefits, and accrued interest on accounting provisions. The third suggested method (Approach 3) is a bottom up approach that would require a group to locate all the net third party interest expense.

7. The IAPT strongly recommends requiring Approach 1 as it will be the most administrable method. The Discussion Draft notes that Approach 1 is in some way subject to manipulation and could result in different figures for net third party interest expense (Discussion Draft, para. 17). To avoid this concern, Approach 1 should be based on audited financial statements. The independent audit function is a powerful check on such “manipulation” and ensures the accuracy of such statements.

8. Approaches 2 and 3 will in fact create significant variation among countries because each country can adopt an approach with a bespoke set of adjustments. This will limit the ability of groups to claim 100 percent of the net third party interest expense, create significant compliance costs for groups, and create less certainty regarding the amount of interest that could be deducted in each jurisdiction. Moreover, Approach 3 would require taxpayers to create a significant list of interest expenses to support the net third party interest expense. It would be very difficult for groups to comply, as they would need to provide work papers to support each deduction, necessarily leading to lengthy audits.
9. The discussion draft for Action 4 from 2014 noted that parties could move debt to achieve a full deduction for third party interest expense. That is far less likely where each country adopts its own starting point that varies from audited consolidated financial statements.

10. To the extent countries are permitted to select one of the three approaches, the differences between approaches adopted by countries would likely lead to a reduction of the amount of net third party interest that a group could deduct, thereby increasing the likelihood of double taxation, even where BEPS does not exist. To ensure consistency in approach and administration, the IAPT recommends the adoption of Approach 1 as the only method for computing net third party interest expense.

11. If Working Party 11 rejects Approach 1, then the IAPT recommends that the only permissible method would be Approach 2, as it would be more administrable for governments and groups. Once again, it is crucial that the adopted approach is consistent for all jurisdictions to ensure that a group can deduct its full net third party interest expense.

Adjustments to Third Party Interest Expense

**OECD Question 3:** It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

**OECD Question 4:** Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

**OECD Question 5:** Are there any other circumstances where a group’s net third party interest expense should be adjusted to include the group’s share of the net third party interest of an entity outside the group?

12. The Discussion Draft considers a series of adjustment to a group’s net third party interest expense. The first is an option to provide for an uplift of 10 percent or less, recognizing that there will be practical or legal constraints that will make it difficult to align net interest expense and activity. The IAPT supports an uplift and believes that a 10 percent uplift is insufficient because the group ratio rule will be based on audited financial statements after the year closes. The IAPT recommends an uplift of 20 percent to recognize that groups will not have certainty prior to the close of the fiscal year. The 20 percent uplift adequately provides cushion and ensures that the full third party interest expenses will be recognized.

13. It is worth noting that the purpose of a group ratio rule is to allow a group to claim its third party interest expense (but nothing more). This rule works only where the expanded group can place debt in locations where it aligns with the economic activity and limitation for entities in a specified jurisdiction. However, it may not be possible to move debt into a country because the country may deny a deduction for such expense. This may be particularly the case where an entity to which the group would need to move debt already has sufficient capitalization (wholly or partly in the form of equity) for its operations and where the introduction of new debt would replace some of that existing capitalization. The 20
percent uplift addresses the unilateral action a country could take to prevent the deduction of the entity’s proportionate share of the group’s net third party interest expense.

14. An example of such unilateral action is the U.S. Department of the Treasury’s section 385 proposed regulations. These regulations, if finalized in their current form, would prevent a multinational group from moving debt to a jurisdiction in order to align its debt with the allocable share of net third party interest expense. The following example illustrates the issues created by the proposed regulations. A British group may have excess capacity under the group ratio rule in the United States. To ensure a full deduction for third party interest expense, the U.S. subsidiary diverts a note to the British parent. Under the proposed regulations, that loan would be recharacterized as equity and the U.S. subsidiary would not be able to deduct the interest related to the loan.

15. The second adjustment to net third party interest expense would prevent interest capacity from being increased by certain payments of interest or amounts economically equivalent to interest that are non-deductible. This would reduce third party interest expense for those expenses that are not deductible for tax purposes. The Discussion Draft notes that this would increase complexity and should be limited to specific identifiable categories of payments made which pose a material BEPS risk. The IAPT strongly recommends against any such adjustments, as they will create significant complexity. If the final draft includes this as a design option, then it should include very specific and limited examples that address significant BEPS risk.

16. The third adjustment to net third party interest expense would address risks posed by interest paid to related parties outside the group. The Discussion Draft would remove net third party interest paid to related parties outside the group, defined as a party where the investment provides effective control, the ownership is 25 percent or greater, or the entity can be regarded as an associated enterprise under Article 9.

17. The Discussion Draft does not provide a very persuasive justification for the need for this adjustment to prevent BEPS risks. For example, is it really likely that an MNE would arrange to pay interest to an entity in which it had only a 25% ownership interest (i.e., to incur a real economic cost equal to 75% of the payment) simply to improve its group ratio? The IAPT recommends that payments made to entities outside of the consolidated group should be included as third party interest expense and similarly should be added to group-EBITDA.

18. The fourth adjustment would take into account group’s share of net third party interest expense of an associate or joint venture entity. The Discussion Draft makes this elective. The IAPT supports allowing taxpayers to include such interest at their election.

19. The IAPT notes that the Final Report for Action 4 provides an exception from the interest limitation for certain debt incurred in connection with public works projects. The Council of the European Union’s Anti-Tax Avoidance Directive (“ATAD”) adopted this approach and provides an exception for “loans used to fund a long-term public infrastructure project where the project operator,

---

borrowing costs, assets and income are all in the European Union.\footnote{ATAD, Chapter II, Art. 4(4) (17 June 2016).} A long-term public infrastructure project is defined as “a project to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by a Member State.”\footnote{Id.} There may be other loans that should be scoped out of the fixed ratio and group ratio rules. Jurisdictions should have flexibility to exclude loans that are used to finance projects that satisfy significant non-tax public policies.

3. **Definition of Group EBITDA**

   **OECD Question 6:** Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

   **OECD Question 7:** Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

   **OECD Question 8:** Are there any practical issues raised by including all dividend income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

   **OECD Question 9:** Are there any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

   **OECD Question 10:** Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

20. The second section of the Discussion Draft addresses modifications to achieve group-EBITDA. The IAPT recommends that the final guidance include recommendations to permit a full deduction for net third party interest expense and avoid double taxation. To achieve these goals, the final guidance should include uniform rules for purposes of calculating EBITDA.

21. The Discussion Draft states that in calculating group-EBITDA, the group’s profit before tax must be increased by its net interest expense, depreciation, and amortization. The adjustment (add-back) of net interest expense is done to ensure that a group’s earnings are measured without taking into account how the group is funded. However, it notes two areas with respect to the interest adjustment where countries need some flexibility.

22. The first area relates to capitalized interest. The Discussion Draft describes two options for capitalized interest. Its preferred approach is to exclude capitalized interest from the adjustment to EBITDA (i.e., not to treat capitalized interest as part of net interest expense to be added back to arrive at
EBITDA). Alternatively, countries could require entities to include it in the adjustment in the year the interest is incurred, and require further adjustments in subsequent years (i.e., in order to prevent double-counting, to reduce the add-back for depreciation and amortization attributable to the capitalized interest). The IAPT agrees with the preferred approach, as it will be simpler for both tax authorities and taxpayers to apply. Given the complexity involved in the alternative approach, the IAPT does not believe the final guidance should treat it as part of an allowable best practice.

23. The second type of adjustment to calculate group-EBITDA is a potential adjustment to net third party interest expense to reflect a country’s tax policy goals. The Discussion Draft describes four types of modifications to net third party interest expenses: (i) an uplift of up to 10 percent; (ii) the exclusion of payments which would not be tax deductible if paid by an entity in the country; (iii) the exclusion of net related party interest; and (iv) the inclusion of a group’s share of the net third party interest expense of a joint venture enterprise or associate.

24. The Discussion Draft recommends two general rules. First, where an adjustment to net third party interest expense is required or permitted to achieve any other tax policy goal (items i-iii), the figure for interest income and expense removed in calculating group-EBITDA should not reflect these adjustments. Second, where an adjustment to net third party interest expense is required or permitted to bring into line with the actual net interest expense funding the group’s earnings, the adjustment should also be reflected in the figure for interest income and expense removed in calculating group-EBITDA. The IAPT believes such adjustments should be consistent for all countries adopting the group ratio rule. The IAPT supports adjusting the calculation of group-EBITDA to address the uplift. However, the adjustments in items (ii) and (iii) would create additional complexity and further reduce the ability of a group to obtain its full third party interest expense. The IAPT therefore recommends not adjusting net third party interest expense for these items. With respect to associations and joint venture enterprises, the IAPT recommends that such interest expenses should be included in the calculation of third party interest and added back to calculate group-EBITDA.

25. The Discussion Draft considers two additional adjustments to subtract from gross earnings. The first additional adjustment says that fair value movements on financial instruments directly connected to a group’s debt finance should be removed in calculating group-EBITDA even though they are not economically equivalent to interest. The IAPT agrees that such amounts should be removed from group-EBITDA, and countries should not have the option of including such amounts in group-EBITDA.

26. The second adjustment is related to the net interest on a group’s defined benefit pension liability and similar post-retirement benefits. The Discussion Draft would permit a country to include this net interest expense in the adjustment for interest income and expense when calculating group-EBITDA. The IAPT notes that the interest from such retirement benefits is not included in the net third party interest expense. To provide parity, the IAPT recommends that the net interest from such benefits should not be added to calculate group-EBITDA. An add back would inappropriately reduce the amount of net third party interest expense that the group could deduct. The Discussion Draft does not include a reason why the dilution of net third party interest expense is necessary to address BEPS.
27. The next category of adjustments are to items to be included in the adjustment for depreciation and amortization. The Discussion Draft recommends that a group’s consolidated income statement could include other items to allocate a group’s fixed asset costs to different periods, which should be removed from group-EBITDA. The IAPT recommends including in the adjustment only those items that are treated as depreciation and amortization for book purposes. Any additional changes distort results and create administrability issues for tax authorities and taxpayers.

28. The next category of adjustments are for dividend income and a group’s share of income from a joint venture enterprise or association. For dividends, the Discussion Draft recommends that all dividend income in a group’s consolidated income statement should be included in group-EBITDA without adjustment, although it notes that in calculating entity-EBITDA, countries should exclude dividends that benefit from a participation exemption and should proportionately reduce dividends sheltered by underlying foreign tax credits. In respect of foreign tax credit systems, the IAPT does not believe that it is necessarily appropriate to disallow interest deductions allocable to dividend income if a country’s foreign tax credit regime has already allocated the interest expense against the dividend income in setting a foreign tax credit limitation applicable to that dividend income. The IAPT notes that there is an election to include interest paid by a joint venture enterprise or association as part of the computation for net third party interest expense. To prevent a mismatch, if such interest is excluded from the computation of net third party interest expense, then a group should have an election to remove such amounts from group-EBITDA.

29. For earnings from a joint venture enterprise or association, the Discussion Draft recommends that countries should include such earnings within group-EBITDA. Further, countries could require or permit shares of earnings to be adjusted to remove interest income and expense, depreciation and amortization. The IAPT recommends that taxpayers have the election to remove interest income and expense, depreciation and amortization if they are required to include earnings to calculate group-EBITDA.

30. The last issue in calculating EBITDA is whether to adjust for non-recurring items. The Discussion Draft provides two options: include non-recurring items in group EBITDA without adjustment, or have an exception for clearly defined and identifiable non-recurring items with clear guidance, and limited to cases that do not pose BEPS.

31. A non-recurring item would make the calculation of EBITDA volatile and could significantly affect the ability of entities in the group to achieve a full deduction of third party interest. Businesses would prefer to reduce volatility and to have a consistent approach to interest for purposes of calculating earnings per share. As a result, groups should have the ability to adjust EBITDA for non-recurring items. A group that elects to adjust EBITDA for non-recurring items should do so for all jurisdictions where it applies the group ratio rule.

4. The Impact of Losses on the Operation of the Group Ratio Rule

OECD Question 11: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues
and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

**OECD Question 12:** If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

**OECD Question 13:** Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

32. The final section of the Discussion Draft addresses loss companies. The first subsection addresses the scenario where the overall group has positive EBITDA, but there are entities within the group that have negative EBITDA and may be viewed as distorting the group EBITDA. The Discussion Draft describes two options. Under the first, the group would exclude entities with negative EBITDA from calculation of group-EBITDA.

33. Alternatively, a country could limit the interest capacity of entities with positive EBITDA. The Discussion Draft would limit the group’s net third party interest expense to a limitation based on the ratio of third party interest expense to EBITDA (not to exceed 100%) and apply an entity’s interest capacity to an amount not to exceed the group’s net third party interest expense (plus any applicable uplift). The Discussion Draft recommends applying both of these rules even where there are no entities with negative EBITDA.

34. The IAPT agrees with the Discussion Draft’s observations that it will be difficult to extract entities with negative EBITDA. Removing all entities with negative EBITDA would significantly increase complexity and further reduce the certainty during the taxable year that a highly leveraged entity could deduct its allocable share of third party interest expense. Additionally, it would be difficult for governments to administer a rule that required backing out all negative EBITDA entities where some or all of the negative EBITDA entities are located outside of a country apply the group ratio rule.

35. However, the IAPT disagrees with the attempt to place additional non-BEPS restrictions on the deduction of third party interest expense. The two proposed general limitations (as they are not limited to groups with loss entities) would have the net effect of denying third party interest expense and remove the benefit of the uplift. The fixed ratio rule serves as an imprecise limitation on interest deductions, and a group ratio rule already provides for an upper limitation for third party interest expense in a jurisdiction. There is no BEPS rationale for providing an artificial upper limit of the group interest through another limitation based a ratio of third party interest expense to EBITDA. This approach is an artificial attempt to further limit legitimate net third party interest expenses.

36. Accordingly, where an entity elects to apply the group ratio rule instead of the fixed ratio rule, the IAPT does not support an additional group cap or entity limitation.
37. The second subsection address the treatment of entities where a group has zero or negative group EBITDA. The Discussion Draft describes three options. The first is to apply the group ratio rule, which could have the effect of eliminating net third party interest expenses for the group. The second option is to apply a group ratio rule for those entities with positive EBITDA. The third option is to apply a similar limitation. For the reasons set forth above, the IAPT does not support computing group EBITDA based on those entities with positive EBITDA or otherwise imposing additional limitations on the group or an entity.

**OECD Question 14: Do you have any other comments on any of the issues covered by this discussion draft?**

38. The IAPT notes that a carry forward of both interest deductions and interest capacity would help groups with deducting the full third party interest expense, even if such deductions are delayed to a subsequent year. The IAPT recommends that the group ratio rule include such carry forwards.
February 6, 2015

VIA E-MAIL

Mr. Achim Pross
Head of the International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75116 Paris
France
interestdeductions@oecd.org

Re: Comments on Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments

Dear Mr. Pross:

...
The Alliance appreciates the opportunity to provide input to the OECD with respect to its Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments released on December 18, 2014. Our comments are set forth in the Annex to this letter.

We look forward to the opportunity to participate in the consultation to be held on February 17, 2015 with respect to this topic and would appreciate an opportunity to speak at the consultation. We also stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Joshua Odintz
Baker & McKenzie LLP
Counsel to the Alliance

James E. MacLachlan
Baker & McKenzie LLP
Counsel to the Alliance

Annex: Comments on the December 18, 2014 Discussion Draft on BEPS Action 4
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON THE DECEMBER 18, 2014 DISCUSSION DRAFT

ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

FEBRUARY 6, 2015
1. Executive Summary

Introduction

1. The Discussion Draft proposes a series of overly broad best practice options, many of which would create double taxation. The Discussion Draft fails to define the term “excessive interest deductions,” and the proposed best practice rules appear to solve for different problems. Some of these problems (e.g., cash box and thin capitalization) could be addressed through other options and Action Items that are not considered in the Discussion Draft.

2. An underlying premise for the best practice options is that groups can push down debt to other members of the group to allow for the deduction of all interest paid to third parties. The Discussion Draft fails to consider the significant costs (both tax and non-tax) that are incurred in a debt pushdown, as well as the practical limitations that will not relieve double taxation. We provide an example to illustrate the very real challenges that a group would face if it had to move debt within the group to be able to deduct its third party interest expenses.

3. As drafted, many of the best practice proposals would discriminate against multinational groups in favor of purely domestic businesses. The Discussion Draft also rejects or abandons the arm’s length principle and fails to respect separate juridical entities.

4. How a business finances its operations is an essential business decision. These comments contain a discussion of the role of leverage and how multinational corporations make investment decisions and explain how interest deduction limitations and double taxation will increase the cost of capital of companies and reduce the incentive to invest.

Policy Considerations

5. The Discussion Draft lays out several policies but omits key policy concerns. For example, in contrast to the BEPS Action Plan, the Discussion Draft fails to articulate the key “base erosion and profit shifting” concerns related to deductible interest expense.

6. Similarly, the practicalities of implementation and how the best practice options would interact with existing legal frameworks, including tax treaties, are ignored.

7. The Discussion Draft subordinates all other policy considerations to the objective of combating base erosion. It is acknowledged that many of the proposals will create double taxation, but there is no thought as to how avoid it other than through the use of carry-forwards. There is little attention given to significant costs taxpayers will incur if a group rule tied to consolidated financial statements is adopted.
8. While the IAPT agrees with many of the outlined policies, additional factors should be considered: cost to taxpayers (which is virtually dismissed by the Discussion Draft), the promotion of economic stability by respecting an economic bargain between a lender and a borrower, rules that actually promote certainty of outcome, including certainty prior to the end of the taxable year as to whether a taxpayer will be able to claim an interest expense.

Existing Approaches to Tackling Base Erosion and Profit Shifting Using Interest Expense

9. We are concerned by the lack of analysis regarding current regimes, including the failure to discuss the experience of jurisdictions with group tests. It also very troubling that the Discussion Draft did not address the arm’s length standard, and any analysis should include an in-depth study of the benefits and problems of the standard, along with recommendations for how to solve the issues.

What is Interest and What Payments are Economically Equivalent to Interest

10. While each country will be allowed to determine the definition of interest, there are significant variations in the definition of interest and equivalent payments. A lack of uniform rules will create additional double taxation, increased costs of capital, uncertain outcomes and additional costs for both tax administrators and taxpayers. The IAPT recommends that interest that is paid to the public not be subject to denial.

Who Should a Rule Apply To?

11. A 25 percent entity should not be included as part of a group for purposes of a group test. As a best practice, a group for purposes of a group test should include only those entities that are fully consolidated in a financial reporting group, which are those entities where the ultimate parent has a direct or indirect control of such entity.

Group Rule

12. The IAPT does not support a group test as a best practice. There are numerous problems with the group test, including the fact that it would deny interest deductions for groups with low third party leverage, it effectively embraces formulary apportionment in contradiction to the BEPS Action Plan, and it has the greatest opportunity for double taxation. A group test is premised on the incorrect assumption that borrowing across the group is (or should be) at a constant rate, while in fact borrowing varies by jurisdiction, line of business, business cycle, and other factors having nothing to do with BEPS risks.

13. There are several practical problems with the group test that were not identified in the Discussion Draft. For example, incongruous rules will create additional double taxation. There are also mismatches between cash tax and financial statements, as well as mismatches between financial statements.

14. The use of consolidated financial statements will make the group test unadministrable. Frequently, many changes are made to the consolidated financial statement that make it impossible to forecast the per entity interest cap before the close of the taxable year. Moreover, publicly traded groups report their results on a quarterly basis, and a group test based on consolidated financial statements will make it impossible to accurately report quarterly earnings.
15. A group test will create odd results where an entity is either making a new investment or where there is geographic variation outside of the control of the group and entities. If a group test is recommended, the IAPT recommends that groups be permitted to elect either an asset or earnings approach to take into account the unique facts of each group.

**Fixed Ratio Test**

16. The data cited by the Discussion Draft do not support a net interest to EBITDA ratio of 10 percent. The IAPT recommends a study of a larger cross-section of multinational businesses, including a review of the OECD’s thin capitalization report, as well as the US Department of the Treasury’s 2007 report on earnings stripping.

17. Similarly, the Discussion Draft dismisses out of hand as too generous those countries that have an interest to EBITDA ratio of 30 percent. We recommend additional study regarding whether a 30 percent ratio is sufficient to address “excessive interest deductions.”

**Combined Approach**

18. The IAPT believes that a well-calibrated thin capitalization rule or reasonable ratio test could address base erosion through interest payments. The IAPT does not support a combined approach that primarily relies on a group test to limit the deduction of interest expense.

**Targeted Rules**

19. The IAPT agrees that there may be a need for targeted rules to address particular situations. However, a layering of general and targeted rules will create complexity, lack of certainty, increased cost of compliance and potential double taxation. Thought should be given to how the rules interact with one another. With respect to the use of debt to fund tax exempt or tax deferred income, we suggest that this should be addressed exclusively through a targeted rule.

**The Treatment of Non-Deductible Interest Expense and Double Taxation**

20. An unlimited carry-forward of disallowed interest and unused capacity, along with a modest carry-back for disallowed interest expense, should be included in any proposed rule. However, the carry-forward will not solve the double taxation issue because an entity may never get the benefit of a deduction unless its share of the earnings increases relative to the rest of the group.

**OECD Model Tax Convention**

21. Even though many of the proposals in the Discussion Draft would give rise to double taxation, there is no discussion as to whether such rules are compatible with the OECD Model Tax Convention. There are issues with respect to compatibility with the provisions in Articles 9, 10, 11, 23, 24 and 25 that should be addressed. Additionally the Discussion Draft represents a radical departure from the permanent establishment work in Action 7.
EU Law Concerns

22. The Draft concedes that an international approach to deductibility is unlikely to be effective unless it can be fully implemented in the EU and that further consideration needs to be given to the design of interest rules that are in accordance with EU treaty freedoms, Directives and State aid rules. It is essential that a full and transparent analysis of EU law be undertaken to ensure that any best practices are compatible with EU law. The IAPT is concerned that the proposed rules conflict with the freedom of establishment and the recent Court of Justice of the European Union (CJEU) ruling on interest limitation rules. Second, a recent CJEU ruling casts significant doubt on whether any fixed interest limitation rule which applies to loans by non-EU third parties to an EU borrower in a group is compatible with the free movement of capital. Any proposed rules will need to be addressed by the European Commission and the EU Parent-Subsidiary Directive, and should be designed in consultation with the European Commission to avoid State aid infringement proceedings.

2. Introduction

23. The IAPT appreciates the opportunity to comment on the work being done on BEPS Action 4. While the Discussion Draft proposes options to eliminate base erosion and profit shifting related to the use of interest deductions, the IAPT is very concerned that the Discussion Draft fails to articulate the base erosion at issue and, rather than risk future base erosion, errs on the side of creating double taxation through overly broad rules. The proposed best practice rules appear to go well beyond the charge of Action 4. The IAPT has several initial observations that overlay the discussion of the proposed best practice rules for Action 4, which are discussed in this introduction.

25. If the perceived problem is the “cash box” (deductions taken in high tax jurisdictions while interest income is recognized in a low or no tax jurisdiction), this base erosion technique could occur regardless of the level of internal leverage compared to external leverage. A better way to address the cash box issue is through targeted rules, which may be addressed in Action 2 (Hybrids) or Action 3 (controlled foreign corporations), or even Actions 8-10 (transfer pricing).

---

7 The IAPT filed initial comments regarding Action 4 on October 16, 2013, which are attached as Appendix 1.
26. If the issue is thin capitalization of entities for inbound investment as described in Box 1 on page 7 of the Discussion Draft, the OECD has done significant prior work in this area. The OECD published a Thin Capitalisation report in 1987, which continues to be the basis for the official guidance on the interaction between thin capitalization regimes and Article 9 of the Model Tax Convention under the Commentary on Article 9. While the report does not prescribe solutions to address appropriate proportions of debt to equity capital, it does study the international effects of various national approaches to addressing thin capitalization. More important, it does consider how to relieve economic double taxation and how treaties may be revised to avoid double taxation. The latter issues are relevant here because the best practices under consideration in the Discussion Draft will lead to double or multiple levels of taxation.

27. The Discussion Draft should better define the problem of base erosion (e.g., “excessive interest deductions”) and propose targeted rules to address the problems. A proposal virtually identical to the first combined approach (primary group test) can be found in the US President’s fiscal year 2015 and 2016 budgets, entitled “Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups”. The US Joint Committee on Taxation analyzed the version from the FY2015 Budget and noted that the Administration failed to define excess leverage and the proposal may go beyond earnings stripping:

   The Administration’s proposal aims to limit the extent to which foreign-parented multinationals can shift profits by disproportionately leveraging their U.S. affiliates. However, it is unclear how one determines whether a U.S. affiliate is overleveraged. Even if the U.S. affiliates of a foreign multinational corporation are more highly leveraged than their non-U.S. counterparts, it is not necessarily the case that this arises because of earnings stripping. As discussed above, it may be the case that a firm’s optimal capital structure involves being more highly leveraged in high-tax jurisdictions than low-tax jurisdictions, absent the motive to strip earnings.

Like the Administration’s proposal, the Discussion Draft has failed to define excessive interest deductions that give rise to earnings stripping. By reaching beyond base erosion and profit shifting, a best practice rule will fundamentally change the way companies finance operations. It will ultimately force companies to either over-leverage with third party debt to have excess capacity or it will force companies to use equity to make additional investments. A proposed rule will affect primarily non-tax business decisions.

28. The Discussion Draft assumes that an MNC group can move debt around the group so that it will be able to deduct all of its third party interest expense. The IAPT strongly disagrees with this assumption. First, it will be virtually impossible for a large group to apply the group test and forecast the amount of interest cap by entity before the end of the taxable year if the basis for determining interest and earnings is the consolidated financial statement. Many MNC groups have several hundred entities that have different

---

8 Adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(4)-1.
9 The Joint Committee on Taxation is a nonpartisan committee that advises both houses of Congress on tax issues. It is also responsible for providing revenue estimates for both houses of Congress.
10 Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President’s Fiscal Year 2015 Budget Proposal (JCS-2-14), December 2014, at 21.
lines of businesses and entities that perform different functions (e.g., active trade or business, holding company, treasury center). Consolidated financial statements are not finalized until after the close of the year and may be subject to significant changes before they are finalized. Significant changes may arise from non-tax adjustments (e.g., changes in sales figures, reserves for non-tax events) that will affect each entity’s share of the earnings and interest cap. It is therefore impossible to forecast the amount of debt cap by entity prior to the close of the tax year.

29. The Discussion Draft does not address the significant tax and non-tax costs and issues associated with debt pushdown. A subsidiary’s payment of interest may be subject to substantial withholding tax, significantly increasing the cost of financing operations. A group may also have foreign currency gain or loss in connection with debt pushdown that otherwise would not have been incurred. Some leverage, such as project financing, cannot be pushed down or otherwise transferred within the group for business reasons. The terms of the third party loan or market expectations may prevent an entity from pushing down the debt to a subsidiary, or result in higher financing costs due to the higher credit risk of the subsidiary. In the case of a joint venture, pushing down debt may not align with the activity occurring in the joint venture, and the other partner(s) to the joint venture may object to the pushdown of debt. Debt pushdown does not provide relief to the group parent in the case of a group test. Finally, other jurisdictions may object to the pushdown of debt and the corresponding interest deduction, giving rise to additional double taxation and an increase in the cost of borrowing.  

30. The following example demonstrates the practical limits of debt pushdown in the context of a group test. For purposes of the following example, A, B, and C are corporations and are each tax resident in a different country:

---

11 See, e.g., Laidlaw Transportation Inc. v. Commissioner, TC Memo 1998-232 (1988) (IRS recharacterized loan from Canadian parent to U.S. subsidiary as debt; court considered the ability of the corporation to obtain loans from outside lending institutions as a factor in whether loan would be respected); Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956) (court rejected IRS’s recharacterization of loan from parent to subsidiary as equity).
31. In order to avoid the disallowance of interest expense, (i) B needs to borrow to obtain the interest deduction but because it does not need the cash, it then must distribute the cash by dividend or share redemption and (ii) cash would need to be contributed by A to C to pay down debt. Debt pushdown into B requires a dividend distribution or a capital reduction. In addition to the typical non-tax restrictions on paying dividends or reducing capital, country-specific regulatory restrictions may make this self-help strategy unworkable. For example, some countries (e.g., China, Russia and Venezuela) have foreign exchange controls that would require governmental approvals before the funds could be moved out of the countries. Additionally, in some countries, dividends are limited by retained earnings (e.g., China requires 10 percent of earnings to be set aside in a reserve account that is unavailable for distribution; corporations in the European Union can only distribute dividends if they have reserves per the EU directive\textsuperscript{12}). Additionally, intercompany debt for B to fund a dividend or capital reduction in countries that require significant administrative reporting with the central bank would slow down and may limit the ability to fund the dividend or capital contribution. Local commercial law may prohibit borrowing to pay dividends. Moreover, dividends are often subject to withholding tax and income tax costs that will

necessarily be financed with more debt. Injecting capital into C in order for C to repay a portion of its
debt will also run into legal and administrative burdens in many countries. Capitalization may also incur
capital or stamp tax on the contribution and may increase capital or franchise taxes going forward. If B or
C is a joint venture, the movement of cash in and out of the joint venture would require consent from
other owners of the entity, who may not agree to such movements.

32. By multiplying this example by the hundreds of entities in a typical multinational group, it
becomes clear that the ability to forecast and move cash and debt within the group to ensure net third
party interest costs of the group are not disallowed will be practically impossible. Additionally,
unforeseen events such as recession, rapid devaluation of a currency (e.g., Venezuela and Russia),
restatements, unanticipated lawsuits, reserves for non-tax items, and natural disasters could cause
dramatic shifts in the debt cap and thus put tremendous pressure on curing through self-help. Political
instability also affects companies’ ability to move debt into certain countries.

33. The proposed group rules discriminate against MNC businesses while favoring purely local
businesses. As the Discussion Draft observes, a group rule will likely result in double taxation if the
group is unable to move third party leverage within the group to match each entity’s cap or allocation of
interest. The Discussion Draft contemplates a carry-forward of disallowed interest expense to address the
created double taxation. In contrast, a local business that does not have cross-border operations will be
able to deduct all of its third party interest expense and will not have to allocate interest to another
jurisdiction. The proposed group rule would effectively reduce or eliminate the capital efficiency of a
global group and would likely increase third party borrowing by groups that operate in more than one
jurisdiction.

34. The Discussion Draft proposes a variety of rules at a time when the cost of borrowing is very low
across the globe. Interest rates are abnormally low in many jurisdictions, and it is likely that the cost of
borrowing will increase. During the liquidity crisis from 2007 to 2010, it was very difficult for many
businesses to borrow from banks or raise capital through bonds or commercial paper. The IAPT cautions
that it is unclear how various proposed rules will affect businesses if interest rates significantly increase in
some jurisdictions. The cost of capital could significantly increase with a group rule or an improperly
calibrated fixed ratio test. See paragraph 123 for a discussion of historic interest rates.

35. The IAPT notes that the proposed group rules will result in significant double taxation and
increased costs for taxpayers, regardless of whether all countries, including the G-20 and OECD countries,
adopt the same definitions (e.g., interest and interest equivalents) and rules to determine the amount of
interest cap or allocation by entity. Double taxation could be reduced (and taxpayer certainty increased)
if uniform definitions and rules are adopted. For example, double taxation could increase if countries
adopt a group rule based on financial statements prepared according to different accounting standards, the
amount of interest cap by entity could vary if each country determines what is added back or subtracted to
the definition of interest, earnings, or assets, etc. The Discussion Draft does not articulate how the OECD
proposes to obtain global consistency and reduce disputes between tax authorities regarding the
application of a group test. To reduce disputes, any best practice proposal will require greater detail to
lead to global conformity and should include recommendations to address conflicts between countries.
36. A best practice rule should respect separate juridical entities. Each entity in a group is legally and often operationally independent with a separate management and balance sheet. In many instances, entities in a group compete with one another for results and are operated as a collection of individual businesses. Corporate and tax law recognize that each entity is separate, and a best practice rule should not override such laws.

37. Any rule that denies third party interest deductions or deductions of intercompany interest set at arm’s length will increase the cost of capital and reduce the incentive to invest. The effects of interest limitation on foreign investment are discussed in sections 3 (the Role of Leverage) and 4 (How MNCs Make Investment Decisions), infra. To address the increase in the costs of capital and distortions in the cost of raising debt or equity, a best practice should not limit deductions for interest paid to third parties or intercompany interest set at arm’s length.

38. The IAPT is extremely concerned that the Discussion Draft rejects or abandons the arm’s length principle. The proposed group rules ignore the bargain struck by third party lenders and borrowers and potentially deny interest deductions for bona fide loans from third party lenders to individual group members. Third party lenders consider a variety of factors in deciding whether and on what terms to lend to a borrower. These factors include the debt/equity ratio of the borrower, the location of the market where the lending is taking place, the credit rating of the borrower, and interest rates for that market. The Discussion Draft ignores these factors as well as the bargain struck by third parties. The Discussion Draft also rejects the arm’s length principle by disallowing interest expense for otherwise bona fide related party loans. The failure to follow the arm’s length principle also leads to a mismatch of income and deductions, as all of the best practice proposals in it would require a lender to recognize income from interest income, yet some or all of the borrower’s interest deduction would be temporarily or permanently disallowed.

39. We recommend that a best practice for interest should include transition rules. Transition rules should exempt preexisting debt to avoid changing the economics of transactions between third and related parties. Transition rules should also take into account reactions by financial markets through delayed or phased implementation.

3. The Role of Leverage

40. It is important to consider the role debt plays in financing a business to understand how the best practice proposals could impact business decisions. A business can capitalize with debt or equity, and there are significant differences between the two. The level of debt versus equity funding in a group is generally driven by non-tax related factors: strategic decisions of companies on targeted credit rating and capital structure, liquidity of financial markets, business cycle, cash needs for sizeable investments, and expansion or M&A activities. Also, the relationship and rights of the investor vary depending on the form of investment. A debt investor will have a guaranteed return, while an equity investor will have greater profit potential but no protection in the event of insolvency.

41. While MNCs strive to place debt generally where the operations are located or investment is made, companies may be limited by the external funding they are able to raise in such locations. If the
group is funded by bonds, the issuance of bonds is often centrally located in few affiliates, on defined markets in view of the liquidity and depth of the market. The location where a group can raise external funding may also be limited by covenants or rules in its funding arrangement to avoid subordination of debt.

42. In a group, entities are normally run with stand-alone fiduciary duties, as mini-entrepreneurs, with local debt and equity as would be done in stand-alone companies without parent guarantees. The purpose of such treatment is to measure individual performance and avoid currency risks. Entities with higher investments and in growth markets will generally have higher debt to sustain the expansion. When groups centrally raise debt, debt is pushed down to affiliates requiring funding through intercompany funding, in the currency of the operations to avoid currency risks. In certain jurisdictions, the pushdown of such funding results in incremental tax cost to the group through withholding tax leakage. The capital structure of each affiliate will depend on the stand-alone capacity of the affiliate and non-tax related drivers such as the business cycle in which the affiliate is, the economic situation of the country (recession or growth), and impact on the affiliate’s results and cash flow generation, expansion plans or currency controls existing in the country.

43. A group that has sufficient liquidity can decide to use a related party loan in lieu of third party financing. This has a significant benefit for purposes of consolidated financial statements, as a related party loan is netted out while third party debt is reflected as a liability on the balance sheet. Related party loans provide additional flexibility for an MNC to borrow from third party lenders in the future.

44. Contrary to the views of the Discussion Draft, equity investment cannot be easily swapped for debt investment. It is not possible to take out capital through dividends and/or a repayment of capital in certain countries and in others there are significant legal restrictions or cost associated with changes in capital structure, as debt to pay out dividends can be non-deductible under local legislation or dividend distributions can attract high withholding tax. Furthermore, changes in capital structure may be limited by governing bodies (e.g., a supervisory board), currency controls, or shareholders or other agreements when a group does not have 100 % ownership in an entity, while debt financing allows the capital to be freed up.

45. A partial or complete disallowance of interest will impact cash flow, increase the costs of capital, and affect the decision to make or not an investment and the location of the investment as increases in the cost of capital negatively impact investment decisions, the return on investment having to be higher to justify the investment, as explained in section 4 below.

4. How MNCs Make Investment Decisions

46. The cost of funding through equity and debt is called the weighted average cost of capital ("WACC"). An investor can invest in a company through debt or equity. This is particularly true for listed companies where a shareholder can decide very rapidly either to buy or sell shares on the stock exchange. As a consequence, a company will look to optimize the value creation for its shareholders and when deciding whether to make an investment, a company will strive for its return on investment to be
higher than the minimum “coupon” that stakeholders will expect which is equal to WACC x investment. This can be translated into:

\[ \text{ROIC}^{13} \times \text{Investment} > \text{WACC} \times \text{investment or ROIC-WACC}>0 \]

47. The level of WACC depends on the risk of the business, the credit rating, cost of funding of the company, and the countries in which the operations are performed. A low risk country such as Germany or the United States will have relatively low WACC (typically single digit WACC), whereas higher risk countries such as for example the Ukraine or Venezuela will have a higher WACC (double digit WACC). The level of return a company will expect on investments will therefore be different per country. Finally, the WACC of an MNC is typically determined by the weighted average of the WACC of the countries it operates in.

48. An MNC will typically work with budgets or envelopes for investments. A company must make choices: investment projects need to be prioritized between the different business units and countries the MNC operates in. To prioritize investments within an envelope and ultimately decide if an investment project such as a capital expenditure or an M&A project should be undertaken, the MNC generally reviews the strategic and financial merits of the investment.

49. Typically, an MNC reviews investment decisions based on financial forecast per project, using a discounted cash flow model over a number of years. The prioritization between projects and the decision whether to invest will be made based on the review of a series of financial indicators which can be the return on investment (ROIC), internal rate of return (IRR), payback, or another indicator. An MNC will often expect a minimum return before deciding to proceed with an investment or not. These can be ROIC or IRR of investment to be [x] % higher than the WACC of the country and payback to be no later than [y] year.

50. An MNC tends to have more project proposals than it can execute in view of financial and human resources available to implement the submitted projects. Examples of decisions a company can be faced with are: Should the company launch a new product? Should a company invest in changes to the plant in country A which would result in lower logistics cost as closer to the targeted market for sales, or should it invest in the plant in country B which required less capital expenditure but will result in higher logistics cost? Should a company invest in a new IT system to reduce the maintenance cost on IT legacy systems or should it invest in upgrading a production line to reduce the maintenance cost in the plant? Projects are generally prioritized in view of their strategic relevance and financial return against alternatives and projects are prioritized within the group between countries and within countries.

51. Interest limitations affect investments decisions. The WACC can be defined as:

\[
\frac{\text{Equity}}{\text{Debt} + \text{Equity}} \times \text{Cost of Equity} + \frac{\text{Debt}}{\text{Debt} + \text{Equity}} \times (1-\text{Tax rate}) \times \text{Interest}
\]

\(^{13}\) ROIC = Return on Invested Capital.
52. The limitation of interest deduction will bring the \((1 - \text{Tax rate})\) closer to 1 and will increase the WACC.

53. The increase may be small in mature markets such as Germany, where interest rates are currently low for companies with a very strong credit rating and relatively low leverage. For entities with weaker credit ratings and/or higher balance sheet leverage, and in countries with higher interest rates, the impact can be material on the WACC. The higher the WACC, the higher the return a company will expect before investing. If the WACC increases due to interest limitations, an entity may decide not to proceed with certain investments as the ROIC may not be higher than WACC. This may change the priority of investment between countries.

54. Investment decisions are internal to companies and are not available in the public domain. While some major investment may be made public (e.g., an acquisition or building of a new plant), smaller investments are generally not made public. Furthermore, investments that a company decides to forfeit are normally not disclosed to the public. It is therefore understandable that limited studies exist on the link between WACC and investment decisions by companies. Nevertheless, increases in WACC in countries result in lower investment in view of higher returns expected (e.g., increased WACC for Venezuela resulted in lower investments in the country).

55. Countries understand the importance of investments of companies in the development of their economies, job creation, infrastructure, and the importance of investment economics. Therefore in different countries, investment can result in national or regional incentives, which can be direct, indirect, tax, or other types of incentives. While a company will consider incentives in its investment decision, it will also consider investment disincentives, such as increased WACC that would result from non-deductibility of funding for investment.

5. Policy Considerations

56. The IAPT generally agrees that the list of policy considerations that should be considered in the design of best practice proposals for Action 4 set out at paragraph 11 of the Discussion Draft is an appropriate list of considerations to take into account. However, the IAPT believes that the Discussion Draft fails to articulate the nature of the key policy aim cited (“addressing base erosion and profit shifting”), lacks a rigorous analysis of how well the policy options selected for discussion measure up against the cited policy considerations, inappropriately omits certain important policy considerations, and subordinates all other policy considerations to the objective of combating base erosion.

a. Failure to articulate the key policy aim

57. In contrast to the BEPS Action Plan, the Discussion Draft fails to articulate clearly what the key “base erosion and profit shifting” concerns are in relation to deductible interest expense. The BEPS Action Plan laid out a relatively clear explanation of the concerns:

The deductibility of interest expense can give rise to double non-taxation in both the inbound and outbound investment scenarios. From an inbound perspective, the concern regarding interest
expense deduction is primarily with lending from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. … From an outbound perspective, a company may use debt to finance the production of exempt or deferred income, thereby claiming a current deduction for interest expense while deferring or exempting the related income.

58. The Discussion Draft does not mention these concerns in its summary of key policy aims and instead leaps to the conclusory statement that the objective of addressing BEPS in the context of interest “may be best achieved through rules which encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group”. There is no effort to tie that conclusion to the policy concerns stated in the Action Plan, and indeed, it is difficult to see how either of those policy concerns is particularly related to the question of whether an entity’s interest expense is aligned with that of its overall group. For example, the issue of whether a subsidiary’s interest expense is aligned with that of its overall group has no direct relationship to whether it has borrowed “from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder”. We would recommend that the OECD refocus its attention on the concerns laid out in the Action Plan and analyze what policy options could best address those concerns, taking into account the other policy considerations cited.

b. Inappropriate omission of some policy considerations

59. The Discussion Draft states that interest rules should minimize distortions to the competitiveness of groups. Its exclusive focus, however, is on the question of whether interest deductibility rules favor MNC groups over purely domestic groups. In our view, an equally important consideration is whether interest deductibility rules favor purely domestic groups over MNC groups, whether in general or in relation to their local operations. This omission is curious, as avoiding this form of distortion has traditionally been an important pillar of the international tax structure, given the extent to which non-neutral tax rules can have a protectionist impact. As discussed elsewhere in this letter, the proposed group rules would create a new distortion by favoring domestic groups. Domestic groups would have unlimited interest deductions, while multinational businesses would very often not be able to claim full deductions for third party leverage. Moreover, under the proposed group rules, a local business of an MNC group would often not be able to obtain a deduction for an amount of interest expense which would be fully deductible if incurred by a comparable purely domestic business, because the former’s deduction could be limited by virtue of wholly unrelated attributes of affiliates elsewhere in the world. A best practice rule should not discriminate against MNC groups.

60. The IAPT similarly agrees that rules should minimize distortions to invest in a country. However, the group rules will increase such distortions by raising the cost of capital and by pushing groups to obtain additional third party leverage where they do not need it just to create interest cap, and that will affect whether and where to invest.

14 See, e.g., Article 24(4) of the OECD Model Tax Convention, which limits the rights of a Contracting State to apply certain forms of thin capitalization rules to restrict the deductibility of interest expense paid to foreign lenders (i.e., where those rules are not based on the arm’s length standard and apply to payments to non-resident (but not resident) creditors).
61. More generally, the Discussion Draft omits certain policy considerations which deserve to be taken into account. One such consideration is whether the practicalities of implementing a particular option are sufficiently realistic to allow the option to successfully achieve its stated objectives. We respectfully submit that this consideration alone would be enough to justify dismissal of both versions of the group rule described in the Discussion Draft. For example, in the absence of a wholly unrealistic global adoption of the group allocation approach, that approach risks leading to widespread double taxation. Similarly, widespread adoption of the Discussion Draft’s group ratio approach, which would require MNC groups to make detailed analyses of their global operations under separate rules in every country where they do business, would impose such unsustainable compliance burdens on taxpayers (and such unachievable verification challenges on auditors) that the option itself should be dismissed. Policy considerations need to take feasibility into account.

62. Another policy consideration that should be taken into account is how well the options under consideration interact with existing legal frameworks. Policymakers should consider, for example, whether the options are consistent with, or conflict with existing treaty obligations, what the options’ relationship is to national law or treaty rules relevant to the deductibility of interest expense (e.g., how do they interact with transfer pricing rules, do they create issues under Article 9, what effect will they have on the operation of the Authorized OECD Approach to the attribution of profits to permanent establishments, etc.), what the legal framework would be for ensuring protection from double taxation as a result of introduction of the options, what the legal framework for ensuring the effective resolution of disputes regarding their application would be, etc. See section 14, below, for a discussion regarding treaty issues that must be considered.

c. Subordination of all other policy considerations to the objective of combating base erosion

63. The Discussion Draft states that a rule should avoid double taxation. However, the group approach turns the presumption against double taxation on its head. Unless a company has perfect facts, legitimate third party debt will be denied interest deductions, and the best practice rule favors the denial of a deduction. Moreover, the Discussion Draft does not address whether and how countries should consider a conflict that arises from the application of the proposed rules. While theoretically every country could adopt the same definitions and rules for purposes of applying the group allocation approach, it is exceedingly unlikely that this will happen. Inconsistent definitions and rules will create double taxation. In paragraph 90 of the OECD’s 1987 Thin Capitalisation report,15 the OECD states that “where double taxation arises because of a conflict of view between tax authorities about the nature of a prima facie payment of interest, or the impact of rules about thin capitalization, the tax authorities concerned should endeavor to resolve the conflict by mutual agreement under the relevant bilateral tax treaty.” The OECD should further minimize double taxation by addressing whether and how countries can resolve conflicts over the application of thin capitalization and group tests. The Discussion Draft, however, includes no discussion of how double taxation arising from adoption of one or more of the options might be avoided, other than a few references to possible mitigation through use of carry-forwards.

15 Adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(4)-1. See also the Commentary on Article 9(1) of the OECD Model Tax Convention.
64. The IAPT agrees that rules should minimize costs for both tax administrators and taxpayers. However, costs will significantly increase for both tax administrators and taxpayers in a group test or a combined approach that relies on a group test, especially if each jurisdiction does not adopt uniform definitions and rules. For example, taxpayers will be required to recalculate group financial statements if each jurisdiction uses different definitions of interest. Also, costs will increase if each jurisdiction adopts additional add-backs and subtractions to arrive at group earnings or assets. Moreover, even if countries adopt harmonized rules, significant costs will arise if the definitions chosen are not easily reconcilable with figures appearing in group financial statements, such that new accounting systems would need to be implemented to capture the necessary information. Significant additional costs will arise if each country can audit the consolidated financial statements and propose changes thereto. These types of concerns are virtually dismissed by the Discussion Draft.

65. The Discussion Draft states that interest rules should promote economic stability by encouraging groups towards less highly leveraged structures. The IAPT believes that this policy is beyond the scope of Action 4 and impinges on non-tax business decisions, specifically whether a business can and should capitalize an investment or entity with debt or equity. Rather, the IAPT believes that the policy should promote economic stability by providing certainty that an economic bargain between a lender and borrower is respected. Economic certainty can also be promoted by respecting arm’s length transactions between third parties and between related parties.

66. The Discussion Draft states that a rule should promote the certainty of outcome. The IAPT agrees that a taxpayer should know whether it will have the benefit of a deduction and the amount thereof. An inconsistent adoption of a group rule will create significant uncertainty over the outcome, especially if there is no mechanism to reduce double taxation. Similarly, in the case of a group test, it will be very difficult for an entity to know its interest cap or allocation prior to the end of the taxable year because it will rely on financial statements prepared after the close of the taxable year. Factors outside the control of the entity and financial group (e.g., an increase in earnings by another entity, lower than anticipated earnings in the entity, or an increase in lending costs in a jurisdiction) can affect whether an entity will be able to fully deduct its interest expenses. A fixed ratio rule also limits the ability of an entity to know whether or when it will be able to deduct interest expense incurred.

67. The IAPT believe that targeted rules to address perceived abuses would both address the issues raised in BEPS Action 4 and satisfy the above principles.

6. Existing Approaches to Tackling Base Erosion and Profit Shifting Using Interest Expense

68. The Discussion Draft includes a fairly cursory description of existing approaches used by countries to address BEPS concerns in relation to interest. It refers to prior analyses conducted by member countries and associates and empirical data obtained with respect to those existing approaches, but its failure to cite to any of those analyses or data makes it impossible to comment on them. We would, however, like to make a few observations on this section of the Discussion Draft.

16 We would also suggest that any attempt to deal with that non-BEPS policy concern would require a far more fundamental re-examination of countries’ rules on interest deductibility than is undertaken in Action 4.
69. One thing which leaps out is that the Discussion Draft does not cite experience with any country applying a group rule based upon apportioning a group’s net interest expense to the members of the group. This is rather remarkable given the prominence that option has in the Discussion Draft, and given the OECD’s traditional practice of basing best practice recommendations on insights gained from experience in applying solutions. We would suggest that this lack of experience should justify a fair amount of caution in adopting such a rule as a best practice.

70. We are baffled by the discussion of debt / equity ratios at paragraph 17 of the Discussion Draft, as it seems to suggest that a given level of debt can be justified by the issuance of new equity share capital which does not correspond to an increase in economic activity on the part of the entity. We are unaware of mechanisms that would allow new share capital to be issued without an infusion of new equity (as opposed to splitting existing share capital), and we believe any infusion of new equity would inevitably lead to an increase in economic activity on the part of the entity (since companies are striving to optimize return for their stakeholders as explained in section 4).

71. We are similarly baffled by the discussion at paragraph 20 of the Discussion Draft which suggests that groups can “manipulate” the outcome of a debt / equity test by increasing an entity’s level of equity. We do not see why an entity with a higher equity level should not also be able to bear a higher level of debt: that is simply an economic fact in the market. Similarly, we are baffled by the suggestion that “a rule which limits the amount of debt in an entity may still allow significant flexibility in terms of the rate of interest that an entity may pay on that debt”. The rate of interest payable will either be set by market conditions (in the case of third party debt) or by the arm’s length principle (in the case of related party debt).

72. In addition, we find it very troubling that the Discussion Draft indicates at paragraph 21 that the countries agreed that arm’s length tests and withholding taxes should not form part of this consultation. The arm’s length test is the bedrock principle which has governed the treatment of intercompany debt for decades. It was endorsed by the OECD in the 1987 Thin Capitalisation Report, it is enshrined in the Commentary on Article 9 of the OECD Model Tax Convention, and it is reflected in the provisions of the OECD Model and thousands of tax treaties currently in force around the world. It is based upon a principle of neutrality which has the avoidance of economic distortions as one of its principal objectives. We submit that it would be irresponsible for the OECD to consider a radical new approach to the treatment of group interest expense without a more rigorous analysis of the benefits and problems of the arm’s length approach and a clear explanation of how to get from here to there. For example, we are unsure why the arm’s length test should be criticized as applying only to intragroup interest payments when we understand that the objective of the proposed group-wide tests is to deny an amount of interest expense in excess of the group’s third party expense.

73. With respect to withholding taxes, while we agree that they are not a suitable tool for tackling BEPS in relation to interest payments, we do believe that in order to emerge from Action 4 with a coherent international system, agreement should be reached on the withholding tax implications (at least under the OECD Model) of any disallowance of interest deductions and on the double tax relief obligations arising from such withholding taxes.
7. What is Interest and What Are Payments Economically Equivalent to Interest?

OECD Question 2: Are there any specific items which should be covered by a best practice rule which would not be covered by the approach set out in this chapter? What are these and how could they be included within a definition of interest and other financial payments that are economically equivalent to interest?

74. The Discussion Draft notes that each country will be left to determine how interest should be defined in domestic law, taking into account existing definitions of interest and equivalent payments. If the Discussion Draft recommends either a group rule or a hybrid rule incorporating a group rule, then the IAPT strongly urges the creation and adoption of uniform definitions of interest and economically equivalent payments. As discussed above in relation to the Discussion Draft’s introduction and policy considerations, inconsistent rules will result in additional double taxation, increased cost of capital, uncertain outcomes, and additional costs for both taxpayers and tax administrations.

75. The IAPT recognizes that there is significant variation in the definition of interest and equivalent payments. While the list of interest and interest equivalent payments in Discussion Draft paragraph 35 may seem extensive, there are many additional payments that may or may not give rise to an interest equivalent payment. Also, there are significant variations by jurisdiction for each rule which could result in the over- or under-inclusion of interest. For example, the United States Internal Revenue Code and regulations have numerous definitions of interest and interest equivalents that are required to be included or excluded as income or deductions, or otherwise are required to be allocated:

- Interest includes the portion of sales proceeds received on the sale of a bond between interest dates that represents interest accrued to the date of sale.\(^\text{17}\)

- IRC section 467 generally requires taxpayers to recognize rent on an accrual basis and also requires taxpayers to recognize interest for rental amounts remaining unpaid from prior years (in effect converting some of the designated rent to imputed interest if adequate interest is not provided).

- Under Treasury Regulation section 1.861-9T(b)(1)(i) (having to do with the methodology for allocating and apportioning interest expense between domestic and foreign income for purposes of determining the foreign tax credit limitation), any expense or loss incurred in a transaction in which the taxpayer secures the use of funds for a period of time is subject to allocation and apportionment under the interest expense rules if such expense is incurred in consideration of the time value of money.

- The original issue discount (OID) rules impute periodic interest income and deductions for notes that do not have adequately stated interest prior to maturity (e.g., zero coupon bonds, which are addressed in Discussion Draft paragraph 35).\(^\text{18}\) However, interest income and deductions are reduced or eliminated if the note is an applicable high yield

\(^{17}\) Treas. Reg. § 1.61-7(a).

\(^{18}\) IRC § 163(e).
obligation, and payments therefrom may be treated as dividends in certain circumstances.19

- Unstated interest on an instrument related to the sale or exchange of property gives rise to interest for tax purposes. Section 483 applies to a debt instrument issued in a sale or exchange of property only if, among other things, there is unstated interest.20 A contract has unstated interest unless it provides for “adequate stated interest”.21 Deferred payments of the sales price made pursuant to a contract for the sale of property, where at least one of such payments is due more than one year from the date of sale, are tested to determine whether the seller has imposed adequate stated interest.

76. These rules illustrate the complexity of determining whether part or all of a payment is treated as interest. The OECD will create significant complexity and uncertainty if it does not provide uniform rules for interest.

77. Additionally, the International Financial Reporting Standard (IFRS) does not have a uniform definition of interest and interest equivalent payments. As a result, a best practice rule that relies on consolidated statements under IFRS may require significant modifications by jurisdiction in determining the amount of interest or cap that is allocated to each entity. Additional issues with consolidated financial statements are discussed below in the context of a group test. Similarly, EBITDA is not uniformly defined under US GAAP or IFRS, and a rule that that relies on EBITDA will vary by entity and jurisdiction.

78. The IAPT recommends that payments on fixed sum principal contracts and inflation adjustments to payments not be included in the definition of interest or interest equivalent payments.

79. The IAPT further recommends that interest subject to denial not include, or a group test or fixed ratio test should not apply to, interest that is paid to the public. Typically, a parent of a group will issue bonds or debt to the public, as opposed to a subsidiary, for non-tax reasons, including debt ratings, rates, and administrative efficiencies. The purpose of such debt includes funding dividends and share buy-backs. Unlike subsidiaries, the parent of the group cannot engage in self-help in order to increase the amount of debt cap unless it actually borrows additional funds at the parent level. Moreover, it is also possible that the jurisdictions where the subsidiaries are located will not accept significant debt pushdown to fund the global operations. If the public debt is not exempted from the definition of deniable interest (or the application of any of the proposed rules), there are at least two likely consequences. First, MNCs may reduce debt-funded dividends and share buy-backs, which will be to the detriment of public and institutional shareholders. Second, treasurers may shorten the duration of their debt issuances. For example, it is difficult to project EBITDA beyond a few years, and it would be difficult to know at issuance whether interest paid on long-term debt will be deductible. To avoid or mitigate this issue, a treasurer may be tempted to issue and roll shorter-term debt. However, this can exacerbate liquidity

---

19 IRC § 163(e)(5).
20 IRC § 483(c)(1)(B).
issues in the event of a credit crisis, among other issues. If there is a concern that the parent jurisdiction is not benefitting from the tax, then the parent jurisdiction can modify its controlled foreign corporation rules and deferral regime to tax such income.

8. Who Should a Rule Apply To? [sic]

**OECD Question 4:** Where do you see issues in applying a 25 percent control test to determine whether entities are related?

80. The IAPT recommends that a 25 percent entity not be included as part of a group for purposes of a group test. A 25 percent owner or an entity with a 25 percent owner may be unable to obtain sufficient information for purposes of modifying consolidated financial statements to determine an interest cap or allocation. Moreover, consolidated financial statements do not include an entity where the parent does not control the entity. The IAPT agrees with the statement in Discussion Draft paragraph 95 that the entities that should be within the group are those controlled directly or indirectly by the ultimate parent.

81. Inclusion of a 25 percent entity in a group could result in confusion as to which interest limitation applies to the entity. For example, MNC businesses frequently use joint ventures to co-invest. If three entities co-invest equally in a joint venture and a group includes an entity where the parent has a direct or indirect interest of 25 percent or more, then the joint venture is theoretically subject to three different interest caps or allocations under a group test.

82. The IAPT recommends that if the OECD recommends a group test as a best practice, a group should include only those entities that are fully consolidated, which are those entities that are controlled by the group and are consolidated as subsidiaries for financial reporting purposes.

9. Group Rule

83. The IAPT does not support a group test as a best practice and believes that the over-breadth of the rule (e.g., double taxation, denial of interest deductions from third party debt) cannot be repaired through modifications.

84. The proposed group rule effectively denies an interest deduction for a group that has minimal or no third party leverage. As described above, an MNC can capitalize its group with equity or debt, and for purposes of debt financing, it can look to other members of the group or third parties to fund operations. A group rule would penalize and deny interest deductions for an MNC with low or no external leverage, and would force such company to obtain additional third party leverage to be able to recognize any interest deductions. However, adding third party leverage would also negatively impact the MNC’s balance sheet.

85. The proposed group rule also conflicts with the BEPS Action Plan’s statement that “there is consensus among governments that moving away from transfer pricing and toward a system of formulary
appointment of profits is not a viable way forward.” The group rule effectively uses formulary apportionment to derive a significant component of the base in computing profits.

86. In paragraph 60, the Discussion Draft notes that group-wide tests in theory have the greatest potential to tackle BEPS using interest. However, as the Discussion Draft recognizes, a broad group approach also has a greater potential for double taxation. A broad group test goes beyond affecting base erosion and will affect legitimate investments and business decisions. To mitigate against double taxation and to accommodate the pushdown of debt, a best practice should include a delay in the payment of withholding taxes that correspond to the denied interest deduction.

87. A group test will create significant uncertainty because it will be impossible to ensure a per entity allocation is met and will work as a disincentive to investment. Tax is only one factor that drives investment, and this proposal will substantially affect where and how businesses make investments.

**OECD Question 7:** Are there any practical issues with respect to the operation of (a) interest allocation rules or (b) group ratio rules, in addition to those set out in the consultation document?

88. Besides being questionable from the standpoint of addressing the BEPS concerns cited in the Action Plan, the two group-wide rules have essentially insurmountable implementation challenges. In order for the interest allocation approach to operate with any kind of coherency and to avoid systematic double taxation and impossible compliance burdens, it would have to be adopted in a highly harmonized form, not only in broad design but also in a myriad of details (e.g., including definition of the group, definition and measurement of interest income and expense and their equivalents, definition and measurement of earnings and assets, definition and treatment of tax exempt items, rules for the allocation of net interest expense among group members, etc., etc.), by most or all countries around the world, and that legislation would need to remain harmonized over time. Moreover, to avoid substantial compliance difficulties for companies (and substantial audit challenges for governments) the definition and measurement of the key elements of the computation just referenced would have to remain very close to those used for purposes of group consolidated financial statements, otherwise groups would need to devise entire new accounting systems to capture the necessary information. The likelihood of either of those factual scenarios prevailing appears close to nil.

89. As for the group ratio approach, the Discussion Draft indicates that countries would have the flexibility of applying their own approaches for determining each of the elements referenced above, which means that MNCs operating in dozens of countries around the globe could face dozens of different sets of requirements for how to do the computations necessary, on both the group-wide and local elements, to determine their interest cap in each country. It does not take much imagination to understand what a compliance nightmare this would be, and the OECD’s experience in working on the CbC reporting portion of Action 13 should have helped to illustrate how fundamentally unworkable such an approach would be.

---

90. It is unrealistic to anticipate that all countries will adopt the same rule and uniform definitions of interest. The potential for additional double tax increases because each jurisdiction has a different definition for interest and interest equivalents for both financial reporting and tax purposes. We agree that the Discussion Draft will need to consider mismatches, especially those that result in double taxation. In paragraph 86, the Discussion Draft recognizes that differences would give rise to double taxation and would also significantly increase costs and administration of an interest rule.

91. Additionally, a group-wide approach incorrectly assumes that borrowing costs are constant across the group regardless of business line, location of an entity, and creditworthiness of an entity. In fact, however, there can be significant variations in those features across the group.

92. Moreover, a group-wide approach would ignore differences in interest rates between countries and result in the denial of the deduction of third party interest. For example, assume Corporation A is tax domiciled in Country X and market interest rates are at 3%. Corporation B is resident in Country Y where interest rates are at 12% (e.g., Brazil). Corporations A and B both have a loan equivalent to 1000 in the group currency, and each represents 50 percent of the group earnings. The third party interest expense reported by the group would be 150 ((3% x 1000) + (12% x 1000)). The group interest allocation rule would result in each affiliate having an allocation of 75 of interest cap based on a share of earnings, when, respecting country interest rates, this allocation should be 30 to Country A and 120 to Country B.

OECD Question 9: Do any difficulties arise from basing a group-wide rule on numbers contained in a group’s consolidated financial statements and, if so, what are they?

93. The consolidated financial statement as a starting point presents a significant logistical challenge because each entity will be dependent on each other and will not know the amount of interest deductible by an entity until there is a final consolidated financial statement. Last minute adjustments could change the balance sheet and make it impossible to forecast how the interest cap would apply on an entity by entity basis in advance of the close of the year. Frequently, there are adjustments/restatements of financial statements in a subsequent year. MNCs are also required to establish or release reserves, and these events could have a significant impact on financial statements. It is unclear how these changes would affect the deductibility of interest.

94. The use of consolidated financial statements ties the local entity to the health of unrelated business activities in other locations for purposes of determining the interest cap. Unrelated events in other jurisdictions could affect earnings and leverage. This will lead to a volatility in the limit and increase the amount and cost of third party debt.

95. In paragraph 136, the Discussion Draft notes that requirements to file entity and group financial statements are determined under local law and entities may be required to file tax returns before financial statements are prepared and audited. This will result in uncertainty regarding the amount of interest that can be deducted at the time the return is filed. The Discussion Draft takes the position that double taxation can be eliminated in most instances if the group moves its debt within the group. That would
require a group and the entities to accurately predict income and deductions without having final consolidated financial statements.

96. The use of financial statements will also create significant non-tax problems for reporting earnings, including quarterly earnings releases, for financial purposes. Part of the profit and loss (P&L) balance sheet is the tax cost, which will be affected by the denial of interest deduction, carry-forwards, and the carry-forward of excess interest cap. The group will need to know at the time of finalizing the consolidated financial statements the amount of tax arising from the disallowance of interest expense. Magnified over several hundred entities, this task will be extremely difficult. It is very unlikely that a medium to large size group will be able to accurately calculate the tax cost, which will call into question the accuracy of the financial statements. By tying the interest deduction calculation to the final financial statement, it will be impossible to provide accurate forecasts to the public and applicable regulatory bodies. Furthermore, as interest deductions would only be known by year-end, it would be very difficult to perform accurate quarterly results announcements (which include taxes and EPS), since the MNC would not know its level of deduction, recovery, and effective tax rate before year-end.

97. From an administrative perspective, it is unclear how tax authorities will examine an entity’s claim of an interest deduction. Will tax authorities audit consolidated financial statements and make further adjustments? Will countries share adjusted financial statements for purposes of ensuring consistency? This could create significant additional costs for MNCs.

**OECD Question 21:** Could all types of timing mismatch be addressed through carry forward provisions (disallowed expense and/or unused cap)? What other approaches could be taken to address timing mismatches?

98. While an unlimited carry-forward of disallowed expense and unused interest cap will not address all timing issues, it will mitigate some of the short term timing issues, such as a mismatch in the year of recognition of an item of income or deduction, so long as the entity’s proportionate share of earnings or assets increase. There could be many differences between the tax return and consolidated financial statements. Some of the differences are temporary while others are permanent. There are also differences between US GAAP and IFRS (e.g., GAAP and the US Internal Revenue Code permit the last-in, first-out method of accounting for inventories, while IFRS does not), as well as differences among countries in their interpretation of IFRS. IRS Schedule M-3 lists some of the potential differences between US financial statements and income tax returns for corporations with total assets of $10 million or more.

---

23 Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President’s Fiscal Year 2015 Budget Proposal* (JCS-2-14), December 2014, at 23.
OECD Question 14: Do any particular difficulties arise from asking groups to identify entities with positive and negative earnings balances? What other approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?

99. Losses are a very significant issue, especially for capital-intensive industries. One way to address losses is to provide an election that would allow a capital-intensive business to use assets as a measure. An entity could then elect in a future year to return to an earnings approach where a percentage of earnings may accurately address the entity’s share of the debt cap.

100. An earnings approach may produce odd results in a jurisdiction where an MNC is investing in new facilities and may not have earnings that will allow the entity to deduct the interest that reflects its contribution. For example, assume an oil and gas company decides to explore in a new jurisdiction. The company receives a loan from its parent (which has a tax rate equivalent to the tax rate of the company’s) and uses the loan to purchase equipment and fund payroll. In the first two years, the exploration is not successful, but in year 3 the efforts are successful. When compared to the rest of the group, the company receives little or no interest cap, and as a result, cannot deduct the interest expense it incurred to fund the exploration. The company will have a carry-forward for years 1 and 2. As the earnings of the company increase, its cap may increase so long as its earnings increase in relation to the rest of the group. Otherwise, the company will be penalized for using debt financing and may never get a deduction for the interest it paid.

OECD Question 16: What specific issues or problems would be faced in applying a group-wide rule to a group engaged in several different sectors? Would an assets or earnings-based approach be more suitable for this kind of group?

101. The IAPT recommends that if a group test is adopted, each entity should be able to elect whether an assets or earnings approach should apply.

102. The cost of borrowing will vary by location, while the group test assumes a constant borrowing rate across the group. Different businesses have different interest ratios and different income expectations. High earnings activities would be able to use greater leverage, while lower margin activities may be denied deductions. An asset approach may not be adequate because it could over-allocate interest cap to those entities that are unable to use interest deductions.

103. Geographic business variation could affect the interest cap. For example, Company C is resident in Country M, and Company D is resident in Country O. A third party loan is obtained in year 1, and the expectation at the time of the loan is that Company C and Company D would have equivalent earnings. While Company C performed as expected, Company D greatly exceeded the estimated earnings. As a result, Company D will have a larger share of the earnings and a larger share of the interest cap. The interest cap for Company C decreased due to Company D’s earnings, and Company C will lose the deduction for some of its interest.

104. Similarly, geographic variation could be impacted by currency fluctuations and unforeseen changes to interest rates. For example, Corporation A is the parent of a group and is tax domiciled in
country X. Corporation B is a subsidiary of Corporation A and is resident in Russia. Corporation A took a loan in year 1, and the expectation at the time of the loan was that earnings in Country X and Russia would be equal. In year 2, the currency in Russia decreases in value, and interest rates significantly increase. The interest rate on the loan from Corporation A to Corporation B resets each quarter based on the average Russian interest rate. Assuming earnings are constant among the group, Corporation B’s interest expense in year 2 significantly increased due to the currency and interest rate changes. However, because its earnings did not increase with relation to the group, the interest deduction attributable to such changes is denied.

105. As the Discussion Draft recognizes in Section XIII, banks and insurance companies present unique issues that do not arise in other sectors. These entities ordinarily have net interest income (see Discussion Draft paragraph 205). As a result, the IAPT recommends that banks and insurance companies within a larger MNC group should be tested separately or excluded from any group-wide test because they are regulated businesses, and the ability to utilize self-help for such companies will be limited by government regulations.

106. In paragraph 107, the Discussion Draft notes that where interest expense is tied to the level of earnings, a group can only increase net interest deductions in a particular country by increasing earnings in that country. This will deter investment in special projects and discourage long term investments in a country where there are not already significant earnings. Moreover, it may take years for such investments to result in interest deductions in the country where such investments are made.

OECD Question 11: What approach to measuring earnings or asset values would give the most accurate picture of economic activity across a group? Do any particular difficulties arise from this approach and how could these be addressed?

107. In paragraph 105, the Discussion Draft notes that the level of earnings in different entities is “usually the clearest indicator of value creation across a group, though there may be exceptions to this…” There are several instances where this assumption is incorrect. Earnings or asset values will not reflect economic activity where an entity is entering a new market, increasing its research budget, and exploring for new resources. A recession, currency fluctuations, and the costs of doing business in a jurisdiction affect earnings and asset values. Further, the business cycle (from introduction of the product to end of life of a product) also affects both earnings and asset values.

108. For capital-intensive industries, assets or deployed capital may be a better indicator of economic activity by entity and across the group.

OECD Question 12: Are there any other difficulties in applying an earnings-based or an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

109. An asset approach will be difficult because it is hard to value resources and other hard to value assets.
OECD Question 15: Where an entity’s earnings or asset values need to be converted into the currency used in the group’s consolidated financial statements, what exchange rate should be used for this conversion?

110. Where a group prepares consolidated financial statements, each member entity’s earnings and assets will typically have to be converted from local currency into the group currency in order to roll those amounts up into the group statements. Those conversions are typically done under applicable accounting conventions. Asset values are generally determined at year-end, and to the extent entity asset values are translated from local currency to the group currency, the conversion applies the rate at the end of the year. Local entity earnings are generally translated to the group currency applying a weighted average exchange rate for the year.

111. It is the IAPT’s understanding that the group elements of the formula needed to apply the interest allocation approach (i.e., group net interest expense and group earnings or assets) would be based to the extent possible on the information in the group consolidated financial statements and would therefore be in the group currency. The Discussion Draft indicates that each group company would calculate “its allocation of part of the group’s net third party interest expense, determined based on the ratio of its earnings or assets to the group’s total earnings or assets”. In other words, it would multiply the group net third party interest expense (A) times a ratio of which the numerator is its earnings or assets (B) and the denominator is the group’s earnings or assets (C): so, A times B over C. While elements and A and C would definitely be in the group currency, it would seem that element B could be expressed in either the original local entity currency or in the group currency (in the latter case, presumably using the same translation convention as was used to roll that element up into the consolidated financial statement). If element B was expressed in the original local entity currency, application of the formula would produce an interest cap for the entity expressed in the entity’s local currency. If element B was expressed in the group currency, application of the formula would produce an interest cap for the entity expressed in the group currency, and that number would have to be translated back into the local currency to determine the maximum deductible interest in that jurisdiction. In that case, it would seem appropriate to do that retranslation back into the local currency using the same exchange rate that was used to translate the relevant element B (i.e. entity earnings or assets) into the group currency in the first place. We note, however, that even applying appropriate conventions for selecting exchange rates for currency translations would not solve the interest rate issue described above in paragraph 92.

OECD Question 18: Do any particular difficulties arise from the application of a group-wide allocation rule to groups with centralized treasury functions? If so, what are these difficulties and do they vary depending upon how the treasury function is structured and operates?

112. Cash pooling, treasury centers, and group finance companies can easily become subject to double taxation; once again, penalizing MNC groups and benefiting purely local enterprises.

113. In many MNC groups, the group financing structure is not simply the ultimate parent company borrowing from third parties and on-lending the funds directly to operating members of the MNC group to fund their capital needs. Typically an MNC group will have specific members that provide
cost-efficient working capital financing for the rest of the MNC group. These treasury center companies often will manage foreign exchange needs for the operating companies. Longer-term loans to finance new investments by subsidiaries may come from the treasury center or may come from other MNC group members that perform that function. It is not uncommon for the MNC group to manage its foreign exchange exposures such that the treasury center and finance companies bear the foreign exchange exposure rather than the operating subsidiaries.

114. Under OECD transfer pricing guidelines, these treasury centers and finance companies should operate on an arm’s length basis and the local taxing authority will expect that they earn a profit by charging more for the loans they make than what they pay in interest expense. By seeking to limit group interest expense to third party net interest expense, the taxable margins in group finance companies should result in double taxation because that additional financing cost paid by the operating companies would become non-deductible.

115. Because financial assets are excluded in the group tests, no treasury center or finance company will ever be able to deduct any interest expenses because their interest caps would be zero. Especially at the very low current interest rates in many countries, the foreign exchange exposure often significantly outweighs the interest and losses are a reality. This is particularly troubling for MNC group finance companies that make long-term loans to related operating companies because the foreign exchange rates can move significantly over the longer term of these loans. For example, suppose that at loan maturity a finance company has a large foreign exchange loss that is 50X the amount of the interest earned on the loan in its final year. An indefinite carry-forward has limited value for the finance company if its net interest expense cap is perpetually zero. If instead there was foreign exchange gain on loan maturity, that gain would be fully taxable when realized. Typically, most MNC borrowing at the parent level is in the parent country’s functional currency such that there is no foreign exchange exposure on the external debt. The foreign exchange solely exists on the intercompany loans. Looking solely to third party external interest without taking into account the group forex exposures understates the true cost of financing the MNC group.

10. Fixed Ratio Test

116. The IAPT makes the following observations regarding data cited in the Discussion Draft with respect to the appropriate level of a fixed ratio test. A net interest to EBITDA ratio limitation should not be set at 10 percent until there is further evidence studying different types of entities (e.g., small, midsize, and other large groups; diverse industries in each size group) and those ratios relied upon by third party lenders in deciding whether to lend and the terms of the loans. The evidence cited by the Discussion Draft does not support a net interest to EBITDA ratio of 10 percent. Moreover, a fixed ratio test will need to address the change of financing over the business cycle, currency fluctuations, and interest rate changes.

117. The Discussion Draft’s analysis of third party interest of large MNCs in Box 4 does not reflect how all other MNC groups fund their investments. The sampling is skewed to the 100 largest corporations and does not reflect a cross-section of the economy. These entities are the largest businesses and have the most flexibility in raising capital through equity. Smaller businesses typically have greater
leverage and are less attractive to equity investors. We recommend a study of a larger cross-section of MNC businesses.

118. There has been significant work in the area of fixed ratio tests that is not included in the Discussion Draft. For example, the OECD studied thin capitalization issues in 1987 and observed that a high debt to equity ratio may be an indication of an effort to achieve tax advantages by a disproportionate use of debt. Alternatively, a high debt to equity ratio could be the consequence of decisions taken for purely commercial or economic reasons and not to obtain tax advantages. Similarly, the United States Department of the Treasury studied earning stripping by analyzing more than 65,000 tax returns in a variety of industries. Ultimately, the Treasury concluded that it was unable to conclude that there was earnings stripping by non-inverted companies and was unable to make estimates about the amount of earnings stripping or draw firm conclusions regarding whether and how to address the issue for non-inverted companies.25

**OECD Question 25:** What would be the appropriate measure of asset values or earnings under a fixed ratio rule?

119. The IAPT recommends providing an entity with an election to use asset values or earnings in order to take into account each entity’s unique facts, such as industry, business cycle, and location.

**OECD Question 26:** For what reasons would the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios of its worldwide group?

120. See paragraphs 102-104 for examples of why interest to earnings or interest to asset value ratios for an individual entity may significantly exceed the equivalent ratios of its worldwide group. Changes can include currency fluctuations, interest rate increases, and credit rating deterioration.

**OECD Question 27:** Would a fixed ratio rule pose particular problems for entities in certain sectors? If so, which sectors would be affected and how could this be addressed?

121. With respect to a fixed ratio rule, the IAPT notes that it will generally be difficult to value assets by either book value or fair market value. As a result, a fixed ratio test should rely on earnings or otherwise allow a taxpayer to elect to apply either interest to EBITDA or interest to assets.

**OECD Question 28:** What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?

122. The actual interest to EBITDA ratios will greatly vary depending on economic conditions, credit ratings, cost of borrowed capital, business cycle, sector, and other factors that are driven by non-tax factors. The Discussion Draft notes in Box 3 that several countries have interest to EBITDA ratios of 30

---

percent, but dismisses these as too generous. However, these rules were enacted by legislative bodies in a deliberative process, and they reflect an attempt to address different industries, business cycles, and sizes of entities. An interest to EBITDA ratio should be reasonable and not so low as to create significant double taxation and to cover a range of groups (e.g., a variety of industries, groups that tend to have more leverage), while at the same time it should be calibrated to address aggressive base erosion. Also, a ratio should be designed to take into account a range of interest rates, especially since interest rates are at record lows in many jurisdictions. More study should be given as to whether a 30 percent interest to EBITDA ratio is sufficient to address “excessive interest deductions.” We also note that the European Commission collects significant data on businesses and could study whether such companies’ borrowing inappropriately gives rise to “excessive interest deductions.” Similarly, the US Department of the Treasury collects robust data regarding business taxpayers and could undertake a study to determine if non-inverted businesses engage in earnings stripping or other base eroding techniques through the use of interest deductions.

123. A fixed ratio test should take into account variation in interest rates by jurisdiction. Moreover, it should take into account borrowing rates over time. It is important to note that borrowing rates in recent years have been at an historic low in many jurisdictions. Indeed, in some major currencies, interest rates over the past several decades have greatly exceeded (sometimes by multiples) the rates seen in the most recent years (i.e., the years from which the Discussion Draft drew its data). Examples of this can be seen in the following charts, showing AAA corporate bond rates from 1976 to 2014 as reported by the US Federal Reserve Bank:

---

26 Germany, Greece, Italy, Norway, Portugal and Spain currently have a 30 percent of taxable EBITDA test. Finland has a 25 percent of EBITD, and the United States has 50 percent of adjusted taxable income (EBITDA with modifications). While the Discussion Draft states that “anecdotal evidence” indicates the number is high, the Discussion Draft does not cite evidence that the ratio as calibrated creates or facilitates base erosion and profit shifting.

and Bank of England interest rates since 1991:\(^\text{28}\).

<table>
<thead>
<tr>
<th>Bank of England interest rate changes</th>
</tr>
</thead>
</table>
| Roll over the bars to see interest rate ...

124. Setting a ratio test too low, based on aberrational data from a period of unprecedented lows in borrowing costs, could have the unintended effect of denying interest deductions when interest rates increase to more normal levels.

\(^{28}\) Available at http://www.theguardian.com/business/interactive/2008/oct/07/interestrates.creditcrunch.
11. Combined Approach

OECD Question 29: What particular issues arise for groups if a combined approach uses (a) the same measure of economic activity in a general rule and a carve-out or (b) different measures of economic activity? In particular, what issues arise where a carve-out uses a test based on (i) earnings, (ii) asset values or (iii) equity?

OECD Question 30: A combined approach should provide an effective solution to base erosion and profit shifting using interest, while allowing lower risk entities to apply a simpler test. What other options for combined approaches which meet this objective should be considered as possible best practices?

125. A combined approach will require a group to perform the group method. The group method based on financial statements is sufficiently complicated and uncertain. A combined approach with a group test would be extremely difficult if it is adopted by just a few countries.

126. The IAPT believes that a well-calibrated thin capitalization rule or reasonable ratio test could address base erosion through interest payments. If the preferred design option is a combined test, then the IAPT urges Working Party 11 to consider the general framework of section 163(j) of the US Internal Revenue Code. Under section 163(j), disqualified interest is disallowed if a corporation has excess interest expense in a taxable year (excess interest expense is defined as the excess of the corporation’s net interest expense over the sum of 50 percent of EBITDA (with modifications) plus any excess limitation carry-forward) and the debt to equity ratio of the corporation exceeds 1.5 to 1).\(^{29}\) Disqualified interest generally applies to certain related party indebtedness. The debt to equity ratio and percentage of acceptable interest could be calibrated. However, this test is relatively easy to administer and does not require multiple calculations based on the performance of the group to determine whether interest expense deductions will be allowed. Moreover, the test is narrowly calibrated to primarily apply to related party interest that is “excessive”.

12. Targeted Rules

127. While the IAPT agrees that there may be a need for targeted rules to address particular situations, we would like to make a few observations in this regard.

128. First, a layering of general and multiple targeted rules can create a great deal of complexity, lack of certainty, cost of compliance, and potential double taxation, and countries should weigh carefully the need to pile rules on top of one another to address similar problems. As a related point, where there are multiple rules, it is critical to think carefully about the order in which they apply and to be very clear about that.

129. Second, thought needs to be given to how the rules interact with one another. For example, the Discussion Draft implies that many of the problems of a group-wide rule (in terms of risk of double taxation, inability to deduct the entirety of a group’s net third party interest expense) can be addressed

\(^{29}\) Other countries with similar rules have different debt to equity ratios, such as Korea (2 to 1); Russia will move to a 3 to 1 ratio for banks (12.5 to 1 for leasing companies) in 2016.
through “self-help”, meaning the group can do internal on-lending to spread the amount of the third party interest expense across the group members. A theoretically straightforward way of doing that, without completely altering the capital levels of individual group members, would be to alter the mix of group members’ capitalization (e.g., to replace equity with debt to the extent necessary to achieve the right proportions across the group). However, the Discussion Draft suggests the need for a targeted rule to attack “artificial” debt, “where no additional funding is in fact raised by the borrower”. Such a targeted rule would seriously impede the ability of a group to engage in the kind of self-help contemplated by the Discussion Draft.

130. Third, thought needs to be given to how other BEPS Action Items can address some of the issues described in the section on targeted rules. For example, the Discussion Draft is vague on what scenarios it is talking about when it mentions “routing of funds through intermediate entities to obtain tax benefits”, but if those tax benefits are related to treaty withholding tax relief, the solutions under Action 6 should address that problem and no additional mechanism in the form of an interest denial is warranted.

131. With respect to the use of debt to fund tax exempt or tax deferred income, we suggest that this problem should be addressed exclusively by a targeted rule. In other words, we do not believe it makes much sense to eliminate tax exempt income from an earnings measure (or to eliminate assets generating tax exempt income from an assets measure) in calculating the ratios under the group tests. Doing so would potentially lead to shifting more interest expense to other jurisdictions. Once the allocation is done, it should be up to each jurisdiction to decide whether the interest expense allocated to its jurisdiction should be denied on the grounds that it is funding tax exempt income or investments of its local entity.

13. **The Treatment of Non-Deductible Interest Expense and Double Taxation**

**OECD Question 32:** To what extent could a carry forward of disallowed interest or unused capacity to deduct interest help to smooth the effects of a general interest limitation rule?

132. The IAPT believes that an unlimited carry-forward of disallowed interest and a carry-forward of unused capacity should be included in any proposed rule. Additionally, a best practice should also include a modest carry-back for disallowed interest expense. Such rules may reduce double taxation related to the disallowance of deductions. However, a carry-forward of disallowed interest or unused capacity would not eliminate double taxation, as if the carry-forward is limited, then it is possible that a group member may never have the opportunity to deduct bona fide third party interest. Moreover, the carry-forward ignores the time value of money of the deduction and does not address different borrowing costs throughout the group. Of greatest importance, a carry-forward does not provide certainty for purposes of forecasting quarterly earnings per share. A cap based on financial statements in combination with a carry-forward will make it impossible to accurately forecast the balance sheet and quarterly earnings per share.

**OECD Question 33:** Working on the assumption that countries would like to limit carry forwards in terms of the number of years what would be the issues presented by say a five year limit? If this does present problems what are they and how and when do they arise?
133. In the context of a group or combined rule, the ability to use interest in a carry-forward depends on the entity increasing its share of earnings of the business as a whole during the period in which a carry-forward may be used. An entity may not have control over its share of earnings relative to other members of its financial group, and the many factors could affect an entity’s ability to increase its share of third party interest expense, including the business cycle, location of the entity, line of business, maturity of market where the entity is located, and the growth of other members in the group. In the case of a ratio approach, the above factors may affect whether an entity will be able to use disallowed interest.

14. OECD Model Tax Convention

134. Notwithstanding the proposal for carry-forward relief, the Discussion Draft’s options for a best practice general interest limitation rule are clearly capable of giving rise to double or multiple taxation as they contain no mechanism for non-inclusion of interest income in respect of which a deduction has been disallowed or other corresponding adjustment. In the absence of effective domestic rules to eliminate double taxation, recourse must be had to an applicable double tax treaty (if any) to obtain relief for double taxation. However, the Discussion Draft does not address whether any of the options for a general interest limitation rule are compatible with the provisions of bi-lateral double tax treaties or, to the extent of any incompatibility, how this should be addressed at a bilateral or domestic level, although there is limited discussion (see Section XII) on elimination of double taxation by recharacterising disallowed interest as a dividend (apparently not a preferred option in the Discussion Draft) or the carry-forward of disallowed interest/unused capacity to deduct interest. An analysis of treaty compatibility issues should be done by the OECD as part of the ongoing work on Action 4 and be fully taken into account in framing the final best practice recommendations. These issues concern the treaty obligations of countries and cannot in our view be ducked if the goal of Action 4 (as stated in the BEPS Action Plan) is to provide “… a fundamentally new set of standards designed to establish international coherence in corporate income taxation”.

135. In terms of the OECD Model Convention, the Discussion Draft’s options for a general interest limitation rule potentially raise specific issues as to its compatibility with the provisions in Articles 9, 10, 11, 23, 24 and 25, in particular the requirement imported by Article 9 for related party lending that any interest limitation rule be compatible with the arm’s length principle. As previously noted, the options proposed in the Draft for a group-wide rule and a fixed ratio rule represent a significant departure from the OECD’s long-held support of this principle as embodied in the international standards which it has been instrumental in developing.

136. We note with interest, for example, that the work done on the attribution of profits to permanent establishments under Article 7, which resulted in a final report on that topic published in 2010, addressed the question of how to attribute equity capital (and consequently, debt) to the permanent establishment of a single enterprise. That Report concluded that even within a single entity, there were multiple acceptable ways of determining how much debt should be able to be taken into account at each location, including both a capital allocation approach (allocating the “free” capital of the entity across its locations based on a risk-based formula) and a thin capitalization approach (comparing the PE to similar local enterprises). The Report explained that the capital allocation approach was appropriate for a single entity, but not for a
group of associated enterprises, on the grounds that all the assets of the entity could potentially be used to satisfy the entity’s debt, whereas that was not the case when one looked at the debt of a separate entity within a group. Even in the case of the capital allocation method described there, the Report noted that there could be valid reasons for departing from a strict formulaic allocation to take into account particular situations (e.g., regulatory issues, a cash build-up to fund an acquisition, etc.). The Discussion Draft represents quite a radical departure from the principles described there.

137. To the extent that any recommended best practice interest limitation rule is determined in the course of the Action 4 work to be incompatible with any bi-lateral double tax treaty provisions this should be addressed not only in the Action 14 work on making dispute resolution mechanisms more effective (as acknowledged in paragraph 229 of the Draft) but also in the Action 15 work in developing a multilateral instrument to enable jurisdictions to amend their bilateral tax treaties as necessary (which is not mentioned in the Draft).

15. EU Law Concerns

138. The Draft acknowledges that a consistent international approach to interest deductibility is unlikely to be effective unless it can be fully implemented in the EU and that further consideration needs to be given to the design of interest limitation rules that are in accordance with EU treaty freedoms, Directives and State aid rules. We agree with this: it is essential that a full and transparent analysis of the EU law issues is undertaken, with input from the European Commission, and published by the OECD, in order for any final best practice recommendations to be, and to be seen to be, compliant with EU law. In addition, it is essential that any EU-law compliant interest limitation rule is framed so that it takes into account the key policy aims discussed in Section II A of the Draft. It would be highly unfortunate if, for example, such a rule results in more risk of double taxation and/or greater compliance costs for groups than would have been the case with an interest limitation rule which took no account of EU law issues/constraints. This comment should not, however, be read as support for an outcome whereby there are two interest limitation rules, one for EU affiliates in a group and another for non-EU affiliates. Such an outcome would be fraught with even more complexity and double tax risk than a single global EU law-compliant rule.

139. In this section, we discuss some of the key EU law issues and constraints that will need to be addressed as part of the ongoing work for Action 4, particularly in relation to any group-wide rule or fixed ratio test.

d. Freedom of establishment

140. Regarding freedom of establishment (and free movement of capital), it should be noted first that the Court of Justice of the European Union (“CJEU”) has recently held that an interest limitation rule which restricts this freedom can only be justified by the need both to (a) preserve the “balanced allocation” between EU Member States of power to impose taxes (i.e. whereby Member States are entitled to prevent conduct which would undermine their rights to exercise tax jurisdiction in relation to activities carried out
in their territory) and (b) prevent tax avoidance and combat artificial arrangements. The CJEU was not prepared to justify the restrictive domestic tax legislation in that case on the basis of the “balanced allocation” justification alone. The Discussion Draft (see paragraph 231) states, however, that either (a) or (b) is a sufficient justification.

141. We do not consider that the alternative group-wide rules or the fixed ratio rule, as outlined in the Draft, can be justified on the basis of the above CJEU-approved test in that they are plainly capable of applying to a wide range of third party and intra-group debt financing arrangements which are not wholly artificial (see further comments in paragraph 143 below).

142. In order for the proposed interest limitation rules in relation to intra-group debt not to constitute a restriction on the freedom of establishment they would have to apply not only to cross-border loans between EU affiliates but also to loans between affiliates in the same Member State. This extension of the rule would impose a substantial additional compliance burden not only on multinational but also on purely domestic groups, often with no net increase of tax revenues for the Member State concerned. Domestic groups which benefit from a full tax consolidation (e.g. fiscal unity) regime may not suffer any additional compliance burden, but in that case the interest limitation rule would effectively discriminate against MNC groups given the greater compliance burden in respect of cross-border borrowing transactions.

143. If, however, the interest limitation rule only applies to cross-border intra-group loans, the CJEU has also repeatedly held that this restriction on the freedom of establishment is only permissible if it is proportionate (as well as justifiable) to combat tax avoidance through the use of wholly artificial arrangements, i.e. the interest limitation rule must not go beyond what is necessary and appropriate to prevent “abusive” arrangements. The alternative general interest limitation rules proposed in the Draft do not address this important issue and in our view would fail this proportionality test. Their effect would, again, be to discriminate against MNC groups compared to purely domestic groups which would not be subject to the same compliance burden.

144. The comments in the two preceding paragraphs serve to emphasise the point that the CJEU will look at the practical effect and not the particular form of the relevant interest limitation rule in determining whether it is compatible with the freedom of establishment.

145. Even if it is determined that the intra-group loan is wholly artificial (i.e. contrived and with little or no commercial justification), it is clear from recent CJEU case law that interest relief should only be disallowed under a justified restrictive domestic rule in respect of excessive interest charges applying the arm's length principle.

30 Société de Gestion Industrielle SA (SGI) v. Belgium (c-311/08) [2010] 2CMLR 1017.
31 For example, NV Lammers & Van Cleef v. Belgische Staat (C-105/07) [2008] ECR I-173.
32 For example, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue (C-524/04).
e. **Free movement of capital**

146. Regarding the free movement of capital (which applies to transactions between an EU entity and a non-EU entity which are not affiliated), the CJEU has recently held that this freedom precludes a Member State from denying interest relief in the absence of a shareholding relationship where the interest limitation rule presumes (without any facility for verification) that the borrower's overall indebtedness forms part of a tax avoidance arrangement.\(^{33}\) This casts significant doubt on whether any fixed ratio interest limitation rule which applies to loans by non-EU third parties to an EU borrower in a group is compatible with the free movement of capital.

f. **EU Directives**

147. Subject to one exception, neither the EU Parent-Subsidiary Directive nor the EU Interest-Royalties Directive include provisions to eliminate double taxation arising in respect of disallowed interest paid by a company in one Member State to an affiliate in another. The exception is that, under the EU Parent-Subsidiary Directive, excessive interest paid by an EU company to its immediate EU parent company which is re-qualified as a (non-deductible) dividend in the source country is not taxable in the hands of the parent. Any recommended group-wide or fixed ratio interest limitation rule should therefore be framed so that the benefits of the Directive can apply in respect of interest paid among EU affiliates. More broadly, the European Commission will need to consider an extension of one or both Directives to eliminate double taxation in respect of disallowed interest paid by an EU borrower to a lending affiliate in another Member State which is not its immediate parent.

g. **EU State aid**

148. We agree that EU State aid issues may come into play if any general (or targeted) interest limitation rule is so framed as to be excessively generous and provide selective advantage to certain taxpayers in the EU. For the IAPT, a particular focus in this area will be on capital intensive industries, for example oil and gas and mining companies which may be subject to special tax régimes under which no relief for interest is available at all. A specific carve-out is clearly needed from any group-wide interest limitation rule to ensure that otherwise deductible interest expense is not allocated to affiliates which are subject to that type of régime. In our view, the carve-out should be able to be framed to avoid any EU State aid issues. For this reason, the rule should be designed in consultation with the European Commission in order to preclude any possibility of any future State aid infringement proceedings.

APPENDIX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION (IAPT)

COMMENTS ON BEPS ACTION PLAN

OCTOBER 16, 2013
IAPT Comments on BEPS Action #4 (Limit base erosion via interest deductions and other financial payments)

**Action 4 - Limit base erosion via interest deductions and other financial payments**

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.

As part of the wider effort to establish international coherence of corporate income taxation, Action item #4 is mainly concerned with “excessive” interest deductions incurred in one country to “inappropriately” reduce the earnings base of the debtor without a corresponding interest income inclusion in another (inbound financing) and the use of tax-deductible debt to “inappropriately” finance deferred or exempt income (outbound financing). The IAPT is unclear what tests (if any) the OECD has in mind to apply the concepts of “excessive” and “inappropriately”. In any event, insofar as the objective here is more symmetrical and consistent tax treatment of debt in a cross-border context, the IAPT would support this objective if it encourages more simplicity and certainty in the design and operation, internationally, of corporate income tax rules relating to debt. However, this must be balanced against and respect the rights of individual jurisdictions to make tax policy choices in their national interest; international coherence in corporate income taxation is not necessarily undermined just because one country chooses to have a more (or less) generous regime for taxation or relief of interest than another. Equally, the IAPT fully supports Action item #4’s objective of improved transfer pricing guidance for related party financial transactions if this means more simplicity, certainty and consistency in how to apply the arm’s length principle (ALP) in a wide range of circumstances. Finally, the IAPT supports the September 2015 timeline for this Action given the complexity of the issues to be addressed and their interaction with other BEPS Actions.

The remainder of this note focuses on some more specific issues which will need to be considered in order to develop recommendations for best practices in the design of rules to prevent base erosion through the use of interest and other forms of deductible financial expense.

**Commercial rationale for the use of debt**

1. The IAPT considers that it is essential not to lose sight of the commercial reasons for using debt as opposed to equity financing. It is axiomatic that the legal attributes of debt compared to share capital are in general significantly different, particularly in terms of the rights and objectives of
the issuer and holder. These differences can be even more pronounced in regulated sectors of the economy. As a general proposition, debt is also more flexible from a legal standpoint than equity. These considerations will frequently be the main or only driver for groups to finance their operations and investments with debt rather than equity. In addition, it is well established that the tax treatment of debt and equity should reflect these real and important legal and commercial differences. The IAPT strongly encourages the OECD not to develop recommendations for best practices in the design of rules to prevent base erosion through the use of interest expense which fail to recognise such differences and which may consequently impede cross-border trade and investment.

**Inbound debt financing**

2. It will be necessary to consider in what circumstances (and why) interest deductions should be regarded as “excessive”, or any corresponding lower or no income inclusion should be deemed “inappropriate”, even though the financing arrangement complies with the transactional ALP. The IAPT notes that application of the ALP to related party financing arrangements has as a fundamental purpose the creation of a level playing field between businesses transacting with related and unrelated parties, as part of an overall framework of preventing unequal tax burdens from distorting efficient allocations of capital and investment. As recognized by the incorporation of the ALP into the non-discrimination obligations of bilateral tax treaties, this purpose is closely tied to objective of ensuring comparable treatment of local and cross-border businesses, again with a view to eliminating distortions and maximizing general welfare.

3. It is therefore appropriate to consider what factors would warrant treating arm’s length borrowing arrangements as “excessive”. For example, would this be the case in the following circumstances, and if so, why?

   (a) where the amount of inbound debt (related party and / or third party) exceeds external group or financing charges debt in absolute and / or proportionate terms 34;

   (b) if there is a preferential tax regime specifically for related party interest income in the lender jurisdiction (e.g. group “interest box”)

   (c) if lending is made by a third country resident through an exempt foreign branch in a jurisdiction which imposes a lower (or zero) rate of tax than the borrower jurisdiction 36;

---

34 The UK’s “debt cap” rules introduced in 2009 are an example of such a limitation (see Taxation (International and Other Provisions) Act 2010 Part 7). The intended target of these rules are foreign multinationals that are considered to have over-leveraged their UK subsidiaries and UK multinationals which have significant upstream loans from their foreign subsidiaries.

35 This type of regime should also be considered in the context of Action #5 (Counter harmful tax practices more effectively), although within the EU it has generally been challenged with success by the EC Commission.

36 So-called “anti-triangulation” provisions already exist in a number of US double tax treaties to deny treaty benefits in the case of this type of arrangement.
(d) where the loan is treated as a non-debt (hybrid) instrument which generates exempt interest income (see also Action item #2);

(e) where the general corporate tax rate (nominal) in the lender jurisdiction is significantly lower than in the borrower jurisdiction; and

(f) if there is a difference between the effective rates of tax (applying general corporate tax rates) in the lender and borrower jurisdictions as a result of generally available tax attributes (e.g. NOLs) in the lender jurisdiction?

4. It will also be important to consider in what situations should statutory thin capitalisation or interest “barrier” rules be regarded as a form of best practice to prevent base erosion through interest deductions, and whether or not such rules comply with the transactional ALP. In particular, it will be useful to consider whether such rules give proper regard to the range of factors that a third party lender would take into account in deciding whether to provide financing on similar terms. This raises the broader point whether there should be different best practices for different countries, taking into account different conditions and industry sectors with each country.

5. As a form of best practice to discourage base erosion through “excessive” interest deductions, thought should be given as to whether there is a case for equity finance relief (e.g. an “allowance for corporate equity” or “notional interest deduction” to achieve partial or total equivalence of tax treatment with debt finance) and what best practice design principles should such a relief observe.

Debt financing of outbound investment

6. The OECD should carefully consider and define the circumstances in which it can be argued that debt financing is used “inappropriately” to reduce the earnings base of the borrower or finance deferred or exempt income. For example, is this only where a foreign affiliate of the borrower is over capitalised based on the ALP or other appropriate financial measure? Alternatively, would this be the case whenever debt is used, directly or indirectly, to fund the foreign shares or other assets which generate deferred or exempt income and where the interest can be deducted against

37 In general, this refers to statutory rules which deny or allow interest relief based on fixed “safe harbour” ratios. Many countries have adopted such rules (e.g. Australia, France, Germany and the US) which vary widely although they are generally intended to serve as a rough proxy to determine whether or not a borrowing arrangement is at arm's length. Other countries, for example the Netherlands and UK, do not have statutory thin capitalisation/interest “barrier” rules and apply the ALP on a case-by-case basis to deal with related party debt.

38 See, for example, the Belgian notional interest deduction rules which have been progressively restricted in recent years. In the UK, the House of Lords has recommended that the possible introduction of an allowance for corporate equity should be considered in order to harmonise the tax treatment of debt and equity finance, see Report of the Select Committee on Economic Affairs (31 July 2013) on “Tackling corporate tax avoidance in a global economy: is a new approach needed? ”, paragraphs 57-64.
domestic profits of the borrower? An important practical question in this context is how, given that money is fungible, one should determine when interest expense is properly "allocable" to exempt foreign income. Does this require a strict tracing approach or is a more formulaic approach justifiable?

Other considerations

7. Work undertaken to evaluate the effectiveness of different types of interest relief limitations should take proper account of the particularities of the wider legal and corporate tax systems in which they sit (e.g. worldwide or territorial) and should respect legitimate tax policy choices (e.g. to promote investment and growth) made by sovereign countries. Furthermore recommended international best practices for the design of interest relief limitation rules should recognise the primacy of the ALP.

8. For loans that satisfy the ALP, it is important to ascertain why relief for interest expense should be restricted if the only reason the interest income is taxed at a low rate is due to the fact the lender is established in a jurisdiction that has a low general rate of corporation tax.

9. Recommendations should also take into account how effective the existing plethora of finance-specific anti-avoidance rules in many countries really are, such as the UK’s unallowable purpose rule, and the difficulties that such finance-specific anti-avoidance rules present.

10. Consideration should be given to how transfer pricing and thin capitalisation rules will interact with other rules designed to limit intra-group finance deductibility and how the transfer pricing guidelines must be best developed in the area of related party financing.

11. As noted in Action item #4, it is also important to consider the interaction with other areas of focus, including hybrid instruments and CFC legislation.

12. Recommendations should ensure that that non-discrimination obligations in bilateral DTAs and multilateral treaties (n.b. the EC and EEA Treaties) are not infringed by limiting interest relief for cross-border debt finance but not for comparable domestic debt.

13. Finally it is important to note that the recommendations should be compatible with the free movement of capital within the EU / EEA.

Conclusions

14. Recommended best practices for the design of rules to limit interest relief are to be welcomed insofar as they result in (a) greater simplicity, certainty and consistency in the operation of such rules in different countries and (b) no double taxation. Subjective/vague new tests for

39 See, for example, the participation interest limitation rule in the Netherlands which applies from 1 January 2013 and seeks to limit relief for “excessive” interest paid by a Dutch company with respect to debt used to finance assets which generate income covered by the participation exemption.
disallowance of interest relief, such as “excessive” or “inappropriate”, should be avoided at all costs. Debt should generally be respected as a commercially legitimate (and legally different) alternative to equity as a source of corporate finance; consequently, the starting position is that debt interest should generally be respected as a legitimate pre-tax business expense. The objective of Action #4 needs to be more clearly articulated: is it (a) only to counteract “abusive” debt financing arrangements which result in double non-taxation and cannot be dealt with under existing rules, (b) to achieve more consistency of domestic interest relief limitation rules, or (c) to limit (or eliminate) the structural tax bias of debt as equity? International symmetry/coherence of the taxation rules for interest relief/inclusion must be balanced against the ultimate right of any sovereign nation, in the context of its tax policy choices, to provide a more (or less) generous regime for taxation of (or relief for) interest than another.
Comments on Discussion Draft on Action 4 of the BEPS Action Plan (Elements of the design and operation of the group ratio rule)

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: Discussion Draft on Elements of the design and operation of the group ratio rule” released on July 11, 2016.

JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of the 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.

General Comments

We welcome the effort of OECD preventing base erosion and profit shifting by aggressive tax planning using excessive interest deduction. On the other hand, it should be taken into consideration that an excessive burden should not be imposed to taxpayers engaging in normal business activities that would not result in BEPS and we would like you to note the following points comprehensively.

As a supplementary position to a fixed ratio rule, a group ratio rule is placed in the final report relating to OECD Action Plan 4, but we are concerned about the further complexity in calculation of numerator and denominator when calculating the group ratio in accordance with approaches proposed in the Public Discussion Draft. Accordingly, we request for a rule which allows more flexibility in the fixed ratio rule to address BEPS without using complex group ratio rule as a back-up.

In addition, considering the complexity of operating the group ratio rule, keeping consistency
among the countries introducing the rule would become important. On the other hand, it should be taken into consideration that elaborating the calculation method excessively will further raise a difficulty in taking consistency among the countries. Since only the parent company of the consolidation group is able to grasp the figures of the group, complex and complicated rule should be avoided and a simple rule is desirable. It is also concerned that such complicated rule would make it difficult even for the tax authorities to operate it appropriately.

Furthermore, though the final report prescribes that the fixed ratio rule would also be applicable to the interest expenses paid even to domestic companies and unrelated parties, given that the purpose of this rule is to prevent the base erosion and profit shifting by aggressive tax planning using excessive interest deduction, we would like to reiterate that the interest expenses that should be a target of restriction on deductions relating to the fixed ratio rule should be limited to only those against foreign countries and related party.

Specific Comments

1. Calculation of net third party interest expense
If the approach 2 or 3 is adopted under the circumstances in which the scope of the interest expense included in the net third party interest expense differs among the legislations of the participating countries, the net third party interest expense for each country will have to be calculated individually in a different way, making administrative workload of the company significantly complex. Therefore, it is practically difficult to deal with the proposed approaches, except for the approach 1 which do not require adjustments on figures from the consolidated financial statements.

2. Definition of group-EBITDA
Similar to concerns about the administrative burden in calculating the numerator of the group ratio, we also have significant concerns about administrative burden in calculating the denominator. It is practically impossible to calculate it after separating the capitalized interest, fair value, tax-exempt dividends and profit of an equity accounted entity in a timely manner and without significant workload and therefore we would like to reiterate that balance between the materiality of such adjustments and the burden placed on taxpayers should be considered.

Considering above points, it is desirable that an option is provided so that the taxpayers could select whether or not to make adjustments, for example, utilizing the figures from the consolidated financial statements as it is.
3. Impact of losses on the operation of the group ratio rule

If it is required to subtract the figures of a group company whose EBITDA is negative from the denominator in calculating the group ratio, since it is necessary to grasp EBITDA of each consolidated group company respectively and identify the group company whose EBITDA is negative, it is concerned that the work burden of taxpayers will increase significantly. Therefore, in order to avoid complication of the rule, the adjustment should not be required.
Japan Foreign Trade Council, Inc.

World Trade Center Bldg. 6th Floor,
4-1, Hamamatsu-cho 2-chome,
Minato-ku, Tokyo 105-6106, Japan
URL. http://www.jftc.or.jp/

Members of the Accounting & Tax Committee of JFTC

CBC Co., Ltd.
Chori Co., Ltd.
Hanwa Co., Ltd.
Hitachi High-Technologies Corporation
Inabata & Co., Ltd.
ITOCHU Corporation
Iwatani Corporation
JFE Shoji Trade Corporation
Kanematsu Corporation
Kowa Company, Ltd.
Marubeni Corporation
Mitsubishi Corporation
Mitsui & Co., Ltd.
Nagase & Co., Ltd.
Nippon Steel & Sumikin Bussan Corporation
Nomura Trading Co., Ltd.
Shinyei Kaisha
Sojitz Corporation
Sumitomo Corporation
Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.
Comments on the Public Discussion Draft on BEPS Action 4
Elements of the Design and Operation of the Group Ratio Rule

In this comment letter, we will first comment on the group ratio rule, and then, also present our view on the fixed ratio rule which is supplemented by the group ratio rule. It is crucial that the BEPS recommendations be consistently implemented under the inclusive framework, and that any remaining issues, including the design and operation of the group ratio rule, be steadily worked on. Keidanren expects the OECD to continue to play the leading role in these endeavors.

1. Group Ratio Rule

(1) Group’s Net Third Party Interest Expense

Of the proposed methods of calculating a group’s net third party interest expense, which serves as the numerator of the group ratio, Approach 1 should be adopted that uses interest figures in the consolidated income statement without adjustment. Given that global companies have a few hundred to more than a thousand subsidiaries, Approaches 2 and 3 are far from feasible in that the former requires adjusting interest figures in a group’s consolidated income statement, and the latter demands identifying and measuring necessary items of interest and payments economically equivalent to interest.

Paragraph 9 of the Public Discussion Draft points out that the downside to Approach 1 is the risk of “manipulation” of interest figures in the consolidated income statement. However, considering the fact that consolidated financial statements normally go through rigorous accounting audits, it is highly unlikely that there is a substantial risk of companies resorting to such manipulation for the purpose of inflating the numerator of the group ratio.
Paragraph 9 also states to the effect that differing definitions of interest income and expense resulting from the adoption of different accounting standards or policies might decrease fairness among corporate groups. We believe, though, that further consideration is needed as to whether such differences are “substantial” enough to justify sacrificing the simplicity of the system.

Attention must also be paid to the fact that, even if the country of domicile of a group’s ultimate parent adopts Approach 1, its effect would be negated should Approach 2 or Approach 3 be adopted by the country of domicile of its subsidiary. This is because a subsidiary itself does not possess the data needed to conduct the calculations required by Approach 2 or Approach 3; thus there is no other option but for the ultimate parent to perform calculations in accordance with the laws and ordinances of the country of domicile of the subsidiary. For that reason, any country introducing the group ratio rule should adopt Approach 1 and respect the accounting standard used by the ultimate parent company.

Additionally, in order not to increase the complexity of the system, it is desirable to minimize room for each country’s adjustments to the definitions of interest income and expense that reflect its tax policy goal. From that perspective, some potential approaches suggested in the Public Discussion Draft warrant careful consideration: in particular, an approach to exclude net interest expense paid to a related party with 25% or greater control from the definition of net third party interest expense; and that to adjust a group’s net third party interest expense so as to include the group’s share of the net third party interest expense of its equity-accounted associates (paragraphs 27 and 30).

(2) Group-EBITDA

Calculations of group-EBITDA, which serves as the denominator of the group ratio, need to be as simple as possible, as with those of the numerator. Non-recurring items should in general be included in group-EBITDA without adjustment, as recommended in paragraph 64 of the Public Discussion Draft.

A problem is that the existence in a group of a subsidiary with negative EBITDA would correspondingly reduce group-EBITDA, resulting in the unreasonably high group ratio. Moreover, if a group as a whole posts negative EBITDA, the group ratio rule no longer works as a system supplementing the fixed ratio rule.
To address the first problem, we consider it reasonable to introduce a certain cap, as a rule. As for the second problem, we disagree with excluding a subsidiary with negative EBITDA from the calculation of group-EBITDA because such exclusion would increase the administrative burden.

In view of these deficiencies the group ratio rule has, what is important is not to address the deficiencies within the boundary of the group ratio rule alone, but for each country to set its fixed ratio sufficiently high and establish an effective carryforward system under the fixed ratio rule. It is essential that, by doing so, the impact on the majority of companies not involved in BEPS be minimized and a greater administrative burden be prevented.

2. Fixed Ratio Rule

The fixed ratio rule lies at the heart of the BEPS final report on Action 4. Although this rule is anticipated to help, to a certain degree, prevent BEPS involving excessive interest expense deductions, we still have some concerns as expressed below.

The first one is the definition of interest subject to the restriction. Because the fixed ratio rule is recommended to be applied to all of a group’s net interest expense, including that paid to lenders within the same country and to third parties, even interest expense on loans from domestic banks would be subjected to the restriction. Developments like this would hamper ordinary business operations, undermining incentives for investment. Further, with interest income being taxable in the recipient entity, double taxation might arise in a large scale.

Whereas the BEPS final report on Action 4 states that BEPS can occur if interest is paid to a domestic lender who makes a corresponding payment to a foreign lender or if interest is paid to a third party under a structured arrangement, we believe that such cases are very exceptional. If a jurisdiction determines that the BEPS risk posed by interest deduction is not material, then the jurisdiction should adopt the more targeted fixed ratio rule which is applied to net interest expense paid to foreign group entities.

The second concern is the definition of EBITDA. The fixed ratio rule dictates that nontaxable dividend income be excluded from EBITDA so as to prevent debt from being used to fund tax-exempt income. Yet, nontaxable dividend income is, in almost all cases, simply the result of business investment, not the goal. Therefore, when
incorporating the fixed ratio rule into domestic law, each country should be given flexibility to determine the appropriateness of excluding any nontaxable dividend income from EBITDA.

For example, assume that Company P located in country X borrows money in country X to finance its large-scale research and development activities in country X and to fund equity investment in its subsidiary, Company S, which operate as a manufacturer in Country Y. Company P may be disallowed to deduct its interest expense to some extent under the fixed ratio rule in country X, since Company P’s EBITDA can be relatively small because of the huge R&D costs it bears and nontaxable dividend paid by Company S. Moreover, the group ratio rule in country X may not give relief to company P, since group-EBITDA can be relatively large due to the large depreciation costs incurred by Company S’s manufacturing activities. In this case, although company P does not have any intention to cause BEPS, disallowed interest expense would arise. Such a situation needs to be avoided.

The third concern is the level of a fixed ratio. While it is recommended that each country set its fixed ratio within a range of 10% to 30%, there is a risk that, if group-EBITDA has declined as a result of deteriorating economic conditions, disallowed interest expense may arise. Even though the fixed ratio rule permits the carryforward of disallowed interest expense, each country should apply a fixed ratio that is high enough to minimize the impact on ordinary companies.

It is true that a portion of the interest expense disallowed under the fixed ratio rule may be deducted under the group ratio rule. Nonetheless, as made clear once again in this Public Discussion Draft, the adoption of the group ratio rule is likely to dramatically increase the administrative burden, depending on its design. We are gravely concerned that each country may build a system whereby a fixed ratio is set so low as to force numerous companies to rely on the group ratio rule. A system should be designed that is completed with the fixed ratio rule alone to the extent possible. Even if there is a case where a taxpayer needs to proceed to the group ratio rule, it should be as simple as possible.

Sincerely,

Subcommittee on Taxation
KEIDANREN
16 August 2016

Dear Sirs

Response to Discussion Draft: Elements of the Design and Operation of the Group Ratio Rule

KPMG in the UK welcomes the opportunity to respond to this discussion draft, and provide comments on the recommendations set out by the OECD in the document “BEPS Action 4 – Elements of the Design and Operation of the Group Ratio Rule” (published 11 July 2016).

Our responses to the discussion draft represent the views of KPMG in the UK.

Overview comments

We consider that a Group Ratio Rule (‘GRR’) is a fundamental component of a regime which intends to allow groups that are highly leveraged for commercial reasons to obtain a higher level of net interest deductions and welcome its inclusion in the OECD’s recommendations.

In the UK in May 2016, HM Treasury released a consultation document “Tax deductibility of corporate income tax expense: consultation on detailed policy design and implementation” which sets out proposals for the implementation of a GRR in the UK. As such the GRR is expected to be an integral part of the UK rules and where appropriate, we have included comparisons to this (UK) consultation as a means of illustrating alternative approaches to the design of a GRR.

Responses to consultation questions

We have set out our responses here to the specific questions raised in the discussion document.
**Calculation of net third party interest expense**

We agree with the issues identified regarding approach 1 in that whilst the proposed approach is straightforward to apply, it would likely result in large inconsistencies between groups and may result in the manipulation of interest like items, and potentially lead to BEPS type activity. As such, we do not consider that approach 1 is a practical way forward.

Regarding approaches 2 and 3, we consider that approach 2 is the most practical way forward as approach 3 appears overly complex in comparison to approach 2 which has a clear start point, being the statutory accounts of the group.

We recommend that practically, an exhaustive list of items that would be included in interest income and expense for approaches 2 and 3 should be set out in the recommendations to minimise uncertainty and the risk of alternative interpretations.

**Question 2: What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?**

We understand that one of the purposes of the BEPS Action Plans was to introduce coherence in the domestic rules that affect cross-border activities. Should countries have the flexibility to apply any of the approaches then this would not achieve a level of consistency and coherence across jurisdictions. This may result in a scenario which provides opportunities for manipulation of the rules leading to BEPS, and will also increase the administrative burden on groups when calculating the GRR for companies located in different countries.

Whilst we acknowledge that there may need to be a level of flexibility in the rules, the objective of the BEPS Action Plans will only be met if there is an element of standardisation in the rules across jurisdictions. Without this there will inevitably continue to be opportunities for multi-national groups to manage their financing arrangements to benefit from the differences.

**Question 3: It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by**
any of the adjustments described in the discussion draft that are not highlighted in the draft?

The intention of the BEPS Action 4 proposals is to limit BEPS through the use of interest deductions and other financial payments, and we consider a consistent approach across countries would be necessary to ensure this aim is met.

We struggle to reconcile a recommendation that flexibility be incorporated to allow countries to achieve their individual tax policy goals (which may create inherent differences in the treatment of interest in different jurisdictions) with the overall BEPS objective of global standardisation and consistency.

In addition, as referenced in response to Question 2, a variety of very different approaches would increase the compliance burden for worldwide groups. Again this seems counterintuitive.

**Question 4:** Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

See response in relation to question 3.

**Question 5:** Are there any other circumstances where a group’s net third party interest expense should be adjusted to include the group’s share of the net third party interest of an entity outside the group?

We consider that if a Joint Venture Entity (“JVE”) has income that is included in group EBITDA, then it is appropriate to include the JVE’s net third party interest expense, as recommended in the discussion draft (and as per our response to Question 9).

For reference, under the UK consultation document, it is proposed that the income from JVEs would be included in EBITDA, but any interest expense arising on third party borrowings from the JVE would not be included in the calculation of net third party interest expense. We recommend that there should be a symmetrical approach for this e.g. either exclude or include both the expense and income, and our response to the UK consultation document includes this recommendation.
Definition of group-EBITDA

Question 6: Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

We recommend that practically, an exhaustive list of items that would be included in interest income and expense for the purposes of adjusting EBITDA should be set out in the recommendations to minimise uncertainty and the risk of alternative interpretations. This should be consistent with the definitions included for the purposes of defining net third party interest expense and income.

Question 7: Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

If different companies are applying different accounting principles in the preparation of their accounts, then this may result in differences between the treatment of certain items or calculation of depreciation and amortisation. This could lead to different outcomes under the GRR due to different accounting standards.

This may not be a significant issue, as generally we would expect methodologies to be broadly similar however this could be managed by insisting on a set of accounting policies to be applied.

It is noted that the UK consultation document states “that financial statements prepared in accordance with a particular accounting framework are acceptable if they are drawn up in accordance with IFRS, UK GAAP or accounting standards of Canada, China, India, Japan, South Korea or the USA. This is in line with the current Debt Cap regime”.

Question 8: Are there any practical issues raised by including all divided income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We do not have any specific comments in respect of this question. For reference, this treatment is consistent with the proposed UK approach which we consider positive.
Question 9: Are there any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

As per our response to Question 5, we consider that if a group’s share of earnings of the equity accounted associates and JVEs is included in group-EBITDA, then it is appropriate to include their net third party interest expense.

If different accounting principles are applied in the preparation of the entities’ accounts, then this may lead to difference in the treatment of certain items but we consider that this may not be a significant issue.

Question 10: Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We note that both the OECD discussion draft and the UK consultation document recommend including non-recurring items within EBITDA and understand the rationale for this approach.

However, practically what constitutes a ‘non-recurring’ item will be open to interpretation. Whilst it will be difficult to define precisely what a non-recurring item is, in order to ensure that this is consistently applied, specific guidance will need to be drafted to set out definitions which are clear and unambiguous, and have reference to an agreed list of accounting standards.

One option could be to base the definition of ‘non-recurring’ items on those amounts disclosed as ‘exceptional’ in the accounts, however what is included in ‘exceptionals’ would vary between accounting standards creating uncertainty. This could be addressed by having specific guidance as set out above.

The impact of losses on the operation of the group ratio rule

Question 11: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?
Excluding an entity with negative EBITDA from the calculation of group-EBITDA would increase the administrative burden on groups for the reasons set out in paragraph 69 of the discussion draft and therefore may not be a practical option.

Approaches for negative EBITDA companies/groups that are considered in the UK consultation document aim to prevent a large build-up of excess capacity and include the following:

- Option 1 – GRR should only be available for groups to utilise current year financing costs.
- Option 2 – The GRR should operate so that the interest limit is capped at a fixed percentage of EBITDA e.g. over 30%, but less than 100%.

We do not consider that either option is appropriate as both could restrict genuine third party interest and this is set out in our response to the UK consultation document.

We consider that the introduction of a rule limiting the entity’s interest capacity to an amount equal to the group’s net third party interest expense (similar to the UK’s modified debt cap rule) may adequately provide protection from excessive interest deductions, whilst limiting BEPS type activity.

**Question 12:** If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

Setting a cap on the maximum net third party interest expense/EBITDA ratio could restrict genuine third party interest which we do not consider is the right approach e.g. depending on the specific percentage cap and whether there is any timing mismatch between tax and accounting treatments.

The relevant information would be obtained through the information collected for the calculation of the GRR, which would not increase the administration burden.

**Question 13:** Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?
As raised by the discussion draft, having one rule for a negative EBITDA group, and another for a positive EBITDA group would lead to a cliff-edge effect. This may not reflect the position that may occur at arm’s length where a negative EBITDA group may be able to raise working capital funds from a genuine third party, on this basis it would be inappropriate to disallow all interest for a negative EBITDA group.

A simple way to approach this would be to restrict the interest capacity of entities with negative EBITDA to the net third party interest costs of the group. This is an approach being adopted in the UK consultation document, and our considerations on this approach are set out in the responses to the consultation document and to questions 11 and 12 of this paper.

Question 14: Do you have any other comments on any of the issues covered by this discussion draft?

We have no further comments.

If any further information or explanation would be helpful, we would certainly be happy to engage in further discussions or clarify any particular points.

Yours faithfully

Daniel Head
Partner
Amendments to the OECD Public Discussion Draft: ”BEPS Action 4 - Elements of the Design and Operation of the Group Ratio Rule”: Comments by NERA Economic Consulting

August 16, 2016
to: International Co-operation and Tax Administration Division, OECD/CTPA

Dear Sir, Dear Madam,

Following the release of an OECD report addressing Base Erosion and Profit Shifting (BEPS) in February 2013, the OECD and G20 countries adopted a 15-point Action Plan to address BEPS by multinational groups. The Action 4 Report includes a common approach to tackle BEPS involving interest payments.

The idea of Action 4 is, amongst other things, to restrict groups from:

- placing higher levels of third party debt in high tax countries.
- using intragroup loans to generate interest deductions in excess of the group’s actual interest expense on third party liabilities.
- using third party or intragroup financing to fund the generation of tax exempt income.

Therefore, the OECD intends to impose two rules to limit the interest deductibility

1. The fixed ratio rule limits the deductible interest expense to a fixed % rate of companies EBITDA.
2. The Group ratio rule provides an exception to the fixed ratio rule.

An interest deduction rule should be based on actual market standards, i.e. it should compare the debt levels and interest expenses of companies within a multinational group to comparable independent companies in the same sector.

Some groups are highly leveraged with third party debt for non-tax reasons. In these cases, the group ratio rule might allow a higher interest deduction than the fixed ratio rule. The group ratio rule allows an entity to deduct net interest expenses exceeding the respective country’s fixed ratio rule level, up to the interest to EBITDA level of the worldwide group.

1 These comments represent independent views of the authors and do not necessarily reflect the views of NERA Economic Consulting.
The group ratio rule recognises the fact that different companies operate in different markets, such as different business sectors, regions, etc. This can naturally lead to different levels of appropriateness for the debt incurred and thus to different levels of net interest expense to EBITDA (see table below).

<table>
<thead>
<tr>
<th>Sector</th>
<th>DAX (%)</th>
<th>FTSE 100 (%)</th>
<th>S&amp;P 500 (%)</th>
<th>Consumer Goods (%)</th>
<th>Energy (%)</th>
<th>Financials (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>6.6</td>
<td>8.5</td>
<td>8.8</td>
<td>6.3</td>
<td>10.3</td>
<td>13.4</td>
</tr>
<tr>
<td>Sample Size</td>
<td>24</td>
<td>75</td>
<td>356</td>
<td>55</td>
<td>16</td>
<td>39</td>
</tr>
</tbody>
</table>

Notes: Data were extracted from Bloomberg. Net interest expense and EBITDA are downloaded separately. Firms without values or with negative entries are excluded from the sample.

The average level of net interest to EBITDA differs amongst countries and, in particular, across business sectors. For example, when consider a sample of publicly listed companies in the consumer goods versus the financial sector, one find that it ranges from 6.3% (consumer goods) to 13.4% (financials).\(^2\) The whole purpose of the group ratio rule is to acknowledge these facts.

“However, a fixed ratio rule does not take into account the fact that groups in different sectors may be leveraged differently ...” OECD BEPS Action plan 4, para. 115, 2015 Final Report

Nevertheless, the proposed group ratio rule applies one single ratio for the interest deductibility of the whole group. It does not take into effect the differences between group entities with regards to sectors, regions etc. that formed the base for this rule (see quotation above). Some entities in a group might be in a completely different field of business than other entities within the same group. Thus, they are likely to face completely different business challenges and consequently require different levels of debt. This is not only in contradiction to the purpose of the rule, but also to other, more fundamental, aspects of the OECD transfer pricing guidance, according to which the basis for any assessment of the appropriateness of a transaction should always be to compare the transaction under scrutiny to what an independent third party would do under similar circumstances. When addressing the appropriateness of an intercompany transaction, the OECD considers the standalone case:\(^3\):

“[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between

\(^2\) The data sample only consider large publicly listed companies that may have very different Net Interest Expense to EBITDA ratios compared to privately held companies or smaller listed companies.

\(^3\) The arm’s length principle is defined extensively by the OECD in paragraphs 1.1 – 1.3 in “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, July 2010.
independent enterprises, (...) any profits (which would have accrued between independent enterprises, but have not accrued between associated enterprises) may be taxed accordingly.”

This means that the OECD transfer pricing guidelines require a controlled company to act as if it was a standalone company.

This implies that from an OECD perspective, each entity within a group should be compared to standalone companies acting under comparable conditions. A mature business would typically rely on much higher levels of debt than a start-up company and would accordingly have a higher level of interest expenses. It is therefore not appropriate to apply one range for a whole group, without regard to the particular circumstances.

As an example one might picture two companies with the same level of profit (EBITDA), operating in different sectors that are characterised by different debt levels. One of them might be operating in a sector with typically high debt levels, thus having a relatively high net 3rd party interest expense to EBITDA ratio (e.g. 40%). The other company might have zero debt (and accordingly zero interest payments). As an independent company, the first company’s interest expense of 40% would be fully tax deductible. One might now picture a merger of the two companies. If both companies would merge (e.g. to make use of synergies), the group ratio rule would lower the allowed level of interest expense deductibility to 20% for both companies, without there being any changes in the business model of both companies. The first company could not deduct its interest expenses to the same extent as before. A company within a group would be disallowed what an otherwise completely similar standalone company would be allowed. This clearly contradicts the OECD approach.

For the aspects mentioned above, the group ratio contradicts itself. It is an approach that is purely based on legal aspects and ignores well established economic concepts such as the arm’s length standard. The results that would be achieved by applying the group ratio rule in its current form would not lead to arm’s length results.

*Amanda Pletz and Georg Dettmann*

*London*

---

Mr Achim Pross  
Head, International Co-operation and Tax Administration Division  
OECD/CTPA  
2, rue Andre Pascal  
75775 Paris Cedex 16  
France

By email to: interestdeductions@oecd.org

16 August 2016

Dear Mr Pross,

**BEPS Discussion Draft: Interest deductions and other financial payments**

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD’s *Public Discussion Draft on Action 4: Discussion Draft on Elements of the Design and Operation of the Group Ratio Rule*.

We have set out below some general comments on the principles which we consider are relevant to the design of the interest deductibility rules. We have also answered the questions set out in the document.

**General comments**

We recognise the importance of consistent approaches by territories to the rules for interest deductibility. As noted in paragraph 4 of the OECD’s draft paper, to the extent that tax regimes are consistent in different territories, this tends to promote the objectives of the OECD’s programme, in that it would ensure that the opportunities for Base-Erosion and Profit Shifting (BEPS) are reduced.

We agree that a consistent approach to the Group Ratio Rule (GRR) in particular will tend to simplify the compliance for international groups of companies.

However, the actual effect of Action 4 rule on interest deductibility in general, and the Group Ratio Rule in particular, will be very dependent on

- the accounting standards applied by a group of companies and/or required to be followed by the GRR, and

- the tax law of the territory in question, and the correspondence (or lack of correspondence) between them.

We consider that this is an important factor not identified in paragraphs 4 and 5 of the paper, which means that a fully harmonised approach may not be optimal.
For example consider a situation where territory A has a tax system in which the deductibility of interest is closely aligned to IFRS accounting rules (e.g. by deducting interest on an accruals basis) and territory B does not (because interest is deductible on a paid basis). A company operating entirely in territory A would expect that the interest allowable under a GRR based on IFRS accounts would result in no timing differences. An identical company operating in territory B would likely suffer significant timing differences between the capacity to deduct interest under the GRR based on IFRS accounts, and the tax deductibility of that same interest.

These timing differences may or may not be significant, depending on whether the regime in territory B has sufficient flexibility to allow carry forward of excess capacity and excess interest expense.

This analysis is even more serious in the case of derivatives hedging debt (whether the hedge is of foreign exchange risk or interest rate risk, or both), where fair value movements may be large compared to the other profits and losses of the company. Under many accounting frameworks, such fair value movements are accounted for in the Income Statement, with limited scope for hedge accounting even where a derivative functions as an economic hedge of interest expense. However, the taxation of these instruments may, depending on the tax regime, and depending on detailed criteria, be on the basis of either fair value movements, accruals of interest, or payments.

When considering how the GRR should apply to such instruments, it should be noted that as with interest cost itself, the effect will depend on the accounting and tax treatment. If a territory enacts rules requiring the group ratio to bring in derivatives on an accruals basis, this will result in a relatively straightforward analysis where derivatives are always taxed on that basis. However, where a derivative is taxed on a fair value basis (either because specific criteria for taxation on accruals basis are not met, or because no such tax treatment is available under domestic law) this will result in significant differences between the capacity to deduct interest under the GRR, and the actual deductibility of that interest.

Similarly, if a territory enacts law requiring the group ratio to be computed following the actual accounting treatment of derivatives, this should create minimal timing differences if that is also the basis used for domestic taxation of derivatives. However, it will create significant differences where derivatives hedging debt are taxed on the basis of accruals or payments.

Given that such derivatives tend to be used by companies for major exposures over long periods of time, this means that material long-term timing differences are likely. If the ability to carry forward disallowed expense or excess capacity is limited, material amounts may be permanently disallowed. This does not appear to be an intended consequence of Action 4.

Consequently, the effect of having an internationally consistent method for computing the group ratio would be that territories whose domestic tax rules for interest and derivatives are not aligned with that method will generate significant differences between interest capacity and interest tax deductible. Those differences are likely to be material amounts for the companies concerned, and to persist over long periods of time (if not permanently, depending on the details of the carry forward / carry back mechanisms in that territory).

This would frustrate the policy objectives of Action 4 insofar as identical companies operating in different territories will experience very different consequences of the same GRR.
Groups affected may conclude that they are incentivised not to use hedging derivatives over debt instruments, and change their hedging policies accordingly. This will likely result in an increase in overall financial risk borne by business.

We would therefore suggest that it is more appropriate for territories to determine their rules for computing a group ratio in a manner which is consistent with their domestic rules for the taxation of interest and derivatives.

Subject to that overall caveat, we have the following comments on the specific questions raised in the draft paper.

1. Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

We have set out above a fundamental issue likely to arise in the measurement of third party interest expense for the purpose of the GRR. This suggests to us that “the importance of having an objective measure of net third party interest expense” noted in paragraph 10 of the document needs to be considered in the light of the constraints of a territory’s specific tax and accounting laws. The potential shortcomings of a single approach are, in our view, at least as significant as the potential shortcomings of allowing various accounting standards to be used.

Consequently in some cases Approach 1 (following the consolidated accounts) may be more appropriate and less subject to manipulation than other approaches.

Nevertheless, we agree that in some cases the use of different accounting standards may allow companies some flexibility in determining the figures to be used in their GRR calculation. However, in our experience most major sets of accounting standards (e.g. UK GAAP, IFRS, US GAAP) are sufficiently robust that such manipulation by choice of accounting policy may be difficult.

It is also important to note that accounting standards change over time. It would be important for the GRR methodology to have the flexibility to deal with such changes. For example, IFRS16 is due to come into effect in 2019, and this is expected to materially change the accounting treatment of leases. Lessees using IFRS will be required to capitalise leased assets on the group balance sheet, and reflect the lease obligations as if they were a debt. If the limitation on interest deductibility proposed under Action 4 is to operate as intended (as regards not only the group ratio but also the fixed ratio), it will be necessary to make adjustments for this and for any future changes to accounting standards.

Approaches 2 and 3 are likely to result in a very complex calculation which will be difficult and costly for large groups to prepare, and similarly difficult and costly for tax authorities to audit.

There will also be some challenges as to the appropriateness of the methodology in certain cases.

A large element of the complexity will arise from the suggestion that gains and losses on financial instruments (including fair value movements, foreign exchange movements, and gains or losses on disposal) should be separated into elements equivalent to interest and those which are not.
This complexity arises for two reasons:

i. It is not straightforward to propose an objective indicator of whether a gain or loss on a financial instrument is “equivalent to interest” or not.

On financial instruments with known future cashflows, (for example a committed forward purchase of a currency or commodity) the element of discount on those cashflows can be computed. However, for instruments where the quantum of future cashflows is not known (e.g. an option to purchase a currency or commodity), it is not straightforward to determine to what extent a change in fair value should be attributed to the change in interest rate applied to possible future cashflows.

Similarly, it would need to be determined what is meant by “future interest”. If a company repays a loan liability at a discount, and that discount arises because the lender has determined that the credit risk of the company would justify a higher credit margin, it could be argued either way whether or not the company’s gain is attributable to interest rates.

Problems may also arise with financial instruments in currencies which have very high interest rates because they tend to depreciate. There are arguments that exchange movements should be classed (economically) as part of the interest return to avoid a distortive result. However, there are no clear criteria as to when this should or should not apply to a particular transaction.

ii. Even where a methodology can be found, the burden of computing the elements of financial instruments attributable to interest could be very large

Some groups, particularly but not exclusively those in financial services and commodity sectors, may have many thousands of financial instruments outstanding with third parties. The compliance burden of separating the gain or loss on each instrument into interest and non-interest components could be very large and impractical.

The challenge to the appropriateness of the methodology may also arise where a financial instrument is used to hedge an item which is properly attributed to EBITDA. For example, where an operating company hedges turnover in different currencies with currency contracts, the implication of Approaches 2 and 3 would be to include the interest element of the currency contracts, notwithstanding that this is effectively part of the operating income or expense. A similar issue arises with groups who hedge turnover with an inflation linked derivative (e.g. because they operate in a government regulated industry where prices are determined by reference to inflation).

Similarly, any criteria based on financial instrument definitions run the risk of creating anomalous situations when financial instruments are compared to transactions which have similar characteristics but are not financial instruments, such as long term contracts, or sales on deferred terms.

These issues would be less significant under Approach 1, to the extent that non-financial instruments are accounted for purely as trading revenue, and financial instruments hedging such items may be hedge accounted (for example as cashflow hedges of turnover), which may mean the interest element
is recorded in turnover rather than group interest income or expense. However, whether this is possible will depend on individual circumstances.

Naturally, some of these issues could be reduced to the extent that groups are given flexibility to choose the approach taken.

In practical terms, it should be noted that rules which require a subsidiary to calculate taxable profits based on detailed analysis of transactions undertaken by an overseas parent tend to give rise to difficulties in some groups. For business reasons, the head office may not share confidential group information with operating subsidiaries, and this puts the subsidiary in a position where they have no right to access the information needed for their return. This situation should be avoided where possible. Therefore rules which require detailed information regarding the affairs of an overseas parent should be minimised.

3. It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

4. Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

We agree that a country’s tax policy goals should be taken into account in determining third party interest expense.

We have no objection to the suggestion that where domestic law does not allow a deduction for a specific class of expense (e.g. coupons on fixed rate preference shares) this should be excluded from the group ratio in that territory.

However, it would be important that this restriction is applied to specific and objectively defined classes of interest expense. If a country were to require that each interest expense in the consolidated financial statements had to be tested in order to determine whether it would be deductible under domestic legislation, the compliance burden would be very significant.

We have a particular concern with the proposal that related party interest should be excluded from the group ratio. Many groups of companies, particularly those structured as joint ventures, are financed by significant amounts of debt from equity investors who do not have a controlling interest. This is commonly to ensure that commercial objectives are met, for example:

- use of a mixture of debt and equity allows different investors to take different levels of risk,
- use of a mixture of debt and equity allows voting rights and funding contributions to be in different proportions, and
- use of debt in place of equity allows funding to be provided, or cash to be returned, without triggering the company law complexities of share capital subscriptions or dividend distributions.

In many cases the corresponding income in the investor will be fully taxable.

These are not transactions which the OECD’s anti-BEPS programme should seek to target.
However, if the computation of external interest under a GRR excludes interest payable to related parties, it seems likely that interest on debts owed by a joint venture to investors would be excluded from the group ratio. The consequence would be that where the joint venture relies on the group ratio, a disallowance would occur.

In the absence of a “corresponding adjustment” mechanism to enable the investors to treat their interest income as non-taxable, the consequence would be a higher tax burden for investors in a joint venture. This does not appear to us to be appropriate.

It would seem more appropriate for the test of whether such interest is tax deductible to be based on domestic law tests. Most countries have tests which disallow interest where a debt cannot be justified by arm’s length principles, or where a debt has a primary purpose of reducing tax. Where the investor’s interest income is not taxable, countries may have rules to disallow the interest expense for that reason. Such rules would seem to strike out related party debt where it is appropriate to do so, and would be better targeted than a mechanism in the GRR.

The comments at the start of this letter related to the tax treatment of derivatives are relevant when considering the interaction of the GRR with a country’s tax policy goals. Many countries have a policy of enabling hedging transactions to be conducted effectively as this promotes good risk management and financial stability. If the GRR were to disincentivise groups from hedging because it would cause large book/tax differences (whether permanent or temporary) this would appear to be contrary to such a policy.

**5. Are there any other circumstances where a group’s net third party interest expense should be adjusted to include interest income or expense of an entity outside the group?**

It may be appropriate for the GRR to allow adjustments for securitisation arrangements, particularly where the securitisation entity is an “orphan” i.e. not part of any group. Commonly such an entity borrows from external lenders, and either lends on to the main group at a small margin, or purchases receivables or an income stream. The securitisation entity may therefore have income which is not interest, but expense which is interest. It may or may not be in the accounting consolidation. Economically, the structure gives rise to a secured loan for the group, and the GRR should reflect this.

**6. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?**

Where it is suggested that items such as capitalised interest may be adjusted, it would be appropriate for the adjustments to follow the timing of deductions being available under a country’s tax law, in order to avoid timing differences.

**7. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?**
It should be noted that as well as depreciation and amortisation of capital assets employed in the business, accounting standards such as IFRS commonly require revaluation (upward or downward) of capital assets held as investments, for example property held by a business whose main activity is not property related. It will be important for legislation to make clear whether these revaluations constitute depreciation or amortisation. Including them in EBITDA will give rise to significant timing issues if (as is commonly the case) the profit or loss on such an asset is only taxed on realisation.

8. Are there any practical issues raised by including all divided income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We note the principle stated in paragraph 51 that exempt income (in particular participation in subsidiaries) should not be funded by tax deductible debt. It should be noted that care should be taken if this policy is applied to income other than participation in subsidiaries or associates. In the case of participations, the policy justification for not taxing the income is generally that it should be subject to tax at the subsidiary or associate level, and the income received is therefore “post tax”. It makes sense that in such a case, the availability of interest deduction against that income is considered at the subsidiary or associate level.

By contrast, where income is exempt from tax, or taxed at a reduced rate, because a country chooses to incentivise that type of income (for example “patent box” or “research and development” regimes) if the consequence of Action 4 is that interest reductions are restricted as a result of the income, this reduces the incentive to invest.

9. Are there any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We make no additional comment on question 9.

10. Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

We make no additional comment on question 10.
11. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

We agree that eliminating the results of an entity with negative EBITDA from the group ratio calculation raises a number of difficulties. As well as those specified, we note that some entities may have losses which can be eliminated on consolidation in whole or in part. These have a distorting effect. For example, a group with total EBITDA of 100 may include two entities party to a financial instrument on which one has a loss of 200 and the other has a profit of 200. Eliminating the lossmaking entity would give EBITDA of 300, which seems an odd result. Losses would therefore have to be net of consolidation adjustments, which increases the complexity and compliance burden arising from the rule.

Care would also need to be taken as to matters of entity classification, as entity recognition for entity accounting and consolidation purposes may differ from entity recognition for tax purposes.

We think it likely that a restriction which limits the group’s overall interest expense carried forward from any period to the actual net interest expense incurred in the group overall would address the objective of ensuring that loss making periods, or periods of very low EBITDA do not give rise to excessive interest capacity.

12. If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

If a cap for the GRR is desirable, one possible measure would be a rolling average of the group’s actual group ratio over a number of years. This would ensure that short term falls in EBITDA did not distort the group ratio unduly.

13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

We note above that in some cases it may be difficult to obtain information as to the detailed affairs of other group entities.

14. Do you have any other comments on any of the issues covered by this discussion draft?

We make no additional comment on question 14.
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,

Stef van Weeghel, Global Tax Policy Leader
stef.van.weeghel@nl.pwc.com
T: +31 (0) 887 926 763

<table>
<thead>
<tr>
<th>PwC Contacts</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neil Edwards</td>
<td><a href="mailto:neil.edwards@uk.pwc.com">neil.edwards@uk.pwc.com</a></td>
</tr>
<tr>
<td>Graham Robinson</td>
<td><a href="mailto:graham.x.robinson@uk.pwc.com">graham.x.robinson@uk.pwc.com</a></td>
</tr>
<tr>
<td>Bernard Moens</td>
<td><a href="mailto:bernard.moens@pwc.com">bernard.moens@pwc.com</a></td>
</tr>
<tr>
<td>Peter Collins</td>
<td><a href="mailto:peter.collins@au.pwc.com">peter.collins@au.pwc.com</a></td>
</tr>
<tr>
<td>Tim Anson</td>
<td><a href="mailto:tim.anson@pwc.com">tim.anson@pwc.com</a></td>
</tr>
<tr>
<td>Michael Urse</td>
<td><a href="mailto:michael.urse@pwc.com">michael.urse@pwc.com</a></td>
</tr>
<tr>
<td>Suchi Lee</td>
<td><a href="mailto:suchi.lee@pwc.com">suchi.lee@pwc.com</a></td>
</tr>
<tr>
<td>Aamer Rafiq</td>
<td><a href="mailto:aamer.rafiq@uk.pwc.com">aamer.rafiq@uk.pwc.com</a></td>
</tr>
<tr>
<td>Phil Greenfield</td>
<td><a href="mailto:philip.greenfield@uk.pwc.com">philip.greenfield@uk.pwc.com</a></td>
</tr>
</tbody>
</table>
To: International Co-operation and Tax Administration Division, OECD/CTPA

15th August 2016

Submitted by email to: interestdeductions@oecd.org

BEPS ACTION 4 – Discussion Draft on elements of the design and operation of the group ratio rule

Introduction

RICS – Royal Institution of Chartered Surveyors - is pleased to respond to the above consultation.

RICS is the leading organization of its kind in the world for professionals in property, construction, land and related environmental issues. As an independent and chartered organization, RICS regulates and maintains the professional standards of over 100,000 qualified members (FRICS, MRICS and AssocRICS) and over 50,000 trainee and student members.

It regulates and promotes the work of these property professionals throughout 146 countries and is governed by a Royal Charter approved by Parliament, and monitored by the Privy Council, which requires it to act in the wider public interest.

Since 1868, RICS has been committed to setting and upholding the highest standards of excellence and integrity – providing impartial, authoritative advice on key issues affecting businesses and society. RICS is a regulator of both its individual members and firms enabling it to maintain the highest standards and providing the basis for unparalleled client confidence in the sector.

Executive Summary

We have reviewed the document and our comments in summary are: -

1 These proposals relating to the Group Relationship Rule (GRR) are aimed at all types of business but we have restricted our comments to those occupying, trading or investing in property.

2 We note that a number of questions focus on the implications for a country’s tax policy; we are not able to answer those questions and focus solely on the practical implications of applying the proposed law to occupying, trading or investing in property. Nor do we comment on more complex issues where we will leave those who face such complexities to comment directly.

The GRR is helpful. However, as the discussion draft recognises, each country has its own regime not only for tax but for funding. Turning to tax first, changes in business rates in the
UK (a local tax based on the value of buildings used in business) could reduce the EBITDA of UK companies and similar governmental charges could also affect other countries. With regard to finance, a group is likely to be borrowing in different countries with different terms, conditions and interest rates. Where bona fide losses arise, a group is subject to pressure; our concern is that such a group’s difficult financial position should not be exacerbated by denial of relief based on a GRR with a random percentage.

If you would like to discuss our comments in more detail then please contact Lewis Johnston, Parliamentary and Public Affairs Manager on +44 (0)20 7695 1663 (or email ljohnston@rics.org).

Yours faithfully

Rosalind Rowe
Chair, National Taxation Policy Panel
ANNEX 1 – SUMMARY OF QUESTIONS FOR PUBLIC CONSULTATION Calculation of net third party interest expense

1. Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

We note that Approach 1 uses accounting information whereas Approaches 2 and 3 focus on deriving the interest and income expense, for tax purposes, incurred in a year regardless of the accounting treatment.

Re approaches 2 and 3, accounting presentation may vary by country and can also alter over time. Any legislation should not be prescriptive in listing those adjustments required to determine interest income and expense for tax purposes. For example, in the UK, impending changes to IFRS will result in significant additional charges to the profit and loss account for tenants of buildings who will be required to carry the value of their operating leases on their balance sheets and then amortise the cost over the life of the lease. Part of the rent will be accounted for as interest – even though it is a direct cost of using the building – consequently, an adjustment to the cost booked as interest in the accounts is required. Instead, legislation should be designed so that adjustments can be made to ensure that the interest income and expense are correctly identified for tax purposes.

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

See point 2 of our letter.

3. It is important that a country’s tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

Example 1 of the discussion draft illustrates the importance of focusing not only on tax interest income/expense but also EBITDA. As set out in our response to Q1 - there are other items which may appear in EBITDA for a property group. For example, investment properties are valued annually and the movement is booked in property and loss account, as are movements on hedging financial transactions. Such items would need to be adjusted for.

4. Are there any areas where a country’s tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

See point 2 of our letter.
5. Are there any other circumstances where a group’s net third party interest expense should be adjusted to include the group’s share of the net third party interest of an entity outside the group?

See point 2 of our letter.

**Definition of group-EBITDA**

6. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating groupEBITDA? If so, what are these issues and how could they be addressed by a country?

See our response to Q 1.

7. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating groupEBITDA? If so, what are these issues and how could they be addressed by a country?

See our response to Q 1.

8. Are there any practical issues raised by including all divided income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

See point 2 of our letter

9. Are there any practical issues raised by including a group’s share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The inclusion of the results of JVs is essential to ensure that third party borrowings by a JV are taken into account. We accept the concerns expressed that the inclusion of JV results may be difficult to determine but we would want the taxpayer to be able to choose whether or not to pursue a calculation rather than have a country determine what is or is not material. Also given funding may vary year on year, for example with project finance, the major drawdown may be deferred until building commences, we would not want any project interest, dismissed because it is de minimis in one year, from being denied relief in later years.

10. Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

See our responses to Q 1 and Q3.

In addition, we would also add that where a group incurs additional interest expense for commercial reasons that such interest should be included in the GRR; consequently, we would encourage countries to apply care in determining specific categories of non-recurring income and expense to be taken into account.
11. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

We are particularly concerned by the examples given where the group’s overall interest expense could be capped due to commercial losses in a group. For example, there are many cases where borrowings are made for commercial reasons but interest expense may exceed income:

- the early years of a development by a housebuilder which is incurring costs on infrastructure, site clearance and environmental improvement before the first house is sold,
- where a factory is being constructed and is being tested before being brought into use,
- an investment property which will not generate rent during the construction phase but only at practical completion, or
- an economic downturn (as in 2008) where borrowing is in place but sales/letting are deferred pending an economic recovery – we raise this given the uncertainties resulting from “Brexit”.

The issue with the GRR is that it is considered as a test applied annually but in all the cases above, the ratio of group tax-interest to group-EBITDA would considerably reduce over time as income flowed. In such circumstances we do not see why any adjustment (including a cap) is required given the debt has been incurred for commercial reasons.

Our fear is, where a group is under financial pressure, that the reduction of tax relief could lead to the possibility of it paying more tax than budgeted. This could increase the need for more debt with further interest costs and could create a vicious spiral. Also it should be noted that when debt is provided to a group, the lender will require the borrower to meet key criteria including cashflow targets which could be breached if additional tax became payable. Given the interest restrictions under BEPS are currently proposed to apply existing debt, without any grandfathering, we are very concerned about the impact of these rules on companies which are loss making, Even though they are pursuing bona fide commercial activities they could be penalised.

Tax relief should be permitted in a country for third party debt if the debt was borrowed on third party terms; relief for unused losses should be given in future where interest exceeds income.

12. If a country does introduce a cap on a group’s net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

See our answer to Q 11.
13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

See our answer to Q 11.

14. Do you have any other comments on any of the issues covered by this discussion draft?

The GRR is helpful. However, as the discussion draft recognises, each country has its own regime not only for tax but for funding. Turning to tax first, changes in business rates in the UK (a local tax based on the value of buildings used in business) could reduce the EBITDA of UK companies and similar governmental charges could also affect other countries. With regard to finance, a group is likely to be borrowing in different countries with different terms, conditions and interest rates. Where bona fide losses arise, a group is subject to pressure; our concern is that such a group’s difficult financial position should not be exacerbated by denial of relief based on a GRR with a random percentage.
August 9, 2016

VIA EMAIL
Pascal Saint-Amans
Director
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(interestdeductions@oecd.org)


Dear Mr. Saint-Amans,

USCIB\(^1\) appreciates the opportunity to comment on the discussion draft on elements of the design and operation of the group ratio rule.

General Comments

USCIB supports the comments submitted by BIAC. We write separately in order to emphasize a few points.

It is difficult to overestimate the difficulty of complying with a worldwide group ratio if countries adopt different standards that will require a worldwide group to compute net interest expense and group EBITDA differently for each country in which the group operates and in which the group ratio rule is applicable. In order to minimize those difficulties, the OECD should recommend that countries not require adjustments to financial statements unless those changes are seen as essential to the proper functioning of the group ratio rule.

Countries have agreed that the starting points for the calculation of net interest expense and group EBITDA are based on the group’s consolidated financial statements whether those financials are based on IFRS, US GAAP, Japanese GAAP or other accounting standard permitted

\(^{1}\) 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 policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.
by the relevant country. Thus, countries are willing to accept some variation in how these numbers are calculated and not insist that all entities use the same starting point. Similarly, the OECD should recommend that, in addition to following the financial accounting standard of the parent company, any adjustments also follow the adjustments required by the jurisdiction in which the group parent is located. This would permit a group to compute these numbers once and use those numbers for the global adjustments.

**Calculation of a group’s net third party interest expense**

The discussion draft provides three approaches to determining net third party interest expense. The first approach is to accept the number from the group’s financial statements. We support the BIAC recommendation which would permit taxpayers to use this number.

**Approaches 2 and 3**

The discussion draft states that the second and third method of computing net interest expense should reach the same result but by different avenues, the discussion draft prefers either of these methods over the first method and there does not appear to be any specific factors which are sufficiently significant for one to be recommended over the other. (Para. 18 and 19.)

The second method starts with the interest income and expense in the consolidated financials and adjusts those numbers to include or exclude items in accordance with whether they fall within the definition of interest and payments economically equivalent to interest. (Para. 12.)

The third method starts by requiring an entity to identify all of the group’s items of income and expense that are economically equivalent of interest and then determine whether those items are included in the consolidated financial statements as interest income and expense.

Assuming countries require adjustments to the consolidated financial statement to reflect items that are economically equivalent of interest, then countries should permit groups to use either approach 2 or approach 3 since both approaches should reach the same answer and neither is preferred. If countries only permit the use of one of these methods and the countries make different choices with respect to whether they prefer approach 2 or approach 3, then companies may be required to do these adjustments both ways at some cost and for no apparent benefit to the tax administrations. Tax administrations should also not require excessive documentation for each item required to be identified in the “bottoms-up” approach 3.

**Adjustments to net third party interest expense**

**To recognize practical issues that may prevent a group aligning net interest expense and EBITDA:** USCIB supports the recommendation of an uplift to a group’s net third party interest expense of up to 10% and believes that the 10% uplift may be insufficient given the practical difficulties (outlined in the BIAC comment letter) of aligning interest expense and EBITDA.
**Adjustments for certain non-deductible payments**: The discussion draft states that because the group’s net third party interest expense is based on consolidated financial statements, net interest expense may include items that are not deductible for tax purposes. Including such payments in net third party interest expense will increase the interest capacity of the entities in the group. Countries may, therefore want to reduce net third party interest expense by nondeductible payments. The OECD recommends, however, that these adjustments “should be limited to specific identifiable categories of payments which, in the assessment of the country, pose a material BEPS risk.” (Para. 26.)

These payments are economically equivalent of interest, so in a sense taxpayers are already being penalized by the denial of a deduction for what is a legitimate “interest” expense. They should not be further penalized by being denied interest capacity. Further, it is hard to see the material BEPS risk inherent in the payments if the deduction is already being denied. It should make little or no economic sense for a taxpayer to incur a non-deductible expense that is equivalent to interest in order to “create” cap that would permit the deduction of other interest expense.

**Adjustment for interest paid to related parties**: The Action 4 Final Report recommends targeted rules to address the possibility that groups could use certain types of payments to avoid the effect of the fixed ratio rule and the group rule. One possible approach to a targeted rule “would be for a country to exclude net interest expense paid to related parties from the definition of net third party interest expense.” (Para. 27.) The definition of related parties (para. 28) is very broad and is already part of the Action 4 Final Report.

USCIB understands the concern of the OECD and countries regarding possible taxpayer planning to avoid the impact of the interest deductibility rules. Nevertheless, we believe that the proposal to exclude net interest expense paid to related parties is not appropriately targeted. A company may be a related party even though the ownership interest in that entity is less than 25%. Thus, interest expense paid to such a related entity will result in unrelated parties having the bulk of the economic return from the payment of interest. Without more (e.g., a structured arrangement) it seems very unlikely that the net interest expense would not reflect a real economic payment. If this option is to be retained, the OECD should further limit its scope to focus more narrowly on addressing legitimate BEPS concerns. Further, even though the discussion draft describes this as one possible option, other options are not presented so it may be more likely that this option will be adopted by countries seeking to address planning. The OECD should describe other more targeted options that would more narrowly address any BEPS concerns.

**Adjustment to take into account group’s share of the net third party interest expense of an associate or joint venture**: Group EBITDA includes the group’s share of earnings from any associates or joint ventures under equity accounting principles. The consolidated income statement does not identify the share of the net interest expense related to the associate or
JV. This creates a potential mismatch – income is included, but interest expense funding the investment is not.

The discussion draft provides that countries may give taxpayers an option to include the group’s share of net third party interest income or expense of an associate or joint venture as part of the group calculation. The discussion draft recommends an option because it may be difficult to obtain this information and it may not be material.

USCIB supports this recommendation.

**Definition of group-EBITDA**

*Capitalized Interest*

The Action 4 Final Report approach to capitalized interest expense would require entities to include capitalized interest in the adjustment for interest income and expense in the year when the interest is incurred and make ongoing adjustments to strip capitalized interest out of depreciation and amortization. This approach is complex, so countries should consider instead requiring an entity to follow the financial accounting treatment of capitalized interest in computing group-EBITDA. (Paras. 35 – 38.)

USCIB supports this recommendation.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)