Comments received on Public Discussion draft

BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

Part 1

11 February 2015
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Dear Mr Pross

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

We welcome the opportunity to comment on the OECD’s discussion draft on Action 4: Interest Deductions and Other Financial Payments.

Who we are

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent around 90% of the market capitalisation of the UK FTSE 100 Index, and in 2014 paid, or generated, taxes equivalent to 14% of total UK Government receipts. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

Our views

The 100 Group has been, and remains, supportive of the OECD BEPS project and in general we support the majority of the emerging initiatives and recommendations. However, we wish to communicate our concerns about the proposals on interest deductions in the discussion draft. In general, we are concerned that the proposals as currently drafted will discourage investment and disproportionately impact capital intensive industries. We also believe they could lead to significant double taxation and seem disproportionate to BEPS issues arising from interest deductions.

Our concerns focus on the following general areas:
   a) The impact of the proposals on incentives and economies
   b) Proportionality and double taxation
   c) Practical compliance

The impact of the proposals on incentives and economies

We are particularly concerned that a global interest limitation rule will have significant unintended consequences for member countries. We are concerned that the proposed recommendations would distort commercial realities and discourage investment. We also
believe that the proposals would have a disproportionate impact on capital intensive industries.

Investment is extremely important to economies globally, especially developing economies. In our view, the proposed recommendation will potentially discourage investment, particularly affecting the economics of long-term infrastructure projects. The proposals will also limit the scope for individual governments to encourage investment and set taxes that are appropriate to their particular tax system.

Capital intensive industries will be disproportionately impacted by the proposed recommendations compared to other industries. An approach that would disallow a percentage of interest expense of an entity presents a tax bias towards lower-gearde business models, which will disproportionately impact certain capital intensive sectors which are naturally more highly geared due to their commercial profile.

We do not believe that groups could simply rearrange their intra-group financing in practice in order to meet the requirements of a group-wide rule. Reasons for this could include, for example, the impact of minority shareholdings, banking restrictions, local regulatory restrictions on borrowings, corporate law constraints related to capital levels, foreign exchange and transactional costs. Structural limitations on tax capacity to relieve interest expense may also exist as a result of effective double taxation and withholding taxes.

In our view, proposals which limit interest deductions according to a share of net consolidated group external interest expense will penalise and distort normal commercial arrangements and competition. For example, say a multinational group acquires a third party group in a specific country. If the acquired company’s pre-existing third party debt means that the relevant interest ratio is higher than that of the acquiring group, then interest allocation proposals would seem to result in partial disallowance of the interest expenses in the acquired company – even though there are no abnormal or abusive arrangements and no change to arrangements of the acquired group. In addition there are secondary impacts of interest restriction that need to be adequately risk assessed before implanting any new legislation. Adjusting a key attribute of a major asset class will create ripples. Governments need to identify and risk assess these secondary impacts that could prove to be significant and damaging to economies.

Proportionality and double taxation.

We believe that anti-abuse rules should be proportionate to the BEPS risk which they are targeting. Individual countries should be able to set their own tax rates and approaches, provided that this does not constitute ‘harmful tax practice’. While excessive leverage can erode the tax base, we believe that in addressing this the OECD should ensure that it does not introduce rules that prevent the deductibility of interest in genuine commercial group structures where no BEPS risk exists.

We are concerned that the discussion draft does not clearly define the nature and extent of the BEPS issue arising from interest. Interest income is generally taxable (or otherwise dealt with by Action 2 – hybrid mismatches), and any unilateral restriction on deductions for interest will cause double taxation. Therefore, we recommend that in addition to considering the concerns outlined above, that the OECD specifically examines the exact nature and extent of BEPS which arises from interest deductibility. We believe that discussion and examination of the risks would enable a determination of whether the recommendations proposed are proportionate to the BEPS risk they are targeting.

We believe that the introduction of the proposed group-wide rules will lead to double taxation because the levels of debt and interest in a group entity will not generally be related to the level of earnings or net assets. We don’t agree that a group-wide test will lead to a group
being able to deduct all of its external net interest costs. There are likely to be large levels of disallowances, and yet corresponding interest income remains taxable.

**Practical compliance**

Global interest allocation proposals will present significant practical compliance problems. These practical difficulties and related costs will impact both taxpayers and tax authorities.

We believe that global interest allocation proposals risk undermining tax systems and audit processes by introducing requirements which compliant taxpayers may struggle to meet and tax authorities may struggle to audit.

Some practical issues that would need to be overcome in order to operate an interest allocation approach include: mismatches in entity groupings between existing processes and the requirements of the proposal; accounting GAAP differences; differences between accounting profit and profit for taxation purposes in different jurisdictions; and the approach to investment income, currencies and loss making companies.

**Recommendations**

In setting out our concerns about the proposed recommendations, we aim to be constructive and to assist the OECD in shaping the future of the Actions. We suggest that you consider the high level concerns we have set out above in shaping the next steps. We include some discussions of suggestions of potential approaches that could help to address some of these concerns below.

As a result of the concerns outlined above, we strongly recommend that the final outcome of Action 4 should take the form of best practice recommendations, in line with the original objective. Those recommendations should focus on problems of double non-taxation or harmful competition, but without creating burdensome rules for genuine commercial finance transactions.

Having set out above our concerns about proposals for a group-wide rule. We strongly recommend that any such rule in a final best-practice approach should be focussed on anti-abuse and not a general allocation rule.

It seems likely that provisions that are well targeted at BEPS risks would need to consider a number of tests, possibly also including some form of purpose test. A global interest allocation would not address BEPS risks in a targeted fashion.

We are concerned that the discussion draft concludes that the arm’s length test should not form part of the consultation process. We would strongly recommend that an arm’s length test is permitted as an option within a range of best practice approaches, possibly in conjunction with other tests. The arm’s length test demonstrates that companies could engage in such a transaction externally, which in turn demonstrates that such a transaction is not excessive when it takes place between companies in the same group. The arm’s length test enables consideration of the actual circumstances of transactions – something that the group wide test and fixed ratios do not do. For example, an arm’s length approach will take into account specific circumstances of different industries as well as credit ratings of individual companies and groups.

The approach to an arm’s length test could potentially be used in conjunction with fixed ratio limits as a ‘backstop’ in a relatively simple way.

Overall, we feel that the nature of our concerns are so fundamental and should form the starting point of continued deliberations. As such we have not responded to specific questions on this occasion.
Work should focus on developing generic, targeted best practice measures that focus on BEPS mismatches in a practical and proportionate way.

We would be very happy to discuss this in more detail with you. Please do get in touch if you wish to discuss this further with me and the Committee.

Yours sincerely

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6 February 2015

By email to: interestdeductions@oecd.org

BEPS Action 4 Discussion draft: Interest deductions and other financial payments

AFME¹ and the BBA² welcome the opportunity to respond to the OECD’s discussion draft entitled: “BEPS action 4: Interest deductions and other financial payments” (the discussion draft). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the discussion draft, both organisations have decided to submit a single, combined response since our respective members share the same concerns with respect to the proposals in the discussion draft.

We note that the relatively short time available to respond to the discussion draft – and the large number of other OECD discussion drafts currently open for comment – poses a challenge for all businesses and the OECD Secretariat. Should it be of assistance we would be pleased to meet with the OECD Secretariat to discuss these matters in greater detail or provide further information upon request.

Executive Summary

We support the OECD’s consultative approach on the development of these proposals. We believe that this will benefit both policymakers and business, by helping to reduce any unintended consequences arising from these proposals. We also believe that it is essential for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

The discussion draft notes that measures based on gross interest expense would have distortive consequences. This is particularly relevant for the banking sector, where interest expense is effectively the equivalent of the cost of goods sold, and is closely linked to the cost of finance to the wider economy. We therefore agree that measures which consider net

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¹ The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

² The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Our associate membership includes over 80 of the world’s leading financial and professional services organisations.
interest expense are a more accurate means of identifying and addressing BEPS concerns. We agree with the comment at Paragraph 209 which notes that because of the focus on net interest expense, banks will not be subject to a general limitation as they will be expected to generate net interest income. We would note, however, that the position of banks as net interest recipients should not be seen as indicative of base erosion in itself.

The banking sector - due to the evolving regulatory environment in which banks operate - is substantively different from other sectors for the purposes of this BEPS action. Banks are subject to strict regulatory requirements which, by a variety of measures, directly impact their capital structure, leverage and behaviour. We welcome the recognition of this distinction in the discussion draft.

Supervisory authorities and banks have sought to ensure that the regulatory framework promotes financial stability, protects deposit holders and ensures the continuity of services to customers and businesses, in particular lending throughout the business cycle. This means that banks are required to hold increased capital reserves against their assets and face limits on their ability to leverage. Critically, this also limits the ability of banks to engage in activity which may cause concern in relation to BEPS.

The discussion draft states at Paragraph 211 that consideration should be given to designing a rule which “limits a group’s net deductions on its regulatory capital to the interest expense paid on these instruments to third parties.” Paragraph 212 then states that targeted rules to address risks posed by specific transactions could be considered as an alternative. We would urge the OECD to first identify any remaining BEPS risks posed by banks. If such risks are determined to exist, we believe any measures taken to address them should be targeted rules that take fully into account and complement the evolving regulatory requirements banks face.

Banking activity and the regulatory environment

The business model of banks is built on borrowing from depositors or in the wholesale markets to provide lending to individuals, SMEs, larger corporates or governments at a margin over the cost of the funds to the bank. Banks may also buy or sell government debt and other securities to provide market liquidity to investors, and deploy their capital to enable their clients to hedge risk.

Regulation plays a critical role in determining how banks are able to carry out commercial activity to support the needs of their customers. Although banking has always been subject to significant regulation, the primary focus of policy makers since the financial crisis has been to improve the stability and resilience of the financial system, ensure deposit holders are adequately protected and support the continuity of services to customers and businesses, in particular lending throughout the business cycle.

We believe that regulatory requirements on banks provide a significant restriction on their ability to undertake activity which may be considered to pose a BEPS risk from a number of perspectives.

i. Capital requirements

The key regulatory focus in recent years has been to strengthen the capital requirements placed on banks to reduce the probability of bank failures. Regulators have sought to ensure, via international standards such as Basel III, that banks have sufficient loss absorbing capital to withstand shocks to the financial system. This has led to a significant increase in the quantity and quality of banks’ capital. In Europe, these requirements apply to
banks both at the group level and at the regulated subsidiary level, effectively requiring sufficient capital to be placed in customer facing operating entities.

In the context of BEPS, these capital requirements also act as a restriction on a bank’s ability to issue debt and push this down to subsidiaries as equity. This is because a bank subscribing for equity in a subsidiary is required to deduct that investment from its own capital when determining how much regulatory capital is eligible to be taken into account when calculating its capital adequacy. In other words, a bank which provides regulatory capital to a subsidiary reduces its own ability to undertake business, as its own capital base is reduced.

It is also worth highlighting that the capital requirements allow banks to meet a limited proportion of the minimum requirements through non-equity capital instruments. These instruments include Alternative Tier I capital (AT1), such as contingent convertible bonds, which have the characteristics of both debt and equity. However, we note that any BEPS risks posed by such instruments are specifically addressed by BEPS Action 2.

Paragraph 211 suggests the design of a group wide interest allocation rule which would limit a group’s total net deductions on its regulatory capital to the expense paid on these instruments to third parties. It is noted that regulatory capital provides core funding for a bank and an assumption that it plays a comparable role with debt in other sectors. We think that is a reasonable conclusion in the context of Action 4. The funds raised from regulatory capital are deployed in the business and generate profits in the course of the banks’ trade. Further, as noted above and unlike other sectors, banks’ ability to issue and redeem regulatory capital is subject to extensive and evolving regulation and regulatory approval.

ii. Large exposure limits

Banks are also subject to a regulatory large exposure limits. This rule limits any exposure, including those to a subsidiary, to 25% of capital net of any equity investment in subsidiaries and other undertakings. The large exposure constraint therefore places restrictions on banks’ ability to issue debt and push this down to subsidiaries as equity as well as the use of intra-group loans from low taxed jurisdictions to high tax jurisdictions. In practice banks' individual exposures do not come close to the 25% limit as this would give rise to concentration risk, which would prompt regulators to require banks to hold additional capital against that risk.

Some jurisdictions also impose domestic rules which further greatly limit BEPS activities for banks. For example, a US banking group would generally not be allowed to inject equity into an off-shore non-regulated entity.

iii. Commercial pressures

In addition to these regulatory pressures, banks’ activity is also influenced by their need to provide adequate returns for investors who have provided capital. Due to the nature of loss absorbing capital, investors expect greater returns than against other types of investment to reflect the potential risk of loss in the event of a default or write down. This creates a commercial pressure on banks to ensure they are not over capitalised and are earning sufficient return on their capital.

In addition to the regulatory constraints noted above, the ability of banks to borrow to fund equity investments is yet further constrained by external commercial pressures. This type of borrowing, or “double leverage”, is seen as a key consideration for investors and credit rating agencies when assessing the position of a bank. Double leverage is measured by inter alia calculating the ratio of equity issued to equity invested by a bank. If the ratio is considered
excessive the holding company's credit rating may be reduced to reflect the perceived reliance on discretionary dividends to fund the interest obligations of the holding company, or its potential inability to realise its assets and repay its debt. The commercial pressure to retain a high credit rating therefore acts as a market incentive for banks not to undertake this type of activity.

These commercial pressures apply directly to banks’ issuing entities (generally the parent or holding company) and this makes capital a valuable resource within a banking group. Once raised, the capital then has to be subscribed to the operating entities to meet local regulatory demands. In addition to the regulatory constraints, the focus on double leverage constrains a group’s ability to borrow to invest capital and means that capital needed by operating entities has to flow down from the issuers. Therefore there are strong commercial reasons for banks not to engage in activity which may pose a risk of BEPS.

Implications of regulatory requirements and commercial pressures for BEPS

These considerations, and the level of scrutiny employed by regulators and investors, mean that banks are over time unlikely to be significantly under or over capitalised, both externally and within the individual entities of a banking group. We believe that this significantly reduces the risk of potential BEPS activity being undertaken by banks through interest deductions and other financial payments.

Achieving BEPS through the use of interest deductions, which Action 4 addresses, requires the ability to freely structure borrowing, including the ability to terminate the borrowing easily. The adequacy and maintenance of a bank’s capital position is of paramount importance and takes precedent over any discretion a bank might have to structure its borrowing in a manner which gives rise to potential BEPS concerns. Banks will also remain subject to significant regulatory scrutiny for the foreseeable future.

If there are specific BEPS concerns which the regulatory environment would permit and require further consideration, we believe these would be best addressed on a targeted basis with appropriate filters. For instance, we would only expect targeted rules to be contemplated when it has been clearly demonstrated that it would not be possible to address any concern using the arm’s length principle.

We would urge that any BEPS risks posed by banks be identified before determining if any further targeted measures are required. This will minimise the risk that any proposals would have unforeseen impact on groups’ regulatory positions and on the cost of finance to the wider economy. If such risks exist, we urge that any measures taken to address them be carefully targeted and take fully into account and support the evolving regulatory requirements banks face. We would be pleased to discuss this further with you.

Specific issues raised by the Discussion Draft

As noted above we fully support the net interest expense approach adopted in the discussion draft and believe that where BEPS risks are identified in the banking sector they should be only addressed by targeted measures.

As a general point we would note that the interest limitations introduced by many jurisdictions to date have provided measures which effectively exclude activity undertaken by banks, or banking groups, or otherwise ensure that the rules do not adversely affect the ordinary course funding of banks.

We would highlight how the approach taken by these jurisdictions recognises the policy drivers outlined elsewhere in this paper, not least the recognition that interest expense is the
cost of sales for a bank and that such measures should operate without a detrimental effect on banks’ ability to lend and support economic activity. We believe that approach is appropriate and should continue to be a feature of any proposals or best practice suggested by the OECD.

Given the significant work that is being undertaken as part of the wider BEPS project, and the short time available to comment on the specific questions raised by the discussion draft, we would also make the following limited observations on the more general questions.

Group Wide Test

As business groups, such as the CBI, have noted the application of a group wide ratio on the basis of earnings or assets will inevitably lead to double taxation, unless that is directly addressed by a corresponding adjustment.

Whichever allocation factor is chosen (assets or earnings), their application will produce a difference between where net interest expense is incurred and the jurisdictions to which the capacity to deduct the expense is allocated. The allocation factors in one jurisdiction in which a group operates will have an impact on every other jurisdiction in which the group is present.

Paragraph 80 notes “Groups may therefore seek to re-organise their intragroup financing to bring each entity’s ratio more in-line with that of the group, subject to any barriers preventing them from doing so”. In the context of banks this “self-help” approach would be particularly ineffective. The ability to locate borrowing to meet any tax ratio would firstly require the ability to predict the ratio for the year, which in itself is challenging for a risk-taking business. In addition to the substantive difficulties already identified by others, having predicted the location of the allocation, banks would also face regulatory barriers, as their ability to deploy and repay capital is subject to the approval of regulators who provide an additional level of oversight.

Fixed Ratio Test

As noted in Paragraph 158, fixed ratio tests have been developed and applied by a number of jurisdictions. When considering the merits of fixed ratio tests we would encourage the OECD to view this on a jurisdiction basis rather than an entity basis. If applicable, consideration should also be given to whether a higher ratio may need to be provided for banks in any proposals or suggested best practice given differences in bank funding compared to other businesses.

Combined Approach

The use of a combined approach has the capacity to resolve the difficulties of each model while still allowing BEPS risks to be addressed. Perhaps more significantly, it may also reduce the risk of double taxation presented by either approach in isolation. Conversely, we would be concerned if any combined approach were to in effect maintain the undesirable consequences of both approaches.

Careful consideration will therefore need to be given to ensure that any final rules are clear, predictable and do not create disproportionate compliance burdens for Tax Authorities and businesses.

Furthermore, if the OECD decides to adopt this approach it will also be important to ensure that any steps taken to address the banking sector are not invalidated by effectively introducing double hurdles.
Payments economically equivalent to interest.

The discussion draft identifies the difficulties that may arise from applying a best practice rule to items including those specified as payments economically equivalent to interest. We agree that there are likely to be practical issues in defining and extracting payments considered economically equivalent to interest when their treatment is likely to vary under different accounting standards.

One matter that could be problematic going forward is the intention to treat the equivalent of today's finance leases and operating leases differently given the proposed divergence of lessee accounting rules under IFRS and US GAAP. We note that the operating and finance lease terms will not be used but there will be a distinction on a similar basis.

The IFRS proposals would require lessees to treat all leases with periods over 12 months in the same way, reflecting a present value of the rentals in the balance sheet and charging a finance charge to the profit and loss account. There would be no distinction between different types of leases.

US GAAP would continue to distinguish between different types of lease and, broadly speaking, continue to charge the equivalent of operating lease rentals to the profit and loss account without separating out a finance charge.

The difference in accounting will either give inconsistent treatment between taxpayers using different GAAP if the finance charge in the accounts is used or practical difficulties for IFRS accounts users in splitting the accounts finance charge based on a split of lease type that is not relevant for the preparation of the accounts.

We would also suggest further consideration is required for the treatment of Sharia finance under any proposals.

Double Taxation

We believe that steps will be needed to ensure that the best practice approaches adopted by Action Plan 4 do not generate double taxation.

The discussion document accepts that the proposed approaches will deny deductions in excess of those needed solely to address BEPS. For instance, the suggestions at Part XII to allow for the carry forward of excessive deductions or capacity accept that there will be excessive restrictions.

Whilst we welcome any measures that prevent double taxation, we would urge the OECD to recommend more timely and comprehensive action to address the risk of double taxation. Any inability of corporates, including banks, to materially predict the tax treatment of debt will introduce uncertainty into investment and funding decisions.

We would therefore consider it of vital importance that the OECD sets out a mechanism which provides for clear and timely corresponding adjustments to be made where deductions are denied in any final proposals or best practice suggestions on the tax treatment of intra-group interest.

It is important to establish that a lender should not be taxed on intra-group interest income to the extent that the borrower is denied a deduction for the corresponding interest expense. In other words, there should be a coherent approach to the treatment of the lender and
borrower to prevent double taxation, and this is particularly important given the proposals diverge from the arm's length principle.

**Interaction with Other Actions**

We recognise that the Action Plans are being produced under intense time pressure and that each is being developed separately. The need for a cohesive response to BEPS is critical if the Action Plans are to be successful. As the discussion draft notes, Action 4 potentially overlaps with a number of the other BEPS Actions. We would therefore ask the OECD to undertake a review of how the recommendations within all the action plans interact in order to ensure there is a consistent and clear approach to BEPS recommendations affecting the intra-group provision of debt finance.

Yours sincerely,

Richard Middleton  
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BEPS Action 4
Comments on the Public Discussion Draft of 18 December 2014

The AFTE welcomes the opportunity to comment on the OECD’s Discussion Draft on Action 4 (Interest deductions and other financial payments) (hereinafter referred to as the “Draft”).

Please find below:

- certain General Comments in relation to the current version of the Draft; and
- the AFTE’s proposed alternatives to those suggested within the Draft to resolve the perceived BEPS\(^1\) issues in relation to interest deductions and other financial payments.

I. General Comments

- MNEs\(^2\) choose to finance their operations through intragroup financing for many reasons unrelated to the potential tax consequences. For example,
  - using internal debt as opposed to equity increases the number of projects / investments that can be undertaken, regardless of the tax impact, as the use of debt lowers the required cost of capital/WACC\(^3\) in assessing and realising projects;
  - the use of internally provided debt reduces the risk of a Group’s overall Corporate credit rating being marked down due to structural subordination concerns;
  - internal debt is used to ensure that local management are suitably disciplined in their spending;
  - use of debt in financing a subsidiary is often important in order to meet rapidly evolving local working capital needs, particularly when operating in territories with relatively limited local financial market sophistication or capital availability;
  - more generally, intra-group debt is used as a risk management tool to better manage the significant risks associated with any material investment and notably to help mitigate risk factors such as operational risk, country risk, cash trap risk and foreign exchange exposure\(^4\). Reducing these risks all help to ensure a suitable, lower, return on monies put at risk by the company providing the capital.

All these reasons are strong drivers for industrial and commercial development and, consequently, economic growth. However, the non-tax reasons to prefer debt financing to equity financing are entirely ignored in the Draft.

\(^1\) Base Erosion and Profit Shifting  
\(^2\) Multinational Enterprises  
\(^3\) Weighted Average Cost of Capital  
\(^4\) Joint venture investments pose their own particular issues, and an individual’s shareholders external financial strategy should not dictate the overall appropriate level of indebtedness
• The Draft, and all of its conclusions, are based on the premise that “The existence of base erosion and profit shifting using interest expense by international groups has been established through a number of academic studies....”\(^5\) The level of this presumed impact is not considered – it is taken as a given based on this statement that the issue exists, and then by implication that it is a material issue, sufficient to rework international treasury practice and to reject the “arm’s length” principle. We feel necessary to draw your attention to the fact that, on the first hand, the statement itself is, at best, overstating the level of conformity in the academic literature on the topic and that, on the second hand, those studies that do suggest some form of profit shifting via interest expense within Groups indicate that the impact is limited. Given that the starting diagnosis is incorrect, the proposed remedies are unfortunately inappropriate.

• The Draft is disconnected from fundamental financial and treasury realities. It also represents a significant shift away from the arm’s length principle and constitutes a “special measure” which would not be covered by double tax treaties.

• The double taxation consequences of such a re-characterisation of interest as dividends are materially underestimated. The Draft also explicitly rejects the possibility of a re-characterisation in one country by Action 4 inspired rules tying automatically to treatment in the other impacted country (see §186), a solution that would have helped relieve the double taxation burden.

• The non-tax consequences of this draft are entirely ignored. This draft will raise the cost of capital globally and will reduce investment, subsequently damaging the growth of the “real economy”. The hardest hit countries will be developing countries or any country with thin or limited financial markets – the link between internal debt financing and FDI into developed countries is well supported. Further, the complexities of reorganising existing internal financing set-ups are considered as minor or unimportant, which is simply not the case.

• Most of the proposals are unworkable, notably those that propose to use assets as a base for the “apportionment” of interest expense.

• Last but not least, we draw your attention to the fact that the proposals related to limiting internal interest expense to external interest expense would create a vicious spiral. The greater the overall external group gearing is, the higher the tax advantage – essentially it changes the equilibrium position of the pre-existing Modigliani-Miller “MM” equilibrium to a higher gearing / higher risk of bankruptcy balance point. Groups that prefer prudent levels of gearing will be rendered less competitive.
II. Proposed alternatives or solutions to perceived BEPS issues in relation to interest expense

- The economically preferable alternative to rebalancing treatment of debt and equity (and hence resolving in a stroke the BEPS issue) via the introduction of some element of equity tax deduction (either in the form of an ACE\textsuperscript{6} or ACC\textsuperscript{7}) is not even considered mentioning in the Draft, which we view as a missed opportunity.

- Properly structured thin capitalisation rules have been shown to work to achieve the overall aim of the report, with a lower impact on investment issues.

- Thin capitalisation rules tied to anti-hybrid regulations that limit interest deduction in the paying country to the interest income being brought into taxable income in the recipient entity would deal with most of what are considered the most “egregious” examples of BEPS issues associated with interest expense.

- If completed with appropriate CFC\textsuperscript{8} rules, the entire issue of BEPS related to interest expense would be solved via the combination of thin capitalisation rules, anti-hybrid rules and CFC rules, without the need to negatively impact worldwide investment and FDI, breach the arm’s length principle as the core international tax principle, and whilst avoiding the risk of massive re-characterisation of cross-border flows with the associated double tax and dispute issues.

- If a solution based on a combination of thin capitalisation, anti-hybrid and CFC rules (all existing tools within the remit of the OECD\textsuperscript{9}, the BEPS project and sovereign states concerned with resolving BEPS issues) was for some reason not considered workable, the use of a combined approach with a Fixed Ratio based on earnings, depending on the company’s activity, defined at a reasonable level\textsuperscript{10}, with a carve-out rule if a Group has gearing or interest expense above the Fixed Ratio, should allow for a solution that is workable for businesses and administrable for tax authorities. This combined approach should be designed in a way that takes into account the specificities of each industry. Therefore, we would further suggest that:
  - The Fixed Ratio should include the possibility to have specific industry ratios, as necessary, to reflect industries with greater than average gearing, for example infrastructure or utilities;
  - Businesses should have the ability to fall back on the application of the standard arm’s length principle if necessary to justify a specific commercial or entity issue; and
  - Businesses should be entitled to an indefinite period carry-forward of any interest expense disallowed based on such rules.

\textsuperscript{6} Allowance for Corporate Equity
\textsuperscript{7} Allowance for Corporate Capital
\textsuperscript{8} Controlled Foreign Company
\textsuperscript{9} Organisation for Economic Co-operation and Development
\textsuperscript{10} Should the fixed ratio be set too low, it would make the rule meaningless and would have the same significant detrimental double taxation consequences as the other proposals
Finally, we strongly reiterate our general concerns in relation to the current Draft. As currently written, it represents a fundamental degradation in the worldwide tax system as well as a significant step back for rational economic decision-making and the free movement of capital.

The current proposals can also only be seen as a precursor to formulatory apportionment, directly contrary to the OECD’s purported continued support for the “arm’s length principle”.

We remain fully available to discuss and further comment on this Draft, and strongly encourage the OECD to consider closely and assess the impacts of its’ proposals on the real economy before any further Draft is circulated or proposed. We consider that it is essential that the fundamental effects of financing, cash management and treasury decisions within corporate organisations be appropriately taken into account when proposing such a major change in the international tax system.

Philippe MESSAGER
Chairman of the AFTE

Co-signed by the AFTE’s Fiscal Technical Committee
BEPS Action 4: Interest deductions and other financial payments – ABI response

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK’s total net worth and contributing £11.8 billion in taxes to the Government. Employing over 315,000 people in the UK alone, the insurance industry is also one of this country’s major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to protect themselves, their families, their homes and assets, provide for a financially secure future and manage the risks faced in their businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The ABI

The Association of British Insurers (ABI) is the voice of the UK insurance industry, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

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

Executive Summary

The ABI supports the objectives of the discussion draft and understands why an overarching global best practice solution is seen as attractive. The ABI also welcomes the acknowledgement that a separate approach is required for the insurance sector. However, in developing any special rules for the sector there are further principles
which should be kept in mind, and any response should be commensurate with the risks in question:

• Regulatory (and commercial) drivers largely govern the issue, quantum, structure and location of debt within the insurance sector.
• Regulatory requirements exist primarily to protect the interests of the consumer in all territories where insurance is purchased. They exist to ensure customers/policyholders are protected from the eventuality of insurers having insufficient funds to meet claims.
• The potential overlap with other BEPS actions should be carefully considered – particularly Action 2 (hybrids), Action 6 (treaty abuse) and Action 7 (CFCs) which all address the taxation of interest in some context – and the necessity for separate rules under Action 4 should be kept under close review as the responses on other Actions develop.

The ABI strongly believes that existing regulatory requirements, together with the commercial rating agency requirements, act as an effective debt limitation rule for the insurance sector. However, we accept that BEPS risk cannot be entirely ruled out, and therefore are willing to work with the OECD and governments to develop targeted rules as envisaged by paragraph 212 of the discussion draft.

• We see a number of problems with a group wide interest limitation approach both generally and if applied to the sector, including the potential detrimental impact on the corporate bond market. Although this could have a detrimental effect on policyholder funds and impact on the cost and availability of insurance, more generally governments need to consider the potential impact on this major asset class.
• We recognise that there may be advantages with a fixed ratio approach but this still raises a number of concerns for the insurance industry. However, given that most insurance groups are net interest recipients, a fixed ratio approach may be appropriate for the sector, as long as it is applied on a territory by territory basis, is set at the right level and by reference to the right measure and recognises the particular circumstances of the insurance sector.
• We note that the discussion draft does not see a role for an arm’s length test. Although we understand the concerns, we suggest that best practice should be sufficiently flexible to allow territories to use such a rule, adapted if necessary, as well as other targeted provisions.
• Best practice should allow territories the flexibility to use and adapt existing rules with a proven track record - including arm’s length rules.
Introduction

i. The ABI welcomes the opportunity to comment on the discussion draft. We support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. We therefore support the objectives of the discussion draft to address base erosion and profit shifting using interest and economically equivalent payments.

ii. We also welcome the acknowledgement in the discussion draft that there may be potential difficulties in applying the proposed general interest limitation rules to the banking and insurance sectors.

iii. In light of this the majority of our response relates to Chapter XIII (Considerations for groups in Specific sectors), although we have commented on some of the more general chapters later on in our response. (We have omitted any chapters where we have no comment). Our response is set out as follows:

- Policy considerations (paras 1-6)
- Considerations for the insurance sector (response to Chapter 13 and question 34)
  - General (paras 7-9)
  - Role of regulatory capital (paras 10-20)
    - Leverage in regulated entities capital (paras 21-31)
    - The approach of rating agencies (paras 32-35)
  - Raising debt and movement of capital (paras 36-47)
  - Suggested approach (paras 48-55)
  - Issues with paragraph 211 suggestion (paras 56-59)
  - Issues with insurers as investors and asset managers
    - The corporate bond market and potential impact on insurers (para 60)
    - UK bond funds held by the long term funds of life companies (paras 61-63)
    - Real estate and infrastructure investments held by the long term funds of life companies (paras 64-66)
    - Asset management (para 67)
- Points on other chapters of discussion draft
  - Chapter III: Existing approaches to tackling BEPS using interest expense (paras 68-70)
  - Chapter V: Who should such a rule apply to? (para 71)

1 Discussion draft on OECD BEPS Action 4 (Interest Deductions and Other Financial Payments) released 18 December 2014.
POLICY CONSIDERATIONS

1. We support the wider objectives of the OECD project to address base erosion and profit shifting, including such activities involving the use of interest and economically equivalent payments. We also support the policy aims of:
   - Minimising distortion to the competitiveness of groups
   - Minimising distortions to investment in a country
   - Avoiding double taxation
   - Minimising administrative costs to countries and compliance costs to groups
   - Promoting economic stability
   - Providing certainty of outcome.

2. We recognise that this is an area of taxation which is approached very differently in different territories and therefore understand why some sort of overarching global best practice solution to provide a unifying approach may be seen as attractive. However, we believe that it is important that a best practice solution also meets the following principles:
   - Is designed to address clearly identified BEPS problems and comprise a proportionate response without unduly impacting the commercial financing of multinationals groups.
   - Allows existing established national rules to form part of the solution where these are effective – i.e. augment what already works well and not introduce unnecessary additional complexity.
   - Works alongside the other BEPS actions, without overlap – particularly the actions related to Hybrids, to the CFC rules, to Permanent Establishments and to Treaty abuse, all of which also address BEPS activities in relation to interest.
• Balances the benefits of an over-arching approach with the advantages and economies of allowing different territories the flexibility to continue to apply rules which work well in those territories.
• Avoids imposing disproportionate compliance burdens both on taxpayers and the authorities whose responsibility it is to administer the rules.

3. It is particularly important to remember that it is regulatory and commercial rather than tax considerations that drive a group’s funding structure and the location in which debt is raised. It should be borne in mind that most groups operate their businesses across a significant number of territories. Debt is not typically issued or located for tax or BEPS purposes, and by the same token, it would be undesirable (and often impossible) to reallocate debt around a large multinational group to bring it in line with some sort of formulaic apportionment. The issue and location of debt is driven by the various and varying funding needs around the group and the location of any surplus cash which can be used to meet these funding needs.

4. This is particularly so in the case of an insurance group. Typically there is limited discretion about the location of the debt as this is subject to regulatory constraints. Due to these regulatory constraints it would be difficult and not commercially rational, to spread debt evenly across all entities in an attempt to match an arbitrary formulaic apportioned cap. Generally, debt (internal or external) is only advanced where there is a commercial need for funding in the particular business. A formulaic apportionment of the group profit and loss position would also be prejudicial where certain legal entities are not able (because of regulatory or other constraints) to carry any debt.

5. We believe there are risks that either a group allocation rule or a fixed ratio approach will not meet the policy principles set out above or the policy objectives in the discussion draft if applied rigidly as a fixed primary rule. For instance, either approach could distort competitiveness and investment and arbitrarily limit tax deductions for interest.

6. We welcome the acknowledgement in the discussion draft that a different approach is required for the financial sector in light of its particular circumstances and regulatory/operating environment. For the insurance sector, any such solution will need to recognise the constraints imposed by regulation and the added risk of further undermining the stated OECD policy aims by impacting on the sector’s regulatory position.
CONSIDERATIONS FOR INSURANCE SECTOR (RESPONSE TO CHAPTER 13 AND QUESTION 34)

General

7. The discussion draft poses the following question (question 34): “Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?”

8. It suggests in paragraphs 211 and 212, two possible approaches:

- Designing a group wide allocation rule which limits total net deductions on regulatory capital (ignoring the interest income generated from using the capital to write business) to the amount of interest expense paid on these instruments to third parties.
- On the assumption that existing regulatory requirements act as an effective general interest limitation rule and prevent excessive leverage in group entities, focussing on interest expense other than that on regulatory capital, possibly through targeted rules.

9. As acknowledged in the discussion draft (paragraph 208), insurance business is generally subject to strict regulations set by state prudential regulators which impose restrictions on a company’s (and in some territories, the group’s) capital structure and generally constrain leverage. In the paragraphs below, we explain the role of regulatory capital in the insurance sector, and how these capital requirements and the approach of ratings agencies constrain leverage. It is these two factors which primarily govern the existence and location of debt and constrain its movement within an insurance group.

Role of regulatory capital

10. Insurers play a unique role in the global economy, protecting individuals, businesses, and governments against financial loss from risks ranging from natural catastrophes to poor health and unemployment. The essence of insurance is the transfer of risk between the insured party and the insurance company in exchange for the payment of a premium. By pooling the risks of multiple insured parties, the insurer can spread the risk of loss. To ensure it will be able to pay any claims that arise beyond those expected, the insurer is required to hold an appropriate amount of capital.
11. The capital position of an insurer is regulated by local prudential regulators (generally government bodies), who set a minimum amount of capital which must be held by an insurer in order to cover its expected liabilities plus an additional margin for additional security. The purpose of this prudential regulation for an insurance company and an insurance group should be emphasised in the context of Action 4. The solvency capital requirement of an insurer has the following purposes:

- To minimise the risk that an insurer would be unable to meet policyholder claims on the occurrence of an insured event;
- To provide an early warning to supervisors so that they can intervene promptly if an insurer’s capital falls below the required level; and
- To promote confidence in the financial stability of the insurance sector.

12. An insurer’s solvency capital requirement is therefore there to ensure that customers/policyholders are protected from the eventuality of the insurer having insufficient funds to meet policyholder claims. As the purchase of insurance is likely to be the norm in many if not all territories, such protection therefore confers benefits universally, not just in those territories where the majority of insurance business is located. Indeed, in many territories the purchase of some classes of insurance, such as motor, professional indemnity etc., may be mandatory.

13. Each company which writes insurance business in an insurance group is subject to local regulation in their territory of residence. Further regulation requirements can apply at the level of the ultimate holding company of an insurance group (and can also apply to the top holding company of sub-groups in certain territories e.g. the EU). This ensures that each individual company as well as the group as a whole holds sufficient capital to meet its potential liabilities.

14. The regulation of insurance groups around the world is evolving. Importantly, the Financial Stability Board (“FSB”) has designated several institutions as “Global Systemically Important Insurers” (GSIs) or Internationally Active Insurance Groups (“IAIGs”). The regulation of these entities will be part of ComFrame, the comprehensive regulatory framework for insurers.

15. Whilst the developing global regulations may bring some harmonisation between the regulatory regimes, particularly for GSIs/IAIGs, there is no “one size fits all” approach in the insurance industry at the moment. There are some notable differences; for example, under European Directives insurance groups are subject to regulation regarding capital adequacy on a group basis. In the U.S. insurance groups are regulated at a state level with regulation applying only at entity level (i.e. the U.S. top co is unregulated in the U.S.). There is an exception to this rule with respect to U.S. firms which are GSIs. (However the practical
implications of a U.S. parented insurance group being designated as a GSII are currently unclear).

16. By way of example to illustrate the difference between these approaches, a U.S. parented insurance group with an EU parented sub-group will, unless it is a GSII, be regulated at a state level in U.S. on an individual insurance company basis and be regulated at a group level in the EU for all its operations held by the EU regulated holding company (regardless of whether the individual subsidiaries are subject to separate regulation or not). For a GSII, group regulation would apply at the U.S. holding company level as well as individual state level and then separately at a group level. In the EU the EU regulated holding company and its sub-group would be regulated. Conversely an EU parented group with U.S. insurance subsidiaries will be regulated on a group basis in the EU and at a state level in the U.S. on an individual insurance company basis.

17. Although local regulatory rules can vary widely, the Solvency II regime will govern all European insurers and many other governments are developing new regulatory rules that follow the same fundamental concepts as Solvency II. Furthermore, EU insurance companies who reinsure to locations outside the EU will need to demonstrate that the local regulations are ‘equivalent’ to Solvency II, or be sufficiently capitalised under Solvency II rules, in order to get regulatory credit for the reinsurance.

18. The Solvency II capital requirements apply equally to each active insurance company in a group of companies and also to the ultimate EU holding company of an insurance group. Each insurance entity and group holding company must hold sufficient regulatory capital which meets the Solvency II capital requirements. Where the parent company of a group of companies is located outside of the EU, the Solvency II requirements will apply to the “top” EU holding company.

19. In the context of EU regulation, the top EU regulated holding company is subject to regulation by reference to the capital and solvency position of that top EU company’s sub-group below it regardless of where they are located. The group regulation applies to all subsidiaries whether or not they are carrying out regulated business. In addition, local regulations will apply to individual insurance companies that are subsidiaries of the EU regulated holding company and located outside the EU.

20. The following sections explain in more detail why a combination of regulation and the role of rating agencies govern both the level and location of debt. The role of ratings agencies is particularly relevant for the sector – not only do they apply a range of credit ratings but they also assign an Insurer Financial Strength Rating (IFSR).
Leverage in regulated entities

21. As noted above, insurance companies and insurance groups must hold sufficient regulatory capital to cover the risk of their assets not being sufficient to cover their insurance liabilities. Capital adequacy standards set by local regulators define the amount and type of capital which an insurance company must hold and detail the characteristics which regulatory capital instruments must have in order to qualify as such.

22. Regulators set strict limits around the amount of debt an insurance company can hold to meet its individual regulatory capital requirements. Although Solvency I will still be relevant for some years to come due to its transitional arrangements, the following analysis focuses on Solvency II as this is the regime which will become increasingly relevant to the sector. It should be noted that although Solvency II comes into effect on 1 January 2016, its requirements and application (supervision) is likely to evolve after it has been implemented (and some regulators are also attempting to anticipate its implementation). The comments below are based on the Solvency II Standards in their present form.

23. Under Solvency II:

- the required regulatory capital of an insurance company is divided into three 'tiers' (Tier 1 to Tier 3) based on both the instrument’s 'permanence' and its 'loss absorbency' characteristics. The “tier” of capital in which an instrument falls will be determined by factors such as its quality, ability to absorb losses, duration, permanence and the obligations of the insurer under its terms to pay distributions or interest. Tier 1 is the capital of the highest quality and the majority of an insurer’s regulatory capital must be Tier 1 capital.

- there are two principle capital requirements of an insurer:
  - The main capital requirement is the Solvency Capital Requirement (“SCR”). The SCR is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. Should available capital fall below this threshold, supervisory intervention would be triggered to restore the appropriate capital level.
  - In addition to the SCR capital, a Minimum Capital Requirement (“MCR”) must be calculated which will correspond to an 85% probability of adequacy over a one year period. Should available capital fall below this threshold, supervisory intervention would be triggered to wind up the insurer.
24. Regulatory rules including Solvency II set limits on the amount of non-equity Tier 1, Tier 2 and Tier 3 capital that can be held to cover an insurance company’s capital requirements, to ensure that the insurer has sufficient capital to absorb any losses that might arise. The terms of the majority of regulatory debt instruments issued by insurance companies are designed to ensure that the instruments meet the requirements in order to be treated as part of the insurer’s Tier 1, Tier 2 or Tier 3 capital.

25. The limits for capital instruments covering the MCR are the most restrictive. The MCR must be made up of Tier 1 and Tier 2 capital only and at least 80% of the capital used to cover the MCR must be Tier 1 capital. For the SCR, at least 50% per cent of the capital making up the SCR must be Tier 1.

26. For supervisory purposes, the SCR and MCR act as regulatory triggers. The insurance regulator would intervene once the capital holding of the (re)insurance company (or holding company) falls below the SCR, with the intervention becoming progressively more intense as the amount of regulatory capital held approaches the MCR.

27. As noted above, the terms which debt instruments must contain in order to qualify as Tier 1, Tier 2 or Tier 3 are also mandated by regulators. These debts must have certain equity-like features (relating to loss absorbency and interest deferral) and therefore insurance regulation can also impact the cost of debt issued by insurance entities. As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory debt instruments are still

Note: DTA is ‘Deferred Tax Asset’
cheaper than equity. Including too much equity in Tier 1 would be prohibitively expensive and regulators recognise this. So they allow insurers to include some debt as long as it has the appropriate loss absorbing characteristics. However, using too much debt increases the risk profile of the business due to the obligation on the business to service the debt and is therefore not permitted by the regulator.

28. Insurers tend to hold a much greater proportion of equity capital in relation to debt than other industries. For this reason, we believe the insurance industry poses little BEPS risk in relation to Action 4.

29. As shown in the figure above, the amount of Tier 1 Capital held by an insurer must always exceed Tier 2 and 3 Capital. Excess Tier 2 and Tier 3 Capital of an insurer is reclassified as an ordinary liability, and hence actually reduces Tier 1 capital further. The practical impact of this restriction is that insurers will have a substantially greater proportion of Tier 1 capital and Tier 2/3 capital than the minimum requirement. The rationale for this can be demonstrated in the below example:

<table>
<thead>
<tr>
<th></th>
<th>Insurance Company 1</th>
<th>Insurance Company 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>75</td>
<td>50</td>
</tr>
<tr>
<td>Tier 2 and 3</td>
<td>25</td>
<td>50</td>
</tr>
<tr>
<td>TOTAL Regulatory Capital</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

30. Both Insurance Company 1 and Insurance Company 2 hold the same quantum of capital (i.e. 100) but the make-up of each company’s capital is slightly different. Now consider the impact on both companies of an insurance loss event of 20 arising (which reduces each company’s Tier 1 retained earnings):

<table>
<thead>
<tr>
<th></th>
<th>Insurance Company 1</th>
<th>Insurance Company 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>55</td>
<td>30</td>
</tr>
<tr>
<td>Tier 2 and 3</td>
<td>25</td>
<td>30 – restricted to total Tier 1</td>
</tr>
<tr>
<td>TOTAL Regulatory Capital</td>
<td>80</td>
<td>60</td>
</tr>
</tbody>
</table>

31. The table above illustrates that Insurance Company 1 only suffers in regulatory capital terms the economic loss of 20 and now holds total capital of 80 (from 100). Insurance Company 2, however, suffers both the economic loss of 20 (which reduces its Tier 1 capital to 30), but also then has to disqualify part of its Tier 2/3 Regulatory Capital as Regulatory Capital (as a result of the requirement to hold more than 50% capital as Tier 1). As a consequence of the
capital tiering limits, Insurer 2 suffers a regulatory capital loss of 40, compared to that of 20 of Insurance Company 1. This may cause Insurance Company 2 to fall below the minimum capital level, or approach close enough to that threshold that the regulator makes an intervention. This will either require Insurer 2 to raise more Tier 1 capital (equity) or impact on the amount of insurance business it can write (or both). This may also stop the insurer from being able to pay dividends and pay interest on its regulatory debt securities which has wider consequences in the market and may impact the insurer’s credit rating (and cost of finance). Hence, this tiering of capital discourages insurance companies from depending too heavily on Tier 2/3 debt and means in practice that insurers hold an additional buffer of tier 1 capital above the minimum tier 1 capital required. We believe this demonstrates that there are regulatory constraints on insurers holding excessive debt.

The approach of rating agencies

32. Ratings agencies provide opinions, such as the Financial Strength Rating, based on an insurer’s ability to meet its senior financial obligations, which are its obligations to policyholders. Many corporate clients and consumers will only contract with insurance groups which have high credit ratings (for example A or above) as this provides more security that the insurer will be able to pay claims even where losses are unexpectedly high.

33. Rating Agencies assess both the quantity and quality of an insurer’s capital. The table below summarises the approach of Rating Agencies for attribution of capital credit to financial instruments to capital or liabilities when assessing the financial strength of insurers and reinsurers. This is a high level summary and the Rating Agencies methods may be more detailed and be applied more on a case by case basis. However, these rules clearly emphasise that insurers are not rewarded by Rating Agencies for issuing too much debt, and to protect the credit ratings, which influence both the cost of capital and the insurance and reinsurance premiums that can be charged, insurance groups and insurers must bear these limits in mind. Both credit and financial strength ratings are vital for selling insurance as the purchases effectively incur a credit risk (which can be very long-term) on the insurer.
<table>
<thead>
<tr>
<th>Rating agency</th>
<th>Treatment of hybrid debt compared to equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard &amp; Poor's</strong></td>
<td>Included in total capital, following regulatory approach but subject to tolerance levels. Lower Tier 2 is treated as debt. Hybrid capital above 15% of total capital is included as debt in leverage calculations</td>
</tr>
<tr>
<td><strong>AM Best</strong></td>
<td>Applies an &quot;Equity-Debt Continuum&quot;. A proportion of a hybrid is recognised as equity depending on its underlying characteristics; the more equity-like, the higher the proportion of the hybrid recognised as equity. Generally, equity credit is granted up to a maximum of 20% of an insurer’s total capital</td>
</tr>
<tr>
<td><strong>Fitch</strong></td>
<td>Debt proportion of hybrids treated as debt. Each hybrid is credited as either 100%, 50% or 0% as equity in capital calculations and financial leverage ratios. If total hybrids are greater than 20% of total capital, computed as hybrids divided by hybrids+equity+debt, then Fitch will consider if the hybrids are stressing the insurer.³</td>
</tr>
<tr>
<td><strong>Moody's</strong></td>
<td>Debt:equity continuum applied to hybrid debt; and included in financial leverage calculation accordingly, which is actively assessed. Included in earnings coverage as debt</td>
</tr>
<tr>
<td><strong>Solvency 1</strong></td>
<td>Restricted to 50% of required (Luxembourg) or available capital (United Kingdom) depending on jurisdiction. Further restrictions on form of hybrid (i.e. dated debt can only be 25% of capital)</td>
</tr>
</tbody>
</table>

34. Broadly, equity is the strongest form of capital, whilst hybrid debt is considered less strong. This is why regulators and rating agencies limit the amount of debt which is eligible as capital.

35. As can be seen from the above, regulators, Rating Agencies, and corporate customers and their brokers, force insurers to hold high quality capital in excess of expected liabilities. These rules also limit the amount and type of debt that may be included in capital. This creates a natural link between the minimum amount of capital required by regulators and ratings agencies, and the maximum amount of capital an insurance group can use effectively. This therefore ensures that the level of leverage (and the type of leverage) is tightly constrained within the insurance sector.

**Raising debt and movement of capital**

36. We have noted above that the location of debt within a regulatory insurance group is driven by regulatory and commercial factors. The decision where to raise regulatory debt in an insurance group depends on a range of different factors. Often the company which issues such debt would be the group holding company – it owns all of the assets and receives all the profit of the group and consequently has the best credit rating.

³ Fitch Ratings Insurance, *Treatment of Hybrids in Insurance, Capital and Leverage Analysis*
37. However, there may be some very specific regulatory considerations which drive the decision as to which entity should issue regulatory debt. For example, some groups are ultimately owned by companies which are not included in the group for regulatory purposes. In this case, the regulatory debt would be raised at the highest level within the regulatory capital group. Another example arises where in the circumstances of specific groups the regulator may impose specific capital requirements.

38. Under European Regulation, the lead EU regulator of an insurance group considers the capital adequacy of the consolidated group of entities, taking into account the structural and geographic diversity of the component insurance portfolios. Accordingly, regulatory capital issuances may inherently be required on a consolidated basis and, therefore, at the level of the group’s EU holding company (effectively, the Solvency II top company) which may or may not be the group’s parent company, depending on whether the group is ultimately parented by an EU resident company.

39. A key practical reason for keeping regulatory debt in the top company is to allow the flexibility to apply it across a group as and when required, on the basis that capital needs to be fungible across the group. Whilst individual companies have solo capital requirements which must be met, the solvency requirement of the group is best covered by holding the capital at the highest possible level. This requirement generally exists because regulatory capital held in a parent company can more easily be redeployed to group members than capital that would be “stuck” in lower-tier subsidiaries. A subsidiary that has issued capital externally cannot deploy that capital readily to other jurisdictions within the group as the regulator of the subsidiary must approve any redemption or movement of that capital between parent and subsidiary. This is particularly the case for equity capital, which can require a substantial period of consultation with regulators before such equity capital can be redeemed or released.

40. Where capital is uncommitted and covers the combined liabilities of the group as a whole it would be held at the highest level so that it is available to cover capital requirements wherever they arise. However, it should be noted that such movement of capital between regulated entities requires local regulatory approval in both territories. The transfer of capital to lower tier subsidiaries through intra-group regulated capital instruments is required by regulators to be accomplished on a true arms-length basis as regulators generally require the insurance subsidiaries operating in their jurisdictions to be as independent as possible, from a capital and management standpoint, from their parent companies.

41. Groups which are owned by companies where there is no group regulation (e.g. the U.S.) will also seek to hold surplus capital at the top company for the purpose of flexibility to apply it across the group as and when required. The key difference is such groups are unlikely to raise external regulatory capital debt via the top company because it will provide no regulatory
capital benefit to the group, such debt is more likely to be issued either externally or internally by a lower tier entity which does obtain a regulatory capital benefit.

42. It will often also make sense to raise regulatory debt in the listed parent company from an investor marketing perspective not least because this enables investors to assess the issuer’s credit risk by reference to a larger and more diversified asset base and income stream (i.e. multiple income–producing operating subsidiaries) and generally this entity will have greater access to capital markets and will lead the majority of the external banking relationships for the group.

43. When considering the issue of on-lending of regulatory debt to operating companies, it is worth noting that insurance groups require capital for a range of purposes. Monies are raised for the financing of group activities. There is generally a preference to retain the proceeds at as high a level in the Group as possible, other things being equal, in order to maximise flexibility regarding the use of the funds (to the extent that they are not committed).

44. Some companies have entered into arrangements whereby external regulatory debt is on-lent to other group companies including operating companies. This will vary from group to group depending on individual circumstances. Whether regulatory debt is on-lent in this way will depend on commercial, legal and regulatory reasons such as bank covenants, foreign currency controls, solo level solvency calculations, individual regulator’s preferences or legal scheme restrictions (for example). In this respect, it may be sufficient from a rating/solvency capital perspective to on-lend to the local holding company of the operating companies in a territory, and not to divide the debt between individual operating companies. Any attempt to divide the regulatory debt in this way between entities in a territory would be difficult and impractical as it would need to be adjusted frequently.

45. It should also be noted that different regulatory rules permit different levels of debt that qualify as regulatory capital and there is no common global standard for regulation. The regulatory rules in the U.S. for example vary by State, the EU rules, whilst operating off a common base, also vary from territory to territory and some other countries prohibit borrowing in insurers. The capital structure of global insurance groups may therefore differ widely depending on which territories it operates business in.

46. The above analysis explains the drivers which govern the location of regulatory debt and the constraints which prevent the arbitrary movement of debt around an insurance group. It also demonstrates why any proposed rule which requires the arbitrary allocation of debt around a group, for instance to optimise tax treatment under a group allocation rule would be difficult and illustrates why insurance groups are naturally less likely to undermine the stated policy aims of Action 4.
47. It may also be helpful to say a little more about how the funding of non-regulated parts of insurance groups works. Most multinational groups have internal treasury functions that manage the group’s cash flow. Insurance groups are no different in that surplus cash is often pooled centrally and lent intra-group to where it is needed to meet the daily cash flow requirements of the businesses. This can be achieved a number of ways through cash pooling, short term deposits & overdrafts, overnight sweeps of cash or intercompany loans. By centralising the management of cash, the treasury function can ensure that the group’s cash is put to work in the most efficient and effective manner. For non-regulated entities in an insurance group the group will implement the system that makes most commercial sense with the only limitation being ensuring adherence to the relevant laws including tax and transfer pricing regulations. For regulated companies in an insurance group there are restrictions on the amount of cash that can be lent to unregulated entities, whether affiliated or not, these restrictions will apply to impact the regulatory capital position of the regulated company. For example, under Solvency II a European Insurance company in considering its regulatory capital position will need to consider a risk charge against an asset that represents a cash receivable from an unregulated company and this will impact the amount of capital the insurance company needs to hold. Insurance regulations also set exposure limits for both related and unrelated counterparties.

**Suggested approach**

48. As above, we strongly believe that existing regulatory requirements do act as an effective interest limitation rule, both in preventing excessive leverage and shaping the financing structures of insurance groups.

49. We understand that the creation of some sort of over-arching best practice may be seen as helpful and recognise that it may be seen as desirable if the insurance sector is not completely out with such an approach.

50. With this in mind and given that insurers are usually recipients of net interest income (as noted in the discussion draft at paragraph 205), we think that this allows insurers to be within the ambit of a general approach, such as a fixed ratio rule, without there being an undue impact on a groups regulatory position as long as:

- Such a fixed ratio rule is applied on a territorial as opposed to an entity basis
- Any ratio is based on a measure which is meaningful for the insurance sector (EBITDA, for instance, is not a relevant measure in respect of long term insurance).
- The level of any such ratio applied to the sector recognises the particular circumstances of the sector and incorporates some sort of carry forward and carry back mechanism to accommodate any extreme outcomes.
51. We believe that such an approach would be commensurate with the very limited BEPS risk posed by the insurance sector given the particular regulatory and commercial environment in which it operates. In contrast, we do not think a rule formulated by reference to net interest, excluding interest income generated from using capital to write business, would be practical.

52. However, we do acknowledge that there may be a concern that BEPS risk cannot be entirely ruled out in the insurance sector. And that as paragraph 212 envisages there may be a need for some specific targeted rules. We would therefore support the approach suggested in paragraph 212 of the discussion draft and suggest that in view of the usual net interest income position of insurance groups, some targeted rules to address risks posed by specific transactions may be appropriate.

53. In this context, it should also be borne in mind that some potential risks may be addressed by approaches developed under other BEPS Actions – in particular through the development of the CFC rules. We also refer to this in our response to Chapter XIV.

54. However, where targeted rules are needed we would suggest that some sort of arm’s length rule would be appropriate, perhaps adapted to ensure that non-taxable elements are taken out of account in arriving at an appropriate comparator. Appropriate protection might also be provided by an approach along the lines of the existing UK unallowable purpose rules.

55. We would also recommend that any such rules are developed to apply on a territorial, rather than an entity basis, not only to help provide consistency across different territories and operate for consolidated tax group jurisdictions but also to reduce any disproportionate compliance burden both for companies and government officials.

Issues with paragraph 211 suggestion

56. We have noted our general concerns with an overall group limitation approach. These concerns persist even with a solution restricted to regulatory debt:

- Limiting the interest deduction in respect of regulatory capital to the amount paid by the group to third parties would distort the capitalisation of insurance groups, increase the cost of funding and could particularly impact interest paid in respect of intra-group regulatory debt.
- Any rule which imposes restrictions on the entities in which deductions can be tax effective, will be similarly distortive and impose arbitrary competitive inequalities.

57. Tax relief on interest deductions is vital for the sector. Any rule which curtails it, especially if it applies capriciously or unevenly will severely impact the competitiveness of the sector. Tax
relief on the interest cost of issuing regulatory debt is a key component in the cost of raising capital. Investors and analysts expect groups to obtain tax relief on interest costs and factor this into the models which are used to predict and influence share prices. In a competitive environment, it is not expected by the markets that groups would be in a fundamentally different position to one another in relation to the ability to obtain relief for regulatory debt interest. Investors expect interest to be tax deductible and explicit guidance is often given to the market in respect of this. If it becomes apparent that there is an issue with the obtaining of tax deductions for regulatory debt for insurers, not only will this increase the costs of raising capital but potentially create an impediment in accessing capital markets.

58. Crucially, any such impact on the cost of raising finance and the competitiveness of the sector will inevitably impact the consumer. Potentially, it will raise the cost of insurance and reduce the availability of cover globally and consequently run counter to the policy aims of Action 4.

59. We note the suggestion in paragraph 211 that in any measure of net interest, interest income generated from using the capital to write business should be excluded. Although we recognise that this is driven by the concern expressed in paragraph 205 that both the banking and insurance sectors are usually net recipients of interest, we do not believe that any solution based on this measure would be appropriate. Indeed, as noted above we believe that the usual overall interest position in the sector may allow for a sector solution to be aligned in broad terms with the overall aims of the discussion draft.

Issues with insurers as investors and asset managers

The corporate bond market and potential impact on insurers

60. There are secondary impacts of any general interest restriction which need to be considered. For example, there is a potential risk both that there will be reduced returns to investors due to higher tax costs in the issuer and that the issue of corporate debt will decline. Corporate debt is a major asset class in which insurers invest to back insurance liabilities. If the supply of corporate bonds is restricted alternatives will be sought - for example, equities. Holding increased amounts of equity will impact an insurers risk profile and therefore capital requirements. Increased capital requirements usually result in increased premiums and as a consequence less insurance coverage. Insurers turning to equities would also have a significant market impact.
UK bond funds held by the long term funds of life companies

61. In many cases life assurance companies will invest in collective investment schemes that are open to a wide range of investors. These investments are made to support the liabilities owed by the life company to its policyholders. Given the quantum of assets invested by life companies, it is relatively common for those funds to be majority-held by the investing life company such that the funds are included on the consolidated balance sheet of the life group.

62. Under the proposals as described, this could have the effect that any form of group-wide interest cap or fixed ratio rule was also applied at the fund level. In the case of most of the more prevalent fund-types such as a Luxembourg SICAV or an Irish OEIC this would have no adverse effect as typically the funds themselves are exempt from tax and so there would be no interest deduction to take into account. UK bond funds would similarly not typically be subject to tax on their income but the mechanics by which this is achieved require the distributions paid by the fund to be treated as interest paid. In the event that any part of the distribution were not permitted to be treated as tax deductible this would result in tax being applied at the fund level which could not be recovered, or offset against the tax liability on the distribution, by the investor. This would be an absolute cost to any investors in the fund, including pension policyholders of the life company and other investors in the fund who are unconnected to the life company.

63. The effect of applying a group-wide restriction to collective investment schemes in this instance would be to create a competitive advantage for non-UK funds and transaction costs for life company investors who would inevitably seek to transfer any UK bond fund holdings into their Luxembourg or Irish equivalents. Even accepting this distortive impact there remains a big question mark over whether any cap would be appropriate for collectives, particularly where widely-distributed, as their investment objectives would not encompass the behaviours that BEPS action 4 is targeting. We would welcome further discussion on this aspect.

Real estate and infrastructure investments held by the long term funds of life companies

64. Life assurance companies are significant investors in commercial real estate and increasingly in infrastructure as it is an attractive investment to support liabilities owed to policyholders. Commercial real estate is very capital intensive, and the amounts of money involved can be very large, particularly where regeneration or infrastructure projects are involved. Debt finance plays a vital role in providing capital to the commercial real estate sector by facilitating the stock of commercial real estate on the market. It thereby contributes to the
economy as a whole. It is also a highly desirable investment for policyholder funds in terms of both capital growth and income generation.

65. Were the tax deductibility of debt interest restricted it would decrease the return from commercial real estate and have a detrimental impact on returns to policyholders, not only in terms of yields but also in terms of the stock of suitable investments. In addition it could lead to a reduction in the capital made available to invest in commercial real estate and infrastructure projects.

66. Life companies often invest in commercial real estate through some form of collective investment vehicle which itself will invest either directly or indirectly in real estate. These investment vehicles can be included in the consolidated balance sheet of the life group. As with our comments on bond funds above, we believe that the application of a group-wide restriction to the real estate investment vehicle in such circumstances is not appropriate.

Asset management

67. Global life insurance groups often contain asset management businesses as a means to invest funds on behalf of the group’s policyholders. Furthermore, the policyholder funds are often used to seed capital for funds taken to the external market. Therefore any new rules that limit the deductibility of interest will affect such groups in two ways. First, it could affect the attractiveness of the fund and second, money that is invested on behalf of policyholders could be impacted by any intragroup restrictions. For this reason we would welcome the opportunity to be part of any of the discussions relating to the development of any special rules for the asset management sector.

POINTS ON OTHER CHAPTERS OF DISCUSSION DRAFT

Chapter III: Existing approaches to tackling BEPS using interest expense

68. We note that the discussion draft does not see a role for arm’s length tests. We understand that this is seen by some territories as unfeasibly onerous to operate and we also note concerns that:

- Existing arm’s length tests may not be fully effective against BEPS because they only apply to intra-group payments, and
- They permit deductible interest to be supported by non-taxable assets or income, such as investments in subsidiaries (although such interest is non-deductible in many territories).
69. These possible failings are not particular to the arm’s length test – indeed the discussion draft acknowledges in Chapter 2 that some sort of targeted rule may be needed in any case to limit excessive interest paid outside the group to connected parties. We do understand that for territories where such rules are not already well established and proven, there may be a reluctance to incorporate them as a mandatory element of best practice. However, for territories where such tests are already established, we would suggest that they should not be ruled out from providing an element of the solution as our members’ experience is that debt is relatively straightforward to transfer price, and to provide sufficient evidence and assurance to tax authorities that such pricing is arm’s-length. This is partly due to the ready availability of market yields for comparable instruments issued and traded on the open market, and widely published data for lending and borrowing rates. Flexibility to retain/incorporate such rules as part of a best practice solution would be particularly helpful in the context of the insurance sector.

70. We are also concerned that the discussion draft (at paragraph 27) cites as a failure of the existing rules that they are unlikely to encourage groups to move towards funding structures where the net interest cost of individual entities reflect the position of the group overall. As we have already noted this is not an appropriate aim – generally debt is raised and located for regulatory and commercial reasons – and this, not tax, drives and should continue to drive financing structures.

Chapter V: Who should a rule apply to? (discussion draft questions 3 and 4)

71. We are not of aware of other scenarios which pose a BEPS risk (Question 3). We note with concern the suggestion that some countries might want to apply the approach to include scenario 4 as a response to difficulties in identifying entities falling within the 25% related parties test proposed in scenario 3. Not only could this result as stated in some companies and entities incurring an inappropriate interest disallowance but an inconsistent approach in different territories could result in disputes and potentially double taxation.

Chapter VI: What should a rule apply to? (A) The level of debt or interest expense and (B) an entity’s gross or net position

Application to an entity’s gross position or net position (discussion draft Question 5)

72. We agree that a net interest expense proposal makes sense in the context of financing transactions (e.g. debt pushed down from the parent to subsidiaries). However, although as paragraph 205 states insurance groups will usually be net recipients of interest received, we do not think this stands in the way of a solution which broadly meets the aims of the
discussion draft. However any attempt to apply a global formulary apportionment to a simple net interest measure (whether or not interest income generated from using the capital to write business is excluded) would not be workable in the context of the insurance sector.

Chapter VIII: Whether interest deductions should be limited with reference to the position of an entity’s group

A: Group wide tests as an approach to addressing BEPS and profits shifting

73. As noted above we believe that a general interest allocation rule, whilst attractive in concept risks failing to meet a number of the stated policy aims and could indeed exacerbate problems. Whilst there are specific issues with such a rule for the insurance sector we believe there are also much wider issues with such an approach.

74. A general concern with a group allocation model as a rigid primary rule is that both for the insurance sector and more widely, regulatory and commercial rather than tax considerations drive funding structures. A group allocation model, especially when combined with a cap approach will not recognise this, and although we note the aspiration that the aims will be achieved by encouraging groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group, we do not believe that this is realistic, especially for regulated sectors. It is not necessarily the case that intra group issues of regulatory debt will be matched with/ limited to an external issue of debt by the holding company. As explained above, it is not feasible to reallocate debt around the group to align it with the outcome produced by a group allocation approach.

75. We have explained above the issues for the insurance sector in redistributing debt. However, more generally, in addition to regulatory factors, problems would arise in the insurance sector and likely other sectors because:

- Operating companies would generally need to have a business need for the financing in order to obtain a tax deduction for the financing costs. It is not simply a case of gearing up a company/territory to their allocated deduction amount.
- Merger and acquisition activity could potentially be impacted.
- Managing deductibility of interest on an on-going basis with global allocation rules would be difficult and disproportionately burdensome for a group operating in numerous territories. Having to constantly review and adjust company/territory debt levels to reflect the overall change in group debt level is not workable in practice. This is especially so once foreign exchange differences across numerous currencies are also taken into account.
Multinational groups operate across a number of territories and therefore operate in a large number of local currencies/interest rate environments. The currency in which the group allocation is required to be made in and the date that this must be done will cause a number of practical issues.

Certain territories may apply withholding taxes on interest payments, which disincentivise debt financing. This can include major territories, and there are some countries, e.g. Brazil which do not have tax treaties with major locations for insurers such as the UK and the U.S.

Cost of funding in local currency is often prohibitively expensive or the value of local currencies may be extremely volatile.

Currency controls may limit flexibility.

Volatile end markets may also present problems.

76. Although we recognise the potential benefits of a rule which limits net interest deductions to the net external position - indeed the UK’s world-wide debt cap is based on that principle – we are concerned that this could be distortive and perhaps more importantly, confers a competitive advantage on more highly leveraged sectors and groups within such sectors. Indeed, it could even encourage groups to incur external debt to provide ‘headroom’ for deductions within the group. In the insurance sector, such a rule could jeopardise interest deductions on intra-group finance, even where such debt constitutes regulatory capital in its own right.

77. Such an approach would be very burdensome in terms of world-wide data collection and, even assuming such data is readily available, issues will arise in terms of timing. For instance, a group will only know its financial results for an accounting period with hindsight (i.e. once the accounting period has ended) and will not therefore know in advance where its debt should be located to align with an allocation model. This is especially so in the insurance sector where results may depend in part on the occurrence of external events such as natural disasters.

78. A likely outcome of a group allocation model, even if double taxation is to some extent alleviated by carrying forward excess interest or unused capacity as suggested in Chapter XII, is that tax relief will be lost on interest costs and groups will be unable to obtain relief in the aggregate for the total net external interest payments. It is noted that this is also the outcome of the large majority of the examples provided in the discussion draft which seems contrary to the stated aim of the Action.

B: Options for group-wide rules: interest allocation rules and group ratio rules (discussion draft questions 7 and 8)

79. As a general point, we suggest that entities should be able to demonstrate that the group’s net interest expense has been distributed around the group based on a commercially rational
basis without the need for tax authorities to resort to formulary apportionment. This would also solve the formulary apportionment problems that would arise from losses and different entity types. We have explained above why, for an insurance group, any time of formulary apportionment of net interest to all entities would be highly problematic.

C: What entities should be included in an interest limitation group? (discussion draft question 9)

80. We have set out above our general concerns with a group wide allocation rule and our specific concerns in relation to the insurance sector. However, it is worth noting under this head that particular difficulties would arise in the insurance sector given then there is no common accounting standard for insurance. IFRS 4, the accounting standard for insurance, is only a holding standard that permits the use of the pre-IFRS method, whilst the final global standard continues to be discussed and negotiated. Furthermore, there are often considerable differences in generally acceptable accounting principles ("GAAP") for insurance business between territories, e.g.:

- Equalisation reserves are required in Germany, France, Netherlands etc. but not in the UK or the U.S.
- The discount rate for life reserves (i.e. the value of the reserve is determined on a net present value basis) is different between U.S. GAAP, UK GAAP, German GAAP and other GAAPs.
- Acquisition costs are immediately expensed in some territories but are treated as prepayments in effect in other territories.
- Life Assurance business is often subject to separate Embedded Value accounting in addition to published accounts. This recognises the future cash flows arising under insurance policies already underwritten but which accounting policies do not recognise. This method is actually reviewed by investors and lenders when making lending decisions.

H: How should risks posed by connected parties and related parties be dealt with (discussion draft questions 22 and 23)

81. We note the expressed concern that some groups may attempt to reduce the impact of group-wide rules by artificially increasing the level of net third party interest expense, through transactions with connected and related parties. We also note the proposal either to include connected parties within the interest limitation group or to apply a targeted provision. Generally, we would favour targeted rules over further complication of the proposed group wide rules – we discuss in our response to Chapter XIII above, the extent to which such targeted rules are necessary in the context of the insurance sector.
Chapter IX: Whether interest deductions should be limited with reference to a fixed ratio (discussion draft questions 24 to 28)

82. Although we would generally favour a fixed ratio over a group allocation approach in the context of the insurance sector (depending on the net interest measure used), there remain a number of potential issues with this approach.

83. In common with a group wide allocation approach, a fixed ratio could result in interest paid for perfectly genuine regulatory and/or commercial reasons being unrelieved. Such double taxation would increase the costs of raising capital.

84. Similarly, for reasons explained above, groups cannot necessarily move the location of their debt to ensure the interest deductions align with the ratios. This is particularly so in the insurance sector as detailed in our response to Chapter XIII. It will therefore be vital that any ratio is set at the right level if it is not to cause undesirable distortion in situations where BEPS concerns do not exist.

85. Although we understand that a fixed ratio approach has been applied relatively successfully in some territories, we would counsel caution in assuming that the experience in these territories means that it could be applied effectively elsewhere and on a worldwide group basis. For instance, exemplar territories may rely to a much lesser extent on inward investment than does, for instance, the UK.

86. Such a rule may have a place in any best practice solution, though not as a primary or stand-alone rule. But however it is applied, the level at which any ratio is set and the reference measure for the ratio will be critical if it is to satisfy the policy objectives.

Chapter XI: The role of targeted rules (discussion draft question 31)

87. We understand that targeted rules may comprise or at least form part of the solution for the insurance sector and more widely should the approach in paragraph 212 of the discussion draft be adopted. The potential value of existing targeted rules should not be dismissed – for instance in the UK, the loan relationship unallowable purpose rule has been in place since 1996, an “anti-hybrid” rule with a similar purpose test has been in place since 2005 and a targeted anti-avoidance rule to prevent abuse of the new loan relationship rules is due to be introduced in 2015. Such provisions (together with the transfer pricing and CFC regimes) are an established and well understood part of the UK anti-avoidance landscape – their development was painstaking and the unallowable rule has given rise to a significant amount of helpful jurisprudence. Similarly an arm’s length rule, adapted as necessary may well have a place in any solution.
Chapter XII: The treatment of non-deductible interest expense and double taxation (discussion draft questions 32 and 33)

88. A carry forward of disallowed interest would be more meaningful than a carry forward of unused capacity, given the “arbitrary” nature of any fixed measure of capacity as compared to the “real” nature of interest expense incurred. Nonetheless, a carry forward provision is not a solution in the situation where an arbitrary formulary apportioned cap bears no relationship to a commercially rational distribution of an insurance group’s interest expense, and where there is no flexibility to redistribute debt owing to regulatory/commercial constraints. For instance, if there are reasons why groups cannot leverage certain operations (for example, in particular emerging markets jurisdictions), then there is a real possibility that groups will never get a deduction for the interest costs. Indefinite carry forward of unrelieved interest expense results in double taxation and non-recognition of deferred tax assets, which will erode the group’s shareholders’ funds and undermine competitiveness – ultimately there is a real risk of groups getting deductions for much less than their external interest costs.

89. Some ability to carry back such excess interest expense to previous periods where there was no such excess would be reasonable. It would also reflect the fact that commercially banks lend based on abilities to generate consistent cash flows over a sustained period of time.

Chapter XIV: Interaction with other areas of the BEPS Action Plan

90. We have discussed above how best practice for the insurance sector might be formulated. This to a large extent predicated on the use of regulated debt capital in the sector. To provide the loss-absorbing characteristics required by the regulator such debt will necessarily have some hybrid characteristics. It is therefore very important that any best Practice arising from this action does not cut across the outcome of Action 2.

91. The extent to which other BEPS work streams address BEPS activities in relation to interest should be carefully considered and the need for separate rules under Action 4 kept under close review. For instance, the extent to which:

- Treaty Abuse actions will limit such activities by increasing the withholding tax due on such cross-border interest payments,
- the Hybrids work will remove the impacts of double deduction or deduction and non-taxation treatment of interest payments and prevent BEPS actions in respect of intra-group interest,
strengthening of CFC and Permanent Establishment rules counter structures designed to shelter taxable interest income in “overly” capitalised finance subsidiaries in low tax jurisdictions, should be kept under close scrutiny.

92. We have expressed our support for a solution for the insurance sector along the lines of that proposed in paragraph 212 of the discussion draft. However, it should be borne in mind that the targeted rules envisaged as comprising the solution to any remaining perceived BEPS risks in relation to debt other than that comprising regulatory capital may indeed be rules already under consideration within the BEPS Action Plan – particularly in relation to CFCs (Action 3). This should also be borne in mind in taking forward the separate project to develop the transfer pricing guidance as envisaged in paragraph 6 of the discussion draft.
BEPS Action 4: Interest deductions and other financial payments
Submission by the Association of Investment Companies

The Association of Investment Companies (AIC) represents approximately 340 closed-ended investment companies with assets under management of over £110 billion. The AIC's members include investment trusts, Venture Capital Trusts (VCT) and non-EU investment companies, primarily Channel Islands companies. All AIC members have their shares admitted to trading on public stock markets, predominantly listings on the London Stock Exchange.

The AIC has 13 members who invest in infrastructure projects with funds under management of approximately £8 billion. Infrastructure funds are particularly attractive to investors seeking a high level of income from their investment.

The OECD has stated that more than $50 trillion of investment is needed to meet transport, water and energy demands over the coming decades. The OECD is also aware that Governments are looking for other sources of funds to support long-term infrastructure projects. The European Commission has developed the European Long-Term Infrastructure Fund designed for investors who want to put money into companies and projects for the long term such as infrastructure projects. It has been recognised by the European Commission that high quality infrastructure improves the productivity of the rest of the economy, enabling growth, and facilitates the interconnection of the internal market. The public policy benefits of the infrastructure sector should not be underestimated.

Question 35: Do any particular difficulties arise from the application of general limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed.

Most major infrastructure projects of the type that our members invest in are financed and delivered through special purpose vehicles, which have a very high level of debt to equity. It is standard international commercial practice that most infrastructure projects are financed by around 80-90% senior debt. The OECD public discussion draft on Action 4 recognises that debt finance is typically used to fund infrastructure projects as this minimises the financial risks for investors, who are willing to lend against the secure, predictable cash flows into the special purpose vehicle. The OECD public discussion draft also states that the characteristics of infrastructure projects are such that their financing may be sensitive to changes in the tax treatment of the financing costs, in part because of the very long term nature of the projects.

The AIC recommends that the rules put in place to combat the base erosion of profits need to either exclude the infrastructure sector or make sufficient accommodations to maintain the sustainability of the infrastructure sector for the following reasons:-

- The high level of debt is characteristic of infrastructure projects due to their very nature and is not an artificial device used to secure deduction of high levels of interest. Lenders to non-recourse structures have assessed the size of the debt to be fully serviceable from the project’s cash flows alone. This means that the loan cannot, by definition, be excessive so there is no risk of BEPS;
- Public Finance Initiative (PFI) projects are low risk as contracts are awarded following an “open book” competitive bid by interested parties which are required to determine the unitary charge based on cash flows, including taxation, and are disclosed to the public sector client;
- Lenders and infrastructure investors need to know with sufficient certainty how much interest relief will be available in the project in the future as the project will have been funded on the basis
of projected cash flows. Changes in interest deductibility could send projects into third party default situations and/or eradicate an investor’s anticipated returns. This would be in contradiction to government policy of sustainable infrastructure;

- It is usual commercial practice for contractors to sell all or part of their interest in a project, in order to free up capital for investments in new projects. Likely purchasers of such projects include pension funds, infrastructure funds and other bodies with a need for known income streams. If key performance indicators are likely to be failed by a project then such investors are unlikely to invest reducing the ability of contractors to finance new projects;

- The rules on base erosion of profits must not distort outcomes between different investor/owner combinations as the availability of interest relief could be sensitive to changes of ownership and could make it impossible to obtain certainty at the time of originally financing the project. This could create barriers to investment with the result of narrowing the flow of capital into a vitally important sector.

The AIC also recommends that, as an absolute minimum, grandfathering should be introduced for existing infrastructure projects including those in the pipeline and due to be signed and any projects undergoing re-financing.

Further, where lenders and borrowers for a PFI contract are all based in the same jurisdiction, there would be no BEPS issue so the AIC recommends that there be a gateway test to exclude such projects.

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To discuss the issues raised in this paper please contact:

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Dear Sir/Madam

OECD discussion draft on BEPS action 4: interest deductions and other financial payments

The Association of Real Estate Funds (AREF) represents the UK unlisted real estate funds industry and has about 70 member funds with a collective net asset value of over £50 billion under management on behalf of their investors. This includes £9 billion in UK authorised retail funds, £17 billion in various forms of UK unregulated Collective Investment Vehicles (CIVs) and £14 billion in offshore domiciled funds. The member funds represent about 75% of UK commercial real estate held in CIVs.

We welcome the opportunity to provide comments on the BEPS Action 4 consultation.

We recognise the need to address any double non-taxation that arises as a result of deductible interest or other similar payments. However, in setting out to achieve this, it is important to recognise the ways in which businesses operate and why, and ensure that the commerciality of operations is not undermined. We also support the broader objectives of the BEPS Action Plan.

Background

Third party investment in both residential and commercial property is crucial to supporting growth and economic prosperity. HM Treasury’s consultation ‘Investment in the UK private rented sector’1 published in February 2010 recognised significant long-term demographic pressures on housing and considered how effective the private rented sector will be at increasing supply in response to this. Since then the UK has worked to boost housing supply and support other housing initiatives.

Funds represent a key source of investment capital. Investors in funds make and hold investments by pooling their funds with other investors rather than investing directly. This occurs because of the economic efficiency and other advantages funds provide. Funds allow small investors to gain the benefits of economies of scale even if they have relatively little invested. They provide access to a number of markets that might be closed to the small investor.

The points above were recognised by the OECD in its report ‘The Granting Of Treaty Benefits With Respect To The Income Of Collective Investment Vehicles’2 of April 2010. This report looked at treaty matters related to CIVs, but the observations it makes on the benefits of investing through funds of diversification and access to markets is even more accurate of investment in property funds.

From an investor’s point of view, funds are an essential savings vehicle, particularly for smaller savers and investors that otherwise lack the scale necessary to access the capital markets. The

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importance of funds as a vehicle for long term saving is all the more relevant today, when citizens 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.

Property funds are typically highly leveraged. Therefore how base erosion and profit shifting using interest might be addressed is of great importance.

**General remarks about the use of debt in funds**

As we mention above, a critical feature of any fund is that it is structured in a way that secures for its investors the same, or substantially the same, tax treatment as compared with direct investment. This feature is recognised by the OECD in its 2010 report.

The tax neutrality of funds is recognised in tax regimes throughout the world. Thus the UK affords authorised funds an exemption from capital gains tax, and exempts many forms of income in a fund from taxation. Many countries offer regulated securities funds a fully tax-exempt regime. The UK also has a Property Authorised Investment Fund regime that does not tax property income, but instead tax on property income is levied at the investor level only.

Outside of the specific tax regimes that apply to regulated funds, funds often secure tax neutrality through the use of debt. Debt shifts the burden of taxation from fund vehicles to the investors, and is a way to ensure that tax is only paid once in a fund structure. Debt is a critical tool in structuring funds outside of the specific tax regimes that exist for only a part of the funds market. Profit shifting occurs in these funds, but for the purpose of shifting the tax burden to the investor, and not for tax avoidance purposes.

Investors in funds are unrelated third parties, and are subject to tax according to their own circumstances. In many cases investors are pension funds, life companies, endowments, charities or other institutional investors. Individuals or tax-paying corporates that invest in funds are subject to tax on income and gains in the funds in the normal ways.

**Relevance of debt in property investment**

Property funds are often structured with various legal entities, often in different jurisdictions. There are a number of reasons for this, but they include legal impediments to the holding of real estate by non-residents, and legal structures that facilitate the development and management of property in different countries. For these reasons property funds have developed outside the constraints of local tax regimes that apply to single-entity CIVs.

For property funds, ensuring that investors achieve a return on which tax is levied only once is uniquely challenging, and often involves the use of debt. Debt finance also ensures that returns can be delivered to investors. Complex accounting treatment of property and the impact of depreciation often create accounting traps that prevents equity returns and dividends from being delivered to investors. Debt simplifies property fund structures for investors.

Much of the above is relevant to many forms of alternative investment (including, for example, private equity). However in the case of property funds this is all the more true because the capital-intensive nature of investment in property requires a greater amount of debt. This is equally true of property investment outside of funds.
For these reasons we are concerned that broad changes to the taxation of debt, and limitation on debt relief could have a significant detrimental impact on property investment, and a knock-on detrimental impact on financing the development of housing and commercial property which are needed to safeguard economic growth and prosperity.

In the appendix, we respond to the questions for consultation of particular relevance to property funds. However, given the short amount of time for responding to the discussion draft, it has been difficult to consider all of the implication for property funds of the proposals. We would welcome the opportunity to discuss the impact on property funds in more detail.

Thank you again for the opportunity to comment on the discussion draft. We hope to continue to be able to contribute to the consultation and 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 5: What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

We agree that rules to tackle BEPS using interest should operate by reference to the level of interest expense rather than the level of debt (e.g. for the reasons set out in paragraph 44). Further, we agree that rules should apply to net interest expense.

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?

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?

Occasionally a property fund forms 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.
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.

Because of the unique characteristics of property fund investment, outlined in our letter, 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.

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?

An assets-based approach is preferable to an earnings-based approach as earnings can fluctuate significantly from year to year. Asset values tend to be more stable.

Question 24: What practical issues arise in applying fixed ratio rules based on asset values or earnings?

For a property fund, one typical commercial reason to fund subsidiaries predominantly with debt is to enable subsequent cash repatriation. In some countries depreciation must be deducted in determining distributable profits meaning that a property holding company is only able to pay very limited dividends. In contrast, debt funding (within safe harbour/ thin capitalisation levels appropriate in the local jurisdiction) may allow higher levels of interest payments. Under the proposals, predominantly funding subsidiaries with debt could result in interest being disallowed. This would leave groups with a choice between 1) limited future cash repatriation and 2) suitable levels of cash repatriation but at a tax cost. Measuring economic activity using EBITDA or asset values would minimise the likelihood of this being a problem.
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?

As noted in paragraph 149, groups operating in different sectors can require very different amounts of leverage. Property funds, for example, are highly dependent on debt funding (commonly up to 90%) due to the capital intensive nature of the industry. To identify a benchmark ratio which represents an appropriate level of interest expense for all entities operating in all sectors will therefore be problematic.

Whether interest deductions are linked to the level of assets or earnings, and how these are measured, will determine which industries are favoured over others. For example, if interest deductibility is linked to earnings, measured by reference to EBIT, property funds will most likely be disadvantaged, and have net third party interest expense disallowed, compared to groups operating in other sectors.

In conclusion, a fixed ratio does not seem to be the best option.

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?

A carve-out using a test based on equity seems the least meaningful for the reasons set out in paragraph 174 (e.g. a simple equity-based test is not a good measure of economic activity in an entity and can be easily manipulated). A test based on earnings or asset values would be more effective at addressing BEPS using interest.

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?

A combined approach could effectively address BEPS using interest whilst reducing the administrative burden faced by groups. Approach 2 seems preferable to Approach 1. Although the carve-out in Approach 1 is described as applying ‘to entities which pose little risk of base erosion and profit shifting’, as it depends on meeting a fixed ratio test, some sectors will effectively be treated as lower risk than others.
February 4, 2015

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ANNEX – CONSULTATION WITH BUSINESS QUESTIONS FOR DISCUSSION

AstraZeneca is pleased to offer its responses to the questions raised by OECD in relation to Action 4.

Before responding to the specific questions we would first like to take the opportunity to set out our order of preference for dealing with excessive interest deductions (leaving aside an arm’s length test) as follows:

1. **Targeted and globally consistent anti-avoidance rules** to close down offshore financing entities in low or 0% tax jurisdictions not already addressed by the proposed hybrid rules.

2. **Fixed ratio tests based on earnings or assets with the ratios set by each country** in the context of their specific tax regimes, combined with targeted and consistent anti-avoidance rules. In our view, the benefits of this approach include:
   - Simple for taxpayers to operate by reference to each entity’s own financial position (or local fiscal consolidated group) without reference to a group position or that of another country.
   - Makes use of existing entity (or local fiscal consolidated) accounting or tax data resulting in only marginal additional compliance costs for taxpayers and a greater certainty of outcome.
   - Countries are able to set a fixed ratio in the context of their corporate tax regime and at a level coherent with the other aspects of their particular regime e.g. anti-hybrid mismatch rules, CFC rules etc.
   - Less instance of double taxation compared with a group-wide test, which would depend on assumptions about earnings, assets and group net interest expense.
   - Lower administration costs for companies and tax authorities.
   - No need for OECD to agree a single definition of interest or a single basis of interest allocation.

3. **Fixed ratio carve out based on earnings or assets with an option for taxpayers to deduct incremental interest payments by reference to a group-wide interest allocation test.** This approach should be combined with targeted and consistent anti-avoidance rules. In our view, the following points should be considered to mitigate the downsides of a group-wide interest allocation test:
   - A factor of at least 125% should apply to the group net third party interest expense in order to overcome the impossibility of pushing down debt on a self help basis to certain countries/entities, and as a result not being able to access that country’s/entity’s allocated deductible interest capacity e.g. France, Germany, India, China, UK, Brazil.
   - Companies should be able to measure economic activity either based on an earnings or a balance sheet measure and to flex between the measures.
from year to year in order to facilitate deductions of group net interest expense each year.

- An entity by entity approach would mitigate the need to push down debt and to accommodate carried forward deductions for offset against future profit generating entities within a country (see our response to question 5).
- EU treaty alignment needs to be considered in selecting the application and an entity by entity or consolidated group by country approach.

**Interest and other financial payments economically equivalent to interest**

1. **What problems could be caused by the approach to defining interest and other financial payments economically equivalent to interest set out in Chapter IV of the discussion draft?**

There are many potential components to a definition of interest which are currently used by countries in different ways to establish various accounting and tax treatments of interest. If required, the OECD should strive to establish a standard definition for global application to avoid taxpayers having to carry out multiple calculations of interest and related restrictions. Multiple definitions would constitute a disproportionate administrative burden on companies, lead to double taxation and increase uncertainty.

When determining which payments are to be considered economically equivalent to interest, many types of payment will need to be reviewed to determine whether those payments should be included or excluded in the interest definition. For example, it should be clear that the interest element related to accounts payable (under normal credit terms) and balance sheets provisions including pension accruals should not be regarded as payments economically equivalent to interest. Guidance is also needed in respect of dividend payments from interest funds and interest elements related to hybrid instruments.

The OECD should also be clear on the treatment of foreign exchange gains or losses. In the UK foreign exchange movements may be left out of account or disregarded for tax purposes, for example when arising on net investment hedge instruments. Foreign exchange gains and losses arising on instruments used to protect the value of assets and liabilities should not be treated as payments economically equivalent to interest.

Furthermore, some companies are non-domestic currency denominated, for example AZ Plc and AZ Treasury Ltd are UK incorporated and resident entities denominated in USD. Therefore, no foreign exchange gains or losses arise on USD denominated balances. This treatment should be respected under any interest definition for the purpose of any definition and restriction.

We attach a more complete list of potential interest equivalents and our view as to whether each should be treated as interest for the purpose of a global allocation or other restriction mechanism for your consideration.
**Group-wide tests**

2. What are the respective strengths and weaknesses of -
(a) an agreed approach applied consistently by all countries; or

A single approach to the definition of interest and payments economically equivalent to interest and to the calculation of a group-wide interest allocation method would be very helpful in minimizing the administrative burden and cost to companies. Otherwise the multiple calculations under various definitions would self evidently result in double taxation and a disproportionate administrative burden which would increase uncertainty and cost.

(b) a flexible approach where each country applies a rule reflecting domestic tax or accounting principles?

A flexible approach to the definition of interest and payments economically equivalent to interest and to the group-wide interest allocation method will undoubtedly result in uncertainty, high administrative cost and double taxation. However, elements of flexibility are required to deliver a fair and non-distorting interest allocation as explained below.

3. Are there any elements of a group-wide rule where either a consistent approach or a flexible approach would be particularly beneficial?

Any group wide definition of interest and payments economically equivalent to interest should be consistent and based on audited consolidated accounts (or equivalent if none are available). Tax based definitions are not uniform and therefore should not be used to define group interest or the basis of any group-wide interest allocation method.

Companies should be able to elect to measure economic activity either based on earnings or a balance sheet measure and to flex between the measures from year to year for the purpose to better allow access to any allocated interest cap.

4. The discussion draft envisages that a group’s net third party interest expense should be based on figures taken from the group’s consolidated financial statements. This should also include payments economically equivalent to interest. What benefits or problems could arise from this approach?

We agree with the proposition of using the group consolidated financial statements to identify the group’s net third party interest expense. This is the only sensible basis. Consolidated financial statements will generally have been subject to independent audit therefore increasing the reliability of the data and reducing the administrative burden for both taxpayers and tax authorities.

Alternatives could be elected by taxpayers on a just and reasonable basis absent audited consolidated financial statements.

5. A group-wide test links an entity’s maximum net interest deductions to the total net third party interest expense of its group, based on economic activity. What are the respective strengths and weaknesses of measuring economic activity based on (a) earnings; or (b) asset values?
There should be flexibility for taxpayers to choose which basis they wish to use to allocate the group net third party interest expense annually. The ability to allocate group net third party interest expense to those entities with capacity will vary dramatically across countries, between sectors and over time. The OECD should consider whether an election could be made each year to allow taxpayers to choose between the measures of economic activity each year given the fluctuating results of entities through economic cycles.

Definitions of earnings and assets will also be required and should be based on IFRS/US GAAP or equivalent definitions.

There are a number of other issues arising in selecting the application of any group-wide interest allocation method to each entity or to each consolidated group. An entity by entity approach would mitigate against the need to push-down debt to profit generating entities that may restrict interest deductions below any allocated interest cap. For example, in the UK we have a profitable trading company and an R&D loss making company. Assuming group net third party interest expense is allocated on a consolidated country basis, in years when there is a UK consolidated loss, debt would be pushed offshore. However, based on an entity by entity approach, the profit making entity in the UK would be allocated its share of the group net third party interest expense leaving the R&D loss to be carried forward and offset against future profits generated from successful R&D. This would be preferable to us suffering a permanent disallowance through inaccessible capacity in offshore territories.

An entity by entity approach would therefore remove a distortion created by the timing difference between investment and returns particularly in sectors with long lead times. Provided this does not lead to excessive deductions relative to the total cap, an entity approach should be acceptable.

In order to mitigate against excess limitations by individual country restrictions, we recommend that a factor of at least 125% should apply to the group’s net third party interest expense. This would offset the impossibility of pushing down debt on a self help basis to certain countries/entities with allocated capacity.

The selected approach for allocated interest capacity (by entity or by country) should also be compliant with the EU Treaty.

**6. Where a group-wide rule uses figures taken from financial accounts to calculate a limit on interest deductions, mismatches may arise when this limit is applied to an entity’s net interest expense calculated using tax rules. What are the key permanent and timing mismatches that could arise and how could these be dealt with within a rule?**

It is our strong recommendation that rules governing limits on interest deductions be based on audited financial statements where available. This approach would broadly align definitions of EBITDA and assets across countries. We acknowledge that this would not be perfect but measurements by reference to individual country tax rules would vary more significantly resulting in greater complexity, double taxation and increasing the administrative burden for taxpayers.
However, there will still be difficulties in using financial statements including:

- GAAP and currency differences between the group’s parent and its subsidiaries;
- local currency denominated accounts will not take into account currency fluctuations resulting in over or under reporting of earnings;
- the impact of group consolidation adjustments and adjustments/restatements of financial statements in subsequent years would need to be addressed;
- the impact of amounts taken to reserves would need to be addressed;
- different accounting period end dates within the group and cases where entities are only part of the group for some of the period;
- impact of transfer pricing arrangements between group entities and any post period adjustments;
- equity accounting related to joint ventures i.e. the groups share of the result is included as a single line item;
- generally companies must make preliminary tax payments which will be inaccurate absent clear understanding of relief for allocated group third party net interest as well as the capacity to deduct interest. Such inputs would not be available until the financial statements are audited and completed for all entities in a group. Interest and penalties will no doubt follow as a result of inaccurate payments.

Many other issues arise in connection with group-wide interest allocation rules:

- It is not possible to extract capital through dividends and/or repayment in certain countries and there could also be exchange controls as well as legal restrictions. This would severely limit the ability of companies to access allocated interest capacity;
- Group interest can move dramatically in a year and earnings and assets can also deviate from forecasts during the year; there can be no way of knowing what interest cap allocation should be applied at the beginning of a year leading to uncertainty whether a taxpayer will get a deduction for the group net third party interest expense or not. This will make pushing down debt on a self-help basis difficult to manage and is likely to result in unutilised interest cap allocations;
- Very few if any MNC’s forecast statutory earnings or assets, which again may vary during the year;
- There is likely to be increased complexity around tax audits as all tax authorities will have an interest in reviewing the debt pushdowns of a group, as well as reviewing the group-wide interest allocation calculation following the debt pushdowns. This will lead to significant management time defending the group’s position and an increase in compliance costs;
- It is highly unlikely that a group would be able to move debt round the group to access each entity’s allocation of net third party interest expense. Foreign exchange issues will arise in connection with the debt pushdown. Furthermore, this will increase hedging costs as groups seek to manage the foreign exchange exposure;
- Such a test may affect decisions regarding whether and where to invest. It may deter investment in a country as such investment is likely to negatively impact earnings, at least in the short term;
- Joint venture arrangements are increasingly common and it is unclear whether, and if so how it is proposed such structures will be affected. For example, if a 25% control test was applied to determine whether entities are related, would a joint
venture be simultaneously related to more than one group for the purpose of the interest restriction, and if so how would the interest restrictions calculated by each group be applied to the joint venture. Clear guidance is required in respect of joint ventures and the extent to which joint ventures should be included in the interest deductibility rules.

- A group-wide interest allocation rule is also likely to result in double taxation:
  - It’s unlikely that all countries agree a uniform approach and therefore adopt the same rule and the same definitions of interest resulting in mismatches and consequently double taxation;
  - Cash Pooling and Group Treasury entities will become centres of double taxation. A group that has no net third party interest expense will be subject to double taxation on 100% of its intercompany lending;
  - Related party finance costs are not deductible for tax purposes in many countries. Some countries rules specifically deny tax relief for finance costs of debt used to pay a dividend or return capital whereas some countries rules focus on the business purpose / benefit of the debt;
  - A group might not be able to credit additional withholding tax incurred in relation to distribution of cash triggered by lending introduced to access interest allocations;
  - Where a subsidiary has minority investors (which is a requirement in many countries) any dividend would result in additional leakage and would likely make a debt push down unviable;
  - A carry forward of disallowed interest and a carry forward of unused capacity should be included in any proposed rule and allow unlimited carry forward. Such rules will reduce double taxation related to the disallowance of deductions. However, such rules would not eliminate double taxation, economic distortions, or fully restore economic stability. Recognition of carry forward items would most likely not be represented on a group balance sheet causing increases to the group tax charge.

In essence a group-wide interest allocation rule is burdensome and will result in significant cost, complexity and uncertainty for MNC’s operating in 80 countries or more.

**Fixed ratio tests**

7. What are the strengths and weaknesses of fixed ratio tests for groups operating in different sectors?

The key strength of the fixed ratio test is that each country may set its own ratio in the context of its corporate tax regime and would allow each country the flexibility to ensure that the rules governing interest deductions interact sensibly with the CFC and hybrid rules of their tax regime. For example, the Sweden Tax Commission has proposed zero net financing cost deductions combined with a 16.5% tax rate. This has the effect of eliminating interest deduction abuse while at the same time meeting fiscal goals of attracting investment and jobs and do away with the existing so called debt bias.

Other countries balance interest deductions with higher rates and other aspects of their tax regime. We do not believe OECD necessarily has a role to dictate national tax policy by imposing restrictions on interest deductions where there is no evidence of BEPS.
A fixed ratio test is much easier to comply with as it relies on analysis of the particular country’s financial position rather than a group-wide interest allocation calculation, and provides much greater certainty to companies who can work within each ratio.

The fixed ratio test may also reflect a much closer approximation of commercial reality in funding companies relative to domestic entities and avoids having forced disparity in investment decisions being made by competing enterprises. The absence of a level playing field enforced by OECD measures would distort competition and make joint venture arrangements more complex.

We understand that countries would also need to introduce targeted anti-avoidance measures alongside a fixed ratio test and this would be sensible in order to prevent BEPS between domestic operations and offshore, low tax centers.

8. What objective information is available to evidence the actual net interest to EBITDA or net interest to assets ratios of entities and groups?

We are not aware of any detailed information that would provide evidence of the net interest to EBITDA or asset ratios. We note that the ratio would vary over time and depend on M&A activity and interest rates. We would prefer to leave this ratio up to local government policy in the context of each tax regime rather than have OECD impose an estimate absent empirical data.

Combined approaches

9. What are the advantages or disadvantages of including a combined approach in a best practice recommendation? In particular, what are the strengths and weaknesses of combined approaches 1 and 2, as set out in the discussion draft?

A combined approach may work as follows. Each country sets its own fixed ratio in the context of its own tax regime and introduces targeted and consistent anti-avoidance measures to cut off income flows to low or 0% tax countries. If this fixed ratio limits the actual interest deduction to less than an interest cap calculated by reference to a group-wide interest allocation calculation then the excess interest deduction should be allowed up to lower of the actual amount of interest or the interest cap. Application of the allocation cap would be optional for taxpayers.

In effect, this means that those operating within the fixed ratios would not have to carry out a complex group-wide interest allocation calculation whereas those groups more highly geared would not be unfairly disadvantaged by having unfair limits placed on the deduction of group net third party interest expense.

10. What other combined approaches could be considered for inclusion within a best practice recommendation?

As per 9 above.

Considerations for groups in specific sectors
The following questions should be answered on the assumption that a best practice recommendation includes rules applicable to all sectors.
11. How could an interest limitation rule be designed that would address BEPS risks posed by banks and insurance companies without having an undue impact on a group’s regulatory position?

No comment.

12. Groups operating in certain sectors such as oil and gas are often subject to special tax regimes. How will this impact the operation of interest limitation rules and how could account be taken of this in the design of a best practice approach?

No comment.

13. What other sectors have characteristics which mean special consideration should be given in the design and application of rules to limit interest deductions?

For our sector, biopharmaceuticals, we would make the following points:

Group earnings vary dramatically as significant patented products lose patent protection. This volatility in group earnings and earnings by entity would dramatically impact the group’s net third party interest deduction capacity making it impossible to know in advance of or even during a year what the group net third party interest expense would be and how it should be allocated under a group-wide interest allocation method.

Similarly, assets used in the sector are mainly off balance sheet, i.e. those developed from in-house R&D which is expensed each year. Assets off balance sheet are not generally subject to routine valuation and are not audited so it would be very difficult for tax authorities to rely on as a basis for an interest cap allocation.

Group and entity balance sheet assets vary dramatically with M&A which can take place at any time during a year. Such asset movements would dramatically shift interest capacity by reference to a static group-wide interest allocation formula. The asset values would be impossible to know in advance or even during a year.

Debt funding is increasing in our sector particularly in support of M&A and may take place in multiple currencies as a hedge against future cash flows from multiple countries. The varying level of debt combined with foreign exchange movements mean that it is impossible to know what the group net third party interest expense will be in advance or even during a year.

We appreciate the opportunity to contribute to the discussion on Action 4 and would be willing to offer any other assistance of further explanation of the above as required.

Yours sincerely,

Ian Brimicombe
VP Corporate Finance
Potential interest equivalents for the purpose of a global allocation or other restriction mechanism

1) Arrangement, surety and guarantee income and expenses incurred when entering loans have interest effects and should be considered interest. Issue discounts should also be considered interest.

2) Limit fees related to loan issuing, overdrafts and factoring in various forms should be considered interest.

3) Banks' and credit card holders' card fees and similar should be considered interest. Intermediaries' fees in the payment chain when using cash or credit cards should not be considered interest.

4) Installment and late payment surcharges are normally an interest based surcharge and should accordingly be considered interest.

5) Dividends on interest funds should be considered interest. Dividends on balanced funds with predominantly investments in debt securities should also be considered interest as well as gains and losses on such instruments. These types of securities normally have a more or less fixed return. IAS 32 can provide further guidance on the classification.

6) Premium and discount on so called interest-free loans should be considered interest.

7) Credit losses and gains driven by changes in market interest rates should be considered interest.

8) Expenses and income incurred on interest forward contracts should be considered interest.

9) Derivative is a collective name for a certain kind of securities. The most common derivatives are options, futures, warrants and swaps. Derivatives are connected to certain events or conditions at a specific time or period of time in the future. Also synthetic instruments with the same underlying characteristics should be treated in accordance with its attributes. The value of a derivative is linked to the value of an underlying asset such as stocks, stock indices, currencies, interest rates or commodities, which value may move positively or negatively during the contract period, resulting in profit or loss. A derivative always has two parties with obligations and rights and thus constitutes a kind of contract. For example, in the case of options, one party buys the right (but not the obligation) to buy or sell the underlying asset in the future, while the other party undertakes the obligation to fulfill the agreement in the future. For swaps, both parties have rights as well as responsibilities. To the extent an interest element is embedded in the derivative, that part should be considered interest. Direct credit derivatives and related gains/losses should also be considered interest.

10) In accordance with the above, gains and losses on interest rate swaps should be considered interest. An interest swap is an agreement between two parties to exchange interest flows over a period of time. For example, one party can choose to pay a fixed interest rate in exchange for receiving variable interest payments. In practice, a swap instrument works as a portfolio of futures contracts. IAS 39 provides further information regarding the characteristics of different types of securities.

11) Hybrid instruments are securities that combine the characteristics of stocks, bonds and options, such as stock and index-linked bonds or other underlying assets. The interest
element of the return (generally the guaranteed return that e.g. is related to an index-linked bond) should be considered interest. The remaining portion represents capital gains/losses.

12) When conducting cross border borrowing or lending it is often difficult to distinguish between interest and foreign exchange gain/loss elements. There are a variety of currency instruments that can be used in foreign exchange trading where the gain/loss should be considered interest. The currency based instruments are usually divided into two different groups, currency transaction instruments consisting of foreign exchange spots and currency forwards and currency derivatives consisting of currency options, currency futures and swaps. Gains and losses on these should, consistent with the general treatment of foreign exchange gains/losses, generally be considered interest. Impairment losses due to unrealized foreign exchange losses should be treated the same way as realized losses.

13) Costs or foreign exchange gains/losses associated with export or import transactions e.g. through hedging or a currency swap on the sale/purchase price within the ordinary course of business should not be considered interest but as part of the sale/purchase. The company should then be able to show the link between export/import business and the hedging or show that an independent currency hedging has been used for an export/import transaction. This type of hedging often concerns a specific volume or an estimated import/export value during the hedged period. The uncertainty related to the exact values or volume should not deprive the hedge of its connection to the export/import. Further guidance on what constitutes an effective hedge for accounting purposes can be found in IAS 39. It is also common that parent companies within international groups would like to protect themselves against losses on assets (including shares in subsidiaries) or obligations in the business due to currency fluctuations, which is why they enter into currency derivatives (usually index based) in order to protect the group balance sheet. Such hedging costs should not normally be considered interest (although no supply under the contract will never take place) but rather as operating expenses which normally also corresponds with the accounting characterization.

In summary, foreign exchange gains/losses of a defensive character, i.e. on what can be classified as “risk insurance instruments” that aim to protect the value of assets or liabilities crystallizing in the ordinary course of a business should be considered operating expenses and not interest; whereas foreign exchange gains/losses on other foreign exchange transactions, such as long term borrowing, should be considered interest.

14) Leasing fees. Often in leasing, the lessor provides the lessee funding and the agreement includes an obligation for the lessee to assume ownership/financial responsibility for the leased asset at the expiration of the leasing period. In these cases, a portion of the leasing fee constitutes an interest element.

15) Factoring is a collective term for the purchase and selling or borrowing of receivables (normally invoices). The factoring fee contains an interest element based on the lending/earlier received payment provided by the factoring company to the borrowing/selling company.
6 February 2015

The Committee on Fiscal Affairs
Organisation for Economic Co-operation and Development
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Email: interestdeductions@oecd.org

Dear Sir/Madam,

Public Discussion Draft – BEPS Action 4: Interest Deductions and other Financial Payments

The Australian Bankers’ Association (ABA) welcomes the opportunity to comment on the proposals in the OECD’s Public Discussion Draft – BEPS Action 4: Interest Deductions and other Financial Payments (Discussion Draft).

The ABA is the peak industry body for Australian banks. Its 23 members comprise all of Australia’s major banks, as well as other Australian owned and foreign owned banks operating in Australia.

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

Summary of this submission

These comments are directed principally to the impact of the proposals in the Discussion Draft for the banking industry. They are organised into 2 sections:

- the first section offers some general comments on the Discussion Draft considered as a whole, and
- the second section responds to some of the specific questions posed in the Discussion Draft.

The Discussion Draft acknowledges that ‘banks and insurance companies present particular issues that do not arise in other sectors’ [para 203] and concludes that it will be necessary ‘to design a specific rule [just] for banks and insurance companies’ [para 210] because ‘the general interest limitation rules set out in this consultation document will not be effective at addressing any base erosion and profit shifting risks presented by banks and insurance companies’ [para 209]. In contrast to industrial and commercial firms more generally, only two paragraphs [para 211 and 212] are devoted to describing what the specific rule for banks might look like. They hint at two options: ‘a group-wide interest allocation rule’ [para 211] or ‘targeted rules to address risks posed by specific transactions’ [para 212].
The general tenor of this submission is that the first option in the Discussion Draft [para 211] is still too incomplete, imprecise and undeveloped to form the basis for significant changes to the taxation of the banking sector. If this option were to be pursued, much more work would need to be done (and appropriate consultation undertaken) to particularise the problem(s) in the design and/or operation of the current rules, and the operation of the solution so far as banks are concerned.

The ABA would also welcome the opportunity to assist the OECD in any ongoing work on the second option [para 212] to develop well-targeted rules that would help eradicate identified abuses.

1. General comments

1.1. A clear problem and a clear response

One of the ABA’s principal concerns with the Discussion Draft is its lack of clarity and precision, both as to the scope of the problem that needs to be solved and the solution being proposed, so far as the banking sector is concerned. In the absence of a clear exposition of both the problem and the solution, it is difficult to be confident that the Discussion Draft forms a sound basis for what could be significant dislocation in the taxation of banks.

The issue in abstract. Item 4 of the BEPS Action Plan foreshadowed developing ‘recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense.’ The Discussion Paper [para 3] amplifies this passage by setting out two possible abuses that require a remedy:

- entities are deducting interest on funds that are used to earn income that is ‘taxed on a preferential basis [such as income] benefiting from a participation exemption, preferential tax rate or taxation only on distribution,’ and
- some entities in a group bear ‘a disproportionate share of the group’s total third party interest cost.’

It is argued below [see section 1.3] that, in part for reasons particular to the banking industry, neither issue poses a serious concern so far as banks are concerned.

The remedy in abstract. In order to address this concern, in general terms, Chapters IV-X of the Discussion Draft set out the variables underlying a rule which would cap an entity’s interest deduction at a share of the group’s net interest expense incurred on debt raised from non-group entities. In essence, the net external debt incurred by a group would be allocated among group members, and each member could deduct interest on their actual debt up to a cap calculated by reference to some criterion. (Chapter XI offers a different approach – recommending a series of targeted rules directed to particular abuses.)

If one were to extrapolate this idea to a banking context, the implication would be that the cost of servicing (some or all of) the net external debt of a banking group would be spread among the various members of the group and each member could deduct interest on (some or all of) their actual debt up to a cap calculated by reference to some criterion. Paragraph 211 refers to this as ‘a group-wide interest allocation rule’ limited to just ‘the net interest expense attributable to regulatory capital instruments.’

There are obvious problems applying this remedy in the banking industry. As the Discussion Draft notes, in the banking industry the notion of allocating the group’s net 3rd party interest expense among members is inapt:
taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore, a rule which caps net interest expense will have no direct impact on a bank or insurance company … [para 205].

But more generally, it is argued below [see section 1.5] that, it is not appropriate to attempt to apply even a modified version of this approach to the banking industry [para 211]. The discussion in para 211 does not appreciate sufficiently the specific features of the banking industry which render such an approach unsuitable.

1.2. The distinctiveness of the banking sector

Chapter XIII of the Discussion Draft examines the application of the general proposals to various industries and sectors and devotes about one page [pars 203 – 213] to banking. It is not surprising that most of the issues and recommendations in the Discussion Draft focus on the treatment of interest (and similar) expenses for entities undertaking general industrial and commercial operations but it does mean that the distinctive issues which arise in the banking sector, and the implications for banks of the recommendations made principally with the non-banking sectors of the economy in mind, are not thoroughly articulated in the text.

The Discussion Draft acknowledges that, ‘banks and insurance companies present particular issues that do not arise in other sectors’ [para 203] and offers five points of difference [paras 204-208]. However, other special circumstances of the banking sector exist which are not fully appreciated in the Discussion Draft, so that some of the recommendations, which might make sense for other sectors of the economy, cannot be transposed to the banking environment.

Several examples can demonstrate these points:

- The rationale for Action Item 4 is the deductibility of interest and the consequent reduction of the tax base in a country, and, for industrial and commercial firms, it is reasonable to start the discussion of new proposals from the assumption that the firm’s interest expense will be deductible. But this assumption does not hold for the banking sector when discussing ‘regulatory capital.’ The regulatory capital of a bank will typically consist of ordinary equity, retained earnings/reserves and funds raised through various kinds of hybrid financial instruments. While the international trend is to make the cost of servicing some Alternative Tier 1 hybrid instruments deductible, currently, in most countries, only the cost of servicing (some) Tier 2 instruments will be deductible. It is, therefore, more than a little curious to propose changes in the name of solving BEPS issues to instruments which do not generate BEPS outcomes.

- The Discussion Draft is focussed on allocating ‘net 3rd party interest expense’ – this phrase recurs throughout the document. As was noted above, this concept is not meaningful in the banking sector where net 3rd party interest is expected to be positive.

- The regulatory environment for banks is much different from that facing industrial and commercial firms. These firms will usually have a plausible choice whether to source funds from related parties or from unrelated financial institutions. But banks will often face local regulatory restrictions which limit their ability to operate in local markets, whether to raise capital or advance funds except from group members. Hence, in the banking industry sourcing capital from a related offshore entity may well be the only viable option for capitalising local operations. The practice is not dictated by tax concerns but by the regulatory environment.
The sourcing, and the allocation, of funds within a banking group is driven by factors that do not apply for commercial and industrial firms:

- it is especially important in the banking industry for an institution to centralise its capital raising activities and then disburse funds to related entities – banks typically wish to present ‘one face to market’, so that the group is able to obtain funds most cheaply. This practice inevitably means that funds will be disproportionately raised in one jurisdiction by the head of the group, or a small number of locations and not by each of the various operating entities; and
- ‘lumpy’ allocations of that capital within a banking group are not abnormal. Banks will often need to allocate significant amounts of capital to one permanent establishment (PE) or subsidiary, rather than another, for reasons other than tax – the different risk profiles of the customers in each jurisdiction, the different business products being offered in each jurisdiction, the different levels of maturity of the bank’s operations in each jurisdiction, the different views of the regulators in each jurisdiction of the required level of capital, and so on.

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

These points of difference are important in the discussion which follows.

1.3. Banking regulation as an effective constraint upon BEPS practices

As was noted above, one of the concerns of Action Item 4 is the possibility that particular entities in a group end up bearing ‘a disproportionate share of the group’s total third party interest cost’ [para 3]. The regulatory environment which surrounds the banking industry already constrains the behaviour of banks in ways which obviate this concern.

First, as was noted above, Action Item 4 is fundamentally about the deductibility of interest and the consequent diminution of the tax base in a country. However, the regulatory environment in which banks operate is directed to ensuring that banks (both as a group and on a stand-alone basis) all have significant levels of non-deductible capital, typically ordinary equity and retained earnings. This is especially so as a result of global Basel III capital adequacy rules introduced after the 2007-2009 global financial crisis. The Discussion Draft contemplates that:

*existing regulatory requirements [might] act as an effective general interest limitation rule, and prevent excessive leverage in group entities [para 212].*

There can be little doubt that this is the effect of banking regulation. Also, instruments which involve no deductible payments raise no BEPS concern and do not justify legislative change.

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

*an [authorised deposit-taking institution – a bank] must:
- monitor, manage and control potential contagion risk between the ADI and other members of a conglomerate group of which the ADI is a part;
- meet minimum requirements with respect to dealings with related entities and certain related matters; and*
In particular, the institution must limit its exposure to related entities to ‘the level of exposures which would be approved for unrelated entities of broadly equivalent credit status’ without the benefit of any implicit guarantee of the risk from other group entities [APS 222, para 11].

These three factors – that much regulatory capital is not debt and involves no deductions, that there are already controls on the total level of debt in each entity, and that some countries limit inter-group dealings controlling the possibility of re-allocating debt disproportionately to one entity – indicate that ‘a group-wide interest allocation rule’ for ‘the net interest expense attributable to regulatory capital instruments’ is unnecessary.

1.4. A focus on ‘share’

There is another dimension to the Discussion Paper which requires modification in the context of banking. As was noted above, the Discussion Draft regards as unsatisfactory a situation where ‘subsidiary entities [are] heavily debt financed, bearing a disproportionate share of the group’s total third party interest cost and incurring interest deductions which are used to shelter local profits from tax’ [para 3]. Item 4 in the BEPS Action Plan refers to base erosion from ‘the use of related-party and third-party debt’ and the Outbound Investment example in Box 1 [page 7] involves re-locating third party debt from Country B to Country A. This decision not to differentiate in the Discussion Draft between related party debt and third party debt is apparently deliberate.

In our submission, for the banking sector, the Discussion Draft should not be concerned with debt that has been borrowed from third parties, and should narrow its focus just to debt borrowed principally from the Parent.

In banking, a ‘disproportionate share’ of total debt is not synonymous with BEPS. Rather, an uneven allocation of third party debt could arise from innocuous matters such as:

- the banking regulator in Country A requires banks located therein to raise 75% of regulatory capital in ordinary equity and permits 25% to be raised as debt; the banking regulator in Country B requires Subsidiary to raise 70% ordinary equity and permits 30% as debt;
- Parent in Country A has just sold a major asset and has used the proceeds to retire some of its more expensive debt; Subsidiary in Country B has just negotiated a significant placement and has a requirement to raise a further $500m to meet its customer’s needs;
- Parent in Country A has significant market penetration and has accepted $1bn in customer deposits; Subsidiary in Country B has little retail business and has raised only $50m in deposits [see para 207];
- Parent wishes to make a temporary injection of capital into Subsidiary to cover a liquidity issue but corporate law restrictions in Country B prohibit or restrict the return of funds by a company if they have been contributed as equity;
- grouping rules under prudential standards may preclude subsidiaries from raising external liabilities, or otherwise be required to operate under different sets of rules (e.g. in Australia, APRA’s Guidance Note AGN222.1 specifically looks to the existence of any third party liabilities in considering eligibility for inclusion in the Extended Licence Entity). That is, subsidiaries within the Extended Licensed Entity are not permitted to raise external funding;

and so on.
In all of these cases one might say there is a “disproportionate share” of total debt in one entity compared to the other but in none of them is BEPS apparent. A “disproportionate share” *per se* is a poor proxy for BEPS practices.

In our view, this Action Item will be better targeted and more likely to gain support if it focuses on related party debt and the deliberate structuring of financial arrangements between associated enterprises.

1.5. **Drawbacks in the ‘group-wide interest allocation’ proposal [para 211]**

This section examines the proposal in para 211 for ‘a group-wide interest allocation rule’ applicable to ‘the net interest expense attributable to regulatory capital instruments.’ Unhappily, there is little detail on how this regime would work and what little information there is, is somewhat confusing.

**Net interest expense.** Firstly, this regime would apparently be applied to ‘the net interest expense attributable to regulatory capital instruments …’ This passage assumes many things:

- It assumes that the cost of servicing regulatory capital instruments will turn out to be greater than the return made from the funds raised. While the cost of regulatory capital will typically be higher than for other forms of capital, why this should be true for money raised by issuing this class of instrument is not self-evident – especially when earlier the Discussion Draft accepts that ‘banks and insurance companies will usually be recipients of net interest income’ [para 205]. Why the return on regulatory instruments will be negative deserves explanation;

- It assumes that it is possible to identify the earnings made with money raised by issuing this class of instrument – the ‘net interest expense.’ While it is certainly true that banks can quantify the amounts raised by instruments which meet Tier 1 or Tier 2 definitions, it is not commonly possible in large financial institutions to identify where those funds are invested at any time. Banks manage cash pools which comprise money raised as regulatory capital, other debt, proceeds of asset sales, fees and so on, and those funds are generally used in a bank’s purposes without ear-marking. (In this context, the instruction to ‘[ignore] the interest income generated from using the capital to write business’ is more than a little oblique. The ABA would be happy to comment further, once the meaning of this passage is clarified); and

- It assumes the cost of servicing these instruments will be deductible. As noted above, the regulatory capital of a bank will typically consist of ordinary equity, retained earnings/reserves and funds raised through various kinds of hybrid financial instruments. Typically, in most countries, only the cost of servicing (some) Tier 2 instruments will be deductible, although it is acknowledged that a small number of countries allow deductions for servicing costs on some types of Alternative Tier 1 capital. So, when the Discussion Draft makes recommendations for the ‘regulatory capital instruments,’ it includes instruments which pose no BEPS issue.

**Regulatory capital instruments.** Secondly, para 211 assumes that ‘regulatory capital instruments’ are a discrete and uncontentious set of instruments on issue. In reality, regulators in different countries disagree about which instruments qualify for regulatory capital purposes. Even within a single country, a bank may have more instruments (with the same set of features) on issue than it needs to meet the regulator’s requirements,

**The amount of the cap.** Thirdly, the regime would ‘[limit] a group’s total net deductions on its regulatory capital … to the amount of interest expense paid on these instruments to third parties.’ This stricture will create problems given the disparity in practices between banking regulators in different countries (even when both countries say they are applying the same Basel III standards) and differing tax treatment for various classes of regulatory instruments between countries.
For example, it is possible that the banking regulators in both Country A and Country B might agree on 9:1 debt to equity funding but the cost of servicing regulatory capital raised in a particular form might be non-deductible if the capital is raised in Country A but is deductible if raised in Country B. If the Parent in Country A raises the finance, the apparent effect of the proposed rule would be to deny a deduction if the funds are then advanced to the Subsidiary in Country B.

Similarly, it is possible that the tax treatment might be uniform, but the banking regulators in Country A might insist on a 12:1 debt to equity funding while the regulators in Country B insist on 15:1 debt to equity funding. If the Parent in Country A raises the finance, the apparent effect of the proposed rule would be to limit the Subsidiary to deducting only a share of 12 in Country B. This will place the subsidiary in Country B at a competitive disadvantage to other banks operating in Country B (both local and foreign-owned) which can fund more of their operations through debt which is typically cheaper to service than equity.

**Allocating the capped amount.** The proposal in para 211 would allocate the capped amount between members of the group ‘in accordance with regulatory requirements.’ This method is obviously the analogue to the method proposed in the rest of the Discussion Draft for industrial and commercial firms where net third party interest is capped at a percentage of some variable which should total across the group to 100% – for example, an individual member’s contribution to the group’s total earnings [para 240] – although the Discussion Draft does admit the possibility of the allocation factor not amounting to 100% in all cases [para 252].

Allocating ‘in accordance with regulatory requirements’ is likely to be one of these situations where the differing views about the amount of regulatory capital will lead to an allocation of less than (or more than) 100% of the group’s net interest expense.

### 1.6. Targeted rules: proposal [para 212]

The Discussion Draft acknowledges the possibility that:

> existing regulatory requirements [might] act as an effective general interest limitation rule, and prevent excessive leverage in group entities [para 212].

Curiously, it takes the position that the presence of ‘an effective general interest limitation rule’ is not a solution to the BEPS problem, so that no additional rules are needed. Rather it takes the position that ‘an effective general interest limitation rule’ requires other rules:

> [to] focus on a group’s [gross?] interest expense other than that on its regulatory capital [para 212].

The observation that the existing regulatory environment creates an effective external constraint leads more naturally to a rather different conclusion: that any underlying BEPS issue is likely already dealt with through other mechanisms in the banking industry, and through measures to implement other BEPS Action Items, and in particular Action Item 2 on hybrids.

However, that is not to say that the ABA would oppose well-targeted rules that would help eradicate identified abuses. But any such rules obviously need to be developed to address specific abuses and would need to be developed in consultation with industry.

### 2. Responses to specific questions

**Questions 1 and 2.** The list of items in Chapter IV obscures rather than illuminates. In our view, Action Item 4 should be targeting amounts which are implicated in base erosion and profit-shifting. That is, instruments which (i) are held between associated enterprises and (ii) are in place to achieve a particular outcome. The first question should not be whether an amount is sufficiently akin to interest or not; the
primary question should be whether the instrument is one which is being used for profit shifting. Many of the items on the list are unlikely candidates as instruments for significant profit shifting, while other instruments exist which are not on the list and are well-suited to achieving profit-shifting.

**Question 34.** In our submission, it is not possible at this stage to conclude whether ‘a general rule [can] be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s regulatory position.’ It appears to us that the argument for such a measure is less than compelling, given the over-arching effect of the banking regulatory environment. It is possible to say that the option as set out in para 211 is not attractive as the basis for significant changes to the taxation of the banking sector. It is not possible to predict whether or not it could be developed into a workable model, and how much work would be involved.

On the other hand, a set of well-targeted rules directed to eradicating identified abuses is likely to be more easily achieved and perhaps just as effective.

Please do not hesitate to contact us if you would like to discuss any of the above matters.

Yours sincerely,

_______________________________
Steven Münchenberg

cc.  Hon Josh Frydenberg, MP, Assistant Treasurer
     Mr Rob Heferen, Executive Director, Revenue Group, The Treasury
     Mr Andrew Mills, Second Commissioner, Law Design and Practice Group, Australian Taxation Office
Mr Achim Pross
Head, International Co-operation and Tax Administration Division
Committee on Fiscal Affairs
OECD
Paris
France

6 February 2015

By email: interestdeductions@oecd.org

Dear Mr Pross

We are writing in response to the OECD’s Public Discussion Draft “BEPS Action 4: Interest Deductions and Other Financial Payments”.

About Balfour Beatty

Balfour Beatty is an international infrastructure group that delivers world class services essential to the development, creation and care of infrastructure assets; from finance and development, through design and project management to construction and maintenance; either alone or in partnership and by integrating local supply chains.

Our Infrastructure Investments business is a leader in UK and US PPP and other models of infrastructure delivery, with a proven track record of developing and financing projects over the last 17 years. We operate a UK portfolio of PPP concessions, mainly in education, health, roads/street lighting, as well as renewables, power transmission and student accommodation projects. We also operate a US portfolio of military housing and student accommodation concessions.

We are developing our investments business in other countries and have two PPP hospital projects in Canada, a student accommodation project in Australia and a technical college PPP project in Singapore.

Investment in Infrastructure

Infrastructure assets by their very nature are highly capital intensive. They often generate secure, stable cash flow streams over a long term project life (usually 20 – 30 years, and sometimes longer). This is typically because they provide essential services to society (roads, schools, hospitals, power generation, transmission etc.) and often the direct customer of the asset is either Government, or government-like bodies with a broader public interest. The income is often paid and/or regulated by Government.
Governments world-wide have been encouraging private investment into infrastructure projects. The UK Government has been a very active champion of the PPP sector, with 728 current projects of which 671 are operational, with a total capital value of £56.6 billion\(^1\).

The combination of significant upfront capital costs, followed by long term, secure income streams has led to project financing structures being the dominant model in the development of infrastructure assets. Under these structures private sector developers and sponsors of infrastructure assets raise long tenor, limited-recourse, third party debt finance (referred to as senior debt) for each project, and also contribute sponsor equity and sponsor subordinated debt finance. Although each territory and sector of the infrastructure industry has developed its own model, these three sources of funding are typical in long term infrastructure projects in the UK and elsewhere.

The long term, secure nature of the income cash flows mean that third party debt finance in infrastructure projects can be at levels of at least 60%, and often as high as 90%. It is typical for debt finance from the sponsors to take the level of overall debt in many UK PPP projects to 99%, with equity finance from sponsors contributing the balance. This debt and equity profile is a particular feature in UK PPP projects, as they are typically structured with the project vehicle being an ordinary taxable company (rather than via a non-taxed unit trust or equivalent non-taxed vehicle in other territories). Project revenues are usually fixed from the start of the project (other than for indexation in line with specified indices) and are not capable of being increased in the future e.g. to respond to changes in taxation. The level of overall senior debt is set depending on the risks in each specific project and the returns to sponsors act as the primary protection for senior debt against these risks, which may subsist for the life of the project.

PPP and other long term infrastructure projects are usually very operationally stable after construction is completed. This characteristic, when coupled with secure income streams from Government clients, allows the project companies to support these high levels of total gearing from an arm’s length transfer pricing perspective under OECD transfer pricing principles (and therefore current UK tax rules).

**BEPS Project – Action 4**

The above summary of the financial structure adopted on infrastructure projects should make it clear that these projects carry a large amount of debt finance, which has historically been treated as carrying tax deductible interest payments at the project company level.

Clearly any restriction on the tax deductibility of interest payments could adversely impact these projects; either by triggering a cash covenant ratio breach on the senior debt, thereby limiting any future payments to sponsors (termed “lock-up”), or ultimately by forcing the projects into default. We commend the OECD for recognising the need for special provisions for infrastructure in Paragraph 215 of the Discussion Draft.

Illustrative Impacts

In order to illustrate the impact of a potential limitation to the tax deductibility of interest expense on infrastructure projects, we have modeled the impact of a "Fixed Ratio" interest restriction rule on three projects within our portfolio. In doing this we modeled the impact of a fixed ratio rule which limited interest deductions to 25% of EBITDA.

We have applied this rule to:

a) A technical college PPP project in Singapore

b) A school PPP project in the UK, and

c) A student accommodation project in the UK

In all the projects, the application of the above restriction resulted in the projects either entering “lock-up” and/or defaulting under the covenants of the senior debt financing.

In a lock-up scenario, no cash (either interest or dividends) is allowed to be paid to sponsors until the lock-up has been rectified, the senior debt has been restructured or the senior lenders have been fully repaid. As you will appreciate, sponsors assume they will get a cash return on their debt and equity investments throughout the life of a project, and so lock-up can result in returns becoming intermittent or being deferred to the very late stages of the project. This will materially reduce the overall economic return to sponsors in that project, in many cases forcing them to write down the carrying value of their investment. For sponsors with large portfolios, such as Balfour Beatty PLC, this could result in having to recognise substantial, portfolio-wide investment write-downs.

In a loan default, there is not enough cash available in the project to service third party debt, and lenders typically have the right to call for full repayment of their debt and take over the project. In extreme cases this could render the sponsor investment valueless and also lead to the termination of the project under the arrangements with the Government client.

We have also modelled the impact of a rule which disallowed interest deductions on sponsor debt alone, whilst allowing interest on third party senior debt to be fully deductible. Even in this scenario on the three projects modelled this brought the projects extremely close to lock up levels. This would significantly reduce returns and leave the projects in a weaker state and less able to bear project risks thereafter. This in turn would increase the risk to senior debt leading to credit downgrades of rated debt and necessitating the requirement for senior lenders to set aside greater capital.

The effect of limiting interest tax deductibility on infrastructure projects is unlikely to be uniform – some projects will be more affected than others, and we do not think that a single, formulaic rule will have a uniform, predictable effect on the wide variety of infrastructure projects that currently exist.

We hope it is clear from the above that changes to the tax treatment of interest expense could be significantly harmful to existing (and future) infrastructure projects. This will likely have direct knock on consequences to investor confidence in the sector, and hence on the ability of Governments to continue to attract private sector investment into this area.
Way Forward

We are clearly sensitive to the wider aims of the BEPS project. We are however concerned that the infrastructure sector could be severely impacted by the current Action 4 proposals in an unintended way. We wonder whether the aims of Action 4 can be better met in a targeted way through other BEPS actions (for example in relation to hybrids and CFC legislation) and this would be our preference?

However, recognising that BEPS participant countries may not accept this, we have considered three potential avenues to ensure infrastructure is not adversely impacted, where as a minimum the tax deductibility of any third party debt is preserved:

a) General infrastructure carve out, perhaps linked as a minimum to where Government, or Government like bodies are the counter-party client and/or regulate the industry in a meaningful way;

b) “Grandfathering” of existing infrastructure projects (perhaps on the same Government linked scope as above); and/or

c) Detailed rules designed to ensure infrastructure projects are not adversely impacted by any new measures – such as either by:

   i). Enabling a definition of “earnings” (such as a cash based measure and not an accounting measure) and setting a test percentage that ensures most/all infrastructure projects will not face a loss of interest deductions (at least on third party debt) and/or

   ii). Allowing third party funded project companies to count this debt as stand-alone “external group debt”, and so at least not suffer any loss of tax deductibility on their third party debt.

Each of these routes has pros and cons, and raises their own challenges in design and implementation. It may be that some combination of the three is required. Balfour Beatty would certainly be willing to discuss any specific proposals further and to test any follow-up proposals on how they might apply against our PPP portfolio, as a large and active stakeholder in the UK and US infrastructure sectors.

Our key recommendation is that the Action 4 recommendations allow individual territories the explicit ability to design their own response to the challenges for their infrastructure industry, whilst ensuring they are operating within the BEPS project’s overall recommendations for Action 4.
Conclusions

As is clear from the above, any significant restriction in the tax deductibility of interest payments on either senior or sponsor debt financing will have a significant impact on infrastructure projects. For existing projects this could lead to financial default. For new projects, this will mean additional equity finance is necessary for the project to be built, and inevitably this will reduce the number of projects which can be afforded. Given the current global economic position, increased investment in infrastructure is a Government priority in many countries, and we are concerned about the potential impact of BEPS Action 4 proposals on this. Specific Action 4 proposals are therefore required to ensure that investment in infrastructure is not adversely impacted, whilst preserving the aims of the BEPS project.

We would be happy to discuss this letter further and/or comment on specific proposals from the secretariat if that would be helpful.

Yours sincerely

Duncan Magrath
Chief Financial Officer
Banking and Finance Company Working Group on BEPS

Comments on Action 4 Discussion Draft (Deductibility of Interest)

Introduction and summary of recommendations

These comments are being submitted to the OECD by the Banking and Finance Company Working Group on Base Erosion and Profit Shifting (BEPS)\(^1\), a group of global banks and finance companies, in response to the public Discussion Draft released on 18 December 2014 by the OECD entitled “BEPS Action 4: Interest Deductions and other Financial Payments” (the “Draft”).

The Draft proposes best practices options to address BEPS using deductible payments such as interest. In this context, the Draft acknowledges the unique role that debt and interest expense play in the operation of a regulated banking or finance company business as well as the strict nature of regulations that are imposed on the industry’s capital structure, including debt/equity ratios. Our comments can be summarized as follows:

- The Working Group very much appreciates and agrees with the OECD’s stated view in the Draft that, as recognized in paragraphs 204 to 208, the regulated financial services industry has characteristics relating to interest income and interest expense that are unique – that for our day-to-day business, interest expense is “the cost of goods sold.”
- Just as important is the role of banking regulation as it relates to the leverage profile of financial institutions, and the still evolving capital requirements developed by global as well as local country regulators. Among other

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\(^1\) The Banking and Finance Company Working Group is comprised of members of the Securities Industry and Financial Markets Association (including Citigroup, T.D. Bank, JPMorgan Chase & Co., Bank of America, State Street, BNY Mellon and Goldman Sachs), and General Electric and American Express. The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information and a complete list of SIFMA members, visit [www.sifma.org](http://www.sifma.org)
things, global regulators are seeking to ensure that financial institutions issue
debt that can be maintained both at the holding company and the local
subsidiary level that will absorb losses and capitalize the institutions in the
event of another financial crisis that may jeopardize solvency. Because the
post-economic crisis regulatory environment continues to evolve, global
financial institutions do not yet know all the different levels of regulatory
capital, including certain types of debt, that global regulators will require or
what form that regulatory capital will be allowed to take. This creates
further risk that any tax rules created now would interfere with the
regulatory regime for financial institutions as it ultimately evolves.

- We agree with the OECD’s view that any limitation on the deductibility of
  interest expense should apply to net rather than gross interest expense. In
  this regard, it is important that net interest be computed in an appropriate
  manner so that interest expense and interest income within a jurisdiction are
  combined.
- Even with a net interest starting point, the operation of both a group wide
  allocation approach and a fixed ratio approach, as presented in the Draft,
  could still have potentially negative implications for the industry due to the
  amount of leverage involved in a financial services business, and the
  regulatory requirements and business practices of the business.
- The Draft, in discussing considerations for groups in specific sectors,
  contemplates development of an approach for regulated banks aimed at net
  interest expense attributable to regulatory capital instruments, suggesting
  these instruments may raise BEPS concerns. The Draft also references the
  possibility of another approach involving targeted measures that are not
  specified but that could be developed if the approach relating to regulatory
  capital is found not to be necessary or viable. We urge the OECD not to
  attempt to develop rules that may apply to limit the deductibility of interest
  on regulatory capital instruments or other targeted rules applicable to
  financial institutions, unless and until specific BEPS concerns can be
  identified.

**The role of debt and interest for regulated banks and finance companies**

We agree with statements in the Draft that banks and finance companies have
special characteristics that must be taken into consideration in developing any
rules that may limit interest expense deductions. Financial regulators, in
considering safety and soundness concerns that might relate to overleverage of
financial institutions, focus on how a lending business is funded and capitalized
in order to protect the interest of customers.
At the most basic level, financial institutions use debt to fund financial intermediation between investors/savers and borrowers. Without borrowing, financial institutions would lack the funds necessary to act as financial intermediaries. Financial institutions incur interest expense on their liabilities – funds borrowed from either depositors or debt holders – and receive revenue from their financial services intermediation activities, including interest-earning assets (e.g., home mortgage loans, credit card loans, auto loans, farm loans, repurchase agreements, etc.).

Thus, financial services companies play an important role in the economy as intermediaries between investor/savers and borrowers. In their intermediation role, they take on credit risk and, often, interest-rate and currency risk. The cost of earning financial services income and other compensation for the provision of financial intermediation services is comparable to the cost of goods sold of a non-financial business (e.g., a manufacturer or retailer).

A limitation on the deductibility of interest expense could have significant adverse effects on consumers of financial services, and on financial intermediation generally, if not implemented carefully and with significant forethought as to how such a limitation would apply in the context of a financial services business. The Working Group is concerned that the options could:

- Interfere with or conflict with regulatory requirements imposed by global, home country, and local country regulators,
- Create costly distortions that ignore requirements of financial regulators and rating agencies, and/or
- Conflict with the business needs of financial institutions at both the holding company and operating company levels.

The regulation of financial services business should and does take into account the role of debt as a key input for financial services transactions

The financial services industry is highly regulated with numerous capital requirements intended to address leverage and excessive risk-taking. Imposition of tax-related limitations on the overall use and specific placement of leverage in a financial services group would inevitably conflict with regulatory requirements and business needs for customer-facing entities.

The financial crisis led to a reexamination of capital requirements, debt-to-equity ratios, bank supervision standards, the role that risk plays in operating
and managing regulated financial institutions, and the manner in which failures of systemically significant financial institutions will be managed if another financial crisis occurs so as not to create contagion in the financial services industry. The Basel Committee on Banking Supervision, consisting of banking supervisory authorities worldwide, sets prudential regulatory standards for banks worldwide and provides a forum for cooperation among banking regulators. Following the financial crisis, the Basel Committee developed the Basel III standards aimed at improving the banking sector’s ability to absorb economic crises, improving risk management and governance, and strengthening banks’ transparency and disclosures.

Along with establishing significantly enhanced bank capital requirements, Basel III also introduced leverage ratio requirements that act as a backstop to the risk-based capital requirements. The leverage ratio is intended to restrict the build-up of leverage in the banking sector and captures both on- and off-balance sheet sources of banks’ leverage. Imposing separate restrictions through limits on the deductibility of interest expense therefore would be unnecessary, would not factor in the considerations taken into account by banking regulators, and would likely create distortions and extra costs that run counter to banking regulatory requirements.

Along with focusing on ensuring that financial services groups have enhanced capital and are subject to more detailed and clear leverage limitations, regulators are also keenly focused on ensuring that global financial institutions can be recapitalized if they become insolvent without requiring taxpayer funds or contributing to further financial sector contagion. Most recently, global regulators, operating through the Financial Standards Board (FSB), have focused on heightened capital and liquidity requirements as well as regulatory and supervisory restrictions on risk-taking designed to reduce the risk of failure by systemically significant financial institutions. For example, global regulators have issued proposals relating to the need for “Total Loss-Absorbing Capital” (TLAC), including certain types of debt, to be maintained by global banks. The proposals would require global systemically important banks (G-SIBs), for example, to hold regulatory capital and other loss absorbing instruments in an amount sufficient to recapitalize a G-SIB if it were to fail. Most relevant for purposes of this BEPS discussion is that the TLAC proposal calls for TLAC in a combination of debt and equity capital, both to be issued at the holding company level and to be placed in regulated affiliates around the world, which may be achieved through the use of related-party debt.
Financial institutions’ creditworthiness is evaluated by rating agencies as well as regulators. The cost of debt capital is directly linked to the credit rating of the holding companies and operating companies, giving financial institutions a powerful incentive to manage debt appropriately in order maintain credit ratings that permit essential access to the debt and equity markets. This is another reason why further limits on the deductibility of interest expense for financial groups are not needed.

The Working Group believes the imposition of interest expense limitations, whether aimed at ensuring groups do not overleverage particular entities disproportionately to the leverage of the entire group, or aimed at ensuring groups do not overleverage specific entities compared to some measure of earnings of those specific entities, would inevitably conflict with these regulatory requirements. Such limitations also appear unnecessary when one considers both the regulatory framework and the role of interest in a regulated financial services group. Because financial intermediation plays such an important role in the economy, financial institutions are regulated by government to ensure that they are prudently managed by qualified staff and hold enough equity capital (or equity-like capital) to absorb potential losses.

In summary, the nature of the financial services industry’s business and the existing and evolving regulatory requirements surrounding capital and risk provide considerable safeguards against the concerns that are driving BEPS Action 4:

- Regulators closely monitor financial institutions’ activities and closely monitor the capitalization and the leverage ratios of each material entity, whether or not it is a regulated entity, and also monitor the transfer of equity or equity-like capital to foreign subsidiaries. The ability, if any, to capitalize an entity in a low tax foreign jurisdiction that might not have actual customer functions but that is utilized to fund operating entities in other jurisdictions is very limited. All material funding structures are monitored and questioned by home country regulators. Financial groups are also restricted in their ability to recognize income in an entity that does not in substance conduct the business that generates the income.
- Regulators are imposing new capital standards aimed at preventing another financial crisis, including mandates on the amount of capital and loss-absorbing debt and on how that additional capital and certain other loss-absorbing instruments should be positioned at the holding
company level and in affiliates. These new rules will create additional capital requirements, and will impose further restrictions on where global financial institutions must maintain capital, including certain types of debt. New tax rules should not be applied to financial institutions in a way that would deny interest deductions for debt mandated by regulators.

- Global financial institutions do not yet know all the different levels of regulatory capital that global regulators will require or what form that regulatory capital will be allowed to take. This creates further risk that any tax rules created now would interfere with the regulatory regime for financial institutions as it ultimately evolves.

More details on the nature of the business and regulatory environment for financial institutions are contained in Appendix 1.

**Application of interest expense deduction limitation options to regulated banks and finance companies**

The Draft presents three general options for limiting the deductibility of interest expense at the group or entity level to the extent the group or entity is deemed to exceed an interest cap. The approaches contemplate:

- A “fixed ratio” rule, which would limit the net interest expense deduction of an entity by reference to a fixed ratio, such as net interest expense to EBITDA. An entity’s net interest expense that exceeds the permitted ratio would be disallowed.
- A group-wide interest allocation ratio rule, which would allocate a cap based on the worldwide group’s net third party interest expense between group entities based on some measure of an entity’s economic activity – either earnings or asset values. An entity’s net interest expense up to the allocated cap would be deductible.
- A combination of the two approaches, in which one approach would take the form of a general rule and the other approach would provide an exception to the general rule. An example is the current German approach, which provides for a fixed-ratio test, but makes that test inapplicable if the leverage ratio of the entity does not exceed that of the entire group.

We agree that net interest expense (as opposed to gross interest expense) is the correct target for a general limitation rule. With respect to financial services,
paragraph 205 of the Draft states: “...taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore a rule which caps net interest expense will have no direct impact on a bank or insurance company, although such a rule could disallow net interest expense in other group entities.”

Due to the mechanics of the Draft’s options, the Working Group questions whether the assertion that the net interest rule “will have no direct impact on a bank” is accurate. In developing a net interest limitation, it is important that netting of interest income and expense be accomplished in a manner that accurately captures net interest. The Working Group believes that the mechanics of both the fixed ratio and group-wide allocation options in the draft should be examined more closely to ensure actual net interest is captured appropriately. In addition, as a general matter, we believe there will be enough instances in which both the group-wide interest allocation approach and the fixed ratio approach could impact a banking or finance company group that attention must be paid to design issues that will help ensure that unintended consequences do not occur. Paragraph 62 acknowledges, for example, that some groups are engaged in a range of different activities and may find that they cannot deduct all their interest expense or that they may not fully use their capacity to absorb interest expense. This is equally true for a financial services group. For example, a group containing banking activities may also operate other businesses that do not generate net interest expense (e.g., asset management, service operations, or technology operations, etc.).

A key issue in applying these approaches is the Draft’s focus on application of the options to “entities.” This seems inappropriate and may be unintended. Because any BEPS concerns are jurisdictionally focused, we believe any rule should apply to combine all entities, including branches, within a jurisdiction.

The industry operates a significant amount of its business in branch form, and therefore the question of how to treat interest attributable to foreign branches would complicate the analysis unless all subsidiaries and branches in a country, and all interest income and expense attributable to them, were combined to determine one net number to which the fixed ratio test or group-wide test would be applied. The potential complications and inadvertent impacts of applying a net interest limitation to banking and finance company businesses have led some countries with net interest limitations based on a fixed ratio approach, for example, to provide an exemption or different set of rules for the financial services sector.
The need to combine entities in a jurisdiction is further reinforced by the very common use of holding companies. A key structural issue for regulated banking and finance groups, often driven by regulatory requirements, is that these groups maintain holding companies that issue debt instruments to the public. Federal Reserve regulations that apply to non-U.S. headquartered banks with operations in the United States, for example, require the establishment of intermediate holding companies that must be capitalized in order to fund separate U.S. operating entities. These non-operating holding companies could be in a net interest expense position because they have little interest income; in fact, their income may mainly be in the form of related-party dividends. Unless a test is applied on a jurisdictional basis, holding companies’ interest deductions might be subject to limitation despite the fact the regulated operating entities in the group, because they have little or no debt, would have no net interest expense and the combined group in that country would not have net interest expense. We cannot emphasize enough that the holding company is a necessary part of the structure of the financial services group, and regulators and rating agencies are as focused on the level of capitalization and the functionality of the holding company as they are on the operating entities.

In addition, regulated entities may include operating businesses, such as broker dealers, that fund their day-to-day operations with debt but may from year to year not have interest income to fully offset interest expense. As an example, regulated broker-dealers within a financial services group use debt funding similarly to regulated banks and finance companies, but typically hold assets across a much broader spectrum than debt securities (e.g., equity securities held in a dealer business). In such cases, on a stand-alone legal entity basis, the broker-dealer may generate net interest expense. Finally, the Draft suggests that groups faced with any business distortions created by the Draft’s interest limitation options may be able to reorganize their debt structures. Given the regulatory limitations imposed on the use of debt, the ability of regulated financial institutions to reorganize their debt to achieve “self-help” would be dramatically constrained by capital requirements and leverage ratio limitations imposed by the regulators.

Even if an aggregate approach is applied generally, it is still possible that net interest expense could arise in a given jurisdiction. If that occurs, we would like to point out that the group-wide allocation rule would be particularly difficult to administer in the case of financial institutions. This approach is premised on the belief that businesses can freely borrow in their home country
and use the proceeds to fund equity investments in foreign subsidiaries. Specifically, even when a group-wide limit is based on net interest expense, for our business we believe distortions could result from:

- Different borrowing costs in different markets;
- Differences in the regulatory capital requirements applicable in different countries; and
- Differences in the mix of businesses conducted by different members of the group.

It is worth noting that a proposal put forward by the Obama Administration in the United States that similarly would use a global allocation approach to limit interest expense deductibility is based on net interest but nevertheless also provides a specific exclusion for financial institutions.

**Potential “special rules” for banking and finance companies**

Paragraphs 210 and 211 of the Draft suggest that, because it is believed that the general options discussed above most likely will not apply to banks and finance companies, it is appropriate “to design a specific rule which would have a similar effect for banks and insurance companies but that focuses on the particular base erosion and profit shifting risks that they present. This may involve separate rules for each of these sectors.”

The Draft describes one option that would focus on the net interest attributable to regulatory capital instruments “which provide a bank or insurance company’s core funding and play a role comparable with debt in other sectors.” Apparently similar in concept to the group-wide allocation debt cap rule, this option would limit a group’s net deductions on its regulatory capital “(ignoring the interest income generated from using the capital to write business)” to the amount of interest expense paid on these instruments to third parties.

Specifically, “within the group, an interest cap could be allocated in accordance with regulatory requirements, so long as this provides an effective solution to base erosion and profit shifting.”

The Working Group has several concerns with this approach. Most importantly, the Draft says the option “focuses on the particular base erosion and profit shifting risks” presented by banks and insurance companies, but it fails to describe those BEPS risks. In addition, the option suggests a solution is necessary to apply to interest expense related to regulatory capital in the same
way that the general approaches would apply to interest expense on group-wide
debt of non-financial services companies, implying that the BEPS concerns
relating to non-financial services companies manifest themselves in the context
of a banking or finance company group in relation to deductible interest on
regulatory capital.

Without a further articulation of these concerns, it is difficult to understand how
this option would apply to any potential BEPS activities by financial
institutions. For example, the Draft states that BEPS arises due to the use of
interest deductions to fund income which is exempt or deferred for tax
purposes. Techniques to achieve these outcomes, according to the Draft,
include the use of intragroup loans to generate deductible interest expense in
high tax jurisdictions and taxable interest income in low tax jurisdictions, as
well as the development of hybrid instruments that give rise to deductible
interest expense but no corresponding taxable income. In the case of a financial
institution, however, using borrowed money to make foreign equity investments
results in “double leverage” (because leverage exists at both the parent and
subsidiary level), which can have significant regulatory and rating agency
disadvantages for broker-dealers and banks, and may be completely prohibited
for banks. Therefore, for a global bank to raise capital through borrowing at the
parent level in order to fund foreign affiliates by first positioning capital in a
low or no-tax jurisdiction, while not impossible, would be very difficult to
achieve simply to produce a tax benefit. For example, such activities, by a U.S.
bank, would be subject to the constraints of Regulation K for the investments in
its subsidiaries and would require regulatory approval – for which a) there are
limits, and b) would be difficult to justify on commercial grounds.
Consequently, it is not likely that the necessary approvals would be
forthcoming. Such activities undertaken directly by the parent entity would,
separately, create an adverse double leverage impact for the parent company;
which would be visible to, and likely trigger an adverse reaction from,
investors, rating agencies and regulators.

Regulatory capital is described in paragraph 211 as “core funding” with “a role
comparable with debt in other sectors.” However, the fact that certain capital
meets regulatory requirements does not mean that it is disassociated with the
production of ordinary income. Moreover, regulators impose stringent limits on
the amount of regulatory capital that can take the form of debt, making it
difficult to use debt that qualifies as regulatory capital to take on excessive
levels of debt. Therefore, regulated banking or finance company groups are not
able to use debt that qualifies as regulatory capital to take on excessive levels of
debt. So while such debt is part of the capital structure of a bank, for example, and other businesses have debt in their capital structures, the regulatory restrictions mean that there is no real comparability with debt in other sectors.

The option described in paragraph 211 also requires further analysis because the role of debt in the regulatory capital structure of regulated banking and finance company groups is still evolving, as noted above. The role of TLAC, as described above, is a good example. Based on the proposed regulations provided by the FSB, it remains unclear whether such obligations will be treated as debt or equity for tax purposes in certain jurisdictions. The exact requirements relating to how TLAC instruments will be structured and how they will be utilized will be a key determinative factor in this analysis, but those requirements are not yet settled, and any final regulations will be phased in over a number of years.

To the extent the allocation formula suggested by this option produced a result that was inconsistent with a group’s actual bearing of debt, the Draft takes the general position, in discussing a group-wide allocation approach, that groups may achieve self-help “by reorganizing their intragroup financing,” as noted in paragraph 76, “so that the net interest expense in each entity reflects the interest cap allocated to it.” The Draft requests comment “as to tax and non-tax considerations (such as increased withholding taxes or exchange controls) that restrict a group’s ability to re-organise its intragroup loans or impose a cost on it doing so.” As noted throughout this submission, regulators restrict the use of debt in both holding companies and regulated operating companies. For this reason, regulated entities would not have self-help options because of the applicable regulatory constraints. Thus, a cap-and-allocation rule would have adverse consequences that could not be protected against nor mitigated.

Limiting the deduction for interest expenses to reduce excessive leverage in a regulated bank’s capital structure would duplicate the capital requirement framework already in place that targets excessive leverage in the financial services industry, focuses on reducing risk in the industry, and aims to ensure that banks will be able to better withstand future financial crises. Regulators use capital requirements to directly reduce leverage and have recently expanded the scope of such requirements. Capital requirements should be managed by the regulators, not indirectly through tax law changes.

Anticipating that a limitation relating to regulatory capital may not be appropriate, the Draft also includes a less specific interest expense deduction
limitation option, in paragraph 212 (targeted measures for interest other than interest on regulatory capital). The option states: “Alternatively, if existing regulatory requirements act as an effective general interest limitation rule, and prevent excessive leverage in group entities, a best practice approach could instead focus on a group’s interest expense other than that on its regulatory capital. This may comprise targeted rules to address risks posed by specific transactions.”

We agree with the suggestion that if BEPS is identified in the context of ordinary course financial services businesses, targeted rules would be the right approach to address the BEPS concerns. However, it is not possible to provide specific comments on such an approach at this time without more information on the BEPS concerns to be addressed and the targeted approach to be developed.

**Conclusion**

We would be happy to work with the OECD on evaluating any BEPS risks in the banking and finance sector that are identified in the future and on developing appropriately targeted rules to address any such specific concerns. It may be appropriate, given the complicated and evolving nature of global banking regulation and the necessary changes in capital structure, capital-related instruments, and related business practices that will be direct results of these regulations, for the OECD to defer further exploration of interest-related options for the financial services industry until after its work on the current BEPS project is completed, and then to work closely with the banking sector and its regulators. To do otherwise, and to attempt to develop recommendations over the next few months within the existing BEPS work plan and timeline, could risk the issuance of a recommended approach that would cause unintended consequences and run counter to the objectives of banking regulators.
Appendix

The regulation of financial services business should and does take into account the role of debt as a key input for financial services transactions

Financial regulators balance the fact that financial services are fundamentally different in their use of debt compared to the rest of the US economy, with concerns regarding overleverage. All other industries have interest expenses that exceed their interest income (e.g., net interest income is negative) because their debt capital is used to finance their purchases of inventory, plant and equipment, rather than used to make loans and fund other types of financial intermediation. In contrast, financial services companies use debt to generate net interest income.

Role of capital requirements

The financial services industry is highly regulated with numerous capital requirements intended to address leverage and excessive risk-taking (Table 1, below). Most recently, global banking regulators have focused on resolution planning in case of another financial crisis, and are requiring additional layers of loss-absorbing capital to be held at the holding company level in a group’s home country. In addition, these proposed requirements contemplate putting such capital into regulated affiliates around the world. These requirements are relevant to the tax treatment of interest expense because, as explained in more detail below, some instruments will be issued in the form of long-term debt that would be converted into loss absorbing capital during resolution. In addition, banks may raise capital through the issuance of subordinated debt to third parties. Affiliates also may borrow from the parent utilizing subordinated debt in a manner that qualifies as good regulatory capital.

The Basel Committee on Banking Supervision, consisting of banking supervisory authorities worldwide, sets prudential regulatory standards for banks worldwide and provides a forum for cooperation among banking regulators.

Banks and other financial institutions have long been required to hold a minimum absolute amount of capital, and beginning in the 1980s, to have minimum capital-asset ratios. The Basel Accords instituted credit risk adjustments to capital-asset ratio requirements in 1992. The Market Risk
Amendment to Basel II introduced additional controls for both market and operational risk, as well as the requirement for value-at-risk modeling, which estimates the potential for asset loss over a period of time.

The financial crisis led to a reexamination of capital requirements, debt-to-equity ratios, bank supervision standards, the role that risk plays in operating and managing regulated financial institutions, and the manner in which failures of systemically significant financial institutions will be managed if another financial crisis occur so as not to create contagion in the financial services industry.

In 2008, the G20 committed to fundamental reform of the global financial system. “The objectives were to correct the fault lines that led to the global crisis and to build safer, more resilient sources of finance to serve better the needs of the real economy. National authorities and international bodies, with the Financial Services Board (FSB) as a central locus of coordination, have taken forward this financial reform programme, based on clear principles and timetables for implementation.” In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in 2010 and called for increases in capital requirements for both U.S.-based banking groups and non-U.S.-based banking groups operating in the United States. The Act did not include specific capital requirements in order to allow coordination of potential increases in capital requirements with Basel III, which was then being negotiated.

Following the financial crisis, the Basel Committee developed the Basel III standards aimed at improving the banking sector’s ability to absorb economic crises, improve risk management and governance, and strengthen banks’ transparency and disclosures.

Accordingly, the Federal Reserve in 2014 announced rules to implement Dodd-Frank and Basel III, which will impose a new 4.5% Tier 1 common risk-based ratio and increase the Tier 1 capital ratio requirement to 6%. In addition, the new rules include a 2.5% common equity Tier 1 capital to risk-weighted assets conservation buffer bringing the total requirement to 7%. Failure to meet the conservation buffer – insufficient common equity Tier 1 capital – would result in limitations on allowable discretionary payments and shareholder.

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distributions. The Federal Reserve estimated that 95% of insured depository institutions are already in compliance and have Tier 1 common risk-based ratios above the 7% minimum.

Table 1. Evolution of capital requirements

<table>
<thead>
<tr>
<th>Year</th>
<th>Regulation</th>
<th>Key provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>Basel I</td>
<td>Required capital-asset ratios include adjustments for credit risk and off-balance sheet assets. Implemented 8% total capital to risk-weighted assets requirement and 4% requirement for Tier 1 capital.</td>
</tr>
<tr>
<td>1996</td>
<td>Market Risk Amendment</td>
<td>Amended Basel I to account for market risk and adopted value-at-risk modeling.</td>
</tr>
<tr>
<td>2005</td>
<td>Basel II</td>
<td>Incorporated operational risk into the risk adjustments for assets.</td>
</tr>
<tr>
<td>2010</td>
<td>Dodd-Frank</td>
<td>Called for enhanced capital requirements but deferred specifics to regulators to allow flexibility in Basel III negotiations.</td>
</tr>
<tr>
<td>2013</td>
<td>Basel III</td>
<td>Included a new 4.5% common equity Tier 1 capital requirement, increased minimum Tier 1 capital ratio from 4% to 6%, kept 8% total capital requirement, included a 4% leverage ratio for all banks and a 3% supplementary leverage ratio for advanced-approaches banks, and imposed a 2.5% common equity Tier 1 capital conservation buffer</td>
</tr>
<tr>
<td>2014</td>
<td>FSB proposals on TLAC</td>
<td>The FSB proposes to require G-SIBs to hold additional regulatory capital and other loss absorbing instruments in amounts sufficient to recapitalize in the event of resolution. The proposal could require equity and loss-absorbing debt approximately double the amount of equity capital required under Basel III.</td>
</tr>
</tbody>
</table>

Along with establishing significantly enhanced bank capital requirements, Basel III also introduced leverage ratio requirements that act as a credible backstop to the risk-based capital requirements. Basel III requires all banks to maintain a minimum leverage ratio, defined as the ratio of Tier 1 capital to average total consolidated assets, of at least 4%. Some banks are subject to a separate supplementary leverage ratio of at least 3%. The leverage ratio is intended to restrict the build-up of leverage in the banking sector and captures both on- and off-balance sheet sources of banks’ leverage.3

Most recently, global regulators have focused on heightened capital and liquidity requirements as well as regulatory and supervisory restrictions on risk taking designed to reduce the risk of failure by systemically significant financial institutions. For example, global regulators have issued proposals relating to the need for “Total Loss-Absorbing Capital” (TLAC), including certain types of debt, to be maintained by global banks. The FSB’s consultative document, released November 10, 2014, sought comments on proposals to require global systemically important banks (G-SIBs) to hold regulatory capital and other loss absorbing instruments in an amount sufficient to recapitalize a G-SIB in resolution. The proposal is another step on the part of international banking regulators to develop a regulatory framework aimed at preventing the insolvency of financial institutions by allowing the resolution of G-SIBs without imposing losses on taxpayers or creating systemic destabilization.

Like other similar initiatives, the proposal to require sufficient levels of TLAC is expected to be adopted as part of laws and regulations in key jurisdictions. Most relevant for purposes of this BEPS discussion is that the TLAC proposal calls for TLAC in a combination of debt and equity capital both to be issued at the holding company level and to be “pre-positioned” in regulated affiliates around the world. A key feature of this initiative is to allow for the recapitalization of G-SIBs, including their subsidiaries in different jurisdictions, by providing an essential cushion of loss absorbing common equity and debt after the base of Basel III minimum regulatory capital has been eroded. The amount of TLAC required will be substantial, with the FSB proposal contemplating combined debt and equity approximately double the level required under the Basel III minimum capital standards.

3 Basel III Leverage Ratio Framework and Disclosure Requirements, the Basel Committee on Banking Supervision, January 2014
The FSB has indicated it will not issue final TLAC standards until November 2015, and global implementation is not anticipated prior to 2019, but certain jurisdictions may seek to implement the TLAC requirements more quickly through their own laws and regulations.

In summary, the nature of the financial services industry’s business and the existing and evolving regulatory requirements surrounding capital and debt provide considerable safeguards against the concerns that are driving BEPS Action 4:

- Regulators closely monitor financial institutions’ activities and impose leverage ratio limits as well as restrictions on the ability to transfer capital and debt to foreign subsidiaries.
- Regulators are imposing new capital standards aimed at preventing future contagion with the financial sector in the event of another financial crisis, including mandates on the amount of capital and loss absorbing debt and on how that additional capital and certain other loss-absorbing instruments should be positioned at the holding company level and in affiliates.
- Creditors and rating agencies provide a second line of defense: they have powerful incentives to prevent financial services businesses from over-leveraging some operations and under-leveraging others.
Dear Mr. Pross,

BASF is a multinational group with operations in over 100 countries. The group comprises a total of over 600 companies, of which approx. 300 are fully consolidated in the group financial statements.

Companies in our group are generally funded by a mix of debt and equity. The mix is determined based on a number of factors. These include a risk assessment of the company/country, currency valuation and conversion issues, restrictions on repayment, any local restrictions on debt-equity ratios, and the cost of increasing/decreasing equity vs debt. The decision is generally not tax-driven; however the ability to achieve interest deductions for tax purposes may also be a factor. The transfer pricing set-up of group companies however ensures that local risks, funding requirements and interest costs are taken into account, and the remuneration generally ensures that group companies can fund their working capital requirements based on their average debt-equity mix. If a subsidiary’s activity requires investments which need to be financed, the remuneration of the subsidiary will generally – in accordance with the arm’s length principle – take such funding costs into account. There is therefore an implicit interdependency between interest deductions and transfer pricing.

The OECD is proposing several methods to restrict interest deductions which are based on a group wide approach, a fixed ratio approach or a combined approach. Each approach seeks to limit a groups interest deductions either to its amount of external debt or to a level of deduction which would be considered by the OECD to be more appropriate. We see much complexity and
uncertainty in the proposed rules and are stunned by the lengths that the OECD is considering to go in its recommendations (e.g. discarding the arm’s length principle, accepting double taxation) in order to tackle a phenomenon of “excessive interest deductions”. We are very concerned about possible distortive impacts which the OECDs proposals on interest deduction may have for our group and therefore welcome the possibility to submit our comments.

We would like to focus our comments below on three main areas:

- Consistency of approach and interaction with other BEPS action points
- Double taxation issues
- Practicability of the approaches proposed

1. Consistency of approach and interaction with other BEPS action points

The OECD is concerned about base erosion and profit shifting which may be caused by excessive interest deductions. Such excessive interest deductions are caused – if one follows the reasoning of the OECD – not by third party loans to a group but rather by intercompany loans within a group. Leaving hybrid financing arrangements aside (which have been rigorously tackled by the BEPS action point 2 recommendations), intercompany interest expense automatically gives rise to intercompany interest income. The issue may therefore be not one of excessive interest expense (as this is matched by interest income), but rather an insufficient taxation of interest income arising within a group. Differentials in tax rates in different countries may therefore be the real cause of the phenomenon which the OCED is concerned with.

Differentials in tax rates apply to all income earned and charged within a group to the extent that there are inter-company transactions, and these do not only apply to interest. In general, the arm’s length principle is used in order to ensure that inter-company income and expense is allocated in a fair way. In order to prevent abusive behavior in allocating income to low-taxed countries where companies may have little substance, most (high-taxed) countries have CFC rules in place in order to tax such income at the higher home-country rate. In addition, BEPS Action Item 3 aims to provide recommendations to further enhance CFC rules. Furthermore, recommendations on Action Item 5 regarding harmful tax practices already address preferential tax regimes.

In our view, the issues identified in the Discussion Draft on Interest Deductions can be comprehensively dealt with by the recommendations in the report on Neutralising the Effects of Hybrid Mismatch Arrangements, the Report on Harmful Tax Practices as well as the (still pending) recommendations regarding CFC taxation.

*The BEPS action plan states that the work on Action 4 will be coordinated with the work on hybrids and on CFC rules. We strongly recommend to the OECD to consider whether the work in these other areas already sufficiently addresses the issues which are the real cause of the matter of concern in this regard.*

2. Double taxation issues

There are many scenarios in which the proposed rules will lead to double taxation. This applies to the group wide approach as well as the fixed ratio rule.
Group allocations Rule

Double taxation will generally occur under the group allocation rule where a group for non-tax reasons finances a company by inter-company debt rather than by equity. There are many non-tax reasons why such financing may be preferred. Where there is currency risk, loan financing enables the risk to be hedged in the financial statements in order to protect against volatility and loss. Recent experience of such currency risk has occurred with regard to the Euro against the Russian Ruble, the Swiss Franc, the US Dollar, and the Norwegian Krone to name just a few. In addition, equity may be subject to legal or regulatory restrictions regarding repatriation of funds when these are no longer required.

Under the proposed interest cap rule, if the subsidiary’s earnings or assets merit a low group allocation, a portion of the interest paid would not be deductible whereas the interest income in the parent would remain fully taxable. The group would be faced with double taxation purely due to a commercial decision on the funding of the subsidiary.

It seems naïve to assume that a group could always adjust its financing in order to locate it at the right place, since this is often either not possible or much more costly as illustrated above. Especially in cases where a group is not a net borrower, it would be forced to take up funds from a bank to be able to deduct any interest at all in order to at least partially avoid double taxation arising from the taxation of interest income. The OECD’s proposals encourage a group to make tax-driven decisions rather than commercially-driven ones in these circumstances simply to avoid a double tax burden.

Whereas the proposals would punish companies which internally lend to group companies due to such restrictions, the Discussion Draft is also quite clear that “using interest in order to fund tax-exempt dividend income” amounts to aggressive behavior and needs to be addressed. Therefore it seems that groups which borrow funds in order to invest equity (and thereby generate dividend income) should be equally punished as those which lend funds internally to group companies. It should also not be forgotten that dividends are tax-free because they relate to underlying income in the source country which is already subject to tax. Exempting dividends from tax is a mechanism which serves to avoid a double taxation of income. If the OCED is seeking to address particular aggressive structures, e.g. inter-group transfers of shares funded by debt, then these should be specifically addressed rather than putting a whole system of double taxation avoidance into question.

Fixed ratio test

Any fixed ratio test can lead to an automatic double taxation, since the portion of interest exceeding the cap becomes non-deductible whereas the interest income is always fully taxable. A carry forward of non-deductible interest does help, but in some cases a company may never be in the position to use the carry forward so the double taxation will be permanent.

In order to address this issue, a recommendation should be made to allow a re-characterisation of any disqualified interest into a dividend to ensure consistent tax treatment in each country. Such re-characterisation could be made dependent on an application of the lender who would need to supply evidence of the disallowed interest deduction.
Withholding tax and the arm’s length test

The Discussion Draft rejects the arm’s length principle as a rule to tackle interest expense. The draft further states: “... in practice countries introducing a group-wide rule may no longer be concerned about the pricing of individual intragroup instruments, which could reduce the need for transfer pricing rules in this area”. The proposals explicitly state that the rules should not apply for withholding tax purposes. Withholding tax is a tax on income, and de-linking the rules applicable for withholding tax to those applicable for tax deductibility is completely incoherent and contrary to general principles of taxation. Interest would become non-deductible whereas interest income would remain subject to withholding tax. In disputes regarding withholding tax, tax authorities may continue to apply the arm’s length principle, whereas in disputes on deductibility of interest an allocation mechanism would prevail. It is difficult to envisage how such contradictory rules can be implemented into a country’s local tax law in practice. If interest is to be non-deductible then there should be no withholding tax levied.

There are wider implications which result from the discarding of the arm’s length test. In particular, the question arises as to whether or not the interest rate set for intercompany loans can be completely arbitrary since only a portion of the expense will be allowed in any case. If the arm’s length test were not to apply for withholding tax purposes either, groups may use the rules to optimize their overall tax position. Particularly under a fixed ratio rule, the interest rate charged will impact the total amount of interest actually deductible and could be used to manipulate the company’s position to ensure a maximum of interest deductions. Alternatively, if a group allocation rule were in place, companies may choose to charge excessively low interest in order to reduce their withholding tax burden.

There is a significant risk of double taxation in the rules proposed. These could be avoided only in a fixed-ratio test and only by re-characterising the non-deductible interest into a tax-free dividend or providing some other relief to the lender for the tax burden on the income. In addition, the role of the arm’s length test on interest payments and the implications for withholding tax need to be clarified and addressed in a coherent manner.

3. Practicability

The fixed ratio rule has the advantage of being practicable even if all countries do not adapt it. It is a rule which does not depend on a coherent definition and can be adapted by countries individually. The main practicability issues we see are in connection with a group-wide test.

The group wide test can only work effectively if a significant number of countries adopt it in substantially the same manner. If this is not the case, then there will be planning opportunities which will arise to enable companies to optimize their interest expense in countries which do not adopt the rules. This will not serve to reduce base shifting and profit erosion but rather to enhance it. In our view it seems unlikely that a consensus will be possible among all major countries. The definition of interest is a starting point. What is to be considered economically equivalent to interest? For example, if convertible bonds are taken up on the market, how should payments on the bond be treated? If one country says they are economically equivalent to dividends, and another country says that they are economically equivalent to interest, how does the dilemma get resolved? Getting all countries to define interest in the same way seems an impossible task, however it is crucial for the group wide test to work as proposed. Leaving countries to define interest
as they want (as proposed by the Discussion Draft) would mean that certain inter-company interest would be excluded and other not. This individual approach can only work for a fixed ratio rule.

It is also unclear how a group wide test could actually be administered – who determines the total group interest – the taxpayer, the authorities, or each tax authority separately? How and when is the information to be provided and who determines the adjustments to be made for tax purposes? If the allocation is contested by the tax payer in one country, does this have implications for the allocation to all other countries? Alternatively should one country’s allocation be binding on all others? If tax audits lead to changes in the earnings or asset values, how does this impact the group allocation? What if years are time barred in certain countries? Does the taxpayer need to go through multilateral dispute resolution for each disallowance or dispute on the allocated interest?
The OCED has not started to formulate any recommendations in this regard.

Using a measure of interest which is based on consolidated accounts provides room for many differences between the treatments of different groups based on different consolidation rules. In addition, non-consolidated companies can be used by groups for planning purposes in order to circumvent the rules. A number of positions make up the line “financial result” in the group accounts which - if taken as a basis for determining the external interest expense of a group - would need to be analysed and adjusted for items such as interest relating to the valuation of pension obligations, interest from discounting other long-term liabilities, changes in fair values of derivatives, write downs or write ups of loans, gains and losses on securities currency conversion impacts, exchange rate gain or loss booked in equity, and many, many more.

In terms of practicability, the fixed ratio rule can be implemented by countries on an individual basis, whereas the group wide allocation rule appears to have insurmountable complications and also would need to be implemented by a large number of countries in order to have any impact.

4. Summary

In summary, we would urge the OECD to consider whether recommendations with regard to hybrid mismatch arrangements, harmful tax practices and in regard to enhancing CFC rules would sufficiently address its concerns in regard to interest deductions. Discarding the arm’s length rule as well as ignoring commercial considerations with regard to group financing may foster a culture of tax-driven decisions rather than achieve the contrary. Recommending a solution which results in double taxation for a large number of groups in order to tackle a phenomenon of excessive deductions caused by a smaller number of groups appears to go far beyond the mandate of the OECD and its own stated policy aim of avoiding double taxation.

Regards,

Oliver Nussbaum             Meera Patel
Dear Mr. Pross,

BDI refers to the OECD Discussion Draft “Interest deductions and other financial payments (BEPS Action 4)” issued on 18 December 2014. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues.

In the BEPS Action Plan the G20/OECD has set out the aim to 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”.

General Comments

- We are concerned with the general assumption that seems to be underlying the Draft, that intra-group interest is per se related to base erosion and profit shifting. Therefore it is important to emphasize that the vast majority of businesses do not use interest payments for tax avoidance purposes. We therefore believe that the starting point for deliberations on Action 4 should be that interest and other costs, such as derivatives and insurance payments, are legitimate business costs and should therefore be deductible. Any restrictions should be limited to abusive situations without genuine commercial reasons.

1 BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.
• We agree with the proposal found in paragraph 49 of the Draft, which is that a best practice tax rule on interest expense deductibility should apply to net interest expense and not gross interest expense.

• The choice between debt and equity is an important business decision, based on many different considerations. 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 or other local regulatory constraints and foreign exchange (including currency restrictions in certain countries).

• Thus, there are good commercial reasons why intra-group loans might be preferred to a contribution of equity. Loans are more flexible than equity and generally carry a lower cost of capital than equity. Dividend distributions remain subject to significant limitations in terms of timing and amounts; loans cater better for potential fluctuations in the need for capital; less formalities are required for reductions or increases of loans compared to equity, resulting in less administrative costs for financing. Also, minority investors are typically passive which means introducing additional equity from the group might not be possible without changing the dynamics of the investment and therefore leading to a preference for group debt. Some controlled entities are listed with the minority ownership spread across a wide number of investors. This can make changes to equity, and in some cases related party transactions per se where shareholder approval is required, impractical.

• In this regard, we disagree with the assumption that adjusting the mix of debt and equity in a group of companies is relatively straightforward.

• In order to ensure flexibility and neutrality of financing, arm’s length intra-group financing should not be subject to stricter rules than external financing. It is normal commercial practice to raise debt in the market through one legal entity that subsequently lends on to different legal entities in a group.

• Efficient and flexible corporate financing is crucial to economic development and growth and should not be undermined. Any changes to interest deductibility should be focused on tackling actual avoidance and should only address situations where there is excessive debt in accordance with accepted business norms. The arm’s length approach should not be discarded, since this is the best method for judging what debt and interest an entity could obtain, as a standalone, from a third party. If an entity can adequately demonstrate its debt capability using the arm’s length principle, then such a fact should be relevant in determining whether related party interest expense is “excessive” before any such excess is disallowed. Therefore, we disagree with the conclusion of the Draft that arm’s length tests should not be considered as part of the consultation process.
Specific Comments

Group-wide tests – conceptual concerns

According to the Draft, global group-wide tests are one option for a general limitation rule which could be developed into best practice rules to deal with abuse. As a general remark, as there is currently no country that applies a group-wide test as a main rule, there is no practice yet that could be developed into best practice. According to the Draft, group-wide tests in theory have the greatest potential to tackle base erosion and profit shifting by using interest.

From a business point of view we are convinced that in practice this would not be the case for a number of reasons. Beyond not feasibly addressing BEPS concerns, a group wide allocation model would lead to major distortions in investment and competition, high administrative and compliance costs for tax authorities and taxpayers due to its immense complexity, an increased risk of double taxation, and eventually would be detrimental to providing certainty of outcomes. Tax rules that create significant collateral economic damage should not be considered as “best practice” rules.

Moreover, we are reluctant to endorse group-wide tests given that they resemble formulary allocation and apportionment of interest expense and thus diverge from the principle of encouraging arm’s length behaviour between related parties.

Group-wide tests – practical concerns

- One prerequisite for a group-wide interest deduction rule to be feasible in practice is to implement the rule consistently throughout the world. A group-wide rule is, in other words, inconsistent with other – already existing – national rules. Therefore, any type of group-wide rule will impact the states sovereignty regarding taxation. In addition, as long as direct taxes are not harmonized neither within the EU nor the OECD and allowing each country to introduce domestic accounting principles, this will create double taxation or non-taxation by definition. Hence, it seems to be an impractical challenge to introduce any isolated action only (as reduction of interest deduction) under consideration that accounting principles, tax bases and tax rates vary enormously from state to state. It would be essential to introduce a global common approach with conclusive definitions and interpretations which lead to an absolute consistent manner by all states to avoid any double taxation or non-taxation at all.

- With regard to basing the composition of a group on the entities included in a group’s consolidated financial statements the first step and condition would be to introduce the same worldwide accounting principles. Currently there are IFRS, US GAAP and many more (HGB, tax accounting due to tax modifications etc.) with enormous differences. Any difference creates a problem for the effectiveness of any
allocation key and will lead to unjustified taxation of entities depending on their individual accounting principles.

- An issue not mentioned is the situation where group entities may have different accounting period end dates, and/or may only be part of a group for some of the period.

- Also, under group-wide rules, in M&A situations, the tax position of a target would be altered when it joins a different group, notwithstanding the economic activity of the target remains unchanged. This is incomprehensible and could lead to serious market distortions – buying and selling of companies based on the interest limitation profile of the seller/buyer.

- The Draft does not discuss whether “group-wide” is reasonable. As recognised in paragraph 62, almost all large groups will have activities that are not homogeneous, because they operate in completely different sectors, or in different parts of the same sector, or even in very similar operations that are different merely because of local differences in regulation or markets in each territory. Global group-wide tests will tend to encourage groups to incur external debt, not otherwise needed. This could especially arise where an MNE’s activities (and entities) span several different business sectors that are best leveraged in different ways. Today, interest rates are at historic lows across the globe generally; if there would be a move into a liquidity-constrained environment with higher interest rates, then a rule that establishes barriers to related party debt based on external debt may drive groups to increase overall external debt which, in turn, has the potential to cause unintended collateral damage.

- In addition to heterogeneity, there are many other tax and non-tax barriers which prevent a group from arranging its intra-group loans to ensure that net interest expense is matched with economic activity, such as:

  o Statutory barriers: How to present interest expense in statutory accounts related to debt in the balance sheet? Debt/equity relation impact?
  o Legal barriers: Tax is completely decoupled from existing legal arrangements.
  o Regulatory barriers: Regulated entities would not be permitted to vary debt levels for reasons unconnected with the regulated business.

Paragraph 80 of the Draft refers to groups “re-organising their intra-group financing to bring each entity’s ratio more in-line with that of the group, subject to any barriers preventing them from doing so”. This may sound simple but there is a very large number of barriers which cannot be satisfactorily addressed.

It would be impossible in practice to maintain each entity’s debt position in a way that exactly or even closely aligned its interest expense
with its “economic activity”, however that is measured. Some of the many reasons are:

- Economic unpredictability (including large non-recurring items).
- Lack of actual/forecast data availability across every single group entity.
- Break clauses with penalties (intra-group loans do have them).
- Minority shareholdings (as already referred to above) – extracting cash to align debt levels would cause commercial leakage. To reverse it one would have to be able to compel the minority investor to inject capital, which is not realistic.
- Increasing leverage in an entity for no reason other than to align with its group would not be guaranteed to give rise to deductible interest expense.

Any of the group-wide methods is therefore certain to lead to some disallowance of interest in multi-national groups. This is a key reason why the allocation methods should not be taken forward.

- An additional important point needing to be addressed in designing a rule is the question of certainty for the taxpayer and tax authorities. We are concerned that this may not have been fully appreciated. Two different aspects are (a) which tax authority(ies) would sign off a group-wide allocation computation and (b) uncertainty arising from the knock on effects of any tax audit adjustment (which could be many years later) on any of the group entities to all the others in the group. We note that the measures in use by countries as set out in Box 3 in the Draft are not simply taken from group accounts – they are influenced by tax returns and therefore tax audits. The proposals in the Draft do also refer to tax adjustments to be made to pure accounting numbers, e.g. for tax exempt income. Under group wide allocation methods there would therefore appear to be some interdependency between the eventually agreed tax positions of each entity – a change in one has a “ripple” effect on all the others in a group:
  - A group might have 1,000 legal entities across 50 countries. Having every entity’s tax outcome interdependent with the other’s, particularly if it were tax and not accounting measures being used in the rule (we note it is tax effective net interest the Draft refers to) would be practically unmanageable. That would be exacerbated further by the possibility of subsequent tax audit adjustments to an entity in one of the 50 countries, rippling through to all the other 49 countries. Would groups have to continually re-open and revise the huge calculation? Which fiscal authority would sign the final calculation off? Some approximation would need to be permissible and a date set after which no further adjustments were possible.

- We share the concern noted about group-wide rules (para. 63-64 of the Draft), in that volatility in one place in a worldwide group has an impact on everywhere else, making it impossible for businesses to plan investments. If lower-risk, higher-debt entities have external project funding with covenant triggers based on post-tax cash flow, then
it would be a highly undesirable outcome if economic events completely unrelated to the project itself (other than affecting a business in common ultimate ownership) should put it into default.

- Another practical problem with global group-wide tests arises e.g. with regard to family owned companies: They are often predominately or fully equity financed because they regularly have a different dividend policy compared to publicly listed companies. They are not forced by expectations of analysts or the public to distribute a certain dividend amount. Family owned groups which are strongly equity financed and finance their group entities with inter-company financing would be discriminated without reasons against highly leveraged groups with debt push down. The discrimination would consist in a distortion of the competition on a local level. Direct competitors would not be entitled to the same tax deduction depending on how their top holding company is financed.

- Either group-wide allocation rule therefore has the potential to be highly impractical, verging on unworkable, have discriminatory effects, lead to double taxation as well as making it even harder to accurately forecast the economic return on a potential investment in a particular territory.

**Fixed ratio test preferable to group-wide tests**

- We consider that a fixed ratio test would be preferable to group wide allocation rules, provided that it is well designed. A proper design can have the advantage of being simple, of giving more design flexibility to national legislators and of flattening business cycles.

- Compared to group-wide rules a fixed ratio rule is mechanistic and – in combination with a monetary threshold for small and medium sized entities – tends to be simpler to apply for companies as well as for tax administrations. Regarding the design flexibility, with a fixed ratio rule there is no need for a worldwide identical implementation in various jurisdictions. For example it is not necessary to have exactly the same definition of interest in different jurisdictions.

- Some countries also have multiple tests, which include for example a group-wide debt-equity test. Contrary to the group-wide test presented in the Draft, this is merely an escape rule, in order to demonstrate that the financing of one entity is not exceeding the group ratio and therefore the interest not deductible under the fixed ratio regime should still be deductible. However, these group-wide tests can be extremely challenging for companies and therefore might not be suitable to allow for an escape even where this would be appropriate. Therefore we suggest that whenever a company can demonstrate that the interest expense has been incurred for a valid business reason, it should be deductible even when exceeding the fixed ratio threshold.
• However, the fixed ratio rules also have major shortcomings, one being the downside to their conceptual simplicity: Because of their mechanistic nature, in weak business cycles as well as in M&A situations they will lead to limiting the deductibility of interest even though a business has in no way used interest for tax planning purposes. In weak business cycles, i.e. for reasons that are neither projectable for nor capable of being influenced by individual businesses, EBITDA can be volatile. The introduction of complementary rules or respective definitions would thus help to smooth out business cycles and accommodate for sector specific differences.

  o Therefore, non-deductible interest should be allowed to be carried forward indefinitely as a limited period for e.g. five years may not be sufficient in smoothing out volatility in earnings. The same should apply to excess EBITDA capacity that has not been used to deduct interest.

  o As sectors of the economy are different, we believe that businesses should be given a choice to use either asset or earnings measures under a fixed ratio rule.

    ▪ Where earnings are used, EBITDA should be used rather than EBIT. EBITDA is more consistent with what banks use for evaluating creditworthiness/covenants (depreciation and amortisation not being cash costs). Using EBIT rather than EBITDA would artificially lower the interest cap and aggravate issues associated with earnings volatility especially in the context of impairment reviews which can lead to large volatility year on year. As EBITDA seems most close to the cash flow of a company, EBITDA seems the most preferable allocation key. Further, EBITDA excludes depreciation and impairments from the allocation key which seems economically reasonable.

    ▪ Problems that will arise using asset value as a measure for economic activity is valuation and impairment of assets, accelerated depreciation of assets or even regular depreciation of assets. For example, similar assets in different countries may be depreciated with difference in timing. Depreciation of local assets does not mean that the local economic activity changes but the relative position within the group and thus interest allocation will change.

Therefore, defining both asset and earnings measures appropriately and giving taxpayers the choice between the two is recommended.

• Regardless of whether an assets or earning ratio is used, for the rule to be workable and effective, it must be set high enough so that it would not distort investment, disrupt economies or cause double taxation. A fixed ratio percentage set too low would undermine the rule and not provide the necessary cushion for cyclical global fluctuations in economic activity. Macroeconomic conditions change constantly, often
resulting in significant changes in interest rates, earnings growth, and operating costs. Changes in such factors may impact a company’s fixed ratio percentage for reasons unrelated to the tax positions of local affiliates. With interest rates at a historic low at the moment, a fixed ratio that is set too low would not contemplate upward movements in the company’s actual fixed ratio as interest rates increase solely for macroeconomic reasons. A higher fixed ratio percentage would provide greater insulation against shocks to economic activity that could cause an increase in the fixed ratio unrelated to tax/transfer pricing considerations.

• With regard to the Combined Approach 2, as set out in paragraphs 170-174 of the Draft, there could be benefits from it. This is because the combined approach could include two references and measures of economic activity. However, introducing a group-wide test as a carve out must not in consequence lower the fixed ratio percentage applied under the main rule. To actually work as a main rule, the fixed ratio must be set at the same level as under a fixed ratio rule only approach. Otherwise there is a risk that the group-wide test with all its difficulties, short-comings and complexities, would eventually become the main rule through the “back-door”. Because of the many reasons set out above we would strongly reject this: For a rule to operate as a carve out exception, the main rule needs to apply widely across most fact patterns without problems.

We are convinced that the overall aim of a well-designed rule should not harm businesses that are not engaged in using interest as a means of profit shifting. At the same time it should prevent the – from a point of view of tax administrations – excessive use of interest deductions. Different industries have differing profit margins as well as differing debt ratios. Therefore the fixed ratio should not be orientated towards the average of all businesses. It should be possible, under a fixed ratio regime, to deduct interest at an arm’s length price. We are of the opinion that further studies should be undertaken to find out how this aim could be reflected in the percentage of the fixed ratio regime.

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

Sincerely,

Florian Holle

Dr. Karoline Kampermann
6 February 2015

Dear Mr. Pross:

Subject:  BEPS ACTION 4 - Interest Deductions and Other Financial Payments

BDO USA, LLP (“BDO” or “we”) welcomes the opportunity to comment on the OECD’s Discussion Draft on BEPS Action Item 4: Interest Deductions and Other Financial Payments (“Discussion Draft”). We greatly appreciate the OECD’s open and collaborative approach on this important subject.

In this letter, we have incorporated our comments by topic. We understand that the OECD has and will receive several comments on this and other discussion drafts; therefore, we have kept our comments brief. We will be happy to expand on our comments and suggestions at the public consultation on February 17th, 2015.

General Comments

We support the OECD’s efforts in publishing guidance around different options to address base erosion and profit shifting through the use of deductible payments, such as interest and other similar payments, in an effort to equip governments with domestic and international tools to address this challenge. Based on our review of the proposed guidance, we believe that parts of the Discussion Draft could be improved through greater clarity and consideration of established rules already in place in many jurisdictions.

Adding to the consideration of rules already in place, there seems to be a departure from the arm’s length principle, and a movement towards an apportionment approach, due to a concern around the uncertainty of outcomes stemming from the use of an arm’s length test. Specifically, there seems to be a sense that this type of test may be burdensome to apply and still not fully address the issue of base erosion and profit shifting. We believe that additional consideration should be given to application of arm’s length principle in preventing base erosion and profit shifting using interest and financial payments which are economically equivalent to interest. While inevitable in some situations, an apportionment approach may lead to distortions that could be avoided through application of the arm’s length principle. To deal with these distortions, there will likely be various exemptions to the rules, which may cause this approach to be as burdensome to implement as an arm’s length approach.
Another general comment we would like to propose is a grandfathering rule that allows companies with long-term debt in place (e.g., for a long-term infrastructure project or other pre-existing projects) a grace period for transition once this new guidance is finalized and adopted. A grandfathering rule will reduce the chances of permanent double taxation and/or unviable financial models. Careful consideration as to the terms and circumstances in which this rule would apply should be made.

We have included suggestions to select topics highlighted in this Discussion Draft that we believe could help refine the proposed guidance. Our focus is to offer practical suggestions that limit the risk of double taxation, while maintaining practical solutions to taxpayers.

**What is interest and what are financial payments economically equivalent to interest?**

The main types of financing appear to be covered, including original issue discount (“OID”), use of hybrid instruments, profit participation loans, finance leases, back-to-back financing, hedges, and guarantee fees. For groups operating in countries where currencies are volatile, consideration should be given as to how to address the treatment of foreign exchange gain or loss.

Some jurisdictions have specific anti-deferral rules that currently tax certain types of passive income including interest. In connection with the anti-deferral rules, some jurisdictions include payments or transactions other than interest as an interest equivalent. These anti-deferral rules should be considered.

The OECD proposal to include such fees in the definition of interest and payments economically equivalent to interest may be too broad in this respect and inconsistent with transfer pricing treatment in the U.S. and case law governing the nature of such fees.

**Who should a rule apply to?**

It is unclear as to whether or not the 25 percent control test is to be calculated on a basic share basis (i.e., based on the current ownership structure or shares outstanding as of a certain date) or fully diluted basis (i.e., basic share basis plus the potentially dilutive effect from any outstanding stock options, warrants, convertible preferred stock or convertible debt, etc.). This could have a substantial impact as to which relationships will be considered “controlled” or “uncontrolled.” Clarification is needed with regard to this control test.

The 25 percent control test also seems over-inclusive as this threshold is much less than the control thresholds around investment activities, such as intercompany financing, currently in place in many countries. A low threshold may place an undue burden on passive investors (e.g., private equity or similarly structured entities), who do not wish to exert management control over portfolio companies, have little or no control over transactions, and little or no access to financial data to determine their level of risk. A control test that would enable investors that have access to financial information, as well as control, seems more appropriate and this is more in line with current control thresholds established in many countries. This type of control test will continue to eliminate base erosion and profit shifting, but will also reduce the compliance burden on passive investors.

The manner in which share attribution or constructive ownership of shares is treated in the application of any tests needs to be considered.
What should a rule apply to? (A) the level of debt or interest expense and (B) an entity’s gross or net position?

The concept of interest expense, as defined in paragraph 34 of the Discussion Draft, could pose problems for non-interest items which can be included as interest in certain jurisdictions, such as foreign exchange gains or losses. The treatment of these items should be considered by the OECD.

Further, compliance with the definition of interest expense envisioned in Part IV. of the Discussion Draft, could pose problems in jurisdictions where that definition is narrower. For example, many jurisdictions do not consider interest paid or accrued by the taxpayer during the taxable year in the definition of interest. Too broad a definition could lead to misunderstandings and a greater risk of over or understatement of interest expense by taxpayers. More clarity is needed around the definition of interest expense.

The Discussion Draft includes “imputed interest on instruments such as...zero coupon bonds.” The determination of such interest would generally mirror how the original issue discount amount is calculated in most jurisdictions; however, the potential disallowance of the original issue discount of certain financing instruments should also be considered.

Should a small entity exception or threshold apply?

Any type of threshold will require tax authorities to have perfect visibility into a controlled group’s operations and consistency across accounting standards. Without visibility or consistency, the threshold falls apart and is inconsistent in its application; leading to more controversy in the future. Action Item 13, covering Country-by-Country reporting, has already demonstrated the difficulties in obtaining consistent information in a single enterprise. This difficulty only increases when you apply a threshold across a number of companies operating in a number of different industries. Further, businesses of any size will face similar problems regarding information availability, specifically if they are organized across multiple business and/or product lines. Group tests, which require perfect visibility and consistency in accounting standards to properly apply the test, are likely to pose more problems in relation to information availability.

Whether interest deductions should be limited with reference to the position of an entity’s group?

The advent of innovative financial products will only serve to compound the difficulties in applying a blanket threshold on interest deductions. To truly eliminate base erosion and profit shifting and keep within the framework of the arm’s length principle, interest deductions should not be limited with reference to the position of the entity’s group, but should also consider industry specific characteristics. Thresholds serve as conclusions. Without a thorough economic analysis of the entity and industry in which it operates, the approaches to limit interest deductions outlined in this Discussion Draft deviate from the arm’s length principle.

The term “group” is used throughout this section, but without clear determination as to what constitutes a “group,” which may vary by country, particularly if hybrids or reverse hybrids are used as well as which attribution or constructive ownership rules are invoked, this term leaves this section open to uncertainty. Further, the tax definition of the term “group” may also differ from the accounting definition under GAAP. For U.S. GAAP purposes, consolidation
generally applies when ownership exceeds 50 percent. In contrast, a consolidated group for
U.S. tax purposes includes only corporations organized under U.S. law and owned directly or
indirectly more than 80 percent by a single U.S. corporation. IFRS utilizes a different
definition of control, which focuses mainly on the amount of power the investor company has
over an investee’s activities, rather than the level of voting rights.

Foreign entities are not included. Thresholds used in other countries vary. Various
calculations are made at the U.S. consolidated group level but would not involve
consideration of foreign corporations. Under U.S. rules, results of a foreign branch or
partnership (including foreign entities characterized as partnerships or disregarded entities)
would have their results included with those of a U.S. owner.

The concept of an “expanded affiliated group,” for example, in the context of the U.S. anti-
inversion rules would include non-U.S. corporations and a lower threshold for inclusion (more
than 50 percent instead of at least 80 percent). Moreover, if an inversion has occurred, the
foreign company will be treated as domestic if certain ownership thresholds are met. This
rule takes precedence over the determination of residence under a double taxation treaty
and increases the likelihood of unrelieved double taxation and a distortion of the concept of
the group for purposes of applying the rules proposed in Section VIII of the Discussion Draft.

Consideration should be given to the local rules that allow for the treatment of affiliated
groups as a single taxpayer when applying rules around the deduction or accrual of interest
and the extent to which these contrast with group-level rules in other contexts.

Depending on whether or not an investment entity (i.e., private equity or similarly structured
entity) falls into any of the scenarios outlined in Part V. of the Discussion Draft, interest
deductions could be limited in portfolio companies of investment entities that are considered
to be controlled parties. Limiting the interest deductions a portfolio company could take on
debt from an investment entity could have a substantial impact on the portfolio companies’
ability to operate as a going concern. In addition, changes to the tax treatment of debt
would make it tougher for investment entities that rely on deductible debt to structure
profitable transactions. Interest deduction is a core component of many investment entities’
business models. For example, investment firms, such as private equity, identify companies
they want to take over and proceed to revamp their operations for the purpose of selling the
company to public or private investors. In a typical deal, investment firms have the target
company take on debt during the restructuring process, which increases the target company’s
profitability. A reduction in interest deductions will increase the target company’s tax rate
and reduce the amount of cash available to pay back existing obligations, fund operations,
and pay dividends. If interest weren’t deductible, investment firms wouldn’t be able to make
such large acquisitions, which could cause a slowdown in the economy.

Further, it is not the goal of most investment entities to actively manage a portfolio
company’s business. If the investment entity assumes management control of a portfolio
company, that company is generally not doing well. Therefore, a group-wide rule may be
over-inclusive and suppress the business activities of investment entities.

With regard to non-investment entities, it is quite possible that taxpayers could alter their
external funding to maximize leverage within the group if there is a group-wide cap to
maximize borrowing at a local level to the maximum available.
**Whether interest deductions should be limited with reference to a fixed ratio?**

It is often assumed that an accurate estimate of a company’s financial position can be made by merely looking at a company’s most recent balance sheet or income statement. In reality, this is often not the case. It is commonly accepted that financial statements prepared under GAAP or a tax basis of accounting often present a picture that is different from economic reality. The OECD acknowledges this point in paragraph 154, which states that companies with more “self-created intangibles could be treated less favorably” in the context of a linking interest deductions to assets. Self-created intangibles may have value, but this value may not show up in GAAP or tax basis accounting. Therefore, it may be useful for an entity to normalize their balance sheet, by creating an “economic balance sheet”, when linking interest deductions to the levels of assets. Economic adjustments made to the GAAP or tax basis balance sheet will reflect current market values of both assets and liabilities. Thus, the issue of self-created intangibles will be factored in as adjustments will be made to include these items on an economic balance sheet. Similarly, goodwill should also be revalued to reflect the true economic estimate of value, as accounting treatment of this item will allow for write-downs for impairment, but not write-ups. This “economic balance sheet” approach will better link the value of the assets held by an entity and the amount of interest expense that entity should bear.

Similarly, under an earnings based approach an “economic income statement” may also prove to be helpful in reflecting the true economic results of operation. For example, GAAP or tax basis policies on depreciation, amortization, provision for bad debts, inventory valuation, capitalization vs. expensing policies, and executive compensation can vary from conservative to aggressive and thus, distort true economic realities. Further, contingent liabilities are often not recognized on the income statement, but can shed light as to an entity’s risk profile. Adjusting these items to an industry standard can make comparisons easier and more accurate when determining an earnings threshold for interest deductions.

Applying adjustments to an entity’s balance sheet or income statement to reflect economic reality will allow tax authorities to make better comparisons across industries/sectors, allow for more accurate projections of future income/growth, and serve as a basis for determining or estimating additional value from unrecorded intangible assets. Adjustments such as these could prove to be administratively burdensome and costly, however, as these types of analyses are neither quick nor easy.

Another problem that could arise with the application of a fixed ratio limitation is one in which entities may be forced to use more equity financing as a result of this rule. An excess reliance on equity financing may result in an inefficient and less productive use of capital by a company, which could stifle innovation and negatively affect the company. Both debt and equity are important ways for businesses to fund their operations and, in a post-financial crisis world where capital structure consideration has become more important, internal funding has become a beneficial and desirable option. Corporate finance departments within companies strive to achieve optimal capital structures and internal funding that is the most cost effective and expedient means to achieve this optimal structure. A capital structure that consists primarily of equity financing may cause internal hurdle rates to rise, which could lead to fewer acceptances of innovative projects.
The treatment of non-deductible interest expense and double taxation?

A five year time limit, as suggested, may be too short to correct all the timing differences between tax and financial accounting. For example, depreciation and amortization, differences in vesting/exercise for stock option deductions, and other similar concepts may not reverse within the five year time period. A business cycle may also require more than five years for a business to recover from start-up slowness, which presents a disadvantage to a taxpayer with a longer business cycle and/or greater capital needs. Further thought should be given to the nature and timing of accounting methods used by taxpayers as well as business/life cycles of entities.

Conclusion

We would like to thank the OECD again for this opportunity to comment and reiterate that we would be happy to expand on these points and contribute further if required.

For clarification of any aspects of this response, please contact the following BDO transfer pricing consultants.

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Response to Action 4: Interest Deductions and Other Financial Payments

This report is published by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

We are grateful for this opportunity to comment on the proposals for dealing with the treatment of intra-group interest and other financial payments. We are grateful for this opportunity to make comments on the proposals, and would like also to speak at the public consultation on this issue.

This paper has been prepared by Richard Murphy, with comments and input from Sol Picciotto, Francis Weyzig and Jeffery Kadet.

1. GENERAL REMARKS

1. Almost by definition the Treasury function is probably the most highly centralised activity in any multinational corporate group: it exists to service the needs of the entity as a whole. Its function necessarily recognises the fact that the group exists as an entity in its own right and is more than the sum of its parts. That fact, combined with the difference in treatment of interest (which is generally treated as tax deductible) from dividends and other returns on equity (which are paid from post-tax earnings), creates a close link between corporate finance and tax planning. It also means that the separate entity concept, which attempts to deal with such multinational groups as if they consist of independent entities in each country in which they operate, is particularly inappropriate in this context. In combination this means that the structuring of intra-group finance has become a key area for tax avoidance for multinational groups.

2. As explained in paragraph 6 of the Discussion Draft (DD), this Action point aims to deal with the aspect of tax deductibility at source, while others are concerned with the use of hybrid instruments or entities, and channelling of interest payments to controlled corporations in low-tax jurisdictions. Our comments made here must also be read in that context.

3. We warmly welcome the approach outlined in the DD. It is the fruit of several decades of attempts by OECD countries to deal with this problem by various methods, such as thin capitalisation rules, which have had only limited success. Resulting from this experience, a number of countries have sought to adopt simpler rules, mainly entailing a cap on deductions. This has led to the realisation, expressed in this report that the only sensible way of tackling the issue is by treating a firm’s debt on a consolidated basis, and apportioning interest deduction limits according to an appropriate allocation key.

4. Nevertheless, we also believe it appropriate to add some notes of caution. First, the DD devotes relatively little attention to the issue of differing accounting treatment of interest for the purposes of accounting and taxation. We are of the opinion that far too little attention has been given to this issue, and many of our comments will attempt to address it. In the longer run, we consider that it should be a high priority for the CFA to work on the creation of an internationally harmonised tax accounting standard. This would not be as daunting a task as it might seem as, although there are significant differences between financial and tax accounting principles, national tax accounting rules generally have similar objectives, even if
outcomes are not always consistent. Considerable work has also been done already in the EU in developing the proposed Common Consolidated Corporate Tax Base, particularly on the harmonised tax base definition. Harmonisation also should focus on basic issues such as income recognition, and need not deal with policy aspects such as depreciation where alternative taxation rules are always likely to apply.

5. While we believe the task will not be daunting, the development and agreement on an internationally harmonised tax accounting standard will take some period of time. In the meantime, we will presumably have to use, of necessity, consolidated financial statements as the basis for various group-wide calculations. If consolidated financial statements are initially used, guidance should require that MNCs must identify and adjust for any material differences caused by (i) inconsistent financial accounting rules and applications, and by (ii) differing accounting and tax treatments of significant items. Such identification and adjustments would be both at the group level and at the entity level. We think it will be important that differences between the two are identifiable to prevent opportunities for arbitrage arising. This leads us to suggest that any allocation of net interest expense based on group accounting must be based on data drawn from the consolidation process where (i) all intra-group transactions have already been eliminated from consideration and (ii) the accounts of subsidiary entities have, if necessary, been restated from the GAAP in which they have been prepared to the consistent GAAP in which the multinational corporation’s group financial statements are presented.

6. Secondly, it should be recognised that the adoption of an allocation rule entails a move away from the separate entity principle, but in this case only in relation to charging for costs. A similar method has also been proposed in the report under Action 10 on Intra-Group Services, at least for low-value-added services. As we noted in our response to that report, many tax authorities, especially in source countries, may be reluctant to accept an apportionment method for joint costs, as such charges may be used for BEPS. Hence, for intra-group services, the ‘simplified method’ of apportionment was proposed only for low-value-added services and subject to a benefits test. The present report goes further, and proposes allocation rules for a group’s consolidated net interest expense, without any benefit test. Tax authorities may nevertheless find it acceptable, for several reasons. First, it has the great advantage, as do apportionment methods generally, of being relatively easy to administer, which is especially beneficial for the difficult problem of intra-group finance. Secondly, the allocation key used (based on either earnings or asset values) reflects economic activity and hence embodies at least a rough-and-ready sort of benefit test. Thirdly, and most importantly, the evidence indicates that application of this method is likely to restrict interest deductions to a level which will normally be well below that resulting from the interest cap or thin capitalisation rules that countries currently apply. Although based on a limited survey, the data in the report (Ch. IX, Box 4) show that a large majority of the largest non-financial companies have a net interest to EBITDA ratio of below 10%.

7. In this case therefore, the adoption of an allocation rule, even though in relation only to costs, may benefit all states, not only because it is more easily administered, but also because it would restrict base erosion. While we welcome this adoption for interest expense deductions, as we said in our response to the report on AP 10 Intra-Group Services, we would generally favour a move to the more comprehensive apportionment solution, which is extending the profit split method, which fairly and easily apportions both costs and revenues.

8. It is clear that any best practices decided upon for defining interest and applying the group-wide interest allocation rules and group ratio rules will require multinational taxpayers subject to the rules to make certain calculations that will be relevant to many group entities
within many countries. We suggest that as part of this project consideration be given to defining the information relevant to these new best practice rules and including them as required content in the Master File. As such, once a best practices group-wide approach is decided upon, the annual Master File updated each year should include a computation of the group-wide net interest expense, applicable ratios, and other relevant information including a full listing of all group members included in the ‘interest limitation group’ for the most recently completed fiscal year. This would allow much easier application of the new rules by both taxpayers and tax authorities alike.

9. Paragraphs 21 – 24 discussed the use of both arm’s length tests and withholding taxes, concluding that neither should be included as options for a best practices recommendation. We thoroughly agree with the conclusion that arm’s length tests are not workable approaches for dealing with BEPS motivated interest flows. However, we are concerned about this initial conclusion that excludes withholding taxes from being considered an option for a best practice recommendation. Paragraph 23 lists reasons that only apply to EU countries and to countries having policy reasons for not currently applying withholding taxes to outbound interest payments. Presumably, the latter concern applies to the United States and similar countries that have considerable amounts of public and private debt in the hands of foreign creditors, many of which are either exempt in their location of residence (such as pension funds, central banks, etc.) or are not reporting the income either legally or otherwise to any jurisdiction. These concerns will often not be relevant for many developing countries. Further, for some developing countries, a major concern is domestic investors round-tripping funds through foreign legal entities back into domestic investment. Given how paragraph 23 acknowledges the simplicity and effectiveness of this withholding tax approach, such countries that have few tax authority resources and often a small or non-existent tax treaty network should perhaps be encouraged to consider this as a possible mechanism. Hence, we believe that this use of withholding taxes should be further considered for inclusion as a best practice recommendation.

2. SPECIFIC COMMENTS

A. What is interest and what are financial payments economically equivalent to interest?

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?

We would encourage the application of a best practice rule covering the items referred to in the chapter but have concern as to its scope in accounting rather than taxation terms. If there is to be an appropriate formula for apportionment that relates, for example, to the total interest expense of a group then the consistent calculation of interest for both accounting and taxation purposes is fundamental. In practice, generally accepted accounting principles vary in their treatment of interest expense, and this is at least as contentious an issue in accounting as it is in taxation. So, for example, some items recognised as interest for accounting purposes, such as the unwinding of discounted valuation arrangements, may not necessarily be considered interest for taxation purposes whilst the capitalisation of interest for accounting purposes may be inconsistent with, and be quite distinctly differently presented in taxation contexts from the way in which the same item might be included in financial accounts. It is important to note that GAAPs are inconsistent, in particular, in their treatment of leases, interest capitalisation, the recognition of interest implicit in hedging relationships and discounting as well as other areas, all of which need to be appreciated as they can, and have, provided opportunity for tax arbitrage. If any arrangement with regards to tax deductibility of
interest is to be based upon accounting data it is not possible to avoid the need for consistency in accounting both within and between corporations and states so that inconsistent accounting treatments cannot be adopted for different subsidiaries in different locations. Otherwise, groups would be able to arbitrage their tax relief allocation. Hence, attention needs to be given to this issue when establishing best practice rules.

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?

The following issues may need to be additionally addressed:

The treatment of capitalised interest;

The unwinding of discount arrangements used in accounting;

The specific interaction with lease arrangements, of both an operating and finance nature, to ensure consistency with accounting treatment within and between states and the different generally accepted accounting principles.

In view of the significant differences in lease accounting, and their interest implications, the last issue is, we think, of particular significance.

B. Who should a rule apply to?

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

The scenarios identified appear to be comprehensive. What is missing is a local deductibility test: in others words, there needs to be a requirement that any interest paid by a company be demonstrably incurred by it in the course of its trade and not to put it in a position to undertake that trade, or to facilitate a trade taxed elsewhere. A targeted anti-avoidance rule that made clear the distinction between revenue cost, capital expenditure and cost incurred other than in the course of the trade is a key component in tackling the abuse of interest at a local level. In principle revenue costs incurred for a trade should be tax allowed whilst the costs of acquiring a trade should only be allowed for tax relief in a parent company (both subject to limitations to be noted, below); but all costs incurred within an entity not in the course of its trade should not be subject to tax relief. If this rule were to be applied then many of the considerations in this section would not be an issue, as loans used by related and apparently unrelated parties would fall out of the scope of tax relief altogether at the local level. The chance of base erosion and profits shifting would then be significantly curtailed, whilst incentive would be given for all group treasury functions to allocate interest costs solely on the basis of the economic substance of the use of the funding provided.

There are two additional matters of specific concern. Firstly, in regard to Scenario 2, it is very possible that an investment manager responsible for more than one collective investment vehicle will coordinate interest-bearing investments from each vehicle into the investments of the other CIVs. Such a situation should be covered by these rules. Paragraphs 140 and 143 acknowledge possible issues here.

Secondly, paragraph 39 states: ‘Entities which are treated as transparent for tax purposes, including partnerships in many jurisdictions, should be taken into account to the extent they are owned or controlled by companies or other entities.’ A partnership vehicle will typically have a management that controls the investments, businesses and subsidiaries of that
partnership. As such, such a partnership and the companies it owns should be a Scenario 1 group. There should not be a look-through to the owners of the partnership unless there is in fact no management function within the partnership.

4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

The issue arising from a 25 per cent control test is in establishing beneficial ownership. It seems that very few registries of beneficial ownership will be open to ready access by tax authorities without specific enquiry being made, despite recent international efforts, and also that those registries that will be open to ready inspection will be largely, or solely, dependent upon self declaration of beneficial ownership by companies who might have self-interest in disguising the true nature of their controlling parties. Hence, the ability of any tax authority to readily assess the nature of control relationships without making extensive enquiry is likely to be extremely limited.

In our opinion the effectiveness of any such registries, and resulting taxation arrangements, is dependent upon a requirement that all banks operating within a jurisdiction be required to report the results of their own money-laundering enquiries of their corporate and trust clients to the corporate registry responsible for maintaining beneficial ownership data on those entities for tax information exchange purposes so that third party verification of this information is available. We are also of the opinion that that information on beneficial ownership should be made openly accessible to the general public, so that any tax official can access this data without the undue cost and delay of making an information request. Only then will any 25% control test be meaningful.

C. What should a rule apply to? (A) the level of debt or interest expense and (B) an entity’s gross or net position

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

The aims of the BEPS process need to be taken into account when answering this question. Firstly, gross interest necessarily provides increased opportunity for profit shifting: there is another boundary (that between asset holding and lending positions) created if a gross interest deduction is permitted that can be exploited for tax advantage, and almost all profit shifting takes place by exploitation of such boundaries for arbitrage purposes.

Second, gross interest expense can always be manipulated by apportioning the net cash holding position of a group so that some companies within it appear to be net deposit holders whilst others are significant borrowers, but with no (or little, after tax impact is taken into account) overall net impact upon the position of the group as a whole. As such any rule relating to gross interest is open to abuse.

Third, for the same reason, any position with regard to debt is also open to abuse.

Fourth, and most importantly, the overall borrowing of a group will, always, and necessarily, be a decision taken at group level, and will never be matter wholly delegated to subsidiary management. Accordingly, the tax treatment of any net leverage must also be both determined at the group level, and be apportioned as an expense across the group only once established as a single figure for the entity as a whole.

We do foresee that those who wish to use interest as a profit shifting mechanism will face problems if the rule applies to net interest expense. We cannot, at present, find any situation
where, in general, gross interest expense or the level of debt would be a more appropriate basis than determining the basis of calculation for net interest available for relief.

We are aware that problems may arise if tax withholding is applied to gross interest expense incurred within a jurisdiction but a net position is used to determine relief available, and that the risk of double taxation for an entity might increase as a result. This problem could, however, clearly be resolved by the multinational group in question funding the operation within that jurisdiction at rates and with borrowing consistent with the overall group leveraged rate, which would appear to be economically appropriate and consistent with the anti-BEPS philosophy. Hence, we do not consider this to be a significant issue or an impediment to using a net basis. The BEPS process should encourage such behavioural responses and this risk of possible double taxation is not a reason to change the recommended net interest basis.

We note that paragraph 49 (where the conclusion is stated concerning use of net interest expense) also recommends: ‘Such a rule could be supplemented by targeted interest limitation rules to prevent groups avoiding the effect of a rule or which disallow gross interest expense on specific transactions identified as posing base erosion and profit shifting risks.’ We believe it important that guidance be provided regarding the suggested supplemental rules that would be specifically targeted on BEPS behaviour.

D. Should a small entity exception or threshold apply?

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

The risk that is being addressed in considering this issue is that base erosion and profit shifting are taking place.

BEPS can occur in entities of all sizes that trade internationally.

The level of risk is not revealed by the absolute size of the corporation as measured by turnover, number of employees or assets, or indeed by its net interest expense. The risk that we perceive to exist is the difference between the gross and net interest expenditure that the entity might record if it accounted on a separate entity or group consolidated basis. It is this ratio that may suggest the degree to which interest expenditure, which is likely to be located in high tax jurisdictions, has been artificially created within the group as a whole, whatever its absolute size. Hence, we suggest that a limit, related to this ratio should determine whether safe harbour provisions apply to a group of any size with regard to the application of the recommendations made in this part the BEPS process.

We believe that some empirical research may be required to determine the precise ratio to be used, but a rule of thumb could be that if the ratio of gross interest to net interest was greater than 1.25:1 then prima facie evidence of BEPS might exist and a group net interest apportionment would be required.

E. Whether interest deductions should be limited with reference to the position of an entity's group

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?

The major practical issues that will arise with regard to the operation of any interest allocation or group ratio rules is the securing of relevant and reliable accounting data on which such rules may be based. Whilst there is a tendency for large multinational corporate
groups now to use either US GAAP or IFRS for the reporting of their consolidated results, this is not true for Japanese entities, whose accounting standards are quite different, and it is not true for all the subsidiary entities within those groups that report using these international accounting standards. The continued use of local generally accepted accounting principles (GAAP) for subsidiary companies is still commonplace within many multinational groups of companies. The result is that both within and between entities there can be significant differences in the accounting basis used for the calculation of interest expense (having substantial impact, for example, upon the presentation of lease expenditure, certain hedging costs, discounting calculations, and even the recognition of capital and loan relationships). Hence, there are significant opportunities for the presentation of inconsistent data, providing in turn the possibility of arbitrage abuse.

To make any interest allocation or group ratio rule work, the OECD should therefore develop harmonised tax reporting standards, as we pointed out in paragraph 1.4 above. Such standards should focus especially on enabling the presentation of relevant and comparable financial information with regards to interest expenditure, asset valuation, loan recognition and the statement of equity capital. Such essentially technical work to establish an agreed standard for enhanced financial reporting on a consistent basis for taxation purposes would make an enormous contribution to the BEPS process.

We in particular emphasise the fact that any apportionment calculation and all interest calculations must be undertaken on the basis of consistent accounting data, and this can only be the case if based on the consolidation data for each group member used for the preparation of group financial statements, i.e. as stated after all intra-group transactions have been eliminated and after restatement on the basis of the GAAP used for presentation of the group financial statements.

8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?

As noted in the DD and in the answer to the previous question, the biggest problem is securing relevant and reliable information from consolidated accounting data, since they derive from financial accounting standards that are specifically and deliberately not designed to meet taxation requirements.

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?

The most significant problem inherent in the use of group consolidated financial statements for taxation purposes is that they are specifically not designed for this use. In particular, IFRS, which is now the most widespread standard used for the preparation of group consolidated financial statements, makes no policy prescription on the capital maintenance concept to be used by a group of companies for reporting income arising during the course of the period, or in the presentation of asset valuation in its statement of financial affairs. No prescription is supplied as to whether a physical maintenance concept, or a financial maintenance concept is to be used, and if the latter, whether that concept is to be stated in historic or current prices. It is, in fact, entirely possible for more than one base to be applied within one set of financial statements, so that compatibility is limited, or non-existent. What is, additionally, almost invariably the case is that there is no consistent requirement that overall income be reported on the basis of a realisation or anticipated loss principle. This means that group consolidated financial reporting does not comply with the fundamental basis of tax, the recognition only of realised profits where there is a reasonable prospect of cash being available for the settlement of resulting liabilities. In addition, the accruals
concept, where costs and revenues are matched, is also absent from much of the thinking of IFRS, because of its focus upon the statement of financial affairs (or balance sheet) as the primary report within a set of consolidated financial statements. This also puts it in direct conflict with most tax reporting systems.

All these inherent weaknesses do, inevitably, mean that there is a fundamental difficulty in using most current group consolidated financial data for the purposes of tax assessment, of any sort. To apply a group wide rule in a fully satisfactory manner, information would be needed, preferably on a country-by-country basis, on how group interest revenues and expenses are calculated and on what set of accounting principles, and how these figures are then adjusted through the group consolidation process for presentation as part of the group financial statements, with those adjusting entries being considered for this purpose to be part of the taxation base. Without this, the information required to apply group accounting rules would not be available on a truly consistent, relevant and reliable basis.

10. In what ways could the level of net third party interest expense in a group’s consolidated financial statements be manipulated, and how could a rule address these risks?

The first and obvious way of manipulating the interest charge in group consolidated financial statements is to manipulate the way in which the group is recognised. Off balance sheet orphan entities are an obvious way of achieving this: in privately owned groups disguising related party entities is very clearly an issue. There may also be difficulties in joint-venture accounting and in entities subject to dual control, whether for taxation or accounting purposes.

There are also significant potential presentational issues with regard to what might be included in the group interest charge. So, for example, there might be occasions when payments otherwise represented as equity return could be included in this charge, in order to manipulate a group interest rule. Leasing arrangements would also need to be subject to review. The application of the accruals principle will also need to be considered: there are jurisdictions where interest is deducted on a paid, and not payable, basis: clearly this is inconsistent with financial accounting standards. Hedging gains and losses are regularly reported as part of group financing costs: care has very clearly to be taken to ensure that all elements of the arrangements included in that cost relate only to interest and not to other aspects of the financing arrangement e.g. currency risk. Precise rules with regard to the cost of arranging finance that are to be considered for inclusion in interest expenditure would also need to be considered, especially when hybrid financing is being used: some elements of that cost may be considered to be of a capital nature. Provisions, including those for movements in the fair value of debt, may also be included in this charge, and should not be tax permissible. It is also quite possible that foreign exchange gains and losses on funding arrangements could be included in such a charge.

What must be understood is that accounting provides considerable latitude in such presentations and tax does not. The suggestion made in answer 9 on reconciling this charge to underlying data is also important here: without this it is unlikely that the group charge could be reliably used.

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?

As previously noted, asset valuation can now be undertaken on a number of wholly inconsistent accounting bases in many generally accepted accounting principles. Some,
perversely in the current context, allow the capitalisation of interest, with potentially interesting consequences for tax deductibility. In addition, many of these accounting standards are extremely loose in their definition of what constitutes an asset. So, for example, many will permit the recognition of internally generated intangible assets within group entities, which can be used as the basis for profit shifting and base erosion through the payment of royalties and licence fees, without necessarily appearing in the group consolidated financial results, since they derive from intra group transactions. This gives rise to very clear difficulties with determining just which assets are to be used for apportionment purposes, where they are located and what they are worth. All such concerns suggest that an asset base for apportionment of interest is highly unlikely to give rise to a reliable basis of calculation, or would result in a basis that was open to significant manipulation.

There are also significant problems with the use of a net earnings before tax basis for apportionment. First of all this would, obviously, mean that interest was being apportioned on the basis of a calculation that already included an interest deduction, which makes no sense. Secondly, if asset valuation is problematic, so too then are depreciation and amortisation charges, which are subject to considerable discretion on the part of the entity and might, therefore, result in significant potential abuse.

Hence, we are of the opinion that Earnings before Interest, Taxation, Depreciation and Amortisation (EBITDA) is likely to be the best most readily available indicator of earnings for apportionment purposes, although we note other possibilities below.

12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

Please note our answer to the previous question.

There are problems with an earnings base for allocating interest within a group and this comes down to the problem of reconciling the earnings of the individual companies within a group with total reported group earnings.

There are a great many reasons why the earnings of the individual companies within a group of entities that make up a multinational corporation need not add up to the total declared earnings of that corporation as a whole. The consolidation process that is used to create the group financial statements does, inevitably, involve adjustments to the earnings declared by the individual entities within that group, for a great many reasons. For example, profits included in the evaluation of inventory in one group entity where that inventory had been made by another group entity have to be excluded on consolidation. In addition, if a tangible fixed asset has been manufactured by one entity but has been sold to another for use, then the profit arising on the sale by the first entity has to be eliminated from asset valuation in the group consolidated financial statements. There may also, of course, be differences in the recognition of certain transactions in different jurisdictions: this is the issue that hybrid entities are, at least in part, designed to exploit. Also, there may be different accounting bases for certain types of income under differing generally accepted accounting principles, which can again be arbitragable for the purposes of taxation, quite legitimately, but where the resulting consequence has to be reconciled out for the purposes of presentation in the group financial statements. There may also be transfer-pricing adjustments to take into account. There is also the problem that different generally accepted accounting principles may be used for different companies within the group, meaning accounts in one country may not be comparable to those reported in another. This is why we believe that examination of the reconciliation that must, in future, take place between the group financial statements and the
individual country-by-country statements that will be required to be submitted for taxation purposes, would expose many of the secrets of where much base erosion and profit shifting is taking place.

Given these problems, earnings remain a difficult basis for the apportionment of interest unless the basis for apportionment used is a top down allocation of EBITDA to country using a consistent set of accounting principles as used in the consolidated accounts with all intra-group transactions having been eliminated from consideration as a result of starting from the consolidated result. A ‘bottom up’ approach to the consideration of EBITDA would provide an unreliable basis for interest allocation for the reasons of inconsistency of reporting as noted above and because the accounts of individual companies in a group will reflect the impact of intra-group transactions that may be motivated by base erosion and profit shifting intentions which would, if used for interest allocation, inappropriately reward that motive by undue interest weighting.

As a result we recommend that a reconciliation process be required as part of country-by-country reporting so that relevant information on EBITDA and its reconciliation from local accounts to the group consolidated result is routinely made available to tax authorities.

It is also the case that net interest costs should, at least in principle, be financing the pre-sales element of working capital: the post sales financing of working capital should, if profit has been made from that sales process, be financed from the equity inherent within the resulting profit retention that the sale should have given rise to and so, logically, be financed from shareholder’s funds. It therefore makes some financial sense to consider the relationship between interest charges and a simply identified cost basis when considering the allocation of interest.

13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

The International Financial Reporting Standards Foundation has explicitly stated that the financial statements prepared using its standards are not designed for use in taxation assessment and are not, in their opinion, considered suitable for that purpose. This might be considered to most especially be the case when international transactions are being considered.

It is true that the financial statements of a multinational corporation should include a tax reconciliation note. This is required to reconcile the taxation charge that might arise on the reported earnings for the period, as if they were taxed in the head office location, with the actual taxation liabilities, including deferred taxation, that it is expected might arise as a result of trading during the course of the period. However, this reconciliation process would not identify any tax-exempt or deferred income that should be excluded from the definition of earnings. It may (or, at the company's discretion, may not) disclose income or expenditure disallowed for taxation purposes; but experience shows that few if any narrative notes will be supplied to explain what those items are. The inclusion of deferred taxation in the reconciliation also makes this entire note almost irrelevant for current taxation, which is the requirement for the purposes of interest apportionment. It has, therefore, to be concluded that there is no basis for identifying tax-exempt or deferred income that should be excluded from the definition of earnings in a multinational corporation’s financial statements without requesting additional information from the company itself.

At this point it is also important to note that a definition of tax exempt and deferred income will default to a country-by-country analysis because it is at the level of the individual jurisdiction that, in most cases, that exclusion will be defined. This does then suggest that an
elaboration of the country-by-country reporting template already recommended in Action Plan 13 will be necessary for this purpose. Alternatively, and as previously recommended, there is a need to develop agreed Tax Reporting Standards to be applied to the financial statements of multinational companies so that the relevant information that is required for international taxation purposes is available to all taxation authorities that want it, since at present those bodies tasked with setting generally accepted accounting principles are not meeting that need.

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?

In principle there are no difficulties arising from asking for this information subject to:

Appropriately defining the necessary income or expense on a consistent basis;

Appropriately defining the entity (which may not be the same for tax and accounting purposes since definitions of control may vary);

Seeking disclosure in the Master File of such data for each and every entity that makes up the entity for tax purposes. The resulting data may not reconcile with country-by-country reporting data if some entities trade in more than one jurisdiction;

The country-by-country reporting template would not be useful as a basis for this reporting since it already represents a sub-consolidation for accounting purposes.

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?

Since this is an issue relating to earnings, and an earnings basis for apportionment is being suggested, the average period rate should be used for conversion purposes.

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?

We do not believe that there are issues in applying a group wide rule to a group engaged in different sectors because the finance function for the group is a central activity relating to the entity as a whole and not to any part of it. If each part of a group that traded in different sectors was to trade quite independently of the other parts of the group and under distinct and separate ownership then it may, of course, be the case that each might have different funding requirements at differing net costs. But, it makes absolutely no sense to pretend that such a situation exists when as a matter of fact a common ownership structure has been adopted precisely because that common ownership provides advantages, including most likely a lower overall cost of capital because of the diversified risk that is likely to be implicit in the group structuring. If it were makes no sense and would, if permitted to treat each sector separately, that would that would most likely allow greater offset of interest for tax purposes than the actual cost for the group as a whole because the savings in cost from group diversification of risk would not be reflected in tax allowances or would, alternatively, be arbitrarily allocated. Clearly, a separate basis of calculation for each different sector within a group makes no economic sense.
17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

We cannot think of any such barriers.

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

In principle the application of a group wide allocation rule to groups with centralised treasury functions should be easier than in other entities because, firstly data is available, secondly there is a centralised cost function from which the group interacts with third party funding sources meaning that determining what those third party funding sources are and what they really cost should be easier to establish and, thirdly, agreeing any necessary adjustments for tax purposes should be easier if there is one central function with which to negotiate.

This being said some such functions are located in places where opacity is the corporate norm and problems may arise in securing relevant information without cooperation from other group functions in that case. Care would be needed to ensure that the power to obtain information was included in any group-wide allocation rule to overcome this difficulty. We believe that given the strong central management found in most multinational groups today, if there are difficulties for local tax authorities to obtain necessary information from other group members, guidance should show no sympathy for such issues and be supportive of appropriate penalties for any non-compliance.

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

We do not believe that an asset basis will ever be suitable for allocating interest charges for taxation purposes and as such cannot endorse a combined approach that makes use of asset values for reasons already noted in this submission.

20. In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

Paragraph 134 provides, in part: ‘…permanent mismatches could for instance be taken into account by allowing a small uplift in amount of net interest expense deductible under a group-wide rule (so for example an entity would be permitted to deduct net interest expense up to say 105 per cent of its interest).’ We recommend against any such automatic adjustments, especially as permanent differences could potentially go in either direction.

Recent and as yet unpublished research by Richard Murphy for the UK Trades Union Congress has looked at the declared reasons for deferred tax provisions in the financial statements of the 60 largest companies in the FTSE 100 in 2013 for the period 2007 – 13 and has analysed, amongst many other things, the stated reasons for deferred tax provisions being made. Capitalised interest was stated to give rise to a provision by one company (Rio Tinto) in one year and ‘effective interest rates’ gave rise to regular, but small, provisioning by Lloyds Banking Group over a number of years. No other companies mention interest as a cause for deferred tax provisions although short term provisions relating from inconsistencies...
in income recognition for tax and accounting may be reflected in short term timing differences for deferred taxation accounting purposes. All such provisions are, however, likely to be immaterial, as the accounting suggests by absence of reference to the issue.

As a result we suggest that the risk of significant permanent or timing mismatches arising if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules is low and can be ignored.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

Based on the deferred tax disclosure noted above we suggest that almost all timing mismatch issues will reverse over the relatively short term. If that is not the case carry forward provisions should cover the situation. It is important that no other option be made available: the ability to manipulate where interest is recognised to ensure maximum relief would otherwise be encouraged and is exactly what the BEPS process is meant to stop.

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group’s consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

This issue is of some significance: the definition of control for accounting and taxation purposes, and which companies do, therefore, make up a group entity, are usually different within a state, and will, very commonly, differ between states. It is, therefore, quite likely that the companies making up a group for accounting purposes will not be the same as the group as defined for taxation purposes in the various countries in which it operates. Pragmatically, it has to be recognised that the chance of bringing these definitions into line is limited given the number of jurisdictions involved and the fact that accounting and taxation definitions of control differ for a range of reasons that also differ between states.

Two solutions are possible, and we think that both should be embraced. The first is that a full list of all related parties for taxation purposes should be prepared by jurisdiction for comparison to the same list prepared for accounting purposes that will be used as the basis for the submission of the country-by-country reporting template. All differences would then be readily apparent. Secondly, as previously noted, it is in our opinion important that a targeted anti-abuse rule be included in any new provisions with regard to interest deduction for taxation purposes that ensures that only that interest cost incurred for the purposes of the trade of the individual entity can be offset against its income for taxation purposes. The apportioned some attributed to an entity as a result of the outcome of this BEPS consideration would, of course, meet this definition. Sums in excess of this apportioned sum would be disallowed. We have already suggested safe harbours that might avoid this apportionment process being required.

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a
bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

Clearly, all tax authorities, regardless of country, will have trouble identifying transactions such as disguised back-to-back arrangements through an unrelated entity and structured transactions involving banks and other financial service companies. Considering this, we suggest after the best practices definitions and computations of interest and interest limit caps and ratios are determined that a best practices listing of disclosures for the Master File, Local File, and Country-by-Country Reports be made. This listing would require specific disclosure of (i) all creditors to which a group member has either directly or indirectly loaned funds, and (ii) all creditors to which a group member has provided security or has otherwise guaranteed loan repayment.

F. Whether interest deductions should be limited with reference to a fixed ratio

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?

In our opinion fixed ratio rules do not reflect the economic reality of the trade of enterprises subject to taxation. In our opinion we believe that they are prescriptive and might lead to excessive taxation, or encourage excessive leverage that might not have otherwise been used. They are unlikely to be sufficiently flexible to meet changing economic circumstances over time, including changing interest rates. We believe that taxation should be based upon the economic substance of transactions actually undertaken and such rules do not achieve this aim which can be instead achieved by apportioning actual net interest charges for the group entity as a whole as discussed in answering previous questions. As a result we offer no further comment beyond this general point in answer to this question.

25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?

We refer to our answer to question 24 and more generally to our answers on asset valuation made earlier.

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?

We refer to our previous answers in which we suggested that multinational corporations are, in practice, managed as single entities, especially when it comes to issues such as financing. Hence, their cost of capital should be calculated for tax purposes for the entity as a whole. Since finance is managed centrally and raised for the group as a whole, it makes no sense to consider that some individual entities have pro rata higher costs of capital within a group than other entities within the same group. Any such suggestion denies the reality that there is only one economic entity that is being taxed.

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?

We refer to our answer to question 26.

28. What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?
Given that all interest allocations within group companies are subject to management discretion there is no such objective evidence.

G. Whether a combined approach could be applied

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?

We refer to our answer to question 24 that we think applies equally to this question. We can think of no situation where economic substance would require a combined approach, or carve outs or differing apportionment bases. All such options would, in our opinion, encourage manipulation, arbitrage and abuse and so result in risk of base erosion and profit shifting.

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?

Paragraph 169 provides: ‘This combination could also provide a solution for groups which have no overall net third party interest expense, as it would still allow entities within the group to deduct net interest expense up to the level of the low fixed ratio.”

Where a group has zero net third-party interest expense, a mechanism such as suggested that allows each subsidiary a calculated amount of interest deduction seems a veritable invitation to structure enough intercompany debt to maximize worldwide interest expense, thereby achieving what may be a very material amount of profit shifting, although the amount may be relatively small for any one country.

Given the above and the need all MNCs will have to calculate their net third-party interest expense, to say nothing of the future required preparation of the Master File, the Local File and the Country-by-Country Reports, it seems silly to suggest that it is a burden to notify all relevant countries of the amount of the group’s net third-party interest expense and other relevant interest limitation information. See our comments above in our paragraph 1.7.

We suggest the following simple approach to dealing with this so that there will be no BEPS motivation. The best practices guidance should include that where the aggregate net interest expenses claimed within all group members exceeds the group’s consolidated net third-party interest expense, then the interest expense within each group member will be reduced by a proportional amount of the excess. This will be a calculation easily made at the parent level.

To take account for country tax filings that must be made prior to the calculation of any excess amount by the parent, the reduction in interest expense would be taken in the following taxable period.

H. The role of targeted rules

31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed though a general interest limitation rule and where would a general rule need to be supported by targeted rules?

We refer to our answer to question 22.
I. The treatment of non-deductible interest expense and double taxation

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

We note the following comment in paragraph 198:

… the countries involved in this work suggest that general interest limitation rules may include provisions for the carry forward of disallowed interest expense and possibly for the carry forward of unused capacity to deduct interest, to smooth the effect of volatility and timing mismatches in the application of a rule and reduce the risk of double taxation. … [Emphasis added.]

To the extent that apportioned interest cannot be offset against taxable income in a period we believe that normal loss relief provisions in a jurisdiction should apply, allowing carry forward, carry back or group relief to be applied within a jurisdiction, if appropriate and as allowed by local law. To the extent that interest charges in excess of apportioned sums, or interest charges disallowed by application of a TAAR are incurred, we think such charges should be foregone for taxation purposes and no carry forward, carry back or group relief rules should apply. If any other arrangement is adopted the goals of the BEPS process will be undermined, by definition.

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?

We support this five year limit but note that some countries currently permit the unlimited carry forward of losses and that this has, in general, not been widely abused for BEPS purposes outside the banking sector, where the UK has recently been forced to take action as a result of such potential abuse. The possibility of restricting interest carry forward in the banking sector alone might be considered in such cases.

J. Considerations for groups in specific sectors

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

No comment.

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

Please see answer to question 33.
Dear Achim,

BIAC thanks the OECD for the opportunity to provide comments on the BEPS Discussion Draft on Action 4 (Interest Deductions and Other Financial Payments) issued on 18 December 2014 (the Discussion Draft).

There is no doubt that deductible payments, together with transfer pricing issues, lie at the heart of the BEPS project. Several governments have expressed concern about inappropriate interest deductions that reduce taxable income, and BIAC agrees that such concerns should be addressed. However, the use of debt and intercompany funding is also crucial to the functioning of many businesses from large multinational groups through to small cap companies, so we also believe that the OECD’s proposals should be as clearly targeted as possible on BEPS-related abuses, rather than imposing substantial restrictions on all taxpayers.

Many countries have long experience of dealing with interest deductibility. Thus, there are existing “best practices” that can be drawn upon to prevent abuses while avoiding double taxation, undue compliance and other trade and investment-inhibiting factors that would come from less focussed rules. In that regard, we are glad that the Discussion Draft rejects flat-percentage disallowances as an inappropriate tool to tackle BEPS concerns. However, by the same token, we continue to believe that the arm’s length principle should be preeminent in this area since it indicates how third parties would deal with each other. Nevertheless, as consideration of the arm’s length principle has been explicitly carved out of this consultation exercise, we will not refer to it further.

It will be no surprise to you that we have substantial concerns about the appropriateness and practicality of global group-wide tests, which we believe would create significant complexity and difficulties for taxpayers and tax authorities alike. We deal with this in considerable depth in the comments which follow, including (as requested) substantial country-level data. However, to give just one example here, ‘self-help’, or the ability to adjust the mix of equity and debt within a group to achieve the permitted level of leverage will be, in most cases very difficult, and in many cases, impossible. In addition to the many practical challenges, there could also be the perverse incentive to increase overall leverage, which runs counter to the lessons of the financial crisis.
Instead, we believe that a fixed ratio approach on a jurisdiction-by-jurisdiction basis is a preferable and relatively simpler approach. It should be an effective and stable means of restricting BEPS activities, as it directly compares the amount of interest expense to the local country base. However, we are very concerned that the Discussion Draft indicates that current benchmark ratios (for fixed-ratio tests) may be too high to be effective in preventing BEPS. Within our response, you will find a detailed analysis prepared by PwC for these comments on net interest-to-EBITDA ratios. This provides evidence of much higher ratios than those set out in Box 4 of the Discussion Draft. A fixed-ratio limitation should operate as a limit on BEPS resulting from excessive levels of debt, not as a limit on the ability of companies to borrow in the ordinary course of business.

In response to the questions in the Discussion Draft, we believe that ‘combined approach 2’ (supplemented with delineated targeted rules) would be most appropriate to prevent BEPS, while not affecting mainstream business activities.

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In closing, I would emphasise again that we do fully appreciate the importance of this issue in the BEPS project, and fully support targeted proposals to deal with abuses. However, any dramatic and overly-restrictive changes to interest deductibility could significantly, and adversely, affect cross-border trade and investment. We hope, therefore, that you find our comments and the detailed supporting evidence helpful in reaching effective, targeted solutions, and we look forward to working with you constructively on this subject in the months ahead.

Sincerely,

Will Morris
Chair, BIAC Tax Committee
Determining Best Practice

1. BIAC supports the development of tax rules based on “best practices” as a general matter. BIAC thus agrees that tax rules should be developed by the OECD by surveying and analysing those practices found in the diversity of tax rules currently applied by countries and reaching consensus as to which practice or combination of practices is best.

2. BIAC agrees that efforts to develop best practices for rules that limit the deduction of interest (and equivalent) expense should minimise distortions in investment and competition, minimise administrative/compliance costs to tax authorities and taxpayers, avoid double taxation, promote economic stability and provide certainty of outcomes, in addition to addressing BEPS concerns. Tax rules that create significant collateral economic damage should not be considered as “best practice” rules.

Net Interest Expense

3. As a starting point, BIAC endorses the proposal found in paragraph 49 of the discussion draft on Action 4 (“DD4”), which is that a best practice tax rule on interest expense deductibility should apply to net interest expense and not gross interest expense.

Survey of Existing Practices

4. To determine best practice, DD4 surveys six existing approaches now used by various governments to limit deductibility of interest expense in an attempt to deduce if one or more could constitute a best practice tax rule. DD4 concludes that three of these existing methods (withholding taxes, arm’s length tests and flat disallowance of a percentage of interest expense on an entity basis) should not be considered options for a best practice rule for the limitation of interest deductibility.

5. We agree that using withholding tax as the apparatus to limit deductibility of interest expense would be a circular, and hence, inherently faulty design of tax rules, and should not be considered an option for a best practice to limit the deduction of interest expense. Likewise, BIAC agrees that a rule that calls for the flat disallowance of a percentage of interest expense on an entity basis with no reference to the payee or the nature of the expense is also not an appropriate option for a best practice.

6. However, given the stated goal of BEPS Action 4 is the development of recommendations for best practice rules to prevent base erosion “… through the use of related-party and third-party debt to achieve excessive interest deductions …,” BIAC is concerned that Paragraph 21 of DD4 flatly concludes the arm’s length tests “should not form part of [the interest limitation] consultation process.” By so doing, BIAC notes that DD4 is overlooking a substantial amount of jurisprudence on the limitation of interest deductions. If an entity can adequately demonstrate its debt capability using the arm’s length principle, then such a fact should be relevant in determining whether related party interest expense is “excessive” before any such excess is disallowed. How can interest be said to be excessive if an intercompany loan uses the arm’s length interest rate that would have otherwise been happily charged by a third party lender in a non-structured transaction?

Remaining Alternatives

7. Even though we strongly disagree with the conclusion, since DD4 concludes that arm’s length tests should not be considered, we will focus our comments on the remaining three
alternatives (global group-wide tests, fixed ratio tests, and targeted anti-avoidance rules) which DD4 considers could be developed into best practice rules to deal with abuse.

8. The core of DD4 is a menu of choices for the general limitation rule which are alternatives between (i) global group-wide tests, (ii) fixed ratio entity-by-entity tests and (iii) tests that combine (i) and (ii), with each of the three categories further subdivided into essentially six total alternatives. DD4 also proposes that each of these alternatives could also be supplemented by targeted anti-avoidance rules in specific circumstances.

Why Global Group-Wide Tests Are Not Best Practice

9. While there is no conclusion in DD4 as to which of the six alternatives constitutes “best practice,” DD4 announces at paragraph 10 that the aim of Action 4 “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.” Encouraging groups to adopt a structure that gives rise to consistent leverage among entities in a group may, at first, seem appealing, but it is an approach that could do considerable harm. It may also encourage artificial behaviour instead of reflecting the genuine commercial activities and circumstances of individual entities within a global group. Global group-wide tests will tend to encourage groups to incur external debt, not otherwise needed. This could especially arise where an MNE’s activities (and entities) span several different business sectors that are best leveraged in different ways. Today, interest rates are at historic lows across the globe generally; if we move into a liquidity-constrained environment with higher interest rates, then a rule that establishes barriers to related party debt based on external debt may drive groups to increase overall external debt which, in turn, has the potential to cause unintended collateral damage.

10. In addition, as acknowledged by DD4, group-wide tests would cause complexities for both taxpayers and tax authorities, adding to the already high costs of compliance with tax laws, incurred by both taxpayers and of government tax administrations.

11. Moreover, BIAC is reluctant to endorse group-wide tests given that they resemble formulary allocation and apportionment of interest expense and thus diverge from the principle of encouraging arm’s length behaviour between related parties.

12. Aside from these conceptual points, there are a number of practical problems with global group-wide tests. These practical problems arise due to an assumption that underlies DD4, both in terms of the BEPS issue it seeks to address and the potential methods put forward to address it. The assumption (or misconception) is that adjusting the mix of debt and equity in a group of companies is relatively straightforward. In a minority of situations this might be so, but in many typical group scenarios it is simply not the case. This presents a key difficulty for groups to rearrange their internal financing in a manner that would be required by a global group-wide test (being either an allocation of external finance costs or a fixed ratio requiring a wider distribution of external finance costs across the group).

13. 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).
14. Minority investors are typically passive which means introducing additional equity from the group might not be possible without changing the dynamics of the investment and therefore leading to a preference for group debt. Some controlled entities are listed with the minority ownership spread across a wide number of investors. This can make changes to equity, and in some cases related party transactions per se where shareholder approval is required, impractical.

15. In some countries, the terms and usage of additional funding introduced by way of related party debt is restricted such that intercompany debt can only be introduced for certain prescribed activities.

16. The above issues would be compounded under a global group-wide allocation which, in order to try to obtain a tax deduction for external financing costs, groups would be required to introduce intercompany debt into many countries where there is no commercial requirement for additional finance. In these situations, it would be necessary for the borrowing company to repatriate the money borrowed back to the lender by way of a series of dividends or reductions of share capital.

17. Such transactions typically require various conditions to be satisfied (distributable reserves, solvency tests, impairment testing, third party creditor protection, court processes, etc.) at each level to repatriate the money. In a group operating in 100+ countries with hundreds of companies and many tiers of ownership this would be a huge and time consuming task (assuming no legal impediments to actually achieving it).

18. Even where it is possible to change the mix between debt and equity, it would also be very difficult to introduce the correct level of debt into each country as it would be necessary to predict the relative level of individual country / company profits and the group external finance costs. Many groups’ profits are volatile and not possible to meaningfully predict. An allocation would require constant tinkering of the intra-group financing in order to try to minimise loss of tax relief on external financing costs. This could only be reliably done after the year is over but financial books would be closed and the year over, only for a new year to begin.

19. Any minority ownership would create leakage in circulating the cash as there would need to be a return to all shareholders. This leakage would often outweigh the benefit of introducing new intra-group debt and make the process unviable, as would any dividend withholding tax on extracting the cash.

20. A further issue would relate to managing foreign exchange exposure as it would require many groups to lend to countries with volatile currencies. This would result in either internal foreign exchange exposure (which in turn would make it impossible to forecast internal financing costs) or an increase in external hedging cost to manage that exposure (which again will often make an allocation to secure a tax deduction unviable).

21. Even where new intercompany debt can be introduced, there are countries where the associated finance costs will not be deductible for tax purposes. Some countries tax systems specifically deny tax relief for financing costs associated with returning money to shareholders. In some countries transactions which have a tax avoidance purpose fall foul of anti-avoidance rules which would likely catch the sort of transaction necessary to allocate debt around a group.
22. As a result of the above, under a global group-wide test, a proportion of an MNE’s external finance costs would not qualify for tax relief, either because the debt cannot practically be allocated to the appropriate group company or it can but the associated finance costs are not deductible for tax purposes. This would impact MNEs differently depending on their global footprint and is likely to disadvantage MNEs which have more business in developing countries (where many of the issues highlighted above are more prevalent). The cost of capital of those businesses would thus increase accordingly making investing in developing countries more difficult.

23. Examples of the issues described in paragraphs 13 to 22 above can be found in the slides at Annex 2 to this paper, together with brief summaries of tax and non-tax limitations adopted by various countries that would either restrict or inhibit rebalancing of debt across entities in MNEs.

Fixed Ratios on a Jurisdiction-by-Jurisdiction Basis

24. As a consequence, BIAC suggests that a fixed ratio approach on a jurisdiction-by-jurisdiction basis is preferable to global group-wide tests. Fixed ratio rules should be applied to a jurisdiction’s consolidated/combined group, and not on an entity-by-entity basis, to minimize potentially distorted results. For a number of legitimate business reasons, entities in the same jurisdiction may either receive or pay different amounts of interest (e.g., due to the need to maintain a certain credit rating or due to regulatory restrictions on facing customers).

25. BIAC strongly agrees with the important point made in paragraph 148 of DD4 that a “key advantage of a fixed ratio rule is that it is relatively simple for groups [taxpayers] to apply and tax administrators to administer.” If fixed ratios were adopted as the preferred rule, then BIAC suggests there would be no need to consider yet another complication; namely there would be no need for a threshold rule as discussed in paragraphs 50 to 57 of DD4, although member countries may wish to maintain existing thresholds set at monetary levels of net interest expense.

26. We further believe that a well-designed fixed ratio limitation can be an effective means of restricting base erosion in a country because it directly compares the amount of interest expense to the local country base whether on an assets test or earnings (EBITDA) test. This can be a more stable way of protecting a country’s tax base because the limitation is not dependent upon group-wide metrics.

27. Importantly, we believe that a fixed-ratio test is the approach most likely to achieve broad consistency in rules across jurisdictions. This is because of the increasing number of countries that already apply a fixed-ratio limitation – in particular, an interest/EBITDA cap. It is already an evolving international norm. In contrast, no major country has yet adopted a group-wide allocation approach (outside of a combined test).

28. DD4 discusses fixed ratios linking interest deductibility to either earnings or assets. Given “one size does not fit all” and various sectors of the economy (and taxpayers within such sectors) are different, BIAC suggests taxpayers be given a choice to use either a fixed net interest expense to assets or fixed net interest expense to earnings as long as the election is consistently applied.

29. In terms of the fixed ratio test linking interest deductibility to earnings, BIAC suggests EBITDA be used rather than EBIT. EBITDA is consistent with what is used for evaluating...
creditworthiness and loan covenants. Furthermore, depreciation introduces some modicum of certainty with respect to what the cap would be in a fixed ratio test referenced to earnings which as DD4 acknowledges can be volatile. EBIT disfavors capital-intensive industries and the ratio should reflect the fact that capital assets generally support more debt (e.g., as collateral), which should not be viewed as contributing to BEPS.

30. In terms of the fixed ratio test linking interest deductibility to assets, BIAC agrees that valuation issues arise as to the measurement of assets. BIAC believes that the concern expressed in paragraph 154 of DD4, which is that assets can simply be inflated by “pumping” in cash, could be ameliorated by limiting assets for this purpose to those used in the trade or business. Further, the concern that self-created intangibles would be undervalued as assets compared with acquired intangibles would be indirectly addressed by permitting an election for taxpayers as between an earnings test and an asset test. Each taxpayer would know its facts best and could judge which approach would achieve better consistency with lower volatility over time.

**Fixed-Ratio Limitations Currently Applied by Countries Are Not Too High**

31. Paragraph 158 of DD4 notes that “most countries with an earnings-based rule apply a benchmark ratio that allows an entity to deduct interest expense up to 30 percent of EBITDA (or alternatively countries have introduced rules that will move to this rate over a number of years).”

32. DD4 then states, in paragraph 159, that “anecdotal evidence from a number of sources, including companies and advisors, indicates that those benchmark ratios may be too high to be effective in preventing base erosion and profit shifting.”

33. DD4 then explains, also in paragraph 159, that, “to get a better understanding of how these benchmark ratios compare to the actual net interest to EBITDA ratios of groups taken from consolidated financial statements, an analysis was carried out in relation to the position of large multinational companies,” as set out in Box 4 of DD4.

34. Box 4 summarises the results by observing:

   The analysis covered the 79 non-financial sector companies from the list of the “Global top 100 companies by market capitalization,” published by PricewaterhouseCoopers in March 2014. The relevant data was taken from published consolidated financial statements for the years 2009 and 2013. . . . Results show that for the year 2009, 69 out of 77 companies had a net interest expense to EBITDA ratio below 10 percent, including 15 companies which had net interest income. In 2013, 75 out of 79 companies had a net interest expense to EBITDA ratio below 10 percent, including 18 companies which had net interest income.

**Analysis of Interest-to-EBITDA Ratios**

35. The PricewaterhouseCoopers (PwC) report referenced in DD4 contained only a list of the largest global companies, based upon market capitalization. It did not provide data on interest expense or EBITDA for the companies; and PwC did not perform the analysis reflected in Box 4 of DD4.
36. PwC has performed a separate analysis of net interest-to-EBITDA ratios for public companies. The results of the analysis are contained in the report appended as Annex 3 to BIAC’s comments (“PwC 2015 Report”).

37. PwC analysed the net interest-to-EBITDA ratios of public companies over the 2009-2013 period in its 2015 Report. The analysis was based upon consolidated financial information for each company, drawn from Standard & Poor’s GlobalVantage data base (~20,000 observations). Financial services companies were excluded.

38. Excluding financial companies, PwC performed separate tabulations for: (i) all companies in the database, (ii) multinationals companies (MNCs), and (iii) companies with public credit ratings from Standard & Poor’s, Moody’s or Fitch. In each case, PwC prepared separate tabulations by industry and market capitalization (i.e., companies with market capitalization above and below $5 billion).

39. PwC’s analysis in its 2015 report finds that net interest-to-EBITDA ratios are much higher than those set forth in Box 4 of DD4. In the chart shown in Box 4 of DD4, few of the companies had net interest-to-EBITDA ratios greater than 10%. In contrast, PwC’s tabulations produced the following:

**Consolidated Financial Statements of Nonfinancial Public Companies, 2009-2013**

<table>
<thead>
<tr>
<th>Sample</th>
<th>Percent of companies with net interest expense:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt; 10% EBITDA</td>
</tr>
<tr>
<td>All companies</td>
<td>42-47</td>
</tr>
<tr>
<td>MNCs</td>
<td>39-45</td>
</tr>
<tr>
<td>Rated companies</td>
<td>54-60</td>
</tr>
</tbody>
</table>

40. This is not surprising. The analysis in DD4 is based upon 79 non-financial companies with the largest equity capitalizations in the world. In general, one would expect such companies to have relatively low levels interest expense relative to EBITDA, for a few reasons. First, companies with large amounts of equity typically are able to borrow at lower interest rates. Second, companies with large amounts of equity would be expected, on average, to have lower debt-to-equity ratios and thus less interest expense relative to earnings.

41. This is reflected in the results of the PwC 2015 Report. Smaller-cap companies had higher interest-to-EBITDA ratios than large-cap companies.

**Consolidated Financial Statements of Nonfinancial Public Companies, 2009-2013**

<table>
<thead>
<tr>
<th>Sample</th>
<th>Percent of companies with net interest expense:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt; 10% EBITDA</td>
</tr>
<tr>
<td>All companies</td>
<td>Large cap</td>
</tr>
<tr>
<td></td>
<td>Small cap</td>
</tr>
<tr>
<td>MNCs</td>
<td>Large cap</td>
</tr>
<tr>
<td></td>
<td>Small cap</td>
</tr>
<tr>
<td>Rated companies</td>
<td>Large cap</td>
</tr>
<tr>
<td></td>
<td>Small cap</td>
</tr>
</tbody>
</table>

42. A fixed ratio interest expense limitation would disproportionately affect smaller-cap companies, exacerbating the higher cost of credit that smaller companies often confront.
43. There is also significant variation in net interest-to-EBITDA ratios across industries. Some industries are more capital intensive than others; and companies will often choose to finance long-term capital using debt. An interest expense limitation needs to accommodate industry variations in debt levels.

44. Based upon PwC’s analysis, two industries with higher net interest-to-EBITDA ratios are Energy & Materials and Utilities:

**Consolidated Financial Statements of Nonfinancial Public Companies, 2009-2013**

<table>
<thead>
<tr>
<th>Sample</th>
<th>Percent of companies with net interest expense:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt; 10% EBITDA</td>
<td>&gt;20% EBITDA</td>
</tr>
<tr>
<td>All companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy &amp; Materials</td>
<td>48-53</td>
<td>32-38</td>
</tr>
<tr>
<td>Utilities</td>
<td>60-69</td>
<td>38-46</td>
</tr>
<tr>
<td>MNCs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy &amp; Materials</td>
<td>45-51</td>
<td>28-35</td>
</tr>
<tr>
<td>Utilities</td>
<td>68-76</td>
<td>46-55</td>
</tr>
<tr>
<td>Rated companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>81-86</td>
<td>42-51</td>
</tr>
</tbody>
</table>

45. Like the analysis in Box 4 of DD4, PwC’s analysis in its 2015 Report is based upon consolidated financial information. This is because consolidated financial information is more widely available than unconsolidated financial information. Countries, however, typically apply fixed-ratio limitations based upon unconsolidated local-country financials. One can expect that the local-country interest-to-EBITDA ratio for a company will often be higher than the group-wide consolidated ratio. Indeed, unless the group-wide ratio is perfectly balanced across jurisdictions, one would expect there to be a mix of jurisdictions, with some having higher ratios and some having lower. As previously discussed, it’s not uncommon for a company to have variations in interest expense across jurisdictions for reasons wholly apart from tax – e.g., business risk, country risk, FX risk, etc.

**Impact of Changes in Interest Rates**

46. Interest rates currently are very low by historical standards. The PwC 2015 Report includes a chart that shows interest rates over the past 20 years for a 5-year BBB-rated bonds. The chart is presented below in Table 1. A BBB-rating was chosen because this represents a mid-range credit rating for non-financial companies with public ratings. The chart shows that the current bond yield is 2.75%, while the average yield over the past 20 years was 5.45% (i.e., the historical average is approximately double the current rate). Moreover, in 1995, the rate was 8.5%, in 2000 the rate was 8.5%, and in 2008 the rate was 7.5%.
47. A critical question is the extent to which changes in interest rates correlate with changes in EBITDA. To the extent there is a close positive correlation, interest rate variability would be less of a concern.

48. PwC has run a statistical analysis to see if there is a positive correlation between changes in the average interest rate and changes in the cash return on assets for companies. Specifically, PwC tested whether there is a positive correlation between changes in interest/debt ratios and changes in EBITDA/asset ratios for companies over the 2009-2013 period, using information from the Standard & Poor’s Global Vantage database.

49. PwC’s analysis in its 2015 report produced no statistically significant correlation between changes in interest/debt ratios and changes in EBITDA/asset ratios. The results were not statistically different from zero. Based upon this analysis, PwC has concluded that there appears to be no correlation between the average rate of interest on a company’s debt and the cash flow generated by its assets.

50. This is not a surprising result. Interest rates and EBITDA can be affected differently by monetary policy and macroeconomic conditions. Moreover, the impact of a change in interest rates can be muted to the extent that a company has issued (or swapped into) fixed-rate debt. A fixed-ratio cap should be set at a level that accommodates global fluctuations in economic activity that could cause an increase in net interest-to-EBITDA ratios unrelated to tax considerations.
51. The foregoing analysis suggests that the net interest-to-EBITDA cap of 30% currently applied by countries is not too high. The fixed-ratio limitation should operate as a limit on base erosion resulting from more extreme levels of debt, and not at as a limit on the ability of companies to borrow in the ordinary course of business. The rule should not contravene the policy goals identified in DD4, of minimizing distortions to the competitiveness of groups, minimizing distortions to investment in a country, avoiding double taxation and promoting economic stability.

52. BIAC is acutely aware that if the fixed percentage for either EBITDA or assets is set too low it would simply undermine the rule and render it meaningless. For the rule to be workable and effective, it must be set high enough so that it would not distort investment, disrupt economies or cause double taxation, but would target the perceived abuse that is the focus of the BEPS project.

53. The percentages set forth in DD4 Box 3 range from 25% to 50% and were adopted in each of the countries listed in Box 3 after considerable analysis and debate of desired outcomes. BIAC suggests that quickly discarding such considered percentages and replacing them with much lower percentages would be imprudent with negative implications for economic growth.

54. Local affiliates also frequently operate in economically and politically unstable countries. Simply due to location, a local affiliate may be required to pay a higher interest rate in a high-risk country environment as compared to a similar company operating in a lower risk country environment. A low fixed ratio percentage would clearly be biased against affiliates operating in greater country risk environments.

55. More generally, a fixed ratio percentage set too low would not provide the necessary cushion for cyclical global fluctuations in economic activity. Macroeconomic conditions change constantly, often resulting in significant changes in interest rates, earnings growth, and operating costs. Changes in such factors may impact a company’s fixed ratio percentage for reasons unrelated to the tax positions of local affiliates. A fixed ratio that is set too low would not contemplate upward movements in the company’s actual fixed ratio as interest rates increase solely for macroeconomic reasons. A higher fixed ratio percentage would provide greater insulation against shocks to economic activity that could cause an increase in the fixed ratio unrelated to tax/transfer pricing considerations.

56. For these reasons, BIAC suggests that the percentages shown in Box 3 be considered appropriate percentages to be changed only after further analysis and consultation with taxpayers in each country.

**Combined Approach 2, Supplemented with Targeted Rules, Is BIAC’s Preferred Option**

57. Of the options proposed in DD4, fixed ratio tests with appropriate percentages are strongly preferred by BIAC as compared with global group-wide tests. As a consequence, BIAC believes the option that holds the greatest promise would be ‘combined approach 2’ described in DD4 paragraphs 170 to 174\(^1\). This is because the combined approach would include two

\(^1\) We should note, however, that one BIAC member dissents from this view. That member believes that only a fixed-ratio test should be recommended (with further narrowly crafted anti-abuse rules). The member is concerned that a combined rule would lead to a lower fixed ratio percentage being adopted, with the
references and measures of economic activity. Combined approach 2 would primarily test, at the jurisdiction by jurisdiction level, on a fixed ratio basis. Only if net interest expense exceeded that ratio would the taxpayer need to test against the global group-wide level. Some taxpayers may choose not to undertake an analysis of the global group-wide position even if the fixed ratio percentage was exceeded and, in such cases, taxpayers would instead carry over any excess amount in order to avoid dealing with the increased complexity of the global group-wide fall-back test under combined approach 2.

58. One question that BIAC believes should be explored is whether 3rd-party debt should be treated differently than related-party debt, or more specifically, whether parent-level (3rd-party) debt should be treated differently. Group-wide allocation is about spreading 3rd-party expense deductions, not about cutting off such deductions. Given the challenges of self-help, the group-wide methodology puts a parent-company at risk of losing 3rd-party interest deductions. If there is a concern that a company may borrow to fund low-taxed foreign earnings, this may be more appropriately addressed through CFC rules.

59. Although DD4 says that, under a combined test, either group-wide or fixed ratio test can be the general rule, with the other operating as a carve-out, the report suggests that the fixed ratio test should function more as de minimis rule. The report states that the fixed ratio rule should operate to reduce compliance costs for entities with low leverage. We believe it is very critically important that the fixed ratio test operate as a broader alternative than simply as a de minimis exception. For a rule to operate as a de minimis exception, the general rule needs to apply widely across most fact patterns without problems. This is not the case with group-wide allocation rules. As discussed, formulaic group-allocation rules can produce distortive results – imprecise and uneven; and self-help through intercompany funding does not provide a solution to this.

60. The combined approach should provide a guard-rail against excessive leverage. It shouldn’t pose an undue burden on more mainstream levels of debt. Otherwise, the combined test will produce economic distortions little different from those produced by a sole group-wide allocation approach.

61. Even with two measures of economic activity of combined approach 2, there may be cases where targeted rules could be used to address specific areas of concerns such as artificially structured arrangements. Using targeted rules would consequentially support maintaining existing fixed ratio percentages in countries where fixed ratios are now used given that targeted rules would be designed to address identified abuse. BIAC would thus support narrowly delineated and targeted rules against specifically identified abuse that could supplement combined approach 2. **We believe that combined approach 2 supplemented with delineated targeted rules would be the preferred option in this area.** We look forward to working with you to identify abuse that would inform the development of targeted rules.

result that more businesses would be forced into the very complex group-wide rules. As described in ¶35 et seq., BIAC shares the concern about using a low fixed ratio percentage, but believes, nevertheless, that there is a role for the group-wide rule as a secondary, fall-back rule to a fixed ratio test set at an appropriate percentage of EBITDA.
Related Parties Should be Controlled or Controlling Parties

62. Given that arm’s length tests (as a method to limit interest deductibility) have been excluded from this consultation by virtue of DD4 paragraph 21 (about which BIAC has noted its concerns in paragraph 6 above), and given DD4 paragraph 94 proposes that group-wide tests be developed on the basis of “entities in a financial reporting group required to prepare financial statements,” the discussion of a 25% related party threshold in DD4 paragraphs 37 to 40 is puzzling. BIAC suggests consideration be given to deleting Chapter V of DD4 (paragraphs 37 to 40), or at a minimum, deleting that portion of DD4 paragraph 38 which raised the 25% threshold.

63. It may be that Chapter V was added to the text of DD4 when targeted specific rules were being developed. Nonetheless, BIAC disagrees with the notion found in DD4 paragraph 38, scenario 3, that related parties are those with “significant” relationships which is, in turn, defined to include two parties where one directly or indirectly holds a 25% or more investment in the other party. BIAC is of the view that this cannot be considered part of the design of best practice tax rules and would cause confusion, uncertainty and unnecessary tax disputes if adopted. Best practice rules as to the meaning of related parties should be focussed on control, with controlled and controlling parties defined with reference to more than 50% direct or indirect investment interests.

64. If combined approach 2 as described in paragraphs 170 to 174 of the DD4 is adopted (as is BIAC’s preference of the various options in DD4), then there would be no point in including a rule that defined related parties with reference to a 25% rule. If the reason Chapter V is included in DD4 is to enable specific targeted rules to apply, BIAC notes that DD4 paragraph 38, scenario 3, subparagraph (3) includes situations where “payment is made under a structured arrangement.” Targeted rules focused on structured arrangements should be adequate in this area; BIAC strongly suggests that unwarranted confusion would be created if a test of 25% or more were to be adopted.

Carryover Rules

65. BIAC notes that there are nine carryover rules for seven countries shown on Box 5 (DD4 Paragraph 200). Of the nine, five are unlimited carryover rules while the shortest is the United States which permits a three year carryover of “excess limitation” and otherwise the United States permits an unlimited disallowed interest carryover period (like four other countries shown in Box 5). DD4 itself does not recommend a carryover period but does ask in question 33 what issues would be raised by a 5 year limit.

66. BIAC supports an unlimited carryover period, subject to change of control/ownership rules that would disallow the carryover of disallowed net interest expense in the event change of control. Net interest expense disallowed under any rule limiting the deduction of net interest expense should be permitted to be carried over to future periods to reduce the risk of double taxation. Also, BIAC agrees with the statement that carryovers “… smooth the effect of volatility and timing mismatches in the application of a [interest limitation] rule …” (DD4 paragraph 198).

67. The risk of double taxation (inclusion on one side and denial of deduction on the other) will increase with adoption of rules designed to limit on deductibility of interest expense. Double taxation should be treated with at least the same importance of BEPS. It is thus suggested that carryover rules be flexible and unlimited to ameliorate double taxation. At a minimum,
the time limits shown in DD4 Box 5 should only be reduced after further analysis with a view toward minimizing double taxation.

Specific Sectors

68. DD4 also points out in Chapter XIII that banks and insurance companies “require particular attention” given the large interest expense and income of financial firms, and given banks and insurance companies are subject to “strict regulations which impose restrictions on their capital structure” (DD4 paragraph 208). DD4 Chapter XIII also observes that other sectors also may require special rules and names real estate, infrastructure projects and oil & gas as potentially such sectors.

Banks and Insurance Companies

69. As DD4 acknowledges, banks and insurance companies are not like than other industries, and therefore require tailored rules. Specifically, leverage is essential to the operation of a banking business, and interest expense to banks is akin to “cost of goods sold.” Banks operate different businesses with unique capital requirements in different parts of the world, and are subject to strict regulatory requirements on their capital structure. As stated above in paragraph 3 above, BIAC strongly supports DD4’s conclusion that any interest deductibility limitation rules apply to net interest expense rather than gross interest expense and this is particularly important in the case of the financial sector.

70. DD4 Paragraph 212 raises the possibility that existing non-tax regulatory capital requirements imposed by banking and other regulators on banks and insurance companies “act as an effective general interest limitation.” BIAC agrees and notes that financial institutions are subject to complicated regulatory capital rules. Moreover, the non-tax regulation of the financial sector by banking and securities regulators in terms of leverage ratios is still evolving. Further, capital requirements are being developed by global as well as local country regulators. This will, among other things, impact the use of alternative tier 1 capital instruments (for regulatory capital purposes) and other loss absorbing instruments that could have debt characteristics. BIAC does not understand how treating regulatory capital differently (and less favorably) would reduce the potential for BEPS. The fact that regulatory capital is required for regulatory purposes does not disassociate it from the primary business of banks – namely, the business of lending money.

71. Likewise, insurance companies are subject to strict regulations. The Solvency II Directive (2009/138/EC) is concerns with the amount of capital that EU insurance companies must hold to reduce the risk of insolvency and is scheduled to come into effect in 2016. Under Solvency II, insurance regulators require insurers to hold an appropriate amount of capital to ensure that claims can be paid out to policyholders. The regulator acts to protect policyholders in their jurisdiction and ensure sufficient capital is available in that jurisdiction to cover any unexpected losses. In addition to this minimum regulatory capital requirement, ratings agencies also impose capital conditions in order for an entity to attain or maintain a specific credit rating. Maintaining the required level of capital in a particular entity is, therefore, not a choice but is a fundamental criticality to the ability to do the insurance business.

72. Therefore, it would be prudent to analyse tax rules on interest expense for the financial sector independently from this exercise since, to do otherwise, could run counter to objectives of banking and other prudential regulators. If the OECD has specific concerns regarding BEPS risks in the financial services industry, BIAC suggests that the OECD work directly with the
industry on the separate development of targeted tax rules on interest expense for the financial sector (for banking, securities and insurance companies). Targeted rules are mentioned in paragraph 212 of DD4 and BIAC looks forward to working with you to develop such rules that are proportionate to the abuse sought to be remedied. In this regard, BIAC suggests that actual abuse in the financial sector related to interest expense be first identified and only then should targeted rules be contemplated to be based on arm’s length standards.

**Capital Intensive, Long-Lead Time Projects (Oil & Gas, Mining, Utility, Infrastructure and Real Estate Sectors)**

73. Capital intensive industries require significant upfront investment, often with a number of years before an income stream (and earnings) are realised. Global group-wide allocation mechanisms do not reflect this commercial reality, and would penalise the making of such investments. Some industries (such as oil & gas and mining) may have specific operating agreements production sharing agreements which limit, or deny, any interest deduction.

74. We agree that the types of activities described in DD4 paragraphs 214 and 215 have similar characteristics (i.e. very long lead times to successful development and very large capital funding requirements) and we note that the structure of the funding of projects and the tax treatment of projects has a material impact on their viability. Due to the high capital costs involved when making capital intensive, long-lead projects, investment decisions consider the impact of interest over the whole life of the project and lack of predictability and variability of the treatment of interest over the life of any such project will have negative effective on the investment decision. Further, the introduction of project financing at the level of the asset in development often has the greater commercial benefit of reducing the political risk associated with the project. These considerations apply to the continuing viability of existing large infrastructure and other projects as well as new developments.

75. Therefore, we suggest that, similar to the finance sector, that the focus should be on identifying actual abuse first with targeted rules subsequently developed and that any targeted rules be based on arm’s length standards. As above in our discussion on the financial sector, BIAC looks forward to working with you in developing targeted rules after abuse, if any, has been identified.

**Transitional Relief**

76. BIAC strongly suggests that final recommendations to be presented to the G20 in late 2015 arising out of the analysis and work of Working Party 11 on Action 4 also include recommendations for reasonable transitional periods and grandfathering rules to enable MNE’s to adapt to any new rules. Transition rules will mitigate excessive administrative costs and possible double taxation.

**EU Rules**

77. BIAC agrees that the BEPS interest deductibility rules should be drafted such that they are compatible with the EU Treaty Freedoms, which are fundamental to EU law. This would be preferable to the creation of rules that require governments to justify restricting those freedoms.
78. We agree that where interest is re-qualified as a dividend, the Parent-Subsidiary Directive should apply to that re-qualified amount, provided that the other requirements of the directive are met.

79. We also agree that careful consideration should be taken of the State Aid implications of the BEPS proposals on interest deductibility as work on BEPS Action 4 progresses, in order to avoid any adverse unintended consequences. This will be particularly relevant to the financial sector. The role interest plays in this sector is distinguishable from the role it plays in other business areas due both to the nature of the sector’s activities and the regulatory constraints to which it is uniquely subject. It is therefore likely that any proposal under BEPS Action 4 should include provisions relating to the financial sector as such, and it will be important to ensure that these provisions do not fall foul of the State Aid rules.
ANNEX 1: BiAC Consensus Responses to Selected Questions in DD4’s Annex 3

IV. WHAT IS INTEREST AND WHAT ARE PAYMENTS ECONOMICALLY EQUIVALENT TO INTEREST?

Questions for consultation

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?

BiAC observes that amounts paid in lieu of interest under Islamic finance arrangements are treated in Malaysia, for example, as being in the nature of interest. Section 2(7) of the Income Tax Act 1967 of Malaysia states as follows: “Any reference in this Act to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the Syariah.” Thus, in one country, Islamic finance arrangements are treated as equivalent to interest. That said, the purpose of DD4 is not to undertake an exhaustive analysis of interest equivalence and instead, for purposes of DD4, Islamic finance should be seen as generating interest equivalents and treated accordingly, just like all interest (recourse or non-recourse, participatory interest and other equivalent payments). BiAC suggests it is beyond the scope of Action 4 to undertake an exhaustive analysis of interest equivalence.

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?

This question hints at “mission creep” and BiAC suggests, given time constraints, the focus be on interest reported in the group accounts as defined by accounting policy, as consistently applied.

V. WHO SHOULD A RULE APPLY TO?

Questions for consultation

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

A company could have several unrelated shareholder’s having > 25%, no one having the control on it. Joint venture arrangements are increasingly common in capital intensive industries (e.g. offshore wind) usually as a way of investors spreading risk and constrained capital across several “big ticket” projects. Whether, and if so how it is proposed that such projects would be affected is not at all clear from paragraphs 38-40.

In a JV owned equally by 4 unconnected groups each with holders of 25%, would the JV entity be simultaneously related to 4 different groups for the purposes of interest restriction, and if so would this not make a group-wide allocation method completely unworkable?

We strongly suggest that the general limitation rules being proposed in DD4 should not apply to an entity unless it should be fully consolidated in a Group under IFRS. If there are specific risks
perceived as arising from JV arrangements they should be addressed by targeted rules on a country by country basis.

The suggestion in paragraph 40 that countries may consider applying interest restriction rules to all companies and entities raises the extremely worrying possibility, under a low fixed ratio test, of a single company facing a disallowance of external interest expense when it has done nothing other than borrow a commercial amount from an unconnected lender to fund its business growth.

VI. WHAT SHOULD A RULE APPLY TO? (A) THE LEVEL OF DEBT OR INTEREST EXPENSE AND (B) AN ENTITY’S GROSS OR NET POSITION

Question for consultation

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

Paragraph 45 expresses a preference for measures referring to level of interest expense rather than debt levels. If interest expense is to be used, then we agree with net rather than gross, in order to avoid double taxation.

VII. SHOULD A SMALL ENTITY EXCEPTION OR THRESHOLD APPLY?

Question for consultation

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

Threshold tests are only necessary when complex global group-wide tests are introduced.

VIII. WHETHER INTEREST DEDUCTIONS SHOULD BE LIMITED WITH REFERENCE TO THE POSITION OF AN ENTITY’S GROUP

Questions for consultation

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?

We have serious concerns on the practicality of global group-wide rules. Volatility in one place in a worldwide group has an impact on everywhere else, making it impossible for businesses to plan investments. If lower-risk, higher-debt entities have external project funding with covenant triggers based on post-tax cash flow, then it would be a highly undesirable outcome if economic events completely unrelated to the project itself (other than affecting a business in common ultimate ownership) should put it into default.

Under global group-wide rules, in M&A situations, the tax position of a target would be altered when it joins a different group, notwithstanding the economic activity of the target remains unchanged. This is perverse and could lead to serious market distortions – buying and selling of companies based on the interest limitation profile of the seller/buyer.

An additional important point needing to be addressed in designing a rule is the question of certainty for the taxpayer and various tax authorities. We are concerned that this may not have been fully appreciated. Two different aspects are (a) which tax authority(ies) would sign off a group-wide
allocation computation and (b) uncertainty arising from the knock on effects of any tax audit adjustment (which could be many years later) on any of the group entities to all the others in the group. We note that the measures in use by countries as set out in Box 3 are not simply taken from Group accounts – they are influenced by tax returns and therefore tax audits. The proposals in DD4 do also refer to tax adjustments to be made to pure accounting numbers, e.g. for tax exempt income. Under group wide allocation methods there would therefore appear to be some interdependency between the eventually agreed tax positions of each entity – a change in one has a “ripple” effect on all the others in a group.

Another practical issue not mentioned is the position where group entities may have different accounting period end dates, and/or may only be part of a group for some of the period.

If global group-wide rules were applied, it would be imperative to allow in-country aggregation of all entities in a group to reduce complexity for both taxpayers and tax authorities. Note that the UK does not have the consolidated tax group concept, so without some aggregation relaxation, any adjustments would have to be on an unnecessarily burdensome legal entity by entity basis rather than a country tax group basis.

| 8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome |
| 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? |

If group-wide rules were introduced, it would be more practical for most multi-national groups to be able to use IFRS rather than parent country GAAP. However, a one-time election to choose a different GAAP should be offered to groups.

| 10. In what ways could the level of net third party interest expense in a group’s consolidated financial statements be manipulated, and how could a rule address these risks? |
| 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? |

Paragraph 106 is not necessarily correct in stating that earnings are a “direct” measure of an entity’s ability to meet its obligations to pay interest. An entity needs cash to pay interest, and earnings are an accounting not a cash measure. Many examples illustrate this, such as IAS39 non-cash movements through P&L, and capital expenditure in cash that is only slowly or not at all depreciated through earnings. By contrast, excluding cash dividend income because it may be tax-exempt as proposed would ignore real income that does enable an entity to pay interest.

The most accurate picture of economic activity will vary with the underlying nature of the business – earnings may be a better approximation for one business but asset values for another. Some choice is therefore suggested as appropriate.

If earnings were to be used then certainly EBITDA rather than EBIT should be the measure because EBITDA is more consistent with what banks use for evaluating creditworthiness/covenants (depreciation and amortisation not being cash costs), and
Using EBIT rather than EBITDA would artificially lower the interest cap and aggravate issues associated with earnings volatility especially in the context of impairment reviews which can lead to large volatility year on year (as experienced in the European power sector recently).

12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

Either global group-wide allocation rule has the potential to be highly impractical, verging on unworkable, as well as making it even harder to accurately forecast the economic return on a potential investment in a particular territory.

A group might have 1,000 legal entities across 50 countries. Having every entity's tax outcome interdependent with each other's, particularly if it were tax and not accounting measures being used in the Rule (we note it is tax effective net interest that DD4 contemplates) would be practically unmanageable.

This would be exacerbated further by the possibility of open-ended tax audit adjustments to an entity in country X, rippling through to all the other 49 countries. Would groups have to continually re-open and revise the huge calculation? Which fiscal authority would sign the calculation off with finality? Some approximation would be needed and/or a date set after which no further adjustments were possible.

13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

No income should be excluded. It is uncommercial to exclude any income of an entity when assessing whether the interest it pays is “excessive”, in as much as excessive means not commercially supportable.

Whether particular income is tax exempt is a matter of sovereign tax policy, and will differ between countries that a group operates in.

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?

Given that lenders do sometimes lend to companies before they generate income, such as start-up companies or those constructing large assets (like infrastructure) it is not appropriate to restrict interest relief for loss makers under an earnings-based method. Aggregation of entity results on a country basis would mitigate this to some extent.

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?

Whatever rates are used and audited in the consolidated group accounts.
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?

As recognised in paragraph 62, almost all large groups will have activities that are not homogeneous, because they operate in completely different sectors, or in different parts of the same sector, or even in very similar operations that are different merely because of local differences in regulation or markets in each territory. ANY global group-wide rule is therefore certain to lead to interest disallowances, and it is far from clear that optional carry-forward provisions would mitigate this. As an example, an energy group may have both highly regulated and more predictable activities (e.g. price-regulated electricity transmission) at the same time as more risky commodity trading or merchant power plant operations. The former would typically be financed with high levels of debt, whereas riskier commodity trading would typically support much lower debt levels. A carry forward of a disallowance of interest for the low-risk higher-debt business would be of no practical use.

17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

Paragraph 80 refers to groups “re-organising their intragroup financing to bring each entity’s ratio more in-line with that of the group, subject to any barriers preventing them from doing so.” This is easy to say but there are a very large number of barriers which cannot be satisfactorily addressed.

It would be impossible in practice to maintain each entity’s debt position in a way that exactly or even closely aligned it’s interest expense with its “economic activity”, however that was measured. Just some of the many reasons are

- Economic unpredictability (including large non-recurring items)
- Lack of actual/forecast data availability across every single group entity
- Break clauses with penalties (intragroup loans do have them)
- Minority shareholdings – extracting cash to align debt levels would cause commercial leakage and to reverse it one would have to be able to compel the minority investor to inject capital, which is not realistic.
- Increasing leverage in an entity for no reason other than to align with its group would not be guaranteed to give rise to deductible interest expense
- Regulated entities would not be permitted to vary debt levels for reasons unconnected with the regulated business

Therefore either of the group-wide methods would in practice guarantee some disallowance of interest in a multi-national group even where no there is no profit shifting going on. This is a key reason why the allocation methods should not be taken forward.
18. Do any particular difficulties arise from the application of a group-wide allocation rule to groups with centralised treasury functions? If so, what are these difficulties and do they vary depending upon how the treasury function is structured and operates?

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

20. In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

Capitalised interest could give rise to very long term timing differences, which would become permanent depending on carry forward arrangements.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group’s consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

Targeted rules to address any BEPS abuse would be preferable to the complications introduced by bringing connected parties into a group rule (see Answer 4).

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

IX. WHETHER INTEREST DEDUCTIONS SHOULD BE LIMITED WITH REFERENCE TO A FIXED RATIO

Questions for consultation

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?

Significant practical advantages of fixed ratio rules include the lack of interdependence of the measure between multiple group entities, and the ability of a country to take into account its own economic environment when setting a benchmark potentially offering lower volatility.

25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?

If earnings were to be used then certainly EBITDA rather than EBIT should be the measure because
EBITDA is more consistent with what banks use for evaluating creditworthiness/covenants (depreciation and amortisation not being cash costs), and

Using EBIT rather than EBITDA would artificially lower the interest cap and aggravate issues associated with earnings volatility especially in the context of impairment reviews which can lead to large volatility year on year (as experienced in the European power sector recently).

For simplification purposes, if assets are used as the measure, then assets should be the depreciated value of assets computed under the particular accounting standard to be applied.

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?

Generally, merely due to how an average number is calculated, many individual entities will have higher than average ratios.

More specifically, entities in lower risk activities would usually have higher debt to asset ratios - as an example, an energy group may have both highly regulated, more predictable activities (e.g. electricity transmission) but at the same time also undertake more risky activities, such as commodity trading. The former would typically be in entities financed with higher levels of debt, whereas riskier commodity trading would typically support much lower debt levels.

Where assets have longer lives, as in the infrastructure sector, a mature project entity may have repaid some or all of the debt used to build it, compared to a newly constructed asset.

In joint venture situations, the co-investors may agree to raise funding at their respective group levels – if the debt-free JV company is consolidated it may have a different profile to wholly owned group companies.

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?

Yes. A fixed ratio rule with the ratio set too low would be a significant problem for much of the infrastructure sector as is acknowledged in paragraph 215. Options for addressing this include the following (several of which could be pursued in parallel):

- Design a carve out exception for entities engaged in specified business activities
- Allow a higher ratio for entities engaged in specified business activities
- “Grandfather” specific legal entities, projects or debt instruments that were set up in good faith before any rules are implemented
- Matching or tracing of debt to particular projects – with debts allocated to specific projects not tested with the remainder
- Developed targeted rules against identified abuse.
28. *What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?*

Firstly, we note that following the global financial crisis, interest rates have generally been lower than usual, so a sample of 2009 and 2013 accounts is not necessarily typical of the longer term trend.

DD4 refers to a view that the quite widely used 30% (tax) EBITDA limit is too generous and it seeks to derive support for this view, based on the accounting ratios for the top 100 global companies (paragraph 159/Box 4).

We therefore believe it is unsafe to extrapolate from potentially unrepresentative accounting data to derive a benchmark ratio to apply globally to tax EBITDA.

In terms of availability of objective evidence, the interest to EBITDA ratio is actually the inverse of one financial measure that is sometimes used commercially, namely interest cover = EBITDA/net interest. However, in our experience it is much easier to find market data on net debt to EBITDA or debt to equity ratios.

**X. WHETHER A COMBINED APPROACH COULD BE APPLIED**

**Questions for consultation**

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?*

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?*

**XI. THE ROLE OF TARGETED RULES**

**Question for consultation**

31. *Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed though a general interest limitation rule and where would a general rule need to be supported by targeted rules?*

Targeted rules should be kept as minimal as possible to retain certainty for taxpayers. The first targeted rule described in paragraph 181 is particularly problematic. According to such rule, Interest may simply be disallowed if the recipient is not subject to a minimum level of taxation on the interest income. Such rules (as have been already implemented by Austria and France for example) are not justified given they do not address situations of excessive related party financing (compared to otherwise available third party financing) but target all interest paid to such related party recipients including non-excessive portions. They hence go beyond addressing BEPS. Also, given corporate tax rates are still to be fixed in light of the autonomy and sovereignty of individual countries. Hence no uniform view should also exist of what would constitute a minimum level of
taxation of interest income. Such rules would potentially produce very distortive outcomes given that the exact same financing position of two borrowers would be treated differently depending to which country the related party interest is paid to and depending on the taxation regimes applied on such interest income there. Furthermore, such targeted minimum taxation rules are troublesome as they would create new situations of double taxation and undermine the purpose of tax treaties to eliminate double taxation.

XII. THE TREATMENT OF NON-DEDUCTIBLE INTEREST EXPENSE AND DOUBLE TAXATION

Questions for consultation

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?

It is critical to be able to carry forward disallowed interest expenses over a long period and also excess EBITDA income over a reasonable period. These tax attributes should be preserved except in cases of abusive situations.

We highlight that the above only serves to mitigate the risk of double taxation.

It is clearly better to have carry forwards, but carry forwards cannot mitigate the effects arising from having structurally differing levels of debts in different parts of a group that cannot be equalised.

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?

An entity may incur sustained losses for several years before it becomes profitable and the recovery may be slow (whether from entering a new market, from constructing a new project which takes years to build, from trying to ride out a cyclical drop in a market etc.). In these cases five years would be insufficient. Furthermore, loss of carry forwards would require annual re-evaluation for deferred tax accounting purposes, thereby increasing volatility in the tax charge in group accounts.

XIII. CONSIDERATIONS FOR GROUPS IN SPECIFIC SECTORS

Questions for consultation

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

DD4 correctly identifies that the impact of a general interest limitation rule on the infrastructure sector would require further consideration. We strongly agree with DD4 paragraph 215’s conclusion
that if the final design of general rules does not provide an appropriate solution, then special provisions will be necessary both to avoid constraints in delivering essential infrastructure and to minimise market distortions arising in particular from group allocation rules.

However, we contend DD4 does not fully identify the significant extent of problems that a general rule would pose to the sector. For example, DD4 refers to the sector involving large “public” infrastructure projects -- however, this sector has a far wider scope -- it will also include electricity, as well as gas and water utilities and telecommunications projects.

We set out below some distinctive characteristics or features which deserve special consideration for entities engaged in the infrastructure and utility sectors, with some suggestions for partial solutions.

**Characteristics of underlying businesses in the sector**

- They are unusually capital intensive, whether due to large installations (e.g., power plants or offshore wind-farms) or large networks of wires or pipes.
- Potential investments are evaluated over a longer than average time horizon due to the longer asset lives.
- They can take years to construct so the entity would have no earnings but still have an interest expense and would therefore suffer under interest-to-earnings tests.
- Most are regulated in some way, which places various constraints on them ranging from environmental/emissions controls through to regulation of prices charged to end users.
- Only some businesses are subject to price regulation, which is (rightly or wrongly) perceived by investors as offering more predictable returns, sometimes inflation linked.
- Notwithstanding their special features, the economic feasibility of most investments in infrastructure is assessed no differently than other sectors -- a return in excess of the cost of capital is needed so higher costs of capital would choke off some investments.

**Characteristics of typical funding for infrastructure**

- In its World Energy Investment Outlook Special Report in 2014, the IEA forecast that Europe alone needs > $2 trillion of power sector investment over the next 20 years. The combined market capitalisation of Europe’s top 20 power companies is less than a quarter of this. It follows that it’s very unlikely that the necessary volume of investment required for power sector infrastructure construction and renewal will be available from the capital markets as equity; therefore, debt is a necessity.
- Debt funding is cheaper than equity funding, so long as it bears less risk. Tax relief for interest is an advantage which helps further reduce the cost of capital further, but it is not the main reason debt is used to fund the expenditure.
- There is greater external investor appetite for debt than equity, because returns which are perceived as more predictable reduce risk, and so support higher gearing levels.
- Compared to other large corporates (and none of the 100 companies referenced in DD4’s Box 4 were in the infrastructure/utility sectors) the naturally higher gearing levels which arise from the
combination of commercial factors mentioned above general fixed ratios for interest limitation cannot be too low.

- The long term nature and relatively low profitability margins (due to regulatory and/or market competition pressure) means that economic viability of infrastructure projects is more sensitive than average to adverse changes in cash flow which would result from restriction of tax relief for interest expense.

- Debt raised to finance infrastructure which was at the project entity level or in a ring-fenced regulatory group would be difficult or impossible to manipulate (for instance to achieve an average group ratio under “self-help”)

In summary, higher than normal levels of debt financing and certainty of tax deductibility for the interest expense are fundamental to the calculation of investment returns, project appraisal and passing acceptable hurdle rates to getting infrastructure projects off the ground. The widespread incidence of debt in infrastructure investment is not driven by BEPS and therefore, we question why BEPS driven legislation should be permitted adversely to impact the economics of such projects.

We consider that the commercial features of the infrastructure sector described above and the importance of the sector to the prosperity of the member countries provide a compelling reason to find a solution that avoids collateral damage to the whole sector.

There is real concern however that a new general interest limitation rule could not be adapted to protect existing infrastructure projects. Infrastructure projects usually have long lead times and therefore there is a considerable risk that projects undertaken in the last 10-15 years would be at risk of unrecoverable losses, or defaulting on their debt. This would result in severely impacted investor confidence, and the potential for more projects and costs to end up on the public balance sheet. We therefore suggest that appropriate grandfathering provisions would need to be implemented for existing infrastructure projects.
ANNEX 2: Examples of Problems with Global Group-Wide Tests

Set out below are some examples of the practical difficulties in allocating debt across a group as required under a Global Group-Wide Test.

The base case is as follows:

There is a parent company, EU 1, in an EU country. EU 1 also has a domestic business. EU 1 has a subsidiary, EU 2, in another EU country.

The working capital needs of EU 1 and EU 2 are each €500m. These are financed with a loan of €1bn to EU 1 from a syndicate of banks of which EU 1 lends €500m to EU 2.

EU 1 and 2 each have €100m of EBIT and India has €200m of EBIT.

The Euro interest rate for this group is 3% (so €30m of external interest on the €1bn of external debt), leading to net interest expense for each of the entities as summarised in the table.

For simplicity’s sake this example has been limited to one parent company and two foreign subsidiaries, but it can be seen as representing a multinational group that has 50% of its activities in developed markets (represented by EU 1 and 2) and 50% of its activities in emerging markets (represented by ‘India’).
Assuming a group wide allocation is introduced based on EBIT, this group would have to calculate how much of its external interest of €30m can be deducted in each of its entities.

Based on the earnings distribution the cap per entity can be calculated as follows:

- EU 1: 100 / 400 * 30 = 7.5
- EU 2: 100 / 400 * 30 = 7.5
- India: 200 / 400 * 30 = 15

As EU 1 and EU 2 have interest expense in excess of the cap, this group has two options. Either, the group accepts that half of the external interest will not be deductible, or it will have to restructure the debt in such a way that it corresponds with the cap.

**Reallocation of the debt**
Assuming for a moment that it would be possible, the group would allocate a pro-rata part of the external debt to the India entity i.e. €500m (200/400*€1bn). This would bring the Euro interest in line with the cap.

However, as the functional currency of the India business is Indian Rupee, it is assumed that it would hedge the loan from Euro to Rupee, to avoid being exposed to the unpredictable depreciation of the Rupee.

The cost of hedging is, in principle, equivalent to the difference in interest rates between the two currencies. In 2014, the hedge cost would be the 9% Rupee interest rate -/- 3 % Euro interest rate = 6%.

The Indian subsidiary will incur hedge cost of 6% * €500m = €30m.

This will increase the India subsidiary’s external interest cost (hedge cost being an interest equivalent) to €45m, and the consolidated group’s external interest cost to €60m.

As a result the cap needs to be re-calculated because the total interest in India exceeds the cap and the total external interest of the group has significantly increased.
This process of re-allocating the debt and re-calculating the debt can go through several re-iterations until a final result is reached where the interest incurred matches the cap as shown in the table below (in practice the result will not be final as interest rates, and thus hedge costs, will change daily such that the interest allocation will require constant re-adjustment).

Now only 25% of the external interest charge (and therefore debt) is allocated to the India subsidiary (despite it earning 50% of the group profits). The total third party finance cost has increased by 50% from €30m to €45m and the subsidiaries in emerging markets went from not having finance costs to incurring €22.5m of expense.

In practice however, in the above scenario, allocating any debt to the India subsidiary would be commercially unviable. Assume an effective tax rate of 25% for EU 1 and EU 2 and 35% for India:

- Currently EU 1 and EU 2 have combined interest costs of €30m and therefore have an after tax finance cost of €22.5m (€30m * 75%)
- If the group suffers the interest cap (such that only 50% of the interest costs are deductible) it’s after tax finance costs increase to €26.25m (€15m + €15m * 75%)
- If the group allocates as set out above, its after tax finance cost increases to €31.5m (€22.5m * 75% + €22.5m * 65%) as a result of the additional hedging cost

Therefore, the group would simply forgo the tax deduction on 50% of its external finance costs at an annual cost of €3.75m.

If instead the group did not hedge the foreign exchange exposure on internal loans, either EU 1 (for a loan in Indian Rupee) or the India subsidiary (for a loan in Euro) would be exposed to foreign exchange risk. As such, it would not be possible to allocate the right amount of debt to the right group company (given foreign exchange gains and losses are intended to be included in the definition of finance costs for the group wide allocation).
Aside from the non-tax issues that foreign exchange volatility would create, under a group wide allocation, there would be a tax mismatch - where there is a foreign exchange gain on the loan the gain would be taxable, but where there is a foreign exchange loss this would be subject to the group wide allocation cap and therefore the tax deduction would be restricted.

Again, simply not reallocate the debt, and therefore forgoing tax relief for 50% of the group’s finance costs, would likely be the most commercial option.

**Effecting the allocation**

Using the same Base Case it is then necessary to consider practically how the group could reallocate its intra-group debt as proposed under a group wide allocation.

Assuming a 3% interest rate on the euro debt, in order to allocate the interest cost in line with the profits of the individual companies, it is necessary to reduce the net debt of EU1 and EU2 and introduce new debt to India.

The above shows that 125m of the net debt of each of EU1 and EU2 needs to be reallocated to India to give the following:

- EU1 375 X 3% = 11.25
- EU2 375 X 3% = 11.25
- India 250 X 3% = 7.5 plus hedge of 250 X 6% = 15 so 22.5 in total
A typical way to effect this allocation would be as follows:

**EU 1 / EU 2**

1. EU 1 subscribes for new share equity in EU 2 for €125m
2. EU 2 repays EU 1 €125m of the existing payable

This increases the net debt of EU 1 by €125m to €625m and decreases the net debt of EU 2 by €125m to €375m.

**EU 1 / India**

3. EU 1 lends India €250m
4. India pays a dividend (or undertakes a share buyback) of €250m to EU 1

This decreases the net debt of EU1 by €250m to €375m and increases the net debt of India by €250m.

The above example is over simplified in that in a typical multinational group, the number of steps to introduce the required intra-group debt allocation could be significant. The group might operate in 100+ countries with hundreds of operating subsidiaries each one of which would require the introduction of additional intra-group debt (which would need to be extracted by way of dividend / share buyback) or a reduction of existing debt funded by additional share capital.

The operating subsidiaries might sit at the bottom of a chain of 10+ holding companies located in various different countries. The proceeds from the additional intra-group debt introduced into the operating subsidiary would need to be extracted from each company in the holding structure.

At each stage it would be necessary to determine whether the money can be extracted by way of dividend or capital reduction. Dividends generally require distributable reserves or solvency tests – share buy-backs tend to be more restrictive often involving additional procedures to protect third party creditors and can take months to complete (in this regard, please see below examples of share buyback procedures in various countries).
However, this is not a one-off exercise:

- As noted above, interest rates, and therefore group external finance costs, change daily

- Many groups do not currently forecast results on a company or even country basis (forecasting is based on management accounting information which often would only give, at most, directional guidance as to the expected statutory accounts position of an individual company).

- Even where groups do currently forecast on a company basis, in some businesses / markets the results can be volatile with profits one year and losses the next.

- M&A activity can have a major impact on group external finance costs and the mix of profits within a group

as such the allocation and reallocation of debt across a multinational group will be an incredibly time consuming exercise and difficult to undertake with any form of accuracy.

In addition, as the commercial financing needs of individual companies in the group change, introducing additional financing will necessarily be a more contrived process as it will require a mixture of debt (from the group treasury company or an external lender) and equity (down a chain of holding companies) so as to maintain the existing group-wide ratio of financing.

However, in many situations, it simply will not be possible to introduce the required debt into the relevant group operating companies. The main barriers to this are currency controls and minority investors:

*Currency controls*

In many countries (see list below) central banks regulate the flow of money in and out of the country and only certain prescribed transactions are only permitted. Such regulations often only permit related party financing for operational investment and typically prohibit related party financing used to fund a return to shareholders (either dividend or share buyback).

*Minority investors*

Introducing intra-group debt to a subsidiary with minority investor ownership will create leakage for the group in that a proportion of the dividend or share buyback will be paid to the minorities.

Using the previous example, if the India subsidiary was held 80% by the group and 20% by minority investors, it would not make commercial sense for the group to engineer a leveraged €250m dividend / share buyback to allocate group finance costs when this effectively result in part of the group’s external borrowings being used to fund a €50m dividend / share buyback to the minorities.

As such, introducing new debt into subsidiaries with minority shareholders is unlikely to be viable for many groups.

In addition, where a subsidiary with minority investors already has internal / external finance costs which exceed the amount deductible under an allocation it would often not be possible to reduce that debt by introducing additional share capital. Minorities are often passive investors and it will often not be possible for the group to introduce additional equity in isolation.
Further, many groups have listed subsidiaries for which changing the share structure is simply not possible.

**Tax leakage**

**Dividend withholding tax**

A dividend from a subsidiary to a parent will not necessarily create a corresponding distributable reserve at the level of the parent, for example due to other losses of the parent, impairment issues (the dividend will reduce the value of the subsidiary), pre-acquisition reserves issues etc.

In addition, for many parent / subsidiary combinations, dividends are subject to withholding tax.

In the above example, assuming dividends payable by India are subject to withholding tax of 10%, the €250m dividend gives rise to a one-off incremental tax cost of €25m. This compares to the loss of tax relief of €3.75m p.a. (as previously calculated) that the group would suffer by not allocating its external debt making it unviable to allocate debt via leveraged dividends where withholding tax applies.

**Non-deductible interest**

Even where intra-group debt can be introduced, it will often not qualify for a corporate tax deduction. Whilst in most countries financing costs for operational expenditure should qualify for tax relief, the sort of transaction required to allocate debt around the group makes it much less likely to generate tax relief in many countries as a result of rules that:

- specifically deny tax relief for financing costs incurred to fund a dividend or return of capital
- only allow tax relief for financing costs incurred for the purposes of the business of the borrower
- specify that financing costs are generally deductible but only against profits generated from activities funded by the new financing
- deny tax relief where the transaction is considered to have a tax avoidance motive (an argument that is often used where debt is pushed down into a company in exactly the sort of circumstances required by a group wide allocation). Indeed, DD4 suggests a targeted rule might be required to “disregard arrangements which create a debt in the absence of new funding and disallow any interest expense on such a debt” (para 181).

In addition, the taxable profit of certain industries (for example upstream oil and gas) is determined by specific Production Sharing Agreements which in many countries specify that interest costs are not deductible.
**Interest withholding tax**

Lending to a wider population of group companies will increase double taxation caused by interest withholding tax. The lending will necessarily include countries with higher domestic rate of withholding tax and less favorable double tax treaties.

The amount of double tax will depend on a number of factors and will be different for each group. However, for many groups, the majority of the external borrowings will be made at parent company jurisdiction by a separate treasury entity and on-lent around the group at a margin.

In the example used previously, Treasury Co would borrow externally and lend intra-group to EU 1 EU 2 and India.

Assuming India levies 10% withholding tax on interest, Treasury Co suffers €0.75m on the €7.5m of interest paid by India. But with corporate tax of €0.25m (25% of €1m) Treasury Co is not able to set off the full withholding tax and as such suffers additional tax of €0.5m.

Sample interest withholding tax rates for payments to the UK (as an example) per the relevant double tax treaty:

<table>
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<tr>
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<th>Rate</th>
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<tr>
<td>Thailand</td>
<td>15%</td>
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</tbody>
</table>
ANNEX 2 (Con’t): Country-specific Limitations

Non-tax restrictions

Currency controls

Angola
Where Foreign Investment Status is not granted by the authorities, it is not permitted to get funds out the country by way of dividends or capital reduction

Argentina
Central Bank restrictions – if debt was pushed into Argentina, it would effectively be impossible to get the funds out. Hard currency is unobtainable and local currency cannot be remitted out of the country. In addition, for Central Bank regulations, a loan for any purpose other than financing CAPEX requires a mandatory deposit with the Central bank of 30% of the principal amount.

Bangladesh
Foreign currency controls apply.

Belarus
Foreign currency controls are in place such that if debt was pushed into Belarus it would be difficult to get funds out.

China
If the loan is in foreign currency or local currency RMB loan but borrowed from an overseas affiliate, the loan has to be registered with the China SAFE (State Administration of Foreign Exchange). If the foreign loan exceeds the difference between the total investment and the registered capital, SAFE will not approve the foreign loan.

The total investment is the sum of the capex and opex, registered capital is the initial cash that is invested in a new company.

Colombia
Foreign currency controls apply.

Ecuador
Foreign currency controls apply.

India
Central bank restrictions – intra-group lending not possible to fund dividends or buyback of share capital per the External Commercial Borrowings Guidelines prescribed by the Reserve Bank of India.

Kazakhstan
Foreign currency controls apply.

Also, there is no clear legal process for undertaking a capital reduction
Morocco
Capital controls in place which prohibit repatriation of certain funds without prior approval of Foreign Exchange Office.

Mozambique
All exchange control transactions, as being those transactions between residents and non-residents that result or may result in payments or receipts to and from abroad, are subject to mandatory registration with the exchange control authority in Mozambique.

Nigeria
Applications required to authorities to put in place intercompany debt, which requires advance approvals. The applications must meet strict business purpose tests. Nigeria also has a rule whereby if distributions exceed taxable profit, the distribution amount in excess of the taxable profit level is subject to the full rate of Nigerian corporation tax.

Pakistan
Currency control issues with putting in place intercompany debt and subsequent remittance of intercompany interest payments

Papua New Guinea
Highly regulated currency controls with a cumbersome process to remit funds / dividends out of the country. Prior approval required by authorities based on their assessment of the application provided. Therefore, in practice, dividends are remitted infrequently

Sri Lanka
There are currency control issues with putting in place intercompany debt and subsequent remittance of intercompany interest payments

Uzbekistan
Currency exchange controls are very heavily regulated - if debt was pushed into Uzbekistan, it would be impossible to get the funds out. Hard currency is scarcely available and local currency cannot be remitted out of the country

Venezuela
Central bank restrictions – if debt was pushed into Venezuela, it would be impossible to get the funds out. Hard currency is scarcely available and local currency cannot be remitted out of the country.

*Share buyback procedures*

Estonia
Includes a creditor notice period of two months during which creditors can submit their claims. The company has to guarantee the claims satisfied during this period; if it fails to do so, the creditor may demand satisfaction of the claim. The company then submits a petition to the commercial register for reduction of share capital. The petition must confirm that claims of creditors are guaranteed or satisfied.
France
There is a creditor notice period and it appears that creditors have the right to object.

Ireland
Court approval currently required unless it is a capital reduction by way of a share buyback (which must be funded from distributable profits). However, a simplified process will apply from June 2015 meaning that a solvency statement, an independent accountant’s report and a special resolution will suffice.

Italy
Includes a creditor notice period of ninety days. If a creditor objects during this period, the court decides whether reduction is permitted.

Korea
Includes a creditor notice period of at least one month. The company must compensate any creditor that objects - this can involve the provision of security or entrusting a trust company with net assets equal to the claim.

Luxembourg
Includes a creditor notice period of thirty days, during which creditors can apply to court for the provision of security. The judge may only reject a creditor’s objection if there are adequate safeguards or if the security being asked for is unnecessary considering the assets of the company.

Norway
Includes a creditor notice period of six weeks. Unclear what creditor is entitled to do during this time (presumably object).

Poland
Includes a creditor notice period of three months, during which creditors can raise objections.

Sweden
The consent of the Swedish Companies Registration Office is required in most cases to effect the reduction; the Office must be satisfied that the reduction will not endanger any creditor’s rights.

Switzerland
Includes a creditor notice period of two months, during which creditors can register their claims to be satisfied or secured.

Turkey
Includes a creditor notice period of two months, during which creditors can make a security claim. If a claim is not paid or secured, the creditor can claim the cancellation of the shareholder resolution authorising the capital reduction.
**Other Non-tax Restrictions**

**Algeria**
Capital adequacy rules apply whereby if the share capital falls below a certain percentage of equity, there is a creditor protection rule which requires the company to recapitalise or creditors can force the company into liquidation. Therefore, if debt is pushed down into Algeria by means of a capital reduction or dividend pay-out from reserves, there may be a subsequent requirement to recapitalise the company.

**Chile**
Capital reductions are only legally permitted it certain circumstances. Chile's current tax system includes a “taxable profits fund” mechanism (FUT). The FUT is a mechanism that is intended to encourage the reinvestment of profits in Chile. It is only legally permitted to carry out a capital reduction once the FUT is used up.

**Turkey**
Capital adequacy rules apply whereby if the share capital falls below a certain % of equity, there is a requirement to recapitalise or creditors can force the company into liquidation. This is to protect creditors. Therefore, if debt is pushed down into Turkey by means of a capital reduction or dividend pay-out from reserves, there may be a subsequent requirement to recapitalise the company.

In Turkey, there are also, certain categories of equity where it is unclear whether it is legally permitted to undertake a capital reduction.

**Tax restrictions**

**Business purpose tests preventing tax relief for debt push downs**

**Bangladesh**
Business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments.

**Malaysia**
Business purpose test whereby purpose of borrowing must be for working capital purposes only. No tax deduction available on borrowings to fund capital reductions and dividend payments.

**Mexico**
Business purpose test for borrowing such that no tax deduction is available on borrowings to fund capital reductions and dividend payments.

**Pakistan**
Business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments.

**Russia**
Business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments.
**Singapore**

*Section 14, Chapter 134, Income Tax Act*

Interest expenses are only deductible insofar as they relate to capital employed in acquiring income. Therefore no tax deduction is available on borrowings to fund capital reductions and dividend payments.

**South Africa**

Business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments.

**Sri Lanka**

Business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments.

**Trinidad and Tobago**

*Section 12, Income Tax Act*

Interest expense is only deductible where the related funds are borrowed and used in the production of the taxpayer’s income. No tax deduction available on borrowings to fund capital reductions and dividend payments.

**Business purpose test where tax relief for debt push downs challenged**

**Brazil**

Tax deductions on interest must meet business purpose test. There have been tax cases in Brazil on deductibility of debt to fund a capital reduction on the basis of no business purpose where the Brazilian tax authorities have been successful in denying the interest deduction.

**United Kingdom**

*Sections 441 and 442, Corporation Tax Act 2009*

Interest expense is not deductible when related to a loan relationship which is deemed to have an unallowable purpose (i.e. a purpose not amongst the business or other commercial purposes of the company). A deduction which arises from a debt push down transaction, intended to create a tax deduction in a UK company, is therefore likely to be challenged.

**Other tax issues preventing tax relief for debt push downs**

**Kuwait**

*Executive rule No. 37, Tax Law 2008*

Interest paid to a foreign company is not deductible.

**Peru**

Deductions on debt to fund dividends and capital reductions are specifically disallowed.

**Qatar**

Interest expense payable to head office or a related party is not deductible.
**Other tax issues where tax relief for debt push downs challenged**

**Australia**
General anti-avoidance rules (Part IVA, Income Tax Assessment Act 1936) apply to debt funding and are commonly used by the Australian Tax Authorities to seek to challenge tax relief for interest on leveraged dividends.

**France**
Abuse of law provisions (section L34 of the French Tax Procedure code) are used to challenge transactions which are considered to be purely tax motivated (which would be the case for a leveraged dividend / share buyback required under a group-wide allocation rule).

**Italy**
Borrowing to fund capital reductions challenged under anti-avoidance legislation, whereby the interest on such borrowing is non-deductible.

**Philippines**
There are no formal thin capitalisation rules, however the tax authorities have issued guidelines which identify thin capitalisation and earning stripping as indicators of tax avoidance.

**Turkey**
Interest expense arising from debt push downs is often aggressively challenged on general anti-avoidance grounds.

**United States**
Interest deductibility by US subs of foreign groups is a major area of audit activity even where section 163(j) does not apply. The IRS has challenged a number of taxpayers’ interest deductions on various theories, including that the debt on which interest is paid ought to be considered equity for federal income tax purposes (which would likely be the case for long term structural debt required under a group-wide interest allocation).

**Upstream oil and gas specific tax restrictions**

**Algeria**
*Hydrocarbon law (PSA regime)*

Interest expense is not a recoverable nor a deductible cost.

**Azerbaijan**
Production agreements in Azerbaijan permit a deduction for interest expense, however the historic approach of the tax authorities is that interest expense should not be deductible when the project is profitable, on the basis that the project should be able to finance its own costs with cash it has generated. There is no legal basis for this.

In addition, a deduction for recharges of centralised interest costs are challenged on the basis that it cannot be demonstrated that the funds are linked to hydrocarbon activities in Azerbaijan.
**Egypt**

In relation to the production sharing agreements, interest expense is not a recoverable cost, therefore also not accepted as a deductible expense (although agreements typically state otherwise).

**Indonesia**

*Article 13, Government Regulation (PP) No. 79/2010*

Within the upstream space, the general principle is that interest expense is not deductible, nor a recoverable cost.

**Iraq**

No restriction under general tax law however in practice interest expense is not deductible.

**Norway**

*Section 3d, Petroleum Tax Act*

In respect of offshore activity, there is no specific thin capitalisation rule, but historical “rule of thumb” limit based on 10% equity ratio for dividend distribution.

**Oman**

In relation to the production sharing agreement interest expense is not a recoverable cost.

**Philippines**

Interest expense in relation to loans to fund exploration activities is not deductible.

**United Arab Emirates**

Concession agreements between Abu Dhabi government and international oil companies do not allow a deduction for interest expense.

**Various other tax restrictions**

**Albania**

*Income Tax Law*

Interest paid in excess of the average 12 month credit interest rate applied in the banking system, as determined by the Bank of Albania, is not deductible.

Interest paid on outstanding loans exceeding four times the amount of net assets is not deductible.

**Argentina**

*Article 4, Law 25,063, as amended by Article 4, Law 25,784*

Thin capitalisation rules apply to loans from foreign parties by reference to a debt to equity ratio of 2:1.

Foreign exchange losses on debt are not deductible.
Debt can be recharacterised as capital if not considered arm’s length – this could apply where a loan has been outstanding for a long period of time. This would result in any interest being treated as a dividend and therefore subject to 35% withholding tax.

**Australia**  
*Division 820, Income Tax Assessment Act 1997*

Thin capitalisation measures apply to investment by foreign multinationals and include a safe harbour debt to equity ratio of 1.5:1 (unless the arm’s length test could otherwise be proved in respect of the level of debt). Other safe harbours also exist, for example, 100% of a group’s worldwide gearing.

**Belarus**  
*Articles 130 and 131, Tax Code*

Thin capitalisation rules apply by reference to a debt to equity ratio of 3:1.

**Brazil**  
*Articles 24 and 25, Law 12,249/10*

Thin capitalisation rules apply by reference to a debt to equity ratio of 2:1 in respect of loans from foreign entities (0.3:1 in the case of entities resident in tax havens).

**Chile**  

Thin capitalisation rules apply to loans from foreign entities by reference to a debt to equity ratio of 3:1.

**Colombia**  

Thin capitalisation rules apply to loans from foreign entities by reference to a debt to equity ratio of 2:1.

**Czech Republic**  
*Section 25.1, Income Taxes Act*

Thin capitalisation rules apply to related party loans by reference to a debt to equity ratio of 2:1.

**Denmark**  
*Corporation Tax Act*

Thin capitalisation rules apply to related party loans by reference to debt to equity ratio of 4:1.

In addition, tax relief on all interest will only apply to 4.2% of the tax basis of certain assets of the group if a Danish company or tax group has net financing costs in excess of DKK 21.3m.

Tax relief on all interest will also be limited to an amount equal to 80% of a Danish company or tax group’s EBIT.

**Ecuador**  

Thin capitalisation rules apply to loans from foreign entities by reference to a debt to equity ratio of 3:1. Interest payable in excess of the maximum rate set by the Central Bank is not deductible.
**Egypt**

*Articles 7, 23.1 and 24.4, Income Tax Law*

Thin capitalization rules apply by reference to a debt to equity ratio of 4:1.

**Finland**

*Section 18a, Business Income Tax Act 360/1968*

Deductibility of interest expenses for intra-group loans is restricted to 25% of fiscal EBITDA. Excess interest can be carried forward to future years. The limitation rules do not apply if (i) net annual interest expense (including both intra-group and third party interest) does not exceed EUR 500,000 or (ii) if the Finnish company's equity-to-gross-assets ratio is greater than or equal to the group-consolidated ratio.

**France**

Various interest restrictions including:

- thin capitalization by reference to a debt to equity ratio of 1.5:1
- a general rule under which only 75% of actual interest costs are deductible
- ‘anti-hybrid’ rules which deny French tax relief where the corresponding interest receipt is not subject to corporate tax of at least 25% of the corporate tax that would be due under French tax rules

**Germany**

*Section 4h, Income Tax Act*

Net interest expense is only deductible up to 30% of EBITDA for corporation tax purposes.

*Section 8(1a), Trade Tax Act*

25% of interest expense is not deductible for trade tax purposes.

**Ghana**

*Section 71, Internal Revenue Act 2000*

Interest expense incurred by an entity controlled by non-residents is not deductible if the entity is thinly capitalised (its debt to equity ratio exceeds 2:1)

**Greenland**

*Section 36, General Corporate Income Tax Act*

Interest expense on loans from foreign entities is not deductible where a thin capitalisation ratio of 2:1 is exceeded.

**Indonesia**

*Paragraph 1, Article 18, Law No. 36/2008*

Interest expense is not deductible where a thin capitalisation ratio of 3:1 is exceeded.
Italy
*Article 98, Income Tax Act*

Net interest expense is deductible up to 30% of EBIDTA (any excess interest can be carried over to subsequent years).

Jordan
*Article 5c, Income Tax Law No. 28 of 2009*

Thin capitalisation rules apply by reference to a debt to paid up capital ratio or debt to average owners’ equity ratio of 3:1 (whichever is higher).

Kazakhstan
*Clause 103, Kazakhstan Tax Code*

Thin capitalisation rules apply by reference to a debt to equity ratio of 4:1.

Kenya
*Sections 4A(a), 16(2)(j) and 16(3), Income Tax Act*

Thin capitalisation rules apply by reference to a debt to equity ratio of 3:1 when a company is controlled by a non-resident (alone, or with fewer than four other persons).

Malaysia
*Section 140A(4), Income Tax Act*

The Malaysian tax law provides for thin capitalisation rules however, the tax authorities have not yet introduced any rules (expected in 2015 for application in 2016).

Namibia
*Section 95A, Income Tax Act*

Interest expense may be deemed disallowable by the Minister of Finance where it relates to a loan from a foreign connected person and the loan is excessive in relation to a company’s fixed capital (rule of thumb ratio of 3:1 used).

Netherlands
*Article 13l, Corporate Income Tax Act*

A deduction for interest expense is restricted where debt is used to finance shareholdings qualifying for the participation exemption.

*Article 15ad,*

A deduction for interest expense is restricted where funding is used to acquire Dutch companies joining a Dutch tax group if the debt is considered excessive (more than 60% of acquisition price). The expense can only be deducted against the acquiring company’s own profits, i.e. the profits of the target company included in the tax group cannot be taken into account.
New Zealand
Subpart FE, Income Tax Act 2007

Thin capitalisation measures apply to inbound investment where the applicable debt percentage exceeds 60% (and 110% of the worldwide group debt percentage) and to outbound investment where the applicable debt percentage of the New Zealand group debt percentage exceeds 75% (and 110% of the worldwide group debt percentage).


General anti-avoidance rules, also applicable to debt funding.

Norway

Interest expense is apportioned to onshore and offshore activity.

Sections 6 to 41, General Tax Act

In respect of onshore activity, related party interest expense deduction is limited to 30% of taxable EBITDA.

Oman

Articles 39 to 43, Section 3, Executive Regulations on Income Tax Law

Interest expense on a loan from a related party is allowable up to a limit of 6.5%.

Thin capitalisation rules apply by reference to a debt to equity ratio of 2:1.

Pakistan

Section 106, Income Tax Ordinance, 2001

Thin capitalisation rules apply by reference to a debt to equity ratio of 3:1 in relation to loans from foreign entities.

Portugal

Article 67, Corporate Income Tax Code

Net interest expense is deductible up to the higher of €1,000,000 and 30% of earnings before depreciations, net financing expenses and taxes.

Non-deductible interest expense may be deductible in the following 5 tax years subject to the above limits.

Whenever net interest expense does not exceed 30% of earnings before depreciations, net financing expenses and taxes, the unused part increases the maximum deductible amount, until the following 5th tax year.

Romania

Article 23, Law No. 571/2003, Romanian Fiscal Code
Interest expense on long-term loans is not deductible where a company’s debt to equity ratio exceeds 3:1. However, these expenses may be carried forward and deducted in the year the debt to equity ratio becomes lower than or equal to 3:1.

**Russia**  
*Clause 268, Russia Tax Code*

Thin capitalisation rules apply by reference to a debt to equity ratio of 3:1.

**Spain**  
*Articles 16.1 and 63 Corporate Income Tax Law*

Net interest expense is deductible up to 30% of EBITDA of a company or tax group and any excess interest can be carried over to subsequent years (although up to EUR 1m is deductible regardless of the 30% threshold).

*Article 15h, Law 27/2014*

Interest in relation to debt used to acquire interests in other group companies or to contribute to capital or equity of other group companies will generally not be deductible.

**Sweden**  
*Section 10, Chapter 24, Income Tax Act*

Under the interest stripping restrictions, a deduction is not allowed for interest accruing on an intra-group loan unless the ultimate creditor within the affiliated group is taxed on the interest income at a rate of at least 10% or it is shown that the debt has a commercial purpose and has not been put in place mainly for the group to achieve a substantial tax benefit.

*Neutral corporate tax for improved efficiency and stability*

A new proposal with the above name set out, in 2014, proposals for new interest deduction restrictions. The aim of the proposal is to increase neutrality in the tax treatment of equity and debt and to abolish the interest stripping restrictions of today.

**Turkey**  
*Article 30/(1)-ç, Law No.5520, Cabinet of Ministers Decision no. 2009/14593*

Thin capitalisation rules apply by reference to a 3:1 debt to equity ratio.

*Article 30 of Additional List No. 2, 488 Stamp Tax*

Financial loans from a non-recognised financial institution in the Turkish financial market are subject to 0.948% on the principal amount, with an upper limit of the stamp tax duty which is TL1.7m.

*Decree No. 88/12944, Communique No. 6*

Loans from a non-recognised financial institution are subject to a KKDF charge of up to 3% for loan with duration of less than a year. For Turkish Lira loans from non-residents, 3% KKDF applies regardless of duration.

*Articles 1, 9 and 17/4-e, Law No.3065 VAT*
Loans from non-resident, non-recognised financial institutions are subject to reverse charge VAT in relation to interest and foreign exchange differences. The same amount is included as output and input VAT on two separate returns by the Turkish borrower, resulting in a working capital impact where the company is in a VAT paying position in respect of input VAT.

Foreign shareholder loans have to be registered agent with the regulatory authorities.

There are General Statutory Reserve requirements in Turkey – which require that 5% of the annual profits are retained in cash in a reserve account until it reaches 20% of the paid-in capital.

**Ukraine**

*Clause 141, Ukraine Tax Code*

Interest expense is deductible up to the amount of interest income and 50% of taxable operating profits.

**United States**

*Section 163(j)*

Earnings-stripping rules may disallow interest deduction when the debt to equity ratio exceeds 1.5:1 and interest exceeds 50% of adjusted taxable income.

**Venezuela**

Thin capitalisation rules apply to loans from foreign entities by reference to a debt to equity ratio of 1:1.
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2 This appendix was prepared by PricewaterhouseCoopers LLP for submission in these BIAC comments. PricewaterhouseCoopers LLP (PwC) is a Delaware limited liability partnership.
Table A1. Consolidated Financial Statements of Public Companies, 2009-2013: All companies

<table>
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<th>Percent of EBITDA limit on net interest deductibility</th>
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Observations 20,175 20,283 20,271 20,330 20,328

Percent with Negative EBITDA 13% 11% 12% 13% 14%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table A2. Consolidated Financial Statements of Public Companies, 2009-2013: Large cap and small cap companies

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Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table A3.1. Consolidated Financial Statements of Public Companies, 2009: By industry

Percentage of Companies Affected by Interest Deduction Limitation by Industry, 2009

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Observations 3,854 4,789 4,154 1,722 1,297 3,565 613

Percent with Negative EBITDA 18% 11% 11% 6% 20% 17% 6%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table A3.2.  Consolidated Financial Statements of Public Companies, 2010: By industry

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<th>Consumer Staples</th>
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Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
## Table A3.3. Consolidated Financial Statements of Public Companies, 2011: By industry

### Percentage of Companies Affected by Interest Deduction Limitation by Industry, 2011

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<th>Consumer Staples</th>
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**Observations**

| Percent with Negative EBITDA | 3,853 | 4,804 | 4,204 | 1,733 | 1,509 | 3,572 | 614 |

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
### Table A3.4.  Consolidated Financial Statements of Public Companies, 2012: By industry

**Percentage of Companies Affected by Interest Deduction Limitation by Industry, 2012**

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**Observations:** 3,881 4,808 4,218 1,745 1,309 3,574 609

**Percent with Negative EBITDA:** 16% 10% 11% 7% 21% 18% 8%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table A3.5. Consolidated Financial Statements of Public Companies, 2013: By industry

<table>
<thead>
<tr>
<th>Percent of EBITDA limit on net interest deductibility</th>
<th>Energy &amp; Materials</th>
<th>Industrials</th>
<th>Consumer Discretionary</th>
<th>Consumer Staples</th>
<th>Health Care</th>
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**Observations**: 3,876 4,790 4,223 1,744 1,311 3,585 615

**Percent with Negative EBITDA**: 17% 11% 11% 8% 22% 18% 6%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table B1. Consolidated Financial Statements of Public Multinational Companies, 2009-2013: All companies

| Percent of EBITDA limit on net interest deductibility | Non-MNC | MNC | Non-MNC | MNC | Non-MNC | MNC | Non-MNC | MNC | Non-MNC | MNC | Non-MNC | MNC | Non-MNC | MNC | Non-MNC | MNC |
|------------------------------------------------------|--------|-----|---------|-----|---------|-----|---------|-----|---------|-----|---------|-----|---------|-----|---------|-----|---------|-----|
| 5%                                                   | 61%    | 58% | 58%     | 53% | 58%     | 54% | 59%     | 56% | 58%     | 56% | 58%     | 56% | 58%     | 56% | 58%     | 56% | 58%     | 56% |
| 10%                                                  | 50%    | 45% | 47%     | 39% | 47%     | 41% | 49%     | 43% | 47%     | 43% | 47%     | 43% | 47%     | 43% | 47%     | 43% | 47%     | 43% |
| 15%                                                  | 42%    | 36% | 38%     | 29% | 39%     | 32% | 41%     | 35% | 40%     | 35% | 40%     | 35% | 40%     | 35% | 40%     | 35% | 40%     | 35% |
| 20%                                                  | 35%    | 29% | 32%     | 24% | 33%     | 26% | 35%     | 29% | 34%     | 29% | 34%     | 29% | 34%     | 29% | 34%     | 29% | 34%     | 29% |
| 25%                                                  | 30%    | 25% | 27%     | 20% | 29%     | 22% | 31%     | 25% | 30%     | 25% | 30%     | 25% | 30%     | 25% | 30%     | 25% | 30%     | 25% |
| 30%                                                  | 27%    | 22% | 24%     | 17% | 25%     | 20% | 28%     | 22% | 26%     | 22% | 26%     | 22% | 26%     | 22% | 26%     | 22% | 26%     | 22% |
| 35%                                                  | 24%    | 20% | 21%     | 15% | 23%     | 17% | 25%     | 20% | 24%     | 20% | 24%     | 20% | 24%     | 20% | 24%     | 20% | 24%     | 20% |
| 40%                                                  | 21%    | 18% | 18%     | 13% | 21%     | 16% | 22%     | 19% | 22%     | 19% | 22%     | 19% | 22%     | 19% | 22%     | 19% | 22%     | 19% |
| 45%                                                  | 19%    | 17% | 17%     | 12% | 19%     | 15% | 21%     | 17% | 20%     | 17% | 20%     | 17% | 20%     | 17% | 20%     | 17% | 20%     | 17% |
| 50%                                                  | 18%    | 16% | 15%     | 11% | 17%     | 13% | 19%     | 16% | 19%     | 16% | 19%     | 16% | 19%     | 16% | 19%     | 16% | 19%     | 16% |
| 55%                                                  | 17%    | 15% | 14%     | 11% | 16%     | 13% | 18%     | 15% | 18%     | 15% | 18%     | 15% | 18%     | 15% | 18%     | 15% | 18%     | 15% |
| 60%                                                  | 16%    | 14% | 14%     | 10% | 15%     | 12% | 17%     | 14% | 17%     | 14% | 17%     | 14% | 17%     | 14% | 17%     | 14% | 17%     | 14% |
| 65%                                                  | 15%    | 14% | 13%     | 10% | 15%     | 12% | 16%     | 14% | 16%     | 14% | 16%     | 14% | 16%     | 14% | 16%     | 14% | 16%     | 14% |
| 70%                                                  | 15%    | 13% | 12%     | 10% | 14%     | 11% | 15%     | 13% | 16%     | 14% | 16%     | 14% | 16%     | 14% | 16%     | 14% | 16%     | 14% |
| 75%                                                  | 14%    | 13% | 12%     | 9%  | 13%     | 11% | 15%     | 13% | 15%     | 13% | 15%     | 13% | 15%     | 13% | 15%     | 13% | 15%     | 13% |
| 80%                                                  | 14%    | 13% | 12%     | 9%  | 13%     | 11% | 14%     | 13% | 15%     | 13% | 15%     | 13% | 15%     | 13% | 15%     | 13% | 15%     | 13% |
| 85%                                                  | 14%    | 12% | 11%     | 9%  | 12%     | 10% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% |
| 90%                                                  | 13%    | 12% | 11%     | 9%  | 12%     | 10% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% |
| 95%                                                  | 13%    | 12% | 11%     | 9%  | 12%     | 10% | 13%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% |
| 100%                                                 | 13%    | 12% | 11%     | 9%  | 12%     | 10% | 13%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% | 14%     | 12% |
| Observations                                          | 7,578  | 12,597 | 7,635  | 12,648 | 7,649  | 12,622 | 7,676  | 12,654 | 7,670  | 12,658 |
| Percent with Negative EBITDA                         | 14%    | 13% | 12%     | 10% | 13%     | 11% | 14%     | 12% | 15%     | 13% |

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table B2. Consolidated Financial Statements of Public Multinational Companies, 2009-2013: Large cap and small cap companies

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Observations 7,713 3,700 7,791 4,118 8,635 3,787 8,778 3,953 8,445 4,355
Percent with Negative EBITDA 19% 5% 14% 2% 15% 4% 16% 4% 18% 4%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table B3.1  Consolidated Financial Statements of Public Multinational Companies, 2009: By industry

<table>
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<th>Percent of EBITDA limit on net interest deductibility</th>
<th>Energy &amp; Materials</th>
<th>Industrials</th>
<th>Consumer Discretionary</th>
<th>Consumer Staples</th>
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Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table B3.2  Consolidated Financial Statements of Public Multinational Companies, 2010: By industry

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Observations: 2,491 3,423 2,374 994 796 2,639 160

Percent with Negative EBITDA: 12% 7% 8% 6% 16% 11% 11%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table B3.3  Consolidated Financial Statements of Public Multinational Companies, 2011: By industry

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<th>Industrials</th>
<th>Consumer Discretionary</th>
<th>Consumer Staples</th>
<th>Health Care</th>
<th>Information Technology &amp; Telecom Services</th>
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Observations 2,472 3,416 2,372 991 797 2,641 162

Percent with Negative EBITDA 12% 8% 9% 6% 18% 15% 12%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
### Table B3.4  Consolidated Financial Statements of Public Multinational Companies, 2012: By industry

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Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
## Table B3.5  Consolidated Financial Statements of Public Multinational Companies, 2013: By industry

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| Observations                                        | 2,492             | 3,114       | 2,376                   | 999              | 799        | 2,645                                    | 160       |

Percent with Negative EBITDA: 14% 11% 12% 9% 18% 17% 10%

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
Table C1. Consolidated Financial Statements of Rated Public Companies, 2009-2013:
All companies

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Percent with Negative EBITDA 5% 2% 2% 2% 2%

## Table C2. Consolidated Financial Statements of Rated Public Companies, 2009-2013: Large cap and small cap companies

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**Observations:**
- 2009: 729
- 2010: 558
- 2011: 679
- 2012: 609
- 2013: 695

**Percent with Negative EBITDA:**
- 2009: 7%
- 2010: 3%
- 2011: 3%
- 2012: 3%
- 2013: 3%

Table C3.1. Consolidated Financial Statements of Rated Public Companies, 2009: By industry

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<th>Consumer Staples</th>
<th>Health Care</th>
<th>Information Technology &amp; Telecom Services</th>
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Table C3.2.  Consolidated Financial Statements of Rated Public Companies, 2010: By industry

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Observations 328 262 262 97 82 176 126

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Table C3.3.  Consolidated Financial Statements of Rated Public Companies, 2011: By industry

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Observations: 328 262 262 97 82 176 126

Table C3.4.  Consolidated Financial Statements of Rated Public Companies, 2012: By industry

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Observations: 328 262 262 97 82 176 126

Percent with Negative EBITDA: 5% 0% 2% 0% 0% 2% 1%

Table C3.5.  Consolidated Financial Statements of Rated Public Companies, 2013: By industry

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Observations: 328 262 262 97 82 176 126

D. Dollar Denominated 5-year BBB-Rated Industrial Bond Yields, 1995 to 2015

Based on 1,659 non-financial companies with public credit ratings, the median credit rating is BBB-. As of January 15, 2015, the current market yield on 5-year BBB-rated industrial bonds was 2.745 percent; about half the average over the last 20 years (5.45 percent). Over the last 20 years, the market yield has ranged from a low of about 2.5 percent to a high of about 8.5 percent, more than three times the current yield (see chart below).

![Graph showing historical yields of USD Industrial BBB-5-Year bonds.](image)


E. Statistical Relationship between Company Interest Rates and Thin Cap Ratios, 2009-2013

One concern about the use of thin capitalization rules based on a fixed percentage of cash flow is that, while currently low by historical standards, interest rates can vary substantially due to monetary policy and macroeconomic conditions. For example, dollar denominated five-year BBB-industrial bond yields have varied from approximately 2.5 percent to 8.5 percent over the 1995 to 2015 period (see Table D).
To test whether there is a positive correlation between cash flows and interest rates (i.e., whether EBITDA tends to increase as interest rates rise), a company-level regression model was estimated using consolidated financial statement data, where the dependent variable is the cash return on assets, measured as the ratio of EBITDA to assets, and the independent variable is the average interest rate, measured as the ratio of interest expense to the year-end book value of debt.

The data for this analysis is a balanced sample of consolidated financial statements for 20,883 US and foreign-headquartered nonfinancial companies over the 2009-2013 period from the Standard & Poor’s GlobalVantage database.

The estimates produced are for a fixed effects model which accounts for differences in the average cash return on assets among companies due to factors unrelated to interest rates.

The follow regression model was estimated:

\[
\frac{\text{EBITDA}_{i,t}}{\text{Asset}_{i,t}} = \alpha_i + \beta \left( \frac{\text{Interest Expense}_{i,t}}{\text{Debt}_{i,t}} \right) + \epsilon_{i,t}
\]

where: \( \alpha_i \) is a constant,

\( \beta \) is the estimated impact on cash ROA of the average interest rate,

\( \epsilon_{i,t} \) is an error term, and

\( i \) subscripts companies and \( t \) subscripts years.

The estimate value of \( \beta \) is -0.0000846194, which is not statistically different from zero (t value of -0.15). The coefficient estimate can be interpreted as follows: an increase in the average interest rate of 1.0 percentage point is associated with a decrease in the ratio of EBITDA to assets of 8/100,000th of a percentage point.

Based on this analysis, there appears to be no correlation between the average rate of interest on a company’s debt and the cash flow generated by its assets.
Dear Mr. Pross,
Dear Sirs, dear Madams,

We are pleased to accept the invitation to comment on the Public Discussion Draft, BEPS Action 4: Interest Deductions And Other Financial, published by the OECD on 18 December 2014 (hereafter the “Discussion Draft”)

As a fairly new professional services firm that tries to bridge the gap between a sound theory and practical implementation of transfer pricing policies, through the mix of its competencies (know-how) built through working exclusively with multi-disciplinary professionals with over 10 years consulting experience in large, international consulting firms, the development and deployment of relevant capabilities (processes), as well as making the capacity available that is required by business in the field of transfer pricing policy design and implementation. As such, bMoxie focuses greatly on providing solutions for transfer pricing in respect of financial transactions, as well as for restructurings and valuations, since this has been the daily core business of the undersigned from some 10 years now.

Furthermore, our genuine commitment to the enterprise architecture of our clients, have lead us to offer our multi-disciplinary services in line with their functional set-up and business processes. This means that we also offer them with an integrated transfer pricing and corporate finance approach. Hence, we are not dealing with the investment and funding structure of companies only from an intra-group and tax/transfer pricing perspective, but in many cases this starts with having a fresh look at the overall, external investment and funding picture. Put differently, given the fact that the specific know-how needed for addressing transfer pricing for financial transactions is not available in terms of guidance, often generally accepted corporate finance principles are required to come to an arm’s length consideration, which in general also seems logic to us since independent enterprises tend to use also these principles for making business decisions in respect of entering into commercial or financial relations with unrelated parties, in the best interest of the enterprise. For sure, we acknowledge that general corporate finance principles on their own are not beatifical for application of the arm’s length principle in accordance with the OECD Transfer Pricing Guidelines, but we are convinced that there can be a great level of harmonization between both. If anything would be required in our view, it would be further formulating specific guidance for dealing with financial transactions and relations in the OECD Transfer Pricing Guidelines that builds on such harmony, but addresses specific transfer pricing challenges. What is not needed in our view, is a further move away from sound economic principles which we consider both to be found in those corporate finance principles as well as the arm’s length principle by introducing the boundaries suggested here within to limit interest deductibility. Therefore, this memorandum is structured as follows: We will start with the fundamental issues we have with the overall nature of the propositions made (Section I), before addressing the specific questions raised in the Discussion Draft (Section II) to the extent they are not at variance with our fundamental issues.
I. FUNDAMENTAL ISSUES

In this section we will address two fundamental issues:

1. Pushing aside the arm’s length principle
2. Interference with rational economic behavior of multinational enterprises, combined with ignorance of sound corporate finance principles and impact on non-financial transfer pricing

We conclude with:

3. Other comments

I.1. Pushing aside the arm’s length principle

From the Discussion Draft we deduct that there is a strong preference to apply group-wide interest allocation rules or fixed ratio rules, or a combination thereof, to limit interest deductions for tax purposes in the light of BEPS. It is with great ease that the arm’s length principle is pushed aside as a potential solution. In our view, it is not because the application thereof may be complex, or burdensome to implement that this principle should be ignored for the targeted financial relations that exist within multinational enterprises.

Admittedly, guidance with the realm of transfer pricing and the arm’s length principle is lacking currently, but, as evidenced by the other complex draft deliverables Working Party 6 has produced until now, we are confident that Working Party 6 is capable of producing not only workable solutions, but also that are sound from an economic behavioral perspective as well as from a corporate finance perspective in light of dealing with interest deductions.

It is daunting to observe that at the OECD the value of the arm’s length principle is defended in the OECD Transfer Pricing Guidelines to be greater than that of a global formulary apportionment, to see here that the work of Working Party 6 on transfer pricing guidance in connection to Action 4 (in progress we assume) is marginalized (paragraph 22 of the Discussion Draft) or even claimed to be superfluous (paragraph 224 of the Discussion Draft) in favor of group-wide interest allocation rules in particular. Therefore, we want to quote certain parts of the 2010 OECD Transfer Pricing Guidelines on global formulary apportionment, as a reminder:

- Paragraph 1.17: “Global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. [⋯]”
- Paragraph 1.18: “Global formulary apportionment should not be confused with the transactional profit methods discussed in Part III of Chapter II. Global formulary apportionment would use a formula that is predetermined for all taxpayers to allocate profits whereas transactional profit methods compare, on a case-by-case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances. [⋯]”

→ bMoxie feels this is exactly what group-wide interest allocation rules entail, mechanically.
Paragraph 1.19: “Global formulary apportionment has been promoted as an alternative to the arm's length principle by advocates who claim that it would provide greater administrative convenience and certainty for taxpayers. These advocates also take the position that global formulary, […]”

Paragraph 1.20: “[…] advocates contend that global formulary apportionment reduces compliance costs for taxpayers […]”

→ bMoxie feels that the Discussion Draft uses the arguments to push group-wide interest allocation rules.

Paragraph 1.21: “OECD member countries do not accept these propositions and do not consider global formulary apportionment a realistic alternative to the arm's length principle, for the reasons discussed below.

Paragraph 1.22: “The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question. […]”

→ bMoxie feels this is not that different from the core assumption made in the proposed Discussion Draft measures that the measures can be adopted on a very broad scale, and from the subsequent complex workarounds proposed to solve double taxation issues.

Paragraph 1.25: “[…] concern is that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises, and management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction. […] Such an approach could potentially assign profits to an entity that would incur losses if it were an independent enterprise.”

→ And this is the key concern of bMoxie, as will be further detailed here below.

I.2. Interference with rational economic behavior of multinational enterprises, combined with ignorance of sound corporate finance principles and impact on non-financial transfer pricing

In respect of group-wide interest allocation rules, the Discussion Draft takes as a key assumption, or even as a requirement, that the aggregated interest burden of the individual members should be no more than the interest burden of the group as a whole. It is easy to see that this will have a significant impact on multinational enterprises that consist of excess cash generating entities on the one hand and entities in short of funding on the other hand in view of their self-financing decisions.

Suppose the group as a whole is fully equity funded this means that there is no room for auto-financing internally, irrespective of the characterization of the entities. Hence, very simple routine entities would also be fully equity financed, whereas on a stand-alone basis this would from a corporate finance perspective be a very expensive way of funding a seemingly risk-free operation, the cost of equity outweighing the cost of debt.
Arguably, we can foresee that one could make the (simplistic) point still that on the overall this is fair, that otherwise the group as a whole should have sought external funding itself to fund such very routine activities if it would have considered its equity to be too costly. Nevertheless, in our view this exactly pushing multinationals to make decisions that are geared towards the proposed measures, away from reasonable self-financing towards unnecessary external financing; Hence, a real impact on real world trade will be a consequence in our view.

Also, arguably, we can foresee that one could still contend that this still is an acceptable side-effect or something other measures can be taken for to avoid multinationals taking such decisions to increase their room for interest rate deductibility, but one should bear in mind that fixing the interest deduction room will likely trigger internal debt restructurings because of such artificial (not taking into account company specific facts and circumstances) solely for the purpose of accommodating such measures, and throwing for instance the matching principle and the like over board. The funding structure of the individual members will therefore most likely be not comparable anymore to those of the peers that may be used to establish their profit before interests (and taxes). As such, as a transfer pricing specialist I must therefore take into account this difference in funding structure, and make the necessary adjustments to my before interest profit base to take into account the difference in leverage with the comparables. This is the case since, in the widely applied Transactional Net Margin Method for establishing an arm’s length operating profit base, a profit level indicator is taken, on the assumption that there are no significant differences between the tested party and selected comparables that would require adjustments (including for asset turnover and leverage). Considering the Return On Equity (ROE) is actually the only sound basis for comparing basis, in accordance with the DuPont formula, there is a trade-off between profitability, operating efficiency and financial leverage, or restated: ROE = Tax burden times interest burden times margin times turnover times leverage. It is from this angle, therefore, that it is not wise to apply a group-wide interest allocation that will induce actual (external or internal) funding decisions to, since simply because one cannot apply the arm’s length principle on EBIT level and ignoring the same principle below EBIT, as it will require revisiting the arm’s length principle’s application on EBIT level as a result – which in our first estimate result in lower sustainable EBIT-margins as the denial of arm’s length interest deductibility gets higher (either directly or indirectly).

In view of setting an interest cap to the group level ratio, we furthermore wish to note that this also from a corporate finance perspective does not make any sense, since the Weighted Average Cost of Capital essentially needs to equal the Weighted Average Return on Assets. Hence, only when the distribution of assets (including intangibles, and consequently functions and risks attached) are distributed in exactly the same manner across each member of the group, there will be no excess in interest deduction capability as well as a full use of interest deduction capability at a given time in a closed circuit. As soon as functions, risks and most notably assets are concentrated, the equilibrium gets disturbed. It is this equilibrium, based on the Capital Asset Pricing Model that is underlying the application of the arm’s length principle and necessitates the arm’s length principle to be applied on the company as a whole, consistently. The arm’s length principle, therefore, is quite capable to deal with the reasonableness of interest deductions (and the bonafide nature and economic rationale of capital structuring decisions), albeit that it may require further guidance to be developed. The complexity of this guidance is complex in nature that it has not been linked to transfer pricing in writing, but is actually based on general economic and basic corporate finance principles.

I.3. Other comments

- It would helpful to state who the countries engaged in the work (paragraph 19) were, to gain a better understanding of the motives for the choices made in the Discussion Draft.
• It would be helpful to give a concise overview of what literature research procedures were performed to substantiate whether the Academic Studies referred to cover the complete spectrum of how to deal with debt and equity in view of taxation, or whether this is an overview of supportive academic material only

II. COMMENTS TO SPECIFIC QUESTIONS RAISED

Question 1: No
Question 2: No
Question 3: No
Question 4: In our experience, there is globally no consensus on participation percentages
Question 5: Please refer to fundamental issues above
Question 6: No
Question 7-23: Please refer to fundamental issues above
Question 24-28: The arm’s length principle should be leading / Useful as safe harbor if conviction remains that arm’s length principle would be too burdensome for taxpayers that could opt for this
Question 29-30: Please refer to fundamental issues above
Question 31: The least possible / The arm’s length principle should be leading
Question 32-33: Please refer to fundamental issues above
Question 34-35: The arm’s length principle is perfectly capable to deal with this

Therefore, we conclude that the arm’s length principle should be leading, any group-wide interest allocation measure idea is to be abandoned, and a fixed ratio measure is also not preferred but may be developed as a safe harbor option to limit compliance burden.

We hope that our comments may contribute to the important discussions that you will organize in the light of further considering the guidance contained in the Discussion Draft. In case you would have further questions, or feel the need to have a sounding board, please do not hesitate to contact us.

Sincerely,

bMOXIE
by Andy Neuteleers
Partner Transfer Pricing, Valuations & Business Modeling
OECD Committee on Fiscal Affairs  
Working Party No. 11

By email: interestdeductions@oecd.org

6 February 2015

Dear Sirs,

Re: BEPS Action 4: Interest Deductions and Other Financial Payments

We are writing on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which is the industry body and public body advocate for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. While our membership is predominantly focussed on private equity and venture capital, a significant number of our members are active in infrastructure, debt and real estate, and some of the comments we make below relate to those sectors specifically.

Our members have invested £30 billion in over 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 790,000 people and almost 90% of UK investments in 2013 were directed at small and medium-sized businesses. The availability of debt finance facilitates this investment in business and jobs growth and the benefits of debt finance in the broader economy should not be underestimated. Potential changes to the tax system, and the uncertainties that this creates, could deter investment at a time when it is much needed.

Overview

While the main policy concerns set out in the Public Discussion Draft on BEPS Action 4 relate to outbound and inbound investment by multinational groups, private equity is mentioned explicitly on a number of occasions. Accordingly, before addressing some of the specific questions and issues raised in the paper, we thought that it might be helpful to provide some general comments on how and why debt is used in a private equity and venture capital context and how private equity and venture capital might be affected by some of the proposals in the Discussion Draft.

Debt

Debt plays an important part in financing private equity and venture capital transactions. In respect of any particular investment and depending on the type of fund and underlying asset class, it may comprise external third party (e.g., bank) debt and / or internal related party (e.g., shareholder) debt.

Bank debt may be used for a number of reasons. Amongst others:

- it can help to finance the acquisition and development of businesses;
- it can improve returns on investments by providing a relatively cheap and stable form of capital;
it can increase the spending capacity of a fund and thereby the number and size of investments in the fund’s portfolio by leveraging investor commitments.

Internal debt, which can cover both loans from a private equity fund to underlying investee companies and loans within a group of companies owned by a private equity fund, may also be used for a number of reasons:

• it can encourage greater investment in and development of new business lines and geographies;

• it can facilitate a quick and immediate investment in an asset, with a view to a subsequent refinancing with external party debt;

• it can ease the repatriation of cash – the repayment of loans and the payment of interest are not usually subject to the same corporate law constraints as the return of share capital and the payment of dividends;

• it can provide comfort and certainty in an insolvency scenario – the rights of loan creditors are generally more clearly defined and rank ahead of shareholders;

• it can create efficiencies which investors find attractive and therefore encourage them to invest further capital.

It will be clear from the list above that the reasons for using debt finance in a private equity and venture capital context are not all tax related. The fact that interest is generally deductible does mean that in some circumstances the cost of capital can be reduced and the returns for investors improved, increasing and encouraging investment in businesses – which we believe has a very important role in promoting growth in the UK and global economy. It does not, however, follow that this amounts to or causes base erosion and profit shifting.

**Effect of Proposals**

Private equity and venture capital are likely to be affected by some of the proposals set out in the Discussion Draft:

• the group tests and fixed ratio tests will affect portfolio companies and groups owned by (or invested in by) private equity funds, potentially limiting where and how much interest is deductible in any particular entity within that group. They will also be of particular concern to those of our members who are active in infrastructure, real estate and debt, where the levels of debt finance for long established reasons can be much higher than in other industry sectors;

• targeted rules, specifically those relating to related party debt, are likely to affect the deductibility of interest costs payable to private equity investors in respect of their investments.

We therefore have a very real and direct interest in this consultation process and hope that our comments are helpful. We follow the order of the Discussion Draft and chapter references are to the relevant chapters in that paper.
Chapter II – Policy Considerations

We recognise that the use of debt finance and interest expense can, in some circumstances, be used to reduce profits in high tax jurisdictions and increase profits in low tax jurisdictions in a way which does not reflect the real economic activities of the companies in those jurisdictions and that countries involved in this action plan are keen to address those distortions.

Chapter II acknowledges, however, that any proposals must be consistent with a number of other policy objectives, in particular:

• in general groups should be able to obtain tax relief for an amount equivalent to their actual third party interest cost – this would suggest that the countries involved in BEPS Action 4 do not fundamentally disagree with the general principle that interest should be regarded as an ordinary business expense and therefore deductible for tax purposes. We wholeheartedly agree with that. What, therefore, is at stake is where to draw the line between what should be regarded as deductible and what not. It is important to ensure that any such line is not arbitrary and artificial;

• any limitation rules should so far as possible minimise distortions to competition and investment – we believe that this is absolutely critical. Companies or groups, whether they are held by a consortium, a private equity fund, an individual, a trust or the public, should be treated equally so that none is at a competitive advantage or disadvantage in terms of their ability to raise or use debt finance to fund investment; and

• any limitation rules should so far as possible promote economic stability and certainty – again, we very much agree with this. Any rules that limit deductibility by reference to the level of activity in a company year on year or by reference to whether the lender is subject to tax on the interest will necessarily lead to uncertainty and, particularly, in relation to bank debt may make cashflow forecasts more difficult. We should also highlight that the introduction of any proposals, without any grandfathering in respect of existing financing arrangements, could present significant problems for businesses with cashflow and other financial covenants in their loan documentation, where full interest deductibility has been assumed in respect of all interest costs. This is likely to be particularly relevant in the infrastructure and real estate sectors, where financing arrangements will be very closely aligned to the underlying cashflows on the assets.

Chapter IV – What is Interest?

We have no substantial comments on what should be regarded as interest or equivalent to interest in the context of this consultation.

Chapter VI – What should a rule apply to?

We agree that any proposals, if introduced, should operate by reference to the level of interest expense of the group or entity rather than by reference to the level of debt for the reasons set out in the Discussion Draft.

We also agree that any proposals, if introduced, should operate by reference to an entity's net interest expense, rather than gross interest expense. This is particularly relevant in the context of funds which invest in the primary and secondary debt markets, where investments will typically
be made by the fund through a special purpose company which is financed with loan notes. The interest receivable by the special purpose company on the underlying loans will therefore be matched by a broadly equivalent interest cost payable to investors. Introducing a limitation by reference to gross interest expense could in this context create significant tax leakage in the holding structure, increasing the cost of capital and reducing liquidity in the debt market.

Chapter VIII – Groups

We recognise the theoretical attractions of the group wide tests considered in Chapter VIII but have the following concerns in relation to how they might work in practice, most of which relate to the risk of distortion and the creation of uncertainty – two of the key policy aims set out in Chapter II. These points are in addition to the concerns which the Discussion Draft itself identifies in relation to any group wide test, i.e., in order for this to work, the proposals have to be adopted internationally, applied on a consistent basis and dovetail with existing domestic restrictions on the deductibility of interest, otherwise there is a significant risk of no deductibility at all (or double non-taxation) and a substantial compliance burden for business.

The allocation of net third party interest expenses amongst the members of a group (the deemed interest rule) or capping the amount of interest expense which may be claimed by the members of a group (the interest cap rule) by reference to the level of economic activity in each of those companies relative to the group as a whole will necessarily create distortion and uncertainty:

- groups do not always operate a centralised financing structure, nor is it sensible for them to do so. Expansion into a new jurisdiction by a group may be financed by third party lenders, who are lending specifically by reference to the assets and expected cashflows in that jurisdiction – allocating the associated interest expenses to other members of the group or capping the amount of any such interest which is deductible in that jurisdiction does not reflect the economic reality of the transaction;

- groups may operate in different sectors and geographies and hold different types of assets, each of which are capable of being financed at different levels. LTV ratios in one jurisdiction in respect of real estate may be completely different to the LTV ratios in another. Similarly, it may be preferable for non-tax reasons to acquire real estate for the business with debt finance in one jurisdiction and to lease it (and pay rent) in another. Again, the application of a deemed interest rule or interest cap rule would not reflect the economic reality of the transaction;

- there may be banking, company and currency law constraints which restrict the amount of debt which can be put into any particular jurisdiction and allocating interest expenses to companies in those jurisdictions (to the disadvantage of other companies in the group), when there is no realistic possibility of ever introducing leverage there due to legal and commercial constraints, would seem perverse;

- allocations by reference to relative levels of economic activity in a group also present problems. If allocation is by reference to earnings, EBITDA and performance are likely to vary across different jurisdictions year on year (and may even do so by reference to FOREX movements). Similarly, in the early years of expanding into a new business line or geography, EBITDA may be low but the growth prospects good. If allocation is by reference to assets, there would be particular difficulties for private equity-backed
companies – for example, the assets of many early growth stage companies backed by private equity funds are likely to include an unusually high proportion of self-generated intangible property which may have no balance sheet value, which might lead to distorted allocations of interest expense; and if assets are required to be measured on a fair value basis, this would be particularly difficult in the case of the unquoted, illiquid securities in which private equity funds typically invest. Adjusting the allocations year on year by reference to these movements not only risks some of the distortions highlighted above but also creates a significant administrative burden for business and uncertainty in terms of modelling cashflows, which are often key in terms of setting and meeting the financial covenants in third party loan documentation. Furthermore, the reallocation of interest expenses year on year may not even be possible, if existing restrictions on interest deductibility in some or all of the jurisdictions in which a group operates are retained;

- the proposed rule could distort behaviour on acquisitions and disposals. For example, on the sale of a company which has existing debt, the impact of the rule could be that bidders with higher levels of external leverage are able to offer a higher price, because the post-acquisition impact of the group allocation rule on the target company is likely to be lower than in the case of a less leveraged bidder. In other words, the rule could incentivise bidders to become more leveraged.

The application of a net interest expense test in the context of an international group also raises the question of whether it is right that a group which is looking to start up a business or invest in a Country A should be in a completely different position depending on whether it finances its subsidiary with a shareholder loan from Country B or third party debt. In the former, the subsidiary would obtain no deduction because the group would have no net external interest expense; in the latter it (or other members of the group) might. Is it really profit shifting where if a deduction were available in both cases, the taxable profits in Country A would be the same? The net interest expense test in isolation may be able to operate appropriately in respect of a single entity or in respect of a group of companies in the same jurisdiction but in the context of an international group it raises fundamental questions of principle such as this.

In relation to the scope of what would constitute a group for these purposes, we completely agree with the comments at paragraph 143 of the Discussion Draft. Combining two connected groups (e.g., two groups held by the same private equity fund) for the purposes of the group tests would be undesirable and distortive for the reasons given. This policy objective should, in our view and for the same reasons, be applied consistently across private equity funds whatever their form, whether they are structured as limited partnerships, limited partnerships with an underlying master holding company structure, single purpose corporates or corporates comprising multiple compartments effectively representing multiple funds with different investor bases and investment parameters.

**Chapter IX – Fixed Ratios**

As with the group wide proposals, we recognise the obvious attractions of a fixed ratio test.

We do, however, share the concerns raised in the Discussion Draft that fixed ratio tests are inflexible and do not take account of the fact that businesses operate in different sectors with different funding requirements. This would be particularly true for those of our members who
are active in infrastructure, real estate and debt, where leverage levels and interest to income ratios are traditionally high.

We believe that, on balance, a fixed ratio test linking interest deductibility to earnings is probably more sensible than linking it to assets but, again, the appropriateness of this will vary from business to business, what sector it is in and whether it is an established business or a developing one.

Finally, we note the anecdotal evidence in Part C of Chapter IX that the benchmark ratios in countries which have adopted fixed ratio tests have been set too high to be effective and that, to provide some sort of better benchmark, data relating to the interest expenses of multinationals in the non-financial sector of the "Global top 100 companies by market capitalisation" has been quoted. Needless to say, the financing requirements of the Global top 100 will be completely different to the developing businesses which are the focus of private equity and venture capital and the data takes no account of industry sector. We do not, therefore, believe that this is an appropriate or helpful benchmark by any measure, unless of course any proposals which do flow from Action 4 are limited to truly global multinationals. The inclusion of this data does, however, illustrate very clearly the difficulties associated with any 'one-size-fits-all' fixed ratio proposals and if benchmarking in this manner were recommended, we believe that the smaller companies and developing businesses in which private equity and venture capital predominantly invest should be carved out because their financing requirements and ability to obtain finance vary so greatly across sectors and geographies and they do not have the same established worldwide cashflows and assets as multinationals against which to leverage, putting them at a potential disadvantage.

Chapter X – Combined Approach

We have, as set out above, concerns about the application of the group wide tests and the fixed ratio tests and whether they are an appropriate means of limited interest deductions in practice. Those concerns apply equally to any combined approach.

Chapter XI – Targeted Rules

One of the concerns expressed in Chapter VIII (Groups) is how to deal with related party debt because related party debt will not be caught by the group wide test if the group (sensibly and properly) stops at the parent company of the consolidated group.

Related party debt restrictions are of particular concern to private equity and venture capital because they could, depending on how related party debt is defined, affect much of the internal debt finance which funds typically look to lend down by way of shareholder loan to finance the acquisition or development of their underlying investments. Before addressing, therefore, some of the potential concerns with the targeted rule in respect of connected or related party debt proposed in the Discussion Draft, we believe that it is important to ask two important policy questions:

- is it right to propose targeted related party debt rules simply because related party debt will not be caught by, for example, the group wide test, without regard to whether that related party debt actually results in base erosion and profit shifting? It is clear that any such rules will not avoid distortion because, if they are introduced, groups which are funded by way of related party debt may be at an artificial disadvantage to those
companies with an equivalent amount of third party debt and, if they are not, may be at an artificial advantage; and

- does the use of related party debt, particularly in the context of private equity and venture capital, give rise to the type of base erosion and profit shifting which BEPS Action 4 is looking to address? If the primary focus of BEPS Action 4 is to counteract the movement of profits from high tax jurisdictions to low tax jurisdictions, we do not believe that it does. In any particular fund, the investor base is likely to be diverse in terms of type and geography. Interest payable to the fund will generally reduce the taxable profits of the portfolio company, subject to any domestic restrictions, in exactly the same way as interest payable on any third party debt. That interest will then be distributed to investors. Those investors may be resident in the same jurisdiction as the underlying portfolio company; they may be tax exempt pension funds or taxpaying financial institutions. Against that background, it seems extremely difficult to identify any concerted base erosion and profit shifting. Imagine a portfolio investment in Country A is funded with bank debt and shareholder debt. Interest payable to the bank will generally be deductible. If, however, the bank is resident in Country B, no domestic tax in Country A may be collected on the receipt. If interest payable to the fund is not deductible because it is paid in respect of related party debt, there may be no deduction in Country A but tax in Country A on any investors resident there. What is more, even if the portfolio company obtained a deduction for the interest payable to the fund, there may be more base erosion in Country A in respect of the bank debt than in respect of any interest which is distributed to investors resident there.

In terms of the targeted rule proposed in respect of connected or related parties, this is inherently unattractive for a number of reasons:

- generally, defining what should constitute a connected or related party for these purposes is difficult. Is a 25% interest in an entity the right measure? Does it create a cliff edge and an artificial barrier to increasing a shareholding in an entity from below 25% to 25% or above? How should transparent entities, such as partnerships be dealt with – on a look-through or single entity basis;

- in relation to (i), the disallowance of all interest payments to connected and related parties may not be appropriate:
  - where a shareholder or a person connected with that shareholder acquires or holds a tranche of what was originally third party debt, alongside genuine third party lenders. It does not seem right that in those circumstances part of the interest costs on the third party debt should cease to be deductible;
  - where a lender becomes a shareholder of the group on an insolvency or restructuring event and part of the original loan remains outstanding or is restructured and remains held by the lender – a relatively common scenario over the last few years; or
  - in the context of a debt fund, where, as set out above, underlying debt assets will be acquired through a special purpose company funded by way of loan notes so that there is an effective pass-through of interest. Creating a substantial taxable
profit in the special purpose company would be completely disproportionate to the economic activity carried out there;

- in relation to (ii), allowing deductions only in respect of interest paid to connected or related parties subject to a minimum level of taxation on the receipt cannot be the right way to determine whether interest expenses should be deductible or not for the reasons set out in Action Plan 2 in relation to Hybrid Instruments. This is particularly relevant in the context of private equity funds, which are often structured as tax transparent limited partnerships, and deductibility would then turn on the composition and status of the investors from time to time. It would be extremely difficult to apply this rule in a private equity context, where information about the precise tax treatment of income received by fund investors is not generally available to fund managers or indeed to investee companies. Either there is base erosion and profit shifting going on or there is not. The fact that the recipient is not subject to tax on interest receipts may be indicative of base erosion and profit shifting but the issue cannot turn on that as a matter of principle;

- in relation to (iii), a fixed ratio is unattractive for the reasons set out above in relation to Chapter IX.

Chapter XII – Carry Forward

We believe that interest expenses disallowed under a general limitation rule should in principle be capable of being carried forward and set against profits in future periods for the reasons given in Part B of Chapter XII, i.e., if as a matter of policy interest expenses are deductible up to a certain level, anything below that should not be capable of constituting base erosion or profit shifting.

We also believe that any restrictions on the carry forward of interest expenses following a change of control should be limited, e.g., only where there has been a fundamental change in the nature of the business or the losses are to be used in sheltering profits of an unrelated group business. This may be particularly relevant in a private equity context where there has been an investment in business which is expanding or requires significant capital investment and carry forward losses may be significant at the point of sale but future trading is expected to be strong. It would seem odd in those circumstances for those carry forward losses to cease to be available to set against the future profits of the business.

Chapter XIII – Specific Sectors

Some of our members are active in infrastructure and real estate. It is critical to them that the sector specific issues raised in Chapter XIII in relation to those two asset classes are properly addressed. Infrastructure and real estate development are key to future growth, both in developing and developed countries where there are increasing populations and infrastructure needs. Increasing the cost of capital and reducing returns for investors in these sectors would reduce investment.

It is also very important that debt funds are considered in the context of financial sector businesses other than banks and insurance companies. As set out above, underlying loan assets are typically acquired by a special purpose company, which itself is funded by loan notes issued directly to investors or through a fund vehicle, e.g., a limited partnership. Direct lending funds and funds operating in the secondary debt market are critical to the supply of credit in the wake
of the banking collapse. Introducing additional costs into those structures by denying tax relief for interest expenses would risk reducing investment in that area.

Grandfathering

Many existing financing arrangements have been entered into on the basis that deductions will be available in respect of a specific level of interest expense over the life of the financing. If any of the proposals set out in the paper are introduced without any grandfathering provisions in respect of existing arrangements and those proposals result in a reduction in the amount of interest which is deductible, financial covenants under those financing arrangements could be breached and the ability of the borrower to refinance those arrangements would be severely limited.

We would therefore ask that grandfathering provisions be considered as part of any best practice recommendation or proposal in respect of Action 4.

Alternative Solutions

We note that transfer pricing and the arm’s length test were specifically excluded from this consultation process.

We do, however, believe that transfer pricing and the arm’s length test represent the most effective and appropriate way of addressing the policy objectives of Action 4, in conjunction with (and given the existence of) existing domestic restrictions on the deductibility of interest and some of the other workstreams being undertaken as part of the BEPS Project. Transfer pricing does not result in all the arbitrary distortions and anomalies potentially created by group and fixed ratio tests and targeted rules in respect of connected and related party debt. It is flexible and adaptable to industry sectors and funding requirements. It is also more consistent with the wider country-by-country reporting proposals and the policy objective of more closely aligning taxable profits in a particular jurisdiction with the economic activities carried out there.

We acknowledge that countries may be nervous that they do not have the expertise or knowledge necessary to be able to carry out a proper transfer pricing exercise in respect of financing arrangements and that they may have to invest in it. That should, however, be no bar to adopting this proposal from a policy perspective, if it delivers a more appropriate outcome.

Conclusions

To conclude, therefore, our key observations on the Discussion Draft are as follows:

• interest should be regarded as an ordinary business expense and generally deductible for tax purposes;

• it is important that any limitations on that general principle do not create artificial or arbitrary distortions across borders and different industry sectors and between companies and groups depending on how they are held and by whom;

• it is also important that any limitations do not create uncertainty or place an unduly significant compliance burden on companies and groups;
• the group and fixed ratio tests are largely arbitrary and artificial because they do not reflect the subtleties of different industry sectors, geographies and markets. Nor, arguably, are they fit for purpose because the existence of a cross-border intra-group loan or the existence of interest expenses in excess of a fixed ratio does not necessarily mean that base erosion and profit shifting is taking place, which is the focus of the paper;

• some of the shortcomings of the group and fixed ratio tests are highlighted by the recognition in the paper that they are not really appropriate in the context of certain industry sectors;

• some of our members are active in those sectors – infrastructure, real estate, finance (debt funds) – and they are very keen to ensure that investment in those areas is not adversely affected by any proposals which may come out of Action 4;

• the group wide tests will only work well if they are applied internationally on a consistent basis and can accommodate (or adapt to) the manifold and varied domestic restrictions on interest deductibility currently in existence around the world;

• it is very important that, if any group wide tests are recommended, the identification of the relevant group is clear and that, in the context of private equity and venture capital, neither companies owned by the same private equity fund nor funds managed by the same firm should be connected or grouped for these purposes;

• if fixed ratios are to be benchmarked by reference to the financial position of very large multinationals, we would recommend a carve-out or more appropriate benchmark for small and medium-sized enterprises;

• the targeted rules in respect of connected and related party debt are of particular concern to private equity and other private funds because, again, the tests seem arbitrary and could create distortion. It is also not clear to us that related party debt in the context of private equity and venture capital ordinarily results in the base erosion and profit shifting which is the focus of BEPS Action 4 and it should not therefore be affected;

• the grandfathering of existing arrangements needs to be addressed otherwise financial covenants in respect of those arrangements could be breached upon the introduction of any new regime;

• transfer pricing does in our view offer, in conjunction with existing domestic provisions, the more appropriate means by which to address the policy concerns which are the focus of Action 4 – i.e., what level of interest deductibility is appropriate in any particular entity before it begins to result in base erosion and profit shifting. We note from the Discussion Draft that the arm’s length principle has been excluded from this consultation process. We do, however, believe that, in light of the distortions and uncertainties that are likely to accompany any of the proposals, two outcomes the Discussion Draft is clear from a policy perspective it wants to avoid, it does have a place in this discussion. It can accommodate differences in sector, geography and size and should therefore provide in any particular jurisdiction a much better guide as to what level of interest deductibility should be regarded as appropriate, it is consistent with the wider country-by-country reporting proposals and the alignment of profits with economic activity and it does not
subject interest expenses to a potentially completely different regime to other ordinary business expenses; and

- if any of the proposals considered in the Discussion Draft are developed further and put forward as best practice recommendations, we would suggest that existing domestic restrictions on interest deductibility which go beyond the restrictions contained in those recommendations should be withdrawn to enable interest costs in a group to be aligned (on a deductible basis) with its more profitable geographies.

Please let us know if you would like us to expand on any of the themes explored in this letter or would like any further information from us.

Yours faithfully,

David R Nicolson

Chairman of the BVCA Taxation Committee
BPF response to OECD Public Discussion Draft “BEPS Action 4: Interest Deductions and Other Financial Payments”

Introduction
The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

Background
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.

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.

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 approximately £683bn. 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.

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 the built environment.

We share the concerns of the G20 and the OECD that action is needed to prevent cases of low or no taxation associated with practices that artificially segregate taxable income from the activities that generate it. However, the use of debt by real estate businesses is driven overwhelmingly by bona fide commercial considerations rather than being tax motivated. We are therefore keen to ensure
that any measures to counter interest-driven BEPS are properly targeted and do not disincentivise investment in real estate.

**Key points**

- Real estate investment is a highly capital intensive activity and as a result involves considerable use of debt finance. This boosts investment in our built environment and supports the real economy by providing space for people to live, work and play.

- Curtailing the tax deductibility of interest will increase its post-tax cost and make real estate investment more expensive, which may reduce the contribution that real estate can make to the economy.

- As a matter of principle, all genuine third part debt should be tax deductible. Non-recourse debt secured against a specific asset – as frequently used in real estate investment - poses a very low risk of BEPS and as a result should not be subject to a restriction on deductibility.

- The group allocation and fixed ratio approaches both have their intellectual attractions, but neither respects the circumstances of individual entities. Also, their practical implementation will either result in a horrendous administrative burden or discrimination against capital intensive industries.

- The funding structure for each individual property is unique to the particular asset and the relative risks associated with it. Accordingly, we are strongly supportive of the arm’s length approach, supplemented by appropriate targeted rules.

- Certain real estate investment structures (e.g. REITs) are already subject to an interest cover test. Imposing a further restriction on their interest deductibility makes no sense.

**Structure of this response**

Our response focuses on two key themes: the commercial drivers behind the use of debt by real estate businesses and specific comments on the Action 4 proposals. The key themes are elaborated further in the appendices to this letter:

- **Appendix 1**: How and why real estate investors use debt finance
- **Appendix 2**: Comments regarding BEPS Action 4 proposals

We would welcome the opportunity to discuss the contents of this submission in more detail. We remain at your disposal should you have any questions or require further details.

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Appendix 1: How and why real estate investors use debt finance

What is real estate investment?
All individuals, most businesses and central and local government all require real estate. Some own and manage their own real estate, while others lease business or residential premises from property owners. The decision to own or lease depends on financial position, relative requirements for stability or flexibility, market conditions and many other considerations.

The real estate industry is typically understood to cover businesses whose primary business revolves around physical ‘bricks and mortar’ real estate development (or redevelopment), and rental income generation and growth over the medium to long term. However, it can also include others, such as those who buy property with a view to a quick sale at a profit (either following development or not); and those who gain economic exposure to property indirectly (for example by acquiring mortgage backed securities, shares in property companies or units or other interests in collective investment vehicles).

It is very common for commercial property to be rented, rather than owner-occupied. In the UK, around 61% of commercial property is separately owned and occupied, compared to only 32% of residential property. Those proportions can differ considerably in different countries, but the prevalence of separate ownership and occupation of commercial property is a natural consequence of the fact that commercial property is expensive to acquire and relatively slow and costly to buy and sell, whereas most businesses often want to be able to alter their property footprint easily and quickly as the size, strength and needs of their business change over time.

It is particularly important for smaller businesses and many retailers to be able to change their property holdings as business conditions change, so commercial property in these sectors is commonly owned by professional property businesses and rented out to the occupier businesses. Without this flexibility, businesses would have to tie up considerable amounts of capital in their own premises, rather than being able to use it to grow and develop.

Who invests in real estate and why?
Investors in commercial real estate are a diverse group, ranging from institutional investors such as pension and sovereign wealth funds to individual retail investors. Ultimately, however, the majority of investment into commercial real estate in the UK (and in most mature economies) provides pensions and savings for ordinary households around the world.

Real estate is attractive to investors as it has relatively low correlation with other asset classes and therefore offers healthy diversification characteristics. It also has the capacity to deliver relatively stable income returns over the medium to long-term (particularly attractive for matching the long-term liabilities of pension funds and insurance companies) as well as the prospect of capital appreciation. Historically, UK commercial property has delivered a total return of between 5 and 10%, lower than returns from the FTSE but higher than those provided by UK government bonds.

The role of debt in real estate investment
Real estate is by its nature a very capital intensive industry. The amounts of money required to purchase large plots of land in prime city locations, acquire construction materials to redevelop the
site, employ contractors to build the asset and maintain/manage it over the long run are fairly self-evidently enormous.

It can also be a risky business; society evolves and the ways in which it uses real estate are constantly changing (e.g. the rise of online retail forcing retailers to streamline their outlet numbers, or remote working technology and cloud computing reducing the demand for office space). Changes in occupier needs and tastes mean that buildings have a limited lifespan and require constant attention and renewal.

Real estate investors deal with these challenges by arming themselves with robust and flexible capital structures. The precise composition of these – and the mix of different types of equity and debt capital – will reflect the overall investment objectives and risk profiles of individual assets or portfolios.

The tax deductibility of debt generally reduces the post-tax cost to borrowers which is clearly a factor which makes it attractive for real estate investment. However; it is far from being the sole driver behind its use. To a greater or lesser extent almost all commercial real estate investors make use of debt finance, for a number of powerful commercial reasons set out below:

- **Debt is vital to equity constrained investors** – in common with most types of businesses, the availability of equity capital for real estate investors is often limited. Debt finance opens up investment opportunities that would otherwise not be possible, and this helps to drive economic growth.

- **Debt allows for greater risk diversification** – borrowing money means you can afford to commit less equity to individual assets and can gain investment exposure to a greater range of assets. This reduces the vulnerability of portfolios and helps to smooth overall returns.

- **Debt is more flexible than equity** – in particular, debt can be more easily drawn down over time than can equity and this is particularly important in the context of real estate development. Borrowing arrangements can also be tailored to reflect individual circumstances and can be periodically renegotiated. The greater accessibility and flexibility of debt allows funding to be provided to investment opportunities more quickly which ultimately facilitates quicker economic growth.

**Debt can facilitate the repatriation of income to investors** – many countries impose restrictions on the amount of equity capital that can be returned to investors in a particular time period. For instance, under Swedish law, companies may only provide dividends to shareholders once a year based on the latest adopted balance sheet i.e. interim distributions based on current year’s profit are not allowed. Intra-group lending arrangements make it easier to provide returns to investors, who may require these on a regular basis in order to meet their own liabilities as they arise.

**Debt in real estate investment structures**

Real estate debt is almost invariably provided by third parties unconnected to an investor. It can either be secured against a particular asset or set of assets (the security pool), or it can be unsecured, made by the lender on the basis of the strength of the borrower’s covenant.
Secured debt is generally cheaper, as it is less risky to the lender, who in the event of a default can take possession of the secured asset(s) in order to make good the loan amount. However, secured debt is generally more restrictive for the borrower, whereas unsecured debt tends to be more flexible. From the lender’s perspective, secured debt does not generally give recourse to the borrower’s group or wider business, but just to the asset(s) on which it has been secured.

Debt can broadly be structured as either a term loan to a business or as bonds/debentures issued by the business. Providers/buyers of debt to real estate businesses include UK and overseas banks, insurance companies, debt funds, pension funds and other institutional investors. Businesses also use revolving credit facilities and overdrafts to manage shorter term/working capital cash flow needs. Generally speaking, secured debt exists at the level of a property holding company (usually a special purpose vehicle, or SPV) and is often secured against a single asset. However, secured debt may also exist at the holding company level; security being provided by that company’s assets (and ultimately, control over the totality of the property portfolio). In such cases it is normal for intercompany loans to exist between the holding company and the SPVs.

Unsecured debt is more likely to exist at a higher level in the structure, for instance the master-feeder vehicle or – particularly in the case of large corporate groups – it may sit within a specific treasury company. It is likely that intercompany loans would exist between the borrowing entity and the property holding SPVs at the bottom of the structure.

The exact mix of secured and unsecured debt used by an investor and where that debt sits in the investment structure varies enormously depending on the investor’s strategy, target returns and corporate culture.

An example real estate investment structure is illustrated overleaf. Real estate investment structures are designed to ensure that investors pay no more tax than if they had invested in property assets directly, while affording them the all of the benefits of collective investment (economies of scale, risk spreading etc.). Typically, tax will be paid on rental profits, property gains, transfer taxes etc in the jurisdiction in which the property is located. As a result, real estate funds are generally structured in a tax transparent manner that involves multiple tiers of legal entities.
Example real estate investment structure

Investors
(Diverse range of investors from multiple jurisdictions)

Fund vehicle
This vehicle is usually a transparent entity. Investors like to invest in a transparent vehicle to ensure that they are taxed according to their individual tax attributes.

Holding Company
A holding company is required in order to consolidate all of the underlying real estate investments. The administration and financing of the property portfolio may also be carried out by the holding company.

It is not uncommon for a local holding company to be used in the same jurisdiction as the investment, as illustrated with the investment in Country A.

SPVs and investments
Individual real estate assets are often directly owned by a special purpose vehicle or holding company, often (but not always) in the same country that the asset is located. This allows flexibility when selling the asset e.g. the ability to sell a proportion of the asset rather than the whole asset. It also allows for specific borrowing at the level of the asset if required.
Appendix 2: Comments regarding BEPS Action 4 proposals

Support for the arm’s length principle
We understand that operating the arm’s length principle in the context of interest deductions can be challenging, particularly where taxpayers or tax authorities lack experience of pricing financial instruments. It can also result in relatively subjective outcomes, as the same fact pattern may be interpreted in slightly different ways, resulting in a different tax outcome.

However, in our view these characteristics are more than outweighed by the intellectual soundness of the overall approach and the fact that it is practically workable. We are therefore strongly supportive of using the arm’s length principle to mitigate the risks of interest-driven BEPS and would recommend that its use is retained rather than implementing an alternative.

Furthermore, while some of the proposals put forward in the Public Discussion Document may appear at first glance to be simpler to apply than the arm’s length test, they are likely to be very difficult indeed to work with in practice. Simplicity can also lead to arbitrariness and the application of a ‘one size fits all’ model that discriminates against certain industries and fails to respect the particular characteristics of a given situation.

To the extent that the arm’s length principle is felt to be too difficult to apply to interest deductions, surely the first thing to consider is what further support can be given to those tax payers and tax authorities that struggle with it. As we outline in the following sections, there is no guarantee that alternative approaches will be any easier to deal with or indeed, any more effective at countering BEPS.

What is interest?
We have no comments in respect of the suggested payments which should be treated as economically equivalent to debt. In order to address BEPS effectively, it is important to ensure that different kinds of financial transactions are treated consistently across jurisdictions.

Who and what should a rule apply to?
Any rules that restrict the tax deductibility of debt should not apply to genuine third party lending arrangements. In other words, a restriction on tax deductibility should not apply to instances akin to Scenario 4 in paragraph 38 of the Discussion Draft. Where a third party lender is prepared to lend to a non-related entity, there is unlikely to be a risk of BEPS and therefore any restriction placed on these arrangements would distort genuine commercial behaviour.

We also consider that any rule should refer to the level of interest expense rather than the level of debt. As the Discussion Draft rightly identifies, the extent of interest-driven BEPS is dependent on the cost of borrowing rather than on the amount borrowed.

Any restriction on interest should be applied to net rather than gross interest expense, as otherwise there is a considerably risk of double taxation across an investment structure as profits are repatriated to ultimate investors.

It seems sensible to apply a small entity threshold to reduce the administrative burden on both small businesses and tax authorities. We would recommend that the threshold is based on net interest
expense. Alternatively, the small entity threshold could be applied in accordance with the small entity definitions already applied in domestic legislation, although it is likely that the protection from interest-driven BEPS provided by such an approach would not be as robust as a threshold.

**Group-wide tests**

Conceptually, a group wide allocation rule seems like an appropriate approach because all third party debt should be tax deductible and the rules allow for a tailored approach for different companies/industries. However, in practice, there are significant constraints which make the group wide allocation rules highly undesirable and impractical.

One of the principal concerns with a group wide approach is that it fails to recognise that different countries have different borrowing conditions and interest rates and therefore, the amount of interest paid in one country is not comparable with interest paid in another country. Indeed, the amount of interest paid can fluctuate even within a country e.g. if a bank is more willing to lend against assets in a particular city or region. Therefore, the reality of where cost arises is effectively replaced with a stylised allocation that may – depending upon individual circumstances – unjustly penalise certain entities in an investment structure.

This approach could also result in fiscal ‘cross contamination’, where the post tax profitability of an investment is affected by the income or capital value characteristics of other investments. This will mainly happen within individual groups, but may affect external investors.

For instance PropGroup A (investing alongside PropGroupB in a joint venture), may see its returns from the joint venture affected by the change in value of an asset (or interest expense, or earnings, depending on the approach taken) elsewhere in PropGroup B’s group. That is totally outside of A’s control and impossible to reasonably plan for. Joint venture arrangements are a very common way of investing in real estate as they allow for risk sharing and pooling of expertise. A group allocation approach could make such arrangements less attractive by introducing significant amounts of tax uncertainty.

From an administrative perspective, the notion that one group company will have timely information on the whole group’s third party debt and earnings/asset values – and then be able to allocate and enforce these among all of the relevant group companies is highly problematic. That’s not to say it can’t be done, but the resource implications for those responsible for tax compliance are significant.

It will also be very hard for multinational groups to compare interest expenses and asset values where group company accounts have been prepared under different accounting standards or where the entities involved have different year ends. Overall then, we consider that the resource required to comply with a group wide approach would be disproportionate and prohibitive.

**Fixed ratio rules**

This approach has the benefit of being administratively simpler for both tax payers and tax authorities than a group allocation method. However, we consider that the approach is too crude and totally unreflective of the way that different industries make use of debt finance. In our view, the arguments against a fixed ratio approach set out in Paragraph 149 of the Discussion Draft are wholly on point and reason enough to give no further consideration to this approach.
It is inevitable that whatever threshold is chosen will to a certain extent be arbitrary and will ultimately negatively impact capital intensive industries that rely heavily on debt - such as real estate - more than other industries. It is not uncommon for banks to lend up to 80% of the value of an income producing real estate asset. Therefore, allowing a maximum interest deduction of only 30% of earnings would in some cases considerably increase the post-tax cost of using debt finance.

Notwithstanding the above, if this approach were to be adopted, we consider that the fixed ratio should be measured by reference to earnings rather than asset value as earnings are more reflective of a company’s ability to cover their interest expense. However, this approach would not work for assets suffering from periods of no tenancy or redevelopment assets that do not provide an income stream. Therefore, the approach would need to be flexible to allow for appropriate ratios for different situations.

The approach will also result in a lack of certainty over the level of interest that will be tax deductible, particularly where there is any volatility on earnings or interest expense. This will be hardest to manage for capital intensive industries where interest expense accounts for a larger proportion of total costs.

Ultimately, whether or not a company is “highly leveraged” depends on the specific business in question and therefore, it would be impossible to set any threshold without giving a competitive advantage to those companies which do not require as much debt financing. Indeed, a fixed ratio may even provide an incentive for companies to leverage up to the arbitrary threshold.

A combined approach
As noted above, we consider that both the group rules and the fixed ratio rules have significant limitations and would be inappropriate solutions to addressing BEPS. Combining these rules would not address the inherent limitations identified in either of the approaches and therefore we would not recommend the combined approaches outlined in the consultation.

Targeted rules
We consider that an arm’s length test combined with a series of targeted rules would be far more effective at countering BEPS than the fixed ratio rule or group rules outlined in the consultation. Targeted rules would allow tax authorities to deploy their resources where there is the biggest risk of BEPS. This approach also reduces the risk that certain industries are unfairly punished merely as a result of being structurally more reliant on debt finance.

In order to use tax authority resource more effectively, there could be mechanisms in place for tax authorities to share examples of complex transactions which pose a risk of BEPS and examples of targeted rules to counter them. In addition, initiatives like country-by-country reporting should help tax authorities to more effectively identify higher risk structures and take appropriate action.

We consider that the list on page 56 of the Discussion Draft of arrangements associated with a high risk of interest-driven BEPS is a good starting point on which to base a set of targeted rules. In respect of the risk of BEPS posed by interest payments made to connected and related parties (first bullet point in paragraph 181) we would argue that the approach ii) is the most practical (a deduction for interest should be allowable providing that the recipient is subject to a minimum level of taxation).
The type of abuse which results in a deduction but no corresponding including will likely be addressed under BEPS Action 2 (hybrids). However, it is important to note that where a payment is made to an entity that is exempt from tax on the income it receives (like a pension fund or sovereign wealth fund); the rules should not restrict the corresponding deductions on payments made to these entities.

**The role of non-deductible interest expense and double taxation**

We would strongly support a mechanism for carrying forward non-deductible interest expense. This is especially important in the context of real estate development where a particular property may go through periods of yielding no income (for instance if it is being developed or refurbished) and yet interest will accrue on the associated debt. It would be only fair to allow that expense to be offset against any future income from the property. Some larger real estate development projects can take significant amounts of time, and as such, we would not recommend imposing a time limit on when the carried forward deductions should be utilised by.

**Sector-specific considerations**

The OECD recognises the need to consider the impact of interest limitation rules on certain industries, such as infrastructure projects. Such considerations arise because the two principal approaches suggested in the Discussion Draft do not take sufficient account of individual business and industry circumstances. In particular infrastructure projects tend to be highly leveraged over long time frames and therefore any rule needs to provide an appropriate solution for this sector, while not creating any arbitrage opportunities.

Real estate investment is in many ways analogous with infrastructure projects. Both are highly capital intensive, large amounts of debt can be secured against specific assets and the investors often favour lower risk, regular income returns over the long term. As such it may be appropriate to allow a tailored approach or carve out for all capital intensive industries.

However, any sector-specific approaches will suffer from real definitional challenges and this might make them difficult to apply in practice. We have proposed two possible suggestions to define real estate businesses below:

- An entity or group whose balance sheet comprises more than 50% real estate. This approach would still pose issues for property developers – unless it is possible to include value of work in progress as a ‘good asset’.

- An entity of group whose income primarily (75% or more) arises from real estate. A real estate business would consist of generating income from land, but any definition would need to be sufficiently wide to cover real estate development.

While it will generally be obvious whether a particular business is or not involved in real estate investment as its main activity, there will be numerous instances where it is not at all clear. Accordingly, we consider that the best way to recognise industry idiosyncrasies while protecting against interest-driven BEPS is to apply the arm’s length principle.

Finally, we would highlight the existence of certain real estate investment vehicles that are subject to special taxation regimes and for whom a restriction on the deductibility of interest poses
particular challenges: REITs (Real Estate Investment Trusts) and PAIFs (Property Authorised Investment Funds).

REIT regimes have been introduced in many jurisdictions around the world and are structures specifically designed to allow investment in real estate in such a way that the tax impact for the investor is similar to that which would arise if they invested in the property directly.

In order to qualify for this special status, REITs need to comply with a number of conditions set by tax authorities. One of the most prevalent is a requirement for REITs to distribute to investors on a yearly basis a large proportion (in the UK, 90%) of the profits from their property rental business. Such distributions are generally subject to a withholding tax, which ensures that investors pay tax in the country where the REIT is resident.

In calculating the profits of their property rental business, REITs are generally allowed to offset their financing costs – at least to the extent that their earnings sufficiently cover those costs (in the UK, earnings must be 1.25 times financing costs). Given that they are already subject to an interest cover test, it would be excessive to impose on REITs another restriction on interest deductibility.

If a further restriction were imposed on the tax deductibility of interest this would have no bearing on the amount of tax that REITs pay (they are not generally subject to corporate tax on most of their activities), but it would affect the amount of profit to that needs – by law – to be distributed to investors every year.

It is likely that such a restriction would lead to a requirement to distribute more profits than under the current rules and this would affect REITs’ ability to reinvest profits into their businesses. It may also affect their ability to control dividend payments to investors and contribute to more unpredictable cash flows.

PAIFs are another property investment vehicle in the UK which is subject to a specific tax regime. The regime is very similar to the REIT regime, but provides an alternative open ended investment structure. Therefore, the concerns outlined above for REITs and particularly the complexities that would arise on calculating the property income distributions will also be applicable for PAIFs.

Neither the proposed group rules nor a fixed ratio approach is likely to easily accommodate structures like REITs and PAIFs. We would therefore reiterate our support for the arm’s length principle, which is sensitive to individual business circumstances. Failing that, REITs and PAIFs should not be subject to a further restriction on their ability to deduct interest for tax purposes.
We welcome the Discussion Draft “BEPS Action 4: Interest Deductions and Other Financial Payments” and thank you for the opportunity to comment on it.

In our view, a group-wide test should be the best practice recommendation in the final report on Action 4. A group-wide test is based on the proposition that a multinational enterprise’s total net deductible interest should not exceed the interest, if any, it pays to third parties and should be deducted in the jurisdictions in which profits are earned. This is consistent with the goals of the BEPS project and with the G20 Leaders Communiqué delivered at the Brisbane Summit on 16 November 2014. It is a structural rule, not just one aimed at avoidance, and is supported by tax policy and academic scholarship to which we refer in the last section of this document.

We generally agree with the proposed features of such a rule that are set out in the Discussion Draft, subject to the comments we make below on these topics:
1. Excluding intra-group dividend income from EBITDA for the purposes of calculating entity earnings.

2. The replacement of the proposed combined approaches described in Chapter X of the Discussion Draft with group-wide thresholds, or the sunsetting of fixed ratio alternatives.

3. Allowing countries to offer a deemed interest approach (subject to safeguards) and an interest cap, reducing incidences of unused capacity and the reliance on carry-forwards.

4. Mutual recognition of the group of countries which adopt this rule, with simpler rules applying to transactions between these countries and cooperation between their tax administrations in applying the rule.

5. The need to ensure that BEPS strategies frustrated by a group-wide rule are not reborn using other forms of intra-group payment such as royalties, or payments just outside the boundaries of the relevant definition of interest and financing payments.

In the second half of this document we explain why, in our view, Action 4 would remain important even amongst widespread adoption of Action 2 on hybrids, we concur with the rejection of arm’s length tests and we refer to the policy principles which underpin a group-wide rule.

2. Discussion of some specific design features

2.1. Intra-group dividend income

In our view, intra-group dividend income should be excluded from EBITDA for the purposes of calculating entity earnings. This is for the reason in paragraph 108 of the Discussion Draft – because non-portfolio dividend income is often taxed preferentially – but also because not to do so would effectively multiply items of EBITDA and thereby interest deductions. The group-wide EBITDA from which the group-wide ratio is calculated is consolidated. It does not include dividends internal to the group. Whereas the EBITDA in each jurisdiction (or for each entity), if not adjusted, could include both amounts earned in that jurisdiction and dividends representing amounts earned in another jurisdiction. The latter amount would contribute to the earnings base by which the interest cap (or allocation) is calculated in both jurisdictions, duplicating the interest deduction where there is only one item

\[1 \text{ It will not be an exact duplication as the relevant dividend will in most cases be less than the underlying EBITDA amount.}\]
of underlying earnings. The net result would be total interest deductions which exceed the group’s third party interest cost.

Distortions that can arise from intra-group payments are considered in paragraphs 112 to 114 of the Discussion Draft but in the context of amounts which are largely symmetrical, that is, included in the earnings of one member of the group and subtracted from the earnings of another. However, it may be worth clarifying how intra-group dividends, which are asymmetrical, fit into that analysis.

### 2.2. Combined approaches and de minimis threshold

It is not clear that either of the two main forms of combined approach described in Chapter X of the Discussion Draft will be useful in situations where, as contemplated in that chapter, some entities in the group are inside the carve-out and others are outside it. This is because the group-wide ratio will have to be calculated regardless, in order to be applied to the entities subject to the general rule (under Approach 1) or the carve-out (under Approach 2). It is the calculation of the group-wide ratio that is said to add the complexity that is sought, in Chapter X, to be reduced. Once the group-wide ratio is calculated, it is just as easy to apply that ratio to the other entities in the group as it is to apply a fixed ratio.

The above will only not be so if countries adopt substantially different definitions of group-wide earnings and group-wide interest, an outcome that should be strongly discouraged and one that is in any event is less likely than variations in the calculation of local earnings and interest. Cooperation between the tax authorities of the countries adopting the group-wide rule, as discussed below, will ensure that tax authorities do not need to “reinvent the wheel” in calculating a multinational enterprise’s group-wide ratio, and may lead to a group-wide rule in fact being less onerous to apply than fixed ratio rules.

Of course, if the rule is introduced in countries in a staggered way, it may be sensible to allow an alternative (but relatively low) fixed ratio option, such as the 10 per cent option in the group-wide rule proposed in the United States budget announcement dated 2 February 2015.² If only one country has the rule, the likelihood of the multinational enterprise (and tax authorities) not needing to calculate the group-wide ratio at all is higher, so the compliance gains from a fixed ratio alternative are more substantial. However, since a group-wide ratio is inherently suited to adoption by multiple countries, and given the objective of Action 4 to set out a best practice standard for OECD and non-OECD countries to adopt, the prospect of sunsetting fixed ratio alternatives should be considered.

We agree with the adoption of a de minimis threshold under which groups are not subject to the rule at all. A stepped approach, under which a second, higher threshold

encompasses groups which can choose to apply a fixed ratio rule safe harbour rather than the group-wide rule (but on a group-wide basis, not entity-by-entity or country-by-country) is a further possibility which may achieve the objectives sought in Chapter X without cherry-picking. These thresholds should be applied at the group level, not the entity level.

2.3. Deemed interest rule

The Discussion Draft compares a deemed interest model with an interest cap model and proposes in paragraph 77 that the latter would be the recommended approach. The main reasons given for this preference are that some countries do not permit deemed deductions and that a deemed interest rule creates double deductions if not all relevant countries apply a group-wide interest limitation rule.

The Draft also recognises advantages of a deemed interest model, though, particularly its simpler administration and the ability for entities to consume interest “capacity” without needing to change their intra-group funding or rely on carry-forwards.

We propose that countries in which deductions for deemed amounts are legal should be able to offer companies a choice between the deemed interest or interest cap approach. Significant safeguards would need to accompany an election in favour of deemed interest, however. The company would have to show that, for example, the relevant interest payments are to entities in countries which also have a group-wide rule. We refer to the development of an informal group of countries cooperating in relation to the group-wide rule in the next section below. Or the entity could demonstrate that the total deductible interest of the group of which it is a member does not exceed the group’s third party interest cost, thus excluding the double deduction possibility.

2.4. Group of cooperating countries

The Discussion Draft refers in a number of places to the dangers posed to the effective or simple operation of the rule by countries in which the relevant multinational operates but which do not adopt a group-wide rule, or adopt an outlier form of the rule.\(^3\)

In our view, a group-wide rule of the variety proposed in the Discussion Draft is a prime opportunity for an informal grouping of countries adopting a similar rule to coordinate their compliance activities with respect to it.\(^4\) The nature of a group-wide

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\(^3\) Paragraphs 68, 75, 144 and 145.

\(^4\) The formation of “Like Minded Groups” in the international tax policy-setting arena has recently been suggested: H. D. Rosenbloom, N. Noked and M. Helal, The Unruly World of Tax: A Proposal for an International Tax Cooperation Forum 15 Florida Tax Review 2 (2014). Here, we propose grouping at the implementation stage because the policy development has so far been effective on a multilateral basis.
rule is suited to cooperation. Countries’ versions of the group-wide rule need not be identical to qualify for group membership. However, the differences should be minimised where possible, and justified (including by reference to domestic principles) where they are intractable.

This would not be an exclusive club. By reason of the staged way in which countries generally implement domestic law change, its membership would initially be small, but would grow as countries implement the rule.

The existence of this group could simplify the group-wide rule by allowing simpler rules for payments between these countries, for example in the situations referred to in paragraphs 75 and 145 of the Discussion Draft.

It would also facilitate the once-only calculation of certain key inputs into the relevant ratios (or even the ratios themselves), with the results of those calculations shared amongst the group, easing the anticipated complexity referred to in the Discussion Draft.

2.5. Coordination with respect to other potentially eroding payments

Action 4 should be developed in concert not just with the other action items referred to in the Discussion Draft, but also with those actions relevant to intra-group royalty (and similar) deductions. If opportunities for BEPS through interest payments are reduced as a result of Action 4, there will be more pressure on other forms of intra-group payment, particularly royalties and similar payments.

Attention will also need to be paid to the areas at the edges of the relevant definition of interest and financial payments in the group-wide rule, such as the distinction between operating and finance leases, to ensure the rule is not circumvented by largely formal recharacterisations.

3. Whether Action 2 on hybrids is sufficient

We do not think that the widespread implementation of Action 2 on hybrids would dispense with the need for reform under Action 4, for four reasons:

1. BEPS through interest deductions can be achieved without the use of hybrids, for example through a borrower company in a higher tax jurisdiction than that of the lender, or a lender in a tax loss jurisdiction. In these situations, interest deductions and interest income are each likely to be disproportionate to the economic activity in the relevant jurisdiction.

2. The common forms of rule presently existing – fixed ratio limits and arm’s length rules – have significant shortcomings which warrant a consideration of whether best practice would see them replaced with a different rule. In a
nutshell, as the Discussion Draft describes, fixed ratio limits are set too high for most companies, leading to excessive deductions, and too low for some companies, leading to the denial of deductions on amounts which effectively represent third party interest cost. Arm’s length tests are time and cost intensive, involve significant uncertainty and may inherently overstate interest deductions, as discussed next.

3. It is desirable to curb the double taxation and double non-taxation that results from the wide variance of interest limitation rules that presently exist.

4. A group-wide test of the variety described in the Discussion Draft would do away with traditional transfer pricing for intercompany loans and guarantees, leading to considerable compliance savings.

4. Arm’s length tests and transfer pricing of interest

We agree with the conclusion in the Discussion Draft that arm’s length tests should not form part of the consultation process. As stated in the Discussion Draft, such tests can be resource intensive and time consuming for both taxpayers and tax authorities, can lead to uncertainty and may be ineffective in preventing BEPS in any event.

For similar reasons an interest barrier rule which, like a group-wide rule, obviates the need to subject each related party loan and guarantee to a transfer pricing analysis is in our view desirable.

An example which illustrates both points is the recent case of Chevron Australia Holdings Pty Ltd v Commissioner of Taxation, which was heard in the Federal Court of Australia last year. Judgment is currently reserved. The case is a dispute over the arm’s length interest rate on an intercompany loan from a United States Chevron subsidiary to an Australian Chevron subsidiary. The correct arm’s length amount of debt for the taxpayer was also in issue.

The final hearing of the case took 21 court days; it was one of the lengthiest tax cases ever heard in Australia. 18 independent expert witnesses gave evidence, from the fields of corporate banking, CFOs and corporate treasury, leveraged finance, credit ratings agencies and advisory, economics, statistics, accounting, foreign law and the history of the transfer pricing guidelines. The majority of the evidence, and the court time, concerned the arm’s length amount of debt and arm’s length interest rate.

The experts differed substantially in their assessment of the taxpayer’s creditworthiness and, accordingly, the arm’s length amount and cost of its debt; a difference representing seven credit rating “notches” in some cases. The taxpayer was not rated but it argued that, hypothetically, it would have a sub-investment grade (“junk”) credit rating. The tax authority argued that the taxpayer would be investment
grade. The difference between these categories alone usually represents a significant difference, at arm’s length, in debt amount and interest rate.

The wide range of opinions held by the independent experts in that case illustrates the resource intensiveness, uncertainty and contestability of an arm’s length test, whether the test is applied to interest rate alone or to the amount of debt on which interest is deductible (and total interest). We pause to note that the process of calculating an arm’s length interest rate usually also involves, as a matter of financial logic, the calculation of an arm’s length amount of debt and total interest.

An arm’s length test also has an inherent tendency to overstate deductible interest, as it poses the hypothetical question of how much the taxpayer could borrow if it sought an arm’s length loan. It is financial orthodoxy that healthy businesses rarely borrow as much as they could, preferring to leave a large buffer to demonstrate to the market their robustness and flexibility. For example, large undrawn bank lines are ubiquitous in the financial reserves of multinationals. Borrowing up to a multinational’s maximum debt amount would also increase interest deductions exponentially because as a borrower’s amount of debt increases, the interest rate it must pay usually does too. Accordingly, this is not often done in the real world – but it can be done in the hypothetical world of transfer pricing and arm’s length thin capitalisation tests. Even if the transfer pricing question is, as some have interpreted it, how much would (not could) the taxpayer have borrowed, this still permits a hypothetical enquiry by reference to highly leveraged peers even where the taxpayer’s group itself has low third party leverage.

Some have argued that the maintenance of relatively generous interest barrier rules such as high fixed ratios or an arm’s length test is necessary in order to ensure that investments are economic. Insofar as this relates to large and long-term infrastructure projects, we agree with the suggestion in the Discussion Draft that special provisions may need to be considered for that sector. But as a general matter, if the factor that is making an investment economic is intra-group interest payments, or interest disproportionate the enterprise’s third party financing costs, this might prompt a review in any event of the economic efficiency of the project in question.

5. Group-wide rule and policy considerations

While interest limitation rules are often discussed in the context of the avoidance or reduction of tax by multinational enterprises, if applied in a balanced way they are also structural rules to ensure principled and predictable deductions for finance

charges across the jurisdictions in which the enterprise operates. They are also structural in the sense of mitigating the tax bias that prefers debt over equity,\(^6\) at least with respect to intra-group funding.

A group-wide rule of the variety recommended in the Discussion Draft implicitly recognises that intra-group debt is usually a close or perfect substitute for equity,\(^7\) so should not be subject to preferential tax treatment. The extensive scholarship on the difference between debt and equity identifies factors almost all of which\(^8\) break down when the debt is intra-group.\(^9\) Of course, there are sometimes internal treasury and regulatory reasons to prefer intra-group debt over equity. However, if debt is being used to repatriate in-substance profits to the parent company because it is more convenient than equity, then it resembles equity, not debt. The practical reasons for its use may be sound but it does not necessarily follow that the payments should be deductible.

A group-wide rule also recognises that the jurisdictional location of third party debt can be shifted to achieve tax outcomes and is not always fixed by purely commercial considerations. The empirical research referred to in the Discussion Draft suggests that intra-group and third party debt are often substitutable.

Various group-wide interest limitation rules have been proposed in academic studies.\(^10\) These models mainly feature debt-to-assets (leverage) ratios as the relevant benchmark. Leverage ratios have historically been the more popular form of fixed ratio in thin capitalisation regimes, although earnings ratios are now becoming as popular. Under the group-wide rules that presently exist as part of a number of

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\(^{8}\) Apart from the main factor, the tax deductibility of interest.


countries’ interest barrier rules the relevant benchmark is generally also a leverage ratio. However, as the Discussion Draft observes, an earnings ratio has significant advantages over a leverage ratio, and volatility in earnings can be mitigated by using rolling averages and carry-forwards. In our view an earnings ratio is an appropriate basis for the group-wide rule. The fact that there is no precise precedent\textsuperscript{11} does not make it a leap into the unknown as it would combine the existing group-wide rules referred to above with the increasing trend towards earnings ratio rules.

Submitted by email: interestdeductions@oecd.org


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.

In the BEPS Action Plan the G20/OECD has set out the aim to 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”.

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 “Interest deductions and other financial payments” 18 December 2014 - 6 February 2015 (hereinafter referred to as the Draft).

General Comments

BUSINESSEUROPE struggles with the overall aim of the published draft. There seems to be a general assumption, that intragroup interest are per se related to
base erosion and profit shifting. It is important to note that the vast majority of businesses do not use interest payments for tax avoidance purposes. As the OECD accepts the deductibility of interest paid to third parties, the question arises why the same interest paid to a related party should not be deductible.

Should the concern with intragroup loans be related less to the deductibility as such and more to the level of taxation at the receiving entity, maybe in combination with the appropriateness of the interest rate, then we suggest to clarify the relationship between Action 4 and the work done by the OECD on hybrids and CFC Legislation. BUSINESSEUROPE believes that the concern on low taxation of intra-group financing arrangements should be addressed by these two Actions as well as by transfer pricing regulations.

BUSINESSEUROPE therefore believes that the starting point for Action 4 should be that interest and other costs, such as derivatives and insurance payments, are legitimate business costs and should therefore be deductible. Restrictions should be limited to abusive situations without a good commercial rational. More international coordination on these restrictions would be welcomed if it reduces the burden of compliance, improves certainty for businesses and ensures that interest costs are deductible somewhere.

The choice between debt and equity is an important business decision, which is based on many different considerations. Legislation should not allow or require tax authorities to second guess business decisions.

Good commercial reasons exist why (intra-company) loans can be preferable to a contribution of equity. Loans are more flexible than equity and generally carry a lower cost of capital than equity. Dividend distributions remain subject to significant limitations in terms of timing and amounts; loans cater better for potential fluctuations in the need for capital; less formalities are required for reductions or increases of loans compared to equity, resulting in less administrative costs for financing.

Long-term investment is most likely to be encouraged in a balanced way by tax regimes that are efficient, consistent and predictable. BUSINESSEUROPE recommends that priority should be given to improving the investment environment through general tax regulations, which focus on raising tax
revenue as neutrally as possible. The efforts to remove distortions between the fiscal treatment of debt and equity should focus on improving the fiscal treatment of equity rather than impairing the fiscal treatment of interest costs.

In order to ensure flexibility of financing, arm’s length intra-group financing should not be subject to stricter rules than external financing. There should not be an “assumption of guilt” that taints intra-group financing costs. It is normal commercial practice to raise debt in the market through one legal entity that subsequently lends on to different legal entities in a group.

Efficient and flexible corporate financing is crucial to economic development and growth and should not be undermined. We urge the OECD to maintain tax deductibility for legitimate business costs, including financing costs, to focus on making existing legislation more fit-for-purpose, efficient and predictable and only to address situations where there is excessive debt in accordance with accepted business norms. We support the OECD in its endeavours to develop further transfer pricing guidance regarding the pricing of related party financial transactions.

Specific Comments

Regarding the concrete proposals contained in the Draft, BUSINESSEUROPE is pleased to provide the following comments:

Group-wide rules for limiting interest deduction

The Draft proposes to limit the group’s total interest deductibility by two factors:
  - the actual net third party interest expense of the group and
  - the allocation of the interest to corresponding economic activity.

BUSINESSEUROPE believes that such group-wide rules should not be pursued for a number of important reasons:

One prerequisite of a group-wide interest deduction rule is to implement the rule consistently throughout the world. A group-wide rule is, in other words, inconsistent with other – already existing – national rules. No major OECD country has implemented a similar rule yet and it does not seem highly probable
that a majority of G20/OECD countries will adopt a similar and thus compatible group-wide rule. Therefore the adoption of such a rule by one country would harm the competitiveness of companies falling under that jurisdiction compared to companies located elsewhere by creating increased administrative burdens and lead to double taxation.

Countries would have to agree to an approach defining which entities are covered by the rule, how net third party interest expense of a group would be calculated, and how an interest cap would be allocated between entities. The Draft notes that because the method for calculating an allocation-based interest cap would need to be agreed to by all countries, mismatches likely would arise where the agreed approach does not align with a country’s domestic tax system. This means, that even though the rules might be implemented in a consistent way throughout the G20/OECD countries, they would nevertheless be incompatible due to national tax law.

Regarding the group-wide interest allocation rule, BUSINESSEUROPE perceives this model as a fundamental systematic change. It would modify the traditional international tax system based on the arm’s length principle to a formulary system, with an allocation of the tax base following the “economic activity” or factors that are deemed to be a benchmark for it.

Aside from the conceptual points above, there are a number of practical problems with global group-wide tests. In this regard, BUSINESSEUROPE strongly disagrees with the assumption that adjusting the mix of debt and equity in a group of companies is relatively straightforward.

For example family owned companies are often predominately or fully equity financed because they regularly have a different dividend policy compared to publicly listed companies. They are not forced by expectations of the public / analysts to distribute a certain dividend amount. Family owned groups which are strongly equity financed and finance their group entities with inter-company financing would be discriminated without sound reasons against highly leveraged groups with debt push down. The discrimination would consist in a distortion of the competition on a local level. Direct competitors would not be entitled to the same tax deduction depending on how their top holding company is financed.
There are many more common scenarios where it is either (i) not possible to push debt down for legal/regulatory reasons, (ii) not commercial to push debt down notwithstanding tax, or (iii) tax leakage in the form of deduction denial and withholding tax on the debt.

- In some countries, the terms and usage of additional funding introduced by way of related party debt is restricted such that intercompany debt can only be introduced for certain prescribed activities. This is compounded under a global group-wide allocation. Under these rules, groups would be required to introduce intercompany debt into many countries with no obvious commercial requirement for additional finance. In these situations, it would be necessary for the borrowing company to return the money borrowed back to the lender by way of a series of dividends or reductions of share capital.

- Such transactions typically require various conditions to be satisfied (distributable reserves, solvency tests, impairment testing, third party creditor protection measures etc.) at each level to repatriate the money with potential additional tax cost in the form of dividend withholding tax at one or more levels.

- In situations with minority investors or a Joint Venture, introducing debt may not be commercially possible as third party investors/partners may not agree to the quantum/interest rate on the loans or the deductibility of interest for the minority Joint Venture partner depends on the group wide position of the majority partner. Lending to fund a dividend would unlikely be desirable as a proportion of the cash attributable to third party investors will be a net outflow for groups.

- A further issue would relate to managing foreign exchange exposure as it would require many groups to lend to countries with volatile currencies increasing external hedging costs (which will often make an allocation to secure a tax deduction unviable).

- Even where new intercompany debt can be introduced, there are countries where the associated finance costs will not be deductible for tax purposes. Some countries tax systems specifically deny tax relief for financing costs associated with returning money to shareholders. In some countries transactions which have a tax avoidance purpose fall foul
of anti-avoidance rules which would likely catch the sort of transaction necessary to allocate debt around a group.

The group wide allocation rule will likely be extremely impractical to implement for a number of different reasons:

- No. of entities to consider – MNCs often have hundreds of entities across dozens of countries.
- Interdependence – Interest deductibility in each country is dependent on not only the earnings and performance in the country but also on that of every other country that the group has presence in, which leads to
  - not being able to forecast the profitability of the country with any certainty and
  - having to amend the tax return every time something changes (as a result of tax audit or otherwise) in the tax position of other territories
  - question as to the level of documentation/evidence needed for tax authorities globally to be comfortable that the interest deduction being claimed by the group in their territory is accurate
- Particularly for year-end and interim reporting, tax numbers in any country could not be closed independently without understanding the group’s overall position which will add significant amount of time and work,
- Annual exercise of assessing and adjusting intra-group loan balances to align with earnings globally will also mean significant additional work for groups.

BUSINESSEUROPE considers that some of the inefficiencies could be addressed by ensuring that the fixed ratio is set at a reasonable level so that overall across the group, net aggregate deduction is capable of matching the group’s external finance cost once the difficulties associated with some countries are taken into account. Similarly, with the group wide allocation rules, flexibility could take the form of an allowance for deduction in any territory to exceed the interest cap (set by reference to the Group’s external finance cost) by say at least 30%.
Finally, BUSINESSEUROPE questions why highly leveraged groups should be treated more favourably for tax purposes. It should be noted that the still ongoing financial crisis was created by overgearing and inappropriate risk taking on leveraged financing activities.

**Fixed ratio test**

BUSINESSEUROPE considers that a fixed ratio test would be preferable to the group wide allocation rules, provided that it is well designed. A proper design can have the advantage of being simple, of giving more design flexibility to national legislators and of flattening business cycles.

Compared to group-wide rules a fixed ratio rule is mechanistic and as such tends to be simple to apply for companies as well as for tax administrations. In combination with a monetary threshold for small and medium sized entities, most legal entities subject to a jurisdiction would not even fall under the rules, which obviously would add simplicity.

Some countries have multiple tests, which include for example a group-wide debt-equity test. Contrary to the group-wide test presented in the Draft, this is merely an escape rule, in order to demonstrate that the financing of one entity is not exceeding the group ratio and therefore the interest not deductible under the fixed ratio regime should still be deductible. It is important to note that these group wide tests can be extremely challenging for Groups and therefore not suitable to allow for an escape in all cases even where this would be appropriate (e.g. for diversified Groups). Instead of a group wide test BUSINESSEUROPE therefore pleads for a Business Purpose test. Whenever a company can demonstrate that the interest expense has been incurred for a valid business reason, it should be deductible even when exceeding the fixed ratio threshold.

Regarding the design flexibility, with a fixed ratio rule there is no need for a worldwide identical implementation in various jurisdictions. For example it is not necessary to have exactly the same definition of interest in different jurisdictions.
However, the fixed ratio rules also have some of the shortcomings as the group wide allocation rules identified above such as inability to push debt into certain territories, potential non-deductibility of interest, withholding tax etc.

BUSINESSEUROPE advocates for the introduction of complementary rules that help smoothing out business cycles. The major cause for the above praised simplicity is at the same time the major concern with fixed ratio rules: its mechanistic nature. Being mechanistic it can in week business cycles lead to limiting the deductibility of interest even though a business has in no way used interest for tax planning purposes. In week business cycles, thus for reasons that are not projectable for businesses, EBITDA can be volatile. Therefore non-deductible interest should be allowed to be carried forward indefinitely as a limited period for e.g. five years may not be sufficient in smoothing out volatility in earnings. The same should apply to excess EBITDA capacity that has not been used to deduct interest. Those tax attributes should not be jeopardized in case of a mere change of control but only in case of abusive situations.

As various sectors of the economy (and taxpayers within such sectors) are different, BUSINESSEUROPE believes that taxpayers be given a choice to use either asset or earnings measures under a fixed ratio rule. Where earning is used, EBITDA should be used rather than EBIT. With regards to asset as a measure, BUSINESSEUROPE agrees with the concerns identified as to asset’s valuation e.g. market value vs. book value, value of intangibles – internally generated vs. acquired etc. Therefore, defining both measures appropriately and giving taxpayers the choice between the two is recommended.

Whether asset or earning is used as a measure under a fixed ratio rules, a fixed ratio rule with the ratio set too low would render it ineffective and unhelpful.

In our view the overall aim of a well-designed rule should not harm businesses that are not engaged in using interest as a mean of profit shifting and at the same time prevent the – from a point of view of tax administrations – excessive use of interest deduction. Different industries have differing profit margins as well as differing debt ratios. Therefore the fixed ratio should not be orientated towards the average of all businesses. It should be possible, under a fixed ratio regime, to deduct the interest on arm’s length levels of loans, calculated at arm’s length rates. BUSINESSEUROPE believes that further studies should be
undertaken to find out how this aim can be reflected in the percentage of the fixed ratio regime. We invite the OECD to have further consultations with the business community on this point.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on Interest deductions and other financial payments.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director Economics Department
February 6, 2015

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Dear Mr. Pross:

Re: BEPS Action 4: Discussion Draft on Interest Deductions

The Canadian Bankers Association\(^1\) (CBA) welcomes the opportunity to provide a submission to the OECD on BEPS Action 4 Discussion Draft: Interest Deductions and Other Financial Payments (the “Discussion Draft”) released December 18, 2014. We bring the perspective of an industry characterized both by intense competition in Canada and the active involvement of our banks internationally.

The CBA is committed to contributing constructively to the BEPS project, in the expectation that the final outcome will deliver fair, certain, predictable, sustainable and principled rules that taxpayers can easily apply and tax authorities can easily administer. The intention of the comments in this submission is to briefly highlight the main concerns the CBA has with the proposal in the Discussion Draft.

Over all, we believe that the proposals to restrict interest deductibility are ill-advised from an economic, policy and technical perspective. The BEPS proposals highlighted in the Discussion Draft would have a dramatic adverse effect on business financing and financial markets. For example, the proposals would have an adverse effect on the mergers and acquisitions market because of the unequal treatment of entities based on the characteristics of their groups. In addition, it is the CBA’s view that the scope of the proposals mentioned in the Discussion Draft goes well beyond the OECD’s mandate to address BEPS. We believe that any concern about different treatment of debt and equity is a broader policy matter that does not implicate BEPS. Any reconsideration of those policy choices should be addressed directly and fully, rather than under the guise of addressing BEPS. As such, Action 4 in particular should be much more narrowly targeted to address specific BEPS concerns.

\(^1\) The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada’s economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. [www.cba.ca](http://www.cba.ca).
A key consideration which is absent in the paper is the ability for parent companies to raise external funding at lower rates than their subsidiaries. In this regard, particularly in the Financial Services Industry, group net interest expense for a particular group could be much lower than what it would be if subsidiaries raised their own funding from third parties (which is likely to be cost prohibitive and/or not even possible). If a parent company raises funds directly with third parties and then lends funds to subsidiaries, the intragroup loans would generally be based on arm’s-length principles and should take into account the risk ratings of the individual subsidiaries, which is why intragroup interest deductions could exceed third party interest deductions. As a result, the group-wide limit (as established by the group net third party interest expense) may be much lower than what it would be if subsidiaries were borrowing from third parties on their own. Consequently, if a group-wide approach is adopted and then specific rules are developed for the banking and insurance industry, consideration must be given to how funds are raised at a parent company level and distributed to subsidiaries through intragroup lending— in particular how this impacts intragroup pricing of that third party debt.

We firmly believe that a generally-applicable group-wide test would be ill-advised and impractical. It is our view that it is unrealistic to think that countries would universally agree to an allocation approach. Less than 100% agreement would mean some interest expense would be non-deductible. Further, it is unrealistic to suggest that taxpayers can “self-help” by moving debt to the jurisdiction where they would have available limitation under a group-wide test as this often would not be feasible because of domestic law, regulatory or commercial reasons. In addition, we believe that treating the amount of external debt/interest as a cap for the amount of deductible interest is based on a false premise that implicitly treats internal debt as illegitimate. We are also concerned that a group-wide test would ignore differences in business and borrowing needs across entities within a group. Finally, group-wide calculations would raise many of the same measurement issues as country by country reporting as both the earnings based allocation and the asset-based allocation would be distortive.

A fixed ratio test would raise issues if not properly crafted. By its very nature, a fixed ratio test is a necessarily a blunt instrument which cannot be applied across industries without extremely disparate impact. The Discussion Draft’s suggestion that 30% threshold used by many countries is too generous fails to recognize the unusually low current interest rate environment. It also fails to recognize the variations in leverage across industries.

We fundamentally believe that financial services are unique and should not be subject to generally applicable rules and that an exception from the generally applicable rules should be provided for financial services Institutions. The CBA urges the OECD to recognize the unique leverage profile and the role of debt/interest in the business of a financial services institution. We also believe that there is a need to recognize that the regulatory capital rules effectively constrain the type of BEPS activity that is the target of Action 4 and that any limits on interest deductibility that are proposed to be applicable to financial services businesses would need to be specially designed for the characteristics of the industry, and any such limits should be narrowly targeted only to types of BEPS activity that are specifically identified.

It is the CBA’s view that the Discussion Draft ignores the arm’s-length standard as a fundamental principle underlying the taxation of multi-nationals in the context of interest deductibility. Specifically, we believe that the arm’s-length principle should be used, or at least considered, by comparing the amount of debt of a related party to the amount of debt third party comparable companies carry relative to equity. To the extent the amount of debt of the related party does not exceed the debt third parties have, this amount should be considered an arm’s length amount of debt and the interest on this arm’s length amount of debt should in principle be deductible, assuming the interest rate is arm’s length as determined based on the guidance in the OECD Transfer pricing Guidelines.

The Discussion Draft notes that the limitation would not only apply to interest but would also be applicable to other financial payments. Unless other financial payments are more specifically defined, this could lead to inconsistencies with views taken by various countries as to what is and isn’t
captured as other financial payments. For example, would “other financial payments” include payments made under derivative transactions? Also, one can imagine different views on what is considered debt – will it be possible to develop a worldwide standard for what is “debt” for all countries in all instances? This may be difficult and could be complicated by Regulatory rules.

Given the complexity of designing any such rules against the backdrop of stringent regulatory capital requirements and the lack of any BEPS concerns identified at this time, we believe that further work on any financial services specific rules should be moved out of the BEPS project and its tight timelines. We kindly thank you for considering our comments and would welcome the opportunity to elaborate on our comments and respond to any questions as the OECD continues its work in this area.

Sincerely,

[Signature]
February 6, 2015

Achim Pross,
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Centre for Tax Policy and Administration
2 Rue André Pascal
75775 Paris Cedex 16
France

Via e-mail to interestdeductions@oecd.org

Dear: Mr. Pross:

Re: OECD Base Erosion and Profit Shifting (“BEPS”) - Action Plan 4

The Canadian Life and Health Insurance Association (“CLHIA”) is pleased to provide comments on behalf of its member companies on the Discussion Draft released on December 18, 2014 by the OECD on BEPS Action Plan 4: Interest Deductions and Other Financial Payments.

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

The CLHIA supports the G20’s and the OECD’s initiative to combat aggressive tax planning, including the erosion of tax base through excessive interest deductions. However, we urge that the final measures taken by the OECD be proportionate and balanced, given the need for an efficient flow of financing and leverage for economic growth, global trade and investment. The CLHIA is concerned that the proposals as currently drafted, especially the considerations put forth for the financial services sector, are ill advised and go beyond the mandate to address BEPS. The negative impact of these proposals on the after-tax cost of capital has the potential to result in higher costs and reduced choices for our customers.
Considerations for the Financial Services Sector

While we welcome the acknowledgement in the Discussion Draft that an alternate approach is necessary for the financial services sector, CLHIA is concerned that any limitation on deductibility of interest, which is a vital input to every insurer's ability to underwrite risks, will undermine both existing and new investments, thereby impeding growth and a competitive global market for insurance and reinsurance. As noted in paragraph 206, restricting interest expense deduction will limit an insurance groups' ability to generate insurance business income. Insurers require capital to underwrite additional risks, however, higher after tax cost of capital would impede this potential.

Insurance is highly regulated to protect policyholders. As such, the prudential regulatory environment of insurers already limits the level of borrowing by insurers at the group level, as well as at each operating company level. Following the 2008 financial crisis, regulators around the world have been working to improve the quality of capital of insurers and banks; this will further limit debt levels within insurers. In addition to the minimum regulatory capital levels, regulators and rating agencies also require insurers to hold additional capital as a "buffer" to ensure higher credit ratings. Like any other business, insurers also try to strike a balance to optimize capital and the cost of capital; however, these regulatory and market constraints effectively prevent insurers from the type of BEPS activity that is the target of Action 4.

Insurance and reinsurance operations are funded by premiums paid up front, and these assets are set aside by way of reserves to meet the future obligations to policyholders. The reserves and regular cash flows from renewal premiums provide insurers' the necessary operating cash-flow. Therefore, unlike other financial institutions, insurers are not dependent on short-term wholesale funding, nor can assets supporting the reserves be diverted for other purposes - such assets are not fungible. It is fungible assets that should be of concern under the BEPS activities targeted by Action Plan 4.

Further, it is important to take into consideration the specific tax rules that apply to insurance businesses around the globe. For example, some countries impose minimum taxes on insurance operations to safeguard cash tax revenues due to volatility in insurance business earnings; while some are based on capital employed, others on investment earnings or a flat tax on premiums. There are also limitations on utilization of insurance business losses against other sources business income in many jurisdictions. Both home and host jurisdictions also impose additional qualifications and restrictions on interest and other deductions when an insurer has branch operations outside its home state. These attributes to taxation of insurers in many countries, including the OECD member nations, already restrict insurers' ability to participate in BEPS activities.

Paragraph 211 proposes a group-wide interest allocation which would effectively limit a group's deductions to the amount of interest paid to third parties on capital instruments. This approach would adversely affect business financing, growth through acquisitions and even organic growth. The proposal to use an external debt/interest cap would impede the ability of insurers to deploy and optimize capital across entities and borders on the false premise that internal debt capital is artificial or should not count. It is important for insurers to continue to manage the use of their
scarce resources efficiently across operations. Groups should be able to deploy excess capital within established operations for an acquisition or organic growth abroad within the boundaries of global and local regulations. Also, the amount of debt (and therefore interest expense) of an insurance business in a particular jurisdiction is principally determined by regulatory limits and business circumstances – in addition to the tax restrictions mentioned above. Accordingly, such debt should not be targeted by BEPS – particularly if similar restrictions are not imposed on entities that operate solely in one jurisdiction.

The CLHIA strongly recommends that insurers be carved-out of BEPS Action Plan 4 for the reasons set out above. We note that many countries that impose interest limitations based on net interest nevertheless have specific carve-outs for financial services businesses. At the very least, given the complexity of designing any such rules against the backdrop of stringent regulatory capital requirements and especially the unique insurance business model, further work on any financial services-specific rules should be moved out of the BEPS project and its tight timelines.

Yours sincerely,

Noeline Simon
Vice President, Taxation and Industry Analytics
CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT ON BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on Action 4: Interest deductions and other financial payments (“discussion draft”).

2. 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.

3. This response paper below highlights the keys areas of concern for British business. Where possible, we have provided real practical examples to highlight the likely commercial impact of the proposals.

4. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that as currently drafted, the OECD’s proposals could be disproportionate to BEPS issues arising from interest deductions, and could lead to significant double taxation.

Key Issues

5. We are concerned that the discussion draft does not clearly define the nature and extent of the BEPS issue arising from interest. Interest income is generally taxable, and any unilateral restriction of deductions for interest will cause double taxation. Where there is a deduction and no taxable income, this was the specific focus of Action 2 – hybrid mismatches. We do recommend that the OECD specifically outlines what the exact nature and extent of BEPS which arises from interest deductibility is, so that it is possible to determine whether the recommendations of best practice which are proposed are proportionate to the BEPS risk which they are targeting.

6. The choice of debt, rather than equity, to finance an investment is primarily a commercial decision. Whilst we do accept that some anti-abuse rules will be needed, they should be proportionate to the BEPS risk.

7. It is a fundamental sovereign right of each country to set its own tax rate and tax base, and to participate in tax competition, provided such competition does not constitute “harmful tax practice”. We accept that, in some cases, excessive leverage can erode the tax base – however, the OECD should ensure that it does not introduce general interest limitation rules that will have wide-reaching effect and prevent the deductibility of interest in genuine commercial group structures where no BEPS risk
exists. Ultimately, any best practice recommendations must focus on problems of double non-taxation or harmful competition, without creating costly and burdensome rules for genuine commercial finance transactions.

8. Therefore, the CBI strongly recommends that the final outcome of Action 4 should remain in line with the original objective of providing a recommendation for a best practice approach and should not compel all OECD member states to implement significant changes to their tax systems.

9. The CBI's primary concern is that the introduction of a general group-wide interest limitation rule may have severe and unexpected consequences, which are detrimental to the efficient functioning of international tax systems and the long-term economic benefits for members of the OECD.

10. The discussion draft assumes that groups could, in practice, rearrange their intra-group financing in order to meet the requirements of a group-wide rule. We consider that this is a fallacy, and have included a number of practical examples to illustrate the difficulties which are likely to arise.

11. We are profoundly concerned about the risks of double taxation and contend that the introduction of any general group-wide rule is going to lead to double taxation because debt/interest levels in a group entity will only by coincidence ever be proportionate to that entity's net assets/earnings. We do not agree that a group-wide test will lead to a group being able to deduct all of its external net interest costs. Again, we have included practical examples to illustrate this.

12. We therefore believe that the discussion draft omits a fundamental feature which would be needed to address the serious risk of double taxation, namely the provision of a compensating adjustment in the territory of the lender. If the OECD is to recommend best practice in the tax treatment of intra-group interest, those recommendations should include the requirement that intra-group interest income is not taxable to the extent that the corresponding interest expense is denied a tax deduction. This is essential for any group-wide allocation rule, but should also be a feature of any best practice approach based on fixed ratios.

13. In addition, the introduction of a group-wide allocation rule would have a distortive and perverse effect on M&A activity. We consider that such a rule could encourage leveraged buyouts of cash positive groups and that there would in fact be a bias in favour of more highly leveraged groups. For example, a relatively debt-free group that has little or no group debt could find that it and its overseas subsidiaries would become more attractive as targets for more heavily indebted acquiring groups. Such a result is not only distortive but also perverse, since acquisitions and other investments by debt-laden groups are preferred to acquisitions by less-indebted competitor groups.

14. To the extent that a group-wide rule is part of a best practice recommendation, we strongly recommend that it should be an anti-abuse rule rather than a general allocation rule.

15. A fixed ratio rule would generally be preferable to a group-wide allocation test, but any rules must (i) allow flexibility for OECD members to set a rate which is appropriate for their particular tax system and (ii) should be set at a level which does not constrain investment in capital-intensive industries and does not disrupt the financial services industry in the supply of funding to the wider economy. Appropriate exceptions should be available, possibly based on the arm's length rule, to ensure that any rule is proportionate to the BEPS risk.

16. We are concerned that paragraph 21 concludes that the arm’s length test should not form part of the consultation process. If a company is able to demonstrate that it would have the ability to borrow both the quantum of debt and at the rate charged from a third party, it is difficult to comprehend that such a transaction could be seen as “excessive” (which is the stated goal of BEPS Action 4) just because the actual borrowing then took place between related parties. The arm’s length principle allows different industries to be catered for without exceptions and the specific circumstances of the debt to be considered (e.g. what are the funds used for, would this need to be guaranteed by the group parent, the credit rating of the company etc), all of which are arbitrarily ignored in both the group-wide test and fixed ratio. There is a substantial amount of jurisprudence based on arm’s length principles and it
also maintains that intra-group funding should remain on a par with the pricing requirements of all other intra-group transactions. A key feature of the arm’s length principle is that it allows multinational businesses and domestic businesses to be treated in a similar manner allowing fair competition.

17. We do accept that there may be some countries where finding comparables and evidence may be difficult and from a practical perspective, may not be suited to all countries. However, as we have seen in BEPS Action 6 (Treaty Abuse), this can be addressed by having options of best practices for member states to choose from to meet the requirements of their own countries. We would strongly recommend that the arm’s length test is permitted as an option for best practice along with the fixed ratio test (as amended in paragraph 15 above and in more detail later in this paper).

18. Other anti-BEPS rules such as anti-hybrid rules (Action 2), Treaty anti-abuse rules (Action 6) and appropriate CFC rules (Action 3) should apply in priority to a more general rule on interest.

RESPONSES TO QUESTIONS FOR CONSULTATION

19. We have outlined below our response in respect of some of the questions which you have specifically asked. We would note that the level of detail requested in some questions has not been possible to ascertain in the short timeframe of this consultation and would be better addressed once the framework of the recommendations of best practice under Action 4 has been agreed.

Chapter IV – What is Interest and what are payments economically equivalent to interest?

Question 1

Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?

20. The CBI agrees that in principle, any rules to tackle BEPS using interest should apply to interest on all forms of debt as well as to other financial payments that are economically equivalent to interest.

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?

21. We have not identified any additional specific items which should be included.

Chapter V – Who should a rule apply to?

Question 3

Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with example of how they might arise.

22. We have not identified any other scenarios.

Question 4

Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

23. We consider that a threshold of 25% is too low and would create practical difficulties in commercial JV situations. It should also be noted that a structure may have a company that holds 25%-30% in a
publicly held group. It would seem perverse that the tax profile of the 25-30% owner could interfere with the interest deductibility of the publicly held group. On this basis, we would suggest a threshold of greater than 50%.

24. However, irrespective of whether the threshold is increased, we remain concerned that a group-wide interest limitation rule would be completely unworkable for JV structures where the JV entity is simultaneously related to up to four different groups for the purpose of the rule. We would request that this is specifically addressed in future proposals on this action. Our recommendation of a threshold of at least 50% would ensure that a company can only be related to a single group, and hence would address the potential difficulties which could otherwise arise for JV structures.

Chapter VI – What should a rule apply to?

(A) The Level of Debt or Interest Expense and (B) An Entity’s Gross or Net Position

Question 5

What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

25. We believe that a rule applying to net interest expense is more appropriate than one applying to gross interest. This is particularly important for the financial sector, where interest is effectively a trading cost and it would lead to extreme distortions to focus on gross rather than net expense.

26. However, the level of interest expense will naturally fluctuate according to global interest rates. A company which has wholly commercial debt, and no change in circumstances, should not face a disallowance merely because the rate of interest has increased and therefore exceeds an arbitrary ratio.

27. In a number of sectors such as property or infrastructure, lenders focus primarily on asset ratios which give security for the debt. This enables commercial debt to be raised for long term projects, particularly during a development phase before earnings have arisen. Any rule therefore needs to allow companies to qualify by reference to an appropriate ratio, which may be by reference to assets, interest expense or cash cover.

28. We would also note that in respect of a net interest expense rule, countries which operate on a company by company tax filing system (such as the UK) should not be placed at a disadvantage compared to countries which operate a full consolidated tax filing system where one company includes all income and expenses of all companies and permanent establishments of the group in that territory. Therefore all such rules should be capable of working on a jurisdictional basis so that any disallowance is by reference to the net expense in a single territory.

Chapter VII - Should a small entity exception or threshold apply?

Question 6

Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?
29. We recommend the use of a "gateway" approach, so that entities which clearly satisfy relatively simple initial criteria, and do not demonstrate a BEPS risk, are not affected by any group wide rule. This would reduce compliance burdens and ensure that any rule is proportionate to the BEPS risk.

30. In our experience, the detailed design of an appropriate gateway will require further consultation in order to strike a balance between reducing compliance burdens and ensuring that BEPS risk is identified. We would be happy to participate in this exercise.

31. Specific gateway tests could include:

- Exclusion for small/medium sized enterprises (or smaller local groups) in any territory. The purpose of this gateway would be to remove the potential barrier to expansion into new territories by relatively small enterprises, such as smaller quoted groups, who might find the complexity and administrative costs excessively burdensome.
- Exclusion for companies or local groups which are financed wholly or substantially by third party debt. There is no BEPS risk in these circumstances. Any projects (such as large capital or infrastructure projects) which are financed in this way should be excluded from any general rule.
- High tax exclusion – there is minimal BEPS risk if the recipient is taxable on the income at a rate of at least 75% of the rate at which a deduction has been claimed.
- “Approved” tax exempt lenders – approved tax exempt bodies such as pension funds or sovereign wealth funds should not be unfairly penalised compared to taxpaying entities just because of their special tax status.
- Low risk exclusion - for example, a safe harbour exclusion if the payer's debt:equity ratio is below an agreed level.

Chapter VIII – Whether interest deductions should be limited with reference to the position of an entity’s group

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?

32. It is the view of the CBI that there are very significant practical difficulties with respect to the operation of interest allocation rules in particular and we would strongly recommend this alternative not be utilised in any form.

33. The key assumption (especially in paragraphs 59 and 80 of the discussion draft) that groups will be able to move debt around the group is in the vast majority of cases misguided. It will therefore be almost impossible for a multinational group to obtain a deduction for its external net financing costs. We have outlined below a number of these practical reasons which relate to both tax and non-tax issues:

Non-Tax Issues

- Ensuring the right amount of debt will be practically impossible for a group operating in multiple territories. Groups would have to accurately predict the levels of earnings or assets in advance to ensure the correct level of debt was created to match the right level of interest. Results for companies are volatile in a number of industries and this would not be workable.
• Changing debt to equity ratios on an annual basis will not be possible where companies are not held 100% within a group as it would affect the capital structure agreed by the different parties if debt has to be put in to replace equity held by just one shareholder.

• Operating companies would need to have a business need for the financing. It is not simply a case of gearing up to their allocated deduction amount. What do they do with the cash borrowed if it is not required in the business? It may be possible to pay dividends or return other capital, however this would either require distributable reserves or permissive company law on capital reductions.

• Different jurisdictions have different accounting standards. This is particularly evident with derivatives. Under IFRS, derivatives are accounted for on balance sheet, whereas not all local accounting standards (hence tax bases) have this requirement (eg. Dutch GAAP). Such differences could mean that the limit under local GAAP calculations (which are normally what tax computations are based on) could be materially different to the global allocation calculated under IFRS or the GAAP of the parent company. A mechanism for dealing with this would need to be catered for in the final rules.

• There may be currency issues with obtaining additional funding. For example, cost of funding in local currency is often prohibitively expensive; it may not be possible to obtain the local currency or to extract funds due to currency controls; hard currency funding is often not feasible due to local taxable FX volatility which could only be mitigated with expensive third party hedges.

• Regulatory capital typically needs to be long term capital and therefore levels cannot easily be adjusted to align with variations in the level of deductible interest expense. Once such capital is contributed, it is usual that the permission of the local regulator is needed to reduce that level. In addition, there will be a capital cost to regulated businesses of providing debt to other entities within the group, if the tax rules for interest require capital to be actually contributed, for example in order to achieve a full deduction for the group’s external interest costs, that seems likely to require an over-allocation of capital to some jurisdictions and will therefore unnecessarily constrain the regulated business the group can undertake in the jurisdiction of the debt provider.

• Lenders into large capital projects typically look for security over the asset and wish to avoid structural subordination.

• Political instability and regimes influence the level of debt and equity that groups are actually willing to invest in jurisdictions.

**Tax Issues**

• Interaction with other local rules (e.g. Denmark asset ceiling test and the UK unallowable purpose test). Will jurisdictions be willing to remove existing legislation restricting interest deductibility where debt has been inserted just to meet the allocation amount?

• High withholding tax on interest payments may make debt funding commercially unviable;

• Specific tax legislation designed to prevent such debt “relocation”; and

• Structural limitations on tax capacity to relieve interest expense. This may arise for example due to deficiencies in international tax systems which result in effective double taxation or more than single taxation. A particular problem area in some industries is caused by foreign withholding taxes on active income streams in conjunction with systems which limit credit to the direct counterparty (rather than extending credit through to material contributing jurisdictions).

34. Therefore, in practice, we consider that group allocation methods will simply guarantee net disallowances of interest expense, whilst also distorting competition and M&A activity. We have provided examples of some of the issues raised above in Appendices I and II.

35. Group ratio rules are potentially easier to apply, and allow more flexibility for each country to set an appropriate ratio while aligning best practice on the type of rule to be applied. Practical difficulties include:

• Groups which operate in mature and emerging markets are likely to have higher debt in their emerging market subsidiaries, simply because a more mature business is more likely to be cash-
generative. Debt may also be preferred to equity in the early stages of a project, since it is easier to extract if a project is not successful. Disallowing interest costs by reference to a rigid ratio will make it more expensive to invest in markets where there may be greatest commercial need.

- If a group which complies with a ratio rule is acquired by a cash rich group with a lower group ratio, the target group will suffer future disallowances despite having no change in circumstances. Conversely, a highly-geared group could acquire an existing group (using new debt) and claim additional interest deductions in the target group. Hence a rigid ratio is also likely to distort commercial M&A activity.

- The commercial level of debt varies widely by sector, so a group which operates across a range of sectors may find that its group-wide average ratio is below the commercial level of debt in a particular sector, leading to a disallowance.

36. As noted in the discussion draft (paragraph 81), a number of territories which have implemented fixed ratio rules have been found it necessary and appropriate to also introduce carve-outs such as an arm’s length override. We would strongly recommend that if a fixed ratio approach is adopted as part of best practice, similar carve outs are also included to help address the issues noted above (see also point 15 above).

**Question 8**

**Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?**

37. The UK operates a worldwide debt cap, which limits UK deductions to the net amount of external interest in the group.

38. These rules still provide commercial issues in distorting competition between leveraged and debt free groups. This is particularly relevant in M&A where a target company may be more valuable to a leveraged group compared to a group which is wholly funded with equity. These issues cannot be dealt with under a group-wide rule unless a significant improvement to dealing with double taxation is proposed.

39. Under the UK debt cap rules, where a disallowance is calculated, the group can offset that amount against any interest income in the UK group – not just in the company where the expense is. This helps alleviate domestic double taxation, though not global. In order for the competitive distortion to be avoided between leveraged and equity funded groups, we would recommend that a full cross border corresponding adjustment system would be required (similar to transfer pricing rules) such that if there is a disallowance, there is an automatic exemption from tax for the income regardless of which state it is in.

**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?**

40. If a group-wide rule was introduced despite its significant defects, we would expect that the starting basis for any group wide test would be the consolidated accounts. However there would still be a large number of issues which would need to be addressed in specific rules. Such issues would include GAAP differences between consolidated accounts and local accounts upon which the tax computation is
based, forex differences between the consolidated accounts and entity accounts. In some cases, it may be more practical for multi-national groups to use IFRS rather than parent country GAAP, however we note that this is likely to be difficult for US groups, which will use US GAAP which still differs significantly from IFRS.

41. In addition, we note that not all groups will prepare financial statements. Furthermore, as mentioned earlier in our response to question 4 above, a threshold of 25% when determining control is too low and would be utterly impractical for standard JV arrangements.

42. There are likely to be significant compliance burdens on groups which have to produce consolidated data purely for tax reasons, particularly if they are not required to produce audited financial statements for other requirements (for example, unquoted groups in many territories). Such an approach would increase the unpredictability of multinational groups' tax liabilities. There is also a real risk that such liabilities would become impossible to understand or explain.

**Question 10**

In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

43. We consider that in the majority of countries where the parent company group accounts would be subject to a statutory external audit, such numbers should not be capable of being manipulated. However, we do not consider that this question is relevant until the actual level of current risk has been established.

**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?

44. We do not consider that this question should be addressed at this stage until the framework has been agreed. However, we note that due to the homogenous nature of businesses and differences between industries, there is unlikely to be a single answer that is appropriate for every situation.

**Question 12**

Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

45. Ultimately, we consider that any group-wide allocation rule would be highly impractical, verging on unworkable as well as making it even harder to accurately forecast the economic return on a potential investment in a territory. For example, in a group with 1,000 entities across 50 countries it would be virtually impossible to have every entity's tax outcome interdependent with each other. This issue would be compounded if the group-wide rule adopted tax rather than accounting measures. It would then be necessary to determine how to deal with subsequent tax audit adjustments to any entity in one country, which would ripple through to all other 49 countries - it would simply be totally impractical to continually re-open the huge calculation. In such a situation it would also be difficult to determine which fiscal authority should sign-off on the calculation.
46. We repeat our firm view that any solution should be proportionate to the BEPS risks identified, and should not result in double taxation.

Question 13

What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

47. As noted above, the mere receipt of tax exempt income should not in itself be a justification to deny interest deductions as it denies the symmetry required in the tax system to prevent both double taxation and double non-taxation (as outlined in BEPS Action 2 – hybrid mismatches). Such a rule would automatically create double taxation.

48. However, in respect of the specific proposal, it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

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?

49. We consider that it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

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?

50. We consider that it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

51. It should be noted that this issue has the capacity to introduce yet further arbitrary results under a group-wide allocation approach for taxing authorities and double taxation for companies.

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?

52. Almost all large groups will have activities that are not homogenous, because they operate in completely different sectors, or in different parts of the same sector, or even in very similar operations that are different merely by virtues of local differences in regulation or markets in each territory. Therefore, we consider that any group-wide rule is almost certainly going to lead to interest disallowances, and it is carry-forward provisions would not fully mitigate this.
53. For example, an energy group may have both highly regulated and more predictable activities (e.g. electricity submission) as well as having higher risk commodity trading activities. Typically, the former would be financed with high levels of debt, whereas the latter would typically support much lower debt levels. In such circumstances, a carry forward of a disallowance of interest for the low-risk higher debt business would be totally useless.

54. There are also particular difficulties in countries such as the UK, which do not have a full consolidated tax return. There would need to be additional local changes to legislation to ensure that losses are not trapped within a particular local entity.

**Question 17**

What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

55. With respect, we consider that this question envisages that tax policy will drive commercial financing decisions. We do not consider that this is an appropriate outcome of the BEPS project. Financing is primarily a commercial decision and groups should not be encouraged to amend their arrangements in order to meet an arbitrary tax rule.

56. We have outlined a number of practical issues with regard to groups arranging their debt in answer to question 7.

57. In practice it would be impossible to keep adjusting each entity's debt position in a way that exactly or even closely aligned its interest expense with its "economic activity"; irrespective of how this was measured. Therefore, either of the group-wide methods suggested would result in some unpredictable disallowance of interest in a group, irrespective of whether profit shifting is actually taking place. In turn, this will impact on economic activity, since the risk of a tax disallowance will affect the expected return from a project and will mean that some (otherwise viable) projects will be rejected on the grounds that they fail to meet a required hurdle rate of return.

**Question 18**

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

58. We consider that it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

**Question 19**

If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?
59. We consider that it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

60. However, we think it will be important to ensure that there is sufficient flexibility in any best practice recommendation to allow a combination of earnings and assets values to be used. In some cases it may be appropriate to allow groups to choose which ratio is most appropriate to their commercial circumstances – for example, a design, build and operate project will be able to borrow from a third party based on asset values during the early phase, but is likely to refinance into earnings-based debt once the construction risk has expired. Different ratios are therefore appropriate to different activities.

**Question 20**

*In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?*

61. We consider that it is too early to respond fully to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

**Question 21**

*Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?*

62. We foresee fundamental difficulties with this approach. This is not just about a timing issue. The proposed general interest limitation rule will result in permanent interest disallowances that will be never be recovered and double taxation will inevitably arise.

63. We consider that there are only two ways to address this important issue:

i) Under a group wide allocation system, a deemed deduction which is allowable in all countries across the globe for the amount allocated regardless of whether debt is actually pushed down into the territories (we do not believe this would be acceptable to a number of countries and is discarded in the Discussion document, however, it would be a solution that would avoid double taxation to an extent. Note that this would still not work where domestic rules prevent an interest deduction, including special tax regimes such as production sharing arrangements discussed in more detail in response to question 35 below).

ii) A corresponding adjustment mechanism, whereby revenue would not be taxed where a disallowance had occurred (regardless of whether the borrower and lender are in the same country or not).

64. For example, under the proposed rule, a company that is cash positive and without debt would be denied interest relief entirely; whilst a leveraged group would be entitled to interest relief for debt over a certain threshold. This seems to be an illogical outcome. We have illustrated this further in Appendix I, Example 4.

65. Example 4 in Appendix I illustrates that without an appropriate corresponding adjustment mechanism, the introduction of a general interest limitation rule could provide significant tax distortions. Similar issues arise in leveraged groups, and indeed whenever there is cross border intra group debt a
disallowance in the borrower needs to be matched by an exemption for the lender if double taxation is not to arise.

66. Another sector specific example is that of an insurance company, where non insurance activities must be carried out in separate companies for regulatory reasons. Since much of the debt will be held in a separate loss making entity or SPV, there is no likelihood of obtaining a tax deduction for the interest payments as the economic activity in these loss making entities will ensure that the interest is disallowed. The proposals to carry the unused interest expenses forward to a later accounting period will not help, since these entities will be loss making year on year.

**Question 22**

It is proposed that any group-wide rules included in a best practice recommendation should apply to the entities included in a group’s consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

67. We consider that it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

**Question 23**

Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

68. It would be appropriate to have a targeted anti-abuse rule so that arrangements with a purpose of achieving a tax advantage could be defeated. Again the BEPS risks need to be carefully identified in designing an effective and proportionate rule.

**Question 24**

What practical issues arise in applying fixed ratio rules based on asset values or earnings?

69. The key difficulty is that ratios vary widely between sectors: a capital intensive industry will naturally be able to support a higher level of commercial debt than, say, a service business. Using different ratios for each sector will lead to disputes over which sector an activity lies in, and will be difficult to apply for groups operating across sectors. Using a single ratio is likely to result in disallowances for capital intensive groups.

70. Any ratio should be set at a relatively high level, so that it is proportionate to the BEPS risk. Groups should be able to demonstrate that their interest expense does not give rise to BEPS risk, for example by being able to exclude project debt from the general ratio (i.e. external debt which is clearly related to a specific project but is then on lent intra—group) or by obtaining a specific Advance Thin Capitalisation Agreement (ATCA) based on fully disclosed facts, on an arm's length basis.

**Question 25**

What would be the appropriate measure of asset values or earnings under a fixed ratio rule?
71. It is too soon to be able to answer this question. See our answer to question 24.

**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?*

72. However the average ratio of a worldwide group is calculated, the simple fact is that many individual entities around the group will have a ratio higher than the blended average.

73. There will be a number of reasons why individual entities may have higher ratios than the average worldwide ratio. Entities in lower risk activities would usually have higher debt to asset ratios. A mature business, which is providing a stable return at relatively low risk, is likely to have less debt than a higher risk start up or new market activity. Groups may operate across a number of sectors, with different funding needs.

74. Groups operate by using their cash efficiently. Cash positive entities may lend funds to a group Treasury company, which in turn on-lends them to other entities with a commercial need for debt. A cash positive entity may not be able to pay a dividend immediately, or may want to retain cash to fund other planned commercial activities in a subsequent period. The corollary of some entities having below average debt levels means that other entities within the group will have ratios higher than the group average.

75. A further example could be a manufacturing group. The group sets up a manufacturing company which required a large capital outlay up front to build the factory and to obtain a stock of raw materials. This company would normally be leveraged as it has the fixed assets to support such debt. In the management company and sales entities, there is no significant up front investment in fixed assets as they are service companies dominated by people. So whilst all the group’s leverage is required by the manufacturing company, that company may only earn a small proportion of the profit which would then distort any allocation or fixed ratio test. Ultimately, this structure is driven by commercial and not tax requirements.

76. Particularly where the business assets have longer lives, a long established operating entity may have repaid some or all of the debt used to finance the assets, whereas an entity operating a similar but newly constructed asset would have a higher debt ratio.

77. In joint venture situations, the co-investors may agree to raise funding at their respective group levels, leaving the JV company debt free. If that JV company is consolidated it may then have a different profile to wholly owned group companies.

78. When a highly leveraged entity is acquired, its ratio may exceed that of the acquiring worldwide group. As discussed elsewhere in this response, it may not be feasible to equalise the ratios, so the difference would persist.

79. Another example could involve a group operating from a jurisdiction where due to local legal restrictions it is difficult for the group entity to return capital to other group members. Consequently, to reduce the possibility of equity becoming locked in that entity, the group may resist transferring capital to that entity and seek to rely on debt financing instead.
80. Finally, when a business enters a particular market it may have a higher debt ratio due a preference for debt financing. A business will often choose debt rather than equity financing due to the increased flexibility of debt. On entering a new market and pursuing a new development, a business may expect losses for a few years before any profits are generated. As soon as profits are realised the debt can be repaid. A company would not be able to pay dividends until the accumulated losses are cleared. Therefore, there is an expectation that tax losses (including interest) can be carried forward and utilised against future profits of that entity. It seems that these events are completely unrelated to BEPS and yet under the proposed fixed ratio rule, the high interest to earnings ratio would give rise to a disallowance.

**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?*

81. We are concerned that a fixed ratio rule would be inappropriate for certain sectors (such as infrastructure) where higher debt levels are expected and unrelated to a BEPS risk. We consider that the main issue with regard to a fixed ratio rule as proposed (i.e. on net interest) relates to loss periods, since projects in certain sectors (such as infrastructure/oil and gas) have long lead times before any profit is generated.

82. We consider that a fixed ratio rule, where the ratio is set too low would be a significant problem for some sectors, including infrastructure, as is acknowledged in paragraph 215. Paragraph 158 and Box 3 assert that a benchmark ratio of 30% of EBITDA is too generous. Example 11 illustrates the use of a lower ratio of 15%. The equivalent reciprocal ratio ("interest cover"), (EBITDA/net interest) would be 6.7. For sectors such as infrastructure this level of interest cover is significantly higher than what is required by actual third party lenders.

83. We are concerned that the evidence supplied by reference to the PwC Global top 100 companies is not reflective of business as a whole. For example, the list is compiled by reference to market capitalisation which by definition is likely to provide better credit ratings and therefore reduce interest costs. Any fixed ratio test must be fit for purpose for all groups and not just focus on large groups, especially in the technology sector. We would also note that the ratio, should by definition be high if it is to be an absolute line over which a disallowance is made. The ratio should not be catching most groups (or even the “average”) - it has to be flexible enough to cope with all commercial lending arrangements, and just be set at a level which purely captures abusive deductions.

84. Companies in the financial services sector are subject to external regulatory supervision to ensure that they are adequately capitalised and do not have excessive debt. We have seen the joint response to this discussion draft of the Association of Financial Markets in Europe and the British Bankers Association in addition to the response of the Association of British Insurers. These papers provide further background on the regulatory framework which companies in those sectors are already subject to regarding levels of debt. We believe that any final BEPS proposals should be consistent such that they either allow companies subject to regulatory capital requirements to suffer no further restriction, or that such companies should be carved out.

85. The ability to carve out certain items like project debt may provide certain comfort for groups in the capital intensive sector. For example, if a parent company were to borrow externally and then on-lend to another group company in a back to back arrangement for a specific project, then this could be treated for the ultimate borrower as external debt. An example of this type of rule can be found in the
UK CFC Rules in Chapter 9 in relation to the “ultimate debtor”. If such project debt is treated as external, then the result will be a pool of debt to which a ratio of circa 30% may then be appropriate.

86. As set out in our response to question 6, we consider that it is essential that any recommended rule includes some form of “gateway” so that commercial situations which do not give rise to BEPS risk are not subject to a disallowance. We also consider that transitional protection may be needed for existing debt.

87. It is also important that groups do not suffer a significant compliance burden merely to determine whether or not they are subject to a disallowance. Again, we think that the gateway approach could assist here.

**Question 28**

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

88. Governments should be asked to provide this data as part of the response to BEPS issue 11. It is vital that the extent of BEPS risk is evaluated before wide-ranging solutions are proposed.

89. In the UK, all company financial accounts are available to the public through Companies House. We would also note that all tax returns and accounts must be submitted to the UK tax authorities with iXBRL electronic tagging.

**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?*

90. We consider that it is too early to respond to questions requiring this level of detail. We consider that we need to determine the framework for any best practice recommendations, prior to determining the specific design of specific interest limitation rules.

**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?*

91. We consider that either approach outlined in the Discussion Document may work, provided that the fixed ratio test is flexible enough to cope with all commercial lending arrangements, is set at a level which purely captures abusive deductions and there is a sensible carve-out or series of carve-outs in addition to those listed. A combined approach (which should feature additional tests to those listed) has the merit of effectively providing more than two filters by which non-BEPS cases may be identified and excluded.

92. We think that approach 2 looks markedly better than approach 1 due to the significant practical difficulties outlined in answer to question 7 in respect of a group-wide allocation method. However,
we contend that approach 2 will only work if it includes appropriate carve-outs in addition to, or in place of, a group ratio test. We suggest that such carve-outs should include, but not be limited to a gateway test, and the nature of a carve out should allow countries flexibility to introduce criteria to reflect their own economic circumstances.

Question 31
Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosions and profit shifting risks posed by interest expense? Which of these could also be addressed through a general interest limitation rule and where would a general rule need to be supported by targeted rules?

93. As outlined in our summary of key issues at the beginning of this document, the Discussion Draft does not clearly define the nature and extent of the BEPS risks arising from interest. Taken in the context of the scope of other BEPS Actions, we agree further work is needed to address the risks that this Action should focus on to ensure the response and final recommendations are proportionate.

94. Given that the receipt of interest is taxable, the symmetry of tax treatment should be maintained by permitting deductions for interest expense except in cases of abuse. However, the key risk of double non-taxation has been addressed through Action 2. We also believe that tax competition should be allowed unless it breaches the boundaries of harmful tax competition which is the focus of Action 5.

95. Our overall view is that targeted rules (such as those proposed by Actions 2 and 6) are a proportionate route to tackle BEPS risk in relation to interest. To the extent that a group wide rule is needed, we consider that it should be a limited anti-abuse rule rather than a widely-drafted rule which has significant risks of double taxation and imposes major compliance burdens.

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?

96. Any measures to alleviate the inevitable double taxation that will result from a general interest limitation rule will be welcome and we therefore, agree that carry forward provisions are needed. However, as outlined in our response to Question 21, they will not be sufficient to eliminate, or systematically address the risk of double taxation.

97. The loss of an interest deduction may be intermittent, for example if annual profits are occasionally reduced by large losses and the restriction is influenced by local profitability. Such cases may be helped by the ability to carry forward interest relief. However, there are also likely to be cases where the normal long run position is that a company’s interest expense exceeds, is at, or is close to the level of any restriction on deductibility; in such cases a carry forward of interest relief does not address the double taxation that would arise.

98. We believe that the Discussion Document omits a fundamental feature which would be needed to address the serious risk of double taxation, namely the provision of a compensating adjustment in the territory of the lender. If the OECD is to recommend best practice in the tax treatment of intra-group interest, those recommendations should include the requirement that intra-group interest income is not taxable to the extent that the corresponding interest expense is denied a tax deduction. This is essential for any group-wide allocation rule, but should also be a feature of any best practice approach based on fixed ratios.
99. Although it is not covered by a specific question in the Discussion Document, we agree with the conclusion that re-characterisation as a dividend is not the best route to address double taxation. That seems to risk further problems, such as the introduction of questions of withholding tax. We consider that the natural and appropriate approach is to provide a compensating adjustment to the lender.

**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?*

100. We do not think that 5 years will be an adequate carry forward period, particularly for some large construction projects such as building power stations or offshore wind farms (such projects may not return profits for more than 5 or even 20 years). We therefore do not believe any time restriction on the carry forward would be appropriate.

101. To the extent that any time limit is recommended, we believe that this should be no more restrictive than that applying in the local jurisdiction to the carry forward of losses. Furthermore, any amount carried forward should be capable of being used by any entity in the local territory, even if there is no local group consolidation system (as in the UK).

**Question 34**

*Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital without having an undue impact on the group's regulatory position (for example, by limiting a group's net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?*

102. It is our view that the regulatory regime already constrains excessive borrowing and therefore, acts "as an effective general interest limitation rule" as suggested in paragraph 212. We consider that the first step should be to identify what BEPS risk remains and then to introduce targeted rules to address specific risks. For example, where the tax rate in the lender's jurisdiction is significantly less than that for the borrower, this may be an indicator of BEPS risk. This would ensure that any BEPS risks are addressed, whilst minimising the risk of unintended or contradictory consequences. Therefore, on this basis, we do not think that a general rule for financial sector groups that uses a net interest measure in the context of regulatory capital should be introduced. Indeed, we contend that such a rule would be difficult to develop and would involve an unwelcome element of subjectivity. In the first instance, we think that it is important to identify any perceived weaknesses in the ability of regulatory capital regime to secure protection from BEPS. Once identified, these weaknesses should be specifically addressed – as explained above; we suggest that it would be more appropriate to introduce targeted exceptions to the regulatory regime if any action is necessary.

103. Any rule introduced for financial sector groups should be applied to a group's overall position (within a territory) where regulatory reasons mean that a company's trading and other activities need to be separated rather than being carried on within the same entity.

104. We would also suggest that a domestic compensating adjustment is available for regulated groups where other activities have to be carried out in separate entities.
105. Please also see our comments under Question 9 above.

**Question 35**

Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

(a) The Extractive Industries Sector

106. Paragraph 214 refers to the fact that certain sectors, including oil and gas, may be subject to special tax regimes, which should be considered alongside any best practice rules introduced to tackle BEPS using interest expense. Similar issues apply to the mining sector. Therefore, we suggest that concerns regarding the effect of best practice rules on the extractive industries (including oil and gas and mining) sector need to be considered further.

107. The extractive industries sector is governed by tax rules that are unique to each country and distinct from the mainstream corporate tax regime; therefore, any general interest restriction will have a distortive effect on the sector. Oil, gas and mineral reserves are not mobile commodities but belong to the respective State and can be a major part of a country’s economy.

108. Oil, gas and mining companies cannot borrow to fund exploration activity. Exploration companies are financed by equity or non-interest bearing loans, tend to be highly capitalised and are often required to hold contracts in separate legal entities.

109. Oil, gas and mining projects have long lead times, with high up-front costs until production of the natural resource commences and positive cash flow is generated from sales on the international market.

110. There are typically 2 types of regime in the oil and gas sector – (1) the Tax and Royalty Regime; and (2) the Production Sharing Regime. Both regimes have a common feature that profits are taxed at a higher rate than the normal corporate regime leading to an existing restriction on interest deductibility. In the mining sector, there are typically separate mining tax or royalty regimes, supplemented in many cases by free carried government equity participation in the mining project.

111. In the Tax and Royalty Regime, oil and gas income and expenses are ring-fenced. Ring-fencing is also becoming more common in the mining sector. Incentives can apply on a project basis to meet challenging geology. Interest expenses are already restricted, not being deductible for royalty, production or supplemental taxes and further requirements are often stipulated by tax authorities in achieving a deduction for corporate income tax (e.g. a loan must be to fund field development, interest payments need to be based on production volume and there have to be specified pay-down periods). Countries operating a tax and royalty regime tend to be the more developed OECD/G20 countries.

112. As an example, the UK is one such country and the regime includes petroleum revenue tax ("PRT", which is a tax on production), ring-fenced corporation tax ("RFCT") (at a higher rate that the main corporation tax regime) and a supplementary charge ("SCT"), which currently results in marginal tax
rates of 81% and 62% (soon to reduce to 80% and 60%). These rates are in comparison to a standard CT rate of 21% (soon to reduce to 20%) for other UK taxpayers.

113. In relation to PRT and SCT, there is no deduction for financing costs and RFCT introduces additional tests for RFCT deductibility.

114. The Production Sharing regime is operated in developing countries with less advanced tax systems, which are generally not members of the OECD or G20. There is always a national oil company that is a party to the contract. Production sharing agreements ("PSA") contain all terms including fiscal terms applicable to a project, and these terms differ between projects within the same country.

115. Generally, PSA costs are recovered from production (and therefore are borne by the oil and gas company up to production) and recovery is subject to an annual cap – to ensure that the state always receives some tax from production. Each PSA will dictate what costs are recoverable – generally, affiliate costs can be charged in at cost (no mark-up) and costs that are not recoverable against production are not tax deductible. In PSA regimes, interest costs are often specifically not recoverable or tax deductible.

116. In the mining industry, developing country governments will often take equity stakes in major projects, as part of a wider investment agreement, which will also provide for an agreed specific tax regime which will apply to the project. Those government equity stakes will also be funded by the mining company, typically under terms which provide that the funding to the government can only be repaid from their share of future profits. Therefore, those governments will typically not be taking any financial risk in relation to the project. To partially mitigate the one-sided risks carried by the mining company, they will often also introduce shareholder debt into a development project. The purpose of such debt is not to obtain a tax deduction on interest (as accrued interest deductions will often time-expire before profits are made) but to enable the mining company’s investment to be at least partially repaid in priority.

117. Another feature of a PSA and many mining regimes is that there is usually a stability clause, meaning that future tax changes within the jurisdiction do not affect the project. This ensures that state return from a project is known form the outset and cannot be varied.

118. We have detailed below a few examples of PSA regimes in different countries and the position regarding the deductibility of interest costs:

- Algeria – Interest costs are not recoverable or tax deductible;
- Angola – Interest costs are not recoverable or tax deductible under the Petroleum Tax Regime;
- Libya - Interest costs are not recoverable or tax deductible;
- Egypt – technically, interest costs are tax deductible but not recoverable. However, the National Oil Company pays tax on behalf of the IOC and therefore, the IOC will not benefit from the deduction; and
- Iraq – Interest is not recoverable; consequently, it is practically very difficult to achieve a tax deduction for non-recoverable costs.

119. In the case of the mining industry, we have examples of specific investment agreements covering projects in Guinea, Madagascar, Mozambique, Mongolia and Indonesia, with their own defined tax
regimes, which are stabilised for the life of the agreement. These agreements are based on mining investment laws in the respective countries, which have been enacted in full knowledge of the fiscal consequences and designed in order to attract mining projects investment bearing in mind their capital-intensive, long lead-time project profiles. It would be wrong to superimpose a set of restrictions on, or to allocate debt to, a project which has its own regime agreed between the investor and the host territory with a view to achieving a fair and equitable outcome between the parties.

120. Ultimately, for both the Tax and Royalty and Production Sharing regimes, an allocation of any group interest expense to an extractive industries exploration or production company will not give rise to a tax deduction and consequently, any relief will be lost. Allocation keys based on profit or asset value would require a disproportionate amount of interest to be allocated to these entities, since they can contribute a significant proportion of a group’s profit and are highly capital intensive and therefore, the interest deduction is likely to be challenged on transfer pricing grounds.

121. In our opinion, one of the principal problems with any global group-wide allocation basis as currently proposed, is the arbitrary and distortive effect that it would have on individual companies and hence their value to others. For example, a relatively debt-free group that has little or no group debt could find that it and its overseas subsidiaries would become more attractive as targets for more heavily indebted acquiring groups. Not only is this a distortion but it also seems to result in a perverse outcome that encourages acquisitions and other investments by debt-laden groups rather than more healthy competitors.

122. Similarly, in relation to the extractive industries sector, any EBITDA restriction would place yet further disallowances on an already restricted expense – a position not seen in other sectors that are subject to the ‘normal’ corporate tax system.

(b) Infrastructure Sector

123. The Discussion Document correctly identifies that the impact of a general interest limitation rule on the infrastructure sector would require further consideration. We strongly agree with the conclusion in paragraph 215 that if the final design of a general rule does not provide an appropriate solution, then special provisions will be necessary both to avoid constraints in delivering essential infrastructure and to minimise market distortions arising in particular from group allocation rules.

124. However, we contend that the Discussion Document does not fully identify the significant extent of problems that a general rule would pose to the sector. For example, the Discussion Document refers to the sector involving large "public" infrastructure projects - however, the threatened sector has a far wider scope - it will also include electricity, gas, water utilities and telecommunications projects.

125. We set out below some distinctive characteristics or features, which we contend deserve special consideration as regards entities engaged in the infrastructure and utility sectors, with some suggestions for partial solutions.

126. Characteristics of underlying businesses in the sector:

- They are unusually capital intensive, whether due to large installations (e.g. power plants or offshore wind farms) or large networks of wires or pipes.
- Potential investments are evaluated over a longer than average time period due to the longer asset lives.
• They can take years to construct, so the entity would have no earnings but still have an interest expense – it would therefore suffer under earnings measures.
• Most are regulated in some way, which places various constraints on them ranging from environmental/emissions controls through to regulation of prices charged to ends users.
• Only some businesses are subject to price regulation, which is (rightly or wrongly) perceived by investors as offering more predictable returns, sometimes inflation-linked.
• Notwithstanding their special features, the economic feasibility of most investments in infrastructure is assessed no differently than other sectors – a return in excess of the cost of capital is needed since higher costs of capital would choke off some investments.

127. Characteristics of typical funding for infrastructure

• In its World Energy Investment Outlook Special Report in 2014, the IEA forecast that Europe alone needs > $2 trillion of power sector investment over the next 20 years. The combined market capitalisation of Europe's top 20 power companies is less than a quarter of this. It follows that it is very unlikely that the necessary volume of investment required for power sector infrastructure construction and renewal will be available from the capital markets as equity; therefore, debt is simply a necessity.
• Debt funding is cheaper than equity funding, so long as it bears less risk. Tax relief for interest is an advantage which helps reduce the cost of debt further, but it is not the main reason debt is used to fund the expenditure.
• There is greater external investor appetite for debt than equity, because returns which are perceived as more predictable reduce risk, and so support higher gearing levels.
• Compared to other large corporates (and none of the PWC global 100 in 2013 (referred to in the Discussion Document) were in the infrastructure/utility sectors) the naturally higher gearing levels, which arise from the combination of commercial factors mentioned above are more likely to lead to general fixed ratios for interest limitation being too low.
• The long term nature and relatively low profitability margins (due to regulatory and/or market competition pressure) mean that economic viability of infrastructure projects is more sensitive than average due to adverse changes in cash flow which would result from restriction of tax relief for interest expense.
• Debt raised to finance infrastructure which was at the project entity level or in a ring-fenced regulatory group would be difficult or impossible to manipulate (for instance to achieve an average group ratio under "self-help").

128. In summary, higher than normal levels of debt financing and certainty of tax deductibility for the interest expense are fundamental to the calculation of investment returns, project appraisal and passing acceptable hurdle rates to getting infrastructure projects off the ground. The widespread incidence of debt in infrastructure investment is not driven by BEPS and therefore, we question why BEPS driven legislation should be permitted to adversely impact on the economics of such projects.

129. We consider that the commercial features of the infrastructure sector described above and the importance of the sector to the prosperity of the member countries provides a compelling reason to find a solution that avoids collateral damage to the whole sector.

130. We consider that this risk could be partly mitigated by the introduction of an appropriate carve-out for infrastructure debt. Alternatively, a "gateway" approach could be adopted, so that any general rule only needs to be considered if a group passes through the "gateway".

131. However, there is real concern that a new general interest limitation rule could not be adapted to protect existing infrastructure projects. Infrastructure projects usually have long lead times and consequently, there is a considerable risk that projects undertaken in the last 10-15 years would be at risk of unrecoverable losses, or defaulting on their debt. This would result in severely impacted...
investor confidence, and the potential for more projects and costs to end up on the public balance sheet.

132. Therefore, we suggest that appropriate grandfathering provisions would need to be implemented for existing infrastructure projects

(c) REITS (Real Estate Investment Trusts)

133. UK REITS are subject to a special tax regime which includes restrictions on interest allowed through the financing cost ratio rules in the UK Corporation Tax Act 2010 section 543. In addition, the profits of the property rental business calculated under tax rules are not subject to corporation tax but instead there is a requirement that 90% of the profits are distributed to shareholders.

134. The majority of REITs have gearing between 25% and 40%. If a fixed ratio rule was introduced with a lower percentage no tax payment would result but the profits required to be distributed may increase. A REIT could therefore have insufficient reserves to make the distribution required particularly if they were highly geared. We suggest that REITs are carved out of these provisions as they already have an interest cover test as described above.

135. Real estate development and investment is a highly capital intensive industry that has historically relied significantly on debt finance. Real estate businesses use debt for primarily commercial reasons; given its bulky nature, it is often difficult to finance real estate through equity alone and debt can help significantly to make projects viable by reducing the overall cost of capital for investors. Debt finance also enables greater diversification by investors (they can gain exposure to more assets than by investing in equity alone) and increases the liquidity of real estate overall (by increasing the finance available to buy it). The tax deductibility of debt almost certainly increases its attractiveness (by reducing its after tax cost), but it is by no means one of the main reasons that real estate investors resort to using it.

136. It seems reasonable to assume that restricting the deductibility of debt will increase its cost and therefore investors’ cost of capital (although the OECD points out that there is not much evidence to support this argument). An increased cost of capital would reduce the number of viable investment/development opportunities, which would result in less money going into our built environment; with potential knock-on implications for the availability of space for businesses and jobs in the construction industry. Furthermore, the type of projects that might end up not happening as a result are likely to be in more marginal/secondary areas - exactly where the investment could have the greatest social impact.

137. Clearly, the potential impact depends on what mechanism is used to restrict interest deductibility. A fixed ratio rule is likely to be far more disruptive than an approach that allows all third party interest to be deducted.

138. Therefore, given that gearing levels tend to be slightly greater than a traditional business, the OECD needs to be careful that any new best practice recommendations do not lead to the creation of overly burdensome provisions that result in serious market distortion.

(d) Other Sector Specific concerns

139. In many industries, including the media sector, growth is achieved by frequent acquisition, which may pay back a return relatively quickly. If subsidiaries making acquisitions are funded with equity they
quickly arrive at a position where there is too much equity and it can be difficult to reduce capital. It is much more efficient to debt-finance acquisitions and as they pay back the debt is repaid. Temporary higher levels of debt should be accommodated, or even longer term levels of high debt where a high level of continuing acquisition occurs.

140. It should also be noted that although adopting a "net" interest measure effectively excludes many financial services providers from the scope of the proposed rule, some financial services businesses offer leasing products which fall to be accounted for as operating leases rather than finance leases. The funding for such products would typically reflect the particular financial services businesses' level of leverage. This produces a situation of relatively high net interest expense, which is nevertheless wholly commercial and does not indicate BEPS. This issue needs to be considered when reviewing the merits of group ratios (since the mix of a large group's different kinds of financial services businesses in each jurisdiction is unlikely to reflect the group average) and in setting fixed ratios.

141. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
APPENDIX I

EXAMPLES - GROUP WIDE ALLOCATION TEST

Example 1 – Impact of Acquisitions (question 7)

Before

B sells A to C

A

Bank lends

After

C deposits

Bank

A

Bank lends

Before

B owns A. Each borrows from a third party, and has the same debt/interest level.

→ No disallowance of interest expense for either of them.

After

C now owns A, but C is cash rich.
A is still borrowing from third party.
A now gets no tax relief because its new group has no net interest expense.

Distortion

Nothing about A’s business or its interest/debt level has changed, but it is now denied any tax relief for interest paid to a third party bank, purely because of an ownership change.

Example 2 – Commercial restrictions on moving capital to meet allocation key (Questions 7 and 17)

Company A, located in Country A is a successful business and has paid off all external debt. It has a valuation (based on assets) of £1m. However, it decides it wishes to expand overseas, and therefore identifies a target – Company B (resident in Country B) which has two subsidiaries in Countries C and D. Companies B, C and D are also successful business with no external debt and sufficient working capital on their balance sheets.
In order to buy Company B, A has to borrow all the proceeds from a third party bank (let's say £1m). For this example; Company B is worth £500k, and Companies C & D are each worth £250k (values based on assets). A pays the full £1m in consideration to the former shareholders of Company B in cash using the borrowed amount. Therefore post acquisition, the structure looks like:

```
<table>
<thead>
<tr>
<th>Company</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td>D</td>
<td>D</td>
</tr>
</tbody>
</table>
```

Under a group allocation rule (based on asset values), Company A would only be allowed interest deductions on 50% of the interest. To get a full deduction, A needs to push down £250k to Company B, £125k to Company C and £125k to Company D. However, there are a number of issues involved with this:

- A has no cash left as all loan proceeds were given to the vendor. Therefore A has no cash to make a simple loan.
- Companies B, C and D are all successful businesses with sufficient working capital. They do not need any cash and therefore even if Company A had spare cash and could make a loan, any loan would be purely for tax purposes.
- It may be possible to reduce capital or pay dividends in lieu of a loan note to push the debt into the right companies. However, all pre-acquisition reserves were distributed to the vendor prior to the sale (as is normal in many commercial deals). Therefore the companies cannot legally pay dividends.
- If a capital reduction in exchange for a loan note could be achieved, as the structure would be purely to ensure tax deductions were obtained, the tax authorities in Countries B, C and D would deny the tax deductions.

Therefore, despite the fact there is no BEPS behaviour, (as the bank is paying tax on the interest income) there will commonly be no commercial ability to push the debt down following an acquisition. Even if there were, the companies do not need the cash and therefore tax deductions would be denied. As a result, double taxation (i.e. taxation on receipt, but denial of deductions) would inevitably arise.

**Example 3 – Distortion of M&A Market (question 7)**

This example continues the example outlined in Example 2 above. Some years later, the group wishes to expand again but this time has targeted an acquisition of a second company (Company A2) in Country A – Company A2 has an asset value of £1m and no external debt. The company A group has had some successful years and is now able to fund the second acquisition through retained earnings.

However, Company A2 is also a target for Company Z. Company Z is part of a large multi-national group which has no external debt and would also fund the acquisition through retained earnings.

If Company A were the successful bidder, the group structure would now look like this:
For the reasons outlined above in Example 2, no debt push down was possible after the acquisition of company B, and therefore prior to the acquisition, Company A is suffering a disallowance of 50% of its interest cost.

Company A and Company A2 are worth £1m each, Company’s B, C and D are worth £1m combined. Therefore if Company A was the successful acquirer, not only would Company A2 be worth the £1m asset value, but in future, only 33.3% of interest would be disallowed in Company A. Therefore the value of Company A2 to Company A is £1m plus the NPV of tax deductions for 16.7% of the interest payments.

Company Z, a successful company with no external debt and not needing to borrow to fund the acquisition would only benefit from buying Company A2 to the tune of the £1m assets purchased.

Therefore, as a result of Company A being in a position where it has excess leverage for the purposes of the global allocation method - it is able to offer a higher price for Company A2 than Company Z. Being highly leveraged has created a distortion in the M&A market.

**Example 4 – Cash Rich Groups (question 21)**

In this scenario, Company A is the head of a multi-national group with no external borrowings. Company’s B, C and D each require some short term cash for various commercial reasons e.g. working capital after making a short-term loss or they require working capital to fund a relatively small project.

The group then it seems to have the following options:

- Borrow locally from a third party and accept that relief from interest will be significantly reduced due to the level of assets in Company A.
- Borrow intragroup, incur interest and accept that an interest deduction will be disallowed and that the corresponding interest income will be taxed;
• Borrow intragroup on an interest-free basis. However, many jurisdictions, including the UK would then seek to impute interest and impose tax accordingly; or

• Fund the project using equity, which may be difficult due to impracticalities in determining the subsidiary’s exact funding requirements. However, in such circumstances, when the company returns to profitability it must pay dividends (but only after any negative reserves have been eliminated) and suffer withholding tax in order to return the funds that it would otherwise have chosen to borrow.

The normal commercial decision would be the second bullet point – to borrow intra-group. However, as noted above, even though the interest income would be fully subject to tax in Company A, all deductions in Companies B, C and D would be denied.

A highly leveraged group on the other hand would be able to claim tax deductions in each entity and therefore have a reduced cost of capital in funding expansion into new markets. Without an appropriate corresponding adjustment mechanism, the introduction of a general interest limitation rule could provide significant tax distortions.

EXAMPLES - FIXED RATIO TEST

Example 5 - involving an Asset Backed Pension Scheme Arrangement (questions 32 and 33)

An asset backed pension scheme arrangement was entered into to provide funding to the pension scheme for a 25 year funding period. As part of the funding the right to receive interest on an intra-group loan was assigned to the pension scheme.

Under this arrangement, interest of £50m is paid by a UK co [loss making] via a UK SPV (which is taxable on the interest income) to the pension scheme. Under the proposals, due to the UK co being loss making the interest of £50m would be disallowed. There are proposals to allow a company to carry forward a loss in these circumstances, however as this company will be making a loss for the next 25 years, no relief will ever be available.

Over the term of the pension funding arrangement, tax relief of £50m x 20% x 25 years = £250m will be lost despite the interest receivable also being taxed in the UK.

It is should be noted that this company would not have assets that would count for the fixed ratio test, nor would it benefit from the carve out as its fixed ratio would be considerably lower than that for the group, therefore, no interest deduction would be due under either approach to a general interest limitation rule.
Example 6 – Issues of central group debt issuer (Question 27)

1 Parent and subsidiaries 1, 2, 3 are all in different European countries.

2 Sub 2 is the long-established central group issuer of group debt to the capital markets. It raises €1 billion which is on-lent to sub 3 at a tiny margin agreed with country 2.

3 Sub 3 uses the on-lent bond proceeds to invest in real assets situated and taxed in country 3 - its business is more capital intensive than fellow group members.

4 Sub 3’s ratio of interest to earnings is say 30% - fully deductible under current country 3 rules. The overall Group ratio is 15%. Country 1 is debt free.

5 Assume a group-wide fixed ratio interest restriction rule of 15% was introduced.

**Result**

Sub 3 would now suffer a significant interest restriction (30% > 15%). The debt isn’t in the highest tax territory – not BEPS driven.

Unfortunately, any exemption for third party interest expense or for secured project debt would not help. “Self-help” is also not possible for various reasons including Country 1 not allowing debt pushdown.
APPENDIX II

Examples of situations where it is (i) either not possible to place debt into a territory or (ii) it is possible to place debt down but no tax deduction available (Question 7)

OECD

- **Australia** – broad anti-avoidance legislation is in place. Borrowing at a higher rate to put cash on deposit at a lower rate would fall within anti-avoidance rules.

- **Chile** - Capital reductions are only legally permitted in certain circumstances. Chile’s current tax system includes a “taxable profits fund” mechanism (FUT). The FUT is a mechanism that is intended to encourage the reinvestment of profits in Chile. It is only legally permitted to carry out a capital reduction once the FUT is used up.

- **Denmark** - there is an asset ceiling test where the tax value of assets multiplied by an interest rate set by the Danish tax authorities annually is the maximum amount of interest deductible. The tax value of assets is limited and excludes the main asset value of many multinationals, being the value of brands. Therefore, the interest deduction cap in Denmark is usually low.

- **France** - Borrowing at a higher rate to put cash on deposit at a lower rate would fall foul of anti-avoidance. Taxpayers have been challenged by the French tax authorities on this point.

- **Italy** – borrowing to fund capital reductions will fall within anti-avoidance legislation, whereby the interest on such borrowing is non-deductible. Taxpayers have been challenged by the Italian tax authority on this issue.

- **Turkey** – Capital adequacy rules apply whereby if the share capital falls below a certain % of equity, there is a requirement to recapitalise or creditors can force the company into liquidation. This is to protect creditors. Therefore, if debt is pushed down into Turkey by means of a capital reduction or dividend pay-out from reserves, there may be a subsequent requirement to recapitalise the company. In Turkey, there are also, certain categories of equity where it is unclear whether it is legally permitted to undertake a capital reduction.

- **UK** – deductions for interest are not allowed where the main purpose is to achieve a UK tax advantage. Therefore any requirement to push debt into the UK purely to meet a global allocation test would not be deductible.

G20 (non OECD)

- **Argentina** – Central Bank restrictions – if debt was pushed into Argentina, it would be impossible to get the funds out. Hard currency is unobtainable and local currency cannot be remitted out of the country

- **Brazil** – tax deductions on interest must meet business purpose test. There have been tax cases in Brazil on deductibility of debt to fund a capital reduction on the basis of no business purpose where the Brazilian tax authorities have been successful in denying the interest deduction.

- **Russia** – business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments

- **South Africa** - business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments.

Non OECD and non G20
• **Algeria** - Capital adequacy rules apply whereby if the share capital falls below a certain % of equity, there is a requirement to recapitalise or creditors can force the company into liquidation. This is to protect creditors. Therefore, if debt is pushed down into Algeria by means of a capital reduction or dividend pay-out from reserves, there may be a subsequent requirement to recapitalise the company.

• **Angola** – where Foreign Investment Status is not granted by the authorities, it is not permitted to get funds out the country by way of dividends or capital reduction

• **Bangladesh** - business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments. Also, there are currency control issues with putting in place intercompany debt and subsequent remittance of intercompany interest payments

• **Kazakhstan** – There is no clear legal process for undertaking a capital reduction

• **Malaysia** - business purpose test whereby purpose of borrowing must be for working capital purposes only. No tax deduction available on borrowings to fund capital reductions and dividend payments

• **Nigeria** – heavily regulated by Central Bank. Applications required to authorities to put in place intercompany debt, which requires advance approvals. The applications must meet strict business purpose tests. Nigeria also has a rule whereby if distributions exceed taxable profit, the distribution amount in excess of the taxable profit level is subject to the full rate of Nigerian corporation tax.

• **Pakistan** - business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments. Also, there are currency control issues with putting in place intercompany debt and subsequent remittance of intercompany interest payments

• **Peru** – deductions on debt to fund dividends and capital reductions are specifically disallowed

• **PNG** – Highly regulated currency controls. Cumbersome process to remit funds / dividends out of the country. Prior approval required by authorities based on their assessment of the application provided. Therefore, in practice, dividends are remitted infrequently

• **Sri Lanka** - business purpose test whereby purpose of borrowing must be to produce taxable income streams. No tax deduction available on borrowings to fund capital reductions and dividend payments. Also, there are currency control issues with putting in place intercompany debt and subsequent remittance of intercompany interest payments

• **Uzbekistan** – currency exchange controls are very heavily regulated - if debt was pushed into Uzbekistan, it would be impossible to get the funds out. Hard currency is scarcely available and local currency cannot be remitted out of the country

• **Venezuela** - Central bank restrictions – if debt was pushed into Venezuela, it would be impossible to get the funds out. Hard currency is scarcely available and local currency cannot be remitted out of the country.
1 Introduction

1.1 The Chartered Institute of Taxation (CIOT) is pleased to respond to the Public discussion draft published on 18 December 2014 on BEPS Action 4: Interest Deductions and other financial payments.

1.2 The discussion draft on Action 4 focusses on group-wide interest limitations based around a group’s external borrowings. We are far from convinced that an interest limitation rule is the best option to address the BEPS concerns arising around interest deductions.

1.3 Although it is noted (at paragraph 5 of the discussion draft) that ‘there is a sense that unilateral action by countries is failing to tackle some of the issues at the heart of the problem’, we note that other Actions of the BEPS project are addressing a number of base erosion issues arising in respect of interest deductibility, and differences between countries regarding the treatment of debt are a natural part of an international tax system where countries retain sovereignty over tax matters.

2 Policy considerations

2.1 We support the work which the BEPS project is doing to counter arrangements which have (rightly) caused so much public concern, namely structures whose purpose is to enable some multinational enterprises (MNEs) to pay low levels of tax in jurisdictions from which they generate significant amounts of profit. However, the proposals set out in the Action 4 discussion draft go beyond action to counter the splitting of profits from the activities which generate those profits. These proposals seek to harmonise the rules which countries have for determining how much interest is tax deductible, even in situations where the amount of profit generated is commensurate with the activity performed and in situations where no tax advantage arises.
2.2 We can see merit in proposals to reduce the scope for tax to distort commercial decision-making but whilst countries retain sovereignty to set their own tax rates, reliefs etc., tax will play a part in investment decisions. It seems to us that domestic rules regarding what expenses qualify for tax relief are, as much as headline rates of tax, matters for each country to determine taking into account all aspects of its tax system (for example, its CFC regime). As such, we take the view that the approach adopted by this consultation document goes well beyond the scope of the BEPS project.

2.3 The area addressed in this discussion draft is different from the other areas addressed by the various BEPS Actions. It considers an issue which is fundamental to all businesses – that is how to finance the business. This is a very different matter to tackling, say, hybrid mismatch arrangements, which are a specific tax tool that can be used by MNEs. Every group has to finance its business.

2.4 The document seems to assume that a group is in effect a single entity and any internal financing of a group is merely an allocation of capital, and the form of this allocation is irrelevant. However, this ignores the fact that groups are made up of separate legal entities, and the transactions between them do have legal and contractual reality. The document assumes a form of formulary apportionment can be applied, ignoring the fundamental concept of separate legal personality.

2.5 The proposals do not distinguish between debt used for tax planning purposes and debt simply used to finance trading and investment activity.

2.6 We accept that intra-group loans and interest deductions can be used to shift profits. However, the vast majority of intra-group debt does not result in base erosion or profit shifting. Most internal debt financing within groups is undertaken because this is the easiest and most convenient method of financing business activities. Equity financing and the payment of dividends is a much less flexible approach, and, generally, requires far more bureaucracy.

2.7 We take the view that a basic premise should be that interest should be deductible if it meets two conditions: (i) an arms-length test – ie the entity could borrow the debt in question on the terms in question from a bank or other lender; and (ii) a taxation of interest test, ie the amount deducted is matched by an amount taxed in the recipient (ignoring possible timing differences). This is one of the targeted rules noted in the discussion draft.

2.8 There is no reason, for example, why a well-capitalised and cash rich group headquartered in a relatively low taxed jurisdiction should be penalised by financing a subsidiary by debt, if that subsidiary could raise the debt externally if it were an independent entity.

2.9 We are of the view there are ways of limiting the BEPS impact of debt financing whilst retaining the ability for groups to finance themselves internally in the most convenient way. For example, if a concern is that groups can use internal debt to shift profits from high tax to a low tax jurisdiction where there is little substance, CFC rules and transfer pricing rules of the type proposed in Actions 8-10 are a better way to tackle this than interest restrictions by way of a cap.
3 Why groups use debt

3.1 The discussion draft appears to take the view that it is equally easy for a group to finance its subsidiaries by debt or equity. We would dispute the perception that equity is an equivalent funding option. Although funding by equity may appear to work from a purely economic perspective, in reality equity is much more bureaucratic, regulated and inflexible. As a result debt is often the commercially preferred route of financing.

3.2 In reality, inter-company debt will usually be the first choice in cash and debt management; equity financing will be a long term financing base. This is because debt is much easier to create, is more flexible in terms of repayment and is integrated into a group’s treasury and cash management systems.

3.3 On a day to day basis, a group of companies will be receiving funds from various sources and locations and paying amounts out in various locations – which may or may not be the same as where revenue is being received.

3.4 Very few businesses will have an even cash flow over a year. Some businesses may be geared to a seasonal event, for example, harvest in agriculture, or the ‘return to school’ for a publisher of textbooks. Some subscription based businesses may receive an extremely high proportion of their cash receipts in a concentrated period. There will also be spikes in expenditure, around the time of dividend payments to shareholders or ‘bonus season’.

3.5 Typically, a group treasury function will run some form of short-term inter-company lending process, which could include cash pooling to ensure funds received in one place are able to be used elsewhere. This itself creates a large number of loan relationships. These may be transferred into longer term ‘structural’ loans where a business is in a net investment/cost position; and sometimes, businesses have to make long term loans of surplus funds if there are barriers to dividend or capital repatriation. From time to time, a group will look to capitalise loans or pay dividend/return capital where it is clear loans are unlikely to be repaid. However, ‘equity’ events generally require more paperwork and are subject to more conditions than ‘loan’ events – for example, it may only be possible to pay a dividend after a set of audited accounts are produced. There may be capital duties associated with equity issues.

3.6 Groups thus prefer the flexibility of loan financing for a variety of non-tax reasons. The proposals as put are likely to penalise groups by increasing their tax rates if they cannot constantly turn loans into equity, or eliminate ‘upstream’ loans by way of dividends.

3.7 We would also suggest that affordable debt is a good thing for businesses and global growth generally. Debt indicates growth within a business and the ability to service debt should be viewed as an indicator of a strong, growing business. Debt is often a preferred route for financing a business as it can be used for growth promoting investment without diluting the interests of equity holders.

4 A group-wide interest limitation

4.1 For the reasons set out above we do not think that the G20/OECD should seek to harmonise global interest deductibility rules using an interest cap.
4.2 We will now detail our specific concerns around the group-wide interest limitation proposed in the discussion draft.

4.3 First, as a matter of principle, a group-wide interest limitation would be a departure from the arm’s length principle and would be a significant move in the direction of formulary apportionment.

4.4 The discussion draft says that the arm’s length test should not form part of this consultation process (paragraph 21). We would like to comment, however, on the concerns cited regarding the arm’s length tests in paragraph 22. We suggest that, given the increasing focus, as a result of the BEPS project, on transfer pricing and reporting to substantiate all types of intra-group arrangements, most MNEs will be producing annual transfer pricing and country by country reports. Hence the expense and burden of applying the arm’s length tests are already with MNEs. We suggest that these reports should be considered by countries as providing a robust safety net for tax administrations and for taxpayers. Application of the arm’s length tests using these mechanisms should be seen as a valuable tool in the protection against BEPS, rather than as an irrelevance.

4.5 A group-wide interest limitation would also result in distortive effects for groups considering similar investments, but with different cash/debt profits. In particular, the implications for cash-rich groups would be significant, in that if they have little or no external interest expense. Financing a subsidiary by a loan could result in a borrower not receiving a tax deduction for the interest even where the lender is in a higher tax jurisdiction than the borrower, and the loan had no tax benefit to the group.

4.6 The proposal would also create the situation where a company funded by a loan from a foreign bank could deduct all its interest, but the same company funded by a foreign parent might not be able to deduct any interest; a clear contravention of the arm’s length principle.

4.7 Some of these effects could in part be mitigated by the proposed combined approach discussed in Part X of the discussion draft. However situations where a group is funding a large capital project, which is expected to be highly cash generative and economically can support a substantial amount of interest, and gives rise to a high debt/equity ratio in the company undertaking the project would not be covered by the combined approach.

4.8 As discussed above, we take the view that the BEPS effects of debt financing can be dealt with by CFC and transfer pricing rules, along with actions on matters such as hybrids. Work on harmful tax regimes to eliminate financing ‘rulings’ with little economic rationale also has a part to play.

4.9 However, if, following this consultation exercise, the OECD nonetheless concludes that some form of interest restriction rule is required, a better approach would be a limit on interest deductibility across a group by reference to what the group could borrow, not what it has borrowed. This would prevent discrimination between highly externally leveraged groups and well capitalised groups.

4.10 Such a limit on interest deductibility should be subject to two levels of test:

4.10.1 at the level of the entity paying the interest, it should be shown that the interest payment meets an arm’s length standard test; and

4.10.2 a fixed ratio approach – a fixed ratio is adopted for all entities, subject to a
maximum limit across the group for deductions equating to the fixed ratio applied to the relevant group figure. This fixed ratio would be related to the Group’s borrowing capacity, not by its actual borrowing.

4.11 A group having net interest expense in excess of the interest cap percentage should be allowed to carry forward the excess interest, as with other interest disallowances arising.

4.12 Examples are attached showing how this approach would affect groups with various levels of leverage. What is important is that they show that the outcomes are much more closely grouped using this combined approach than by allocating a cap based on actual interest expense, and correcting internal financing to avoid disallowances can be done whilst maintaining inter-company debt financing. Adopting this approach would mean that discrimination between groups is significantly reduced without creating base erosion.

5 Part IV. What is interest and what are payments economically equivalent to interest?

5.1 We are cautious about what payments/expenses might be included on the basis that they are ‘economically equivalent’ to interest. In our experience such other ‘things’ are often not all that comparable when other considerations are taken into account. In this context, we think it is very important that any test which seeks to include other payments/expenses involves both limbs in paragraph 34 of the discussion draft. That is the payment/expense is:

(a) linked to financing

AND

(b) calculated by reference to an interest rate.

5.2 Ensuring there is a link to financing would (properly) exclude the following situations from the proposed rule:

(i) a trader agrees to buy an asset – say some land – with completion due 1 January 2015. As the trader is slow getting its finance in order, it pays interest at the agreed daily rate on the overdue completion monies;

(ii) the trader sells goods and offers a discount for advance payment calculated by reference to an interest rate; and

(iii) damages are awarded against the trader subject to judgement interest.

5.3 It would also be useful to see an acknowledgement that a payment that is restricted by reference to the performance of the overall business – ie a dividend on a share in a jurisdiction that has a distributable profits rule – is never economically equivalent to interest. This is because it is a hallmark of interest that it is payable whether or not the business is profitable and whether or not the borrower is able to pay it. The two limbs test above does not seem to exclude fixed rate dividends. However, we suggest that fixed rate dividends should not be taken treated as interest: it would seem incorrect to treat non-deductible items as interest for the purposes of a deduction limitation rule.
5.4 This leads us to suggest that there should be a third limb to the test – that is an amount is only economically equivalent to interest if it is tax deductible on no less favourable a basis in the relevant jurisdiction than interest would have been. If it does not command the same tax treatment, it isn’t ‘economically equivalent’.

5.5 With regard to the payments identified in paragraph 35 of the discussion draft, we have concerns about the final three bullet points.

5.6 Foreign Exchange (FX) gains and losses – many groups enter into hedging arrangements of various kinds to neutralise the impact of foreign exchange fluctuations. Many tax regimes have already developed detailed rules to accommodate this and prevent abuse. It is very difficult to see how these regimes could be aligned with the type of measures proposed in the consultation document. FX gains and losses should not be considered interest for these purposes.

5.7 Guarantee fees, arrangement fees and similar - whilst these amounts are often added to finance costs such as interest for the purposes of reporting, they are auxiliary and contractual amounts required for the finance to be provided, and are generally not seen as ‘high risk items’ used for base erosion. To the extent that such items occur as inter-group payments, they are better dealt with from a transfer pricing perspective, and should not be dealt with in this action.

5.8 Question 1 refers to amounts incurred with respect to Islamic finance as an example of, presumably, ‘economic equivalent’ payments. It would be helpful to clarify what other types of payments Working Party No 11 has in mind.

6 Part V. Who should a rule apply to?

6.1 We suggest that a 25% control test to determine whether entities are related is too high. 25% control is no control at all if one other shareholder has 75% control. Equally, if there are four 25% shareholders, one of them on their own has no power to force things through against the wishes of the others. We note that the 3rd bullet point of paragraph 38 of the discussion draft actually refers to a 25% investment, and not control. Is this intended to pick up relationships involving loan stocks etc. as well as shares? If this is the case, then the result could be that the rules would capture things which should really fall within ‘scenario 4’; for example where a bank has loaned an amount which represents 25% of the total financing or conceivably where there is a Eurobond in issue which is held by a depositary for a clearing system or where a bond trustee holds rights on behalf of investors.

6.2 We suggest that using a 25% test and definition similar to the definition of related parties for the purposes of anti-hybrid rules recommended under Action 2, is not appropriate in these circumstances. The anti-hybrids rules are designed to negate benefits to people who would otherwise be getting them and structures to access hybrid benefits do not generally happen outside fully controlled groups. However an interest disallowance rule that works mechanically without enquiring whether the arrangements have in fact been engineered to produce a BEPS effect is rather different; the rule could have quite harsh and/or unexpected effects in commercial situations, particularly where capital/financing structures have been entered into without thinking about the tax consequences or in the context of joint ventures between unrelated parties.
6.3 We would therefore suggest a higher level of control to determine whether parties are related.

7 Part VI What should a rule apply to?

7.1 The conclusion in paragraph 45 of the discussion draft demonstrates the bluntness of the proposed interest limitation rule. Consider a company A, which is financially sound and is making good profits; the interest rate on which it can borrow funds is likely to be lower than company B which is struggling and thus pays more interest on the same amount of debt and has lower profits. If the restriction looks at debt by reference to EBITDA, company B is more likely to be denied a deduction than company A simply because it is struggling commercially and not because it is indulging in BEPS. We do not think that it can be right to have rules which restrict a company’s deductions and, thereby increase its tax bill at a time when it is struggling.

7.2 Although it could be argued that the business should not be so highly geared, we are considering a situation where the debt was supportable at the time it was borrowed but a shock to the trade has changed things. There is a risk that a badly-designed BEPS Action 4 rule could apply with increasing harshness the more the company struggled. Paragraphs 51 and 52 of the discussion draft suggest that a company would not have to be ‘large’ to be within the rule, so it could apply to companies with low profitability.

8 Part VII. Should a small entity exception or threshold apply?

8.1 We suggest that, at least for an initial period of, say, seven years the new rules should apply only to large groups (as with UK Debt cap) so that the cost of addressing any initial issues arising on the implementation of any new rules and the expertise to do so is provided by those groups that have most resources. Such an exception for small entities would also be helpful for tax authorities as it would mean that the number of groups that they have to deal with is smaller and they can concentrate their resources.

8.2 We note the point made in the first sentence of paragraph 56 of the discussion draft, that if a group is close to a country's threshold for moving into the new BEPS interest limitation, it may decide not to locate its new factory there. We agree that this is a concern and suggest that where, as in this case, a BEPS solution may end up distorting commercial decision making and capital ownership neutrality (see paragraph 3) then one has to query whether the approach is the correct one. Although the concern in paragraph 56 can be addressed by not having a threshold to entry to the new rule, the same concerns will arise if not all States agree to adopt the new rules, fearing a cost to jobs and inward investment etc.

9 Part VIII. Whether interest deductions should be limited with reference to the position of an entity’s group

9.1 Part VIII of the discussion draft begins to consider the considerable accounting and compliance issues that would result from the proposals. At the very least any rule that allocates group debt, would need to have a mechanism that takes into account different types of businesses within a group. For example, if you had a group where
some companies owned land, other companies carried on farming trades and other companies engaged in commodity trading, there might have to be some acknowledgement of the different types of debt levels/interest costs incurred by the different types of trades in allocating group debt rather than allocating on a strictly pro rata basis. We would anticipate that this area would be one where considerable effort would be required to make an interest limitation work.

10  Part IX. Whether interest deductions should be limited with reference to a fixed ratio

10.1 We agree that there is very little to be said in favour of a fixed ratio rule on its own other than simplicity. It has the potential to produce the distortion referred to in paragraph 176 of the discussion draft. However, we do take the view that a ratio rule related to a Group’s ability to borrow, rather than actual borrowing, would be a better approach for any interest restriction rule.

11  X. Whether a combined approach could be applied

11.1 Approach 1 is effectively using a fixed ratio test as a gateway to a more complex test. This seems quite a practical approach, within the context of a limitation of interest by reference to external borrowing (and thus does not deal with our fundamental points discussed above). However approach 2 seems to impose a higher compliance burden on groups with a poor credit rating (implying high interest and lower profits). These are just the sort of companies which do not need to incur extra compliance costs.

12  Part XI. The role of targeted rules

12.1 The discussion on targeted rules, comes back to the initial question, which is: what is BEPS Action 4 trying to achieve? Is it to prevent too much interest expense in the entity in question (as measured against some form of yardstick for the ‘right’ amount) or is it trying to prevent interest expense arising in an entity for the ‘wrong’ reasons? If the entity has no more interest expense than permitted by the yardstick, does it matter why it has the interest expense? If the reason for having the interest expense is important, then why are deductions for ‘good’ interest (ie interest borne for bona fide commercial reasons) denied by the yardstick?

12.2 Please refer to the circumstances discussed at paragraph 7 above for an example of situations in which the rule as proposed could operate harshly.

13  Part XII. The treatment of non-deductible interest expense and double taxation

13.1 Under BEPS 2 (Hybrid mismatch) the OECD recommend rules to prevent asymmetries which lead to double deductions or deduction/non-recognition. It is disappointing that in BEPS 4 the OECD is not prepared to recommend rules that prevent double taxation. Indeed the application of interest cap as outlined would lead to double taxation in many cases.
13.2 There is no need to take the step of re-characterising the amount as a dividend if that leads to complications (as indicated in paragraphs 189-191 of the discussion draft), it would be sufficient to recommend that the rules in the other country do not impose a tax charge. This linked approach is of course the one adopted for Hybrid Mismatches. This is particularly important if BEPS Action 4 is going to produce a general rule that does not look at the purpose of the interest flow in question.

13.3 With regard to carry forwards, in principle it seems odd when the interest in question might be over the limit, but not produced by any form of tax avoidance (it just failed the yardstick test) to have an arbitrary cut-off. It may be that one group takes longer to turn its operations around than another or that one industry sector has different needs from another.

13.4 If the interest disallowance is a function of interest paid and EBITDA or some other profit metric, and there is no tax-avoidance criterion, interest carry-forward would be essential otherwise start-ups would be in a very odd position (lots of interest, no profits yet) and so would any other company which had a major problem or experienced a recession. The same problem could also be faced by groups which invested in long term projects. Putting a cap on the number of years would disadvantage long term investments,

13.5 A further point in relation to carry forwards: even if an MNE retains the ability to carry forward an interest deduction following the implementation of rules under BEPS 2, the ability to utilise the carry forward will still be subject to domestic rules which may, effectively render the ‘benefit’ worthless. For example, the UK rules only allow non-trading interest deductions to be off set against future non-trading interest (and other loan relationship) income. For a holding company which has interest expense, but whose income is non-taxable dividends, the deferred tax asset of the carried forward interest expense will not be recognised under most GAAPs as its potential utilisation is too remote; hence, commercially, it has no value on the balance sheet.

14 Part XIII. Considerations for groups in specific sectors

14.1 The discussion draft recognises that banks and insurance companies present particular issues. Although noted above, for all MNEs the decision to use debt is nearly always commercially driven, it is important to remember that for the insurance and banking sectors, commercial (and where applicable regulatory) rather than tax considerations drive funding structure and the issue of debt and, often govern where it can be located. Capital is particularly expensive for insurers and banks, as regulators force insurers and banks to hold high quality capital in excess of expected liabilities, and limit the amount and type of debt that may be included in regulatory capital. There is therefore a natural tension between the minimum amount of capital required by regulators and ratings agencies, and the maximum amount of capital an insurance and banking group can use effectively. In light of this we welcome the recognition that specific rules should be developed for these sectors.

14.2 REITs in the UK are subject to a special tax regime which includes restrictions on interest allowed through the financing cost ratio rules (in Corporation Tax Act 2010 section 543). In addition the profits of the property rental business calculated under tax rules are not subject to corporation tax but instead there is a requirement that 90% of the profits are distributed to shareholders.
14.3 The majority of REITs have gearing between 25% and 40%. If a fixed ratio rule was introduced with a lower percentage no tax payment would result but the profits required to be distributed may increase. A REIT could therefore have insufficient reserves to make the distribution required, particularly if they were highly geared. We suggest that REITs are carved out of these provisions as they already have an interest cover test as described above.

15 The Chartered Institute of Taxation

15.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

The Chartered Institute of Taxation
9 February 2015
Example C

Interest Cap Rule - Cap - 30% earnings
Highly Leveraged Group

A. Co
Earnings €10m

B. Co
Earnings €45m

C. Co
Earnings €45m

BASE FIGURES

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
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<td>€m</td>
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<tr>
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<tr>
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<td>3.00</td>
<td>(34.00)</td>
</tr>
<tr>
<td>Overriding Cap</td>
<td></td>
<td></td>
<td></td>
<td>30.00</td>
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### Allocation of overriding cap

<table>
<thead>
<tr>
<th>Entity Cap</th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
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<tr>
<td>3.00</td>
<td>13.50</td>
<td>13.50</td>
<td>30.00</td>
<td></td>
</tr>
</tbody>
</table>

| Interest paid | 37.00 | 24.00 | 18.00 |
| Interest received | 24.00 | 18.00 | 3.00 |

| Net Interest income (expense) | (15.00) (34.00) |

| Entity Cap | (13.50) (30.00) |
| Interest allowed | (3.00) (6.00) |

| Interest taxed | 0.00 |
| Net interest taxed/(allowed) | (22.50) |

| Net third party interest | (34.00) |
| Interest disallowed | 11.50 |

### ALTERNATIVE FIGURES

<table>
<thead>
<tr>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>€m</td>
<td>€m</td>
<td>€m</td>
<td>€m</td>
</tr>
</tbody>
</table>

| Earnings | 100.0 |
| Entity Cap | 3.00 | 13.50 | 13.50 | 3.00 |

| Net third party interest expense | 0.00 | 0.00 | 3.00 | 3.00 |

| Overriding Cap | 30.00 |
| Allocation of overriding cap | 0.00 | 0.00 | 0.00 | 0.00 |

| Interest paid | 37.00 | 30.00 | 16.50 |
| Interest received | 30.00 | 16.50 | 3.00 |

| Net Interest income (expense) | (13.50) (34.00) |

| Entity Cap | (13.50) (30.00) |
| Interest allowed | (3.00) (13.50) (30.00) |

<p>| Interest taxed | 0.00 |
| Net interest Taxed/(allowed) | (30.00) |</p>
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
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<tr>
<td>Net third party interest</td>
<td>(34.00)</td>
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<td>Interest</td>
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Opinion Statement FC 5/2015

on interest deductions and other financial payments

(BEPS Action 4)

Prepared by CFE Fiscal Committee
Submitted to the OECD
in February 2015

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 (16 OECD member states) with more than 100,000 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).
Introduction

This Opinion Statement by the CFE Fiscal Committee relates to the OECD discussion draft “BEPS Action 4: Interest deductions and other financial payments”\(^1\), released for public consultation on 18 December 2014.

Please note that this is a preliminary Opinion Statement. The final version will be made available on the CFE website (www.cfe-eutax.org) in the course of February 2015.

We will be pleased to answer any questions you may have concerning our comments. For further information, please contact Mr. Piergiorgio Valente, Chairman of the CFE Fiscal Committee or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.

General remarks

As a preliminary remark on this action point we would like to express our concern about the impact this action point may have as it may influence the way companies make investments and how they finance them. This action point might result in hindering future investments and have a negative impact on the future economic development.

While we understand that multinational enterprises might be tempted to exploit differences in the tax systems of countries all over the world, the instauration of a limit on the deduction of interest payments may not be the best solution to counter these problems that arise in first place from the different treatment most countries apply to the remuneration of equity and the remuneration of debt.

Where dividends as remuneration of equity are, in general, a non-deductible item, interest that remunerates debt financing will in general be tax-deductible. Most countries apply already certain rules to limit the deduction of interest. Installing a more general rule will only be beneficial if it is applied worldwide (in all countries) in the same way. As we look at the proposals of this action point, although it is preliminary what the conclusion of action 4 will be, the proposed rules leave a lot of room for local implementation that might differ between countries. Therefor it can be expected that countries will, as before, adapt their policies in order to remain (as) attractive (as possible) for foreign investors. MNEs will probably adapt their policies to exploit differences in the laws of the different countries.

Other solutions that could be envisaged would be to install a tax system where the effects of financial income/costs are neutral for the calculation of corporate income tax, or where the corporate tax treatment of the remuneration of equity or debt is not or not substantially different.

Finally, we would like to stress that financing with equity or with debt is also treated very differently from a legal point of view. These differences will also have an impact on the decisions companies make when choosing how to finance their investments.

Policy considerations (Chapter II)

\(^1\) http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf.
A first remark concerns the last sentence of § 10. ‘Overall, however, in general groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost’.

Although this statement is made as a general rule we have the feeling that the instauration of rules to limit the deduction of interests will, at least in some cases, lead to situations where not all third party interest cost will be tax deductible.

**Double taxation**

We are also concerned about the (risk of) double taxation that will occur when rules to limit interest deductibility, as described in the consultation document, will be installed.

Although the avoidance of double taxation is considered to be a principle when designing these rules (§ 11 – 4th bullet) the proposed solution for the avoidance of double taxation by allowing the carry forward of disallowed interest expense into future periods does not avoid double taxation as such. It only softens or reduces the double taxation by allowing a possible future deduction. The suggestion to limit the carry forward in time made in chapter XII (§ 198) is unacceptable from a tax payer point of view. From practice in several countries where interest limitation rules were introduced it is apparent that a lot of companies that struggle with the limitation of the interest deduction and who are in a stress position during a certain time are never able to use the carry forward interest in future assessment years and as such the double taxation becomes permanent.

**Existing approaches (Chapter III)**

Another matter of concern is § 21. ‘It was also agreed that arm’s length test and withholding taxes should not form part of this consultation process.’

We believe that the existing arm’s length principle should be taken into account in the design of rules that would limit interest deductions, rather than replacing it by an overall limitation of interest deduction.

The same goes for withholding taxes. They are part of the actual tax landscape and cannot be ignored when establishing new rules. Although we agree that in certain cases (like in the EU with the Interest & Royalties Directive) the withholding tax will be reduced to zero, this is only to avoid, as much as possible, double taxation. Double taxations arises because in most countries the withholding tax paid in the source state is only partially reduced by a tax credit. The tax credit will only be given to the amount of tax on net income whereas the withholding tax is applied on gross income (Cfr § 23).

In our opinion it is not appropriate to keep transfer pricing and withholding taxes, which by themselves already cause a lot of concern for the taxpayer, out of the discussion. The consultation paper should at least give an indication how the interest limitation rule will interact with the transfer pricing rules and what the impact will be on withholding taxes.

**What is interest and what are payments economically equivalent to interest (Chapter IV)**
As CFE stated in its Opinion Statement on BEPS action 2 (hybrid mismatch arrangements), we remain of the view that the ideal solution would be common, internationally agreed concepts of debt and equity. The solution proposed in § 35 that consists of a non-exhaustive list of interest payments and payments economically equivalent to interest is not a good solution and will give rise to different interpretations/applications of the rule in different countries.

As such, foreign exchange gains and losses, guarantee fees and arrangement fees should not be considered as interest or economically equivalent to interest for these purposes.

What should a rule apply to (Chapter VI)

CFE agrees that, if any rule should be installed, that rule should apply to the entity net interest expense after offsetting interest income. Application of a rule to the entity’s gross interest expense is not acceptable.

Small entity exception (Chapter VII)

CFE also agrees that the rules should foresee a small entity exception. We favour the small entity exception as a size threshold rather than a monetary threshold, which will probably be different in every country. Countries are not likely to review the monetary threshold periodically and update it to reflect change in the economic environment. In practice, we see that monetary thresholds stay in place over a very long time without any review (except lowering of thresholds, where this generates more tax income). We believe that a size threshold is a more objective criterion and is easier to be set in all countries at the same level. Size thresholds already exist and are also used for instance in accounting law at EU level. We regret that the proposal does not propose a threshold as part of a best practice recommendation and that the statement favours a monetary threshold over a size threshold.

Finally, we believe that in the first ten years, any rule should only be applied to multinational enterprises that have operate on a truly global scale.

Whether interest deductions should be limited with reference to the position of an entity’s group (Chapter VIII)

As stated in the draft discussion paper, the impact on accounting and compliance issues from a group wide test will be considerable.

The statement of § 59 that the group-wide test would allow a group to centralise its third party borrowings in the country and entity which is the most efficient is rather allegorical as groups already do this and we have the impression that limiting intra-group debt and intra-group interest deductions is the main concern for action 4.

We have also serious doubts about the ‘mechanical allocation’ of interest deductions to group companies and how this will affect the revenue of the different countries involved.

**Whether interest deduction should be limited with reference to a fixed ratio (Chapter IX)**

Although a fixed ratio rule is relatively simple to apply we do not agree that current systems that apply fixed ratio rules set these ratios too high.

A ratio rule should also consider the groups ability to borrow rather than the actual borrowing.

**Whether a combined approach could be applied (Chapter X)**

Both approaches have their advantages and disadvantages. We remark that the proposed rule can lead to double taxation if the rules are applied. As said earlier, the avoidance of double taxation by allowing carry forward of non-deductible interest expenses is not a good option. Any rule that leads to double taxation should be disregarded.
Interest Deductions and Other Financial Payments – Concerns and Recommendations

A REPRESENTATION
BEPS: Action 4 – Interest Deductions and Other Financial Payments – Concerns and Recommendations

Background

On 18 December 2014, the Organization for Economic Co-operation and Development (‘OECD’), as part of its work on the Action Plan to address Base Erosion and Profit Shifting (‘BEPS’), released a Discussion Draft (Action Item 4) in relation to deductibility of interest expense and economically equivalent financing payments.

The Discussion Draft outlines three main alternatives to tackle non-taxation through the use of interest deductions. The alternatives are - a group-wide approach which limits a company’s net interest deductions to a proportion of the group’s actual net third party interest expense; a fixed ratio approach which limits a company’s interest deductions to an amount determined by applying a fixed ratio to earnings, assets or equity; certain combinations of the two approaches.

We recognize the efforts of OECD towards limiting the interest deductions to address the tax leakages and base erosion. However, in view of the existing Indian tax system and the legal and economic environment, we foresee certain practical challenges. Accordingly, we wish to bring to notice the concerns and recommendations for your kind consideration.

Group-wide approach for limiting interest deductions

The Discussion Draft proposes group-wide tests that aim to match net interest expense within a group to economic activity, so that the aggregate tax deductions do not exceed the group’s actual third party interest expense.

The two types of group-wide tests include - interest allocation tests and group ratio tests. As per the Discussion Draft, interest allocation tests or deemed interest allocation was strongly objected and hence not considered here. The group ratio tests however, compare a relevant financial ratio of an individual entity (such as net interest to earnings or net interest to asset values) with that of its worldwide group.
Fixed ratio tests to limit interest deductions

As per the fixed ratio approach mentioned in the Discussion Draft, an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets or equity. The key advantage of a fixed ratio rule is that it is relatively simple to operate and would be determined on the basis of an entity’s own financial position. Further, as per this approach, it should be possible to apply different fixed ratio to different industries.

Combined approach

The Discussion Draft considers a combination of the above approaches to address BEPS. It considers that a group-wide approach could be combined with a fixed ratio approach to achieve the “best of both”. This approach would allow entities with lower levels of interest expense to apply a simple fixed ratio rule, while more highly leveraged entities would apply a more complex group-wide test. This also could provide a solution for groups that have no overall third party interest expense, as it would still allow entities within the group to deduct a certain level of interest expense.

The concerns and the related recommendations emerging out of the above rules are discussed in the below paragraphs -

Concerns

a) In the legal framework specific to many countries (for instance India), the adhoc debt/interest pushdown, obtained by group entities across the globe, may not be permitted under the Exchange Control Regulations. This would involve bringing significant changes in these regulations in the respective countries.

b) Most groups borrow centrally and if the proposed guidelines are implemented, the third party debt (obtained in various currencies viz. Yen, USD, GBP or Euro) would be required to be allocated to all entities in a group by provision of loan. This would have administrative issues. Also, the external interest cost would increase as these loans need to be hedged back to the currency of the third party debt. This would lead to a vicious circle since the third party interest would keep on increasing and so would be the net interest to be ‘distributed’. It will also lead to an increase in the hedging costs of a group.

c) No guidelines are provided to demarcate the debt requirements in case of a capital intensive company vis-à-vis a service company. In a scenario, where a company in country A makes huge investment in assets or acquires another company and borrows debt externally, then the debt
cost would have to be allocated to all other group entities including any service company. Justifying the position of debt in the books of a service company could be a difficult proposition.

d) Many multinational groups find that the aggregated interest deductions across their group are less than their external third party interest costs due to the disallowance in individual entities. In other words, there is likelihood that none of the entities in any given year would able to claim deduction for their actual interest cost under the above approaches.

e) There is a possibility that the multinational groups would be at a disadvantageous position in comparison to domestic groups. Also, it is likely that emerging markets like India would have to bear a larger part of the debt of European and American multinationals.

f) Position of JVs and minorities needs to be evaluated. If JVs are heavily debt financed (for instance in case of infrastructure projects) to limit the economic risk to the partners, under the proposed rule, a large part of this interest would have to be allocated to the majority partner’s other entities. Conversely there would be an issue to the extent that interest needs to be allocated to entities with minority partners. These minorities are unlikely to agree to fund the group’s other projects in which they do not have a stake.

g) The volatility in one part of the group could have a ripple effect on other entities of the group which may lead to lot of uncertainty regarding the amount of interest to be recognized in the books of accounts etc.

**Recommendations**

(a) The suggestions provided in the Discussion Draft would be successfully implemented if the respective governing laws of the countries are modified appropriately to that effect. Thus, the Group may consider guidelines/ policies that can suitably sync in with the regulatory framework of various economies.

(b) The Group may consider providing detailed guidelines/ parameters to apply ratios/ allocations which are industry/ business specific i.e. the ratio/allocations should not be applied on a blanket basis to all the group entities.

(c) Group should provide guidelines as means for carry forward of non-deductible interest cost by permitting the carry forward or carry back of disallowed interest, or by rules that allow excess capacity to be utilized.

(d) The Group may consider providing an ideal ratio (which should vary from industry to industry) which may not attract any allocation of interest whatsoever.
General Comments

In this section, the comments are given to the specific relevant questions mentioned in the Discussion Draft which require additional consideration.

4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

A 25 percent control test seems low, but the extent to which this would be a concern depends on what the consequences would be of being deemed related.

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

Many multinational companies have cash trapped in entities with insufficient dividend capacity in local books. This cash is not available to the group to lower the level of external debt. As such it ought not to be included.

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?

It is practically challenging to lend – relatively small amount to number of legal entities in a group. The administrative burden of doing so makes it challenging.

Another practical issue would be that not one legal entity in the group will have the exact right amount of interest in any given year, which means that special set of books will need to be maintained to calculate the carry forward of interest or capacity, the expiration date of the carry forward and the use made. Also, accounts based on the group’s consolidated accounting method will usually not be available for individual legal entities.

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?

The link between assets and income is not very strong and therefore assets are not appropriate for allocation. For example, the value of assets does not mention anything about the risks associated with such asset, and similarly does not mention about the return. As a result, an asset rich entity (real estate) could have a high asset value, but low risk and income. This poses the risk that the value of interest allocated to this entity exceeds its income.

12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

A fixed ratio allowance could be made for different types of business.
13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

Dividend could be one example. However, a carve-out would be required for dividends that are taxable as many countries (particularly) outside of Europe do not exempt dividends paid up by subsidiaries.

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?

The exchange rate that is used in the consolidated accounts. This would yield the most consistent outcome.

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?

Different business sectors operate with different levels of debt.

For instance in a group with two entities, one in real estate and which owns hotel property, but does not manage the hotel itself, and the other manages a hotel owned by a third party. Suppose each entity has EBIT of 100. The real estate entity has assets worth 1500, equity of 500, debt of 1000 and pays interest of 80. The service entity has equity of 25, no assets, no debt and EBIT of 60.

Under a group wide rule the third party interest would have to be split between the two entities as follows:

Real estate entity 100/160*80 = 50 and the service entity 60/160*80 = 30. The third party debt to be allocated to the service entity would be 30/80*100 = 375, but who would finance a service provider with no assets at a 15:1 debt equity ratio. Economically that would make no sense.

17. What barriers exist which could prevent a group from arranging its intra-group loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

Refer comments provided under question #7 and #16.

20. In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

This would arise in all cases where an asset is depreciable for tax purposes, but not for accounting purposes. If such an asset would be acquired with debt, than a considerable part of the related debt (in an asset based allocation, over time most of the related debt) would have to be allocated to other entities in the group.

Consider a situation, where a group has two entities. One entity acquires the business of a competitor, most of the value is in intangibles such as goodwill. The acquisition is largely financed with third party
debt. If this entity is allowed to depreciate intangibles, its income would be reduced by the amount of
depreciation and therefore, part of interest incurred in relation to the acquisition would be allocated to
the other entities of the group. In such a situation, mismatch may arise.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering
disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches
could be taken to address timing mismatches?

Refer comments provided under question #7.

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to
the entities included in a group’s consolidated financial statements. This could introduce competition
concerns where a group-wide rule applies to entities held under a parent company (which typically would
prepare consolidated financial statements) but does not apply to those held under a trust, fund or
individual (which may not prepare consolidated financial statements). Would these concerns be more
effectively addressed by including connected parties within an interest limitation group, or through
targeted rules?

Although, this would depend on the definition of ‘connected’ however, it is likely that including
connected parties and entities in the group would add further complexity. Targeted rules should better
be able to address this.

23. Payments to connected parties may be disguised through back to back arrangements, where the
payment is effectively routed via a related party (such as a bank under a structured arrangement). In
applying a group-wide rule, how might payments made through such arrangements be detected?

This would be very difficult unless the tax authority would have access to the financial accounts of the
connected party that receives the payment. It should then be possible to compare payments made by
one party to a bank and then from bank to another party. Using a group ratio would not solve this as it
would be equally possible to inflate third party interest but a fixed ratio would possibly curb the issue.

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?

Using a single ratio may not be appropriate for different types of business and possibly for the same
business, but in a different phase of market development, or in a different country. Asset values would
be inappropriate because of the weak link between the asset and the income generated.

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?

The possible reasons could be heavy capital expenditure, recent acquisitions, start-up losses for the
disparity.
31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed though a general interest limitation rule and where would a general rule need to be supported by targeted rules?

Under a fixed ratio regime, there would be virtually no scope for manipulation. Under group wide allocation, risks would be related mostly to undisclosed related parties and back to back arrangements.

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?

This would differ mostly on the economic cycle of various industries as well as on the volatility of the earnings. If earnings can be volatile over an extended period, 5 years may not be appropriate.
The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry-led and industry-managed organization, playing a proactive role in India's development process. Founded in 1895, India's premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme of ‘Accelerating Growth, Creating Employment’ for 2014-15 aims to strengthen a growth process that meets the aspirations of today’s India. During the year, CII will specially focus on economic growth, education, skill development, manufacturing, investments, ease of doing business, export competitiveness, legal and regulatory architecture, labour law reforms and entrepreneurship as growth enablers.

With 64 offices, including 9 Centres of Excellence, in India, and 7 overseas offices in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organizations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

The Confederation of Swedish Enterprise is Sweden’s largest business federation representing 49 member organizations and 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 "BEPS Action 4: Interest Deductions and Other Financial Payments" 18 December 2014 - 06 February 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise appreciates the efforts by the OECD to develop recommendations regarding best practice in the design of rules to prevent base erosion through the use of interest expense.

The Confederation of Swedish Enterprise would like to outline the foundation on which any suggestion regarding rules that aims to eliminate base erosion through interest expenses should be based. That is that the vast majority of interest payments are not made with the intention of tax avoidance, but rather as a valid business expense without concerns of the possible effects on taxation. Any suggestion of best practices in this field must consider this, and seek to resolve the problem of base erosion with minimal impact on all valid interest payments made by companies.

It must also be stressed that in many situations, for commercial reasons, a loan can be preferable to contribution of equity. A loan can often be obtained at lower cost, and offer more flexibility and require less administrative work than equity. In some
situations a company may not have an alternative, for commercial reasons, but to finance an activity with a loan.

With the starting point that the vast majority of all payments of interest are legitimate and that there are a number of commercial reasons for a company to choose a loan over equity, it is important to adopt well-balanced recommendations regarding best practice in the design of rules to prevent base erosion through the use of interest expense. The best practice should aim to have a minimal impact on investments and competition, and to avoid double taxation and high compliance costs.

The Confederation of Swedish Enterprise do acknowledge that there is a problem with base erosion through some interest deductions and understand the need to act in this area. We support the development of best practice through analyzing the practices currently applied by countries and reaching consensus on which practice is the preferred one.

In the work on reaching best practice, the EU Treaty Freedoms and relevant EU-legislation such as the Parent-Subsidiary Directive should be considered, in order to make sure the OECD BEPS interest deductibility recommendations are compatible with EU law.

Any rule with the purpose of preventing base erosion through the use of interest expense should be neutral in its design, not disfavoring certain countries or sectors. One situation where neutrality issues may arise is when comparing companies only operating in one country and companies active in several countries. For a company active in more than one country any type of tax rule discussed in the Draft will almost certainly lead to a limitation on the amount of deductible interest, while a company only operating in one country in many cases will not be affected by such limitations.

It should also be noted that the different alternatives discussed in the Draft will have different consequences for both countries and companies. Applying e.g. a group wide-rule would mean a clear disadvantage for many companies from small economies compared to companies from large economies, given the current corporate tax regimes. It is therefore important that neutrality issues are given significant weight when deciding best practice.

The Draft presents six existing approaches currently applied by different governments to limit deductibility of interest expense. Three of these are concluded not to be suitable options for a best practice rule; these are withholding taxes, arm’s length tests and rules which disallow a percentage of the interest expense of an entity. The Confederation of Swedish Enterprise shares the concerns regarding these three approaches and agrees that they should not be considered as best practice.
We are also concerned about the lack of “transitional rules” within the draft. The suggestions set forth in the Draft might, if adopted, for some countries and entities lead to significant changes of deduction of interest expense. This should be acknowledged in order to ensure certainty and stability for affected companies.

**Specific Comments**

In the Draft it is concluded that three approaches should be considered more closely in the evaluation of best practices. The Confederation of Swedish Enterprise has found that the Combined Approach 2 based on EBITDA should, when compared to the other alternatives suggested in the Draft, be considered as best practice. The reasons leading up to this conclusion will be developed in the following.

**Group-wide rules**

The Draft suggests a group-wide rule to address base erosion through interest expense. Such a rule would be based on some relevant financial ratio, such as earnings or asset values. A group-wide rule could either be an interest allocation rule or a group ratio rule. The Confederation of Swedish Enterprise does see two major flaws in a group-wide rule. That is a lack of neutrality between small and large economies and technical/practical difficulties.

The Confederation of Swedish Enterprise is of the opinion that a group-wide interest allocation rule is not a feasible alternative for best practice, considering technical issues related to the implementation and major difficulties in applying such a rule. The other alternative, a group ratio rule, has similar drawbacks, but is not as complicated to implement as a group-wide allocation rule.

We would once again like to emphasize the fact that the vast majority of loans are not intended to create tax advantages. Hence, businesses should be able to arrange their financial structure in a way that is most efficient without concerns of tax rules. A group-wide rule would mean that this possibility is not given to companies, as they will be pressured into arranging their financial structure not in the most cost efficient way, but in the way most favorable in a taxation perspective. This could e.g. be the case when different entities within a group may be engaged in completely different sectors, which can have different debt requirements. A group-wide rule would put pressure on companies to structure their financing in such a way that might be completely opposite how they would have structured it from a commercial perspective.

In addition, a group-wide rule would encourage some groups to incur external debt that would not have been incurred otherwise. This is because highly leveraged group are treated more favorably if a group-wide rule is applied. It would also, as acknowledged in the Draft, cause complexities for both companies and tax authorities, which would increase compliance costs.
Any limitation to the right to deduct interest expenses increases the risk of double taxation. With a group-wide approach the risk of double taxation would be clearly present, since it is very difficult for an MNE to match third party net interest expenses in exactly the way that is needed for maximum deductibility. This leads to double taxation since part of the interest payment will be taxed at the third party and at the same time not be deducted by the MNE.

In theory, it might seem easy to move around assets within an MNE group to achieve maximum deductibility. However, there are a number of obstacles related to the matching process. By way of example, let us assume there is a need to transfer assets from one entity within an MNE group to another entity within the same group to be able to deduct all incurred interest expenses. This transfer of assets can be related to a number of obstacles, including withholding taxes and stamp duties. In addition the two entities may be operating their businesses in different currencies. Fluctuations in a currency can make it very expensive for owners to conduct a capital injection into a company. A relatively new example of such a situation is the Russian Ruble weakening compared to other currencies. If a Russian entity needs to transfer assets to another entity for the purpose of interest deductions it could be very expensive considering the weak Ruble.

A group-wide rule would, in addition to the mentioned problems, mean that there is not neutrality between small and big countries. Big economies can, due to the size of their economy, have relatively high corporate taxes, contrary to small economies. One consequence of this is that, e.g. groups established in big economies generally are financed by debt to a higher degree. A group-wide rule would thus lead to disadvantages for companies from small economies compared to companies from large economies.

With all obstacles a wide-group rule would mean, we find it not to be suitable as best practice.

**Fixed ratio rules**

Another rule suggested in the Draft is a fixed ratio test. Such a test has the advantage compared to a group-wide test that it has good potential to be simple for companies and tax authorities to apply and control, as the rule is mechanistic. A fixed ratio test also has the advantage that the rule does not need to be identically designed in all countries.

An important issue regarding a fixed ratio rule is to what base interest deductibility should be linked. The Draft discusses earnings or assets as potential grounds for deductibility. We believe that deductibility should be based on earnings, as set forth in the Draft. To use assets as a base would give rise to valuation problems and a number of other concerns as outlined in the Draft. Earnings are therefore the preferred base.
The next issue arising is how earnings should be calculated. It could either be earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA). We recommend the latter alternative to be used, since EBITDA takes different capital-needs and capital-intensity into account, which is not the case with EBIT. EBITDA does also provide stability in the system, since amortization and depreciation are relatively stable over time. This also gives better predictability. It should also be noted that EBITDA is used when assessing creditworthiness in the commercial market and in loan covenants. It is therefore natural also from a commercial point of view to use EBITDA as a base for interest deductibility.

A fixed ratio rule requires that a percentage is set to determine the size of the interest deduction. No recommendation is given in the Draft regarding the size of this percentage. The Confederation of Swedish Enterprise encourages OECD not to set the percentage too low, as this would lead to more situations where double taxation will occur. A low percentage also increases the risk of distorting the financing of investments. A percentage at a reasonable level would on the other hand mean an effective and simple rule. We believe that a fixed percentage of EBITDA should be at least 30 % in order for the fixed ratio rule not to be harmful. It is crucial that a recommendation of the fixed ratio is not set too low. If the combined approach 2 would be chosen as best practice it is even, from a neutrality perspective described above, more important that the fixed ratio is not set too low.

The mechanistic nature of a fixed ratio rule does entail a rule that is simple to operate. A weakness with this kind of rule is that, during some parts of business cycle, a company may be unable to deduct interest due to low profits, even if the interest is not used for tax planning. The same issue may arise due to a recession in the economy that makes the company not making profit. To deal with this obstacle, a carryover rule must be implemented to neutralize this effect arising from the volatility in a company’s earnings over time. It is essential that it is possible to carry forward both non-deductible interest and unused capacity. Such carryover rule could be unlimited or limited to a number of years. The Draft asks about issues arising from a 5 year limit on a carryover rule. We support an unlimited carryover rule as time limitations increase the risk of non-deduction. If a time limit indeed are to be applied we believe it should be at least 10 years considering the very long period of time it sometimes may take for a company to turn around a loss making business into a profitable and thus be able to deduct the carryover debt. Considering the possibility that a recession could follow after such a low profit period in the business cycle, it is obvious that there is a need for a generous carryover.

Combined Approach 2

When comparing group-wide rules and fixed ratio rules, we find the fixed ratio approach to be the preferred one as it is a much simpler rule to operate and gives the companies the needed predictability.
The Draft suggests a Combined Approach 2 which would complement the fixed ratio rule with a carve-out in form of a group ratio rule. By adding a carve-out to the fixed ratio rule, an additional measure of economic activity could be added to the model. This could be important in avoiding double taxation. A group ratio carve-out could, as set forth in the Draft, apply to an entity which can demonstrate that its indebtedness does not exceed that of the group. Since it is a carve-out rule and therefore voluntary to use, the difficulties that follows with applying such a rule is acceptable.

It is important that the combined approach 2 offers an effective carry forward opportunity, allowing the companies to carry forward both non-deductible interest and unused capacity within the EBITDA.

The Confederation of Swedish Enterprise therefore concludes that the combined approach 2 have such attributes that it should be considered best practice.

On behalf of the Confederation of Swedish Enterprise

February 6, 2015

Krister Andersson
Head of the Tax Policy Department
Memo

To: Working Party No. 11 of the Committee on Fiscal Affairs
From: John C. Hollas and Gordon Hands, CUFTanalytics
Date: February 5, 2015

Re: OECD’s Consultation Document on BEPS Action 4

Our comments with respect to the OECD consultation document are specific to the objective of BEPS Action 4 to address the OECD’s concerns regarding base erosion and profit shifting using deductible payments such as interest and/or financial payments that are economically equivalent to interest. The OECD’s main objective, as we understand it, was to prevent double non-taxation in both inbound and outbound financial transactions.

As the OECD consultation document states, “From an inbound perspective, concerns focus on excess interest deductions reducing taxable profits in operating companies even in cases where the group as a whole has little or no external debt. From an outbound perspective a company may use debt finance to produce tax exempt or deferred income, thereby claiming a deduction for interest expense while the related income is brought into tax later or not at all. Similar concerns are raised by payments under financial instruments such as guarantees and derivatives.”

In the first section of this memorandum we provide our best practices recommendations. The second section will describe the unintended consequences of the OECD’s proposed interest cap rule.

CUFTanalytics’ recommendations

While we recognize that part two of Action 4 will deal with transfer pricing guidance with respect to intercompany financial transactions and that the interest expense deductibility cap rule (“interest cap rule”) proposed in the OECD’s consultation document is not intended to be consistent with the arm’s length principle, we are still of the view that the best practices to combat BEPS should, and can, be accomplished through the application of the arm’s length principle. Specifically, and with reference to intercompany lending, we would recommend the following best practices to determining a rule to cap the interest expense deductibility.

First Recommendation:

We recommend that related party financial transactions should be considered as being structured as a senior secured debt obligation of the related borrower unless the taxpayer can provide evidence that arm’s length parties would have agreed to structure the debt obligation differently based on the circumstances of the borrower (e.g., that the related party borrower has third-party debt that would be senior in ranking to the related party loan).

In fact most related party loans would be the most senior (if not the only) debt obligation of the related party borrower. Even if the related party loan is unsecured it will (as it is the most senior debt or only debt of the related borrower) provide the related party lender with an equivalent of a first priority over the related borrower’s cash flow and assets (i.e., equivalent to a senior secured ranking). However, in the situation in which the related party loan is unsecured and lien subordinated to the borrower’s existing
third party debt then it would be an appropriate exception to our recommended “senior secured rule” and it would be priced as being structured as unsecured and/or subordinated.

Accordingly, we recommend as a best practice that the terms and conditions of the related party loan (i.e., determining the type of financing) be structured as ones that arm’s length parties would have agreed to in the circumstances.

Second Recommendation:

We recommend, as a best practice, a rule that would limit interest expense deductibility based on the maximum allowable debt for a related borrower by reference to the maximum leverage ratio in arm’s length financing agreements made to comparable borrowers (i.e., comparable in terms of credit risk profile and/or industry). Specifically, the maximum allowable leverage (or gearing) ratio is a relatively common financial covenant in an arm’s length credit agreement and is sometimes used in bond indentures. Typically, the arm’s length leverage (gearing) ratio will be defined as the consolidated funded debt divided by the consolidated annual EBITDA.

Our proposed rule is that the maximum amount of the related party loan would be an amount that arm’s length parties would have agreed to given an evaluation of the earnings and asset values of the related party borrower. Specifically, in an arm’s length loan the amount of the loan that a lender would be willing to commit to will be a function of the borrower’s EBITDA (it’s leverage on a debt to cash flow basis) or as a percentage of the borrower’s asset values (if this is specific to the borrower’s industry and/or credit risk profile). The arm’s length level of debt can therefore be determined by reference to the financial covenant data provided in comparable arm’s length financial transactions.

As an example of the maximum debt rule, CUFTanalytics performed a search for filings of third party credit agreements with the US Securities and Exchange Commission (“SEC”) by BBB rated distribution companies (SIC codes 50 & 51 wholesale trade and 52-59 retail trade) that had maximum leverage ratio (i.e., Debt to EBITDA) as a financial covenant. This search was for 4Q2014 and produced five (5) credit agreements. The arm’s length maximum leverage ratio for a BBB rated distribution company during that time period was in the range of 3.25x to 4.0x, with a median and mode of 3.5x (two observations out of the five). This arm’s length maximum debt rule would work (along with our first and third recommendations) to limit the interest expense deductibility.

Third Recommendation:

The third recommendation is less a rule than it is the application of the arm’s length principle to determine the interest rate that an arm’s length lender and borrower would have agreed to given the rules outlined in the first two recommendations.

If the arm’s length principle is applied to the terms and conditions so that the related party loan is considered to be, in the absence of any other rationale, as senior secured debt and the maximum level of debt is based on arm’s length leverage ratios from financial covenants in comparable unrelated credit agreements, and finally the interest rate is determined by the application of the arm’s length principle then base erosion and profit shifting should be significantly (and perhaps sufficiently and effectively) mitigated.
Unintended consequences of OECD’s proposed interest cap rule

CUFTanalytics commends the Working Party No. 11 of the Committee on Fiscal Affairs for its work in developing best practices recommendations in the design of rules to prevent base erosion and profit shifting by taxpayers using interest expense and other types of financial payments which are economically equivalent to interest. However, we are of the view that the implementation of the proposed interest cap rule may have unintended consequences in some cases. Specifically, the proposed interest cap rule may actually result in (or cause) base erosion and profit shifting, the opposite of the OECD’s objective. We elaborate below by reference to some examples of unintended consequences.

Unintended Consequence #1

In the consultation document the OECD states that:

“Rules to tackle base erosion and profit shifting by limiting interest deductions balance two objectives: allowing entities to claim tax relief for the real cost of their funds, while at the same time protecting a country from excessive interest deductions.”

The OECD views the “real cost of debt” as being the group’s overall third-party cost of debt (net or gross). However the OECD’s proposed interest allocation rule ignores the fact that in intercompany lending a group can use its member’s surplus cash that has been generated from operations (in addition to funds from external financings) to efficiently fund its global operations and reduce third party interest expense (mainly through internal cash pooling arrangements which are a widely used means of financing by multinationals). Intercompany lending is not necessarily 100% funded from third party debt.

The unintended consequence occurs as the owner of this asset (i.e., the surplus cash) will not receive an arm’s length return for its use (i.e., the intercompany lending of such excess cash) and the tax administration in the country of that member will not earn its share of tax on the interest income that the member would have earned. This is a shift of benefit from one member to the other without arm’s length compensation, and in effect, creates profit shifting, the opposite of the OECD’s objective.

If the OECD is concerned with double-dip type financings it could introduced a rule that interest expense is deductible by the related borrower only to the extent that interest income from that related party loan is included in income by the related lender.

Unintended Consequence #2

There is an unintended consequence that arises from the OECD’s questions, “What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?”

In our view there are a number of problems that could arise in applying a rule to cap interest expense (net or gross) deductibility based on earnings and/or asset values. However we disagree that earnings and/or
asset values are the best economic activity factors to be considered in the application of the rule in the first place.

To demonstrate the unintended consequence of the interest cap rule being earnings-based we provide the following scenario. If the group, on a consolidated basis, has negative earnings (losses) the earnings-based rule results in the third-party interest expense not being deductible by any entity in the group, even ones that have positive earnings. Therefore the member that has incurred the third-party debt would not be able to take any interest deduction (against its earnings). This scenario (which could occur if the rule is based on earnings) is not related to BEPS as the interest expense incurred by the borrowing entity in the arm’s length loan transaction is a third party expense and should be deductible (if permitted under domestic law). It does not impact on base erosion.

In another similar example (albeit an extreme one) a group could have one member whose borrowing requirements represents the entire amount of the group’s third-party debt. In this case, it would not be able to deduct its interest expense (or all of it) even though all the debt was from third parties (i.e., actually arm’s length) and it required the third-party debt to fund its capital expenditures and/or on-going operations. The OECD’s proposed rule would cap the interest expense of the member based of the member’s relative proportion of the group’s earnings and/or asset values. As a result it would report higher taxable income because of the proposed rule. The proposed rule, in this case, did not prevent tax base erosion but resulted in the opposite, tax base creation.

Unintended Consequence #3

Another example of unintended consequences is in the practical difficulties for the group in applying the rules. As suggested by the OECD, determining the amount of interest expense including financial payments economically equivalent to interest would be a rather complex process for the taxpayer, as it involves consideration of exchange rates, swaps, includes fees paid to third parties, etc.¹

The OECD’s interest cap rule (as described in paragraph 59 of the OECD’s consultation document) to determine the deductible interest expense based on economic activity is unworkable in practice for the following reasons. First, earnings and/or asset values are not relevant economic activity measures of interest expense. Consider the following example: the parent of a group using its investment grade credit rating issues bonds/notes in the capital markets (third party debt). All of the proceeds of the bond/note issue are on-lent to one member of the group. If we assume that the borrowing member has 25% of the group’s assets by value and/or 25% of the group’s earnings, it would be able to deduct only 25% of the third-party interest costs of the parent’s bond/note issue. This is not an outcome based on economic activity. In this example, the borrowing member required 100% of the financing for its business but could only deduct 25% of the third-party interest expense. The parent had effectively reduced the third-party interest expense by using its creditworthiness to issue bonds/notes but it will not be able to recover its cost of the debt nor will it be adequately compensated for the credit risk it bears to its subsidiary for the related party loan.

In addition the parent of the group and the other members (that hold 75% of the group’s assets and/or earnings) that have no debt (third-party or intercompany) would be allocated interest expense cap under the rule (that can be used to carry forward to use as a deduction when they have income). The application of the rule in this example, would actually lead to profit shifting. This could occur if a member that had for example 50% of the earnings (and/or 50% of the assets) with no external debt and a relatively small

¹ For example should financing fees be amortized over the tenor of the financing or included in current year interest?
intercompany loan. This member could reduce its earnings by deducting the 50% allocation of the third-party interest expense.

Also consider the case where, based on its funding requirements, a member of the group borrows from a third party bank. However under the group wide rule it cannot deduct all of the third party interest as a deductible expense. This would not be a matching of interest expense with economic activity of that member.

Unintended Consequence #4

With reference to Example #3 provided by the OECD (see page 75 of the consultation document) a group would endeavor to re-arrange its financings so that it could utilize the interest expense deductibility caps for each tax jurisdiction (as stated in paragraph 80). The unintended consequence is that some members that did not have any debt before the taxpayer reorganizes its debt will now have debt with an interest expense deduction that lowers its profit and taxes. For the tax administrations in these jurisdictions, the group’s debt reorganization has caused an undesirable profit shifting.

Unintended Consequence #5

The implementation of a cap on interest expense deductibility could have further unintended consequences as it may lead to the OECD introducing of caps on expense deductions for other types of intercompany transactions.

Would the OECD suggest a cap on the expense deduction for high-value services be based solely on the group’s actual total third-party expenses related to those services?

Also, would the OECD suggest a cap on the deductibility of royalty payments for the use of intangibles based on third-party costs for the use of intangibles from unrelated parties (which is likely to be at or close to no external costs)?

Or for that matter would the OECD suggest that transfer pricing for tangible manufactured goods be determined by designing a cap based on the group’s total third-party cost of manufacturing these goods. While this type of rule would only apply to the group’s manufacturing entities it could result in a shifting of actual manufacturing related expenses and profit from a high cost entity to a low cost entity

The introduction of expense deductibility caps (interest payments on intercompany financial transactions and payments on all other types of related party transactions) would lead to the total abandonment of the arm’s length principle!
Summary and Conclusion

In summary we would recommend the approach as outlined above (one that is built upon the arm’s length principle) rather than proposing an interest expense cap that would have unintended consequences with respect to the OECD’s BEPS Action 4 objectives.

Sincerely,

John C. Hollas
Global Managing Director
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Gordon Hands
Global Managing Director
CUFTanalytics
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Dear Achim

Discussion Draft on Action 4 (Interest deductions and other financial payments)

We welcome the opportunity to comment on the Action 4 Discussion Draft published on 18th December 2014.

We support the objectives of the G20/OECD Base Erosion and Profit Shifting project – and we acknowledge that there are examples of base erosion within multinational groups through the use of intragroup financing. However, in our view the proposals put forward in the Discussion Draft released last December go much further than eliminating base erosion.

Financing the activities of a group is critical to its commercial and economic success and involves many more factors than taxation. Issues such as credit risk, currency risk, transactional costs, exchange controls and legal issues such as company law drive companies to make the choices they do. Naturally, minimising financing costs is important, so this is an area where centralisation delivers significant commercial benefits. We think these factors need to be borne in mind when considering recommendations for best practice to limit excessive interest deductions. We would also add that major countries may need to consider how the availability of tax relief for financing costs supports the development of so-called invisible earnings through headquartered multinationals.

The Discussion Draft puts forward the proposition that a multinational should be able to deduct all its third party finance costs – and we agree. However, both the main approaches are likely to result in a multinational having significant non-deductible third party financing costs. This would be a significant economic constraint and could restrain global economic growth.

Group allocation methods bring the significant disadvantage that it is impossible for a multinational to adopt ‘self-help’ and locate debt in every country in which it has operations, proportionate to economic activity. We have discussed this with many groups – and it is clear that if it was possible to spread financing more widely many would already do so. In practice, it is commercially difficult to locate finance
in countries with small scale operations – but many in the service sector will earn 20-40% of their group profit from a great many countries each with low activity and thus profits. Many companies have subsidiaries with minority interests (which is especially common in emerging and developing economies). Placing finance in those companies isn’t commercially possible. Others will have joint ventures where the different profile of the JV parties means that in practice typically finance costs are held at the shareholder level. Project finance typically carries with it covenants on the level of debt in the entity/local group. Currency weakness and fluctuations expose a company to significant risk – encouraging more debt may increase the risk of capital losses.

There are then further levels of restriction that would prevent multinationals from pushing debt into locations. Company law restrictions can prevent dividends being taken to attribute the right amount of debt. Exchange controls apply in some countries. In others, the withholding tax cost could exceed any benefit of the future deduction of interest. There are also many limitations in national tax systems which prevent so-called debt pushdown – details of some are included in Appendix 2.

Options for ameliorating the adverse impact of group allocation approaches include a compensating adjustment system, where interest disallowed in one country would not be taxed in another; offering the potential for countries to receive, say, a 150% allocation; or perhaps a system of deemed deductions. In all cases, the system would only be effective with global adoption, which would include a commitment by countries to remove current barriers to interest deductions.

Under a fixed ratio approach, all groups (multinational and domestic) would be affected. The use of a single ratio may not be appropriate to all sectors and of course does not directly link to third party debt. The rules would need to be flexible, at the cost of simplicity to a certain extent, such that the ratio can be specifically adjusted to take account of, inter alia: different industry sectors; borrowings in different currencies (which have different interest rates); the impact of market interest rates increasing and decreasing; the impact of the economic cycle on leverage ratios, etc. We are concerned that there are reports that some countries consider current fixed ratios adopted in some European countries to be too high. We include in Appendix 3 data on third party debt levels in a range of sectors in the UK.

Fixed ratio rules could lead to significant disallowance of interest costs in some sectors. We are surprised that the Discussion Draft does not consider the private equity industry, or the real estate sector, both of which operate with relatively high levels of third party debt. Surely third party debt is not base eroding?

We would also note that, at least in the UK, a number of sectors effectively have their debt levels set by regulation, contracts with government or other factors such as minimum income levels set by government. Typically relatively high levels of third party debt are required, essentially because there is support for minimum income or profit levels. Since those levels are set by government action there is no potential for base erosion. We believe they should be excluded from any measures to limit debt deductions. Without an exclusion, the cost of services to consumers would inevitably rise.

The ability to carry forward disallowable expenses presents only a limited solution. In some cases the reason for the disallowance would be the fluctuation in profit – so a company might well also have operating losses. It would also not help start-up businesses or long-term projects, where often losses arise in early years. Introducing a limit on the number of years’ carry-forward would further penalise such activities. The financial accounting aspect is also important; deferred tax assets can typically only be recognised where recovery within a short time frame is reasonably assured.
Finally, there will be a separate Action 4 paper on the transfer pricing of intragroup debt later this year. It may be that aspects of that paper impact on the issues discussed in this paper.

We hope that the G20/OECD will consider different options to the ones put forward in the Discussion draft, directly focussed on base erosion.

If you would like to discuss any of these points further please do not hesitate to contact Sally Jones (saljones@deloitte.co.uk) or me (bdodwell@deloitte.co.uk). We would be happy to speak on this topic at the Public Consultation meeting on 17 February 2015 if it would be helpful.

Yours sincerely

W J I Dodwell
Deloitte LLP
Appendix 1 – Responses to questions raised in the discussion draft

What is interest and what are financial payments commercially equivalent to interest?

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?

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?

The most appropriate definition of interest and equivalent payments depends, at least in part, on whether the general rule, once determined, is to be based on an accounting measure of economic activity or on a tax measure. In principle, we agree with the proposed two-limbed test set out in paragraph 34 (i.e. that the payment/expense is both linked to financing and calculated by reference to an interest rate). However, if the general rule is referenced to an accounting measure then, on the grounds of simplicity, we would prefer for the definition to be the interest reported in the group accounts as defined by accounting policy.

We suggest that there should also be a carve-out such that where interest is already treated as non-deductible then it should be excluded from the general rule - on the grounds that any base erosion has already been countered.

We take the view that derivative contracts should be excluded from the rules. Derivatives whose underlying subject matters are not financial instruments are too far removed from interest to be included. Derivatives which hedge financial instruments are subject to too high a degree of fair value accounting volatility, which would give rise to significant distortions. Derivative contracts are held at fair value under IFRS accounting standards and, increasingly, under individual countries' GAAPs as they converge with IFRS. Such fair value movements could be considered to represent future expectations of constituents of a company's/group's finance cost, but given our concerns regarding their distorting effect we would prefer that, absent a full exclusion, only notional interest amounts payable/receivable under such contracts should be included, as suggested in the Discussion Draft. This will, though, lead to book-to-tax mismatches as noted at Question 9 below.

The Discussion Draft proposes that foreign exchange differences be included within amounts equivalent to interest. This makes sense in relation to exchange differences on finance cost payments themselves, but not, we consider, exchange differences in relation to the principal amount of financing instruments. Similar to derivatives above, this could result in significant distortion and also book-to-tax differences, as often exchange differences on debt instruments will not be taxable (due to an individual company’s functional currency, or specific tax hedging rules) but may appear in the accounts. Hedge accounting may result in such volatility being removed from the financial statements, but this can be difficult to achieve and groups often choose not to hedge account.

Also, exchange differences arising from intra-group loans can result in volatility in a group’s consolidated income statement and such volatility (which is unlikely to be matched by taxable exchange differences at entity level) could again result in the distortion of a restriction on finance cost deductibility. Therefore, we consider that exchange differences should not form part of the definition.
Who should a rule apply to?

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

4. Where do you see issues applying a 25 per cent control test to determine whether entities are related?

It is not clear what Chapter V seeks to achieve. It seems to us that its application may differ depending on whether the general rule is determined to be a group-wide limitation or a fixed ratio limitation. Each is considered in turn below.

**Group-wide limitation**

The premise underpinning the group-wide limitation concept is that a multinational group (MNG) should not be entitled to interest deductions that exceed its external financing costs. Accordingly, the question of ‘Who should a rule apply to’ has two separate components: (1) to determine which of the MNG’s debts are indeed external debts; and (2) to define the ‘group’ among which its external financing capacity should be allocated.

We presume that the two components should give rise to the same answer. It would be illogical for debts to be treated as intragroup debts for the borrower if the lender is not also treated as being in the borrower’s ‘group’. Doing so would give rise to inequitable mismatches. Envisage, for example, debt extended to a joint venture (JV) by, say, a 40% shareholder. There would be a mismatch if that debt were treated as ‘tainted’ intragroup debt but the 40% shareholder’s own contribution to the JV’s ‘borrowing capacity’ were ignored.

We consider that the threshold test for associates in a group-wide limitation context should be similar to accounting, in line with the consolidation requirements of generally accepted accounting standards (GAAP). From a practical point of view, it would seem most sensible to work on the basis of the consolidated group under accounting principles, as any other basis would create a significant compliance burden and it would likely be unmanageable for groups to have to apply many changes. In addition, it should be recognised that adjustments from the accounting definition will give rise to mismatches. This would most closely align with Scenario 1, and is explicitly acknowledged as the preferred route by Question 22.

One point which requires additional consideration is how subordinated shareholder debt should be treated under Scenario 1 for Private Equity (PE) portfolio companies. The reality is that such shareholder debt is, to all intents and purposes, external debt. It is managed as external debt on a wholly commercial basis. We argue that its inclusion within the definition of intragroup debt would unreasonably taint its true nature, and we urge that any group-wide limitation should carve out shareholder debt from private equity funds and similar lenders.

A practical solution to manage the question of related and connected parties could be to include an anti-avoidance type rule targeted at the particular situations which cause concern. For example, this is a solution which has been applied in the UK World-Wide Debt Cap (‘WWDC’) rules. Broadly, the anti-avoidance rule operates to bring within the WWDC those entities which have entered into a scheme during the relevant accounting period the effect of which was to move the group outside the WWDC thresholds entirely. There is also a purpose test associated with this rule.
Scenario 2 (parties under common control) is a situation typically found in the context of funds. We do not consider that two portfolio companies should be treated as associated. In our view each portfolio investment should be dealt with separately, which reflects the commercial reality of each portfolio company’s management and of its debts. Furthermore, we do not see an approach which requires the aggregation of different parts of a fund’s investments to be practical, as the necessary data would not be available – the accounting basis on which funds consolidate is different to the proportional rules typically used in consolidation accounting. For this reason we reject a definition of associates based on Scenario 2.

Scenario 3 (related parties) is a situation commonly found in the context of commercial JVs. The debt and equity position of JV companies is inevitably constrained by the agreements put in place by their various shareholders, and their use in base erosion activities is negligible for this reason. JVs within a single consolidated group would be adequately dealt with under Scenario 1 and therefore we reject a definition of associates based on Scenario 3.

In any case, in this context a Scenario 4 definition would clearly be nonsensical as all of a MNG’s debts, even those that are evidently with third parties, would then be treated as intragroup and there would be no scope for any interest deductions under any circumstances.

*Fixed ratio limitation*

We recognise that many jurisdictions include all debts – i.e. intragroup and with entirely unconnected external lenders - when setting fixed ratio limitations, which would imply that Scenario 4 represents current international consensus.

However, we question whether this is the right approach in the context of preventing base erosion and profit shifting.

The vast majority of companies have external borrowings, and we believe it is wrong for external borrowings to be disallowed for tax purposes beyond some arbitrarily defined cut-off which may or may not be appropriate for the relevant facts and circumstances: if a third party lender has determined that a certain level of debt is appropriate then that should be the end of the matter for tax purposes. Only debts associated with profit shifting activities should be caught.

Therefore, as an alternative to focussing on ownership structures, we would encourage the OECD to consider whether there are hallmarks which characterise debt which is not used profit shifting purposes (or where any base erosion would be better tackled through other BEPS actions). Deductions of ‘hallmarked’ debt should be deductible without limitation, whereas other debts should be subject to fixed ratio limitations. These might include:

- Debt where the borrower can demonstrate that the lender is taxed on the interest income at the same or a higher tax rate than the borrower experiences on its tax deduction (perhaps, as with the hybrids proposals, within a certain percentage of the tax rate of the borrower’s deduction).

- Lending between entities in the same jurisdiction, whether related or not, on the basis that any shifting of profits between the entities takes place within the same territory – if the shifting is abusive in some way then it should be left to the local jurisdiction to tackle the abuse.

- Debt issued on bond markets, where the bond issuer oftentimes has no knowledge of the bondholders’ tax position.
- Debt lent by third party licensed banks on normal commercial terms.

- Debt lent by alternative lenders. These lenders have become invaluable to business as the traditional lenders have retrenched, reducing the amounts which they have been prepared to lend and the risks that they are prepared to take. Interest expense paid to these types of lenders should be classified as third party expenses. In addition, debt lent by debt funds separate from equity funds (as proposed in Scenario 2 of paragraph 38), including in the context of sovereign wealth funds should be classified as third party expenses, because in general the funds are managed by different teams and the lending will only be made if it complies with the relevant fund mandate and will achieve the financial metrics required.

We understand that there may be concerns that cash-rich groups could locate their cash reserves in low-tax jurisdictions, while borrowing from external lenders in high-tax jurisdictions. With respect, in our view such matters should be dealt with via strengthened Controlled-Foreign Company rules rather than through the introduction of swingeing interest deduction limitations that will undoubtedly give rise to double taxation of external financing costs.

What should a rule apply to? (A) the level of debt or interest expense and (B) an entity’s gross or net position

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations where gross interest expense or the level of debt would be more appropriate?

Within a single entity (or fully consolidated tax grouping), net interest is the better answer, as applying the rule to net interest reduces the risk of double taxation.

However, we are concerned by the use of net interest expenses beyond a single entity (or fully consolidated tax grouping). In very simplistic terms, imagine a simple group made up of just two group companies; one company has bank interest income of £100 and the other has bank interest expense of £100. The group as a whole has net interest of £0. Applying a group-wide limitation rule to the group’s net interest would mean that the £100 expense would not be deductible but the income would remain taxable. We question whether this is appropriate and would like to highlight that it is not always possible for a group to manage its affairs such that cash can be used to repay debt, or cash is located in the same jurisdiction as the debt.

We consider many of the issues which applied to the WWDC debate are also relevant to this discussion. In designing the UK WWDC rules, there was much debate as to whether the rules should apply to gross group finance costs or net group finance costs, with the final rules applying to gross group finance costs identified as the amount available as a deduction to the group. The net tax deductible finance costs of UK companies are then compared to this amount, to determine whether there is a disallowance. This achieves a balance between not penalising groups which hold significant cash, and reducing the risk of double taxation arising from intra-group loans. (We note that while the level of cash holdings in corporates is currently high compared to historic norms, the income generated is very low due to unprecedentedly low exchange rates.)

Some of the key issues surround businesses which hold large cash balances concentrated in particular jurisdictions. Large cash balances may be held for numerous normal commercial reasons. We are concerned that using net interest expense unduly penalises holding cash balances and encourages groups to be cash poor. This effect would be magnified should interest rates rise from the historic lows that have been seen across much of the globe over the past few years. Some examples of where groups hold cash balances in normal commercial circumstances include:
- Holding a temporary cash surplus. For example, if a big part of the business is sold it is not unusual for there to be a 12 month or longer wait until the next investment comes along.
- Regulated industries which require entities to hold a certain amount of cash or capital. We have seen this in practice in the infrastructure industry where cash has been required to be held as surety for a contract.
- Financial services businesses which are required to hold liquid assets to meet their obligations under the EU Capital Requirements Directives.

We suggest that one solution may be to include an election to apply the rules on either a gross or net interest basis. There would need to be consideration as to whether an election needed to operate on a jurisdiction or group-wide basis. However, this would allow some flexibility and may go some way to address the issues which would be seen by conglomerates / mixed groups, as highlighted in the Discussion Draft. Another alternative is to adopt the ‘mixed’ approach used for the UK WWDC outlined above (i.e. gross group finance costs identified but with entity level restrictions based on net finance costs). A third alternative would be to incorporate targeted anti-abuse rules into the design of the general rule.

**Should a small entity exception or threshold apply?**

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

We suggest that the OECD should consider whether it can identify characteristics of low risk entities who might be excluded from deduction limitations all together. These might include:

- Groups whose operations are undertaken wholly within one jurisdiction.
- A de minimis threshold (to be determined by each jurisdiction based on local conditions and tax law).

**Whether interest deductions should be limited with reference to the position of an entity’s group**

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?

We object in principle to an interest allocation rule, which amounts to a formulary apportionment. We consider that this kind of rule creates too many practical problems for large groups. Some of these are included in our response to Question 8 below, with reference to practical experience of this type of rule.

Please also refer to our answer to Question 17, which outlines the considerable difficulties associated with restructuring to match debt deductions to economic activity.

As discussed at Question 24 below and illustrated by the data in Appendix 3, we consider that different ratios would be necessary for different industry sectors.

8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?
The UK’s WWDC rules seek to achieve a restriction on the overall level of finance costs claimed in the UK by reference to the group’s total gross external financing cost – i.e. this is less restrictive than the proposals in the paper, but the rules share similar practical difficulties.

The legislation was first introduced in 2009 and as such has now been in place for a number of years. Significant alterations were made to the rules over a number of years in order to amend the provisions for various mismatches that had been identified between the way in which accounts are prepared and the UK tax system works. These issues are likely to be common to any global group-wide rule.

The alterations have been made by secondary legislation, first introduced in 2010 but amended several times since. The process is reactive, in that a mismatch can be corrected only once it has been spotted, which means that some groups will suffer disallowances as a result of the mismatch before the legislation takes effect. This is a major practical difficulty, as mismatches are often caused by changes in accounting standards, and therefore cannot be predicted or prevented.

The result of the above process is that the rules become extremely complex to apply, and we consider that this would also be the case with a global group-wide rule.

We have set out a summary of some of the practical issues experienced with the WWDC rules below:

- **Paid versus accruals basis of taxation**: Under UK corporate tax law interest is usually deductible on an accruals basis. Accordingly, where a group-wide allocation mechanism links to the consolidated accounts of a group there should not generally be a mismatch between the timing of the recognition of interest in the accounts compared to that for tax purposes. However, there are circumstances (though now more limited) where interest is only deductible on a paid basis (or a discount is only deductible when the loan is redeemed). The mismatches caused by this difference in treatment has been allowed for within the WWDC provisions through the introduction of provisions which enable the group to effectively carry forward the consolidated income expense from the year of accrual to the year of payment.

This issue could be much more significant when considering a group-wide allocation rule if interest is taxed purely on a paid basis in other territories; for example, in the US in relation to intra-group interest. A similar fix to that used for the WWDC may be appropriate – however, the administrative burden this could create may be prohibitive for both tax administrations in jurisdictions that apply a paid basis and multinational taxpayers.

- **Finance costs recognised in the balance sheet rather than income statement** e.g. capitalised interest: The WWDC provisions include specific rules which allow a tax payer to make adjustments to the interest expense disclosed in their consolidated accounts in order to prevent groups from losing a deduction for interest expenses that are recognised in the balance sheet as part of the cost of an asset rather than the income statement. Under a group-wide allocation rule, a similar rule would be required to preserve tax relief for capitalised interest, where jurisdictions give such relief.

- **Amounts disclosed in financial statements**: The WWDC includes a provision which allows the taxpayer to look behind the headline numbers disclosed in the financial statements so as to disaggregate net amounts. This provision is required so that the true gross financing expense can be identified. In particular this enables groups to separate amounts incurred or received in
respect of derivative contracts from the financing expense related to its loans (see comments below in relation to the scope of the WWDC and derivative contracts).

- **Mergers and acquisitions and impact on the defined group**: The WWDC operates in a similar manner to the proposed group-wide allocation rule in that it uses the consolidated accounts position to define the amount of interest deductions available to the group. An issue arises when the group is involved in a merger, acquisition or sale as the defined group changes part way through an accounting period. The rules include provisions to deal with this, which have been amended to improve their effectiveness, but it is still unclear as to how the rules work in certain merger/acquisition scenarios.

The proposed new rules will need to cater for the fact that groups are not generally static for an entire accounting period so that identifying the appropriate consolidated financing expense may be difficult.

- **Fair value adjustments in the consolidated accounts**: Fair value accounting can lead to mismatches between the amounts recognised in the consolidated accounts in respect of financing arrangements and the amounts recognised in an individual company/taxpayer. As an example, a company may adopt fair value hedge accounting in relation to a debt and associated interest rate swap, and tax the resultant fair value adjustments. Alternatively the debt may be fair valued in the consolidated accounts but not in the entity-only accounts. It would be essential to exclude the fair value adjustments from the scope of a group-wide rule both from the accounting measure, and the tax measure of finance costs. Holding financial instruments at fair value in the financial statements is becoming more common as local GAAPs converge to IFRS.

- **Embedded derivatives**: The mismatch rules referred to above also allow groups to make adjustments for amounts recognised in respect of embedded derivatives. In some instances embedded derivatives must be recognised separately from host loan contracts for accounts purposes, with the loan element being amortised over the life of the security giving rise to a finance charge which is tax deductible in the borrower. However, this finance charge is not included within the consolidated finance expense that is used to define the total financing expense available for the group for the purposes of the WWDC rules (the “Available Amount”), even though the finance charge is part of the cost of the group’s borrowing. Accordingly, the mismatch rules allow for the Available Amount to be increased by an amount equal to the finance charge recognised in the company only accounts.

- **Deemed finance costs**: To the extent that tax law deems an amount to be a finance cost for a group company, which is not a finance cost in the consolidated accounts a mismatch arises. One example of this in the UK is certain transactions to contribute assets to pension schemes, in relation to which a deduction may be available in the UK as a deemed finance cost, but no charge may arise in the consolidated accounts. Again the mismatch regulations allow for the Available Amount to be adjusted for this amount so that the deemed deduction is not restricted by the operation of the WWDC.

- **Debt restructuring**: A distressed company may restructure its debt by modifying the terms of its existing borrowing or exchange its existing borrowing for new borrowing on different terms. If these changes represent a substantial modification of the terms of the loan, the UK accounting standards require the company to derecognise the loan and re-recognise it at its fair value. The difference between the face value and fair value is taken to the profit and loss account as a credit. The loan is then amortised over the remaining life of the loan giving rise to an increased finance charge for tax purposes. However, whilst the amortisation of the loan is a financing
expense of the UK company, it will not be included within the Available Amount, so a mismatch arises. Again the mismatch regulations allow for the Available Amount to be adjusted for this amount so that the deemed deduction is not restricted by the operation of the worldwide debt cap.

In addition to the above it should be noted that the scope of the WWDC provisions is significantly narrower than the proposed scope of the group-wide allocation rule. The WWDC applies to loans (not derivatives) and it only applies to financing costs arising from those loans; it does not apply to foreign exchange movements arising. When the WWDC was drafted initially it had a broader scope; however, it was decided that including items such as derivative contracts and foreign exchange movements was too complicated and would have made the rules inoperable.

It is currently proposed that a group-wide allocation rule would encompass foreign exchange movements, derivative contract and all other expenses relating to financing – this will mean that the rules will have a significantly higher level of complexity to deal with (as noted in Question 2 above).

Potential changes to the accounting definition of a group have also caused concerns, as these could change the identity of the “group” for the purposes of the WWDC rules –external debt could turn into ‘internal’ or vice versa. In addition, the activities of group treasury companies can cause complexity (see Question 18 below) and the WWDC rules contain an election to exclude such companies from the rules – which can resolve some, but not all, problems arising from group treasury companies, and in any event adds complexity.

Overall, the WWDC has introduced significant complexity into the tax compliance process for corporate groups in the UK, and also has created complexity for the tax authorities due to the need to audit computations and returns. We consider that similar rules operating on a global basis have the potential to be exponentially more complex, with issues such as those outlined above but in multiple jurisdictions, and we would reiterate the experience in the UK, that ‘mismatches’ (which result in the rules not operating as intended) are often only spotted once they have been in place for some time.

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?**

As set out at Question 4, we agree with the premise that a group-wide limitation rule should be based on a group’s consolidated financial statements (Scenario 1 in the parlance of Chapter V to the Discussion Draft).

We have, however, identified four issues associated with using consolidated financial statements and which we consider to be important and which we do not consider to be adequately explored in the Discussion Draft. We have outlined each of these below:

- **Definitional issues**: The definitions of group, debt and interest (and payments economically equivalent to interest) are critical to the operation of an interest limitation rule. Our experience from the introduction of the UK WWDC rules, as outlined at Questions 5 and 8 above, gives a flavour for how problematic definitional issues very quickly become.

- **Book to tax differences**: Book to tax differences arise on a number of items and can result in significant permanent or timing mismatches between accounting and tax figures. One example is transfer pricing adjustments (to any aspect of a taxpayer’s computations, not merely interest deductions), and it is by no means clear how transfer pricing adjustments should be treated.
- **GAAP to GAAP adjustments**: there are differences between the GAAPs of different jurisdictions, and indeed differences between the GAAP used at entity level and the GAAP used at the consolidated group level. Consideration will need to be given as to which GAAPs are acceptable and whether there are any jurisdictions which have GAAPs which could result in an unanticipated outcome. Even where the GAAPs for both the group and the taxpayer are acceptable, there will be differences between them. For example, there are fundamental differences to the treatment of employment costs such as pensions and stock options between US GAAP and UK GAAP.

- **Consolidation adjustments** can result in significant permanent or timing mismatches between accounting and tax figures, and the complexity is compounded by consolidation adjustments arising in the group accounts but not the accounts of individual entities. This issue is particularly acute for acquisitive groups, where each acquisition gives rise to consolidation goodwill at a group level which does appear in any individual company’s books.

10. **In what ways could the level of net third party interest expense in a group’s consolidated financial statements be manipulated, and how could a rule address these risks?**

We are not aware of any ways to manipulate the level of net third party interest expense in a group’s consolidated financial statements, not least because the group’s auditors will scrutinise the interest line as part of their audit processes. Any residual concerns could be addressed through an anti-avoidance rule.

That said, as requested we have identified a handful of techniques that could in theory be used to manipulate the rules. We should emphasise that we have not encountered these ideas in practice, and are firmly of the view that an anti-avoidance rule would counter them effectively.

- Depending on the measurement criteria for a group’s overall finance cost (gross v. net), back-to-back borrowing and depositing by a group from/to third parties could have the effect of increasing gross finance costs. To do this on a no (or low) cost basis, it is likely that there would be some right of offset between the borrowing and the deposit, from the third party’s perspective, which may (depending on the precise circumstances) result in the interest amounts being netted in the accounts in any event.

Absent that legal right of offset, it is likely that the third party would charge the group a spread for such transactions and therefore the group would be incurring a commercial cost, and increasing its reported gross debt, in order to increase the capacity for tax deductions.

Whilst in theory this could happen, in practice we have not seen such behaviour in the UK in response to the WWDC rules.

- Borrowing in high interest currencies could also increase gross finance costs. However, this would constitute a commercial cost for a group that would seem to exceed the tax benefit. In addition, the group would in any event want to hedge the resultant foreign exchange risk, and therefore would be likely to swap the debt back into its desired currency (resulting in notional interest income on the swap).

This could potentially increase gross finance costs if, for example, the interest cost on the debt were to be disclosed as a finance cost (and included in the measure of finance costs for the purposes of the interest restriction rules) but all amounts in respect of the derivative flow through the financial statements as a single fair value entry.
We consider this to be unlikely in practice given the likely significant commercial cost of (a) borrowing in a non-core currency and (b) then hedging the resultant currency risk. If interest amounts received / paid under derivative contracts are included in the definition of interest-like amounts, then such actions in any event should not be effective in increasing available tax deductions.

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?**

12. **Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?**

Of the two approaches outlined, it is our view that as a general principle, an earnings based approach would be preferable, whether in application to a group-wide allocation or a fixed ratio test. Earnings are arguably the most transparent indicator of value creation, except in specific and particular circumstances where assets would be a more appropriate measure.

In our experience, when lenders evaluate a borrower’s capacity to service debt they are primarily concerned with its ability to generate cash. Note that the obligation to pay interest is not dependent on making profits (otherwise start-ups and infrastructure projects with long lead times would never be able to borrow) but nevertheless earnings measures are widely used by third parties when determining arm’s length lending terms and associated covenants, as a proxy for cash, and earnings before interest, tax, depreciation and amortisation (EBITDA) is the most common earnings measure used by lenders.

However, EBITDA is not a formal accounting measure and as such there is no accounting standard that governs it. Many lending agreements use variations of EBITDA which, for example, strip out the effect of significant and non-recurring one off items. This is because, for a lender, such items do not impact an entity’s longer term ability to service financing. Insofar as EBITDA is used within a group allocation methodology, there would need to be a standardised definition.

(More generally, we note that in determining both earnings and asset valuations one is required to apply GAAP. We envisage a number of potential issues that arise from this, including items within GAAP that are open to subjective interpretation and different jurisdictions apply different accounting methodologies and local GAAPs. As such there is a risk that the valuation and/or earnings calculation methodologies employed across different jurisdictions may be inconsistent. Potential solutions would, in our view, need to include standard methodologies that would be applied across all jurisdictions, classes of assets, and industries that are to be used for the purposes of determining either earnings or the value of assets. However, this may result in very significant computational complexity for the taxpayer, and for tax authorities on audit/review.)

Clearly, there are some industry sectors where earnings will be more volatile, on an accounting period to accounting period basis, than the value of assets—certain types of insurance are one example. In these circumstances, arguably an assets based approach would be the most appropriate measure of economic value.

However, one significant issues associated with assets concerns their valuation. Assets acquired from third parties are generally brought into a company’s books at their purchase price (and then either fair valued on a periodic basis or amortised/depreciated) while assets generated internally are, broadly, not recognised on balance sheet. It seems unfair that two groups operating similar business
models should have different measures of economic activity due to differing approaches to how their business assets were acquired.

13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

We take the view that no income should be excluded. Any cash income can be used to service interest payments, and the tax treatment of individual categories of income is a matter to be determined by local jurisdictions. We also note that exclusions from taxation (e.g. participation exemptions, dividend exemptions) are often intended to prevent multiple layers of taxation. The income has (likely) been taxed in the company which has made the profits, and so excluding it is not justified.

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?

As set out above, lenders can and do extend debt to loss-making entities where there is a reasonable expectation of future earnings. (Where there is no reasonable expectation of future earnings in the foreseeable future, such as in the biotech industry, lenders simply will not lend.) Accordingly, it would be wrong to restrict interest relief for loss-making entities.

However, we also take the view the issue of individual loss-making entities is far less relevant for jurisdictions with full tax consolidation regimes insofar as those tax consolidations include profitable entities whose income can be offset by the losses made by other entities. Absent full tax consolidations, jurisdictions will need to take particular care to avoid loss-making entities being penalised while profitable entities have ‘unused capacity’, and we would hope that a mechanism akin to the UK’s group relief rules (allowing current year offset of losses and/or capacity within a tax grouping) could be incorporated into any group-wide limitation.

Carry-forward provisions (e.g. for both excess interest and unused capacity) would help to smooth the effect of any short term fluctuations in earnings such as the impact on oil and gas companies of the recent fall in the price of oil; however, this may not be adequate for addressing situations where there is a long lead time to profit, such as in the infrastructure and real estate industry). Another approach which could smooth the effect of any short term fluctuations would be to apply a three year average to earnings, although this would have the disadvantage of increasing complexity and we would therefore consider this to be opt-in option only as required.

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?

The appropriate exchange rates are the rates used in preparing the consolidated financial statements. We would, broadly, expect earnings items to be translated using the average exchange rate(s) for the relevant period, whereas assets valuations typically use the year end or historic rate(s).

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?

There are a number of industry sectors that, based upon our experience of arm’s length lending transactions, can achieve significantly higher levels of leverage than those which would be classified as ‘normal trading entities’. Such sectors would include;
Public infrastructure projects can be distinguished from other forms of investment by the way in which they operate on timescales and for objectives outside of the normal commercial business environment. By their nature they are activities which would not take place without the support of government, either through a commitment to fund the costs upfront or through a commitment to fund, either directly or indirectly, the ongoing availability of the project assets.

Due to the nature of infrastructure projects and the wider benefits to the economy that infrastructure creates, debt is often supported and guaranteed by local governments, EU or international bodies to encourage investment and raising of capital. High levels of third party debt associated with infrastructure projects are not considered by local or international bodies to be excessive and are simply a necessary feature of funding large scale projects. Any proposals that result in uncertainty of relief for interest costs and financing fees is challenging to the overall economics of the project. Not only would this increase the cost of capital, it would reduce the attractiveness for returns to investors and subsequently deter finance being raised, risking the commissioning of the project. This would seem to go against international, OECD, EU or domestic policy objectives which are committed to encouraging infrastructure projects which are necessary for the wider sustainability of global economies.

Financial services businesses which often have (1) highly liquid assets that can be realised quickly to satisfy debt obligations or (2) trade in debt instruments, which we consider should specifically be carved out of the scope of this BEPS action. At paragraph 210 of the Discussion Draft, the OECD recognises the need for a specific rule for banks and insurance companies. We would stress that the definition of a financial business for these purposes should be carefully considered. There are many categories of financial businesses that have money as their stock in trade. Therefore, using a narrow definition of a financial institution (for example, businesses that are regulated only) may not adequately capture all financial businesses. This is because regulation in this sector typically focuses on deposit taking, and therefore might exclude those financial businesses that fund themselves from the retail debt markets.

Private equity backed businesses – investments in this sector are typically made in fast growth portfolio companies that attract high leverage ratios on acquisition due to the relatively rapid deleveraging as the business grows. An earnings based approach is likely to be most suitable together with rules allowing carry forward surplus interest expense to be utilised through a local tax consolidation to reflect the lower earnings in the earlier years.

Real estate businesses often have a secure asset base, which provides lenders with significant security and results in these businesses being able to secure higher amounts of debt finance. In a real estate context, whilst an earnings based approach would be appropriate for ‘steady state’ real estate investments, there are many occasions when projects are not ‘steady state’. There can often be long periods where real estate is being developed or refurbished where there are little or no earnings and therefore based on the current proposals some or all of the third party interest cost would be disallowed. To address this it will be important to ensure that there is some form of carry forward of disallowed expenses which will enable these expenses to be set against future income; i.e. will not result in those expenses being ‘trapped’.

An asset based approach is considered less desirable for real estate in a falling market. This is because money is usually borrowed to buy the asset and the amount borrowed is based on the value on acquisition. An allocation based on assets would mean that if one property in a special purpose company in group went up in value and another in a different group company went down there may be a restriction on the amount of interest deductible in relation to the property which
has gone down in value whilst there would be no increase in the interest to be deducted by the company whose property has gone up in value as this will be capped at the actual interest expense.

We note that many businesses, including those that fall within the sectors outlined above, may be part of corporate groups that operate across multiple sectors. As such, for some but not all subsidiaries within a group, an asset based allocation methodology would be more appropriate than an earnings based allocation methodology, or vice versa.

We cannot see, in practice, how both methods could be applied simultaneously to allocate within one corporate group. Examples include: retail groups with a financial services division; a motor manufacturer that also provides customer finance; Japanese trading houses which form conglomerates spanning many sectors. Offering groups some level of choice (to be applied consistently) might be one possibility.

Another example would be a typical structure that many property backed trading businesses have adopted, known as a Propco-Opco structure. In the run up to the 2007 crash many groups with significant property portfolios organised themselves into a Propco and an Opco structure. The characteristics of this are that the business’ property is held in one or more Propco entity and the trading business is held in another. Many of these structures still exist. The borrowings of the Propco(s) were generally greater than the Opco as the Propco had a secure income stream and a high level of asset backed security. As a result an asset based approach would be more suitable for this type of business as it more accurately reflects the lending criteria applied by the banks.

17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

In our view the Discussion Draft significantly underestimates the issues associated with matching interest expense to economic activity. It many normal business scenarios it is difficult or outright impossible to achieve.

There are various non-tax reasons why it may not be practical for an MNG to push debt down into a particular subsidiary. These include:

- exchange controls (including currency restrictions in certain countries). Exchange controls in, for example, South Africa make debt insertion very difficult; likewise many Latin American countries, China and India;

- regulatory constraints operated within a particular jurisdiction. For example, certain financial services groups, such as banking and insurance groups, are in effect limited by regulation as to how much debt they can issue, the terms of the debt, and which entities can issue the debt, for it to count as regulatory capital.

- structural issues such as minority interests (sometimes required by jurisdictions where the minority is local to the jurisdiction, existing creditors or existing debt covenants;

- One of the peculiarities of a group-wide limitation is that it would oblige MNGs to push debt into jurisdictions with no funding requirements (e.g. because they are cash generative). It would then be necessary to repatriate the funds and many jurisdictions have restrictions on how such repatriates can be achieved (e.g. a requirement for distributable reserves to facilitate dividend payments).
In acquisition situations, MNGs borrow before the acquisition takes place in order to pay the vendor, and therefore it is impossible for the acquired entities to borrow direct. Although debt can sometimes be assigned to other legal entities upon conclusion of the transaction, there can be a significant period of time before it is possible to facilitate a debt push down. A grandfathering provision which allowed a group two years to restructure following an acquisition before an interest limitation applied would go some way to addressing this issue but would not fully address the issue faced by PE businesses where there may not be restructuring options.

In addition to non-tax restrictions, jurisdictions oftentimes operate tax rules that prevent tax deductions for debt push-down. It seems perverse to require MNGs to push debt down to jurisdictions in which no tax deduction is available. Tax-based restrictions may be grouped under four broad headings:

- Rules requiring intragroup debt to be benchmarked against to arm’s length borrowings, which may be deemed to be exceeded under a group-wide allocation;
- Rules restricting interest deductions to those created for a non-tax motivated commercial purpose (sometimes referred to as ‘unallowable’/‘business’ purpose rules);
- Rules restricting interest deductions to those demonstrably linked to taxable income streams, irrespective of the purpose for the borrowing;
- Existing fixed ratio limitations.

There are also jurisdictional specific issues. For example, debt push downs into Germany can trigger real estate transfer tax or loss of tax loss carry-forwards; leveraged dividends can result in withholding taxes.

Appendix 2 sets out a summary of jurisdictions where we are aware of tax-related problems with debt push down, and brief details of the nature of the issues encountered. The list is not comprehensive, but indicative of the extent of difficulty.

Finally, even assuming that the non-tax and tax restrictions can be managed, there are practical issues associated with ensuring that exactly the ‘right’ amount of debt is pushed into each jurisdiction. These include:

- Economic unpredictability (including large non-recurring items such as acquisitions which may fundamentally and permanently rebalance ‘capacity’ within an MNG);
- Lack of actual/forecast data availability across every single group entity and the fact that final data for an accounting period is not available until after the end of that period, so there is no time to fix any inefficiencies;
- Regular movements in intra-group balances which will cause inefficiencies as there will always be a time gap until debt amounts can be ‘right-sized’ — see Question 18 below;
- Difficulties in reducing debt in jurisdictions which would have excessive finance costs under a group-wide test – for example, debt waivers / capitalisations may result in tax charges for releases of debt;
- Debt may be retained in jurisdictions for entirely non-tax reasons – most commonly, for ease of cash repatriation through interest payments and principal repayments. Whilst the debt is not tax-motivated, denying deductions whilst still taxing the interest income in the lender leads to effective double taxation.

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

In our view the application of a group-wide allocation rule could significantly distort the commercial benefits arising from centralised treasury functions due to the fact that these functions typically generate a network of intra-group loans or balances which could lead to one sided disallowances of interest deductions. The balances created by these arrangements are fluid and may move monthly or even daily. As a result it is not possible to restructure these arrangements to locate the net interest expense in entities with operating profits without significantly impacting the commercial arrangements.

We have set out below two examples of common commercial treasury arrangements and highlighted the difficulties that a group wide allocation system could cause.

- **Physical cash pooling.** Under a physical cash pool a group’s surplus cash is centralised in the pool leader. This gives rise to inter-company loans which will generate interest income in the pool members and an interest expense in the pool leader. The pool leader typically deposits net surplus cash or has an overdraft for a net deficit. One benefit of pooling the cash is that the group will be able reduce borrowing costs by eliminating cost of carry due to gross borrowings and deposits – these higher returns are shared between the pool leader and the pool members such that the pool leader will benefit from a margin to compensate it for the risk that it is taking on. They also enable groups to use surplus cash from one part of the business to fund other parts of the business, hence reducing the overall requirement to borrow externally and allow groups to earn a higher rate of interest on its surplus cash due to the fact that it is pooled. Overall the arrangements should result in a higher net interest income and/or lower borrowing costs as there should be a lower requirement for third party borrowing.

In addition to these cash pooling arrangements which use structured products provided by banks, we are aware of a number of groups who effectively carry out cash pooling arrangements but on an informal or unstructured basis. It is common practice for surplus cash to be centralised where possible and this is usually done through intragroup lending rather than dividends or equity subscriptions, due to the flexibility loans can create and the lower administrative costs.

There is a risk that if a group-wide allocation rule were introduced, a proportion of the expense arising in the pool members could be disallowed as it would not match external borrowing – whilst the interest income in the companies with surpluses would remain taxable on their net interest income. The effect of this could be to significantly reduce the commercial benefits arising from this type of cash management and may encourage groups to revert to a decentralised cash model with all of its associated risks and commercial inefficiency; potentially increasing overall finance costs.

- Further the suggestion in the consultation document that a solution to the double taxation issue would be to allow for losses to be carried forwards would be unlikely to be an effective in this instance. This is due to the fact that:
• the purpose of these arrangements is to reduce the net external cost of borrowing for the
  group such that the limits imposed by a world-wide allocation rule on a company by company
  basis are likely to be lower than if gross external borrowing were in place,
• whilst the isolated borrowing costs on a company by company basis may remain at the
  higher level (pre-pooling).

- This would mean that a pool of carried forward losses would accrue in the borrower
  entities whereas the pool leader and other net lenders under the arrangement will continue to
  be taxed on their net income. If borrower entities are consistently in deficit, this position would
  be unlikely to reverse itself.

- Centralised payment and collection centres. We are seeing a growing number of companies
  establishing centralised collection and payment centres or in-house banks. This is again being
  driven by companies’ desire to reduce cost, mitigate risk, focus expertise and drive efficiency.
  However, these arrangements will again generate intra-group arrangements without increasing
  external third party interest costs.

These types of arrangements allow groups to have a single entity which is dedicated to dealing
with payments to and / or receipts from third parties. This leads to intra-group balances
between the contracting entity and the payment and collection centre. These balances may be
settled on a regular basis or may accrue until a year end or other trigger; however they will exist
for a period of time. The benefit of these arrangements for the contracting parties is that they
no longer need to operate their own payment operations, which helps to drive down cost.

The concern with a group-wide allocation rule is that the interest expense would be disallowed
on the basis that there would be no increase in the group’s external borrowing costs (even
though it is effectively a normal operating cost of the business) whilst the interest income in the
payment centre would continue to be taxed. As with the cash pooling arrangements above, this
means that the effect of a group-wide allocation rule could be to significantly reduce the
commercial benefits arising from this type of arrangement and the proposed solution of carried
forward losses is unlikely to be effective.

There is continual innovation in groups’ treasury structures, with liquidity management structures
becoming more sophisticated and efficient and driving commercial value for corporate groups. This
risks being undermined by the proposals if such structures contribute to groups failing to obtain tax
deductions for their economic external finance costs. The UK’s WWDC rules include an exemption
for ‘group treasury companies’, but such an exemption would not resolve the particular issues
mentioned above as the gross lending and borrowing positions in participant companies (i.e.
operating companies) would still be taken into account.

This further illustrates the need for a mechanism to ensure that groups do obtain deductions for their
external finance costs (see Question 21 below).

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be
   reduced if a rule used a combination of earnings and asset values (and possibly other measures of
economic activity)? If so, what could this combined approach look like? What further practical
difficulties could arise from such an approach?
We do not support a combined approach as we consider this would create too great a compliance burden for groups. As set out above, it may be possible to offer groups some element of choice as to which measure to adopt, provided that they apply the measure consistently.

20. In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

Please refer to the responses provided to Questions 8 and 9 above.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

We consider the carry forward provisions to only be a partial solution to timing mismatches. There will undoubtedly be situations, in particular where jurisdictions do not operate a tax consolidation system, where the carry forward would never be utilised. In our view, it would be important that there is no time limit placed on the use of any carry forwards to accommodate long lead time projects, although it should be noted that this would have implications for tax accounting and the recognition of deferred tax assets.

Also, even if relief is ultimately obtained, this could be years after the group has suffered the cash outflow associated with its external finance costs and we do not consider this to be an acceptable result of the proposals.

An approach which allowed the income related to the disallowed expense to be exempted from tax would go some way to address the issues created by mismatches. Without such a provision there becomes a risk of double taxation. If this scenario, where there is no exemption for income but the corresponding expense is disallowed, is carried through to its logical conclusion there is a danger that this has the effect of encouraging groups to operate finance companies in low tax jurisdictions, which would clearly be counter to the stated policy objectives of BEPS Action 4, and/or actually distort commercial activity (investment decisions, decisions as to how to commercially raise finance and where).

We return to our fundamental belief that external finance costs to be deductible in full. Any abuse associated with external finance costs is better countered by other BEPS measures and/or targetted anti-abuse rules.

Finally, allowing each entity in the group some additional headroom i.e. more than 100% of its allocation of the group’s external finance costs may also go some way towards smoothing inequitable results arising from the practical issues of forecasting, etc.

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group’s consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?
Our primary concern is to minimise the adjustments required to the statutory consolidated accounts for the reasons discussed under questions 8 and 9 above. We therefore believe that connected (and related parties) should be dealt with through targeted rules.

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

We refer to our discussion of the targeted anti-avoidance rules within the WWDC rules under question 4 above.

Please also see the response to Question 10. In terms of how such arrangements would be detected, gross finance costs and income would increase, which we would expect to be visible from the financial statements or from enquiry into the constituent parts of the financial statements.

It is also worth noting that the precise legal terms of groups’ liquidity management structures could in theory result in distortions between different groups, in an entirely non-tax motivated way (which again illustrates the problems of the group-wide measure including cash pooling and the like) – e.g. where there is a clear legal right of offset, it may (depending on the circumstances) be that amounts are presented net in the financial statements whereas the absence of such a right could result in gross presentation.

**Whether interest deductions should be limited by reference to a fixed ratio**

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?

If the general rule is ultimately determined to be based on fixed ratios then we are absolutely clear that external interest expense will be disallowed in some, perhaps many, cases. The only questions are how many companies will suffer such a disallowance and at what quantum. If, and to the extent that, a fixed ratio results in disallowing third party debt, this would have economic consequences which go well beyond the scope of the BEPS project. Ultimately such a system could distort capital markets and has the unintended effect of favouring state controlled enterprises making global investments which in turn creates a danger of changing the nature of global trade. Clearly such a result would not be aligned with the stated policy objectives of BEPS action 4.

Against that background, if the general rule were ultimately determined to be based on fixed ratios then care would need to be taken in setting appropriate fixed ratios that minimise the damage. We highlight that some industries have atypical levels of leverage, for which different ratios might be appropriate.

However, the problem of setting the ratio is not limited to different industries – ratios can be affected by the jurisdiction of the borrower (whether due to regulatory restrictions or simply cultural differences in terms of the level of indebtedness), the currency of the debt, the stage in a borrower’s corporate life-cycle (expansion vs. steady-state for example), and a variety of other factors. We also note that globally we are in a period of unprecedented low interest rates and levels of borrowing. It is therefore critical that any fixed ratios set now would also be appropriate in an economic environment with higher interest rates and/or higher levels of borrowing and would take account of the various other factors noted above – either by having several different ratios which are dynamic, or by setting a ratio at a high level to deal not with the ‘average’ borrower, but the majority of borrowers.

25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?
We refer to our answer to question 12.

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?

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?

The Real Estate investment sector has specific economic circumstances which mean that companies investing in real estate assets can usually achieve greater gearing levels on an arm’s length basis than those typically achieved by conventional trading businesses, and thus achieve lower but more stable levels of interest cover.

This can be seen from the information provided within the reviews of the UK commercial property lending market published by De Montfort University on a bi-annual basis, which provide a wide range of information and statistics relating to loans provided by arm’s length lenders secured by various categories of real estate asset. As an example, the information provided within the year end 2013 edition of this study regarding the interest cover ratios required on loans by UK lenders secured against three core categories of prime real estate assets is summarised in the table below.

<table>
<thead>
<tr>
<th>Interest cover ratio</th>
<th>Prime Office</th>
<th>Prime Retail</th>
<th>Prime Industrial</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>1.10</td>
<td>1.10</td>
<td>1.10</td>
</tr>
<tr>
<td>Average</td>
<td>1.62</td>
<td>1.63</td>
<td>1.65</td>
</tr>
<tr>
<td>Maximum</td>
<td>2.00</td>
<td>2.00</td>
<td>2.20</td>
</tr>
</tbody>
</table>

Recognising that the lack of depreciation/amortisation costs for real estate companies means that the net rental income measure used to calculate interest cover within the real estate sector is frequently broadly equal to EBITDA, capping interest expense at say 30% of EBITDA (i.e. interest cover of approximately 3.33) can be viewed as being entirely out of line with commercial practice.

Please also refer to Appendix 3, which analyses small and mid-sized companies listed on the Financial Times Stock Exchange. It shows that healthcare providers; hotel, restaurant and leisure groups; real estate management and development groups; speciality retail groups; and textiles, apparel and luxury goods groups all had EBITDA ratios in excess of 50%.

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

Our view is that the data contained at paragraph 160 and in Box 4 is not representative of business in general. By only looking at the “Global Top 100 companies by market capitalisation”, you select a small number of the very largest public companies – many of which are cash rich businesses, and so not significant borrowers at all. Using their average net interest expense to EBITDA ratios to set a global benchmark ratio unfairly disadvantages the majority of taxpayers who are much smaller, privately owned, and who need to borrow more as they do not have the same cash resources.

1 Source: De Montfort Study (2013 year end edition) – Technical Supplement pages 1-2
General data on average net interest expense to EBITDA is available for the large number of credit rated companies. This data is shown below in a graphic from Standard and Poor’s (S&P) that shows that the EBITDA to interest of rated US industrials. Companies will borrow at all the ratings below, but the finances of the majority of (often private) businesses will be akin to the lower ratings – BB and B.

![EBITDA To Interest U.S. Industrials](image)

The EBITDA to interest ratio for B rated businesses has consistently been between 2 and 2.5 times (i.e. equivalent to a 40 – 50% fixed ratio) from 1996 to 2013.

We suggest that if a fixed ratio limitation is recommended as best practice, then it should be set at a level of 40-50%, with flexibility to manage market changes. This would be in line with existing ratios already adopted by countries following this approach shown in Box 3, and more representative of businesses as a whole, and would also minimise the risk of disallowing external interest.

Please also refer to Appendix 3 for our analysis of relevant data for small and mid-sized companies listed on the Financial Times Stock Exchange (the ‘FTSE 350’ companies). We note that considerably more than half of the sample would experience external debt disallowances at an EBITDA ratio of less than 10%.

We also refer you to the work of Büttner et al (2012)\(^2\), using Deutsche Bank data on the foreign affiliates of German-based multinational firms between 1996 and 2004. The mean debt ratio in this sample was 0.28. They found a modest impact of tax rates on the use of intragroup debt – a 10% increase in the affiliate’s statutory tax rate was associated with an 8% increase in the affiliate’s ration of internal debt to total capital, corresponding to an increase from a debt ratio of 0.28 to 0.30.

**Whether a combined approach could be applied**

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?

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?

We agree that where a disallowance is arrived at under the ‘general rule’ then there should be the opportunity for a group to perform a detailed calculation on an alternative basis in order to support its position. It may be that a highly leveraged group can support higher interest deductions than would be indicated under a fixed ratio rule.

Such a rule could be along the lines of the test applied under the UK thin capitalisation rules which, simply, test whether a company has more debt than it either could or would borrow without group support and acting in its own interests. We disagree with the premise that arm’s length restrictions that include a motive or purpose test (i.e. ‘would the company borrow?’ in addition to ‘could the company borrow?’) do not counter profit shifting activities.

The role of targeted rules

31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed through a general interest limitation rule and where would a general rule need to be supported by targeted rules?

As set out above, anti-avoidance rules could be used to target situations where groups attempt to manipulate accounting definitions in the context of a group-wide limitation.

The treatment of non-deductible interest expense and double taxation

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

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?

Please refer to the responses provided to questions 12 and 21 above. We view carry-forwards to be only a partial solution, and suggest that they should carry forward without time limit.

Further, one practical issue is the treatment of withholding taxes on disallowed interest amounts. In some jurisdictions, there may be a recharacterisation of the income to a dividend but this would only remove withholding tax cost in jurisdictions with no dividend withholding tax. There is a danger that withholding taxes become a real cost.

Consideration for groups in specific sectors

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s...
regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

Certain financial sector groups, notably banking and insurance groups, are subject to regulation which determines the amount and quality of capital that they must hold. Regulatory capital requirements must be met both at regulated entity level and, depending on the location of the regulated entities, in many cases at a consolidated group level. Credit ratings agencies also scrutinise and report on the capital adequacy of banks and insurers, and counterparties look to the ratings in deciding whether to do business with them.

Moreover, banks and insurers are in a different position from most other companies in that their interest income is generally treated as part of the trading result. We believe that the regulatory and other commercial constraints are such that they provide an effective general interest limitation, as suggested in paragraph 212 of the discussion document. This, coupled with the sheer complexity of trying to make a rule work for such groups, leads to the conclusion that banking and insurance groups should not be subject to such a rule. [We note that the UK’s worldwide debt cap rules do not apply to banking and insurance groups.] If, and to the extent that, there are base erosion possibilities that are not otherwise addressed it would be better to deal with these through targeted rules.

Although many banking and insurance groups will be in an overall net interest income position, this is not invariably the case. A number of factors, including the current low interest rates and financial institutions’ choosing to invest in different asset classes, may lead to a group’s being in a net interest expense position.

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

Many European countries have now introduced a Real Estate Investment Trust (‘REIT’) regime for real estate investments. Whilst some jurisdictions rely on that country’s ‘normal’ interest restriction rules, many of the REIT regimes have specific interest limitation rules which need to be adhered to. Some regimes operate restrictions based on asset values and some based on earnings. On the basis that most REIT income is exempt from tax it would appear unduly onerous to insist on REITs applying the interest restriction rules suggested under BEPS Action 4 in addition to the interest restriction rules which already apply as a result of their REIT status. Further reductions on interest deductibility may increase the dividend that needs to be paid by the REIT and therefore the withholding tax suffered by shareholders. As a result, this may restrict the REITs’ ability to re-invest profits into their businesses. We are therefore of the view that REITs should be exempt from the proposals under BEPS Action 4.

We also note that, particularly but not exclusively in the context of distressed companies, an interest disallowance may cause a breach of loan covenants, with implications for solvency.
Appendix 2 – Jurisdictions where debt push down is currently problematic

The table below sets out feedback received from members of the Deloitte global network highlighting those jurisdictions where debt push down is problematic and a brief outline of the nature of the issues encountered. In summary, many jurisdictions highlight the impact of their local thin capitalisation and arm’s length provisions on limiting debt push down, especially where there is no tax consolidation system and the limitations created by general anti-avoidance/anti-abuse/unallowable purpose rules.

<table>
<thead>
<tr>
<th>Country</th>
<th>Nature of issues encountered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Interest on borrowings used to pay dividends generally give rise to a high risk of being disallowed on the basis that funds have not been used in a taxable income generating activity. Similarly, interest on borrowings to fund the acquisition of a local operating company (i.e. shares) are not deductible for the reason that dividends are not taxable income for the shareholder.</td>
</tr>
<tr>
<td>Australia</td>
<td>The ‘arm’s length’ rule, ‘unallowable purpose’ rule and/or ‘worldwide debt cap’ rule could apply to deny interest deductions on debt pushed down into Australia.</td>
</tr>
<tr>
<td>Austria</td>
<td>The ‘arm’s length’ and ‘thin-capitalisation’ rules could apply to deny interest deductions on debt pushed down into Austria. Interest on borrowings to fund the acquisition of a local operating company (i.e. shares) are not deductible.</td>
</tr>
<tr>
<td>Belgium</td>
<td>As Belgium’s tax legislation does not provide for tax consolidation or group relief, relief for interest expense requires that the relevant loans are entered into by the local operating companies. Deductibility of interest expenses is further subject to transfer pricing rules, specific thin capitalisation rules and broadly defined business purpose tests (unallowable purpose rules).</td>
</tr>
<tr>
<td>Brazil</td>
<td>Acquisitions in Brazil through local companies followed by a merger in order to push down the debt to the operational company gives rise to a risk that the interest expense will be disallowed. This is on the basis that it could be argued that the interest paid is an unnecessary expense for the regular business/trade of a Brazilian entity when the merger was effected. The transfer pricing limitation/cap on interest expense also needs to be met.</td>
</tr>
<tr>
<td>Canada</td>
<td>The ‘arm’s length’ approach, ‘thin-capitalisation’ rules, ‘back to back’ financing rules and ‘foreign affiliate dumping’ rules need to be taken into account when pushing down debt into Canada. As Canada does not have a tax consolidation regime, restructuring or other arrangements may need to be put in place to ensure that the interest expense is allocated where appropriate within the Canadian group. Basic Canadian provisions on interest deductibility related to purpose may constrain pushing debt into operating entities. Finally, introducing cross-border debt or the equivalent may trip deemed dividend rules as a consequence of anti-surplus stripping limitations. Canada has also proposed adopting anti-treaty shopping measures that will also have to be taken into account if enacted.</td>
</tr>
<tr>
<td>Country</td>
<td>Details</td>
</tr>
<tr>
<td>---------</td>
<td>---------</td>
</tr>
<tr>
<td>Croatia</td>
<td>The ‘arm’s length rule’ and the ‘thin-capitalisation’ rule could apply to limit interest deductions on debt push down into Croatia. A merger may result in tax liabilities if there is a difference between the net book value and fair value of the merged entity’s assets and liabilities. No tax consolidation regime is available in Croatia.</td>
</tr>
<tr>
<td>Cyprus</td>
<td>The ‘interest restriction on non-business assets’ rule could apply to deny interest deductions. A tax deduction for interest on funds borrowed to acquire shares may only be claimed if the shares purchased are in a wholly owned subsidiary to the extent such subsidiary does not hold non-business assets. As Cyprus does not operate a tax consolidation regime, any debt push down may need to be into each Cypriot operating entity unless the group relief rules apply. General anti-avoidance and ‘arm’s length’ rules may also apply in certain cases.</td>
</tr>
<tr>
<td>Denmark</td>
<td>The ‘arm’s length’ rule, ‘thin-capitalisation’ rules, ‘net interest limitation’ rules and/or ‘net interest deduction limitation’ rule could apply to deny interest deductions on debt pushed down into Denmark.</td>
</tr>
<tr>
<td>Finland</td>
<td>The arm’s length rule, general anti-avoidance rule (all transactions need to have a business purpose) and earning stripping rules (inter-company interest may be deductible only up to 25% of the adjusted taxable income). As Finland does not operate a tax consolidation regime, any debt pushed down would need to be into each Finnish entity.</td>
</tr>
<tr>
<td>France</td>
<td>Interest on debt pushed down into a French operating entity shall not be fully tax deductible as net financial expenses are only 75% tax deductible in France. In addition, the ability to perform an actual 75% deduction will be subject to the feasibility of a tax consolidation (which requires among other conditions a 95% ownership). Pushing debt down into each French operating entity is unlikely to be possible in most cases in view of case law (interdiction of mergers of operating companies with indebted vehicles) and legal and accounting restrictions to the ability to distribute dividends. Even if a consolidation is possible, various rules may result in a total disallowance, notably Art. 223-B of the French tax code (internal reorganizations), Art. 209-IX (absence of control by the French acquisition vehicle), Art. 212-II (thin capitalization ratios), Art. 212-I-B (hybrid debt structures).</td>
</tr>
<tr>
<td>Germany</td>
<td>Interest on borrowings are subject to the ‘earnings stripping’ and ‘arm’s length’ rules. However, a debt push down into a German operating unit may trigger real estate transfer tax or loss of tax loss carry-forwards.</td>
</tr>
<tr>
<td>Greece</td>
<td>The general ‘anti-abuse’, ‘arm’s length’ and ‘thin-capitalisation’ rules could apply to deny interest deductions on debt pushed down into Greece. Where a dividend distribution is exempt from corporation tax by the Greek participation exemption, interest deductions could be denied on a loan used to acquire participation producing exempt income.</td>
</tr>
<tr>
<td>Hungary</td>
<td>Arm’s length interest expense on loans taken to pay dividend or capital reduction could be tax deductible. As there is no tax consolidation in Hungary, debt push down needs to be completed through merger; where the ‘exercising the laws within their meaning and intent’ and ‘substance over form’ rules could apply to deny interest deductions. Thin capitalisation rules may also restrict interest deductions.</td>
</tr>
<tr>
<td>Country</td>
<td>Details</td>
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</tr>
<tr>
<td>India</td>
<td>Presently, the domestic tax law does not have ‘thin capitalisation’ rules. However, proposed General Anti-Avoidance Rules, effective from 1 April 2015, empowers Indian tax authorities to re-characterize debt into equity, which may lead to denial of interest expense. Interest payable to non-residents shall be subject to tax withholding in India, and also needs to adhere to the ‘arm’s length’ principle where pay outs are made to associated enterprises. Expenditure towards interest on borrowings used to earn tax free income and / or non-business purpose will not be allowed as a deductible expenditure.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Interest on an overseas company loan will be tax deductible in the Indonesian company provided that the loan is used for activities that will generate taxable income in the Indonesian company. However, the ‘arm’s length’ rule and ‘debt-equity’ provisions could limit interest deductibility. As Indonesian Tax Law does not recognize consolidated tax groups, debt push down would need to be into each operating entity.</td>
</tr>
<tr>
<td>Ireland</td>
<td>Irish tax law contain provisions that restrict the availability of interest deductions in certain instances, including certain debt push down situations involving connected parties. Interest incurred on borrowings used to acquire shares is deductible in limited circumstances only and the deductibility of interest can further be limited by arm's length and other connected party rules which could deny a deduction on debt pushed down into an Irish company. Ireland does not operate a tax consolidation regime and any debt push down may need to be into each Irish entity unless the ‘group relief’ rules apply</td>
</tr>
<tr>
<td>Poland</td>
<td>Only interest, which serves the purpose of earning taxable revenue or preserving or securing the source of revenue, may be tax-deductible. Further to this, ‘thin-cap’ rules and the ‘fixed interest’ test should be considered. Tax consolidation is generally possible by creating a ‘Tax Capital Group’, a fiscally transparent partnership or via a legal merger. The current practice of the Polish tax authorities is generally positive in the case of upstream mergers. Debt push-down via leveraged dividend payment is generally not possible. The Polish Minister of Finance intends to introduce tax general anti-avoidance rule. Under new rules, all restructurings (including debt push-down schemes) should be justified from a business perspective in order not to qualify for the general anti-avoidance rule. These rules may be enforced from January 2016.</td>
</tr>
<tr>
<td>Portugal</td>
<td>The general anti-abuse provision (all transactions need to have a business purpose) and ‘arm’s length’ principle could apply on debt pushed down into Portugal. Portuguese corporate income tax ‘thin-cap’ rules also apply to the deductibility of net financial expenses. This limit is computed both at an individual level or a tax-group level in accordance with specific provisions.</td>
</tr>
<tr>
<td>Romania</td>
<td>Interest deductibility on debt pushed down in Romania could be denied based on general deductibility rule (i.e. purpose of deriving taxable income), arm’s length principle, interest rate limitation and thin capitalisation rules. There is no consolidation or group taxation in Romania so any debt push down may need to be into each local operating entity.</td>
</tr>
<tr>
<td>Russia</td>
<td>As Russia does not operate a tax consolidation regime, any debt pushed down need to be into each Russian operating entity. Interest deduction at the level of operating entity could be achieved through establishment of a new leveraged acquisition entity which acquires</td>
</tr>
</tbody>
</table>
the operating entity, followed by a merger of both entities. Further to this, ‘thin-capitalisation’ and transfer pricing rules may lead to partial denial of interest deduction.

<table>
<thead>
<tr>
<th>Country</th>
<th>Note</th>
</tr>
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<tbody>
<tr>
<td>Slovenia</td>
<td>In terms of interest expense, the ‘arm’s length rules’ as well as the ‘thin cap rule’ should be observed. Borrowing to pay out dividend is generally tax allowable. Fiscal consolidation is not available. Interest expense on a loan used for acquisition is tax non-deductible after the target and the acquirer merge.</td>
</tr>
<tr>
<td>Spain</td>
<td>The ‘arm’s length’ rule and the ‘30% EBITDA cap (with a floor of €1m)’ rule could apply to deny interest deductions on debt pushed down into Spain. Also, acquisitions that form a tax group or involve a merger, an additional limit could restrict the deductibility of interest on loans obtained to purchase shares in a company to 30% of the acquiring company’s EBITDA (without taking into account the target company’s EBITDA). There are also anti-abuse rules targeted at aggressive positions taken which could affect intercompany acquisitions with intercompany funding.</td>
</tr>
<tr>
<td>Sweden</td>
<td>The interest expenses on debt push down could be subject to the Swedish interest deduction limitation rules and thus be deemed non-deductible. The current rules only apply to intra-group debt, but there are ongoing discussions, including a proposal, suggesting that deduction limitations should apply to all debt. When pushing down debt, interest rates and terms must be at arm’s length.</td>
</tr>
<tr>
<td>Turkey</td>
<td>As per the Turkish Corporate Tax Law, the financial expenses incurred in relation to the acquisition of participation shares are deductible but subject to ‘arm’s length’, ‘thin capitalisation’ regulations. Besides these limitations, in case of a subsequent merge of the acquisition and the operating entities, the interest deductions could probably be denied as concluded in the recent rulings issued by the Tax Authority. Although there has been no explicit relevant clause in the existing Law and not tested in the courts so far, debt push down is prone to criticism on the grounds that there remains no link between the acquisition loan and the acquired participation shares as the shares no longer exist on the post-merger balance sheet. In other words, the Tax Authority argues that in case of a merger of both entities, the financial expenses arising from the acquisition loan could not be treated as tax deductible since the corresponding loan is no longer linked to the generation and maintenance of operating company’s taxable business income.</td>
</tr>
<tr>
<td>UK</td>
<td>The ‘arm’s length’ rule, ‘unallowable purpose’ rule and/or ‘worldwide debt cap’ rule could apply to deny interest deductions on debt pushed down into the UK. As the UK does not operate a tax consolidation regime, any debt push down may need to be into each UK operating entity unless the ‘group relief’ rules apply.</td>
</tr>
</tbody>
</table>
Appendix 3 – Evidence of the actual interest to EBITDA ratios of entities and groups across different countries and sectors

We have carried out an analysis of the net interest expense / EBITDA ratio calculated from published data available covering 253 of the FTSE 350 groups operating in the non-financial sector. This is a measure of the extent to which a group can meet its interest obligations and is comparable to the data illustrating the third party interest expense of large multinational companies shown in the Discussion Draft (in Box 4 page 50).

Our analysis of the data shows that the average net interest expense / EBITDA ratio for the non-financial sector FTSE 350 groups is 9.6%. As illustrated in Chart 1 below, 83% of groups fall below the 20% mark which is substantially lower than the 97%/99% achieved by the groups covered by the analysis in the Discussion Draft.

Chart 1

We also looked at the data by industry sector as illustrated in Chart 2 below. Our analysis showed that although the average ratio in almost all sectors was 30% or below, in a number of industry sectors the average masked a wide range of values. This was particularly true for the healthcare providers and services (5 groups), hotels restaurants and leisure (23 groups), real estate management and development (10 groups), speciality retail (12 groups) and textiles, apparel and luxury goods (3 groups) which all had a range in excess of 50%. It should also be noted that the average ratio in the REIT sector (13 groups) was higher than all other sectors with an average ratio of 39%. This data supports the comments made in response to question 24 above in respect of industry specific ratios.

3 Source: Bloomberg 23/01/2015. All figures trailing twelve month (using latest period filings).
We have also carried out an analysis of the total debt / total capital ratio calculated from published data available covering 310 of the FTSE 350 companies. This ratio was calculated as a measure of total indebtedness and showed the average total debt / total capital ratio to be 0.35. The chart below illustrates the spread and demonstrates that most groups have a total debt / total capital ratio of 0.5 or less, with a significant amount (18%) having no debt. An analysis by industry, as illustrated in Chart 4 below, demonstrated that there is little industry alignment, with a wide variation in most industry sectors.

Chart 3
February 6, 2015

Mr. Pascal Saint-Amans
Director
OECD/Centre for Tax Policy and Administration (CTPA)

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

Subject: BEPS Action 4: Interest Deductions and Other Financial Payments (Public Discussion Draft)

Dear Mr. Saint-Amans and Mr. Pross:

We are pleased to submit comments on behalf of Deloitte Tax LLP, a U.S. member firm of Deloitte Touche Tohmatsu Limited (“DTTL”)¹ regarding the Public Discussion Draft, “Interest Deductions and Other Financial Payments” (the “Discussion Draft”). The Discussion Draft makes recommendations on “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.”

We appreciate the opportunity to share our views on the Discussion Draft and hope you find our comments useful as you continue to analyze these important tax issues.

Introduction and Overview

Debt, whether between related² or entirely unrelated parties, is a legitimate part of any capital structure. All companies use debt to finance investment and fundamental business activities. In recognition of this fact, most OECD and G20 countries allow interest to be deducted as a normal business expense. The issuance of debt, in conjunction with equity, optimizes the overall cost of


² We use the term “related” generically rather than by specific reference to the definition in paragraph 38 of the Discussion Draft.
capital and therefore the return on investment, helping to further economic activity that grows local economies. In the intra-group context, loans are frequently used as a tool to move capital from parts of a group that are cash rich to those are that are in need of additional capital. Thus, any proposal to impose an interest deduction limitation should be considered with caution.

Our comments may be summarized as follows:

- While the proposals in the Discussion Draft are presented as potential best practices to address base erosion, the Discussion Draft would deny interest expense even in cases where no base erosion is present. Limitations based purely on the fact that interest is being paid, and without regard to whether it reduces the overall tax liability of group members, or is the result of choosing the most efficient method of financing the group members, are inappropriate.

- The debt vs. equity and arm’s-length standards generally limit the deductibility of interest in the related party context to instances when, and according to terms under which, third parties would have extended credit. Additional limitations on interest deductions without reference to more particular tax avoidance concerns are unnecessary and beyond Action 4’s stated mandate.

- If additional limitations are adopted, it would be inconsistent with the Action 4 objectives to let a group’s third party net interest expense, scaled to the share of the group represented by each payer, define that payer’s limitation. In fact, the Discussion Draft never articulates why a group’s net third-party interest expense is the appropriate measure of each and every group member’s allowable net interest deduction.

- The group-wide interest allocation rules discussed in the Discussion Draft would lead to significant distortions and often result in group members in the aggregate being unable to deduct an amount of net interest expense that is equal to its third party interest expense. As a result, that approach would require companies, in many instances, to undertake gratuitous restructurings (if possible) simply to avoid the loss of a tax deduction on interest put in place for business reasons.

- To begin to address these distortions, we would agree with the Discussion Draft suggestions that disallowed interest expense, and excess capacity for interest deductions, must be carried forward. We also believe the carryforwards should extend indefinitely, but if they do not, they must not expire before a business cycle (e.g., 10 years).

- Given the flaws inherent in the group-wide limitation, we believe that if it were ultimately to be recommended as a best practice the rule must also have significant carve-outs. The carve-outs should include exceptions for members that have minor variations from the group-wide position, and for members that meet a fixed ratio test. There must also be a carve-out that would allow the direct allocation of interest and debt to a particular group entity or asset when factually supported, and a carve-out that would apply to a group member that proves that its financing arrangements are arm’s-length under the circumstances.
- Finally, other action items, namely those related to hybrid instruments and arrangements and CFC regimes, are more appropriately tailored to address the base erosion concerns arising from debt.

**General Comments**

The treasury department of a multinational business is charged with the accumulation and redeployment of cash among affiliates in the most efficient manner possible to meet the funding needs of the business. This involves sweeping global cash into a treasury center on a periodic basis where it can be put to use in the most efficient manner possible. Cash that remains idle in an enterprise is a lost opportunity to earn a higher rate of return from operations and to avoid the cost of borrowing from a third party. The tax deduction of interest expense is one factor in evaluating the rate of return derived from the deployment of cash.

Countries seeking business investment do not lose sight of the impact that a tax deduction for interest expense bears on the rate of return derived from the capital investment. Provided that the debt is incurred in an arm’s length transaction and there is a proper relationship of debt to equity capitalization in the borrowing entity, then there appears to be no basis to impose a broader restriction on interest deductibility in the name of preserving the tax base of the borrower’s jurisdiction.

The Discussion Draft does not take on the tax policy debate surrounding the treatment of debt vs. equity more generally in the tax law. It recognizes that most countries provide a deduction for interest, and it does not propose interest deductibility limitations with respect to standalone entities. However, the Discussion Draft’s core proposal – a group-wide limitation – limits the deductibility of interest expense in many instances where there is little or no tax avoidance. Thus, the group-wide approach has little to do with base erosion per se. To deny a deduction for a payment of interest, as the Discussion Draft would propose, simply because it is interest would be inappropriate and beyond the scope of Action 4’s mandate. As a result, the group-wide approach is a thinly-disguised tax rate increase on multinational corporations that is shared by the relevant countries via formula (i.e., based on relative earnings or assets).

**Proposals to Limit Related Party Interest Expense**

**A. Group-Wide Third Party Interest Expense Limitation**

In Chapter VIII, the Discussion Draft deviates from the mandate for Action 4, as articulated in the Action Plan, under which Action 4 was intended to lead to “the design of rules to prevent base erosion through the use of interest expense.” Chapter VIII proposes to limit group members’ deductions with respect to net interest expense by reference to the group’s net interest expense to third parties. This proposal appears to be at the core of what the Discussion Draft offers as a best practice.

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3 Emphasis added.
The group-wide limitations proposed in Chapter VIII have not been crafted in a manner that targets base erosion. It would be wrong to assert that a group’s net third party interest expense is the best measure of each member’s interest expense that could have a non-base erosion purpose. In fact, if each group member’s deductible net interest expense were determined by its share of the group’s net third party interest expense, interest deductions could be denied even in instances where the relative tax rates between a creditor and lender are such that no base erosion is occurring; at the same time, interest deductions would be allowed even when debt was clearly being utilized to erode a tax base. Consequently, this renders the entire group-wide approach so flawed as to make it not a best practice for addressing base erosion.

In addition to its lack of focus on base erosion, a limitation based on an apportionment of group-wide net interest expense among group members seems to inaccurately assume that all members of a group will have similar needs for debt. The Discussion Draft explores two possible ways of allocating this group-wide position: earnings or assets. As acknowledged by the Discussion Draft, both approaches have flaws. In addition, both approaches tend to over-allocate to those group members that have the least need for debt funding. We believe these flaws are so significant that the group-wide approach should be abandoned.

The need for debt can vary significantly within a worldwide affiliated group. For example, different members of a group may be at different stages in the business life cycle; some may conduct mature or more stable businesses while others are in start-up mode. Regardless of business life cycles, some business units within a group will be in greater need than others of financing via debt rather than equity or retained earnings, depending on their differing asset mix or cash needs. By allocating an interest deduction limitation uniformly among the members of a group regardless of their need for leverage, the group-wide limitation will in many cases result in a worldwide affiliate group not being able to deduct an amount of net interest expense equal to the amount of its net third party interest.

The Discussion Draft also appears to hope that a group-wide approach would be adopted and administered in precisely the same way in every country. Not only is this unrealistic, but administering a group-wide test will be burdensome and in many cases imperfect. Given the realities of different countries’ currencies and internal tax and accounting rules and practices, a group’s allowable net interest expense may often fall short of its external net interest expense.

Moreover, the deduction that is allowed to any one group member may vary from year to year through no fault of the member or its financing arrangements. For example, assume that a member of the group borrows internally, in an amount limited so as not to incur interest in excess of its share of the group’s net interest expense at the time of the loan. Assume that during the life of the loan, the borrower’s assets and earnings remain constant. Under a group-wide approach, the borrower’s later-year annual interest deduction ceiling could nevertheless fall below the borrower’s annual interest liabilities, simply because of a rise in the assets, earnings, or other apportionment factors of the other members of the group. These extrinsic factors would reduce the borrower’s allocable proportion of the group’s net interest expense deductions, yet there exists no thinness of capitalization or tax motivation—in other words, no economic or tax policy rationale for imposing a harsher interest deduction limit in the later year than in the year of the borrowing.
The Discussion Draft offers two remedies to the many companies that will fall in this category: (i) they can carry forward their interest expense and possibly their interest limitation, and (ii) they can restructure. The first proposed solution can only be utilized if a member’s earnings or assets improve relative to the rest of the group, and does nothing to make a taxpayer whole on a present value basis. The second will not be a solution in many instances: for example, due to debt vs. equity or similar limitations of certain group members or regulatory restrictions; the result may be that interest deductions are permanently lost. In addition, artificial restructuring of debt that has nothing to do with the needs of a given business may raise other issues regarding the tax treatment of such financing. At a minimum, it needs to be made clear that such restructuring will not run afoul of business purpose, economic substance, and other requirements if the purpose of the restructuring is to address the inherent limitations of the group-wide rule.

Given the flaws inherent in the group-wide limitation, we believe that if it were ultimately to be recommended as a best practice the rule must also have significant carve-outs. The carve-outs should include exceptions for members that have minor variations from the group-wide position, for members that meet a fixed-ratio test, and for group members that prove that their financing arrangements are arm’s-length under the circumstances.

There must also be a carve-out that would allow the direct allocation of interest and debt to a particular group entity or asset when factually supported. As articulated above, the group-wide approach denies interest expense as a result of a methodology that has nothing to do with base erosion. It appears exclusively reliant on the assumption that money is infinitely fungible, and consequently, all group assets or earnings support all of the group’s third party debt. However, there are limits to the notion that money is fungible. For example, a group may borrow at the parent company level (e.g., in order to achieve the best terms for a financing, such as the lowest interest rate) and on-lend the funds to a particular subsidiary where the funds are needed, and there may be an ability to factually link the unrelated party funding to the related party funding. The U.S. tax rules recognize exceptions to the notion of fungibility in a variety of places. Such exceptions would be appropriate here as well, such that the group-wide limitation is first allocated to those group members that can show factually that outside funding was utilized for a specific group member’s needs.

B. Fixed Ratio Test

As acknowledged in Chapter IX of the Discussion Draft, a fixed-ratio rule that would root out all base erosion would inherently suffer from over-inclusiveness. For reasons alluded to in the Discussion Draft, no one, single, fixed ratio of net interest expense as a fraction of any benchmark, regardless of the benchmark chosen, can identify the presence or absence of over-leverage, much less base erosion, in the case of all taxpayers for all tax years. Moreover, the

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5 Discussion Draft ¶ 149, first sentence (“this approach does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector groups may adopt different funding strategies for non-tax reasons”).
bluntness of a fixed-ratio rule is in some ways greater than that of a group-wide allocation rule (described above). Any one group’s own group-wide allocation rule would at least be determined by reference to the debt financing needs of that group, and thus would theoretically better suit that particular group’s members if all of a group’s members could be expected to be homogeneous in terms of their relative financing needs (contrary to reality). But even that made-to-measure aspect of a group-wide allocation rule is lacking in a fixed-ratio rule.

In our view, a fixed-ratio rule, in contrast to any of the other types of rules listed or discussed in the Discussion Draft, has only one raison d’être: it is easy to administer. In order to retain this unique virtue, the ratio must be high enough to avoid penalizing legitimate transactions. The alternative would be to provide for multiple ratios for multiple circumstances, or to provide other exceptions, thus abandoning the one attribute—simplicity—that warrants a fixed-ratio rule’s candidacy as a “best practice.”

For this reason, we disagree with those who may believe that the ratio should be set by reference to, for example, the third-party-net-interest-to-EBITDA ratios of the non-financial sector companies in the top 100 companies in the world ranked by market capitalization. It is hard to imagine a more unrepresentative group of companies by which to benchmark the financing needs of the run of a country’s taxpayers, whether or not “standalone.” Even if it were true, considering more than merely the anecdotal evidence referred to in the Discussion Draft, that base erosion or profit shifting is possible under the fixed-ratio rules listed in Box 3 on page 49 of the Discussion Draft (with ratios ranging between 25 and 50 percent), that would not justify enacting more restrictive fixed-ratio rules. Rather, it would simply be proof of the obvious—in order to be simple and non-punitive, the rule must be loose enough to accommodate the universe of taxpayers, to such a degree that its drafters must acknowledge that it may be too loose to eliminate, on its own, all base erosion.

In its 2007 study of section 163(j) of the Internal Revenue Code, the U.S. Treasury Department could draw no conclusion that foreign-controlled domestic corporations (FCDCs) generally (which are subject to the U.S. fixed-ratio rule, based on a 50-percent ratio of net interest expense to adjusted taxable income) were engaged in earnings stripping relative to domestically controlled domestic corporations (which generally are not subject to the U.S. fixed-ratio rule). At the same time they concluded that there was “strong evidence” that inverted corporations, a subset of FCDCs, “are stripping a significant amount of earnings out of their U.S. operations” despite the U.S. fixed-ratio rule to which they were subject.

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6 Discussion Draft Box 4, page 50. See also Example 11 on page 92, which uses a 15-percent ratio of net interest expense to EBITDA.

7 Discussion Draft ¶ 163.

8 Discussion Draft ¶ 159.


10 Id. at 26.
We believe that the lesson to be taken from the U.S. experience, and the Discussion Draft, is that enactment of a fixed-ratio rule is not a best practice for solving all base erosion concerns relating to interest deductions. As the Discussion Draft implicitly recognizes, “[w]here a fixed ratio is used as a main rule for addressing excess interest deductions” (emphasis added), it is doomed to be over- and under-inclusive. Thus, it must be judiciously calibrated. To ratchet down the fixed ratio so as to “catch” every entity involved in efforts to erode their base would discriminate against many taxpayers with legitimate financing needs, rather than solve the problem to which Action 4 is addressed. Any such a rule should not be viewed as a “best practice”; arm’s-length rules, and the rules recommended by other Actions in the BEPS Action Plan, are the answer to the inevitable fact that a fixed-ratio rule is not a recipe for limiting all base erosion via interest deductions.

* * *

We appreciate your consideration of our comments.

Sincerely,

T. Timothy Tuerff
Partner
Deloitte Tax LLP

Gretchen Sierra
Principal
Deloitte Tax LLP

Harrison Cohen
Director
Deloitte Tax LLP
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February 7, 2015

Re: Comments pertaining to the Public Discussion Draft on deductibility of interest and other financial payments

Sherif Assef and Stefanie Perrella, Duff & Phelps, LLC

Dear Mr. Hickman:

This letter is in response to the OECD’s request for comments on its public discussion draft titled BEPS Action 4: Interest Deductions and Other Financial Payments, issued December 18, 2014, and hereinafter referred to as the “Discussion Draft” or “Draft.”

The Discussion Draft considers a number of approaches to restricting the potential for profit shifting using third-party and intercompany financial transactions and corresponding interest payments. These approaches include the following (or some combination of the following):

1. Rules which limit the level of interest expense or debt in an entity by reference to a fixed ratio (“group ratio rules”).

2. Rules which allocate group net interest, or interest capacity, by some measure of relative economic activity (“interest allocation rules”).

3. Targeted rules for specific circumstances.

4. An arm’s-length test.

5. Withholding tax on cross-border interest payments.

6. A straightforward disallowance of a set percentage of any entity’s interest expenses.

The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of Duff & Phelps as a whole or those of its clients.
The Discussion Draft primarily focuses on approaches (1) – (3), and our comments will address issues raised by these approaches, specifically approaches (1) and (2). However, it is our view that approach (4), an arm’s-length test, is too quickly dismissed in the Discussion Draft. We believe that such an approach, wherein a borrowing entity’s capacity to take on debt and bear the associated interest expense are evaluated on a stand-alone basis, is more appropriate and can combat base-erosion strategies within multinational groups (perhaps as part of a combined approach).

**Base Erosion and Profit Shifting Using Interest Payments**

The Discussion Draft notes that money, as a fungible asset, can be moved around for tax planning purposes, even if there is no related business or economic imperative.\(^2\) We agree that this is a legitimate concern, and believe that our preferred approach of an arm’s-length test (discussed below) goes a long way toward allaying this worry. Furthermore, we believe that it is important to precisely define the nature of the issue.

For example, at several points the Discussion Draft objects to the possibility that a multinational enterprise might be able to achieve combined “interest deductions which are greater than the actual net interest expense of the group.”\(^3\) In fact, rather than combined interest deductions exceeding the group’s actual net interest expense, in practice the converse may be more likely. With so many restrictions on interest deductibility (anti-arbitrage, debt-cap, thin cap, transfer pricing, etc.) in various jurisdictions, the overall level of group deductions is likely to be less than the net interest expense actually incurred.

Further, in the case that interest deductions do exceed the group’s actual net interest expense, we do not see this as a problem as there is no reason that the total interest deductions claimed by the entities making up a multinational group should be limited to that group’s net interest expense with third parties. If the group has a surplus of cash, the best use for that cash might be to fund internal operations, acquisitions, or other projects, as opposed to forcing individual group entities to borrow externally for the same purpose in order to secure their tax deductions.\(^4\)

Similarly, the Discussion Draft lists as one of the policy aims of this project that “...groups should still be able to obtain tax relief for an amount equivalent to their actual third-party interest cost.”\(^5\) Again, we find the focus on third-party, as opposed to total, interest cost to be

\(^2\) Discussion Draft, page 6.
\(^3\) See for example Discussion Draft, page 6.
\(^4\) Cash pooling arrangements, in which a related group efficiently leverages internal cash surpluses, could lead to interest deductions which exceed net interest expense, yet few would argue that cash pooling is not a beneficial funding strategy under the right circumstances. (Cash pooling is addressed again later in this document, as part of the discussion on the Discussion Draft’s proposed approach.)
\(^5\) Discussion Draft, page 10.
too narrow. Intercompany interest should also be deductible if the borrowing entity can bear the related-party debt (in the context of all of its financial obligations, intercompany and third party) and the interest rate is set at market levels.

**Examples**

The Discussion Draft presents two examples, one showing an “outbound investment” scenario and the other covering “inbound investments”, to illustrate the potential for a taxpayer to shift profits using interest expense. However, the examples may include some simplifying assumptions which exaggerate the practical ability to use interest-related strategies among related parties to distort financial and tax results.

For example, in the “outbound investment” example, two related parties, A Co and B Co, are subject to 35 percent and 15 percent income tax rates, respectively. B Co could borrow €100 from a third-party bank at a 10 percent rate and invest in the business, resulting in incremental profits of €15. Subtracting interest expense of €10, pre-tax profits realized are €5 and post-tax profits are €4.25.

Alternatively, applying a profit-shifting strategy, A Co could borrow the same amount from a bank and contribute it to B Co (it is assumed that foreign source dividends are tax exempt), resulting in the same total pre-tax profits for the two companies of €5, but post-tax profits of €6.25 – a negative rate of taxation.

However, this outbound investment example assumes that A Co and B Co can borrow externally at the same rate of 10 percent. Suppose, however, that B Co is the borrower in the base case because it has lower credit risk than A Co. If B Co could borrow from the bank at a 5 percent rate rather than 10 percent, pre-tax profitability in the base case (no profit shifting) would be €10 and post-tax profits would be €8.5 (as opposed to €4.25). Shifting the debt to A Co, still borrowing at 10 percent, would lower pre-tax profits to €5. After-tax profits would be €6.25, so the negative overall tax rate would persist, but at the cost of reduced overall profitability for the group (pre- or post-tax).

The “inbound investment” example considers the possibility of A Co replacing existing equity in B Co through an intercompany loan. The income tax rates are reversed, with A Co paying 15 percent and B Co paying 35 percent. If B Co borrows €100 from a bank at 10 percent and generates €15 of incremental profits, it earns a pre-tax return of €5, or €3.25 after taxes. If at the same time A Co replaces €50 of existing equity in B Co through an intercompany loan, at the same 10 percent rate, B Co’s pre-tax profit is eliminated, while A Co has a pre-tax profit of €5 and a post-tax profit of €4.25. Thus, through the intercompany loan, the combined tax rate has been reduced from B Co’s 35 percent to A Co’s 15 percent. (If A Co were to replace €100 of B Co’s equity, the group would achieve a negative rate of taxation.)

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However, unlike in the outbound investment example, no consideration is given to A Co’s source of funds. For example, if the €50 contributed by A Co to B Co comes from external borrowing, at 10 percent, then the total pre-tax and post-tax profits from this strategy are nil (vs. pre-tax and post-tax profits of €5 and €3.25, respectively, without A Co’s involvement). In addition, if the €50 is sourced internally, as the example implicitly suggests, then from an economic perspective the opportunity cost of using the funds to replace a portion of B Co’s equity should be factored in (also potentially cutting into the pre- and post-tax benefits).

By evaluating the ability of a group entity to take on intercompany debt (through a reliable credit analysis) and pricing it, relative to observed third-party behavior and benchmarks, an arm’s-length approach (as described below) can minimize opportunities for shifting of profits among related entities that is not linked to sound business purpose and market practices.

**Arm’s-Length Test**

**Description**

In an arm’s-length approach, interest deductions, including for intercompany loans, would be allowed up to a level which is consistent with an individual entity’s credit standing, on a stand-alone basis and reflective of normal market practices.\(^7\) Debt-bearing capacity and interest rate benchmarks are based on an assigned “synthetic credit rating,” which can be determined using a credit model provided by a public rating agency (e.g., Standard & Poor’s, Moody’s). Such a model determines a credit score based on an entity’s key financial ratios (e.g., revenues, gearing, interest coverage, debt to capitalization), including the impact of a specific loan. The pricing of an intercompany loan can then be determined, taking into account its specific terms (e.g., duration, security, currency, covenants, etc.) and based on comparable rates observed in transactions among unrelated parties (such as corporate loans or bond yields).\(^8\)

Rather than using a formal credit model, the borrowing entity’s credit standing can also be evaluated by comparing key financial ratios to those of similar independent companies, particularly those who are borrowers in the marketplace, to derive an implied credit rating or otherwise establish the borrower’s capacity to take on debt and the market price (rate) that it would be expected to pay.

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\(^7\) No one would advocate “unlimited” deductions for interest, as suggested by the Discussion Draft (page 10).

\(^8\) This type of analysis would generally not need to be conducted in situations where an entity is borrowing from a third party, such as an external bank, as the external lender would conduct the needed credit analysis under its own processes. Consequently, the interest rate on third-party debt, and indeed the very existence of that debt, is by definition reflective of arm’s length dealings. Still, there may be questions as to whether any form of credit support provided by a related party to the borrower is impacting the lender’s analysis, which could give rise to the need for a guarantee fee payment to that related party.
The possibility of abusive profit shifting using interest is not simply a matter of the interest rate charged, of course, but is also dependent on the decision to bear debt in the first place. Here again an arm’s length test can be helpful. For example, in situations where the borrowing entity’s financial ratios suggest a credit score so low that no loanable funds would be available to it other than from a related party, then the economic substance of any intercompany loan provided to it can be questioned.9,10

An arm’s length approach would tighten competitive parity between an entity which is part of a multinational group and unrelated parties in the same tax jurisdiction which are comparable in terms of financial standing, functions, industry, market level, and other relevant factors. It would limit the ability of a multinational enterprise to take unfair advantage of its global status, while allowing it to efficiently leverage its internal resources.

Finally, an arm’s length test lends itself well to pricing an associated type of financial transaction – an intercompany financial guarantee. A guarantee from a related party to support a loan from a third-party bank can lower the interest cost to the borrower; consequently, the maximum value of the guarantee is often quantified as the reduction in the loan interest rate that is due to the guarantee. A stand-alone credit analysis of the borrower will determine the arm’s-length interest rate it would have to pay without the guarantee, to be compared to the rate actually offered by the bank with the guarantee.11 (We understand that guidance on guarantees under BEPS Action 4 is forthcoming.)

**Challenges for the Arm’s Length Test**

The Discussion Draft points out that an arm’s length approach “can be resource intensive and time consuming for both taxpayers and tax administrations to apply”.12 This is a fair point, and may be especially relevant when a multinational group operates a centralized treasury function which makes numerous loans on a regular basis to related parties around the world. It would not be reasonable to expect the taxpayer to conduct a full credit analysis for each loan. However, it is possible to facilitate the application of a reliable credit analysis approach by evaluating just a couple of key borrower financial metrics against ranges based on observed comparables.13 Pricing of the loans, if they are viable, can then proceed using a menu of regularly-updated market data, with adjustments available for differences in key financial ratios.

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9  Again, where an entity has third-party debt, its ability to bear that debt is already established.
10  At a minimum, the terms of a related-party loan should reflect market practices in high-risk situations (e.g., security, financial covenants), assuming that loans with similar terms can be observed among unrelated parties.
11  Asking the bank what the interest rate would have been in the absence of a guarantee is not likely to yield a reliable indicator as the bank has no incentive to conduct a proper credit analysis for circumstances under which it is not being asked to lend.
13  For example, some rating agencies publish tables with the median three-year averages for key financial ratios by industry and credit rating.
terms. Once the pricing model is set up, there would be a manageable amount of effort required to maintain it.

The Discussion Draft also states that arm’s length tests “may not be fully effective against base erosion and profit shifting because they only apply to intra-group payments.”\textsuperscript{14} However, the credit analysis approach described above would indeed take into account all of an entity’s debt in calculating the relevant financial ratios and deriving a stand-alone credit rating (or comparison to independent parties). The approach factors in a potential borrower’s ability to bear debt, as well as benchmarking the arm’s length price of that debt, in the context of its overall capital structure.

**Interest Allocation Rule**

The Discussion Draft considers restricting interest deductions by entity based on a level of group interest expense. Specifically, each entity would be assigned an interest cap for its allowable deductions based on a proportional allocation of the group’s net third-party interest expense. The allocations would be based on some measure of economic activity, such as earnings or asset values.

We believe that interest limitation rules (or limitations for debt, also considered) are, at best, an inexact method for limiting profit shifting, and, at worse, distortive in their divergence from arm’s length practices and results. The arm’s length standard generally requires that we evaluate any entity, even if part of a multinational group, based on its specific functions, assets, and risks. Under a separate-entity approach, each member of a multinational group should be treated as separate rather than an inseparable part of a single unified business.\textsuperscript{15} Such an analysis should include a review of the entity’s unique funding needs, as well as the optimal means by which it should meet those needs. Basing an entity’s allowable interest deductions on a group-wide allocation formula would link the deductions to aggregate global business activities rather than those of the entity itself. This can lead to counterintuitive outcomes if the activities and financial standing of an entity, and consequently its funding needs/options, are materially different from that of the consolidated group (and other connected parties, if applicable).\textsuperscript{16}

For example, if an entity can borrow externally more efficiently than any other member of the group, and none of its related parties needs external funding, it does not make sense to spread around the ability to deduct the interest expense. This is particularly true given

\textsuperscript{14} Ibid.

\textsuperscript{15} OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010, Section 1.6.

\textsuperscript{16} Differences which are not likely to be adequately measured using a broad allocation metric such as earnings or asset values.
potential year-to-year variability in whatever metric is used to allocate the interest cap, which could add to the arbitrariness of the entity-by-entity results.  

Limiting total interest deductions to a group’s net external interest expense makes matters worse. We see no reason why interest income should offset gross interest expense. Whether interest income is earned by the entity seeking the deduction or (particularly) by one of its related parties, it is not clear why interest should be treated differently from other types of income when determining allowable interest deductions. Basing the allocable interest cap on net as opposed to gross expense could exacerbate non-deductibility of legitimate interest expense under the cap rule.  

It is also unclear how the interest cap approach would be applied to an intercompany cash pooling arrangement. The Discussion Draft states “when applying a group-wide rule, the group’s net third-party interest expense will be calculated taking into account the benefits obtained from the cash pool”. Given our view of the general need for any approach to allow for tax deductions related to loans made using internal funds, as previously discussed, will there be any special rules for interest deductions tied to cash pooling arrangements? And exactly what benefits will be taken into account in calculating a group’s net third-party interest expense? How will the benefits be taken into account in the calculations? Would the calculations related to cash pooling arrangements be distinct from those associated with other third-party interest expenses? Additional guidance is needed for cash pooling arrangements.

With regard to the allocation factors for the interest cap, the Discussion Draft suggests either earnings or asset values. If an interest cap rule is adopted, we do not believe that a single allocation factor would adequately capture the relative magnitude of economic activity in an entity, much less its interest-bearing capacity. Two or even three allocation factors, properly weighted, would be more reliable. Alternatively, consider that the arm’s length test described earlier evaluates multiple financial ratios, all more directly related to an entity’s ability to bear debt and related interest expense.

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17 See page 58 in the Discussion Draft. The Draft suggests that provisions to carry forward disallowed interest expense or unused capacity to deduct interest can reduce the sting of foregoing deductions for interest expense actually incurred. However, due to dependence on future capacity under the interest cap rule, or sufficiently high future net interest expense for the group, these provisions are likely to be imperfect solutions at best.

18 Imposition of targeted rules to address base erosion and profit shifting caused by allegedly excessive group interest deductions on third-party debt could exacerbate the issue even further. (We do not see how interest deductions on third-party debt can be excessive, assuming a non-frivolous business purpose for the debt, since the interest paid is by definition arm’s length.)

19 Discussion Draft, page 44.

20 For example, netting benefits? Volume benefits?

21 Discussion Draft, page 29.
Finally, consideration should be given to potential challenges in applying and enforcing such a rule. For example, the debt cap in the UK is widely seen as an administrative mess. The OECD should give consideration to recommending a “holistic” clearance application (e.g., an APA process) for all types of possible restrictions on interest deductions (where resources would permit such a clearance). This would reduce burdens on tax administrations and lead to greater certainty for businesses.

Despite our misgivings about the proposed interest cap rule, we agree that it is preferable to the deemed interest rule, under which interest deductions taken by any entity are not at all related (even imperfectly) to interest actually paid or accrued. In addition, the deemed interest rule would not allow for any deductions of intercompany interest expense.

**Use of Combined Approaches and/or Targeted Rules**

While we believe that an arm’s length test is more reliable than any sort of group-wide apportionment or fixed ratio rule, we recognize that the arm’s-length test, on its own, could allow a multinational to exploit interrelationships among its member entities to implement base erosion and profit shifting strategies. Consequently, a combined approach, where an arm’s-length test is adjusted to limit the opportunity for non-arm’s length use of interest payments, or which is supported by one or more targeted rules, may be an appropriate best practice. Some examples for consideration, either in isolation or in combination:

- It might be possible to introduce an arm’s-length test that disregards a borrower’s non-taxable assets and income.

- In order to guard against the unwarranted bearing of debt by an entity on behalf of an unrelated entity (i.e., not for the borrower’s own business purposes, as suggested by the examples provided in the Discussion Draft), the arm’s length test could be adjusted or supplemented to pay particular attention to cash flow-related financial metrics for the borrower (particularly one that subsequently or regularly engages in intercompany lending or contributes capital to related parties).

- As a component of the arm’s length test, attention could be paid to the overall capital structure of a group entity relative to that of functionally and geographically comparable independent companies.

- More broadly, the use of intercompany funds can be scrutinized in order to establish a business purpose for the financing. Any such analysis is constrained by the fungibility of money; however, it may be possible to at least address potentially problematic and obvious non-arm’s length examples, such as debt push-downs in cross-border acquisitions.²²

²² Discussion Draft, page 56.
These and similar adjustments or add-on rules can and should be considered, with the arm’s length test forming the core of the approach.

Questions for Consultation

Our general comments above address many of the specific consultation questions in the Discussion Draft. Below are comments on a selection of the remaining consultation questions.

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?

We understand that specific transfer pricing guidance on intercompany guarantees is forthcoming. It will be important to coordinate that guidance with whatever rules are adopted for interest, as the two issues are closely linked.

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

A percentage ownership rule is subjective. It could be useful in balancing resources if applied to each and every location but that is not a likely eventuality. We recommend that the final guidance recommend criteria for evaluating the presence of effective management control of one entity over another rather than a specific percentage.

Question 6: Are there any other approaches that could be used to exclude low-risk entities? What are these and what advantages would they have?

The arm’s length approach that we favor can be applied in an abridged form to low-risk entities, perhaps by evaluating only one or two key financial metrics against broad market indicators, as opposed to conducting a comprehensive credit analysis. If the entity in question is sufficiently economically integrated with related parties, for example a routine service provider, some thought can be given to applying a “notching” approach to determining a credit score, wherein the entity’s rating is deemed to equal a set number of notches below that of the overall group. Alternatively, it may be appropriate to limit the use of a group-wide rule to such entities (i.e., a “carve-out” from the arm’s length test, as per Question 30).

Some consideration could also be given to statutory safe harbors for smaller and more “vanilla” loans.

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?
The possibility of negative earnings helps to highlight the drawback of using earnings (or most other single factors) as a proxy for interest-bearing capacity. It should also be pointed out that entity-level earnings could be impacted by transfer pricing policies within the group, further reducing the reliability of this approach. (The problem is exacerbated if group companies are engaged in several different sectors (Question 16).)

**Question 18:** Do any particular difficulties arise from the application of a group-wide 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?

As previously noted, a group-wide rule of the type described in the Discussion Draft is particularly problematic in the case of a cash pooling arrangement if the rule acts to limit interest deductions stemming from the use of internal surplus cash. Outside of cash pooling, given a treasury operation with a high volume of intercompany loans, the group-wide rule will likely significantly limit what might be legitimate interest expense deductions in many countries in which the multinational operates. An arm’s length test, with the level of analysis tailored to the size of the borrowers and individual loans, will yield more reliable results overall.

**Question 22:** It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group’s consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund, or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

If a group-wide rule were to be applied, we would favor including connected parties within the interest limitation group as opposed to using targeted rules for them. This would control potential distortions caused by applying different rules to entities based only on the form in which they are held.

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We are in full support of the Committee’s efforts to bring clarity and transparency to the complex issue of intercompany financial transactions, and hope that our comments are helpful to those efforts. Please contact Sherif Assef at Sherif.Assef@DuffandPhelps.com if we can be of any further assistance.
Dear Dr. Achim Pross,

Head of International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

By e-mail: interestdeductions@oecd.org

4th February 2015

Dear Sir,

First, by way of introduction, EDF Energy is one of the UK’s largest energy companies, producing around one-fifth of the nation’s electricity from its nuclear power stations, wind farms, coal and gas power stations and combined heat and power plants. The company supplies gas and electricity to 6 million business and residential customer accounts and is the biggest supplier of electricity by volume in Great Britain.

EDF Energy’s safe and secure operation of its eight existing nuclear power stations at sites across the country makes it the UK’s largest generator of low carbon electricity. EDF Energy is also leading the UK’s nuclear renaissance and has published plans to build four new nuclear plants, subject to the right investment framework.

These new plants could generate enough low carbon electricity for about 40% of Britain’s homes. They would make an important contribution to the UK’s future needs for clean, secure and affordable energy.

Discussion Draft on Action 4 (Interest deductions and other financial payments)

EDF Energy welcomes the opportunity to provide comments on the OECD’s Discussion Draft regarding BEPS Action 4.

We fully support the OECD’s efforts to prevent BEPS activities through the use of interest deductions and think it is important to engage with you on these important issues to design rules that achieve these aims. Our input below is focused on comments with
respect to third party interest costs, and given EDF Energy's activities, the practical application of the proposed rules to the infrastructure sector.

1. Executive Summary

We understand and commend OECD’s desire to address BEPS concerns arising through the use of interest deductions and other financial payments. However, we would note that the current proposals advanced by the OECD in the Discussion Draft (under any of the proposed approaches) would capture interest deductions that are not and could never be considered to be BEPS motivated. This is manifestly unfair and must be addressed in any BEPS proposals to ensure bona fide commercial financing is not denied tax relief.

We recognise the need to design any rules based on broad principles to ensure that all perceived abuse is identified and restricted. However, we believe that the impact of the final design should be tested against one over-arching principle:

“The rules should not result in limiting tax relief for interest on debt that is not BEPS motivated”

This is entirely consistent with the statement in paragraph 10 under the Key Policy Aims which states that Action 4 sets out to address base erosion and profit shifting through third party and related party loans.

This principle is not achieved under the current proposals, and interest deductions on innocent financing arrangements will be disallowed, because:

i. The group allocation rules cannot work in the real world because of the complexity of corporate and commercial arrangements

ii. The fixed ratio tests are too inflexible to ensure they are targeted only at BEPS motivated lending

iii. The combined approach can never cover the myriad of non-BEPS motivated corporate and commercial arrangements

We are sure that representations from other stakeholders will provide a comprehensive list of examples that expand on these three points; this representation is focussed on providing a solution that will stop BEPS activity through financing in a way that does not make tax compliance an impossible burden.

The current proposals of interest allocation or fixed ratios would certainly deny tax relief for new nuclear projects and also infrastructure projects more widely. These projects are particularly badly affected because they have some key characteristics that have not been considered or factored into the OECD proposals. These characteristics include:
1. Unusual ratios - Very long construction lead times with high levels of capital expenditure and borrowings but no earnings;
2. Credit risk mitigation - the requirement of lenders to lend directly to the Project Company or ring-fenced project group of companies;
3. Stable earnings stream - global financial investors that are unable and/or unwilling to take equity risk but do require the predictable long term, low risk return infrastructure provides. These investors wish to lend directly to the asset owners, not to the equity providers of such projects;
4. Insufficient capital - Strategic investors (those with the knowledge and capability to build, operate, maintain and decommission) do not have the financial strength or depth to fund these projects from their own balance sheets and therefore are forced to raise debt to allow the projects to proceed;
5. High gearing - Points 3 and 4 above combine to ensure gearing levels in infrastructure projects are normally very high and well above the levels in section IX of the OECD document.

To ensure that the rules do not capture by accident any non-BEPS motivated lending, it will be essential to exclude pure commercial debt (i.e. not created or structured to push tax deductions into higher tax territories) from these proposals. This will still satisfy the remit of BEPS Action 4. We believe the objectives can be achieved through excluding from the rules:

i. Genuine third party debt – we propose excluding third party debt that has been invested into assets and not equity. This would capture interest arising under Scenario 4 in Section V of the Discussion Draft from the scope of any rules. This exclusion could be limited in its scope by reference to either certain hallmarks of genuine commercial lending (the “lending criteria”) or by reference to the nature of the underlying activity e.g. infrastructure (the “project criteria”);

ii. Non-BEPS motivated cross border financing – we propose excluding intra-group interest where it is clear that the borrowing is not BEPS motivated. A tracing/matching test should provide a gateway out of the rules if no tax benefit is obtained – by excluding interest arising under Scenario 1 in Section V of the Discussion Draft where the receipt of interest gives rise to a tax liability equivalent to the tax benefit of the deduction of the interest. This aligns with the BEPS process on hybrid instruments.

These proposals recognise that we agree with the desire to remove any incentive for companies to engage in BEPS motivated financing arrangements. However they do so in a way that still retains certainty over the tax compliance for individual entities, prevents multi-year disputes with tax authorities, and gives sufficient certainty for projects to proceed.
2. Background to general public infrastructure projects

Public infrastructure projects can be distinguished from other forms of investment by the way in which they operate on timescales and for objectives outside of the normal commercial business environment. By their nature they are activities which wouldn’t take place without the support of Government, either through a commitment to fund the costs upfront or through a commitment to fund either directly or indirectly the ongoing availability of the project assets.

The nature of public infrastructure projects is such that they require long term funding at the minimum cost of capital. As the funding is required to support the substantial upfront costs of the project, but revenues are inevitably deferred, it is critically important that groups minimise the risk associated with the revenues that will arise from the project. The sources of the funding (debt or equity) and the security of the revenue streams are intrinsically linked.

The lowest cost of capital will be achieved when debt is maximised as a percentage of total funding and the amortisation schedule for the project debt is matched, as closely as the financial markets will permit, to the cash inflows of the project. Strategic investors are forced through commercial necessity to minimise equity investment due to the combination of high cost and restricted availability and therefore debt plays an important role in matching those seeking to invest capital with those projects requiring investment. For example pension funds will often choose debt instruments in infrastructure projects with a stable yield to match their obligations to pensioners; however they can only do this if the stable yield is supported by a low level of risk.

Therefore it is typical that infrastructure projects are largely debt financed by external means, and such financing arrangements of infrastructure projects are never designed to give rise to BEPS activity, but are designed instead to minimise the overall cost of an infrastructure project to the sponsoring Government or its citizens to ensure such projects are propagated.

It is critical to understand that therefore interest relief obtained on such debt provides a crucial role in the effective pricing of such returns to investors and therefore any uncertainty with regard to timing and availability of relief could materially impact the projected income streams and the anticipated returns of investors.

Due to the nature of infrastructure projects and the wider benefits to the economy that infrastructure creates, debt is often supported and guaranteed by national governments, the EU or international bodies to encourage investment and raising of capital. However Governments do not give away the value applied to their assurance over the revenue stream or financing of the infrastructure project. Therefore discussions
and negotiations over the precise level of assurance required by the infrastructure project and the impact that has on the cost of capital and the returns to investors tend to be extensive, well understood and fully justified and supported.

The high levels of third party debt associated with infrastructure projects is not considered excessive but are simply a necessary feature to fund large scale projects. Any proposals that result in a restriction or uncertainty of tax relief for wholly commercial interest costs and financing fees which are not in anyway BEPS driven is clearly unwarranted and draconian. Changes in law that are drafted so widely as to capture the innocent and consequently jeopardise strategically important projects must obviously be avoided and so gateways out of these rules must be found. Otherwise, by challenging the overall economics of the project, not only would this increase the cost of capital, as noted above it would reduce the attractiveness for returns to investors and subsequently deter finance being raised, and hence risking the commissioning of projects. This would seem to go against international, OECD, EU or domestic policy objectives which are committed to encouraging infrastructure projects which are necessary for the wider sustainability of global economies.

3. Proposals to exclude third party interest costs from the remit of Action 4

3.1 We consider the reach of the proposed restriction of interest deductibility should be narrowly targeted, with only specified categories of interest covered. The proposed rules, either on a group wide or fixed ratio limitation basis, operate in a mechanical way which does not take account of the commerciality of arrangements through which interest arises. The basis of restriction clearly takes no account of particular capital intensive sectors which are highly geared for commercial reasons. We therefore propose a mechanism is introduced to ensure that commercial financing arrangements are not impacted by the proposed rules.

We set out below (in sections 3.2, 3.3, 3.4 and 3.5) why the proposed approaches will result in an unfair impact on the tax position of groups that have raised significant external debt, We set out in section 3.6 the proposed amendments to avoid this unfair impact.

Applying the proposed approached in the Action 4 Discussion Document

3.2 Paragraph 10 of the Discussion Draft highlights within its policy aims that in general groups should still be able to obtain tax relief for an amount equivalent to their third party interest cost. However the proposed approaches in the discussion document will not achieve the objective of ensuring that commercial funding arrangements are not impacted for the reasons set out below.
3.3 Group wide test

It is clear that due to the mechanics of the group wide limitation rules there will be many instances when the allowed entity level tax relief for interest will be less than total external interest expense of the group. The variability of earnings at a local and a group level, the corporate level at which external debt is taken out, the difficulty for external debt to be moved around the group for non-tax reasons, and the fact that entities within groups engage in numbers of different activities which have different earnings, balance sheets and debt profiles, mean that it would be impossible for entities to match the economic activity to its interest expense and consequently full relief for third party interest expense could never be taken.

This is exemplified in the case of infrastructure projects where funding may be taken out (and interest accrued) in respect of capital investments but “economic activity” (identified through EBITDA type measures) may only arise several years later. While provisions with respect to the ability to carry forward disallowed interest expense or unused capacity to deduct interest into future periods is considered in the Discussion Draft as a method to address these concerns (albeit with some form of limit to the carry forward e.g. 5 years), for long term construction based projects this does not provide a viable solution. Large infrastructure projects typically can take anything up to 15-20 years to construct, and therefore an income stream may not be generated until well after this date, which would effectively result in a permanent disallowance of interest costs.

In addition it would be inevitable under a group wide limitation rule that there will be level of uncertainty as to the deductibility of interest relief, and at the entity level its position would be unknown until group wide data is collected, thereby making it extremely difficult if not impossible to forecast and appropriately price projects. This will impact the outcome of investment decisions around infrastructure projects.

3.4 Fixed ratio test

Under a fixed ratio limitation basis, it would be impossible for a ratio to be fit for purpose for all industries and sectors. Infrastructure projects that commercially support high gearing levels (e.g. it is not uncommon for infrastructure projects to have in excess of 90% of their funding raised through external commercial funding arrangements) would subsequently fail any ratio that attempts to apply to all industries and sectors. This will lead to a disallowance of interest on commercial third party debt that will increase the costs of the project and potentially impact on the investment decisions.

3.5 Combined approach
A combined approach (either Approach 1 or Approach 2) will also not address these concerns on ensuring deductibility of external debt. For example, under Approach 2 it may be common for an entity to have a higher ratio than its group, particularly where a specific project at an entity level supports a higher gearing than the rest of the group. This is relevant where different parts of the group carry out different functions and has different risks, e.g., the part of the business constructing low risk/highly geared energy generating assets may be completely separate from the part of the business that sells the energy to the end user (high risk/low gearing).

3.6 Proposed changes to the Discussion Document to achieve the policy aims

We consider that Action 4 should accommodate two principle changes to allow the tax deductibility of interest where BEPS is not taking place:

3.6.1 Exemption for external debt

We consider that narrowing the scope of who the interest limitations should apply to may prevent unintended consequences. We note Section V of the Discussion Draft considers 4 scenarios. We would recommend that interest that arises as result of arrangements in scenario 4 (i.e., interest payments to third parties) be completely excluded from the scope of the rules as we consider such arrangements pose the least risk from BEPS activity.

3.6.2 Exemption for non-tax advantaged intra-group lending

In addition to the removal of external interest from the scope of the rules, we consider it necessary for specific carve-outs to be introduced for certain intra-group lending. In its simplest form, there are two arrangements where by entities funding can be sourced from external parties. Firstly, external interest can be raised directly at the entity level which requires the funding, as often commercial lenders require direct access to the secured assets. Alternatively, it is common for external debt to be raised at the parent company level and subsequently pushed down to the entity, in cases where commercial lenders wish to have security of the collateral of the wider group. Either should be seen as acceptable from a BEPS perspective providing there is no tax benefit obtained through following one approach over the other.

The level of BEPS risk could be perhaps assessed by excluding transactions where the lender is subject to tax on the interest income at an appropriate minimum rate of taxation. Therefore, we recommend a carve-out for interest costs where the corresponding interest income is being taxed at an appropriate rate, or where the interest income gives rise to a tax liability that corresponds to the tax benefit of the interest expense.

3.6.3 Potential additional conditions to achieve the Action 4 policy aims
We accept that in granting the two exemptions that we have put forward above, there will be a need for either the OECD or individual Governments to put forward proposals to limit the breadth of the exemptions, to either prevent BEPS or to preserve the tax base of individual countries. These further proposals may introduce additional complexity and practical problems, but these will be less burdensome and more manageable for international groups than complying with the approaches currently being proposed in the discussion document.

If it is deemed appropriate for the exemptions mentioned above to be restricted to certain situations then we propose that the following criteria could be adopted to determine when an acceptable exemption may be granted:

a) **The lending criteria** - identification of good commercial lending

b) **The project criteria** - identification of good commercial projects

3.6.3.1 Exclusion for third party interest costs - restricted to certain **lending criteria**

Where exclusion for all payments to third parties under scenario 4 of Section V of the Discussion Draft is not achievable, some variation of scenario 4 could be adopted to carve-out third party interest costs which arise from “good” commercial lending (as this should not pose a BEPS risk). This is considered below in the context of the infrastructure sector, however we consider this would also be applicable to other industries in which multinationals operate.

It needs to be ensured that any approach to tackle intended BEPS arrangements through the use of interest and other financial payments shall not affect a multinational’s freedom of selecting a certain legal form or its freedom of financing. As long as the form of funding is determined by legitimate business and commercial reasons it would seem inappropriate for interest relief to be denied.

We consider that certain hallmarks of good commercial lending may provide the basis for exclusion.

For instance this may include but not limited to the following types of third party interest costs:

- Debt which is supported by a domestic government guarantee, EU approval or some form of government backed infrastructure scheme;
- Debt instruments which are widely held or traded. As noted in the OECD’s Discussion Draft with respect hybrid mismatch arrangements (BEPS Action 2), an instrument that is widely-held will typically be offered to the public, will have market standard terms and conditions and will provide holders with a market rate of return. The fact that the same instrument is widely-held by different
taxpayers across a number of jurisdictions demonstrates that the issuer by its nature should not pose BEPS risk and therefore should not be subject to the scope of any limitation rules. For instance a widely-held instrument is one that is held by a large number of holders across a number of jurisdictions and it would include a widely-held and regularly traded bond, which is common for large infrastructure projects;

- Debt instruments which are listed on a stock exchange (this may also provide practical way of identifying instruments that are widely-held or traded);
- Debt supported/reviewed/imposed/dictated by a regulatory body or where the regulatory model calls for a certain level of debt financing in the regulated business;
- Debt lent by third party licensed banks on normal commercial terms. There has been a significant increase in the variety of commercial lenders and commercial lending arrangements in recent years and any solution will need to retain flexibility to ensure a level playing field.

3.6.3.2 Exclusion for third party interest costs – restricted to certain project criteria

As illustrated above infrastructure projects operate very differently from the large multinational organisations on which the OECD’s work on BEPS appears to be mainly focused. It is vital that these differences are understood and accommodated in order that the industries involved in such projects are not inappropriately disadvantaged, which would in turn lead to a disruption in global investment flows, impacting countries that rely on inward investment and hence reducing economic growth across the globe.

Infrastructure projects are typically heavily debt financed to meet the needs of investors. A change in this principle would reduce investment returns, increase the risk for investors and reduce the attractiveness of infrastructure projects for large groups of investors. Thereby, this could risk whether the projects are subsequently commissioned if appropriate funding cannot be achieved.

If it was not deemed appropriate to allow exclusion for all third parties then a sector specific carve out may be appropriate to ensure that infrastructure related projects are not disproportionately affected by a blanket approach.

We recognise the difficulty in defining infrastructure projects for a carve-out to be adopted, however there are hallmarks that could be indentified either at a global or individual jurisdiction level. The hallmarks could include:

- Projects that are government guaranteed/backed or formally supported through an infrastructure scheme;
Projects that are overseen by a Government appointed economic regulator where the revenues of the project are subject to approval by the regulator;

Projects tendered under certain specific Government procurement procedures, whether at a domestic or international/EU level (for examples projects that have been subject to EU State Aid review).

4. Conclusion

We support the OECD’s efforts to put in place a framework to prevent excessive relief for interest; however we consider further analysis should be undertaken to prevent unintended consequences, particularly with respect to interest relief arising from genuine commercial activity together with specific issues in relation to the infrastructure sector.

The proposals that we have put forward can deliver on the objective of addressing base erosion and profit shifting through financing arrangements, but does so in a way that ensures all international groups can remain compliant with their individual tax authorities. It will not be in the interest of companies, tax authorities or Governments to introduce a system that is fundamentally unworkable and introduces too much complexity and uncertainty; we fear that an interest allocation or fixed ratio approach may have precisely that effect.

We would like to thank the OECD again for this opportunity to comment and should be happy to expand on these points noted above and contribute to further stages of this review if required.

If you would like to discuss any of these points further please do not hesitate to contact me (Mike.Powell@edfenergy.com).

Yours faithfully

Mike Powell

Tax Director
06 February 2015

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

Dear Mr. Pross:

EY appreciates the opportunity to submit these comments to the OECD on the Discussion Draft on BEPS Action 4: Interest deductions and other financial payments dated 18 December 2014.

We are very concerned about the far-reaching implications of the options for restricting deductibility of interest expenses that are reflected in the Discussion Draft. We believe that advancement of one or more of these options as the OECD’s recommended measure or measures with respect to BEPS Action 4 would severely impact corporate financing decisions and potentially disrupt the global capital markets. We urge the OECD to be more measured in their approach to addressing concerns about the potential for BEPS activity using leverage and interest.

The Discussion Draft starts from the premise that leverage decisions are driven by tax considerations. This is not the case. The choice between debt and equity financing, and choices regarding the borrowing entity within an MNC group, are commercial decisions that are affected by legal requirements, regulatory constraints, contractual limitations, foreign currency implications, and business needs, as well as tax considerations. Similarly, the Discussion Draft treats payment of interest as if it necessarily involved some kind of base erosion or profit shifting. However, interest payments are compensation to the lender for the use of borrowed funds; as such, interest is a necessary cost of doing business for a business that needs capital. In this regard, the differences in the tax treatment of debt and equity are common across countries. These differences do not mean that interest should be equated with BEPS activity. The implications of any
We believe that the Discussion Draft too quickly dismisses the use of arm’s length tests as a relevant and appropriate tool for addressing concerns related to leverage and debt. We believe that arm’s length tests have an important role to play here.

We urge the OECD to take a more targeted approach in its recommendations under Action 4, with a focus on narrowly addressing the specific BEPS concerns regarding non-taxation that are the mandate of the BEPS Action Plan. We also urge the OECD to coordinate its work on interest deductibility with the measures that are being developed under other Actions, including Action 2 on hybrid mismatch arrangements, which will serve to address underlying BEPS concerns and therefore reduce concern about needing broader measures under this Action that would have significant adverse collateral consequences. We also urge the OECD to consider the potential for targeting concerns with respect to interest from the income inclusion side rather than the deduction side.

Turning to the details of the interest limitation options set forth in the Discussion Draft, our concerns about impracticality, unworkability, and unintended consequences reinforce our overall conclusion that a much more measured approach is needed with respect to Action 4.

Group-wide Rules

The group-wide rules operate on two basic premises: first, that a group’s total interest deductions should be limited to its actual net third party interest expense, and second, that within a group interest expense should be matched to economic activity.

The assumption in the Discussion Draft seems to be that where a group’s capital structure does not align with these premises, some degree of BEPS is likely taking place. However, in practice, the optimal capital structure at the entity level is a function of various factors including sector specific issues, the stage of an entity in its life cycle, the local cost of capital, market conditions, regulatory aspects, and currencies. A group-wide
allocation method presumes that the optimal capital structure of an individual entity correlates to that of the group overall, whereas in fact this will occur only coincidentally and divergences do not necessarily indicate the presence of BEPS.

For example, consider a stand-alone company, T, that is capitalized with 1/3 equity and 2/3 debt. Now imagine that 80% of T is acquired by B, a company with no external debt. Often third party debt covenants require debt to be renegotiated or repaid if there is a change in control. If B makes a loan to T to enable to T repay its external debt, a group-wide rule would disallow T’s subsequent interest expense, even though T is capitalized no differently than it was before. Further, the cost of the interest expense disallowance would be shared by the minority shareholders in T. Thus, the effect of the first premise is to create competitive distortions between stand-alone businesses and those that are affiliated with larger groups.

This is an outcome that the OECD has traditionally looked to avoid by means of the application of the arm’s length standard as a way of creating a level playing field between domestic and foreign owned enterprises.

To extend the example further, imagine that B borrows an amount in its local currency that is sufficient to fund a loan to T in replacement of T’s third party debt. However, assume that market interest rates in B’s functional currency are low, whereas T operates in an inflationary environment where market interest rates are much higher. If B chooses to lend to T in T’s functional currency, T’s interest expense will exceed that of the group, even though T’s leverage level is equal to that of B. In a complex multi-currency environment, it is difficult to imagine a rule that would fully compensate for the differences in interest rates arising between different currencies.

Similarly, although there is some attraction to the premise that within a group interest expense should be matched to economic activity, it would be impossible to design a proxy for economic activity that would adequately reflect the myriad factors that in practice go into determination of the optimal capital structure for a business. Even in a controlled group setting, the market provides a much more accurate allocation of interest expense: in practice, groups will strive to place debt in businesses where the interest expense can be supported by, and offset against, taxable income. If taxable income is otherwise an accurate reflection of economic activity (as it should be and as is the focus of other BEPS measures) there should be no need for an external rule to dictate the distribution of debt within a controlled group except to the extent that groups will also tend to locate debt in countries with higher tax rates rather than lower ones. However, we do not see it as within the mandate of BEPS to compensate for reactions to the statutory tax rates adopted by the member jurisdictions.

Thus, although the fundamental premises of the group-wide rules have an initial theoretical attraction, on closer examination their main strength is only that they provide a framework for designing limitations on interest expense, but without consideration of whether those limitations operate in a manner that fully accommodates the operational needs of the different businesses within a group.
In addition, the use of group-wide rules raises a number of practical issues relating to the need to determine a group’s actual third party interest expense, translate that into various functional currencies, and allocate it among dozens of countries and, where consolidated filing within a country is not applicable, possibly hundreds of entities. Consolidated financial statements can be used only as a starting point. Consideration would need to be given to reinstating intercompany transactions (sales, royalties, etc.) that are eliminated in consolidation, pushing down purchase accounting adjustments and other topside entries, accounting for branch operations, and dealing with entities that are not wholly-owned. The computational questions would far exceed those posed by country-by-country reporting.

In this regard, it should also be noted that issues would arise that are related to the definition of interest. The amount of interest expense at an entity or group level will be affected by two types of questions, neither of which is easily coordinated between countries. First, there are variations in the determination of the nature of a transaction that creates interest expense. These variations typically fall in areas such as the treatment of preferred equity (e.g., mandatorily redeemable preferred shares), leases, and hybrid tier 1 capital. To the extent these differences create opportunities for BEPS they would fall within the ambit of other Actions such as Action 2 regarding hybrid transactions. Second, measurement issues arise in situations involving multiple currencies having different market interest rates, and derivative transactions used to manage currency and interest rate risk. We believe the discussion draft should be expanded to more fully address currency and risk management issues.

Finally, and fundamentally, group-wide rules would necessarily cause the interest expense deductible in one country or entity to be dependent on the capital structures and operating results of its affiliates across the world, regardless of whether there is any interaction between the affected companies. This would introduce a level of uncertainty regarding the impact of these rules on individual entities that stands in stark contrast to one of the stated policy aims of the draft, which is providing certainty of outcome, and that likely would have a chilling effect on future capital investment and growth.

Interest Allocation Rules

The interest allocation approach would provide each entity with a deemed interest expense, equal to an allocation of part of the group’s net third party interest expense. This allocation would be made in accordance with either earnings or asset values.

It is agreed that, as stated in the Discussion Draft, a deemed interest rule should be rejected. Simply put, it is impossible to conceive that a rule that would allocate interest expense irrespective of a company’s actual capital structure would be supported by individual countries around the world. Any interest allocation approach in practice would operate as an interest cap for those countries unwilling to allow a deemed interest deduction, which would therefore involve all the problems discussed below with respect to the
interest cap approach, compounded by the uncertainty that would be caused by the fact that the approach would purport to allow deemed interest deductions.

Under the interest cap approach, an interest cap would be determined for each entity, equal to an allocation of part of the group’s net third party interest expense. This allocation would be made in accordance with either earnings or asset values. Either allocation method would raise the computational difficulties noted above. In addition, neither earnings nor assets would be an adequate basis for allocating interest expense.

With respect to an earnings based approach, an entity’s earnings are not reflective of its needs for debt; a mature business with strong cash flow may require little debt financing, while a growing business whose earnings are used to fund capital expansion or R&D may require higher levels of debt. Entities that have operating losses likewise may require debt financing and, as the Discussion Draft acknowledges, it is unclear how to apportion interest expense where some companies in the group operate at a loss. The suggestion of rules allowing interest expense deductions to be deferred and carried forward would not be adequate to address these issues. Moreover, carryover rules would introduce additional complexities when applied in a group-wide context. Rules would be needed to take into account entities that join or leave the group during the carryover period, for example.

Similarly, an assets base approach for apportioning interest expenses would raise a number of practical issues as well. It seems axiomatic that the book value of an entity’s assets is not reflective of either the debt capacity or the funding needs of the entity. Furthermore, if book value were used as a starting point for allocating interest expense, there are a number of potential distortions: the treatment of investment in subsidiaries, consolidation and elimination entries relating to intercompany payables and receivables, and currency translation issues (should assets be translated into the currency used as a frame of reference using historic exchange rates in effect when the assets were acquired, or spot rates as of the comparison?) The use of fair market value would solve some of these issues but groups do not typically prepare financial statements on a fair market value basis and attempts to adjust book values to reflect fair market values would necessarily introduce a level of subjectivity and increase the potential for disagreement between interested parties. Moreover, the use of fair market value would impose substantial annual compliance burdens and would create significant uncertainty for other members of the group.

The Discussion Draft acknowledges that use of an interest cap rule would mean that in practice many groups would not be able to claim interest deductions equal to their actual third party interest cost, because some group entities would have interest expense in excess of the cap allocated to them. Many factors, such as regulatory issues and exchange controls, operate to prevent a group from restructuring its debt to minimize the cost of the interest cap. Because the group apportionment factors would not be static, it would seem impossible to align actual interest expense with the calculated cap. We believe this cost would be significant and should not be dismissed lightly.
The many costs, complexities, and shortfalls that would arise if either assets or earnings were used as a basis for allocating group interest expense should be taken as an indication that the fundamental premise – that interest expense should be matched to earnings or assets – is fundamentally flawed.

**Group Ratio Rule**

A group ratio rule would compare a relevant financial ratio of an individual entity (such as net interest to earnings or net interest to asset values) with that of its worldwide group. Where an entity’s ratio is equal to or below that of the group, all of its third party and intragroup interest expense would be deductible. Any interest expense which takes the entity’s ratio above that of the group would be disallowed.

Ultimately the group ratio rule would be broadly similar in effect to the interest cap approach. It would raise at least as many practical issues as the interest allocation methods discussed above. As with the interest cap, the likely effect would be that a worldwide group would not be able to deduct all of its third party net interest expense, even though such a deduction is stated to be a key policy objective of the proposal.

**Fixed Ratio Rules**

As stated in the Discussion Draft, the premise underlying a fixed ratio rule is that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets or equity, ensuring that a portion of an entity’s profit would remain subject to tax in a country. It is envisioned that the underlying benchmark ratio would be determined by each country and would apply irrespective of the actual leverage of an entity or its group.

A fixed ratio approach can be viewed as potentially more straightforward and easier to implement than the group-wide approaches. Many countries have already adopted a variation of this approach (although many regimes have debt/equity safe harbors, which we note the Discussion Draft rejects). Further, certain ratios (e.g., debt to EBITDA and interest coverage) are often already evaluated by third party lenders and rating agencies in determining the amount of debt an entity can support. Unlike the group-wide approaches, in many situations the analysis may only need to be done for a single legal entity in a given jurisdiction (e.g., a parent company of a consolidated group). It would be anticipated that some discretion could be left to a given country to determine some of the specifics. This would mean that the ratio used could be fixed with consideration given to other aspects of that country’s tax system, such as its tax rate, coordination of individual and entity level taxation, and the treatment given specific items of income and expense.

In short, a primary advantage of a fixed ratio approach is that it could be implemented on a country-by-country basis rather than requiring coordination of multiple factors across countries that likely would be impossible to achieve.
The primary drawback of the fixed ratio approach is that a single ratio would not work well for all industries or even within an industry or company for all the constituent parts of its supply chain. Significant attention would be required to be given to the determination of ratios that fairly reflect the very different leverage ratios of the component parts of different industries. This could involve having different fixed ratio rules for different sectors, or business strategies, or for entities for which a particular fixed ratio rule would be clearly inappropriate (such as, perhaps, group finance companies). Potential approaches to address this could include benchmark ratios for each industry based on an industrial classification system (e.g., standard industrial classification (SIC) codes). Rating agencies also utilize SIC codes for various benchmarking purposes. It could be said that use of a fixed ratio approach would be more appropriate the more the benchmark ratio can be adjusted to reflect the optimal capital structures of various industries. In other words, a fixed ratio approach would be more appropriate the closer it gets to operating as a proxy for the arm’s-length standard.

However, we are very concerned by the comment in the Discussion Draft that the fixed ratios currently used in several countries (most commonly, 30% and ranging between 25% and 50%) “may be too high to be effective in preventing base erosion and profit shifting.” We believe that the data that the OECD reviewed and found to show net interest to EBITDA ratios significantly below the benchmark ratios does not in fact support such a conclusion. The data relates to the companies included in the global top 100 companies by market cap. These are typically mature businesses and the debt levels of these companies would not be representative of the whole range of multinationals that would potentially be affected by the interest limitation recommendations. Furthermore, the data is from consolidated financial statements, which likely would not provide information sufficient to determine net interest expense or EBITDA under the tax concepts that are relevant for purposes of countries’ fixed ratios. As one example, some interest expense may be included in cost of goods sold on the financial statements, which would mean the net interest expense number would appear lower. In addition and importantly, current interest rates are at historic lows, so data on interest expense levels in the current environment is not at all representative and cannot properly be used in benchmarking an appropriate fixed ratio.

Finally, we would note that a fixed ratio approach would limit interest expense in a given country to levels that the country in question deems acceptable. We would suggest that attention should be directed toward developing a framework that would reduce incidents of double taxation, e.g., instances where a lender is taxed on interest income that the borrower is unable to deduct. In general, such double taxation would seem to be best alleviated by rules that restrict the ability of a country to limit deductions for cross-border interest expense, rather than the reverse.

Usefulness of the Arm’s Length Method

We are concerned that an arm’s length test is not being considered as a possible ‘best practice’ recommendation for countering base erosion using interest payments. The Discussion Draft provides two reasons for this. One reason is that the arm’s length principle is seen as resource intensive and difficult for
both taxpayers and tax administrations to apply. We agree that this may be the case, particularly for tax administrations with no familiarity with the practical application of the arm’s length principle. In principle, however, it is no more difficult to apply this test to intra-group debt than it is to apply it to any other type of intra-group transaction. Indeed, because there is a plethora of market data to facilitate the application of the arm’s length principal to intra-group debt such that it would be fair to view application of the arm’s length principle as relatively more straightforward in the case of intra-group debt. In addition, we are concerned that the alternatives being considered as part of the Discussion Draft (in particular the various group rules) would themselves create very considerable compliance and administration burdens, with the likelihood of significant disputes and substantial double taxation.

The second reason a pure arm’s length test is not being considered as a ‘best practice’ recommendation is that it is seen as not being effective in countering base erosion using interest. We understand that the OECD is seeking a more objective approach which could be applied consistently across different sectors and geographies.

An arm’s length test does, however, have certain advantages over the current proposals in the Discussion Draft. Significantly, it provides a great deal of flexibility which reflects and recognizes that leverage and interest cover ratios vary between entities depending on, inter alia, the nature of their business, their stage in the business cycle, their business strategies (expanding or steady state), their size, and the markets in which they operate. It also in principle maintains the level playing field between domestic and foreign owned companies which has been seen by the OECD as important for facilitating trade and avoiding or minimizing economic double taxation.

For example, the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations indicate that:

“Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm’s length principle promotes the growth of international trade and investment.”

In this regard, we cannot understand why a subsidiary should not be able to have a capital structure based on its own needs just as a local stand-alone entity would do. Therefore we feel that the arm’s length test would have a useful role to play.

We are aware that many OECD countries currently have arm’s length tests as part of their overall tax regimes, often combined with other tests (such as debt/equity safe harbors). Within these regimes, the arm’s length test can often be invoked if the safe harbor test is considered to result in an unreasonable outcome.
This combination gives the flexibility to taxpayers to comply with the safe harbor limitations (so providing them with certainty at minimal cost) or, where they feel this would result in an inequitable outcome, to approach their tax authority to see if agreement can be reached that a different outcome is more appropriate for their situation.

This kind of approach would, we consider, address many of the concerns we have regarding the arbitrary nature and distortive consequences of any of the current proposals for a best practice recommendation. It would recognize the point that a ‘one size fits all’ approach would inevitably lead to inequities in a number of scenarios (highly leveraged sectors, expanding businesses, start-ups, diversified groups) and that it would be beneficial for there to be a level of flexibility in applying the rules to reflect this.

**Sector-specific Considerations**

The Discussion Draft recognizes that there are some sectors with specific characteristics for which the general approach proposed may not be appropriate and accordingly raises the issue of other options for those areas. Consistent with comments noted above, we agree that sector-specific characteristics must be taken into account in any approach for potentially limiting interest deductions. We provide below brief comments on sectors specifically identified in this section of the Discussion Draft.

**Banking and insurance**

For the banking and insurance sectors, the OECD’s conclusion that any interest limitation rules should apply to net, rather than gross, interest expense is critically important. However, the conclusion general limitation rules based on net interest therefore would not have any impact on businesses in these sectors goes too far. For example, an important consideration in this regard is how net interest would be calculated. An approach that determined net interest for each entity would be too narrow; netting should be applied by aggregating entities within a jurisdiction.

We note the Discussion Draft’s suggestion that a specific rule could be developed for banks and insurance companies that focuses on the particular BEPS risks that they present. However, the Discussion Draft does not identify what specific BEPS risks arise from interest deductions in the financial sector. We consider that risk to be low. In this regard, we would note that regulatory constraints mean that banking and insurance groups do not have a free choice as to where to locate borrowings and capital. Moreover, given these regulatory constraints, the Discussion Draft’s suggestion of potentially developing a specific rule that would focus on regulatory capital raises grave concerns about the risk of a fundamental misalignment between an institution’s regulatory capital requirements and the limitations that could be sought to be applied for tax purposes. We urge the OECD to work with the industry and its regulators first to further consider what BEPS concerns may exist for the banking and insurance sectors and then in developing any responsive measures if and as appropriate.
**Infrastructure**

The OECD has stated that USD 50 trillion+ of investment is required to meet transport, water and energy demands for the future. Furthermore, the OECD acknowledges the importance of infrastructure in driving competitiveness, boosting trade and promoting economic growth. The infrastructure sector typically receives capital from multiple investor types (corporate groups, funds, pension and sovereign investors) in varying proportions, and whose ownership profile changes over the life of the asset as do third party financing arrangements. As such, for the infrastructure sector it is important that any interest limitation rule apply consistently throughout the asset’s life and its financing arrangements and is not sensitive to or impacted by changes in the shareholder base.

Following the financial crisis, the source of funds for long-term infrastructure projects has diversified to include funding from banks, governments and, increasingly, institutional investors such as pension funds and sovereign wealth funds. Both pension funds and sovereign wealth funds may have no third party debt yet regularly make investments for commercial purposes using debt. If group-wide rules were to be implemented in the infrastructure sector to restrict interest deductions to net third party interest expense only, it would increase the cost of capital for the infrastructure sector and would be likely to impact the availability of long term capital for international investment, which is itself the focus of an OECD project. Furthermore, it could create a competitive disadvantage for pension funds and sovereign wealth funds that have an absence of third party debt compared to banks and governments.

We would note that the 25% control test could have a significant impact on the infrastructure sector as it would mean infrastructure projects owned by four or fewer shareholders will receive no tax relief on related party debt funding. This could create a distortion in competition as consortia of five shareholders or more would arbitrarily gain a competitive advantage over those bidding for projects as a consortium of four or less shareholders. This could act as a barrier to investment in the infrastructure sector. Further uncertainty could be introduced if the consortia bidding for a contract could be treated as ‘acting together’ to provide finance and so may be treated as ‘connected’.

A subsidiary involved in 3rd party financed infrastructure project is likely to have a higher ratio than its blended group ratio if the group is also involved in other activities. Therefore, a group ratio rule could lead to a restriction on third party debt which has been obtained for the infrastructure project. Fundamentally, a fixed ratio test would not take into account sectors which require high leverage such as capital intensive sectors for example, energy, transport, waste management, water and other infrastructure. If at the time of arranging finance in advance, there is uncertainty about whether tax relief would be available, even on the third party debt, then no tax relief on interest could be assumed. Therefore, the amount and cost of borrowing would be increased. This uncertainty alone would feed back to consumers in the price agreed for provision of the
infrastructure or services and hamper the wider OECD objectives of economic growth through removal of investment and financing barriers to infrastructure investment.

The proposed best practice recommendations outlined in the Discussion Draft give rise to a number of distortions both in terms of competitiveness of groups and which may affect investment into utilities and infrastructure. They also appear to adversely affect the economic stability and certainty currently experienced in the infrastructure sector. We would note that the cost of long-term third party borrowing and/or costs to consumers could increase even if there is no loss of tax relief. Moreover, the international investment market which releases capital for new development would be discouraged. We urge the OECD to work with the sector in considering how any interest limitation rules should apply in light of specific industry considerations.

Real Estate

Any form of group allocation rule would be impractical to implement for businesses operating in the real estate industry. In order to apply a group allocation rule, the group would need to have timely information on the entire group’s third party debt, earnings and/or asset values. Most significantly, a group allocation rule would ignore the fact that conditions for borrowing and interest rates differ from country to country. Further to this, the group would then need to enforce the allocation of interest calculated among all of the relevant group companies. For large and complex groups this is likely to be unrealistic and the administrative cost associated with it prohibitive. This approach would also result in the post-tax profitability of investments in one part of the group being affected by the income or capital value characteristics of other investments.

The only perceived benefit of the fixed financial ratio approach over a group allocation approach is that it is likely to be administratively simpler to implement and enforce for both tax payers and tax authorities. The ability of a business to take on debt finance would depend on the specific circumstances affecting that business. Accordingly it would not be possible to set any meaningful uniform threshold without giving a competitive advantage to those companies which do not ordinarily operate with such levels of debt financing. Therefore, if a fixed financial ratio rule is chosen to apply across all industries, this will be at best an arbitrary figure, and unreflective of the range of factors affecting the ability of investors in that industry to fund operations through debt finance. This approach will have a disproportionately negative impact on capital intensive industries that rely more heavily on debt financing to fund operations, the real estate industry being a notable example. A fixed financial ratio approach would also penalize real estate asset owners holding properties with periods of reduced tenancy or in development (i.e. where there is no rental income stream). Such an approach would also result in a lack of certainty over the level of interest that will be tax deductible where there is any volatility in earnings.

Again, we urge the OECD to work with the sector in considering how any interest limitation rules should apply in light of specific industry considerations.
If you have questions or would like further information regarding any of the points discussed above, please contact Karla Johnsen (karla.johnsen@ey.com), Lee Holt (lee.holt@ey.com), Jo Myers (jmyers@uk.ey.com), Martin Ryback (mrybak@uk.ey.com), Graham Wright (gwright1@uk.ey.com), Tom Passingham (tpassingham@uk.ey.com), Barbara Angus (barbara.angus@ey.com), Jim Tobin (james.tobin@ey.com) or me, Alex Postma (alex.postma@ey.com).

Yours sincerely
On behalf of EY

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OECD

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Subject: EBF Comments on the OECD Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments

Dear Mr Pross,

The European Banking Federation (EBF) welcomes the opportunity to comment on the OECD’s current work on interest deduction and other financial payments as part of the Base Erosion and Profit Shifting (BEPS) project.

The EBF is committed to contributing constructively to the BEPS project, in the expectation that the final outcome will deliver fair, certain, sustainable and principled rules.

While the EBF is supportive of the efforts of the OECD we consider that Action 4 should not be implemented on the premise that interest deduction automatically leads to (abusive) base erosion and profit shifting. Many countries indeed already apply thin capitalisation rules and/or interest deductions rules to regulate the amount of interest expense that may be deducted by a company. These rules are the international norm and those that are properly crafted represent a sufficiently effective means of preventing excessive interest payments or, for instance, debt pushdowns. We thus consider that the issue of base erosion via interest deductions should be circumscribed in accordance with this reality.

To the best of our understanding, the primary concerns relating to potential profit shifting techniques involving financial arrangements are addressed by Action 2 on hybrid mismatches. Thus, it remains to be seen, whether or not the objective of preventing excessive or undue interest payments should be addressed by two, potentially overlapping, layers of rules.

Our recommendations

• Banks are subject to strict regulation which imposes restriction on their capital structure. This regulatory environment of the banking industry, together with the level of scrutiny employed by regulators and investors, already constrains the behaviour of banking groups in a way which obviates the BEPS risks. We consider that any underlying BEPS issue is thus likely already dealt with through banking regulations and other mechanisms in the domestic tax legislation. Should the OECD in any case believe that there are specific concerns which require further consideration, the EBF considers that actual abuse in the financial sector related to interest expense be first identified and only then should targeted rules be contemplated when it has been clearly
Chief Executive

demonstrated that it would not be possible to address any concern using the arm’s length principles.

• The practical significance of the issue of base erosion via interest deduction, as contemplated in the Discussion Draft, should be appraised and circumscribed by taking into consideration (1) existing thin-capitalisation rules and related anti-abuse rules currently enforced worldwide and (2) other areas of the BEPS action plan, in the first instance Action 2.

• The material scope of Action 4 should be generally restricted to what interest is effectively about, that is remuneration on money lent. Other remunerations, relating to different services, should conversely be excluded and their deduction should be granted as long as they are at arm’s length. Specific/sectorial carve-outs within a broader definition of interest for the purpose of Action 4 could be difficult to apply within the European Union as these might conflict with applicable state aid rules.

Specific points of attention for the banking sector

We welcome the recognition within the Discussion Draft that banks and insurance companies give rise to particular considerations, which do not arise in other sectors. In the meantime, we are concerned that the Discussion Draft still considers submitting banks and insurance companies to a general interest limitation rule. This approach would be to our view inappropriate. As for the latter, we would like to refer to the views expressed by HM Treasury (United Kingdom) in March 2014 in the specific context of Action 4:

- “Banks make profits from, among other things, the margin between interest paid on money borrowed and interest earned on money lent. Debt is thus part of the circulating capital of the business and the associated interest cost of servicing that debt is a core trading expense. (…) Banking and insurance groups are subject to both group capital requirements and local capital requirements in respect of those parts of their groups operating in different local markets. (…)”

- Therefore any structural interest restriction or allocation method is likely to either create asymmetries or place disproportional burden onto the financial sector and would, in many cases, wholly undermine their business models. We do not therefore believe that it is appropriate to apply a structural interest restriction model to the financial sector, and certainly not to their day to day trading activities”.

The preceding statements make a strong case for banking activities to be considered outside the scope of application of Action 4 to the extent that it would apply a structural interest restriction upon banks.

Some concerns also arise from the broad material scope ascribed to Action 4 in the Discussion Draft, which should cover not only interest on all forms of debts but also “other financial payments which are economically equivalent to interest” and “expenses incurred in connection with the raising of finance”. A literal reading of these definitions would potentially affect a series of transactions that are not set-up for base erosion purposes, such as, for instance, foreign exchange and hedging transactions. Likewise, we believe that guarantee fees and arrangement fees should not be

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1 HM Treasury and HM Revenue & Customs: Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting, March 2014, paragraphs 3.15 and 3.16
Chief Executive

assimilated as interest for the purpose of Action 4, as they remunerate in the first instance a commercial service and not a provision of funds.

The foregoing considerations on the material scope currently ascribed to Action 4 certainly apply mutatis mutandis to sectors of activities other than the banking sector. In the meantime, specific/sectorial carve-outs within the definition of “interest” (and equivalent payments) for the purpose of Action 4 could be difficult to apply in practice within the European Union, considering the applicable state aid rules. The foregoing pleads for narrowing the scope of the definition of “interest” for the purpose of Action 4 to what interest is effectively about, that is remuneration on money lent. Other forms of remunerations, relating to different services, should conversely be excluded and their deduction should be granted as long as they are in accordance with arm’s length principles.

The Discussion Draft further notes that measures based on gross interest expense would have distortive consequences and we believe this is particularly relevant for the banking sector. We therefore believe that measures which consider ‘net interest expense’ are a more accurate means of identifying and addressing issues in the banking sector.

We hope you find our comments and suggestions useful and remain at your full disposal should you wish to further discuss our letter.

Yours sincerely,

Wim Mijs
Dear Achim,

EBIT is grateful for this opportunity to provide comments on the OECD Public Discussion Draft on BEPS Action 4: Interest deductions and other financial payments 18 December 2014 - 6 February 2015 (hereinafter “the Discussion Draft”).

**General comments**

Whilst we commend the OECD’s Working Group No. 11 of the CFA for its efforts in describing and analysing how BEPS effects can arise as a result of inappropriate use of interest deductions and other financial payments economically equivalent to interest, and setting out different options for approaches that may be included in a best practice recommendation to tackle BEPS effects of excessive interest deductions, EBIT’s Members have several concerns about the Discussion Draft, which are outlined below.

**Group-wide test**

From our experience as a group of tax practitioners from a cross-section of industry, we believe that the group-wide test proposed in the Discussion Draft is not practical, not realistic and will considerably increase double taxation for groups.

Importantly, the group-wide test will likely create an internal mismatch between a group’s commercial treasury requirements and activities and the pressure to adjust internal debt levels worldwide (i.e. allocating external finance costs or a fixed ratio requiring a wider distribution of external finance costs across the group), which will lead to artificial behaviour in order to be compliant (to the extent that finance costs can indeed be allocated across the group). Secondly, the Discussion Draft mentions that group-wide tests if they are applied consistently worldwide have the potential to reduce complexity for international groups which would otherwise need to comply with different, sometimes overlapping, rules in countries where they operate.

In EBIT’s view, consistent or, perhaps more appropriately, identical, implementation in all BEPS-44 countries is a central assumption in the Discussion Draft’s approach to group-wide interest allocation rules. However, we note that there is no consensus within the CFA on Action 4 so far, nor is it likely in our view that this is likely to happen.

Furthermore, the Discussion Draft states that individual countries may consider allowing groups to carry forward disallowed interest expense or unused capacity to deduct interest into future periods and/or leave it to groups to rearrange their internal funding arrangements on a regular basis to avoid double taxation. EBIT’s Members consider that this is not a realistic or
practical assumption and the Discussion Draft in our view clearly, and, very worryingly, downplays a) the difficulty many groups will face in adjusting their internal mix of debt and equity financing and b) the degree of complexity and administrative compliance costs this will entail for both taxpayers and tax administrations given the many different domestic tax systems involved.

For many groups it will simply not be possible to adjust the internal mix of debt and equity financing in many markets in which they operate. In some countries currency flows are heavily regulated and intra-group debt to fund dividends or effect share buybacks (which would be required to allocate debt) is not permitted. Foreign exchange volatility will make allocating debt to many countries prohibitively expensive as will any other leakage (for example dividends or share buybacks to minority investors or dividend or interest withholding taxes). In addition, even where debt can be allocated to a particular company, it will still be necessary to obtain a corporate tax deduction for the associated interest costs. In many countries finance costs for debt push down transactions are either not deductible or the deductibility is routinely challenged.

In effect, a group-wide allocation (or a fixed ratio requiring a wider distribution of external finance costs across the group) will result in a proportion of a multinational group’s external finance costs no longer being deductible. This allocation will impact the cost of external funding of acquisitions, where a proportion of external debt would need to be allocated to every group company to achieve a full deduction, irrespective of how the acquisition would impact these entities. The distortive effect also becomes quite apparent where multinational groups are cash rich at group level, impacting the financial cost for companies to be funded through intercompany debt. A relatively debt-free group including overseas subsidiaries which both have little or no group debt would become more attractive as targets for more heavily indebted acquiring groups. The distortion might therefore also have the perverse effect of making acquisitions and other investments by heavily indebted groups rather than by relatively debt-free competitors more likely.

Whilst we do accept that group-wide allocation of third party interest might also have some potential benefits i.e. discussions about transfer pricing and financial transactions or transfer pricing and cash boxes are no longer needed, and many of the proposed OECD hybrid rules would not be required either, we do not believe that these potential benefits outweigh the distortive effect of this approach.

The OECD rules accept the use of cash-pools as a valid option for multinational groups. However, the group-wide allocation considers the net interest position for the group which would be decreased by the reduction of third-party interest payment (as a consequence of using the cash-pool). This net-position is subsequently allocated to group entities for the purposes of calculating their debt cap. Since interest paid to or received from the cash pool would also be included in the calculation of each entity’s net interest, the cash-pool impact appears to be double-counted.

EBIT is not in favour of the interest cap as proposed in the Discussion Draft. One way of mitigating BEPS concerns surrounding the carry forward of non-deductible interest, could be to allow groups to use such carry forwards only after a certain period of time has passed, for instance 5 years. The same should apply to EBITDA capacity which has not been used to deduct interest. We also strongly recommend the possibility to allow excess limitation incurred in a particular year to be carried forward.

The Discussion Draft’s apparent preference for a world-wide type of formulary allocation and apportionment of interest expense is in our view a departure from the current, traditional arm’s length principle approach between related parties, which underpins most of the OECD/G20’s BEPS initiative. Moreover, it appears to treat multinational groups as single entities, in which internal financing is merely an allocation to projects. The reality is that groups are made up of individual legal entities operating under the specific legal frameworks
of the countries in which they are resident and operate. Internal financing transactions are contracts with real impact and legal obligations for each of the parties involved.

The group-wide test also overlooks the diverse nature of operations that exist within a MNC. For example, a manufacturing group may retain a portfolio of products to lease to customers, funded by third party borrowing secured on the lease assets. Whilst the debt ratios of the leasing arm may be characteristic of the leasing industry, they are likely to far exceed the debt ratios of the group.

**Fixed-ratio test**

EBIT Members are more open to the fixed-ratio test approach proposed in the Discussion Draft as a best practice approach, i.e. if it is well-designed, flexible and simple, and again, reflects current business realities. A fixed ratio rule has an advantage vis-à-vis a group-wide test that it at least does not require the worldwide identical implementation and use of identical definitions, and is therefore probably less impractical to apply. The mechanical nature of the fixed ratio test can at the same time stand in the way of necessary flexibility, however. EBIT believes that the fixed-ratio test proposed in the Discussion Draft is too inflexible, too restrictive and too much a “one size fits all” approach which grosso modo ignores the specificities of different industry sectors with different profit margins and different debt ratios, and also negates the flexibility that countries will require for determining appropriate domestic threshold ratios.

Fixed ratio tests are more mechanical by nature and essentially simpler to apply for groups than group-wide tests, and also for tax administrations. From our day to day experience, we note that multiple tests including a group-wide debt-equity test already exist in some OECD countries so groups can actually prove that the financing of one entity is wholly in line with the group debt-equity ratio and that the interest not deductible under the fixed ratio regime should still be deductible. However, as some of these existing multiple tests are very challenging for groups to apply today, if the OECD believes that this is the way forward, EBIT recommends that such multiple tests be simplified. Such simplification should include aligning the test with a group’s borrowing capacity, rather than its actual borrowing. This would allow a cash rich group to internally finance new projects with debt, without suffering double taxation, rather than forcing equity financing which is more bureaucratic and can lead to cash being trapped in a country due to accounting or legislative requirements.

The Discussion Draft’s presumption that under a fixed ratio test approach, any net interest expense to EBITDA expense in excess of 10% may be excessive or inappropriate, in our view is not a representative benchmark and potentially misleading, given that it is based on a survey of 79 of the global top-100 companies by market capitalisation which showed that these MNCs had a net interest expense to EBITDA ratio below 10%.

Countries that have already introduced a domestic fixed ratio test must have done so to the extent they believe an acceptable balance has been struck between maintaining levels of inward investment and sufficiently combating base erosion through debt financing. The former seems to have been somewhat overlooked by the Discussion Draft and the reference to a 10% EBITDA suggests that the decision by a MNC to use anything more than a minimal amount of internal debt financing is predominantly motivated by taxation.

In EBIT’s view, therefore, a fixed ratio approach could work but only if it were complemented with override rules as a fall back option to ensure that groups with external leverage which is higher than the fixed ratio will have the possibility to continue to deduct external interest cost.
EU Law Issues

EBIT welcomes the Discussion Draft’s considerations in ANNEX 2 which explicitly acknowledge that any consistent international approach will be flawed if it cannot be fully implemented by the 28 EU Member States on account of EU Law.

In the CJEU case Test Claimants in the Thin Cap Group Litigation (C-347/04), the CJEU held with regard to the pre FA 2004 UK thin capitalisation rules that “legislation of a Member State which restricts the ability of a(n EU) resident company to deduct, for tax purposes, interest on loan finance granted by a direct or indirect parent in another Member State..” or by another EU subsidiary of the common EU parent of the borrower, could only be consistent with the freedom of establishment if, amongst other things, “that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce evidence as to the commercial justification for the transaction.”

This is reiterated in Itelcar (C-282/12) but in the context of the free movement of capital as regards Portuguese thin cap rules which “presume(d) that the overall debt owed by the borrowing company forms part of an arrangement designed to avoid the tax normally payable or where they (the rules) do not make it possible, at the outset, to determine their scope with sufficient precision.”

Accordingly, EBIT considers that neither the pro-ration of a group’s net external finance expense to group members nor the fixed cap approach canvassed would be EU law compliant unless the taxpayer was allowed to demonstrate on their facts that any greater level of debt of a particular EU company was commercially justifiable, at least insofar as the borrower is controlled by another EU company in a different Member State and borrowing either from that company or a third EU company which was also a subsidiary of the common EU parent, but in a different state to that of the borrower.

XIII. CONSIDERATIONS FOR GROUPS IN SPECIFIC SECTORS

According to paragraph 214 certain sectors, including oil and gas, may be subject to special tax regimes. We suggest that concerns regarding the effect of best practice rules, introduced to tackle BEPS using interest expense, on the oil and gas sector need to be considered further.

The oil and gas sector is governed by tax rules that are unique to each country and distinct from the mainstream corporate tax regime; therefore, any general interest restriction will have a distortive effect on the sector.

Oil and gas companies cannot borrow externally to fund exploration activity. They are financed by equity or non-interest bearing group loans. There are typically two types of tax regime in the sector; the Tax and Royalty Regime and the Production Sharing Regime. Both regimes have a common feature that there is a restriction or prohibition on interest deductibility.

For both regimes, an allocation of any group interest expense to an oil and gas exploration or production company will not give rise to a tax deduction and consequently, any relief will be lost. Allocation keys based on profit or asset value would require a disproportionate amount of non-deductible interest to be allocated to these entities, since they can contribute a significant proportion of a group’s profit and are highly capital intensive. Similarly, any EBITDA restriction would place yet further disallowances on an already restricted expense – a position not seen in other sectors that are subject to the ‘normal’ corporate tax system.

**Interaction with other BEPS Actions**

EBIT considers BEPS Action 4 addressing excessive interest deductions to be one of the most crucial and most challenging of the BEPS Actions for the international business community.
The Discussion Draft rightfully states that work on interest limitation rules has potential interactions with a number of other BEPS Actions, including in particular Action 2 (hybrid mismatch arrangements), Action 3 (CFC rules) and the second part of Action 4 (guidance on the pricing of related party financial transactions). In addition, there are overlaps with Action 6 (prevent treaty abuse), Action 9 (risks and capital), Action 11 (establish methodologies to collect and analyse data on base erosion and profit shifting and the actions to address it), Action 13 (transfer pricing documentation and country-by-country reporting) and Action 14 (make dispute resolution mechanisms more effective). We acknowledge the strong inter-linkages in particular with the OECD’s ongoing work on addressing hybrid mismatches, treaty anti-abuse and CFCs which are also looking to prevent BEPS through the deduction of interest and other financial payments in inappropriate circumstances. However, EBIT Members are concerned that the proposed recommendations in the current Discussion Draft are sufficiently aligned with the OECD’s work on these other BEPS Actions in particular for the sake of a consistent, holistic approach.

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

Yours sincerely,

European Business Initiative on Taxation – February 2015

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.

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

Dear Sirs,

It is a pleasure for us to submit our comments on OECD Discussion Draft on BEPS Action 4, regarding Interest Deductions and Other Financial Payments, and thus contributing to this necessary debate aimed to the construction of fairer tax rules in the international arena.

FCC is a multinational group engaged in the following business activities: (i) environmental services, (ii) water management, (iii) infrastructures and (iv) cement production. We are therefore in a good position to observe different financial environments existing in diverse sectors of activity, which probably should be taken into account when proposing rules about interest tax deductions.

We hereinafter include our suggestions to some of the questions raised in the referred Discussion Draft published.

QUESTIONS FOR CONSULTATION

Question 2, regarding the definition of interest and other financial expenses that are economically equivalent to interest.

In our view, only the interest payments related to a real indebtedness should be covered as a best practice rule, since only said interest payments might derive from abusive practices. Thus, financial expenses corresponding to the financial actualization of future provisions, or financial expenses deriving from currency exchange differences arisen in speculative financial transactions should be excluded from the interest payments definition. Also, financial expenses which are capitalized or activated, and which are subject to future depreciation or deterioration, should not be considered either when establishing tax limitation rules.
Question 4, regarding the application of a 25 per cent control test to determine whether entities are related.

We think that a 25% is a percentage very low to determine the existence of relationship among parties. If that limit were applicable, FCC would result to be related with almost all its competitors within the infrastructure sector, with which joint venture agreements are usually entered into to execute Engineering, Construction and Procurement (EPC) contracts or public concession agreements. We can assure that, although this is a very typical situation, there is not a common control in these cases, where each company defends its own interests with independent and sometimes diverse criteria.

Question 5, regarding the problems that may arise if a rule applies to net interest expense

We would like to point out that, when determining the net (or gross) interest expenses subject to limited tax deductions, the debt/equity ratio computed for these purposes might be misleading due to:

1. An exceptional economic situation of the company, which leads it to a transitory low level of equity.
2. An extraordinary level of financial expenses in a determined fiscal year, due to the accrual of a variable interest previously agreed in a profit participating loan.
3. Foreign exchange differences, that might affect the level of equity or indebtedness of the borrower in a particular year.

Consequently, to avoid these distortions, an average debt/equity ratio referred to a certain period of time (3-5 years) might be taken as a good practice.

Question 6, regarding other approaches that could be used to exclude low risk entities

We deem that financial expenses deriving from project finance should be excluded, since these financial expenses are consistent with normal market conditions by definition. Only shareholder loans existing within the frame of these projects might pose a risk of base erosion and therefore might be taken into account when setting up limitations to deduct interest payments.

Question 7, regarding any practical issues with respect to (a) interest allocation rules or (b) group ratio rules.

We think both approaches present serious problems to tackle base erosion on the grounds of fair rules, since they do not take into account the solvency, the capacity of indebtedness of the borrower entities, nor the average indebtedness either existing in different economic sectors, as we will refer below.

Question 11, re what approach to measuring earnings or asset values give the most accurate picture of economic activity across a group.

In our view, both approaches do not necessarily lead to a real and balanced picture of the excess of financial expenses at the level of a company. Other options, certainly more complex but still
sufficiently simple, might be considered in order to be close to the reality of financial markets. For instance, a third approach to determine excessive interest expenses might consist of the following:

1. Estimating the solvency of the borrower entity, through certain formulae or methodologies generally accepted in the market to evaluate, in general terms, the theoretical credit ratings of borrower entities (e.g. use of Moody’s or Altman Z-Score methodologies). The theoretical credit rating assigned to the borrower entity would determine the maximum interest rate applicable.

2. Estimating the maximum level of indebtedness attributable to the borrower entity on the basis of the average indebtedness granted within the sector of activity to a company with the same credit rating. This statistical average indebtedness could be fixed by an independent third party.

3. The maximum interest deductible would be the one resulting from multiplying the maximum level of indebtedness by the theoretical market interest rate applicable. This limit of interest tax deductibility would not be linked to the financial expenses actually registered in the accounting books, following thus the approach non correlated with the accounting rules suggested in paragraphs 134 and 135 of the Discussion Draft.

This alternative would permit avoiding the disadvantages of using asset values to limit interest expenses pointed out in paragraph 154 of the Discussion Draft, and would avoid the disadvantage of possible arbitration practices that might derive from different domestic tax or accounting rules. As discussed in paragraph 133 of the Discussion Draft, permanent mismatches arise when there are differences of treatment for accounting and tax purposes. In Spain, for instance, the criterion of tax deductibility of interest payments accrued in profit participating loans significantly differ from the criterion established by accounting rules. Also, within the infrastructure sector, significant differences exist between the imputation rules to deduct financial expenses according to IFRS and the imputation rules according to Spanish GAAP and corporate income tax rules.

Finally, our suggested approach to determine the cap of interest tax deductions would make more difficult to device planning alternatives for increasing earnings or assets at the convenience of the taxpayer (as referred to in paragraphs 139, 140 and 141).

Question 13, regarding the categories of tax exempt or deferred income that should be excluded from the definition of earnings.

The Discussion Drafts take the position that, in order to address base erosion and profit shifting using interest to fund tax exempt of deferred income, any measure of earnings used might exclude dividend income. Such practice would oblige companies to place indebtedness always at the level of the local legal vehicles and not at the level of the stakeholders, which could be tax resident in another jurisdiction. However, in many cases it is just not possible or economically convenient to accede to local financing. On the other hand, the introduction of restrictions in this sense might be incompatible with the principle of free movement of capital applicable within the EU countries.
Question 16, regarding the specific issues or problems that would be faced in applying a group-wide rule to a group engaged in several sectors.

As already mentioned, a group-wide rule does not take into account the average indebtedness and the particular risks existing in specific sectors, as underlined by the Discussion Draft in paragraphs 143 and 149. An approach to determine a cap of interest tax deductions based on the theoretical degree of solvency of the borrower, as we suggested in question 11, would avoid this problem. In any case, a group-wide rule approach should always take into account the corresponding debt/equity ratios existing in subgroups engaged in the same sector of activity.

Question 18, re the difficulties that may arise from the application of a group-wide allocation rule to groups with centralised treasury functions.

These kind of groups might be extremely penalised by a group-wide allocation rule. It should be noted that the centralisation of treasury functions normally respond to a number of legal, operating and financial reasons. Thus, groups with centralised treasury functions would face severe restrictions to deduct financial expenses for tax purposes, despite the possible lack of abusive intentions to erode the tax base.

Question 19, regarding the practical difficulties that may arise under an earnings or assets-based approach.

For the reasons explained when answering questions 11, 16 and 18 above, we think that, definitely, a combined approach based on the real solvency and capacity of indebtedness of the borrower entities should be explored.

Question 20, about the situations that could imply significant or timing mismatches if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules.

Apart from the mismatches already pointed out in question 11, an important mismatch to be considered when calculating the debt/equity ratios is the one deriving from the non-deductibility of expenses corresponding to the deterioration of assets. These expenses could significantly reduce the debt/equity ratio, and thus the subsequent limit to deduct interest payments for tax purposes, despite the expenses incurred for the deterioration of assets could not be tax deducted either. A double tax penalization would then unjustifiably be imposed to the taxpayer.

Question 21, re other approaches that could be taken to address timing mismatches.

The approach not correlated with the accounting and tax rules, suggested when discussing question 11, might permit avoiding these mismatches.

Question 22, re the competition concerns where a group-wide rule applies to entities held under a parent company and not under a trust, fund or individual.

These kind of rules might imply inequitable tax treatments in comparable situations, and thus might contravene the non discriminatory principles envisaged by the EU Law, or even might be
deemed as State aids not covered by EU Law, due to the potential selective character of these rules.

Also, a targeted rule that disallowed the tax deduction of all interest payments made to connected or related parties might be deemed as an anti-abuse general measure not compatible with the principle of proportionality contemplated by EU case law.

**Question 24, re the practical issues that may arise in applying fixed ratio rules based on asset values or earnings.**

As already mentioned, fixed ratio rules do not fit well with the underlying financial environment existing in different countries or different sectors of activity.

Also, these rules might eventually pose incompatibility problems with the principle of free movement of capital, given that these rules penalise, in general terms, the external financing. Also, in certain cases these rules might be considered as a selective State aid prohibited by EU law, to the extent that the same tax treatment regarding the deductibility of interests would be applicable to non comparable situations.

**Question 26, regarding the reasons why the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios or its worldwide group.**

As discussed, these ratios might significantly vary in different sectors of activity. For instance, the average level of indebtedness in regulated sectors may be higher, since stable income can be reasonably estimated on the basis of concessionaire agreements whose yield is partially secured by legal instruments such as the material responsibility assumed by the State or the public grantor entities.

**Question 27, regarding the particular problems that the fixed ratio rules may pose in certain sectors.**

As explained in question 26, fixed ratio rules might give rise to extremely unfair and arbitrary results if applied without any specific particularity within the infrastructure sector, where concessionaire agreements or project finance schemes are the general rule.

**Question 30, regarding possible combined approaches that might provide an effective solution to base erosion and profit shifting.**

As already indicated, we think it would be essential to define combined approaches that take into account the actual degree of solvency and capacity of indebtedness of borrower entities, on grounds similar to the ones we have suggested when answering question 11.
Question 31, re the situations that should be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting.

As sustained in paragraph 175 of the Discussion Draft, a balance between effectiveness and simplicity should be considered when defining targeted rules. In this sense, general rules, which apply to a wide range of situations and on the basis of mathematical formulae are normally contrary to the general principle of justice. We should not forget that BEPS plan is oriented, basically, to redefine the current rules of the game in order to be closer to the concept of Tax Justice. Consequently, in our view it is key to make an effort to introduce targeted rules and general approaches on tax deductibility of interests that, although somehow more complex, are sufficiently workable and achievable to reach more equitable, balanced and fair tax results.

To this aim, the business purpose test should always be required when defining targeted rules, and the taxpayers should be entitled to supply evidences to challenge the proves initially provided by the tax authorities, to disallow an interest deduction.

We hope that our above comments and suggestions are useful to enrich this discussion on the deductibility of interest payments. We would be delighted to extend on any of the issues you might have in connection with this matter.

Yours faithfully.

Daniel Gómez-Olano
Head of Tax

FCC Group.
Paris, le 6 février 2015

Monsieur, Madame,

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 le document de discussion relatifs à l’action 4 du plan « BEPS ».

Ce document fait l’objet d’un certain nombre d’observations de notre part 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.

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

Blandine LEPORCQ
Directrice du département fiscal
APPENDIX: COMMENTS FROM THE FRENCH BANKING FEDERATION ON THE PUBLIC DISCUSSION DRAFT RELATING TO THE ACTION 4 OF THE BEPS REPORT “INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS”

PRELIMINARY REMARKS

The FBF, as the voice of the French banking sector representing the interests of over 400 banks operating in France, encompassing large and small, wholesale and retail, local and cross-border financial institutions, welcomes the opportunity to provide the OECD with comments on certain questions of the proposed Public Discussion Draft relating to the Action 4 of the BEPS Report “interest deductions and other financial payments”. It is crucial for us to have the opportunity to provide our comments as well as our input, particularly given the complexity of certain issues under discussion. We thank the OECD for the consultative process underway and call for a continued interaction with the private sector so that the voice of business is duly taken into account.

As preliminary remarks, we would however like to express some concerns about the “BEPS project”.

The subjects under discussion and the issues at stake are far-reaching and sometimes extremely complex. The accelerated pace planned by Member Countries of the OECD do not allow us to analyse thoroughly the topics, to consult our members as much as necessary and thus do not allow us to contribute as deeply as we would wish to. We believe that analysing the consequences of the proposed changes is also a great challenge for both tax administrations and the private sector, which requires more dialogue and more time. We would therefore call for a more realistic timeframe, with more reasonable consultation periods in particular. It would also be extremely useful to have a track of the different changes brought to the various reports on every action issued by the OECD after collecting the comments of the stakeholders.

We would like to underline that the BEPS project may entail significant changes to well established tax principles which have followed and have been adapted to the evolution of economic models. We are particularly concern that the new set of tax rules may cause major disruptions to the economic and commercial flows.

For instance, action 4 may prevent at the end of the day debt financing which is however a perfectly sound mean of economic growth.

On action 4, we want particularly to focus on questions 34 and 35 under consultation.

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?
A. THERE ARE STRINGENT REGULATORY REQUIREMENTS ON THE BANKING SECTOR...

We would like to stress out that European banks are the leading financial intermediaries in Europe. Their business is to lend money to corporate, individuals and public bodies. To do so they complement traditional deposits as a source of funding by directly borrowing in the money and capital markets. This may be done by issuing securities such as commercial paper or bonds. They also have many other activities such as payment agents but also private banking, trading activities and so on. To this extent, it must be kept in mind that the turnover of a bank consists mainly of interest flows as being part of its core activity.

Due to its activities, the banking sector is regulated and such regulation has considerably been strengthened over these past few years (further to the financial crisis) to ensure its resilience: this has been achieved by setting stronger prudential requirements, requiring banks to keep more capital – both in quantity and in quality- and liquidity. The EU has to this extent adopted the bank recovery and resolution directive in April 2014 and created a banking union which comprises the creation of a Single Supervisory Mechanism (SSM) led by the European Central bank (ECB) and a Single Resolution Mechanism (SRM) for banks.

Banks must therefore comply with a stringent set of rules briefly described below which are mainly provided for by Basel III. These rules are binding and in the end determine the level and structure of capital as well as the leverage ratio of banks.

Basel III is a comprehensive set of reform measures in banking prudential regulation developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. It is a global, voluntary regulatory standard on bank capital adequacy, stress testing and market liquidity risk. These measures aim to:

- improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source;
- improve risk management and governance;
- strengthen banks’ transparency and disclosures.

The recommendations of the members of the Basel Committee on Banking Supervision for reviewing the banking prudential rules (Basel III) have been published on December 16th 2010 after the endorsement of the Basel III agreement by the G20 in November 2010. It was first agreed to be introduced from 2013 until 2015; however, changes from 1 April 2013 extended implementation until 31 March 2018 and again extended to 31 March 2019. http://en.wikipedia.org/wiki/Basel_III - cite_note-1

Banks must hold more capital against their assets, thereby decreasing the size of their balance sheets and their ability to improve their leverage ratio.

Basel III gave a more restrictive definition of common equity tier one which mainly consists of shares and reserves. Certain debt instruments may be issued by banks and qualify as a tier 2 capital. The solvency ratio has been raised up to 10.5%.

Basel III also introduced a minimum "leverage ratio". The leverage ratio was calculated by dividing Tier 1 capital by the bank’s average total consolidated assets (not risk weighted). This ratio was introduced to limit the leverage effect. The banks are expected to maintain a leverage ratio in excess of 3% under Basel III.

Due to this set of cumulative rules, banks are already submitted to a minimum leverage ratio and it is merely impossible for them to be in a situation of under capitalization. In particular, abusive debt push-down scenarios cannot occur due to the regulatory
framework. For e.g.: when setting up a subsidiary or branch, regulatory capital would be required, thus excluding any debt financing.

In addition, it should be noted that the banking regulation is so stringent and absorbs so many resources that it is unlikely to have over capitalization situations in the banking sector. The scrutiny employed by regulators and investors also means that banks are unlikely to be under or over capitalized.

**B. ...THUS, THERE IS NO NEED TO IMPOSE A RESTRICTION ON DEDUCTION OF INTEREST ON BANKS**

Paragraph 212 of the public discussion draft raises the possibility that existing non-tax regulatory capital requirements imposed by banking and other regulators on banks and insurance companies “act as an effective general interest limitation.” We agree of course with this statement and as detailed above financial institutions are subject to regulatory capital rules and interest expense to banks may be compared to the cost for industrial companies to acquire their goods. Thus banks have very different issues from other companies in relation to interest expense. To this extent, the Public Discussion Draft acknowledges that “a specific rule” has to be designed for banks (cf. § 210). However, only two paragraphs (§§ 211 and 212) of the Public Discussion Draft explain the possible options for banks:

- Option 1: a “group-wide interest allocation rule” under which “an interest cap” would be allocated (§ 211);
- Option 2: “targeted rules to address risks posed by specific transactions” (§ 212).

As far as the banking sector would be concerned, the meaning of this passage needs to be clarified (for instance: the “interest cap” is not detailed; the scope of “regulatory capital instruments” needs to be clarified, as regulators in different countries disagree about which instruments qualify for regulatory capital purposes). The Discussion Draft is too undeveloped on how the proposals would apply for banks and special circumstances of the banking sector are not fully appreciated in the Discussion draft, so that some of the recommendations, which make sense for other sectors of the economy, cannot be transposed to the banking world.

The general (non-tax) regulation of the financial sector by banking and securities regulators in terms of leverage ratios is still evolving. Further, capital requirements are being developed by global as well as local country regulators. This will, among other things, impact the use of alternative tier 2 capital instruments (for regulatory capital purposes) and other loss absorbing instruments that could have debt characteristics.

The discussion on net interest expense and gross interest expense has no real meaning for banks as already stated, interest being part of their normal business result.

Therefore the discussion on the best way to achieve a limitation of deduction of interest cannot be applied to banks. Indeed, the prerequisite that an entity or group of entities is in a **net interest expense situation** is an unsuitable approach for banks, as the very business model of banks requires them to generate a net interest profit / margin.

All six alternatives detailed in the public discussion draft “best practice” may not be applied to banks whether through a fixed ratio approach on a jurisdiction-by-jurisdiction basis or a global group-wide test. To analyse and develop tax rules on interest expense which would apply to the financial sector could run counter to objectives of banking and other prudential regulators.

**Therefore, we strongly recommend that the banks be excluded from action 4 as any tax measure which may interfere with the regulatory rules may totally disrupt their aim. We think**
that it is not necessary to mention “targeted rules” in this context or at this stage although we note that provisions dealing with general anti-abuse rules already bring sufficient comfort for tax authorities. We would rather refer to general arm’s length standards, which would allow, if necessary, addressing abuses.

In other words for banks, to use the terms of the public discussion draft on action 4, the use of interest is certainly not one of “the most simple of the profit-shifting techniques available in tax planning”.

FFSA’s Comments on OCDE public discussion draft on “BEPS Action 4 on interest deduction and other financial payments”.

The French Federation of Insurance Companies (FFSA) is a trade association which groups together 234 insurance companies representing 90% of the French market. In particular, its purpose is the promotion of insurance, the defense of the interests of the profession and the establishment of common ethical standards.

Prior to our upcoming discussions, we regret the short deadline given to respond to this consultation draft on the deductibility of interests, since it is a dense document and raising numerous hypotheses.

Part 1 - General considerations

(A)- As outlined in the report, in some particular situations, recourse to debts and its corollary interest payments, enable in fact-when these interest payments are deductible- the optimization of the taxable base in a group or the shift of an income from one entity to another. It is thus legitimate, under the BEPS consultation to consider measures that need to be taken in order to avoid this situation and the most aggressive schemas.

However, it is appropriate to move away from any general approach which would penalize in general and in an undifferentiated manner, the deduction of interests in the different entities of a
Such an orientation would penalize the recourse to debts, which would be economically penalizing. Indeed:

-debt responds primarily to commercial and strategic concerns. This is a normal way to raise funds for economic projects and an effective development tool for companies and groups. This type of market call mode is in fact more complementary than competing to the issuance of new shares, a transaction that is operated on a narrower market and generating different legal and governance issues.

-in a group, on an economic standpoint, it might be more rational to concentrate the ability of approaching lenders in a better equipped entity for the raise of external capital, as being more attractive to investors, operating on financial markets which are suited to the group's needs and most likely to get the most interesting financial conditions. Also, we can ask ourselves if it is still relevant to consider, as envisioned by the consultation draft that we must “encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group” (P10);

-lastly, the intragroup debt remains an extremely useful tool to achieve common economic objectives in the best financial conditions and ensuring the overall cohesion of the group. For some activities - such as real estate construction - this is in fact also a traditional method of financing. So it should not be penalized a priori and must be able to deduct the corresponding charges.

From our point of view - and provided that the remuneration of internal or external debts are carried out under normal market conditions - the corresponding interest expense must be deducted, since it is undeniably a burden for the entity that bears it.

Also, any blanket rule for the limitation of the deductibility of interests - by definition blind and without nuances – seems to us as being inappropriate on an economic standpoint. We believe that in this field the issues identified under BEPS should be resolved either by the use of the arm's length principle test or by targeted measures. As the report reminds us, many countries -
including France – have in fact adopted these types of measures and a possible solution might be
to look for a better coordination between states on the application of current national rules.

If this path had to be discarded in favor of a general rule of “best international practices”, it
would be necessary to simultaneously convince states to repeal their current regulatory devices,
in order to rule out any risk of stacking regarding their penalizing devices. And it would be
required to implement simultaneously measures avoiding a proliferation of double taxation
issues relating to interests which have become non-deductible.

(b)- The report does not retain the "arm's length test" approach (§21) but instead explores
primarily the definition of an international “best practice” rule.

It is essential that the solution effectively meets the different conditions which are set out in
section 11 of the consultation document, which will be a prerequisite. It is also important that it
appears as an adequate solution to the problems identified.

It is essential that the adopted solution effectively meets the different conditions which are set
out in paragraph 11 of the consultation document, which are prerequisites. It is also important
that it appears as an adequate solution to the problems identified.

But the two main types of solutions developed in this consultation paper have, on a technical and
economic standpoint, significant disadvantages with consequences exceeding the simple
resolution of BEPS issues.

- The first type of solutions- general rules for groups - is to limit the overall net charge of
deductible interest of a group to its net interest expenses in relation to third parties, and dividing
this total capacity of deduction between all group members based on income or assets criteria.
While being very complex to implement, this solution is also very detrimental. Firstly, it requires a strict uniform and worldwide approach. But above all, according to the proposed terms, it leads either to a notional deduction for each member of the group disconnected from its financial reality, or the inability to fully use the possibility of theoretical deduction. Indeed, it is unlikely that the various entities of a group have naturally the average financing structure of the group. And in many cases they would not be able to reorganize themselves in order to achieve it. Also a fraction of the possibilities of deduction may remain unused regarding certain entities of a group, without the possibility of transferring it to other entities in need.

- The second type of solutions leads us at the level of the company ("stand alone approach"): it thereby limits the possibility of deducting the net interest expense - external or internal -of each entity of a group according to an economic ratio (earnings or assets) determined either by reference to the situation of the group, or by the state of implementation of the entity. It is certainly easier to implement than the previous method, but it has implications that go beyond the BEPS issues. It tends more broadly to prevent that the debt load exceeds a "standard", which is above all an economic issue. It also raises issues which are difficult to resolve, since the debt needs can be structurally different in different economic sectors, and the interest expense will be dependent upon the currency to borrow. Therefore it will potentially generate unequal treatment between activities.

Part 2 – Specificity of the insurance sector

In paragraphs 203 and subsequent, the consultation paper recognizes the need to provide well targeted measures for the financial sector in general and in particular for the insurance sector.

Insurance companies are institutional investors who play a key role in the financing of economy and in fact it is important to avoid any inappropriate measure that would disrupt this role or question it.
However, section 201 states that "The proposal is therefore to design a specific rule which would have a similar effect for banks and companies aim insurance that focuses on the particular base erosion and profit shifting risks that they present. This may involve separate rules for each of these sectors."

Therefore, as outlined in paragraph 211: "For example, one option could be to focus on the net interest expense attributable to regulatory capital instruments, which provide a bank or insurance company’s core funding and play a role comparable with debt in other sectors. A group-wide interest allocation rule could be designed which limits a group’s total net deduction on its regulatory capital (ignoring the interest income generated from using the capital to write business) to the amount expense paid on this instruments to third parties."

And paragraph 212 provides for “alternatively, if existing regulatory requirements act as an effective general interest limitation rule, and prevent excessive leverage in group entities, a best practice approach could instead focus on a group’s interest expense other than that on its regulatory capital. This may comprise targeted rules to address risks posed by specific transactions.”

The FFSA is deeply concerned about the general approach mentioned in paragraph 211 which suggests that one way or another, the deductibility of net interest expense associated with the regulatory capital of an insurer, therefore associated with debt instruments and meeting the mandatory regulatory requirements in order to participate in all or part of the constitution of the solvency margin, could be governed by a limitation rule at the group level.

It should be noticed in prior, that there are no precisely identified assets that are in equity representation and solvency margin of the insurer. The identification of elements that need to be taken into account to compute, in such a situation, faces conceptual problems.

It is also important to bear in mind that the regulatory requirements in terms of minimum solvency margins which insurers and reinsurers are subject to, primarily satisfy general interest and the protection of policyholders. For regulatory authorities overseeing this industry, the objective is to ensure that their commitments would be covered, if for one reason or another, assets backing liabilities should prove to be insufficient.
This margin may consist of capital securities, but also, within certain limits and under certain conditions, instruments remunerated by interests and meeting specific characteristics. The combination of the various elements of the solvency margin is in any case constrained by regulatory requirements. Within this limitation, it will then depend on strategic and commercial concerns, concerns in terms of financing cost, and capacity - financial but also legal - of the insurance company to access various financial markets, it being recalled that the debt market is larger than that of equity.

In an insurance group, the level of solvency margin is assessed simultaneously in each insurance company individually and in aggregate for the group as a whole whilst taking into account its different entities.

In such a situation, it is common to have recourse to debt instruments, recognized at regulatory level and which comes at a relatively high level in the entities controlling the group. This situation tries to solve a twofold problem:

- find the necessary capital in the best financial terms and thus by shifting debt at the most appropriate level;
- be able to have the best distribution of funds raised among members of the group, so that they have the means to meet local regulatory requirements and their development projects.

Reshaping these funding structures among different entities of a group in order to meet an interest limitation rule is not a viable option both for financial reasons and for reasons of local technical regulations. An overall limit on the deduction of interest expenses would significantly alter the balance struck in the funding structures and their hedging arrangements in terms of their solvency margin. Therefore, this perspective must be resolutely rejected.

Other tracks - that seem to be emerging under the editorship of paragraph 211 – need to be examined in light of the following particularities:

- The principle of specialization in the insurance sector prohibits the implementation in a single entity life insurance operations and damage insurance operations. Also market players are led to develop several entities in order to be able to exercise in these areas. But for the application of a "stand alone approach" type rule, the economic unity remains primarily the subgroup, as constituted to operate on a national territory.
- The concept of EBITDA, based on a classical analysis of manufacturing industry, has no legitimate translation regarding the insurance industry, a service industry, marked by the inversion of the production cycle service activity of the production cycle and the burden of technical provisions.

Yours Faithfully,

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For the attention of: Kate Ramm

By email to: interestdeductions@oecd.org

6 February 2015

Dear Sirs

BEPS action 4: interest deductions

We write with comments on the public discussion draft relating to BEPS action 4 (interest deductions), released on 18 December 2014. We are grateful for the opportunity to participate in discussions with OECD about the proposals in the draft, which discussions have involved a number of specific questions that OECD have raised. We are aware that OECD will receive detailed submissions addressing those questions and will in this letter outline our overall conclusions based on our participation and the views that we have read and heard from affected businesses.

General; relationship with other actions

1. Whilst we appreciate the scope for interest relief to contribute to base erosion and profit shifting we do wonder whether, given the progress made and expected on other actions, much of the abusive BEPS planning will be addressed through them. They include

- anti-hybrid proposals (Action 2)
- CFC proposals (Action 3)
- transfer pricing/thin capitalisation proposals as they relate to finance and finance charges (e.g. Action 4, other aspects)
- risk and capital proposals (Action 9)
- treaty abuse (Action 6)

In addition there are local anti-abuse and interest limitation rules already in place in many countries. We still see a case for completing the actions with targeted measures, directed at agreed “hallmarks” of BEPS abuse.

2. We would also add that some of what is contemplated in the discussion draft (e.g. at Box 1 on page 7), especially in the context of the approach to a group-wide rule, seems to us perhaps to go beyond what would generally be regarded as BEPS abuse. For example, if a cash rich UK multi-national parent (with little or no net debt at the group level) lent directly to a US operating subsidiary, to meet the subsidiary’s medium term funding needs for a new project, would this necessarily be regarded as BEPS? It appears to be caught by a group-wide rule. The subsidiary may in overall terms be well capitalised and able to borrow from a third party. Is the mere existence of a tax rate differential sufficient? What if it does not influence the chosen funding method? What would prevent structural double taxation? What would prevent a group-wide rule operating even if the lender country had the higher tax rate?

3. In intra-group situations OECD proposes group-wide interest allocation or ratio rules or fixed ratio based limitations. We see both as somewhat unsatisfactory:

(a) whilst group-wide allocation or ratio rules, limiting overall net interest relief to the group net third party interest expense, may have some academic appeal (though see paragraph 4 below), we are concerned that the rules will be sufficiently difficult to operate in practice that they will lead (at least in the absence of a material “uplift” factor) to disallowance of net third party interest expense, or to double taxation, thus disrupting business activity and overreaching. See further below.

(b) fixed ratios are ultimately crude measures, which do not fully accommodate the differences between different business ownership and funding models, business sectors and local environments. As such they naturally function as a form of safety net and if used as more than that they will easily overreach too.

**Group-wide tests**

4. An initial point on group-wide tests is that, as may appear from paragraph 2 above, we doubt that there is general acceptance of the proposition that “the best measure for total net interest deduction within a group is the group’s actual net third party expense” (paragraph 59 of the draft). The arm’s length standard might indicate otherwise, and a group-wide rule seems to be a move towards a formula apportionment. Such a rule might also lead to increased third party debt. The better use of a group-wide rule seems to us to be as a form of exception or safe harbour (as in France).

5. As regards practicality, the reasons why we think group-wide rules are likely ultimately to be impractical include the following:
Volatility. Assuming a cap based rule is used, the problems involved in matching precisely the levels of net interest cost with the allocated or allowable amount in each territory are considerable, having regard to factors such as interest volatility; local funding terms differences, including FX aspects; and business/earnings volatility. (To take examples from recent months, consider a group part of whose business is oil price dependent or is affected by Swiss franc exchange rates.)

Consistency. The prospects of obtaining worldwide adoption, country by country, on a consistent basis of a group-wide rule are limited, especially where adoption is required to extend to countries that are less than fully engaged in the OECD BEPS process, and which may have material interest limitation rules already in place. The challenge is far greater than it is with, say, hybrid mismatch proposals, which are more targeted and which should not prejudice business if they are not implemented by some states. The hybrid proposals also contain general domestic law recommendations, primary responses and fallback defensive (and even tertiary) responses, which combine together to provide worked-through recommended outcomes where particular States do not implement the rules fully.

Complexity. The operation of a rule worldwide is difficult: equivalent rules need to be grafted on to different tax regimes; there is a good deal of definitional complexity (e.g. as regards accounting and tax mismatches); there is an interaction with local limitation rules (which may require States to abandon rules that do not fit well with the group-wide test); there will be administrative and compliance complexity; and the difficulties will increase when account is taken of the need to operate a group-wide rule at a detailed level locally between possibly large numbers of subsidiaries based in one country. The UK worldwide debt cap, which is a good deal more limited in scope than BEPS Action 4 proposals would contemplate for a group-wide rule, indicates how awkward the technical rules can become. Difficulties increase, of course, when companies join and leave groups.

Diversity. A single apportionment or allocation basis is unlikely to be suitable for conglomerates with diverse businesses, operating (and competing) in diverse local environments.

Double taxation. Double taxation is unlikely to be addressed by carry forward of disallowed interest, particularly where the disallowance relates to a structural issue. This is especially so if there are limits on carry forward (paragraph 198 of the draft).

Timing issues. The application of a group-wide rule also requires dealing with timing mismatches issues, depending on how interest (or assimilated expense) is recognised for accounting and tax purposes at the level of the group and at the level of each entity/jurisdiction.

Other matching constraints. Corporate law, regulatory considerations, withholding tax considerations, exchange controls, foreign exchange considerations, minority shareholder issues (where relevant) and other commercial funding issues affect where
debt is allocated and located within a group. For example, some business models may commercially require a third party debt location which does not fit with a group-wide rule. Project financings of controlled subsidiaries of multi-nationals may involve levels of third party debt, and debt terms, that are based on recourse to the project and bear little relationship to the wider funding position of the group.

(h) Business distortion. Mergers and acquisitions activity may be affected in such a way that tax continues to distort the market, or may itself cause a tax distortion. For example,

(i) a cash rich multi-national may be unable to bid competitively for a company that is substantially debt burdened;

(ii) a disposal may produce proceeds that have a material effect on net debt pending distribution or reinvestment (this is in addition to the impact on the group calculations of the removal of the business/company sold);

(iii) a company may need, when looking to bid for a company in a foreign country, to push debt down to that company, which is often difficult to achieve for local reasons;

(iv) if a company with high earnings in a home jurisdiction wishes to expand into a new market elsewhere it will initially be encouraged to raise the debt in its home jurisdiction (where it has the current earnings) not in the country where the capital investment is to occur and the funding is needed. A push down of some debt at a later date when the local business turns profitable may be required by a group-wide rule but may be particularly vulnerable to local anti-abuse or other business purpose based disallowance rules (e.g. if there is a circular flow with a dividend or capital extracted).

Fixed ratios

6. Depending on how they are used fixed ratios provide scope for some greater flexibility: precisely consistent implementation is not required of all countries; different markets and local environments can be recognised; different business sectors can be respected, etc. It seems to us however that the relatively crude nature, ultimately, of fixed ratio tests is such that they should operate essentially as a safety net, with ratios not set too low. Otherwise they will all too easily do more than counter BEPS.

7. Fixed ratio tests will also fit better with business by business differentiation if they can be combined with group ratio tests, as suggested in Part X of the discussion draft. A combination, perhaps along the lines of Combined Approach 2 (paragraph 170), may have the benefit also of having been tested by some countries. An alternative would be fixed ratio rules but with a carve-out where a business can demonstrate that there is no BEPS abuse, by reference to agreed hallmarks or otherwise.
Special cases

8. It is evident to us that some businesses are in a special category that should be kept out of the main rules contemplated, either by being excluded altogether or with specially adapted, or targeted anti-avoidance, rules. They include:

- upstream oil and gas. This sector is highly regulated in terms of the State participation in production, through production sharing contract arrangements, licence royalties and special tax regimes (which often limit or disallow interest relief). Indeed the starting point is sometimes an after-tax production sharing percentage. We do not readily see how the general interest limitation proposals could usefully apply, although we would observe that when dealing with the oil majors that have integrated businesses the downstream elements of the business may lend themselves more readily to the general rules. This is a specific example of different businesses carried on within conglomerates requiring different rules.

- banking and similar financial services, as widely acknowledged.

- infrastructure and project financings, where debt finance is typically an integral part of the project. The project company’s ultimate ownership should not make a difference and the regulatory environment will often provide the protection that a State needs. In addition, the modelled tax projections will have an impact on the project pricing and therefore typically on the costs incurred by state-owned organisations under the project.

Yours faithfully

Freshfields Bruckhaus Deringer LLP

Freshfields Bruckhaus Deringer LLP
Madrid February 6, 2015

Dear Sirs,

We thank you for the opportunity to present our comments to the BEPS Action 4 Public Discussion Draft during the meeting held on January 20th. In this regard, we consider appropriate to make some written comments to the issues highlighted during the meeting and more generally to the Discussion Draft.

Before going into the list of questions that was addressed in the referred meeting, we make two suggestions regarding the overall approach of the Discussion Draft.

**The risk of over-reaction and the convenience of a safe harbor.**

Sections I (Introduction) and II (Policy Considerations) of the Discussion Draft summarize the main purposes of BEPS Action 4, which focus on targeting base erosion and profit shifting achieved by MNE through intra-group interest and interest-equivalent payments.

While the overall concern is well justified, it is also noticeable that many jurisdictions have already addressed this problem with general interest limitation rules plus targeted rules and SAAR. Now, the basic guidelines of the Discussion Draft will add an additional layer of restrictions which if taken together and in an uncoordinated manner may generate an scenario where interest charges become non-deductible. This would lead to double taxation and to distortions of competition in the local markets.

In our view, once the international tax policy is defined i.e. the maximum amount of deductible interests is the amount accounted for as financial expenses in the group consolidated F/S. National legislations should be aligned so that this maximum allowance of deductible interest can be used by the group as a safe harbor so that interest charges allocated to the different Group affiliates would be deductible as long as the total amount is not higher than the group financial expenses.

In case the total amount of interest charges is higher than the group financial expenses, there will be a partial disallowance of interest charges in each jurisdiction.

**The definition of deductible charges as “Net” interest expenses**

Paragraphs 46 to 49 cover this specific point, which is highlighted as beneficial for taxpayers as any disallowance of interest charges would only apply after discounting the
interest income accrued by the company. Apparently, this approach would protect individual companies within a group from the risk of double taxation.

However, Example 7 (paragraphs 253-257) shows that the netting takes place at a group level and that when the group has net interest income the affiliates with net interest expenses will face full disallowance of these expenses, regardless of whether the interest income is effectively. In our view, this outcome is contrary to the one of the policy goals, to avoid double taxation. If there is a concern with a potentially low effective taxation on the interest income, this concern should be addressed independently, through some of the other BEPS actions. The proposal, as it stands now, would imply that many groups would face a substantial amount of interest charges disallowances resulting in effective double taxation. The reality is that it is very frequent that for business, corporate, contractual or legal reasons a group may borrow funds from third parties through some affiliates while at the same time may hold cash or financial assets in other affiliates, generating interest income, regardless of any favorable or detrimental tax consequences.

**Interest and other financial payments economically equivalent to interest**

1. What problems could be caused by the approach to defining interest and other financial payments economically equivalent to interest set out in Chapter IV of the discussion draft?

   While a definition of “interest” will always be controversial, we understand that there is a need for a common one. In this regard, using the accounting standards is the most appropriate approach as accounting rules are becoming a common language for MNE and markets.

   Special care should be given to some of the items which may be included as financial expenses. We refer to the exchange gains and losses as in many cases these items would be offset at a group level as they may derive from intragroup loans or they may be hedged in the group consolidated balance sheet. Taking into account foreign exchange gains or losses may only be suitable when they derive or are linked to third party financing.

   A problem to be addressed is the possibility that in order to preserve a fair competition tax environment, the adoption of an internationally accepted definition of interest charges may require the simultaneous adaptation of local CIT rules as interest should not be defined in a different way for MNE and for local companies.
**Group-wide tests**

2. What are the respective strengths and weaknesses of –
   
a) an agreed approach applied consistently by all countries; or
   b) a flexible approach where each country applies a rule reflecting domestic tax or accounting principles?

   It is difficult to coordinate the overarching principle (“interest deductions should be limited to the group net interest expenses”) with a flexible approach in which every country applies different tax and/or accounting rules. This may lead to inconsistencies, distortion of competition and effective double taxation.

   In this regard, we favor the agreed approach applied consistently by all countries.

3. Are there any elements of a group-wide rule where either a consistent approach or a flexible approach would be particularly beneficial?

4. The discussion draft envisages that a group’s net third party interest expense should be based on figures taken from the group’s consolidated financial statements. This should also include payments economically equivalent to interest. What benefits or problems could arise from this approach?

5. A group-wide test links an entity’s maximum net interest deductions to the total net third party interest expense of its group, based on economic activity. What are the respective strengths and weaknesses of measuring economic activity based on
   
a) earnings; or
   b) asset values?

   Using earnings as the distribution tool may be more sensible if the deemed interest rule would be accepted by the tax administrations. However, as this possibility is discarded in the Discussion Draft (paragraph 75) we revert to the interest cap model.

   In this scenario, the reality is that interest expenses are naturally connected to assets and not so much to earnings. On top of this, asset values are less volatile than earnings. If earnings are used as the allocation tool, MNE would have to engage in dynamic exercise of transferring assets and borrowings to the companies where more earnings are forecasted. This exercise should take place every tax year and would generate extraordinary difficulties.

   Besides, using earnings is a pro-cyclical measure as it punishes companies which become less profitable.
6. Where a group-wide rule uses figures taken from financial accounts to calculate a limit on interest deductions, mismatches may arise when this limit is applied to an entity’s net interest expense calculated using tax rules. What are the key permanent and timing mismatches that could arise and how could these be dealt with within a rule?

*Fixed ratio tests*

7. What are the strengths and weaknesses of fixed ratio tests for groups operating in different sectors?

There is a real need for different ratios in different business sectors, as they have completely different features in terms of fixed asset investment effort, the stability of earnings and the lenders appetite to finance the activities. Financial markets have traditionally been very effective in identifying the leverage ratio for each of these sectors.

The Discussion Draft already identifies the most affected sectors – infrastructure, oil&gas, natural resources, real estate -. In order to preserve the efficiency of capital markets, a specific regime should be applied to them.

8. What objective information is available to evidence the actual net interest to EBITDA or net interest to assets ratios of entities and groups?

We understand that capital markets offer enough information about public companies to make effective approaches to these concepts. Capital markets reporting usually requires the consolidated F/S of the group to which the entity belongs. Market researchers prepare periodically industry analysis which may be useful to evaluate specific ratio tests for certain sectors.

*Combined approaches*

9. What are the advantages or disadvantages of including a combined approach in a best practice recommendation? In particular, what are the strengths and weaknesses of combined approaches 1 and 2, as set out in the discussion draft?

In our view, fairness is better respected if the approach includes the Group ratio rule. At the end of the day this should act as a safe harbor as it will provide the group the opportunity to achieve tax deductibility for its whole interest charges.

In principle it may be better to adapt Approach 2 as in the German model. It gives a safe harbor while at the same time it allows for final tax deductible figures being adapted to real third party interest expense figures at group level.

10. What other combined approaches could be considered for inclusion within a best practice recommendation?
Considerations for groups in specific sectors

11. How could an interest limitation rule be designed that would address BEPS risks posed by banks and insurance companies without having an undue impact on a group’s regulatory position?

This area is difficult to tackle as interest income and expenses are in reality sales and cost of sales for banks and insurance companies. The proposal included in paragraph 211, which limits the analysis to the gross interest expenses deriving from instruments computed as regulatory capital, deserves further consideration. In principle it may be appropriate to tackle double deduction of interest although it may not be so effective to counter profit shifting.

12. Groups operating in certain sectors such as oil and gas are often subject to special tax regimes. How will this impact the operation of interest limitation rules and how could account be taken of this in the design of a best practice approach?

As stated in our reply to question 7 we consider a must to establish different ratios for these specific sectors to ensure that competitiveness among peers in those sectors is not harmed by tax provisions.

13. What other sectors have characteristics which mean special consideration should be given in the design and application of rules to limit interest deductions?

See reply to question 7
Comments on the Public Discussion Draft of BEPS  
Action 4: Interest Deductions and Other Financial Payments of 18 December 2014

To: interestdeductions@oecd.org

Introduction

The OECD released its latest draft on the public discussion of “Interest Deductions and Other Financial Payments” on 18 December 2014 with comments invited by 6 February 2015. The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

General Overview and High Level Concern

Action 4 was intended to make recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense and to evaluate the effectiveness of different types of limitations. We recognise the need for work in this area and welcome some aspects of the proposal. However, elements of the discussion draft go far beyond where interest is used in BEPS and impact on every single company regardless of size, level of tax risk and the presence of any tax motive.

In particular, the newly conceived concept of a group-wide interest rule in our view is simply not workable. It is incredibly complex, will result in significant time, cost and uncertainty to taxpayers, as well as double taxation and distortion of commercial investment decisions. The draft too quickly discounts valid measures including withholding tax and arms length tests, already applicable to interest rates, and how current rules could be adapted to make them fit for purpose.

Interest deductions are already subject to withholding taxes and transfer pricing plus individual domestic rules. A best practice which potentially includes several layers of additional rules is overly complex and excessive.

Existing approaches

The paper quite quickly dismisses a number of current approaches (including withholding tax, arms length debt tests and debt/equity ratios) that it considers should not be included as options for a best practice recommendation. We do not believe these should be so easily discounted and we consider each of these below. We also question the general approach of recommending any single method as a “best practice”, as it seems highly unlikely that a sufficient number of countries would be willing or able to change their existing domestic legislation to implement, as opposed to providing
guidance on how each of the more commonly used existing approaches may be adapted to tackle BEPS.

**Fixed Ratio (Debt/Equity) rules**

The draft raises several concerns with this approach. Firstly, it states that a debt based test still leaves significant flexibility over the interest rate applied. However, this completely ignores the fact that the interest rate is already subject to transfer pricing rules as well, further discussed below. The interaction with transfer pricing needs to be considered in all approaches.

Secondly, it asserts that it is easy to manipulate such a test by simply increasing the amount of equity. However, this ignores that putting in more capital means the company has a corresponding asset of some description. This will either be an asset which generates taxable income, in which case the result should be more tax overall to that country, or one that produces tax exempt income. The latter case is an issue that is common across all approaches and can be dealt with by having some form of exclusion for assets that generate non-taxable income.

Whilst fixed ratio rules can be inflexible at times, they importantly do provide both taxpayers and tax authorities with a very clear and consistent framework.

**Arms length test**

The draft notes that the outcome of applying such a rule can be uncertain because each entity is considered individually. In addition it is noted that such an approach only applies to intergroup payments and may permit deductible interest to be supported by a non-taxable asset. However, it rightly acknowledges that these can easily be overcome by simply modifying such a rule to include third party payments, where there is a significant guarantee, pledge etc, from a related party, and to have some exclusion for non-taxable assets.

It suggests that such modifications would be “burdensome to apply and enforce”. However, in our opinion they would be far less burdensome, and uncertain, than the group-based test which it then goes on to propose.

Whilst the paper considers it a disadvantage that each entity is considered individually, it is simply a matter of fact that each entity/industry is different and is actually a better and more commercial approach to take into account those differences rather than setting arbitrary thresholds for all companies. For example, a commodity trading company which owns liquid assets that can be readily converted into cash, such as oil, can support more debt as banks would generally be willing to lend based on a high proportion of the (very liquid) commodity value. To arbitrarily limit interest based on a debt/equity or earnings ratio could prohibit certain industries locating in a country with such a test in favour of a country where an arm’s length amount of debt is deductible.

**Withholding tax**

The draft also asserts that withholding tax is not a suitable tool for tackling BEPS. It notes the disadvantages are that it is not effective if withholding tax is applied at a lower rate than the corporate tax rate, it is diminished by being reduced under treaties and EU rules and it is not applied by some countries.
All of the points noted are not flaws in the approach but are deliberate policy decisions by the countries involved. States are generally freely able to impose a withholding tax and to determine the rate of that compared to the headline corporate tax rate. The fact they may not impose withholding tax is in large part due to them trying to entice investment. In that case those same States which choose not to impose withholding tax, or at a lower rate, and who typically also have more relaxed interest deductibility rules for the same reason, would be unlikely to adopt any of the proposals in the discussion draft. In fact, the most likely countries to adopt these measures are ones who already have withholding tax and therefore results in companies in those countries paying withholding tax on interest and subsequently having that interest disallowed, giving rise to double taxation.

Additionally, the reduced rate of withholding tax under a tax treaty is also a policy decision which is based on the desire for investment and some consideration of the balance of withholding tax payments between the two countries. Further, the work on Action 6 (Treaty Abuse) has proposed several measures, again subject to a State choosing to adopt these, to prevent the abuse of tax treaties and which will in fact restrict the use of treaties even beyond cases of “abuse”. This further strengthens the role of withholding tax as a tool against BEPS through interest deductions.

We believe that withholding tax is a valid and effective tool against BEPS, rather than something that can be so easily dismissed.

**What should a rule apply to?**

**The definition of interest**

The paper suggests that any rule should apply to interest on all forms of debt as well as payments economically equivalent to interest and other expenses incurred in connection with the raising of financing. It is suggested this would include guarantees, arrangement fees, foreign exchange, interest components of lease payments, and imputed and deemed interest.

In our opinion this is far too broad. For example, taxpayers have no control over foreign exchange movements and these could result in either gains or losses which cannot be anticipated or estimated when setting the amount of debt. It is therefore unreasonable that unexpected foreign exchange losses may be disallowed, potentially permanently, whilst on the other hand foreign exchange gains on the exact same loan would likely remain fully taxable.

**Net interest/debt versus gross interest/debt**

We would agree that any measure for evaluating interest limitations should be considered on a net basis, whether that be net debt or net interest expense. Companies will naturally maintain a level of cash or similar short-term cash equivalents to manage its working capital and liquidity and should not be penalised for doing so by only considering gross interest in an interest limitation rule. Similarly, for a group treasury or finance company, it is unreasonable to limit gross interest expense whilst leaving the gross interest income subject to tax, likely resulting in double taxation.

This is an area that currently differs between countries, some still adopting a gross measure, and we would welcome best practice guidance which recommends that local interest limitation rules are implemented on a net measure.
Another aspect of this which should be considered is where interest is effectively recharged under a transfer pricing arrangement. For example, X and Y may operate under a global book with all the profit and interest being booked in X but with a profit split to reallocate 50% of the post-interest profit to company Y. Say X has 100 profit before interest and 30 of interest (which would ordinarily satisfy a 30% EBITDA test in country X), therefore paying 35 to Y. Typically the 35 payment by X is recorded as one composite expense and as an operating cost. Therefore, in X’s accounts it now shows 65 profit before interest and still the full 30 of interest expense. It therefore now faces an interest limitation despite the fact it never economically bore the full interest expense.

**Level of debt or interest expense**

We also agree that it is reasonable to consider interest limitation, in part, by reference to the interest expense, rather than a solely debt based test. However, we would note that it is important to consider both the level of debt and the interest rate as it is those combined which determine the interest expense. In particular, for related party loans, the interest rate is typically already subject to transfer pricing rules in addition to an interest limitation rule. This creates two layers of rules which are not necessarily aligned and can lead to inconsistencies.

For example, two companies, A and B, could be making the same investment which gives rise to the same level of profit. A may decide to leverage the investment highly but at a lower interest rate, say £180m at a 9:1 debt/equity ratio and with 5% interest, whereas B may decide on lower leverage but with a higher interest rate, say £100m at a 1:1 debt/equity but with 9% interest. Both companies have the same interest expense of £9m to which an interest limitation rule would apply, however, B is more likely to face a transfer pricing adjustment because of the higher percentage rate. The combined impact of transfer pricing and interest limitation is more likely to result in B having a lower amount of deductible interest than A, albeit the investment and profitability of the two is exactly the same.

We therefore believe it is necessary to consider how the best practice should interact with transfer pricing of interest and, if transfer pricing is still expected to apply to the interest rate, whether there should also be consideration of the level of debt. To avoid the inconsistency between rules, one alternative adopted by countries is to make both the level of debt and interest rate subject to an arm’s length test, although the paper discounts this option as discussed above.

**Should a small entity exception or threshold apply?**

Many countries include a threshold to apply their interest limitations and for very good reasons. Such rules can be complex and can involve unnecessary time and cost to tax payers if the company is small, the interest amount is low and there is a very low risk of BEPS. The aim of this work should be to target the real cases of BEPS, rather than putting an additional burden on every single taxpayer in order to catch a minority in the process.

We therefore believe that a threshold, similar to those already used in practice should be included in any recommendation for best practice. The need and level of the threshold is also dependent on the level of complexity and uncertainty created by the approach adopted.
Group-wide Test

We are extremely concerned with the proposal outlined for a group-wide test. It’s acknowledged this is not a method currently used by any country and is therefore a radical and very theoretical approach without any experience or understanding of how it would work in practice.

We cannot see how an approach which has never been used can be recommended as a best practice, let alone one which is incredibly complex, will result in significant time, cost and uncertainty to taxpayers, double taxation and distortion of commercial investment decisions. It also seems unlikely that many countries would choose to adopt such an approach in favour of the more practical approaches they already employ, making this as a “best practice” quite meaningless.

The proposal is extremely complex and will be incredibly costly and time-consuming to administer, principally for the tax payer but also for the tax authorities who would need to verify it. In the examples provided with only three companies and ignoring all other factors it may seem feasible. In practice even a medium size corporate group can have hundreds of companies, independent subgroups with a lack of transparency over group financials and complexities from differences in year ends, difference in functional currencies, different GAAP, consolidation adjustments etc. All of which will make it almost impossible to do such a calculation.

The approach is also going to create a significant uncertainty for large groups on how ratios may fluctuate year to year and will certainly lead to numerous and large cases of double taxation. It could deter investment in countries applying such an approach due to lack of certainty.

The draft is quite blasé in suggesting where inefficiencies arise groups can simply “align” debt and interest across the group. Whether the allocation is done on an earnings based method or even an asset based approach (which fluctuates with additions, disposal, investments, divestments, impairments etc.), a group will never be able to practically monitor and adjust debt level in each entity to achieve the precise result required under this method.

In addition, this approach results in different competitive distortions whereby highly leveraged investors (e.g. private equity funds) are benefitted in making the same investment from greater interest deductions over more prudent corporate’s and sovereign wealth funds which may have no/low debt on a group basis. It should never be the case that tax should be a discriminating factor in commercial investment decisions.

Fixed Ratio Test

In comparison we believe this is a more reasonable approach and is one already used by several States. It is relatively simple to use for both taxpayer and tax authorities, assures consistency and a degree of certainty. We would suggest that earnings based ratio (e.g. % of EBITDA) is more appropriate as this more closely aligns deductions with income and is also more akin to a commercial interest cover calculation. Conversely, an asset based ratio is relatively arbitrary and doesn’t reflect how the assets generate income.

In reference to determining the percentage ratio, we would note that the Top 100 companies have strong earnings and low debt which is resulting in the lower EBITDA ratios. However, the threshold should be set for a “typical” medium size group and not based on the Top 100 which we would
consider to be a-typical. We would therefore suggest that a ratio in the region of 30% of EBITDA as used in several countries is probably reasonable.

**Targeted rules and combinations**

Having multiple rules which need to be evaluated in conjunction significantly increases complexity, cost and uncertainty even further. The recommendation of a best practice should surely be to have one approach which is fit for purpose, as opposed to a belt and braces approach of layering multiple different rules. Whilst they may have been ignored here, States already have withholding tax and transfer pricing and therefore adding two or even three interest limitation rules in conjunction is simply giving States a third, fourth and even fifth bite of the cherry.

Similarly, targeted areas should be dealt with within the general rule as far of possible to avoid creating exceptions and additional layers. For example, the concern of assets generating non-taxable income can be dealt with by excluding non-taxable income from any EBITDA test and routing of funds through intermediaries is dealt with by both withholding tax and work on treaty abuse and under CFC rules.

**Treatment on non-deductible interest**

We believe that any approach must include a carry forward of excess interest to avoid cases of double taxation. Issues will normally arise either due to changes in market conditions which result in lower profits for a period or at the start of a new project when there may be initial losses. Typically the level of debt is determined at the start of a project or investment and therefore an adequate amount of time is needed to give to achieve the expectation and allow use of interest. In our opinion 5 years is too short and 10 years would be more reasonable.

These comments have been prepared by:

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5 February 2015

Dear Andrew,

**OECD public discussion draft - BEPS action 4: Interest deductions and other financial payments**

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled *BEPS action 4: Interest deductions and other financial payments*, issued 18 December 2014. Our summary of key points, general observations and detailed responses to the questions set out below.

**Executive summary**

- We consider that the arm's length principle is an important feature of transfer pricing rules around the world and should be considered further as part of the options presented in this discussion draft.

- There needs to be a clear definition of interest. The definition should exclude fees associated with the raising of finance. To the extent that amounts paid under derivative and hedging arrangements are included in the definition of interest, a spreading mechanism should be introduced for these costs (where not currently available), allowing their impact to be 'smoothed' over many years.

- Whilst there may be a potential for small investee companies to be over leveraged, we consider that it is more important to apply an exemption from these rules for small and medium sized businesses (including those invested in by private equity funds), in order to minimise the administration and compliance cost of these rules.

- The group wide tests face significant implementation challenges including; the need to apply a consistent Generally accepted accounting principles (GAAP) across a group; foreign currency translation and exchange control issues; the need for every group company to collect detailed financial information on every other group company; the presumption that every group company faces the same credit risk and country risk profile; and the issue that the interest deduction in one country is determined in large part by the earnings or assets profile of all other group companies even if their businesses are very different in their nature.

- We have a preference for applying the arm's length principle. In the absence of the arm's length principle, we prefer fixed ratios but these have to be set at reasonable levels so as not to disadvantage certain industries or sectors. Sectors such as infrastructure, real estate and private equity businesses are likely to be significantly impacted by these proposals. We suggest that one set of ratios is applied to businesses with security (over either income or assets) and another set of ratios for other businesses.

- These proposals appear to encourage businesses to seek bank borrowing even if it is more expensive that borrowing from within the group, in order to seek tax relief.
General observations
We disagree with observation that the use of (related party) interest 'is perhaps one of the most simple of the profit-shifting techniques available in respect of international tax planning'. Tax authorities should not automatically assume that associated enterprises have sought to manipulate their profits. For example, debt financing (related party and third party) is used by our clients because debt:

- is a more flexible form of financing compared with equity. For example, debt can be drawn down in tranches at the point that it is needed (which is harder to do with equity)
- it is also typically easier (and quicker) to return loan principals to lenders than it is to return equity to shareholders, which in turn increases the liquidity in a market
- a range of debt instruments and equity investments allow investors to diversify their portfolio risk.

Furthermore, we strongly disagree that consideration of arm's length tests should not form part of the consultation process. Paragraph 1.8 of the OECD 2010 Transfer Pricing Guidelines, notes that there are several reasons why the arm's length principle was adopted including for example, it 'puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity …(and) the arm's length principle promotes the growth of international trade and investment'. The arm's length principle offers important benefits and should not be set aside easily.

Responses to specific questions

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts with respect to Islamic finance? If so, what are these difficulties and how do they arise?

The key challenges arising from the definition of interest set out in the discussion draft are: it is too widely drawn, it has potential to be misinterpreted and it could have 'knock-on' effects on other taxes. For example:

- there needs to be a clear definition of interest and amounts equivalent to interest. Absent a clear definition (for example making clear whether amounts under Islamic finance should be treated in the same way as interest), there remains a risk that tax authorities apply different interpretations of what is interest or taxpayers seek to characterise payments as something other than 'interest'
- in the UK, the imputed interest on a zero coupon bond is considered to be a discount on the price of the bond, which is not subject to withholding tax. By effectively 're-characterising' its treatment from discount to interest may suggest that its withholding tax treatment should change too
- the amounts paid under derivative instrument and hedging arrangements as well as foreign exchange gains and losses can be material for a business and very unpredictable in their timing. We have seen recent cases where it was commercially beneficial for a business to pay £50m of interest rate swap break costs in order to secure a long term, lower cost of debt to finance their infrastructure project. The inclusion of such one-off costs in the application of the ratios proposed in the discussion draft would have a highly distorting impact on the tax deductibility of interest, which otherwise may have been treated as allowable in any other year. A spreading mechanism should be introduced for these costs (in those countries where it is not currently available), allowing their impact to be 'smoothed' over many years
- arrangement fees and similar costs (which typically include commitment fees, drawdown fees and legal costs) would not appear to be in the nature of interest as they do not represent the time value of money. These are typically levied by lenders to cover the costs of the loan acceptance process and the on-going costs of loan administration. If such activities had been outsourced to a third party service provider it is highly likely that the costs would have been treated as tax deductible. It therefore appears unfair to include such costs in the definition of interest.

1 Para 1.2 OECD TP Guidelines
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?

There are a number of situations where 'interest expenses' could arise that are not envisaged under the current broad definitions proposed. We do not consider them as interest costs and suggest that they are excluded from the proposed definition. Examples include:

- forward contracts (for example, commodity or foreign exchange) contain an element of compensation for the time value of money. These amounts are not necessarily included as 'interest' in the profit and loss (P&L) depending on the GAAP or hedge accounting approach adopted by the company
- businesses that accept delayed payment for goods ('buy now pay later'), where an element of the purchase price could be 'interest' but the 'interest expense' is accounted for as the cost of the purchase, potentially in cost of goods sold in the P&L.

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, give a description of these scenarios along with examples of how they might arise.

We disagree with the inclusion of scenario 4, which does not appear to pose any base erosion risk and would only add to the compliance burden on all companies unnecessarily.

It is not clear how the 'connection' rules could apply to joint venture arrangements, particularly if the shareholder does not have 25% or in situations where one or more investment funds may have made a private equity investment in a company but where they have a less than 25% interest.

In the UK, many companies invested in by private equity houses would be considered small or medium sized businesses (SMEs) were it not for the UK 'acting together rules'. These rules broadly deem a connection between the investee company and the private equity shareholder, for the purposes of the UK thin capitalisation rules. This has meant a significant compliance burden for typically small businesses that have limited experience of such rules. In our experience, there is a high demand by these types of business to apply for an advance thin capitalisation agreement from local authority so they can have a level of certainty as to their deductions.

In line with our comments below (see question 6), we consider that these types of businesses should be excluded from the proposed measures.

4. Where do you see issues in applying a 25% per cent control test to determine whether entities are related?

A shareholding of 25% neither gives a shareholder control (over 50% normally represents control) nor does it necessarily convey any influence over the investee company. For example an investor with 25% shareholding has very limited power over a company where there is one other 75% shareholder. Conversely, a 25% shareholder may have significant influence over a business where all the other shareholders have a 5% shareholding.

5. What are the problems that may arise if a rule applies to net interest expense? Are there situations in which gross interest expense or the level of debt would be more appropriate?

Whilst it is possible to imagine extreme examples of businesses attempting to generate interest income (a manufacturer converting all its sales to leases in order to generate interest income), we consider this very unlikely. We therefore agree that net interest expense is a reasonable approach.
6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

The simplest and most consistent approach is to apply rules similar to the European Union (EU) Commission Recommendation (2003/361/EC) on the qualification for SME status and not to apply the proposed thin capitalisation rules to such entities. We consider that it is important to minimise the amount of compliance effort and cost for SMEs (as well as tax authorities) even if that comes at the risk that some of them are highly leveraged.

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?

The group wide tests pose a number of practical challenges, some of which we have considered below:

- To be allowed a deduction for all a group's third party interest payments, the rules need to be adopted by all tax authorities of countries in which the group operates. Otherwise a restriction could be made in Country A (which applies the proposed group wide tests) but in Country B (which would have been entitled to the balancing amount of third party interest) no deduction is allowed because of the application of local rules on interest deductibility. Given that the proposed rules are not binding on all tax authorities, there is a low probability of all countries adopting the proposals consistently.

- Different countries apply different GAAP and consequently the calculation of third party interest and the economic base upon which it is proposed to apportioned may be the subject of controversy between countries. Inconsistent allocations between different groups of companies could arise because (a) local GAAP allows a different accounting treatment compared with say, International Financial Reporting Standards (IFRS) accounting rules or (b) where there is some choice as to how to account for a cost or income, for example, whether certain costs should be capitalised on the balance sheet or written off to the P&L or the choice a group has over its depreciation policy. There would need to be a widespread requirement to say, apply IFRS if there is to be a consistent application of these rules. Furthermore, the impact of local exchange controls, regulatory requirements and the presence of minority interests all add complexity to these calculations.

- A group wide allocation of interest assumes that all entities have the same credit rating. In the cases of mixed conglomerate groups this is unlikely to be the case, yet a company in a territory subject to a high level of country specific risk and a low credit rating could be entitled to the same amount of interest deduction as another company in a safer country and better risk rating, if they both earned the same level of profits (which can be affected differentially by local inflation rates).

- The group wide rules also ignore the fact that different countries have different borrowing conditions and interest rates and therefore, the absolute amount of interest paid in one country may be very different from a broadly comparable company in another country. In effect there is a risk that one part of the business interest deductions become 'contaminated' by the income or asset values of other group companies. For instance it appears that a company in a joint venture may see its after tax returns impacted because of a movement in the value of an asset elsewhere in the JV partner's group, over which it has no control.

- The global allocation of interest would only become clear once the group's earnings or asset profile has become known. Particularly in seasonal businesses this may not be clear until the year end, which places significant uncertainty in calculating for example quarterly instalment payments of tax. Many group companies will find it difficult to get timely information on the whole group's third party debt and earnings/asset values – and then to be able to allocate and enforce these among all of the relevant group companies is administratively burdensome. Furthermore, if the auditors require changes after the year end or where group companies have different accounting period end dates, there could be a subsequent impact on the local interest deductions and additional complexity in its calculation. This approach also requires in-country consolidation of data (even if no local audited consolidated accounts are prepared).
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?

The use of a group's consolidated, audited financial statements would appear to be a good starting point for this analysis, although this assumes that all groups prepare such statements in a form and language that other countries' tax authorities could review.

The key challenge as referred to above is the need for all companies to prepare accounts on a consistent basis and where the treatment of debts such as say convertible instruments are treated consistently across different group's accounting policies.

There would need to be agreement as to how foreign currency translations are made to convert local accounts into a single currency (see comments on question 15).

10. In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

The group wide tests could incentivise companies to adopt financial policies designed to manipulate the level of net third party expense. Naturally, this outcome is achieved through either maximising third party interest expense or reducing third party interest income in cases where such income exists.

For non-financial companies investing excess cash reserves in short-term liquid securities, an optimal level of interest deductibility may be realised by redirecting such reserves into other non-interest bearing liquid investment products with limited downside risks. There would be a natural incentive for such tax payers to redirect cash reserves into such investment vehicles (should they exist) and for investment advisors to tailor investments that do not produce income classified as interest income under the local accounting specifications.

Similarly, higher third party expense could be generated by reclassifying any preferred shares into subordinated debt investments with conversion options. Alternatively, common shareholders could invest in some type of pass-through investment vehicles set up by third party banks to transform equity capital into interest bearing debt capital via an arm’s length financier, with the result that the consolidated group is able to support higher levels of overall leverage than what have been attainable under normal market conditions.

11. What approach to measuring earnings or asset value would give the most accurate picture of economic activity across the group? Do any particular difficulties arise from this approach and how be they be addressed?

The key issue with using earnings as a measure of economic activity is that they may be volatile, which could lead to very different allocations of interest expense in a short run of years. For example, economically nothing in a business could have fundamentally changed but the earnings of that business may have fallen because say, there was an asset write-down, yet the interest deduction could be significantly reduced.

Furthermore, volatility in the earnings of the wider group can also impact the interest deduction in a particular country. For example, if one group company has an unusually strong year, all the other companies may face a reduced interest deduction.

Earnings volatility can be a particular issue at certain points in a business' lifecycle (for example in the start-up phase or when launching a new strategy – no relief on interest is like a tax on loss making companies) or for particular industries (for example in the real estate sector where properties can be fully let, being developed or empty).

Some companies may not have earnings for a long period of time during which they are investing and growing the market. For example, Research and Development (R&D) research companies may be heavily investing in a new technology yet the fruits of that labour will not come through until many years later.
To the extent that earnings are used as an apportionment measure, we suggest that earnings before interest, taxes, depreciation, and amortisation (EBITDA) is applied (rather than EBIT) so to avoid distortions generated through companies adopting different depreciation and amortisation policies. We note however, this would benefit capital intensive businesses.

12. **Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? if so, what are they and how could these difficulties be deal with?**

The primary issue with using earning-based approaches is the level of volatility that would be experienced in the allocation of the deductible interest allowance. Furthermore, even using a broad-based earning measure such as the EBITDA is not always highly correlated to the degree of economic activity. Using an earning-based approach could also create a lot of uncertainty for estimating quarterly interest expenses. The earning results for all specific entities within the consolidated group would need to be known before the level of deductible interest can be established.

While using an asset value based approach could reduce the year on year volatility of the interest deductibility compared with an earnings-based approach, such an approach can lead to other inconsistencies, such as potentially creating a prolonged disconnect between an entity’s level of economic activity and allowable interest deductibility based on group-wide asset-based rules. This could occur when new entities enter into the consolidated group structure via acquisitions, necessitating the revision of their asset values to the FMVs. At the same time, incumbent operating entities that may have experienced strong organic growth but continue to operate with an under-valued asset base, would be restricted in their level of interest deductibility, perhaps limiting their potential for obtaining capital funds (even if their level of economic activity may justify it).

13. **What categories of exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?**

In countries with a dividend exemption, dividends could be excluded from the definition of earnings.

14. **Do any particular difficulties arise from asking groups to identify entities with positive and negative balances? What other earnings approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?**

The position of loss making companies is a particular issue because even if relief is given in the future (through a carry forward mechanism), the time value of money erodes the value of that deduction. There are a number of ways that this could be mitigated including:

- allowing companies to use an average EBITDA over a number of years to minimise the peaks and troughs of the business cycle
- permitting companies to exclude one-off type costs prior to calculating its EBITDA to identify the ‘core’ profitability of the business.
- applying a measure based on a company’s average cash balance throughout the year.

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?**

We suggest the business choose the appropriate exchange rate to apply but is required to apply a consistent measure across financial years, for the purposes of calculating interest deductions.

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?**

It is common to see consolidated groups with holdings in entities operating in widely different industry sectors, with disparate capital requirements (both in frequency and overall leverage).
Typically we observe that industries that tend to have a high earning to operational asset ratios, such as manufacturing businesses, are able to obtain a higher level of leverage than borrowers engaged in the business services industry and with no significant levels of tangible assets. Hence it is commonplace to see companies with similar levels of EBITDA but with significantly different levels of leverage. These differences may arise due to the following considerations:

- industries with high operational asset base have a greater capacity for borrowing at lower interest rates due to their perceived credit strength to the lenders
- asset-intensive businesses generally require a higher level of leverage, in the form of working capital facilities, due to the asset maintenance requirements.

It is important to note that the first explanation is related to the ability to raise debt, while the second is related to capital structure decision making. In this context, it would make more sense to use asset-based ratios instead of earning-based ratios in order to better align the internal capital structures with what would be seen in an arm’s length circumstance.

However, given that the consolidated group is involved in both asset-intensive and service-oriented businesses, the overall leverage offered by arm’s length lenders would be influenced by a consideration of the diverse nature of the businesses for the combined group. Typically from a credit-risk perspective, lenders are more amenable to borrowers with diversified operations. Hence, the consolidated group may be able to obtain greater leverage than the total absolute leverage that could have been obtained by its subsidiaries acting independently.

This would result in the subsidiary engaged in the services industry to be able to obtain a higher level of interest deductibility (even if it is allocated based on assets) than what it would have been able to obtain acting independently.

Even though this would not, in of itself, create a transfer pricing risk if all jurisdictions in which the consolidated group operates unanimously espouse the group-wide rules. However, in instances, where certain jurisdictions do not adhere to this principle, a challenge could be posed by the taxing authority invoking the arm’s length principle and denying interest deductions for entities which would not otherwise be able to obtain such high leverage (such as services companies).

17. What barriers exist which could prevent a group from arranging its intra-group loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

The potential to carry-forward surplus interest capacity is welcome although clarity is needed as to how it could be applied. For example, could a business use the current year's capacity plus any carry forward capacity in any one year; would the interest capacity expire? However, the value of tax relief in the future is typically less than it is now (through the impact of the time value of money). Therefore, if businesses are to be entitled to a deduction for their third party interest in a financial period and to avoid surplus interest capacity in some countries and carry-forward capacity in others, they will need to 'match' their asset base/earnings or debt profile to their actual third party interest paid in each territory.

This may lead to a significant exercise undertaken prior to the year end in order to reallocate actual debt around the group in order to minimise the risk of the need to carry-forward interest deductions. Such pre-year end reorganisations of debt may encourage the use of group treasury or cost-pooling arrangements to channel third party financing across the group. It may also make it very difficult for businesses to estimate quarterly instalment payments of tax (where such regimes exist) in a country, with any certainty. The flexibility over these debt reorganisations may be limited by commercial concerns such as bank covenants.

Some of side effects of this need to reorganise debt could include:

- currently decentralised groups needing to become increasingly centralised with large tax teams probably at head office locations with reductions in non-head office personnel
- a preference to borrow funds from banks that can lend across border and are happy for funds to be channelled as needed to territories outside the location of the lending bank
- an increased need for cross group financial guarantees.

Furthermore, to the extent that dividend income is excluded from any measure of earnings for the purposes of these proposals, there may be a move to reorganise loans such that they are not routed through or into holding companies (although this will be determined by wider commercial decisions).

19. **If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?**

Groups could be given a choice whether to apply an asset or earnings approach in any one particular year (so long as the whole group adopted the same measure) with no requirement to use the same measure each year. However, we note that this could add complexity and additional costs of compliance.

21. **Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches.**

So long as there was no restriction on how capacity could be carried forward indefinitely, it should go some way to relieving timing mismatches. In the event that there is a five year time limit (as suggested in the discussion draft) on the use of that capacity, it should be allowed on a FIFO basis. Alternative methods would be to allow a group to share its unused capacity around the worldwide group to allow it relief for all its third party net interest.

24. **What practical issues arise in applying fixed ratio rules based on asset values or earnings?**

The fixed ratio is conceptually simple to implement. However, applying one ratio (either asset or profits based) regardless of industry or size of business risks benefitting some entities whilst disadvantaging others. We have considered some of the implications of the fixed ratio approach to interest deductions below.

Interest rates vary between different countries depending on the currency and the underlying macroeconomic factors that impact on the country. Interest rates may also vary between different companies even if they are in the same industry and operating in the same territory, because they may have different credit ratings. Consequently, the actual amount of third party interest charged to each company could vary widely. A single ratio (either based on assets or earnings) could lead to a different level of restriction on companies in the same industry or say, in neighbouring territories. Where a business can relocate easily and the cost of doing so is low, the availability of an interest deduction may distort the decision as to where to set up or relocate. Such a distortion could be avoided if all countries adopted the same fixed ratios in the same way. This would appear to be highly unlikely.

Setting fixed ratios on the basis of statistics of the Global top 100 companies by market capitalisation, is at best distorting. Such companies often have higher levels of free cash available by virtue of a ready market for their equity (compared with smaller public and private companies), which allows such large companies the luxury of not needing to borrow to invest. Smaller groups are facing the prospect of a continuing restrictive lending market (or borrowing on unacceptable terms) accompanied by the cost of their existing debt (which may be all third party finance) becoming more expensive in the event that a tax deduction is not available. This may have a negative impact on the ability of these groups to grow and expand and to compete with larger rivals, in the future.

The 30% of EBITDA ratio referred to paragraphs 158 and 159 would appear to be low for many private and smaller public companies. Seeking to make the fixed ratios at this level or below is likely to make debt considerably more expensive for such groups.
Although less likely, given the comments above regarding gearing levels typically seen in groups outside the global top 100, fixed ratios can become the new 'cap' on interest deductions, whereby businesses could gear up more than they do at the moment in order to take advantage of additional interest deductions available to them. This could have a market distorting impact (because businesses seek third party debt funding to a level, which in the past, they may have used equity).

25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?

As mentioned above, different businesses would need different ratios in order to limit the possibility of BEPS. Only the arm’s length model allows for such flexibility whilst requiring that non arm’s length deductions are denied.

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 the worldwide group?

See comments below in respect of specific sectors.

27. Would a fixed ratio rule pose particular problems for entities in certain sector? If so, which sector would be affected and how could this be addressed?

Sectors that will be particularly impacted by the fixed ratio proposals include:

- Infrastructure
- Property and real estate
- Private equity backed businesses
- Financial services (see question 34 below)
- Companies in the service sector

We have addressed the factors impacting on these sectors below:

Companies that invest in infrastructure assets typically engage in very long term contracts (often 25 to 30 years in length). The decision to enter into such a contract is based on a detailed analysis of all the costs. Tax deductions for interest are also a key part of the financial modelling that is used to decide whether to go ahead with the project or not. The longevity of the projects mean a number of large infrastructure projects may become more expensive than previously was understood to the case (because the tax relief may not be available). This may cause financial stress in this sector and / or may deter new infrastructure investments.

Furthermore, infrastructure and to a lesser extent, property and real estate businesses often have the benefit of security to support their borrowing (for example unitary charge income in the case of infrastructure projects and the value of the property in the case of real estate). The security allows these sectors to have much higher levels of gearing compared with many other industries. A fixed ratio rule, applying to all industries could have a serious impact on these two industries, unless the ratios are set at such a level that high levels of gearing could be allowable. It could be possible to have one type of fixed ratios for businesses with secure income streams or assets with other ratios for those businesses with less certain income or asset values.

Many smaller businesses have benefitted from the management skills and investment funds brought to them through investment from the private equity industry. Traditionally, private equity investments have been through a leveraged structure. The potential for the disallowance of interest costs may have an adverse impact on the level of funds available to invest in smaller companies as well as pushing up prices of better quality assets, with many more businesses being unable to fund their growth and expansion plans. Furthermore, private equity has become an important industry in its own right to many countries and the possibility that such businesses leave their home territory (because they are often run by highly mobile and globally connected individuals) should be carefully reviewed.
Companies in the service sector also appear to be adversely affected if the chosen ratio is assets based, as these companies typically have do not have assets that are recorded on the balance sheet (eg self-created intellectual property qualified and skilled workforce in place etc).

In general, we consider that it is better to apply targeted anti-avoidance rules to particular scenarios arising in these industries rather than creating rules that could potentially damage these important business sectors.

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital without having an undue impact on the group's regulatory position (for example, by limiting a group’s net interest deduction on regulatory capital to the level of its interest expense on instruments issued to third parties)?

We welcome the recognition that banks and insurance companies are unique and that restrictions of interest expense deductions would not be consistent with the business model. Any material disallowance could easily result in taxation which inflates the effective tax rate on commercial profits of such businesses, possibly to over 100%, which would clearly create an absurd result.

The recognition of the importance of prudential regulatory supervision in these sectors is also welcome. This presents a natural limit to the amount of permitted leverage for such businesses. We would note that prudential regulation normally applies both at an individual regulated entity level and at an overall group level. The ability within a financial services group to provide intra-group debt funding is also significantly constrained by regulatory considerations.

We are however, concerned at the statement in the discussion draft that “the proposal is therefore to design a specific rule which would have a similar effect for banks and insurance companies but that focuses on the particular base erosion and profit shifting risks that they present”. The discussion draft does not give any detail as to what these “particular base erosion and profit shifting risks” posed by these sectors are. We consider that these sectors should not be seen as presenting any such risks due to the strict regulatory environment in which they operate.

In particular it is unclear why regulatory capital instruments have been identified as a particular point of concern. Regulatory capital instruments range from Common Equity Tier 1 (eg ordinary share capital) through Additional Tier 1 (which may be equity or debt in legal form) to Tier 2 and other potentially loss-absorbing capital instruments (subordinated debt). Apart from the question of potential hybrid mismatches within a group, which is dealt with under Action 2, we see no reason why the tax treatment of such instruments should differ from their natural tax treatment merely because they serve a regulatory function.

We trust that this letter contains useful commentary. If you would like to discuss any of these points in more detail then please contact Elizabeth Hughes, Director, Grant Thornton UK LLP at elizabeth.hughes@uk.gt.com.

Yours sincerely

Global head - tax services
francesca.lagerberg@gti.gt.com
Submission on the OECD discussion draft on ‘BEPS action 4: Interest Deductions and other financial payments’

6 February 2015
Ms Marlies de Ruiter  
Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris Cedex 16  
France

By e-mail to: taxtreaties@oecd.org

6 February 2015

Ref: OECD public discussion draft on follow up work on BEPS action 4: Interest Deductions and other financial payments

Dear Ms de Ruiter,

I am pleased to communicate the views of Ibec and its members on the public discussion draft published by the OECD on ‘BEPS action 4: Interest Deductions and other financial payments’. Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations work with government and policy makers at national and international level to shape business conditions and drive economic growth. Ibec is also a member of BIAC and Business Europe and broadly supports the views communicated by these partners in their submissions on the OECD discussion draft.

**General comments**

Ibec supports the commitment within the draft to develop tax rules based on best practices as part of the BEPS practice. The development of such best practice rules within the BEPS process should as a first point be cognisant of the need to encourage investment by companies, minimise the administrative burden and costs for both companies and authorities whilst also providing the clarity and certainty needed to minimise market distortions.

Ibec believes that it is regrettable that discussion draft four begins from the assumption, that intragroup interest is chiefly related to base erosion and profit shifting. This does not clearly reflect the fact that interest and other costs, such as derivatives, are legitimate business costs in the same manner as interest payments to third parties. The vast majority of such transactions are not related to tax avoidance and as such restrictions should be limited to abusive situations without a good commercial rational.

The final rules developed from discussion draft 4 should acknowledge that the choice between debt and equity is a legitimate decision best made by the commercial entity. In many cases intra-company loans can be preferable to equity. Loans are more flexible than equity, generally carry a lower cost of capital and less administrative costs for financing. Efforts to remove distortions between the fiscal treatment of debt and equity should focus on improving the fiscal treatment of equity rather than impairing the fiscal treatment of interest costs.
Changes to rules coming from the BEPS process should not prove an impediment to efficient and flexible corporate financing and investment. It is crucial a balance is struck between the aims of the BEPS process and the need to not undermine or impair economic and business development.

Specific comments

Discussion draft 4 gives a number of options for the general limitation rule which are alternatives between (i) global group-wide tests, (ii) fixed ratio entity-by-entity tests and (iii) tests that combine (i) and (ii). Below we outline some brief comments on those suggestions from the point of view of Irish business.

Group wide rules and fixed ratio tests

Ibec’s believes that group wide tests should be discounted as an option under the process for a number of reasons. In the first instance group-wide tests would significantly add to the cost and complexity of administration for both firms and authorities thus failing on both the test of cost effectiveness and simplicity. Additionally, group-wide tests would see a move away from the principle of arm’s length behaviour and toward formulary allocation and apportionment of interest expense.

There is a fundamental assumption within the draft that adjusting the mix of debt and equity in a group company is a straightforward and costless process. In a minority of situations this might be so, but in many typical group scenarios it is simply not the case. For example, the funding mix between debt and equity financing will often be dictated by external structural issues for example minority interests, existing creditors and foreign exchange. This presents a key difficulty for groups to rearrange their internal financing in a manner required by a form of group-wide test.

There are also structural issues with the prospect of a group wide test. In some countries funding by related party debt can only be introduced for certain activities such as operational investment. Under a group-wide allocation, in order to claim a tax deduction for external financing costs, groups would be required to introduce intra-group debt into many countries where there is no commercial requirement for additional finance. In this situation, it would be necessary for the borrowing company to repatriate the money borrowed back to the lender by way of a series of dividends or reductions of share capital. Such transactions typically require various conditions to be satisfied (distributable reserves, solvency tests, impairment testing, third party creditor protection, court processes etc) at each level to repatriate the money. In a group operating in many countries with hundreds of companies and many tiers of ownership this would be a huge and time consuming task assuming it is legally possible at all.

Even if this process could be overcome without significant transaction costs, it would also be very difficult to introduce the correct level of debt into each country as it would be necessary to predict the relative level of company profits in each country and the group external finance costs. This is an exceedingly difficult task due to the inherent difficulty in forecasting accurately as well as the fact that many groups do not currently forecast results on a country basis but at a regional, divisional or brand level.

Any minority ownership would create leakage in circulating the cash as there would need to be a return to all shareholders. This leakage would often outweigh the benefit of introducing new intra-group debt and make the process unviable, as would any dividend withholding tax on extracting the cash.
Additionally the fact that certain countries have volatile currencies and do not have qualifying tax reliefs mean that groups operating in developing countries in particular would be affected. This would increase the cost of capital in those countries thus making investment less attractive.

Ibec’s position is that a fixed ratio test would be preferable provided that the test is well designed and has some level of flexibility. The mechanistic nature of the fixed ratio test while advantageous in its simplicity and clarity for taxpayers and authorities can also cause unintended distortive results. Adopting something close to ‘combined approach 2’ along with the introduction of complementary targeted rules (allowing the indefinite carry forward of non-deductible interest for example) to help smooth business cycles would in this case be the preferred option presented in draft 4.

That combined approach two would include two references and measures of economic activity which would allow sufficient variation to account for the variation in groups and sectors of the economy. Where assets are used as a measure under this variation, issues around value (for example the valuation of intangibles) should be addressed by defining measures appropriately.

Finally, groups and industries have extreme variety in debt profiles and margins. As a result further studies should be undertaken to find out how this can be reflected in the rates attached to the fixed ratio regime.

**Conclusion**

Ibec supports the commitment within the draft to develop tax rules based on best practices as part of the BEPS practice. The development of such best practice rules within the BEPS process should as a first point be cognisant of the need to encourage investment by companies, minimise the administrative burden and costs for both companies and authorities whilst also providing the clarity and certainty needed to minimise market distortions.

We are concerned, however, that the draft does not clearly reflect the fact that interest and other costs are legitimate business costs in the same manner as interest payments to third parties. Of the options outlined Ibec believes the best option would be fixed ratio rules outlined in combined approach 2 with some complimentary targeted rules to ensure the mechanistic nature of fixed ratios is not distortive. Group-Wide rules on the other hand should be avoided as unwieldy, complicated and potentially damaging for investment.

Yours sincerely,

_______________________
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6 February 2015

Achim Pross
Head, International Co-operation and Tax Administration Division
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

RE: Interest Deductions and Other Financial Payments

Dear Achim:

ICI Global,¹ on behalf of our collective investment vehicle (CIV)² industry members, appreciates the OECD’s recognition, in the BEPS Action 4 discussion draft on interest deductions and other financial payments, of the CIV industry’s unique structure. Specifically, we support the proposition in paragraph 38, Scenario 2, that CIVs under the control of the same investment manager should not be treated as “connected parties” for purposes of these proposals if there is no other connection between the CIVs.

CIVs that are managed by the same investment manager, as we have discussed previously,³ have different portfolio managers with separate fiduciary duties and investment objectives. The investment manager typically has an insubstantial, if any, equity interest in the funds it manages. Requiring funds to assess the holdings of other funds in the same fund complex before entering into financial transactions would impose substantial burdens but few, if any, benefits. Therefore, the final interest disallowance recommendations should not apply any

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.1 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² A CIV is defined for this purpose consistently with the OECD’s Report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (the “CIV Report”). Specifically, paragraph 4, page 3 of the CIV Report defines CIVs as “funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.”

connected party rules to CIVs with a common investment management company unless the CIVs affirmatively take coordinated action.

* * *

Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) if you would like to discuss this issue further, or if we can provide you with any additional information. My colleagues Karen Gibian (at kgibian@ici.org or 001-202-371-5432) or Ryan Lovin (at ryan.lovin@ici.org or 001-202-326-5826) also may be called upon for assistance.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

cc: interestdeductions@oecd.org
Kate Ramm
Mexico City, February 6, 2015

Via e-mail
interestdeductions@oecd.org

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

Dear Mr. Pross,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below the comments to the Public Discussion Draft on BEPS Action 4 – “Interest Deductions and Other Financial Payments” (the “Draft”).

Overview

The discussion draft focuses on the OECD’s intention to develop a best practice for addressing base erosion and profit shifting via deductions of interest expense.

The draft is an extensive discussion of options for limiting interest deduction through a group-wide rule, a fixed ratio rule or a combination of the two approaches.

Comments

Group-wide rules for limiting interest deductions

This rule is founded on two basic premises: a) group’s total interest deductions should be limited to its actual net third party interest expense and b) the interest expense within a group should be matched to economic activity.

The draft concludes that the rules in question do have the potential to address BEPS.
Group-wide interest allocation rule and group ratio rules

The starting point for this rule is an allocation of the third party net interest expense among the companies of a group. The allocation will be measured based on the economic activity, such as earnings or asset values.

We believe that, while it is true that this rule offers an improvement in addressing BEPS risk, it is also true that in practice a group may be made up of several companies that are involved in various different economic activities and so this measurement may end up being less precise than intended. To analyze this in more detail, we must start with how we should understand the term “group”. Based on the above we may believe that a group could have a so-called “super holding company” at the top, with two sub-holding companies through which different types of activities are carried out. In this light, it is important to be clear on what a group should be understood as and how the rules would apply.

Although the report mentions that the proposed alternatives may be applied in a group that is required to prepare consolidated financial statements, the draft recognizes that the consolidated financial statements may also be a starting point for measuring net interest paid to third parties. For some groups this may be very simple if they are public companies, since there would be a universal language in this regard (IFRS). However, for other groups this measure could be complex and expensive in terms of performing a financial statement conversion if standard language is required, not to mention the concepts of materiality, unconsolidated joint ventures and other types of arrangements such as trusts or partnerships, which the draft does not address accordingly.

A potential solution is to first determine the nature (industry to which each of the entities belongs) and then, based on the industry in question and provided there is interest paid to a third party or a related party, apply targeted rules. In view of the above, for example, for investment projects that require significant leveraging, specific measures may be established to allow for the deduction. For example, this may apply to infrastructure projects such as Oil & Gas and Power, residential developments, etc.

It is important to also consider that not all companies of a group have the same capacity. Although the document under analysis recognizes this point, it is important that a specific rule be established addressing the possibility that such company may be excluded from this limitation.

Special emphasis must be placed on companies in the pre-operating period and on companies whose primary assets are liquid assets. We believe that the issue of liquid assets has no bearing on limiting BEPS when the entity in question is a
treasury company whose principal activity is providing funding for related parties. The rule on net interest paid to third parties must therefore be reviewed considering the effects of intra-group financing structure (even though the draft states that the cash pooling structure will not be affected by the new rules, it is important to clarify how treasury entities will be affected). This would seem to be the case in the group-wide interest allocation rules and not in the group ratio rules; more clarity is needed in this regard. In this case, the proposed rules could work with the addition of specific targeted rules. The draft proposes establishing carry-forward rules for disallowed interest under interest limitation rules. It suggests that deduction periods (interest carry-forward) be established in all cases, while considering the deduction of intra-group interest where applicable.

It is also important to have a clear definition of “earnings”. In order to apply a universal language, we may be tempted to turn to standard principles such as IFRS, however, we do not consider taxable earnings to be the best definition of earnings, given the effects of reconciling items, among other aspects that may distort the amount of reported interest. The draft mentions that EBITDA could also be used as a basis for earnings; however, would that mean EBITDA under local GAAPs? US GAAPs? IFRS? According to the draft some countries are already doing it this way and so we recommend reviewing how successful this method has been in those jurisdictions. We would recommend that both earnings and asset values be determined based on book values, considering an entity’s obligation to prepare financial statements.

There also needs to be a definition of assets and specifics on how to consider assets in the calculation. This is relevant because certain assets are eliminated in consolidated financial statements; however, for purposes of taking on debt from third parties, it is often the individual financial statements that are used to measure the debt capacity of the entity asking for the loan and so the elimination of assets through consolidation is not necessarily the best option. Again, there must be a universal language in this regard. As mentioned above, the high liquidity of a group does not always mean that it has a higher probability of having deductible interest.

We also believe that the group ratio rules need to be clearer on how the proportion is to be determined. While group ratio rules are based on either net interest to earnings or net interest to asset values to the equivalent financial ratio of the entity’s worldwide group, the actual ratio (or proportion) does not consider specific factors related to all possible industries represented in the group. This means that each country will have to determine the amounts that they will use to calculate the ratio, and will need to do so considering the external factors for each industry and/or the nature of each company in question. Accordingly, although this determination may offer flexibility, as the report discusses, it may also become an
overwhelming task for companies, particularly for those in the process of taking their business international. In fact, the suggested rules are quite focused on fully mature companies with the financial wherewithal to adopt these types of rules; however, in our opinion, the rules fail to address other types of groups (just once does the draft mention the potential need to evaluate the capacity of small enterprises). We believe that safe-harbor rules should be established to provide more legal certainty in this regard. Also, it is not clear how the position of a company subject to this test should be measured when, for example, the ratio is primarily influenced by activities that differ from those of the company being tested. The fact that the rule is based on assets and that the assets in question are subject to valuations is a matter of some concern. This issue could give rise to discussions down the road and even more importantly, it could cause differences, since the methods and comparables used may not necessarily be the same as those determined by the tax authority.

The draft concludes that there should be a certain degree of coordination between countries; however, we believe that this would be very difficult to achieve in practice. In fact, both rule options should be considered viable alternatives for countries. A specific targeted rules approach could be a possible solution where a specific country does not adopt either the group-wide or ratio rules.

With regard to the question of whether to consider a net or gross interest position, we believe that a net position is the best option and that this determination should consider factors not only related to payments to third parties, but also the fact that the debt may be intra-group but with the basis for substantiating that the loan would have been obtained between independent parties in a similar fashion (not only in terms of the market value, but also based on the terms and conditions of the loan). Again, targeted rules could be of great help in this area.

The scope and definition of interest could create very deep distortions and so the concept of “interest and payments economically equivalent to interest” needs to be defined. In practice, this uncertainty has led to double taxation.

As regards to group-wide rules, something mentioned in the Draft (para. 66) is in connection to Constitutional limitations for the adoption of these types of rules. In the case of Mexico, we consider the group-wide rule would be a challenge in terms of the Constitutional principles governing taxation.

Under the Mexican Constitution, the principle of tax proportionality governs the manner in which taxpayers are supposed to contribute to the public expenses. The Mexican Supreme Court of Justice has established in several decisions the notion of this principle, which has evolved over time. In general, the proportionality
principle states that taxpayers shall pay taxes based on their contributing capacity, or their ability to effectively contribute to the public finances based on their circumstances.

As regards to authorized deductions, the Mexican Supreme Court of Justice has also stated that deductions are categorized between structural and non-structural. The former ones relate to costs or expenses inherently related to the activity of the taxpayer, allowing the application of the tax to a particular circumstance in a proportional manner. The latter refer to benefits granted through tax breaks, which are meant to foster a particular activity for certain taxpayers.

The distinction made above is important as they relate to new intended rules bound to limit the deductibility of interest expenses on Mexican taxpayers (likely to be seen as structural deductions), based not on their individual contributing capacity, as the proportionality principle mandates, but on the overall capacity of an entire group, as related to a third party debt only and based on an allocation mechanism, or a ratio of the entire group. In this regard, the Mexican Supreme Court of Justice has ruled on the constitutionality of fixed ratios as part of thin capitalization rules, based on the intention to avoid an artificial erosion of the Mexican tax base; however, a substantially more complex mechanism as the one described in the group-wide rules, with many additional financial elements and information not readily available to the Mexican subsidiaries; or distorting elements such as different accounting standards, currency conversion and inflationary issues and the like, will likely encounter a stronger constitutional opposition in Court from Mexican taxpayers than the fixed ratio alternative also being proposed; thus our inclination for this latter approach.

Combination of rules

A combination of the rules could be an effective approach; however, until the issues discussed in the preceding paragraphs are resolved, both rules have the potential to create distortions. The purpose of this proposal is to prevent BEPS, but the proposal does not really address any external factors beyond a passing consideration of concepts such as EBITDA. Countries with a net capital inflow will have to design targeted rules that help them better address more concrete and specific cases of base erosion. There are questions that need to be answered, such as: how should exchange losses be addressed? Could a functional currency approach be effective? Should there be definitions of all the concepts involved? If a company has a tax loss but has earnings in terms of EBITDA it is not clear what to do. What should happen in this case? How can the interests between countries be reconciled?
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 a 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.
Invitation for comments on BEPS Action 4: Interest Deductions and Other Financial Payments

Dear Mrs. Ramm,

We would like to thank you for the opportunity to respond to the OECD Public Discussion Draft regarding BEPS Action 4: Interest Deductions and Other Financial Payments. Besides the issues on which the OECD has requested comments, we would like to add some general remarks on the approach taken by the OECD, as we have serious concerns as to its feasibility in practice.

A. Comments on the classification of BEPS in the Discussion Draft

Although not explicitly stated in the Discussion Draft, the OECD is proposing an approach that would classify any interest expenses that exceed the individual company's share in the group's third party net interest expenses as an abusive deduction of interest expenses, i.e. BEPS. Such a classification is too restrictive in some cases, because there can be valid reasons besides abusive intent for financing an individual controlled entity with debt:

- Depending on the corporate laws of the state in which the entity is located, debt is generally easier to transfer than equity. In particular, capital maintenance regulations often preclude the withdrawal of certain amounts of equity from the entity.
- A transfer of equity often requires additional documentation under the applicable corporate law. If a company transfers funding to another company in the group to close a short term liquidity gap, most countries'
civil law systems, commercial GAAPs and tax GAAPs will require the payment be recognised as debt and presume there is a repayment obligation if no other documentation is produced. Depending on the circumstances of the particular case, it may be necessary to define and document the type of equity, or even to notarize a contribution of equity, which is both costly and time consuming.

- In many cases, it will not be possible to achieve a tax neutral repatriation of equity at short notice. Assume e.g. a German resident corporation needs a short term funding in cash that its foreign parent company wishes to provide in the form of equity. As the funding is only short term, it will be necessary to repatriate the cash in the same fiscal year. For this reason, the funds transferred are credited to the subsidiary’s capital reserves, which are then debited when the funds are repatriated to the parent company in the same fiscal year. Sec 27 German Corporate Income Tax Act (CITA) regulates the so-called tax contribution account, which is formally determined only at the end of the fiscal year. Payments from a German corporation to its parent company are deemed to be accrued profits at first and consequently are subject to German dividend withholding tax. Only if all accrued profits have been distributed or there are no accrued profits because the subsidiary is a loss making entity are these payments deemed to constitute a refund of capital reserves that can be repatriated free of German dividend withholding tax. However, even when the company never made any profits, German tax authorities would in some cases take the formal view that contribution would need to be formally assessed in a tax assessment notice to allow a dividend withholding tax-free refund deemed from capital reserves. As the assessment notice is only as of the end of each fiscal year, contributions that are repatriated in the same fiscal year have not been subject to assessment and consequently in a number of cases cannot be repatriated free of withholding tax. As a result, even a corporation that generates no profit would not be in the position to receive and pay back a funding credited to its capital reserves without deducting German dividend withholding tax, unless the end of the fiscal year incidentally happens to be within the funding period. The liquidity effect of the 25% German dividend withholding tax (plus solidarity surcharge) is a key consideration in the parent company’s decision as to whether to provide equity or debt funding to its German subsidiary, even though the withholding tax would be refunded at a later point in time.
Further, some jurisdictions, such as China, obstruct the repatriation of equity from companies located in their territory in order to keep cash from inbound investments within their country borders. There are many more examples that can impact cross-border cases. If equity is to be as an appropriate means of short and medium term funding of subsidiaries as is debt, all current obstacles to cash repatriations and the fungibility of equity will need to be removed completely throughout the world. In the examples above, the presumption of an abusive creation of interest expense – as in the Discussion Draft – is clearly not justified. Indeed, such a presumption would lead to a corporate tax system within which only net third party debt of the group can be transferred tax neutrally as debt within the group. If third party equity of the group were forwarded to a subsidiary as debt, this transfer of funds would be regarded as abusive creation of interest expense.

In our view, there are obvious valid economic or commercial reasons for parent companies to close liquidity gaps in their subsidiaries by providing short term funding.

B. Comments on issues of an implementation of an interest cap rule under German constitutional law

Looking at the proposals in the Discussion Draft, it seems that the OECD favours a group ratio rule in the form of an interest cap rule combined with some type of fixed ratio rule at entity level. From a purely theoretical point of view group ratio rules may seem an appealing approach for addressing BEPS as classified above. However, in practice groups are likely to incur prohibitively high costs in preparing the figures and then calculating a potential interest cap rule at group level. Further, the rule, as currently proposed, will have further detrimental impact on groups, i.e. double taxation in various forms.

In Germany there seem to be reasonable doubts as to whether an interest cap rule would be permissible under German constitutional law. According to the constitutional principle of equality, each individual entity needs to bear a share of the taxes allocated among the taxpayers according to a comparison of their individual abilities to bear financial burdens. From this principle the German Constitutional Court has derived the so-called “objektives Nettoprinzip” (objective net income principle), which means that the ability to bear financial burdens should be measured according to the objective net income generated by the individual entity in the fiscal period. The German legislator has to uphold this principle when setting tax law.
In this context, an interest cap rule appears questionable, because it would result in a form of gross income taxation by denying the deduction of interest expenses for reasons beyond the control of the individual group entity affected. The German earnings stripping rule pursuant to Sec. 4h German Income Tax Act (ITA), the so-called Zinsschranke, is currently subject to review by the German Constitutional Court. An interest cap rule as proposed by the OECD is much more restrictive in terms of the objective net income principle and thus raises far more concern under German constitutional law.

C. Comments on selected questions for consultation

For the reasons outlined above, it seems inappropriate to implement a group ratio rule in the form of an interest cap. The questions asked mainly deal with issues that would occur, if an interest cap were introduced. Nevertheless, we would like to comment on the questions raised in the Discussion Draft.

**Topic:** What is interest and what are financial payments economically equivalent to interest?

**Question No. 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?

The definition of interest varies widely between the respective commercial and tax GAAPs of the OECD member countries. Additionally, there are different definitions under IFRS and SME-IFRS.

Interest is not defined separately under German tax GAAP, German commercial GAAP and IFRS but is derived from the definitions of the terms “debt” and “equity”. Proceeds from debt are usually treated as interest, while proceeds from equity are usually treated as dividends.

The definition of debt pursuant to IFRS, German commercial GAAP, and German tax GAAP is incongruent. Financial instruments exist as depicted in the following matrix to represent each combination of debt respectively equity under German commercial GAAP and German tax GAAP:
Examples for financial instruments exist for each field in the above matrix that would either be debt or equity under IFRS. In practice each form of mismatch will occur. Specific examples include:

- German tax and commercial GAAP include criteria that will result in a qualification of a financial instrument as a whole as either debt or equity depending on its prevailing similarities to a typical equity or debt instrument. In contrast, under IFRS it may occur that the proceeds from a financial instrument would have to be split into an equity share and a debt share. Thus, proceeds which are equity under German tax and commercial GAAP could, at least partly, qualify as debt under IFRS.

- Practitioners guidance on qualification of financial instruments pursuant to IAS 32 has been given in:
  - IDW HFA RS 45 (attached),
  - Interpretation 3 by the German DRSC of IAS 32.16A et. seq. (attached).

**Topic: Who should a rule apply to?**

**Question No 4: Where do you see issues in applying a 25 per cent control test to determine whether entities are related?**

Our response to this question is only in the context of the rule in question. Whilst the control concept is the sensible approach for a group ration rule in form of an interest cap rule, in our view, a control threshold of 25% for the implementation of an interest cap rule would not be appropriate. An economic or commercial decision to lend money to an entity under one’s own control is quite different from a decision to lend money to a related party outside one’s control. Therefore related parties should not be covered by an interest cap rule. It may be appropriate to introduce targeted rules to account for related party arrangements,
where necessary. A 25% control-concept could be an appropriate definition of a related party e.g. for a rule targeted towards back to back financing.

**Topic:** Should a small entity exception or threshold apply?

**Question No. 6:** Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

A small group or a small entity exception is necessary. In Europe small and medium sized groups are generally not obliged to prepare consolidated financial statements under local commercial GAAP or IFRS. Where EU Member States have exercised Member State options to introduce size thresholds for the presentation of consolidated financial statements, these thresholds can vary from Member State to Member State. As an equal treatment of groups throughout the world would be appropriate, the small group threshold should be chosen high enough so as to exceed the highest European Member State threshold. Issues will however arise to the extent that non-EU countries have implemented thresholds using different criteria. These criteria would also have to be considered when determining a suitable threshold.

A further exception is necessary for groups that operate in only one country, because these groups are not in a position to cause BEPS although they may forward group equity as debt within the group. This example clearly demonstrates that forwarding third party equity as debt should not be deemed as constituting BEPS in every case.

However, if such a sole country exception was introduced this might raise issues from the perspective of EU-law. Applying a potential interest cap rule to intra EU cross-border cases whilst an exception exists for merely national cases would likely be an infringement to the freedom of establishment. There are considerable doubts that such an infringement could be justified by merely stating that what is accepted in a national context becomes BEPS if it is done cross-border. Further conceptual work with regard to the definition of abuse needs to be undertaken.
**Topic:** Whether interest deductions should be limited with reference to the position of an entity’s group?

**Question No. 8:** Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?

The German earnings-stripping rule includes an escape clause that can be invoked when the group is more severely leveraged than the individual entity. This involves comparison between the debt-equity-ratios calculated on the basis of the group’s consolidated financial statement and the individual entities’ financial statements pursuant to local GAAP. The fact that the taxpayer has the burden of proof coupled with the complexity, means that in practice it is virtually impossible to prove that all relevant entities have been included at correct values, and thus this escape clause is of virtually no practical relevance.

In some cases, local tax offices accept a group ratio calculation without further questioning. Such a situation is, however, arbitrary and not desirable in the context of establishing a new worldwide approach.

**Topic:** Whether interest deductions should be limited with reference to the position of an entity’s group?

**Question No. 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?

Accepting – as a working hypothesis – the definition of BEPS presented in the paper (with the above shortcomings), it might be worth discussing whether interest deductions could be limited based on numbers from the group’s consolidated financial statements.

The underlying assumption is that the group financial statements would be comparable to the group financial statements of an identical group located in another country. However, even this would not be the case because different accounting standards would be applicable according to the location of the group’s ultimate holding entity.

From a German perspective, groups that are “kapitalmarktorientiert” (financial instruments publicly traded or in the application process) would need to prepare their consolidated financial statements pursuant to IFRS as currently endorsed. Other groups would prepare their consolidated financial statements according to German commercial GAAP. A high number of discrepancies between German commercial GAAP and IFRS will influence the maximum interest expense allowed in each individual entity even for the same group. It can be expected that
countries outside the EU will compete by having wide local GAAP definitions of
debt to attract the holding entities of a group to their jurisdictions so as to in-
crease the interest deduction capacity of group entities in other countries. Such
shortcomings could only be avoided if all groups were to prepare their consoli-
dated financial statements under the same GAAP, which would currently lead to
an untenable situation as the majority of groups would have to prepare two sets
of consolidated financial statements according to different GAAPs, incurring
prohibitively high costs.

The numbers reported in a group’s financial statements are only a good meas-
ure under the above assumptions provided the group definition is comprehen-
sive. Basically, the control concept seems the adequate concept under the as-
sumptions made. However, if the GAAP applicable to the group financial state-
ments allows for individual entities under control of the group to be excluded
from consolidation, the numbers cannot be taken from such statements. This is
because entities under common control would be treated as third parties and
thus intra group financing would be mixed in with actual group third party debt.
In conclusion, only numbers from group financial statements that include all enti-

ties under common control are suitable for this purpose.

Due to the fact most GAAPs currently aim at giving a fair presentation of the
group’s overall consolidated activity, the principle of materiality is applied when
group financial statements are prepared. Therefore, a group would be able to
receive an unmodified auditor’s opinion on its group financial statements al-
though there may be misstatements in the statements below a certain materiality
threshold. This example illustrates that group commercial GAAP figures might
not provide a sufficiently accurate picture of the net interest position of a group
because the GAAP systems are designed for so called general purpose finan-
cial statements for a wide range of users, but are not aimed towards calculating
a tax base.

This example also indicates that in future the tax authorities would need to audit
the consolidated financial statements, which would necessitate coordinated tax
audits, which is currently not necessary. In groups with several hundred entities
the international coordination of tax audits is a minimum requirement for auditing
all entities effectively.

There is additional complexity because the interest cap method requires a ratio
that is defined as a number from the financial statements of an individual entity
divided by a number from the consolidated financial statements. It is questiona-
ble whether the individual commercial GAAP financial statements can provide
appropriate unbiased information for the numerator of the ratio, since the
amount of earnings or asset values taken from entities’ individual GAAP financial statements might well be determined pursuant to various different local GAAPs, if the entities’ individual financial statements are used. In particular, such individual financial statements will likely contain different treatments in terms of recognition and measurement even of identical assets and/or liabilities under the different local GAAPs. Thus such individual financial statements are neither able to deliver figures that are comparable between entities, nor are these figures comparable to the figures in the group financial statements. Finally, local tax GAAPs are likely to deviate in a number of respects in comparison to local commercial GAAPs.

There are numerous differences between German commercial GAAP and IFRS. In the following we list a few areas:

- Other comprehensive income, partly recycled, partly non-recycled,
- Optional valuation of certain assets at fair value (e.g. IAS 40),
- IFRS separates service components in leasing arrangements,
- German commercial GAAP only allows micro hedges,
- Percentage of completion method (IAS 11),
- Definition of debt and equity,
- Purchase price allocation under IFRS,
- Impairment only approach under IFRS,
- Definition of CGUs in the group financial statement and goodwill allocation to CGUs under IFRS,
- etc.

In order to prepare consolidated financial statements, most individual local GAAP financial statements have to be adjusted to comply with the local group GAAP or IFRS applicable to the holding. In the course of calculation, virtually all groups make adjustments to all items presented in their statement of financial position (or balance sheet) and try to align the accounting treatment of the entity’s assets and liabilities to the group policies where material. The modified statements would seem to be the most suitable basis for calculating a ratio. However, these statements are not audited as such. In particular, other than the elimination of intragroup transactions at the subsequent consolidation stage, the auditor of the group financial statement would not audit transfer prices per se – this will severely influence the asset and EBITDA values included in such statements. If a group ratio rule were to use these unaudited modified individual financial statements, tax auditors would, in future, have to audit the transfer pricing in such statements to preclude any misallocation of available interest ex-
penses. This would only be feasible if an international tax audit was implemented and tax authorities cooperated to an extent not known before.

Finally, permanent establishments do not fit into the proposed interest cap rule. In any case foreign permanent establishments of a corporation outside its country of residence would be under no obligation to prepare individual financial statements, neither pursuant to local commercial GAAP, nor pursuant to IFRS. In cases where an entity’s permanent establishment is not a transparent entity – subject to coordination with BEPS Action 2: Hybrids – the data is usually included in the financial statements of the entity’s head office. Although many countries require the permanent establishment to prepare a local tax GAAP financial statement, local GAAP or IFRS figures for a comparison would not be available. The permanent establishments would need to prepare individual local commercial or IFRS financial statements solely for interest deduction purposes. This could be a major obstacle for companies operating through permanent establishments. Under EU-law this might also be contrary to the freedom of establishment in certain circumstances.

**Topic:** Whether interest deductions should be limited with reference to the position of an entity’s group?

**Question No. 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?

**Question No. 12:** Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

**Question No. 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?

Neither the reported earnings nor asset values alone provide a reliable view of an entity’s economic activities. Earnings fail in a situation where losses occur temporarily. The company may be very active and generally profitable even if losses are incurred over an interim period. In such an interim period the company would likely finance its economic activity from retained earnings and possibly new debt. An earnings based ratio (e.g. EBIT or EBITDA) would not reflect such circumstances. It could lead to an add back of non-deductible interest expense where no cap is allocated and increase the tax base to a positive amount despite the entity’s economic loss position. The company would need additional debt to finance taxes. The financing costs would, again, not be tax deductible.
Such a situation will aggravate the crisis of the company considerably, and may even lead to default.

An asset based figure might mirror the financial requirements relating to investments into long-term and current assets, which would not, however, be regarded as economic activity under an EBITDA ratio. Furthermore, a solely asset based approach could not reflect the ability to bear taxes, as it would merely allocate interest cap according to assets. This would mean that countries with capital-intensive industries would have to accept a structurally higher interest expense deduction than countries in which R&D is prevalent or countries which have primarily human capital-intensive industries.

**Topic: Whether interest deductions should be limited with reference to the position of an entity’s group?**

**Question No. 19:** If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

The desire to achieve equitable treatment of countries would likely lead to the adoption of a combined approach. However, the complexity of the calculations increases with each additional figure used from a group’s financial statements. Rules for addressing mismatches in asset recognition and valuation would be needed to cope with, timing and permanent differences. Further precautions must be considered to avoid abusive shifts in the relative share of overall interest cap between countries by making use of options in asset recognition and asset valuation.

**Topic: Whether interest deductions should be limited with reference to the position of an entity’s group?**

**Question No. 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?

It is extremely unlikely that IFRS, local commercial GAAPs and local tax GAAPs use the same concepts for currency conversion. While group financial statements are likely to apply a functional currency concept, local tax GAAP will very likely use figures in local currency. The interest cap so calculated would be used to cap interest expenses according to local tax GAAP. In most cases the resultant mismatches would be permanent and either to the disadvantage of the tax-
payers or the local tax authority, whereas other tax authorities would benefit. This is not acceptable even given the BEPS objectives. To resolve the mismatches it would be necessary to adjust every single transaction which involves currency conversion and to apply consistent standards in so doing.

**Topic:** Whether interest deductions should be limited with reference to the position of an entity’s group?

**Question No. 17:** What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

We refer to the examples given under A. above, and would like to point out further tax obstacles, as follows:

- If an interest cap were to apply, transfer pricing with regard to interest must not be relevant within a group context. According to the assumptions in the paper, it should be possible to provide debt and equity funding via non-interest bearing loans without any corrections by the relevant tax authorities. Otherwise, under the arm’s length principle, the impact on profit margins would be such as to result in systematic and cumulative double taxation at each level in the participation chain. The arm’s length principle and its implementation at national level in regard to interest would have to be amended where an interest cap applies.

- A group will seek external finance in the country where the capital market offers the best conditions which is not necessarily the country of investment. This means that forwarding loans within a group or centralizing group treasury in a financial service entity is not BEPS motivated.

- When subsidiaries default and parent companies have to write off third party debt forwarded intra-group, the write-off should be fully tax deductible for the parent company. This is systematic, because the default will considerably limit the ability of the parent company to bear taxes since it will have to repay the debt to its third party lender. Consequently the current German Sec. 8b para. 3 sent. 4-7 Corporate Income Tax Act would have to be amended. The same is true for transparent German entities with regard to Sec. 3c sent. 2 Income Tax Act.

- It is impossible to contribute equity to a permanent establishment.
**Topic:** Whether interest deductions should be limited with reference to the position of an entity’s group?

**Question No. 20:** In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

**Question No. 21:** Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

There are numerous differences between German commercial GAAP and German tax GAAP. In the following we list a few areas:

- Allocation of assets to entities (permanent difference)
- Recognition of certain immaterial assets (permanent difference),
- Depreciation of material assets (usually timing difference),
- Goodwill depreciation (usually timing difference),
- Present value calculation, depreciation rates (usually timing difference),
- Impairment of assets (usually temporary difference),
- Valuation of current assets (timing or temporary difference),
- Recognition and valuation of pension accruals (timing or temporary difference),
- Provision for contingent losses (usually timing difference),
- Provision for expenses (usually timing difference),
- Recognition and valuation of other provisions (usually timing difference),
- Deferred taxes,
- Etc.

If interest calculations result from valuation methods which require i.e. present value recognition of assets or liabilities/provisions and depreciation rates vary, the resulting timing differences cannot cause BEPS concerns because they are internal to the entity. Such interest expense and interest income from internal financing should not be subject to interest cap rules.
Page 14/14 of the letter dated 6th February 2015 to the OECD

Should you have any questions regarding our comments please do not hesitate to contact Jörg Peter Müller from the IDW Team on +49 (0)211 4561 403 or via e-mail at mueller@idw.de.

Yours sincerely,

Hamannt

Rindermann
Technical Director Taxes and Law

Attachments
DRSC Interpretation 3 (IFRS)*
Auslegungsfragen zu Instrumenten mit Gläubigerkündigungsrecht gemäß IAS 32


* Verabschiedung der geänderten Fassung der Tz. 21-25 sowie Aufteilung der bisherigen Tz. 21 in Tz. 21 und 21a am 10. Februar 2010.

* DRSC Interpretation 3 (IFRS) wurde in der aktualisierten Fassung durch den IFRS-Fachausschuss am 12. Juli 2013 mit Änderungen der Tz. 1, 2, 4, 6, 9, 10, 19, 20, 29 und 42 verabschiedet.

ASCG Interpretation 3 (IFRS)*
Interpretation Issues relating to Puttable Financial Instruments in Accordance with IAS 32

* ASCG Interpretation 3 (IFRS) was published on 22 January 2009 as Accounting Interpretation No. 3 (AIC 3). The interpretation is applicable on its date of publication. Earlier application as of 31 December 2008 is encouraged.

* Revised paragraphs 21 - 25 and the division of the former paragraph 21 into paragraphs 21 and 21a were adopted on 10 February 2010.

* ASCG Interpretation 3 (IFRS) was adopted by the IFRS Committee at its meeting on 12 July 2013 with amendments to paragraphs 1, 2, 4, 6, 9, 10, 19, 20, 29 and 42.
Accounting Standards Committee of Germany
The Accounting Standards Committee of Germany (ASCG) has been mandated to develop principles for financial reporting in consolidated financial statements, to advise the legislature on the development of financial reporting, to represent the Federal Republic of Germany on international accountancy bodies and to develop interpretations of international financial reporting standards within the meaning of section 315a(1) of the Handelsgesetzbuch (HGB - German Commercial Code).

Note on application
Interpretations of the international financial reporting standards within the meaning of section 315a(1) of the HGB (ASCG Interpretations) address issues of predominantly national relevance for which the IFRS Interpretations Committee is unable to issue a generally binding interpretation, and for which the ASCG therefore develops appropriate interpretations in consultation with the IFRS Interpretations Committee.

Interpretations are adopted after careful consideration of all relevant circumstances, in particular taking account of all effective IFRSs, the IASB Framework, and the comments received, and after holding public hearings.

The Interpretations adopted by the ASCG provide guidance for the accounting treatment of the relevant issues in financial statements prepared in accordance with the applicable pronouncements of the IASB, unless other specific pronouncements have been issued by the IFRS Interpretations Committee or the IASB.

Entities in Germany which state that their financial statements have been prepared in accordance with IFRSs should therefore examine carefully whether, given all the circumstances of the individual case, application of the ASCG Interpretations is required.
Vorbemerkung

Deutsches Rechnungslegungs Standards Committee

Das Deutsche Rechnungslegungs Standards Committee (DRSC) hat den Auftrag, Grundsätze für eine ordnungsmäßige Konzernrechnungslegung zu entwickeln, den Gesetzgeber bei der Fortentwicklung der Rechnungslegung zu beraten, die Bundesrepublik Deutschland in internationalen Rechnungslegungsgremien zu vertreten und Interpretationen der internationalen Rechnungslegungsstandards im Sinne von § 315a Abs. 1 HGB zu erarbeiten.

Hinweis zur Anwendung der Verlautbarung

Gegenstand von Interpretationen der internationalen Rechnungslegungsstandards im Sinn des § 315a Abs. 1 HGB (DRSC Interpretationen (IFRS)* bzw. Interpretationen) sind Fragestellungen mit deutlich dominierendem nationalem Bezug, die durch das IFRS Interpretations Committee nicht in einer allgemeinverbindlichen Weise interpretiert werden können und zu denen das DRSC entsprechende Auslegungen in Absprache mit dem IFRS Interpretations Committee erarbeitet.

Interpretationen werden nach sorgfältiger Prüfung aller maßgeblichen Umstände, insbesondere der gültigen IFRS, des Framework des IASB sowie der eingegangenen Stellungnahmen, nach Durchführung von Anhörungen in öffentlicher Sitzung beschlossen.

Die vom DRSC beschlossenen Interpretationen gelten, solange keine anders lautende Regelung durch das IFRS Interpretations Committee oder den IASB beschlossen wurde, als Leitlinie für die Bilanzierung der behandelten Sachverhalte in einem Abschluss, der nach der gültigen Regelungen des IASB aufgestellt wird.

Unternehmen in Deutschland, die ihren Abschluss als gemäß IFRS aufgestellt kennzeichnen, haben daher sorgfältig zu prüfen, ob unter Berücksichtigung aller Besonderheiten des Einzelfalls eine Anwendung der Interpretationen des DRSC geboten ist.
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Interpretation Issues relating to Puttable Financial Instruments

Relevant IFRSs:
- IAS 1 Presentation of Financial Statements
- IAS 32 Financial Instruments: Presentation

Background

1. The IASB issued amendments to IAS 32 and IAS 1 on 14 February 2008 entitled Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation (IAS 32, including the 2008 amendment, is referred to as follows in this Interpretation: IAS 32 (amended 2008)).

2. These amendments largely represent specific exceptions (see IAS 32.16A). As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all of the following features: [...].(4) to the previous provisions of IAS 32 governing the classification of issued financial instruments as equity or financial liabilities. These exceptions relate to issued financial instruments that are puttable by the holder of the financial instrument or that only entitle the holder of the financial instrument to a pro rata share of the net assets of the entity issuing the financial instruments in the event of that entity’s liquidation. On the basis of these exceptions, and provided that all the conditions set out in IAS 32 (amended 2008) are met, the financial instruments designated above are classified as equity, in contrast to their normal classification as financial liabilities under the previous version of IAS 32.

3. In technical terms, the amendments described above have mainly been implemented by amending the definitions and adding the new para...
Auslegungsfragen zu Instrumenten mit Gläubigerkündigungsrecht gemäß IAS 32

Maßgebliche IFRS:
IAS 1 Darstellung des Abschlusses
IAS 32 Finanzinstrumente: Darstellung

Hintergrund

Diese Änderungen stellen im Wesentlichen spezifische Ausnahmeregelungen (vgl. IAS 32.16A: As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all of the following features: [...]”) zu den bisher bestehenden Vorschriften des IAS 32 zur Abgrenzung emittierter Finanzinstrumente in Eigen- und Fremdkapital dar. Die Ausnahmeregelungen betreffen emittierte Finanzinstrumente, die durch den Gläubiger des Finanzinstruments kündbar sind oder die nur bei Liquidation des der Finanzinstrumente herausgebenden Unternehmens einen prozentualen Residualanspruch des Gläubigers des Finanzinstruments gegen das Unternehmen zur Folge haben. Aufgrund dieser Ausnahmeregelungen sind bei Beachtung aller Voraussetzungen des IAS 32 (amend 2008) die zuvor genannten Finanzinstrumente als Eigenkapital zu bilanzieren, während nach dem bisherigen IAS 32 im Regelfall eine Bilanzierung als Fremdkapital zu erfolgen hatte.

Technisch werden die oben aufgezeigten Änderungen im Wesentlichen durch Anpassungen der Definitionen und eine Erweiterung des IAS 32

graphs 16A to 16F to IAS 32, accompanied by corresponding additions to the Introduction and the Application Guidance.

4. The provisions of IAS 32 (amended 2008) do not affect the financial instruments already required to be classified as equity, because they merely supplement the criteria for classifying a financial instrument as equity.

Scope

5. This Interpretation addresses selected issues arising from German company law in the context of the new provisions of IAS 32.16A and the related disclosures required by IAS 1.136A.

Issues, Consensus and Basis for Conclusions

IAS 32.16A – Puttable financial instruments

6. IAS 32.16A defines puttable financial instruments as follows: A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put [...]. Classification as equity requires a number of specific conditions to be met. These are explained in the following.
um die Paragraphen 16A bis 16F nebst entsprechender Erweiterung der Anleitungen und Empfehlungen zur Anwendung vorgenommen.

Eine Auswirkung auf die bereits bisher als Eigenkapital zu erfassenden Finanzinstrumente haben die Regelungen des IAS 32 (amend 2008) nicht, da lediglich eine Erweiterung der Kriterien für die Klassifizierung eines Finanzinstruments als Eigenkapitalinstrument vorgenommen wurde.

Anwendungsbereich

Diese Interpretation beschäftigt sich mit ausgewählten Fragestellungen vor dem Hintergrund des deutschen Gesellschaftsrechts in Bezug auf die neuen Regelungen des IAS 32.16A sowie der zugehörigen Anhangangaben gemäß IAS 1.136A.

Fragestellungen, Beschlussfassungen und Begründungen

IAS 32.16A – Instrumente mit Gläubigerkündigungsrecht

In IAS 32.16A werden Finanzinstrumente mit Gläubigerkündigungsrecht ("puttable financial instruments") – nachfolgend kurz als "kündbare Instrumente" bezeichnet – wie folgt definiert: A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put [...]. Für eine Klassifizierung als Eigenkapital sind mehrere spezifische Bedingungen zu erfüllen, die im Folgenden erläutert werden.
IAS 32.16A (a) – Pro rata share of the entity’s net assets

- It entitles the holder to a pro rata share of the entity’s net assets in the event of the entity’s liquidation. The entity’s net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
  (i) dividing the entity’s net assets on liquidation into units of equal amount; and
  (ii) multiplying that amount by the number of the units held by the financial instrument holder.

Issue 1: Does the condition set out in IAS 32.16A (a) relate to the paid-in or the agreed capital?

7. The condition set out in IAS 32.16A (a) relates to the agreed capital because the liquidation proceeds are distributed on the basis of the pledged capital contributions, and not merely on the capital contributions actually paid. In the event of liquidation, the owners will be required to pay their capital contributions.

8. If the provisions of the articles of association stipulate that some, but not all, owners are not required to pay their subscribed capital contributions in full, this represents a breach of the condition set out in IAS 32.16A (c).

Issue 2: What is the effect of the unlimited (external) liability of the general partner of a limited partnership (in Germany: Kommanditgesellschaft)?

9. The external liability of the general partner of a limited partnership is unlimited. By contrast, section 171 of the Handelsgesetzbuch (HGB – German Commercial Code) limits or excludes the liability of a limited partner provided that the capital contribution has been paid. If, in the event of liquidation, the liquidation assets are negative and no assets can therefore be distributed, as a result of which the general partner must bear the deficit, the different liability of the two classes of
IAS 32.16A (a) – Proportionaler Residualanspruch

(a) It entitles the holder to a pro rata share of the entity’s net assets in the event of the entity’s liquidation. The entity’s net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
(i) dividing the entity’s net assets on liquidation into units of equal amount; and
(ii) multiplying that amount by the number of the units held by the financial instrument holder.

Fragestellung 1: Bezieht sich die Bedingung des IAS 32.16A (a) auf das eingezahlte oder auf das vereinbarte Kapital?

Die Bedingung des IAS 32.16A (a) bezieht sich auf das vereinbarte Kapital, da der Liquidationserlös unter Berücksichtigung der Einlageversprechen und nicht nur der geleisteten Einzahlungen verteilt wird. Im Liquidationsfall werden die Gesellschafter auf die Leistung der Einlage in Anspruch genommen.

Sehen die gesellschaftsvertraglichen Vereinbarungen vor, dass einige, aber nicht alle Gesellschafter ihre übernommenen Einlagen nicht in voller Höhe auch einzuzahlen haben, so liegt eine Verletzung der Bedingung in IAS 32.16A (c) vor.

Fragestellung 2: Wie wirkt sich die (im Außenverhältnis) unbeschränkte Haftung des Komplementärs einer Kommanditgesellschaft aus?

Die Haftung des Komplementärs einer Kommanditgesellschaft ist im Außenverhältnis unbeschränkt. Im Gegensatz dazu ist die Haftung des Kommanditisten gemäß § 171 HGB beschränkt bzw. ausgeschlossen, so weit die Einlage geleistet ist. Wenn im Rahmen einer Liquidation das Liquidationsvermögen negativ ist und demzufolge kein Vermögen zu verteilen ist, sondern ein Fehlbetrag vorliegt, der vom Komplementär zu tragen ist, führt die unterschiedliche Haftung beider Gesellschafter-
partner means that the distribution can no longer be made pro rata on the basis of the partners' share of the equity of the partnership. However, this does not represent a breach of the condition set out in IAS 32.16A (a). In accordance with IAS 32.AG14F and IAS 32.AG14G, the personal liability of a general partner of a limited partnership is separated from the capital contribution and treated as a separate financial instrument. If the general partner participates disproportionately in the liquidation assets as a consequence of its unlimited, personal external liability in the event of negative liquidation assets, this is a result of the guarantee (liability) provided by the general partner to the entity, which is to be treated as a separate financial instrument. As a consequence of the separate treatment of the capital contribution and the personal liability or guarantee, under IAS 32 (amended 2008) the puttable instruments also entitle the holders to a pro rata share in the case of a limited partnership. The unlimited external liability of the general partner of a limited partnership does not therefore breach this condition.

**Issue 3:** Does non-performance-related remuneration for the general partner as compensation for its assumption of liability represent a breach of the condition set out in IAS 32.16A (a)?

10. Equally, non-performance-related remuneration for the general partner as compensation for its assumption of liability does not lead to a breach of the condition set out in IAS 32.16A (a), because this relates to separate remuneration to compensate for the unlimited liability assumed by the general partner. IAS 32.AG:4F-IAS32.AG14H give examples – including IAS 32.AG14G for the case of unlimited liability equivalent to a guarantee, which is relevant here – where there are other contractual arrangements between the holder of the puttable instrument (owner or partner) and the entity. Because the owner is essentially considered to have the role of a non-owner in such cases, the terms and conditions of these other contractual arrangements must be similar to those applying to equivalent transactions between non-instrument holders and the entity, as set out in IAS 32.AG14i. It will be difficult in many cases to demonstrate this level of equivalence for the unlimited liability of a general partner. However, IAS 32.AG14i makes it clear that the contractual terms and conditions do not have to be identical, but merely similar. The condition set out in IAS 32.AG14i is

**Fragstellung 3:** Stellt eine ergebnisunabhängige Vergütung für den Komplementär zum Ausgleich der übernommenen Haftung eine Verletzung der Bedingung in IAS 32.16A (a) dar?

designed to ensure that the entitlement conveyed by the puttable instruments is not impaired indirectly by excessive remuneration because of these other contractual arrangements. This requires an examination of the specific situation prevailing at each individual company that considers all the material facts and circumstances. Because of the differing interests of the owners, it can generally be assumed that the remuneration for the assumption of liability has been agreed on an arm's length basis unless indicated to the contrary by the outcome of the individual examination. Excessive remuneration that does not meet the equivalent transaction test within the meaning of IAS 32.14 is a tainting factor.

IAS 32.16A (b) – The class of instruments is subordinate to all other classes

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation, and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

Issue 4: Is the condition set out in IAS 32.16A (b) breached if an instrument entitles the holder to an advance distribution from the liquidation proceeds?

11. If a financial instrument has a preferential right on liquidation within the meaning of IAS 32.14C, it cannot be classified as equity on the basis of the example contained in that paragraph because it is not an instrument with an entitlement to a pro rata share of the net assets of the entity. For example, the right to a fixed dividend on liquidation in addition to a share of the entity's net assets is a preferential right on liquidation.
IAS 32.AG14I soll sicherstellen, dass über den Umweg dieser anderen Vertragsbeziehungen durch überhöhte Vergütungen nicht der Anspruch der kündbaren Instrumente beeinträchtigt wird. Dazu ist eine unternehmensindividuelle Einzelfallprüfung durchzuführen, die alle wesentlichen Faktoren und Umstände berücksichtigt. Aufgrund der unterschiedlichen Interessen der Anteilseigner kann grundsätzlich davon ausgegangen werden, dass die Vereinbarung der Vergütung für die Haftungsübertnahme zu marktüblichen Bedingungen erfolgt, wenn nicht die Einzelfallprüfung zu einem entgegenstehenden Ergebnis führt. Eine überhöhte Vergütung, die einem Fremdvergleich i.S.v. IAS 32.AG14I nicht standhält, ist schädlich.

**IAS 32.16A (b) – Letztrangige Klasse von Finanzinstrumenten**

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:

(i) has no priority over other claims to the assets of the entity on liquidation, and

(ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.

**Fragestellung 4:** Ist die Bedingung des IAS 32.16A (b) verletzt, wenn ein Instrument zu einer Vorabzahlung aus dem Liquidationserlös berichtet?

Besitzt ein Finanzinstrument ein Vorzugsrecht im Falle der Liquidation ("preferential right on liquidation") i.S.v. IAS 32.AG14C, so liegen dem dort enthaltenen Beispiel zufolge die Voraussetzungen für eine Klassifizierung als Eigenkapital nicht vor, da es sich nicht um einen Anspruch auf eine anteilsmaßige Partizipation an dem Nettovermögen des Unternehmens ("pro rata share of the net assets of the entity") handelt. Beispielsweise stellt das Recht auf eine zusätzlich zur Teilhabe an dem Nettovermögen des Unternehmens fest vereinbarte Vorabdividende
12. The following two scenarios must be distinguished for the review of the condition set out in IAS 32.16A (b):

13. If an instrument has a preferential right and, in addition to the preferential right, also participates pro rata in the entity's net assets, the instrument with a preferential right breaches the condition set out in IAS 32.16A (b) and cannot therefore be classified as equity. Because the condition is breached, the instrument with a preferential right cannot be allocated to the class of instruments that is subordinate to all other classes, in contrast to the preliminary allocation. Puttable instruments without a preferential right that only participate pro rata in the entity's net assets therefore remain in this class.

Example: The articles of association stipulate that an advance dividend on the capital contribution of owner A will initially be paid from the liquidation proceeds. The remaining liquidation proceeds are then allocated to owners A, B and C on the basis of their capital contributions - in other words as a pro rata share. Owners B and C are not entitled to an advance dividend. In this scenario:
- A's capital contribution cannot be classified as equity (the advance dividend breaches the condition set out in IAS 32.16A (b), as a result of which A's capital contribution does not belong to the class of instruments that is subordinate to all other classes);
- the capital contributions of B and C can be classified as equity (provided that the other conditions are met).

14. If some instruments have a preferential right on liquidation but do not also entitle the holder to a pro rata share of the entity's net assets, the instruments with a preferential right are not in the class that is subordinate to all other classes, and therefore cannot be classified as equity. Nonetheless, the other instruments without a preferential right on liquidation may still meet the criteria for classifying puttable instruments as equity.
aus dem Liquidationserlös (fixed dividend on liquidation in addition to a share of the entity's net assets) ein Vorzugsrecht im Falle der Liquidation dar.

Für die Prüfung der Bedingung in IAS 32.16A (b) sind folgende zwei Konstellationen zu unterscheiden:


Beispiel: Der Gesellschaftsvertrag bestimmt, dass aus dem Liquidationserlös zunächst eine Vorabdividende auf die Einlage des Gesellschafters A geleistet wird. Der danach verbleibende Liquidationserlös wird unter den Gesellschaftern A, B und C nach Maßgabe der Einlagen – also beteiligungsproportional – verteilt. Die Gesellschafter B und C haben demzufolge keinen Anspruch auf eine Vorabdividende. In dieser Situation kann die Einlage des A nicht als Eigenkapital klassifiziert werden (die Vorabdividende verletzt die Bedingung in IAS 32.16A (b), wodurch die Einlage des A nicht der letztrangigen Klasse von Finanzinstrumenten angehört);

können die Einlagen von B und C als Eigenkapital klassifiziert werden (sofern die übrigen Bedingungen erfüllt werden).

Besteht ein Vorzugsrecht im Falle der Liquidation bei einigen Instrumenten, die jedoch zugleich keinen beteiligungsproportionalen Anspruch auf das Nettovermögen gewähren, so sind die Instrumente mit Vorzugsrecht ebenfalls nicht der letztrangigen Klasse und damit auch nicht dem Eigenkapital zuzuordnen. Die Voraussetzungen für die Klassifizierung von kündbaren Instrumenten als Eigenkapital bei den übrigen Instrumenten ohne Vorzugsrecht im Falle der Liquidation können dann gleichwohl gegeben sein.
Example: The articles of association stipulate that an advance dividend on the capital contribution of owner A will initially be paid from the liquidation proceeds. The remaining liquidation proceeds are then allocated to owners B and C on the basis of their capital contributions – in other words as a pro rata share. In this scenario:
- A's capital contribution cannot be classified as equity (the advance dividend breaches the condition set out in IAS 32.15A(b));
- by contrast, the capital contributions of B and C are classified as equity (provided all the other conditions are met). Because A's capital contribution only participates in the advance distribution of the liquidation proceeds, but does not entitle the holder to a pro rata share of the entity's net assets, A's capital contribution is not in the class that is subordinate to all other classes and is therefore also not subject to the review of the condition set out in IAS 32.16A(c).

IAS 32.16A(c) – Identical features

...  
(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.1

Issue 5: Does this condition refer solely to the financial features of the instruments (e.g. rights to a share of profit or loss for the period, rights on liquidation) or does it also relate to other features (e.g. the different rights to information of general and limited partners, or the differences powers of management, in a limited partnership)?

15. This condition refers solely to the financial features. Based on the examples given in IAS 32 (instruments must be puttable, the formula or other method used to calculate the repurchase or redemption amount), it is clear that condition (c) in IAS 32.16A relates solely to fi-
Beispiel: Der Gesellschaftsvertrag bestimmt, dass aus dem Liquidationserlös zunächst eine Vorabdividende auf die Einlage des Gesellschafters A geleistet wird. Der danach verbleibende Liquidationserlös wird unter den Gesellschaftern B und C nach Maßgabe der Einlagen – also beteiligung proporotional – verteilt. In dieser Situation
- kann zwar die Einlage des A nicht als Eigenkapital klassifiziert werden (die Vorabdividende verletzt die Bedingung in IAS 32.16 A (b));
- die Einlagen von B und C sind hingegen (bei Erfüllen aller anderen Bedingungen) als Eigenkapital zu klassifizieren. Da die Einlage des A ausschließlich vorab am Liquidationserlös partizipiert, eine anteilmäßige Teilhaberschaft an dem Nettovermögen des Unternehmens hingegen nicht besteht, ist die Einlage des A nicht der letzt rangigen Klasse zuzuordnen und unterliegt demnach auch nicht der Prüfung der Bedingung in IAS 32.16 A (c).

**IAS 32.16 A (c) – Identische Ausstattungsmerkmale**

> "...

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

**Fragestellung 5:** Bezieht sich diese Bedingung ausschließlich auf die finanziellen Ausstattungsmerkmale der Instrumente (z. B. Ansprüche auf das Periodenergebnis, Ansprüche in der Liquidation) oder sind auch andere Merkmale angesprochen (z. B. bei einer Kommanditgesellschaft die unterschiedlichen Informationsrechte zwischen Komplementären und Kommanditisten oder die unterschiedlichen Befugnisse zur Geschäftsführung)?

Die Bedingung betrifft ausschließlich die finanziellen Ausstattungsmerkmale. Aufgrund der in IAS 32 angeführten Beispiele (Kündbarkeit, Bestimmung des Abfindungsbetrags) wird klar herausgestellt, dass die Bedingung (c) des IAS 32.16A ausschließlich auf finanzielle Ausstatt-
Financial features. Examples of financial features include participation in profit or loss for the period and in the liquidation proceeds. Disproportionate voting rights may represent an exception (see para. 18).

16. Differing rights to information do not prevent the classification of puttable instruments as equity. However, differing rights to information may be an indication that other features (especially financial features) may differ.

17. In addition, management authority and the rights attached to cash capital contributions must be analysed separately by reference to IAS 32.4. The inherently different features relating to liability and management in a limited partnership because of the general partner’s status compared with the rights and obligations of a limited partner do not prevent the capital contributions from being identical. Rights that are comparable with management authority may also be granted without being attached to the capital contribution.

Issue 6: What effect do different voting rights have?

18. Different voting rights of the individual members that are proportionate to their equity interests are not a breach of the condition set out in IAS 32.16A (c). Equally, a situation where voting rights are proportionate to the equity interests held and an individual member is able to procure resolutions of the owners’ meeting or amend the articles of association without the involvement of other owners does not represent a breach of the condition (provided that the articles of association stipulate in certain cases that amendments to the articles of association do not have to be resolved unanimously, but may also be adopted by a majority resolution). Disproportionate voting rights of one or more owners only breach the condition set out in IAS 32.16A (c) from the time they are actually exercised.
tungsmerkmale abstellt. Als finanzielle Ausstattungsmerkmale gelten beispielsweise die Beteiligung am Periodenergebnis und am Liquidationserlös. Eine Ausnahme können nicht-proportionale Stimmrechte darstellen (vgl. Tz. 18).

Unterschiedliche Informationsrechte verhindern nicht: die Klassifizierung der kündbaren Instrumente als Eigenkapital. Unterschiedliche Informationsrechte können aber ein Indikator dafür sein, dass auch andere (insbesondere finanzielle) Ausstattungsmerkmale unterschiedlich ausgestaltet sind.


**Fragestellung 6: Wie wirken sich unterschiedliche Stimmrechte aus?**

Ungleiche, aber beteiligungss proportionalen Stimmrechte der einzelnen Gesellschafter stellen keine Verletzung der Bedingung des IAS 32.16A (c) dar. Eine Verletzung der Bedingung liegt auch dann nicht vor, wenn ein einzelner Gesellschafter bei beteiligungss proportionalen Stimmrechten in der Lage ist, ohne Mitwirken anderer Gesellschafter Beschlüsse der Gesellschafterversammlung herbeizuführen oder den Gesellschaftsvertrag zu ändern (sofern der Gesellschaftsvertrag für bestimmte Fälle vorsieht, dass Änderungen des Gesellschaftsvertrages nicht ausschließlich einstimmig, sondern auch durch einen Mehrheitsbeschluss erfolgen können). Überproportionale Stimmrechte einzelner oder mehrerer verletzen die Bedingung in IAS 32.16A (c) erst ab dem Zeitpunkt, in dem sie tatsächlich ausgeübt werden.
ISSUE 7: Does the simultaneous classification of perpetual instruments (eg perpetual profit participation rights) and puttable instruments as equity breach the condition of uniformity (identical features)?

19. The simultaneous classification of perpetual instruments (eg profit participation rights) and puttable instruments as equity does not breach the condition set out in IAS 32.16A (c), provided that the perpetual instruments have priority over the puttable instruments on liquidation. If the other conditions are met, puttable instruments are therefore classified as equity in addition to perpetual instruments. The wording of IAS 32.16A (c) refers to the class of instruments that is subordinate to all other classes of instruments on liquidation within the meaning of IAS 32.16A (b). This implies that there can be several classes of residual instruments (equity instruments), although the condition set out in IAS 32.16A (c) does not refer to all equity instruments, but only to the puttable instruments addressed by IAS 32 (amended 2008). Only the latter instruments must meet the condition that they are in the class of instruments that is subordinate to all other classes on liquidation, ie they are the most subordinated class on liquidation.1

IAS 32.16A (d) – No additional payment obligations

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity’s own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

1 The IFRS Interpretations Committee opted for this view in its response to a corresponding request for guidance from the AIC; for details, see the IFRS Interpretations Committee's agenda decision in the March 2009 edition of the IFRIC Update (Financial Instruments: Presentation-Classification of puttable and perpetual instruments).
Bitte korrigieren Sie die Transkription, da es nicht lesbar ist.


**Issue 8:** Does the owners' cash withdrawal right within the meaning of section 122(1) of the Handelsgesetzbuch (HGB - German Commercial Code) breach this condition?

20. One of the objectives of the condition in IAS 32.16A (d) is to help reduce structuring opportunities that might arise as a result of the amendments to IAS 32 and IAS 1. It can be assumed that there will be no such undesirable structuring in the case of German partnerships that comply with the standard legal model.

21. In the standard legal model, neither the non-profit-dependent capital withdrawal right in accordance with section 122(1), half-sentence 1 of the HGB (which does not apply to limited partners in accordance with section 169(1) sentence 1 of the HGB) nor the profit withdrawal right in accordance with section 122(1), half-sentence 2 of the HGB lead per se to an individual claim by the owners for payment; the same principle applies to provisions of the articles of association governing this matter. There is no payment obligation in respect of the capital withdrawal right in accordance with section 122(1), half-sentence 1 of the HGB if the owners' meeting can unilaterally prevent the payment by means of a resolution.

21a. In respect of the profit withdrawal right in accordance with section 122(1), half-sentence 2 of the HGB, the adoption of the annual financial statements must first be resolved. Moreover, the appropriation of net profit is also decided. Although the law does not stipulate a separate explicit resolution on the appropriation of net profit for commercial partnerships, there is no conflict if an ad hoc resolution on the retention of profits can be resolved at the same time as the adoption of the annual financial statements.

22. If no appropriation to reserves is resolved when the annual financial statements are adopted, this is viewed as implied confirmation of the anticipated resolution on the appropriation of net profit. Accordingly, an individual claim for payment of profit only arises at the time of the resolution on the adoption of the annual financial statements and the decision not to retain profits. The profit payment claim arising in this case is consequently classified as a liability as from this time.
**Fragestellung 8: Verletzt das Entnahmerecht der Geellschafter i.S.d. § 122 Abs. 1 HGB diese Bedingung?**

Die Bedingung in IAS 32.16A (d) soll u.a. dazu beitragen, sog. *structuring opportunities*, die sich aus den Änderungen zu IAS 32 und IAS 1 ergeben könnten, einzuschränken. Bei deutschen Personengesellschaften, die dem gesetzlichen Regelmodell entsprechen, kann nicht von einer solchen unerwünschten Strukturierung ausgegangen werden.

**Weder das gewinnunabhängige Kapitalentnahmerecht gemäß § 122 Abs. 1, 1. Halbsatz HGB (welches gemäß § 169 Abs. 1 Satz 1 HGB nicht für Kommanditisten gilt), noch das Gewinnentnahmerecht gemäß § 122 Abs. 1, 2. Halbsatz HGB führen im gesetzlichen Regelfall per se zu einem individuellen Auszahlungsanspruch der Gesellschafter, entsprechendes gilt für diesbezügliche Regelungen im Gesellschaftsvertrag. In Bezug auf das Kapitalentnahmerecht gemäß § 122 Abs. 1, 1. Halbsatz HGB besteht keine Zahlungsverpflichtung, wenn die Gesellschafterversammlung die Auszahlung durch Beschluss einseitig verhindern kann.**

**Bezüglich des Gewinnentnahmerechts gemäß § 122 Abs. 1, 2. Halbsatz HGB ist zunächst die Fassung des Beschlusses über die Feststellung des Jahresabschlusses erforderlich. Darüber hinaus findet auch eine Gewinnverwendungseinscheidung statt. Zwar ist bei den Personenhandelsgesellschaften gesetzlich kein separater, expliziter Gewinnverwendungsbeschluss vorgesehen, dem steht es jedoch nicht entgegen, dass zeitgleich mit der Feststellung des Jahresabschlusses eine ad-hoc Gewinnthesaurierung beschlossen werden kann.**

**Wird bei der Feststellung des Jahresabschlusses keine Rücklagenzuführung beschlossen, so ist darin implizit (konkludent) eine Bestätigung der vorweggenommenen Gewinnverwendungseinscheidung zu sehen. Demgemäß wird jeweils erst mit dem Beschluss über die Feststellung des Jahresabschlusses und der Entscheidung zur Nicht-Thesaurierung ein individueller Gewinnauszahlungsanspruch entstehen. Der in diesem Falle entstandene Gewinnauszahlungsanspruch ist ab diesem Zeitpunkt als Fremdkapital auszuweisen.**
However, the owner's cash withdrawal right is limited in each case to the period until adoption of the annual financial statements for the following financial year. It expires if no withdrawal has been made, or no corresponding claim has been asserted, by that time. In such cases, amounts for which no claim has been asserted remain as permanent credit balances in the owner's variable capital account in accordance with section 120(2) of the HGB. They are thus subject to the prohibition on withdrawal set out in section 122(2) of the HGB and are consequently classified as equity as from that time.

This prohibition on withdrawal applies to general and limited partners insofar as and to the extent that section 169(1) sentence 2, 2nd half-sentence of the HGB applies to them. If they are not covered by such a prohibition on withdrawal, limited partners can normally withdraw their existing and non-retained profit shares on the basis of adopted annual financial statements at any time without the need for the approval of the other partners. In this case, the amounts not covered by a prohibition on withdrawal are consequently classified as liabilities.

23. However, the owners may depart from confirmation of the anticipated resolution on the appropriation of net profit in each specific instance and resolve to retain profits at the same time as they adopt the annual financial statements. In such cases, the amounts of profit are classified as equity of the partnership within the meaning of IAS 32.

It should be noted in this context that withdrawal rights that can be cancelled by unilateral resolutions by the owners - taken for the purpose of internal decision-making by the company - must be distinguished from individual claims for payment resulting from the company's external contractual obligations. This distinction must also be considered if an owner is a contracting party of the company (for example in the case of shareholder loans).

24. In accordance with the case described in para. 22 (anticipated profit distribution), the right to withdraw personal taxes attributable to an owner that relate to the profit share attributable to that owner for the financial year (tax withdrawal in the case of sufficient accounting profit available in the current financial year to cover the tax withdrawal...
Allerdings beschränkt sich das Entnahmerecht des Gesellschafters je-
weils auf die Zeit bis zur Feststellung des Jahresabschlusses für das
nachfolgende Geschäftsjahr. Es erlischt, wenn die Entnahme bis zu die-
sem Zeitpunkt nicht durchgeführt bzw. geltend gemacht wurde. Die
nicht geltend gemachten Beträge verbleiben in solchen Fällen gemäß
§ 120 Abs. 2 HGB dauerhaft als Guthaben auf dem variablen Kapital-
konto des Gesellschafters. Sie unterliegen damit dem Entnahmeverbot
des § 122 Abs. 2 HGB und sind ab diesem Zeitpunkt als Eigenkapital zu
klassifizieren.

Dieses Entnahmeverbot gilt für persönlich haftende Gesellschafter so-
wie Kommanditisten, sofern und soweit für diese § 169 Abs. 1 Satz 2, 2.
Halbsatz HGB eingreift. Besteht ein solches Entnahmeverbot für sie
nicht, können Kommanditisten aufgrund eines festgestellten Jahresab-
schlüsse für sie bestehende und nicht-thesaurierte Gewinnanteile re-
gelmäßig jederzeit entnehmen, ohne dass es einer Zustimmung der
übrigen Gesellschafter bedarf. In diesen Fällen sind die nicht gesper-
ten Beträge als Fremdkapital auszuweisen.

Die Gesellschafter können jedoch von der Bestätigung der vorwegge-
nommenen Gewinnverwendungseinscheidung in jedem Einzelfall ab-
weichen und im Rahmen der Feststellung des Jahresabschlusses zeit-
gleich eine Gewinnthesaurierung beschließen. In diesen Fällen sind
die Gewinnbeträge im Sinne des IAS 32 als Eigenkapital der Personen-
handelsgesellschaft zu klassifizieren.

In diesem Zusammenhang ist darauf hinzuweisen, dass Entnahme-
rechte, die durch einseitige Beschlüsse der Gesellschafter – die der in-
ternen Willensbildung der Gesellschaft dienen – aufgehoben werden
cönnen, zu unterscheiden sind von individuellen Zahlungsansprü-
chen, die aus vertraglichen Verpflichtungen der Gesellschaft im Au-
ßerverhältnis resultieren. Diese Unterscheidung ist auch dann zu be-
achten, wenn ein Gesellschafter Vertragspartner der Gesellschaft ist
(etwa bei Gesellschafterdarlehen).

Das Recht zur Entnahme der auf den Gesellschafter entfallenden per-
sönlichen Steuern in Bezug auf den ihm zuzurechnenden Gewinnantei-
teil des Geschäftsjahres (Steuerentnahme bei zur Deckung der Steue-
rentnahme ausreichendem handelsrechtlichen Gewinn im aktuellen
Geschäftsjahr) stellt gemäß dem unter Tz. 22 dargestellten Fall (anti-
wal) represents part of the profit entitlement. The guidance in paras. 21, 21a and 23 applies in this respect.

If the articles of association also provide for a tax withdrawal right for years in which there is insufficient accounting profit or even a loss, the withdrawal is normally made in practice by debiting any revenue reserves (for the reversal of which the provisions of the articles of association must be applied in this respect) or an owner’s drawing account. The latter would be the case, for example, in the event of withdrawals that are debited to a tax account to which profits from previous years have been transferred; the withdrawal represents repayment of a shareholder loan in this respect. In the event of a withdrawal that is debited to any revenue reserves, there is no payment obligation if the owners’ meeting can unilaterally prevent the payment by means of a resolution.

25. If amounts must be classified as liabilities because of the capital, profit, or tax withdrawal right – as described above – this does not affect the instrument itself and its classification as equity – there is no breach of the condition in IAS 32.16A (d) in this respect.

**IAS 32.16A (e) – Permitted basis of expected payments**

... The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).


**IAS 32.16A (e) – Zulässige Grundlagen der erwarteten Zahlungen**

3 ... (e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument)."
Issue 9: The expected cash flows attributable to a puttable instrument over its life must be based substantially on the accounting profit or loss or the economic performance of the entity. What does substantially mean in this context?

26. The term substantially is not defined in IAS 32. IAS 39 uses only the term substantially all (eg in the derecognition provisions in IAS 39.20 ff.). Some of the literature quantifies this latter term by assigning it a lower limit of approximately 90%. The requirements for substantially are lower than for substantially all so that, in quantitative terms, substantially falls below the 90% threshold mentioned above. Consequently, it is not necessary for the expected cash flows attributable to the puttable instrument to be based solely on the performance of the entity.

27. Conversely, the condition requires the performance of the entity to be the factor that substantially determines the cash flows, i.e. the factor on which the structure of the cash flows is based. This would suggest that a lower limit of 50% must be clearly exceeded in the factors determining the expected cash flows.

28. The life of the instrument ends when the instrument is put back to the entity. Changes of ownership during the life of the instrument are irrelevant in this respect.

Assessment of contractual repayment or redemption clauses

29. A number of issues must be considered in the case of contractual repayment or redemption clauses in the context of IAS 32 (amended 2008):

- Repayment or redemption clauses can be significant in terms of the conditions set out in both IAS 32.16A (e) and IAS 32.16A (e).

- The condition set out in IAS 32.16A (e) can be met in two ways: the expected cash flows attributable to the puttable instrument can be based substantially on the accounting profit or loss of the entity determined in accordance with IFRSs, or alternatively on the economic performance of the entity (change in the fair value of recognised and unrecognised net assets).
**Fragestellung 9:** Der erwartete Zahlungsstrom eines kündbaren Instruments über dessen Lebenszeit muss substanziel auf dem buchhalterischen oder ökonomischen Unternehmenserfolg basieren. Wie ist der Begriff substanziel in diesem Zusammenhang (substantially) auszulegen?


Umgekehrt stellt die Bedingung darauf ab, dass der Unternehmenserfolg derjenige Faktor ist, der den Zahlungsstrom substanziel bestimmt, d.h. die Struktur des Zahlungsstroms überwiegend prägt. Dies würde dafür sprechen, dass im Sinne einer unteren Grenze ein Anteil von 50% bei der Prägung des erwarteten Zahlungsstromes deutlich überschritten werden muss.


**Würdigung gesellschaftsvertraglicher Abfindungsklauseln**

Bei gesellschaftsvertraglichen Abfindungsklauseln sind im Hinblick auf IAS 32 (amend 2008) mehrere Dimensionen zu betrachten:

- Abfindungsklauseln können sowohl vor dem Hintergrund der Bedingungen in IAS 32.16A (c) als auch IAS 32.16A (e) bedeutsam sein.
- Die Bedingung in IAS 32.16A (e) kann auf zweierlei Arten erfüllt werden: Der erwartete Zahlungsstrom des kündbaren Instruments kann substanziel entweder durch den buchhalterischen Unternehmenserfolg, ermittelt nach IFRS, oder alternativ durch den ökonomischen Unternehmenserfolg geprägt werden.
• Contractual repayment or redemption clauses commonly replace
the settlement in accordance with the statutory principle set out in
section 738 of the Bürgerliches Gesetzbuch (BGB = German Civil Code),
or define in greater detail the computation required by section 738
of the BGB. However, the provisions of section 738 of the BGB can
only be waived to a limited extent. In the case of a commercial part-
nership, care must generally be taken to ensure that, at the time
when a repayment or redemption clause is agreed, any difference
compared with the statutory principle set out in section 738 of the
BGB, i.e. repayment or redemption at the pro rata enterprise value,
may not be so significant that the statutory objective of stipulating
an appropriate settlement if a partner leaves the partnership would
be defeated. If a repayment or redemption amount payable by virtue
of a contractual repayment or redemption clause differs materially
from the pro rata enterprise value, and if the proportion of the two
amounts is inappropriate, the clause must normally be construed
by way of supplementary interpretation of contract or by examina-
tion of the exercise of rights (Auszügungskontrolle) in accordance with
section 242 of the BGB to the effect that the partners leaving the
partnership have a good faith right to an appropriate repayment or
redemption. This applies regardless of whether the partner leaving
the partnership has the claim established and enforced by a court.

Issue 10: Repayment or redemption clauses in the context of IAS 32.16A (c):
does a contractual repayment or redemption clause with a repayment or
redemption amount below the pro rata enterprise value breach the identical
features requirement?

30. Contractual clauses that provide for repayment or redemption below
the pro rata enterprise value do not breach the condition set out in IAS
32.16A (c). However, the puttable financial instruments in the class
that is subordinate to all other classes of instruments must have identical
features in terms of the repayment or redemption clauses.

31. Repayment or redemption arrangements in the sense described above
represent an economic benefit for the partners remaining until liqui-
dation because the difference between the repayment or redemption
amount of the partners leaving the partnership and the pro rata enter-
prise value accrues to them. Conversely, the partner who has left the
• Gesellschaftsvertragliche Abfindungsklauseln ersetzen regelmäßig die Abfindung nach dem gesetzlichen Leitbild des § 738 BGB oder konkretisieren die Berechnung i.S.d. § 738 BGB. Das Abbedingen des § 738 BGB ist indes nur in Grenzen möglich. Generell ist für den Fall einer Personenhandelsgesellschaft zu beachten, dass zum Zeitpunkt der Vereinbarung einer Abfindungsklausel kein so erheblicher Unterschied zu dem gesetzlichen Leitbild des § 738 BGB, einer Abfindung zum anteiligen Unternehmenswert, bestehen darf, dass der gesetzliche Regelungszweck einer angemessenen Abfindung bei Ausscheiden verfehlt würde. Weicht der aufgrund einer gesellschaftsvertraglichen Abfindungsklausel zu zahlende Abfindungsbetrag wesentlich vom anteiligen Unternehmenswert ab und ist das Verhältnis der beiden Beträge unangemessen, so ist im Wege der ergänzenden Vertragsauslegung bzw. der Ausübungskontrolle gemäß § 242 BGB die Klausel regelmäßig dahingehend auszulegen, dass den ausscheidenden Gesellschaftern eine nach Treu und Glauben angemessene Abfindung geschuldet wird. Dies gilt unabhängig davon, ob der ausscheidende Gesellschafter den Anspruch gerichtlich feststellen lässt und durchsetzt.

Fragestellung 10: Abfindungsklauseln vor dem Hintergrund von IAS 32.16A (c); Verletzt eine gesellschaftsvertragliche Abfindungsklausel mit einem unter dem anteiligen Unternehmenswert liegenden Abfindungsbetrag die Gleichartigkeit?

Gesellschaftsvertragliche Klauseln, die auf eine Abfindung unterhalb des anteiligen Unternehmenswertes gerichtet sind, stellen keine Verletzung des IAS 32.16A (c) dar. Die kündbaren Finanzinstrumente der letztrangigen Klasse müssen hinsichtlich der Abfindungsklauseln allerdings gleich ausgestattet sein.

Abfindungsregelungen in dem obigen Sinne stellen für die bis zur Liquidation verbleibenden Gesellschafter einen Vermögensvorteil dar, da die Differenz zwischen dem Abfindungsbetrag der ausgeschiedenen Gesellschafter und den anteiligen Unternehmenswerten ihnen zuzüglich. Umgekehrt erleidet der vorher durch Kündigung Ausschied-
partnership earlier suffers an economic loss. However, this unequal treatment also does not breach the condition in question because ante all partners have the same rights in liquidation or if they leave the partnership prior to liquidation. During the course of the required comprehensive balancing of interests (para. 29); however, factors attributable to the partner who is leaving the partnership must be taken into consideration. Nevertheless, because the methodology used for the balancing of interests and the weighting to be attached to the individual factors is the same for all partners, the condition set out in IAS 32.16A (c) is not breached.

**Issue 11:** Repayment or redemption clauses in the context of IAS 32.16A (e): what clauses are conceivable in cases where the cash flows are based on accounting profit or loss?

32. A repayment or redemption that is contractually agreed for a partner leaving a commercial partnership and that is calculated on the basis of the carrying amount of the net assets in accordance with IFRSs meets the condition set out in IAS 32.16A (e).

**Issue 12:** Is the accounting profit or loss based on the separate or consolidated IFRS financial statements?

33. Accounting profit or loss is based on the financial statements to which the contractual repayment or redemption clause refers. See para. 35 ff. for cases where a repayment or redemption clause refers to German CAAP amounts.

**Issue 13:** Repayment or redemption clauses in the context of IAS 32.16A (e): what clauses are conceivable in cases where the cash flows are based on economic performance (change in the fair value of recognised and unrecognised net assets)?

34. A repayment or redemption in accordance with the statutory principle set out in section 738 of the BGB or a contractually agreed repayment or redemption for a partner leaving a commercial partnership at the pro rata enterprise value meets the condition set out in IAS 32.16A (e).
dende einen Vermögensnachteil. Auch diese Ungleichbehandlung verletzt die genannte Bedingung jedoch nicht, weil ex ante alle Gesellschafter die gleichen Rechte in einer Liquidation bzw. bei einer vorzeitigen Kündigung haben. Im Rahmen der vorzunehmenden umfassenden Interessenabwägung (vgl. Tz. 29) finden jedoch auch in der Person des ausscheidenden Gesellschafters liegende Faktoren Berücksichtigung. Da sich die Methodik der Interessenabwägung und das Gewicht, welches dabei den einzelnen Faktoren beizumessen ist, für alle Gesellschafter gleich darstellen, ist die Bedingung in IAS 32.16A (e) dennoch nicht verletzt.

**Fragestellung 11:** Abfindungsklauseln vor Hintergrund von IAS 32.16A (e): Welche Klauseln sind bei einer Prüfung durch den buchhalterischen Unternehmenserfolg denkbar?

Eine gesellschaftsvertraglich vereinbarte Abfindung des ausscheidenden Gesellschafters einer Personenhandelsgesellschaft zum Buchwert des Nettovermögens ermittelt nach IFRS erfüllt die Bedingung in IAS 32.16A (e).

**Fragestellung 12:** Ist für den buchhalterischen Unternehmenserfolg auf den IFRS-Einzel- oder Konzernabschluss abzustellen?

Es ist der Abschluss zugrunde zu legen, auf den sich die gesellschaftsvertragliche Abfindungsklausel bezieht. Für den Fall einer Abfindungsklausel mit Bezugnahme auf HGB-Größen vgl. Tz. 35 ff.

**Fragestellung 13:** Abfindungsklauseln vor Hintergrund von IAS 32.16A (e): Welche Klauseln sind bei einer Prüfung durch den ökonomischen Unternehmenserfolg denkbar?

Eine Abfindung gem. des gesetzlichen Leitbildes des § 738 BGB oder eine gesellschaftsvertraglich vereinbarte Abfindung des ausscheidenden Gesellschafters einer Personenhandelsgesellschaft zum anteiligen Unternehmenswert erfüllen die Bedingung des IAS 32.16A (e).
35. In the case of a contractually agreed repayment or redemption for a partner leaving a commercial partnership that is calculated on the basis of the carrying amount of the net assets in accordance with German GAAP, the question of whether the expected cash flows attributable to the putable instrument over the life of the instrument are based substantially on economic performance (change in the fair value of recognised and unrecognised net assets) must be examined.

36. It should be noted that the expected cash flows (in the event that the partner gives notice of leaving the partnership) are based on both participation in the current profit or loss (as well as any capital redemptions) and the repayment or redemption when the partner leaves the partnership.

37. Determining the current profit or loss in which the partner participates in accordance with German GAAP, rather than IFRSs, does not present a problem. Interim distributions, regardless of their amount and the accounting standards used to measure them, reduce the enterprise value by the corresponding amount, so the combination of the current distributions and the pro rata enterprise value by definition exactly equals the economic performance.

38. As a rule, it can be assumed that, together with the current distributions, a repayment or redemption calculated on the basis of the carrying amount under German GAAP, taking into consideration any adjustment (see para. 29), means that the total expected cash flows attributable to the instrument over its life are based on economic performance, thus meeting the condition set out in IAS 32.16A(e) (change in the fair value of the recognised and unrecognised net assets of the entity).
Bei einer gesellschaftsvertraglich vereinbarten Abfindung des ausscheidenden Gesellschafters einer Personenhandelsgesellschaft zum handelsrechtlichen Buchwert des Nettovermögens ist zu prüfen, ob der erwartete Zahlungstrom des kündbaren Instruments über die Laufzeit des kündbaren Instrumentes substantiell auf dem ökonomischen Unternehmenserfolg basiert.

Zu beachten ist, dass der erwartete Zahlungstrom (für den Fall der Kündigung) sowohl durch die Partizipation an den laufenden Ergebnissen (sowie etwaigen Kapitalrückzahlungen) als auch durch die Abfindung bei Ausscheiden geprägt wird.

Sofern die laufenden Ergebnisse, an denen der Gesellschafter partizipiert, nach den handelsrechtlichen Normen ermittelt werden und nicht nach IFRS, ist dies unproblematisch. Zwischenzeitliche Ausschüttungen, unabhängig in welcher Höhe und nach welchen Rechnungslegungsnormen sie bemessen werden, mindern in entsprechender Höhe den Unternehmenswert, so dass die Kombination aus den laufenden Ausschüttungen und dem anteiligen Unternehmenswert per Definition exakt der ökonomischen Performance entspricht.

In der Regel dürfte davon auszugehen sein, dass auch eine Abfindung zum handelsrechtlichen Buchwert unter Beachtung einer etwaigen Anpassung (vgl. Tz. 29) in Verbindung mit den laufenden Ausschüttungen eine Prämie der dem Instrument während seiner Lebenszeit zuzuordnenden und insgesamt zu erwarteten Zahlungsströme durch die ökonomische Performance ergibt, so dass dann IAS 32.16A (e) (change in the fair value of the recognised and unrecognised net assets of the entitys) erfüllt ist.
Loans granted to the entity by the owners

**Issue 14:** What is the effect of loans granted to the entity by the owners on the classification of the capital contributions of the owners as equity?

39. Loans granted to an entity by an owner are financial instruments that must be considered separately. The owner can also enter into other contractual arrangements with the entity over and above its role as an owner. These include contractual loan arrangements. The grant of a loan does not generally affect the classification of an owner's capital contributions as equity or financial liabilities. However, there are potential scenarios that may affect the classification of capital contributions. For example:

- the owner may subordinate its claims under the loan it has granted by means of a qualified declaration of subordination such that it is only entitled to payment in the event of the entity's liquidation after all other legitimate claimants have been satisfied and only together with the parties entitled to benefit from final distribution within the meaning of section 199 of the Insolvenzordnung (InsO - German Insolvency Code). In this case, the loan would also have to be allocated to the class of instruments that is subordinate to all other classes; however, the conditions set out in IAS 32.16A (c) regarding the classification of puttable financial instruments (capital contributions of the owners) as equity would then be breached;
- the loan agreement does not feature arm's length terms and conditions (eg interest and/or repayment of principal), thus breaching the conditions set out in IAS 32.14I;
- the interest payable on the loan may have the effect of fixing or restricting the expected cash flows attributable to the puttable instruments (capital contributions of the owners) within the meaning of IAS 32.16A (e), and the loan is a tainted contract within the meaning of IAS 32.16B.
Darlehen, die der Gesellschaft durch die Gesellschafter gewährt werden

**Fragestellung 14:** Wie wirken sich Darlehen, die der Gesellschaft durch die Gesellschafter gewährt werden, auf die Klassifizierung der Einlagen der Gesellschafter als Eigenkapital aus?


- der Gesellschafter mit seinen Forderungen im Zusammenhang mit der Darlehensgewährung durch qualifizierten Rangrücktritt im Rang so zurücktreten, dass er im Liquidationsfall erst Befriedigung nach sämtlichen anderen Anspruchsberechtigten und nur zusammen mit den i.S.v. § 199 InsO bei der Schlussverteilung Berechtigten verlangen kann. In diesem Fall wäre das Darlehen ebenfalls der letztrangigen Klasse zuzuordnen; die Bedingungen in IAS 32.16A (c) hinsichtlich einer Eigenkapitalklassifizierung der kündbaren Finanzinstrumente (Einlagen der Gesellschafter) wäre dann aber verletzt;

- die Darlehensvereinbarung marktüblich sein (z.B. Verzinsung und/oder Tilgung) und damit die Bedingungen in IAS 32.6C14f (equivalent transaction) verletzen;

- die Verzinsung des Darlehens dazu führen, dass im Ergebnis der erwartete Zahlungstrom der kündbaren Instrumente (Einlagen der Gesellschafter) i.S.v. IAS 32.16A (e) fixiert oder begrenzt wird und das Darlehen einen »schädlichen Vertrag« i.S.v. IAS 32.16B darstellt.
For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):

(a) summary quantitative data about the amount classified as equity;

(b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;

(c) the expected cash outflow on redemption or repurchase of that class of financial instruments; and

(d) information about how the expected cash outflow on redemption or repurchase was determined.

Issue 15: What are the specific disclosures required to satisfy the disclosure obligations under IAS 1.136A (c) and (d)?

40. In accordance with IAS 1.136A (c), the expected cash outflow that may result from the owner's statutory right of redemption or repurchase shall be disclosed. The objective of the disclosure is to allow an assessment of any effect on the entity's liquidity (IAS 1.1C1008). The quantitative disclosure is thus dependent on the entity's expectation of whether there will be cash outflows in the foreseeable future, whereby the frequency and extent of such cash outflows in the past must also be considered. If cash outflows are therefore expected in the foreseeable future, these amounts shall be disclosed. By contrast, if there is no expectation, including on the basis of past experience, that an owner will require the entity to redeem or repurchase the instruments in the foreseeable future, this expectation must be disclosed. Only in this case is there no requirement to present the other components of the quantitative disclosure.

41. IAS 1.136A (d) additionally requires disclosure of the methods and underlying assumptions applied to determine the amount of the redemption or repurchase. This requirement does not expressly stipulate
IAS 1.136A – Anhangangaben

»For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):
(a) summary quantitative data about the amount classified as equity;
(b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;
(c) the expected cash outflow on redemption or repurchase of that class of financial instruments; and
(d) information about how the expected cash outflow on redemption or repurchase was determined.«

Fragestellung 15: Welche konkreten Angaben sind notwendig, um der Angabepflicht hinsichtlich IAS 1.136A (c) und (d) zu genügen?


Gemäß IAS 1.136A (d) wird darüber hinaus eine Angabe zu der Art und Weise und der zugrunde liegenden Annahmen der Bestimmung des Abfindungsbetrags verlangt. Diese Vorschrift stellt keine expliziten An-
the methodology to be used for determination and computation, but requires selection of an appropriate methodology that reflects past experience and the expected cash outflows. The reporting entity thus has a relatively far-reaching scope in its choice of methodology, and there is no requirement for a full enterprise valuation. Given this situation, approximations and standard sector-specific simplification methods are also acceptable for determining the amount to be disclosed in accordance with IAS 1.136A (c).

Effective date

42. The provisions of this Interpretation shall be taken into consideration in the preparation of financial statements in accordance with sections 315a and 325(2a) of the HGB when applying IAS 32 (amended 2008).
forderungen an das zu verwendende Ermittlungs- bzw. Kalkulationsverfahren, sondern verlangt eine sachgerechte Auswahl unter Berücksichtigung der Historie und der zu erwartenden Zahlungsabläufe. Den berichterstattenden Unternehmen wird somit eine vergleichsweise weitgehende Methodenfreiheit eingeräumt, eine vollständige Unternehmensbewertung wird nicht verlangt. Vor diesem Hintergrund sind auch überschlägige sowie branchenspezifisch übliche Vereinfachungsverfahren zur Bestimmung des anzugebenden Wertes nach IAS 1.136A (c) zu akzeptieren.

Inkrafttreten

Die Regelungen dieser Interpretation sind bei der Anwendung des IAS 32 (amend 2008) bei der Aufstellung von Abschlüssen nach den §§315a, 325 Abs. 2a HGB zu berücksichtigen.
Subject: Comments on the Public Discussion Draft on BEPS Action 4 (Interest Deductions and Other Financial Payments)

Dear Dr. Pross,

The Institute for Austrian and International Tax Law is grateful for the opportunity to provide comments on the Public Discussion Draft on BEPS Action 4 (Interest Deductions and Other Financial Payments) (hereinafter “Discussion Draft”), issued on 18 December 2014.

As a general premise, the Institute for Austrian and International Tax Law is pleased that the OECD Committee on Fiscal Affairs has included a specific action point in the BEPS Action plan specifically dedicated to work related on interest deductions and other financial payments. These issues, as properly stated in the Discussion Draft, are of great concern for all current stakeholders in the international tax environment.

Additionally, the Institute for Austrian and International Tax Law welcomes the comprehensive approach developed by the OECD in order to identify solutions to these issues, combining practical experience in many countries with academic studies.

The comments presented below will not provide specific answers to all questions raised in the Discussion Draft, but rather briefly highlight some high level considerations on the approaches proposed in the document.

General Comments on the Proposed Approaches

The three main approaches proposed in the Discussion Draft in order to address issues of BEPS via interest (and other financial payments) deductions (i.e. limitation of interest deduction with reference to the position of an entity’s group, limitation of interest deduction with reference to a fixed ratio, and a combination of the two approaches) identify solutions characterized by a great amount of potential benefits. As highlighted throughout the entire Discussion Draft, these approaches would be able, on the one hand, to tackle BEPS using interest deductions and, on the other, to provide a set of rules characterized by a high degree of certainty. Additionally, many other relevant advantages would be generated by the adoption of the proposed approaches.

Therefore, generally speaking, the Institute for Austrian and International Tax Law positively welcomes the approaches suggested in the Discussion Draft. We also welcome that the re-characterisation of disallowed interest payments as dividends should not be included in a “best practice” approach.
However, it might be worth taking into account the considerations highlighted in the following sections of this document which aim for a degree of evaluation of the various proposed approaches.

**Possible Considerations to be taken into Account when Implementing the Proposed Approaches**

One of the main areas of concern that could possibly arise from the implementation of the suggested approaches (apart from all the aspects already highlighted in the Discussion Draft) is the compatibility of these rules with other domestic and international rules and principles.

On the domestic level, the suggested approaches, when implemented, should be carefully coordinated with any relevant national transfer pricing rule, in order to avoid conflicts deriving from the application of two sets of rules to the same transactions. In other words, since the deductibility of interest expenses might be limited, at the same time, by both the suggested rules and the local transfer pricing rules, it is recommended an appropriate evolution of the local rules or at least a robust mechanism in order to coordinate the two sets of rules.

On an international level, the suggested approaches should be coordinated with international tax agreements, mainly with any relevant double tax treaty, and with EU law. For example, the proposed rules should be in line with existing double tax treaties, with reference to the two most adopted models (i.e. the OECD Model Convention and the UN Model Convention). To this end, the following possible areas of conflict (already highlighted by the OECD Council in the 1986 OECD Report on Thin Capitalisation\(^1\)) should be carefully analysed:

- The compatibility of these rules with article 9 OECD Model Convention and the arm’s length principle: while it is understood that such application is resource intensive and time consuming it ensures the focus on a genuine commercial behavior;
- The impact of these rules on articles 10 and 11 OECD Model Convention;
- The impact of these rules on article 23 OECD Model Convention;
- The relationship of these rules with article 24 OECD Model Convention; and
- The application of these rules to article 25 OECD Model Convention.

Finally, as also highlighted in the Discussion Draft, careful consideration should be paid, as well, to any possible conflict with the existing EU law (i.e. EU treaty freedoms, EU directives, and EU State aid).\(^2\)

**Possible Solutions to the Abovementioned Issues**

In order to avoid (or minimize) the above-mentioned areas of concern of the proposed approaches, the introduction, in the final rules, of an appropriate reference to the arm’s length principle might be considered. Any reference to this principle might generate, indeed, the following benefits to the system:


• No disincentive to foreign direct investments: reference to the arm’s length principle would better reflect the economic reality and reasoning of the specific situation;

• Prevention of phenomena of tax avoidance and/or aggressive tax planning: the arm’s length principle would be flexible enough to capture any BEPS structure;

• Fair and balanced allocation of taxing powers between different states: the arm’s length principle would allocate the taxable base between different states in a fairer way;

• Avoidance of double taxation and of less-than-single taxation: the arm’s length principle, implemented in the existing double tax treaties, would allow avoiding phenomena of double taxation or of less-than-single taxation;

• Allowance of a coordinated approach: an internationally coordinated approach might be more easily reached, since, as mentioned in the previous point, the arm’s length principle has already been internationally agreed and implemented in the existing double tax treaties;

• Stability and certainty of law: when applied correctly and without any distortion, the arm’s length principle has the potential of providing stability and certainty of the law;

• Compatibility with tax treaties: the adoption of the arm’s length principle would be compatible with the points listed in the previous section;

• Compatibility with EU law: the adoption of the arm’s length principle would be in line with the principles set by the jurisprudence of the EUCJ;

• Enforceability: rules based on the arm’s length principle would be in most cases easily enforceable, since the principle has already been embedded in many countries’ legislations;

• Avoidance of conflicts between different kinds of rules: any reference to the arm’s length principle would avoid conflicts, for example, with national transfer pricing rules based on this principle.

An option for such an arm’s length related approach could be using the second approach (i.e. limitation of interest deduction with reference to a fixed ratio) and the fixed ratio test within that approach as a safe harbor. In case the interest deduction on a group entity would be above the limits of the local rule, the option to apply a group ratio test or alternatively a “benchmarking” with a genuine commercial behavior under article 9 would be possible. This, however, would require that the local fixed ratio rule would not be set “slightly” higher than in the first approach (i.e. limitation of interest deduction with reference to the position of an entity’s group), but in a more balanced way. The current German fixed ratio rule or the two-step approach in the US rules appears to be a basis for such a “best practice” rule. In this way, MNEs working for various reasons with rather low debt at group level would not be penalized with regard to their intra-group financing.

The targeted rules in addition to the “general rule”, as described above, should focus on clearly defined situations, e.g. debt related to tax exempt or tax deferred income, but otherwise approached with the other BEPS Actions.

One of the main concerns generated by the reference to the arm’s length principle (in
addition to the compliance issues referred in the Discussion Draft) is that it would potentially lead to distortions and manipulations of the principle itself, by both taxpayers and tax administrations. However, these distortions and manipulations might be minimized by a more detailed guidance on the application of this principle, possibly developed in the second part of the BEPS Action 4.

Conclusive Remarks

In conclusion, the Institute for Austrian and International Tax Law generally welcomes the approaches suggested in the Discussion Draft in order to limit phenomena of BEPS via interest (and other financial payments) deductions.

However, some areas of concern should be taken into account when implementing one or a combination of the suggested approaches. Specifically, among the questions already identified and analyzed in the Discussion Draft, the compatibility of the proposed rules with existing international rules and principles should be carefully reviewed. The same applies for domestic rules which, in the context of the proposed solutions, should be required to move more towards a broadly accepted “best practice”.

Many areas of concern might be mitigated by including in the proposed approaches an additional reference to the arm’s length principle.

This could be done by, for example, inserting a further approach in the Discussion Draft, whereby suggesting the solution of the analyzed issues by reference to the arm’s length principle.

Alternatively, an “escape clause” from the ultimately suggested rule(s) might be included, in order to allow interest payments above the limits of the applied limitation approach, but in line with the arm’s length principle, to be still deductible.

Faithfully yours,

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BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

ICAEW welcomes the opportunity to comment on the discussion draft BEPS Action 4: Interest Deduction and other financial payments published by OECD on 18 December 2014.

This response of 6 February 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.
ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW’s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
General comments

1. We note that the current paper does not represent the definitive views of OECD but is intended “to provide stakeholders with substantive options for analysis and comment.”

2. We are concerned that Section III, which examines existing approaches to tackle BEPS arising from interest expense, rejects the arm’s length approach (paragraph 21 et seq).

3. We do not see why if a company can demonstrate that the amount it is borrowing, and the terms of that borrowing, is the equivalent of what it could have borrowed from a bank or other third party lender that there should be any restriction of the interest deductibility merely because the borrowing is from a related party. In such circumstances this surely cannot be an excessive interest deduction which is the stated target of Action 4.

4. Having decided against an arm’s length approach the paper then goes on to recommend a group wide interest limitation rule.

5. We are concerned that such a rule would exacerbate the risks of double taxation and would often result in a group not being able to deduct all of its external net interest costs. We are aware of examples that have been put to OECD which provide evidence of this problem. For instance if a subsidiary has borrowed money from a bank and is a member of a group in which other companies are also borrowing funds then it will obtain relief for any interest cost. If that subsidiary is sold to a group which has money invested with banks then there is no, net, external, borrowing the same external bank interest paid by that subsidiary will be disallowed under the current OECD proposals.

6. If a group wide test is to be part of the OECD recommendations of best practice under Action 4 then we believe it should be an anti-abuse rule rather than a general allocation rule.

7. We would also favour a fixed ratio rule and that there should be flexibility to allow OECD members to fix the rate which is appropriate for their particular tax system.

8. We have not responded to the detailed questions in the discussion draft but we do feel, in relation to question 4, that the 25% test in section V to determine whether a significant shareholder or significant relationship exists is too low and, depending on the other shareholdings, will often not represent anything like a control situation. We suggest that a greater than 50% rule would be more appropriate.

9. Also, in relation to question 5, we believe that a rule applying to net interest expenses is more appropriate than one applying to gross interest.

EU Law Issues

10. Annex 2 deals with EU law issues and it is clearly important that any OECD recommendation can be implemented, without breach of EU Treaty rules, by those EU member states which represent a significant number of those countries involved in the G20/EU BEPS project.

11. In order for the group wide test, or the fixed ratio approach, to be compatible with the EU treaty rules we believe there needs to be the ability of the taxpayer in an EU member country to demonstrate, by reference to their particular facts, that what would otherwise be a level of debt above the OECD prescribed levels can be commercially justified. In addition to the cases cited in Annex 2 we believe that the CJEU case Test Claimants in the Thin Cap Group Litigation case (C-347/04) supports this conclusion.
APPENDIX 1

ICAEW TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

Insurance Company Working Group on BEPS
Outline of Comments on Action 4 Discussion Draft (Deductibility of Interest)

Introduction and summary of recommendations

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS),¹ a group of global insurance and reinsurance companies², in response to the public Discussion Draft released on 18 December 2014 by the OECD entitled “BEPS Action 4: Interest Deductions and other Financial Payments.”

The Discussion Draft proposes best practices and options to address BEPS that results from using deductible payments such as interest. In this context, the Draft acknowledges the unique role that debt and interest expense play in the operation of insurance and reinsurance companies, as well as the strict regulations that are imposed on the industry’s capital structure, including debt.

Our comments can be summarized as follows:

- The Working Group very much appreciates and agrees with the OECD’s stated view in the Discussion Draft that, as recognized in paragraphs 204 to 208, the business of insurance and reinsurance has characteristics relating to interest income and interest expense that are unique, and that the capital structure and use of debt is subject to strict regulation.
- We agree with the OECD’s view that any limitation on the deductibility of interest expense should apply to net rather than gross interest expense. However, the operation of both a group wide allocation approach and a fixed ratio approach, as presented in the Draft, could still have negative implications for the industry. Both approaches as drafted would be difficult to apply due to regulatory, accounting, and other issues and could have distortive effects on the industry. Of the two approaches, a fixed ratio

¹ The members of the Working Group are AIA Group Limited; American International Group, Inc.; MetLife, Inc.; Prudential Financial Inc.; Prudential plc; Swiss Reinsurance Company Limited, and XL Group plc
approach may be a somewhat more viable option for the industry, if it is constructed in a manner that does not create such distortions.

- The Draft, in discussing considerations for groups in specific sectors, contemplates an option aimed at regulated banks and insurance companies and net interest expense attributable to regulatory capital instruments, suggesting these instruments may raise BEPS concerns. A measure that imposes a debt cap or requires allocation of interest relating to regulatory capital could result in a misalignment between regulatory and tax positions that would interfere with an insurance group’s commercial position.

- The Draft also suggests another less specific option if the approach relating to regulatory capital is found not to be necessary or viable focusing on targeted rules to address risks posed by specific transactions. To the extent that any BEPS concerns are identified in the context of an insurance business, targeted rules would be the right approach to address those concerns.

- The Discussion Draft on BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements, adequately addresses potential BEPS issues with respect to hybrid debt instruments, and includes proposals for implementing hybrid mismatch rules in countries’ domestic tax law. This work should prevent any use of regulatory debt instruments by insurers to obtain inappropriate tax results. We note also that disallowance of treaty benefits in some cases as a result of Action 6 (Treaty Abuse) could result in withholding on interest, which would also discourage the use of interest to achieve BEPS results.

**Role of debt in an insurance business**

By way of background, and as correctly noted in the Draft, insurance operating companies are generally net lenders as they are required to match investment assets to policyholder liabilities. For this reason, insurance companies are among the world’s largest institutional investors in debt, mainly in the form of high quality government and corporate bonds. Regulators supervise and restrict the type, duration and stability of assets, including debt assets, held by insurance companies in order to ensure that the duration and quality of the debt effectively and safely matches potential customer claims, and that these claims can be paid within a time period reflective of the liability to the policyholder.
Overall, the forms of capital across the group are strictly regulated and the regulators are looking to ensure that the obligations to policyholders come first. Both investment capital and working capital are subject to regulatory restriction in form and amount, with the focus being on the insurer’s ability to meet policyholder liabilities. The ability to overcapitalize is therefore restricted by these regulatory requirements.

However, insurance groups may be net borrowers “at the top of the house” as insurers also must seek capital from investors, sometimes in the form of debt and sometimes as equity, often through a holding company which may be required for regulatory or ratings agency purposes. Therefore, at the top company level, the group needs to access the debt capital markets. Debt capital is primarily issued because the cost of such capital is significantly less than the cost of equity, approximately 4% post-tax compared to approximately 10%, varying by company. However, insurance entities are restricted in the issuance of their own core capital, with the majority of it required to be held in the form of equity that is loss absorbing.

Under European and equivalent regulatory law, Tier 2 capital (capital issued in the form of subordinated debt instruments) cannot exceed Tier 1 capital (effectively share capital and retained reserves); otherwise, it is reclassified as an ordinary liability. While some Tier 2 capital in the form of debt is permitted, it is limited. In practice, this means Tier 2 capital is maintained at a level significantly below Tier 1 capital, as any large insurance or investment loss immediately impairs Tier 1 capital. If Tier 1 and Tier 2 capital were at the same level, this would then have the double effect of converting Tier 2 capital, no longer matched by Tier 1 capital, into an ordinary liability against which the insurer would need to hold capital. The riskier the underlying insurance business, the greater this margin needs to be.

In the case of Working Group members, which are global insurance and reinsurance companies, regulators both in the home country and in the local jurisdictions in which operating companies are located impose these restrictions, both at the entity and the regulatory subgroup level.

It is also worth noting that the regulation of insurance groups around the world is still evolving. While there is some convergence between the regulatory capital structures being implemented by European regulators, U.S. regulators, and regulators in jurisdictions wishing to implement Solvency II equivalent regimes such as Australia, Bermuda, Hong Kong, Mexico, Singapore, South
Africa, and Switzerland, U.S.-based insurance groups are regulated by individual states with an overlay of Federal regulation depending on the size and significance of the group. Therefore it is impossible to develop a one-size-fits-all rule relating to the tax treatment of regulatory capital that would not be tremendously distorting and at odds with one set of regulatory requirements or another. Under European Directives (Solvency I and Solvency II), insurance groups are subject to regulation regarding capital adequacy on a group basis, and a similar approach is increasingly being imposed by other regimes around the world. Insurance groups classified as Globally Significant Systemically Important Financial Institutions (G-SIFIs) are subject to an even higher level of supervision by the regulators.

Note further that not all regulatory rules are consistent within the European Union. The implementation of EU Directives is by way of domestic legislation and the legal restrictions on qualifying Tier 2 debt vary from territory to territory. For example, the UK and Luxembourg have different rules, with Luxembourg permitting a smaller amount of capital to qualify as Tier 2 debt under Solvency II.

In the context of EU regulation, the top EU company is subject to regulation by reference to the capital and solvency position of the whole group/sub-group below it (i.e., the top EU company), in addition to the regulation applied to the individual insurance companies. Importantly, in the context of this “group” regulation, which company – top company or insurance subsidiary – issues the debt is not relevant to the regulator, but the existence of the debt that is treated as regulatory capital within the regulated “group” is important.

In summary, insurers are among the world’s largest investors and investment income is typically treated as business or trading income under existing insurance tax principles in most countries. Due to strict regulation and rating agency requirements, insurers typically have very low gearing ratios and therefore generally comply with existing thin capitalization principles under the arm’s length standard.

**Exclusion of some types of interest expense from rules designed to prevent BEPS**

Paragraphs 32 through 36 of the Draft seek to define "interest" broadly so as to prevent the use of interest and other similar financial payments to achieve
BEPS results. However, the OECD should strongly consider excluding from the anti-BEPS rules certain types of interest or similar financial payments that do not present a realistic risk of BEPS.

Customer-based interest payments generally should be excluded because they do not create opportunities for abuse. For the insurance industry, customer-based interest includes interest on claim payments, pension obligations, and other deposit-type contracts issued by insurance companies. So long as there is an adequate economic nexus between the interest paid and the customer obligations, no base erosion rule should apply to this type of interest.

Risk-management interest is similar to customer-based interest and should be subject to the same general considerations. It includes payments relating to transactions designed to manage risk, such as interest, or interest equivalents, paid by an insurance company with respect to reinsurance, securitisations, or hedging. These types of interest payments are made in the ordinary course of an insurance company’s business and therefore should not be covered by base erosion rules if a requisite economic nexus is present between the payer of the interest and the risk being managed.

Application of group allocation rules or fixed ratio rules to insurance companies

The Discussion Draft presents three general options for limiting the deductibility of interest expense at the group or entity level to the extent the group or entity is deemed to exceed an interest cap. The approaches contemplate:

- A “fixed ratio” rule, which would limit the interest expense deduction of an entity by reference to a fixed ratio, such as net interest expense to EBITDA. An entity’s net interest expense that exceeds the permitted ratio would be disallowed.
- A group-wide interest allocation rule, which would allocate a cap based on the worldwide group’s net third party interest expense among group entities based on some measure of an entity’s economic activity – either earnings or asset values. An entity’s net interest expense up to the allocated cap would be deductible.
- A combination of the two approaches, in which one approach would take the form of a general rule and the other approach would provide an exception to the general rule. An example is the current German
approach, which provides for a fixed-ratio test, but makes that test inapplicable if the leverage ratio of the entity compared to that of the entire group is in proportion.

Paragraph 205 of the Draft states: “…taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore a rule which caps net interest expense will have no direct impact on a bank or insurance company, although such a rule could disallow net interest expense in other group entities.”

Due to the mechanics of the Draft’s options, the Working Group questions whether the assertion that a net interest rule “will have no direct impact on a bank or insurance company” is accurate. In developing a net interest limitation, it is important that netting of interest income and expense be accomplished in a manner that accurately captures net interest expense. The Working Group believes that the mechanics of both the fixed ratio and group-wide allocation options in the draft should be examined more closely to ensure actual net interest is captured appropriately. Therefore, attention must be paid to design issues that will help ensure that unintended consequences do not occur.

A key issue in applying these approaches is the Draft’s focus on application of the options to “entities.” Because any BEPS concerns are jurisdictionally focused, we believe any rule should apply to combine all entities in a jurisdiction, i.e., a net interest limitation rule should use the combined total amount of interest expense and interest income of all entities within a jurisdiction. It is also important that branches be treated in accordance with the principles of Part IV of the OECD’s 2010 Report on the Attribution of Profits to a Permanent Establishment.

A key structural issue for insurance groups, mainly driven by regulatory requirements, is that insurance groups maintain holding companies that issue debt instruments to the public. These non-operating companies could be in a net interest expense position because they have little interest income; in fact, their income may mainly be in the form of related party dividends. Unless net interest is calculated on a jurisdictional basis, the Draft’s claim may be correct that the regulated operating insurance entities in an insurance group, because they have little or no debt, would be largely immune from an interest expense deduction cap, but the holding company would be subject to limitation. This result seem inappropriate and may be unintended. We cannot emphasize enough that the holding company is a necessary part of the structure of the
insurance group, and regulators and rating agencies are as focused on the level of capitalization and the functionality of the holding company as they are on the operating entities.

We have particular concerns with a group-wide allocation rule, mainly due to the practical difficulties with implementing such a rule, many of which are mentioned in the Draft. For example, under existing tax laws, some countries do not allow a deduction for certain interest expenses of insurance companies that may be allowed in other countries, making it difficult to apply an allocation rule consistently to a global group. Furthermore, given the strict regulatory requirements in respect to an insurer’s debt, this approach could result in a mismatch between tax and regulatory bases.

For the insurance industry, we also question the practicality of calculating group-wide ratios relative to a universal measure of assets or earnings when accounting standards in various regions for the industry remain in flux. The Draft acknowledges the differences, for example, between IFRS and US GAAP, but these differences would be particularly pronounced if a global insurance company were to attempt to apply a group-wide allocation approach. There simply is no common standard to measure assets or earnings for insurance companies. It is important to understand that the current IFRS 4 accounting standard is only a temporary standard allowing the use of the former local accounting standard for insurance business and no global IFRS 4 accounting standard has yet been agreed. This is also true for life insurance businesses, where embedded value (i.e. the actuarial computation of the projected future cash flows of insurance policies already underwritten) is frequently seen by third-party lenders and acts as a further restriction on the amount of loan financing available. Ordinarily, these figures are published by life insurers, but are often not reflected in individual entity accounts except where the business has been acquired from a third party.

If insurers are to be subject to a group allocation method, the preference would be for an asset-based allocation rather than an earnings-based allocation. This is due to the fact that insurers can have large volatility in profits and losses due to the underlying insured risks, which can mean that any earnings allocation approach can generate interest allocations that bear, for a single accounting period, no genuine resemblance to what third party interest costs would be on a stand-alone basis. Even if an asset allocation approach is utilized, however, it would still be subject to the accounting issues noted above.
Furthermore, as discussed in connection with Action 2 on hybrid mismatch arrangements, there is currently inconsistency regarding deductibility of certain types of instruments in different countries, which again could result in mismatches, in particular between tax and regulatory bases. The impracticality of this approach for the insurance industry was recognized when debt cap rules were introduced in the United Kingdom in 2009-2012 and the insurance industry was eventually carved out of the UK rules.

**Comments on the Examples**

We consider that Example 7 illustrates the problems of the intended approach. In the example, A Co has surplus funds that it lends intra-group. Ordinarily, groups will seek to maintain pools of surplus funds to protect against contingencies known and unknown and often to collect such funds in a single entity, e.g., those where the people functions for treasury activities are maintained, and hence the location where such treasury related risks are managed.

For insurers, this includes having funds that can be used at relatively short notice to make capital injections into subsidiaries in the case of a large insurance loss into a subsidiary, and rating agencies effectively credit insurers for having such funds. Lending these funds intra-group, to where they can be best used, is most cost effective, as it prevents a subsidiary (B Co) obtaining a third party bank borrowing, and A Co placing money on deposit with a bank, i.e., the margin made by banks on borrowing and lending transactions is retained, and taxable, within the group illustrated. The table at paragraph 256 shows that the outcome of this prudent treasury management is a disallowance of interest cost in B and C, while A remains fully taxable on interest income.

This creates a distortion between:

- a group that as a policy of economic management has retained group funds to ensure it has resources to survive and pay individual and small business policyholders claims after even the very largest insurance losses, and
- a group that has over-distributed or over-geared, hence endangering such policyholders through less prudent treasury management.

The rationale for creating a fiscal disincentive to follow the first course of action is perverse and clearly contrary to a strong and resilient regulatory and
commercial framework for insurers. It is also contrary to the Discussion Draft on Actions 8-10, which seeks to reward those that manage the asset risk.

**Potential “special rules” for insurance companies**

Paragraphs 210 and 211 of the Discussion Draft suggest that, because the general options discussed above “will not be effective at addressing any base erosion and profit shifting risks presented by banks and insurance companies,” it is appropriate “to design a specific rule which would have a similar effect for banks and insurance companies but that focuses on the particular base erosion and profit shifting risks that they present. This may involve separate rules for each of these sectors.”

The draft describes one option that would focus on the net interest attributable to regulatory capital instruments “which provide a bank or insurance company’s core funding and play a role comparable with debt in other sectors.” Similar in concept to the group-wide allocation debt cap rule, this option would limit a group’s net deductions on its regulatory capital (ignoring the interest income generated from using the capital to write business) to the amount of interest expense paid on these instruments to third parties. Specifically, “within the group, an interest cap could be allocated in accordance with regulatory requirements, so long as this provides an effective solution to base erosion and profit shifting.”

The Working Group has several concerns with this approach. Most importantly, the option suggests a solution is necessary to apply to regulatory capital in the same way that the general approaches would apply to group-wide debt of non-financial services companies, suggesting that the BEPS concerns relating to non-financial services companies manifest themselves in the context of an insurance group, but in special ways.

As a general matter, the Draft finds that the main tax policy concerns surrounding interest deductions relate to the debt funding of outbound and inbound investment by groups. However, we do not believe the specific concerns articulated in the draft apply to insurance and reinsurance groups. Particularly, it is difficult to see how these concerns apply to interest expense deductions relating to regulatory capital and, for the reasons identified below, we do not believe an approach as described in paragraph 211 is required.
Regulators impose stringent limits on the amount of regulatory capital that can take the form of debt. Therefore, insurance groups are not able to use debt that qualifies as regulatory capital to achieve any other objectives (including any BEPS-related objectives). So while such debt is part of the capital structure of an insurance company, and other businesses have debt in their capital structures, the regulatory restrictions mean that there is no real comparability with debt in other sectors for these purposes. It is also important to note that not all regulatory debt capital is tax deductible; the approach suggested in this option would therefore create distortions by lumping all regulatory capital debt into one category.

Furthermore, the role of debt in the regulatory capital structure of an insurance group is still evolving due to the evolving requirements of global regulators. The Draft appropriately notes that allocations under this option should be accomplished in accordance with those required by regulators. For global insurance and reinsurance groups, a further convergence of regulatory requirements is necessary before all the implications of such an allocation rule for tax purposes can be determined.

To the extent the allocation formula produced a result that was inconsistent with a group’s actual bearing of debt, the Draft takes the general position, in discussing a group-wide allocation approach, that groups may achieve self-help “by reorganizing their intragroup financing,” as noted in paragraph 76, “so that the net interest expense in each entity reflects the interest cap allocated to it.” The Draft requests comment “as to tax and non-tax considerations (such as increased withholding taxes or exchange controls) that restrict a group’s ability to re-organise its intragroup loans or impose a cost on it doing so.” As noted throughout this submission, regulators restrict the use of debt in both holding companies and regulated operating companies. For this reason, an insurance group would not have self-help options because of the applicable regulatory constraints. Thus, a cap-and-allocation rule could have unintended consequences that could not be protected against or mitigated.

Consequently, we believe that the answer to Question 34 on page 64 of the Discussion Draft is that it is not possible to design a rule limiting interest deductions on regulatory capital instruments, nor is such a rule required as the regulatory environment already provides the necessary safeguards and limitations. Indeed, the introduction of such a rule may create risks of undue impact on a group’s regulatory position.
Anticipating that a limitation relating to regulatory capital may not be appropriate, the Draft also includes a less specific interest expense deduction limitation, in paragraph 212 (targeted measures for interest other than interest on regulatory capital). The option states: “Alternatively, if existing regulatory requirements act as an effective general interest limitation rule, and prevent excessive leverage in group entities, a best practice approach could instead focus on a group’s interest expense other than that on its regulatory capital. This may comprise targeted rules to address risks posed by specific transactions.” We agree with the suggestion that, to the extent any BEPS concerns are identified in the context of an insurance business, targeted rules would be the right approach to address those concerns. The members of our Working Group would be happy to work with the OECD on evaluating any BEPS risks in the insurance sector that are identified in the future and on developing appropriately targeted rules to address those specific concerns.
Insurance Europe comments on the OECD’s discussion draft: BEPS action point 4

Introductory statement
Insurance Europe welcomes the opportunity to comment on this OECD discussion draft on interest deductions and other financial payments. Insurance Europe supports the aims of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan to address weaknesses in the international tax environment. Consequently, Insurance Europe also supports the objectives of the discussion draft to address BEPS practices using interest and economically equivalent payments.

General comments
1. Insurance Europe welcomes the acknowledgement in the discussion draft that a different approach is required for the financial sector in light of its particular circumstances and regulatory/operating environment. Requiring tax treatment that is inconsistent with the sector’s regulatory position would undermine the OECD’s stated policy aim of disallowing only those deductions which are used to achieve BEPS. Insurance Europe agrees that existing regulatory requirements act already as an effective limitation rule for the insurance sector.

2. Therefore, Insurance Europe’s first preference would be for insurance company interest to be excluded from the scope of BEPS Action 4.

3. In the absence of this blanket exclusion, Insurance Europe sees as a second best solution, a role for targeted rules (due to the very material difference of leverage ratios in the (life) insurance industry compared to other industries); best practice should allow territories the flexibility to use and adapt existing rules with a proven track record - including arm’s length rules.

4. Given that most insurance groups are net interest recipients, as a third best solution a fixed ratio approach may be appropriate for the sector, as long as it is applied on a territory by territory basis, is
set at the right level and by reference to the right measure and provided that the ratio test is not so restrictive that it effectively abandons the arm’s length principle.

5. In any case, Insurance Europe sees that there is an important issue that has to be solved with the proposed scope of the discussion draft’s interest rules presented in Paragraph 35 (i.e. interest on all forms of debt, payments economically equivalent to interest and expenses incurred in connection with the raising of financing). There has to be a precise carve-out for all payments linked to the insurance business; possibly there has to be a positive list of interest that has to be taken into account when computing the allowed interest deduction.

6. Insurance Europe disagrees with the approach proposed in Paragraph 211 on the basis that a group-wide solution is not appropriate for the insurance industry.

7. The scope of any limitation of interest deductibility should be restricted to the tax policy concerns identified in paragraphs 3 and 10 of the discussion draft — debt funding of inbound and outbound investments by groups. Therefore, the discussion draft should consider whether any tax policy concerns arise, for example, (i) where the borrower and the affiliate that uses the loan proceeds are in the same country or (ii) where the interest-payer is located in a country that has a tax rate that is equal to or lower than the tax rate in the country in which the affiliate receiving the interest is located (if the interest is otherwise subject to tax).

8. Europe is an important centre of insurance and reinsurance, with London, Köln, Munich and Zürich being worldwide centres of excellence and many European insurers have worldwide prominence. Paradoxically, a rule that limited interest deductions in such European locations may have the undesired effect of effectively enhancing the competitiveness of competitors based in tax haven territories, and hence running directly contrary to the purposes of the wider OECD BEPs project.

**Difference between Banks and Insurers**

9. Paragraphs 203-208 of the discussion draft identify several ways in which banks and insurance companies differ from companies in other industries. However, there is another important difference that should be considered. Insurance company regulations generally make it difficult, as a practical matter, for insurance operating companies to borrow directly to meet their capital needs. Instead, it is routine to have a holding company engage in debt financing and then contribute the proceeds to the insurance company subsidiary. Any interest disallowance rule designed to address holding company affiliated debt should take into account this fact. Excluding dividend income from the definition of earnings as proposed in paragraph 155 would, therefore, also negatively impact (insurance) holding companies.

10. Paragraph 206 overlooks a crucial difference between banks and insurers. The (re)insurance business model has specific features that makes it less dependent on attracting capital from external sources. Insurance is funded by premiums which are paid up front, which provides insurers with strong operating cash-flow and reducing the need for requiring wholesale funding.

**Role of Regulatory Capital**

11. As acknowledged in paragraph 208, insurance companies worldwide are subject to strict regulations. Solvency II (and prior to 1 January 2016, Solvency I) requires insurers to hold an appropriate amount of capital in order to ensure that claims can be paid out to policyholders (while Solvency II applies only
in the EU, many other OECD member governments will implement new regulatory rules that follow the same fundamental concepts as Solvency II).

12. Furthermore, it is common for regulators to impose a further “buffer” or margin over and above the minimum capital requirement. Again, the insurer has no choice in this matter as it needs an insurance licence to do business and if it does not meet the regulator’s requirements that licence will be withdrawn. Similarly, the insurer often has no choice over the legal structure it must adopt in a particular jurisdiction. Some regulators may allow a permanent establishment, others may require a subsidiary.

13. Regulatory capital exists to ensure that policyholders are protected in the eventuality of insurers having insufficient funds to meet claims. It is not meant to benefit insurance company shareholders. Capital is needed, but it is a scarce resource and it is therefore expensive. In the insurance sector this is exacerbated by the regulatory requirement from regulators to hold high quality capital (i.e. capital in the form of assets that are more secure and therefore more expensive to hold). Insurers need to strike this balance between the demands of regulators and ratings agencies to hold relatively large amounts of capital and the fact that holding capital is expensive.

14. As with all companies, there is an optimum capital structure under which insurance companies aim to operate. Although more expensive than senior debt, regulatory debt instruments are significantly cheaper than equity.

15. In addition to this regulatory aspect, rating agencies also assess both quantity and quality of capital. Insurers and reinsurers receive a credit rating. This has a substantial influence on the desire of insurance brokers and clients to place business with that insurer or reinsurer, and on the premium they would pay to do so. Rating agencies, in a similar manner to regulators, place limits on the quantum and quality of regulatory debt that insurers can issue and which rating agencies assess as capital rather than ordinary liability in their models.

16. It can be concluded that regulators and rating agencies effectively force insurers to hold high quality capital in excess of expected liabilities, and importantly limit the amount and type of debt that may be included in regulatory capital. Maintaining the required level of capital in a particular entity is, therefore, not a question of choice but is rather critical to an insurer’s ability to do business.

17. Paragraph 209 states that due to the focus on net interest income, the general interest limitation rules set out in the draft would not be an effective instrument at addressing any base erosion and profit shifting risks presented by insurance companies. Example 7 (paragraph 253) “Application of a group-wide rule to groups with net third party interest income” states that insurers are usually recipients of net interest income. They would, therefore, be negatively and unjustly affected by general group-wide interest rules. Insurance Europe shares this point of view and, therefore, strongly recommends excluding insurance companies from a tax rule that limits interest deductibility. Given the role of regulatory capital, an exemption for the insurance industry is possible without endangering the goals of BEPS respectively action point 4.

Paragraphs 211 and 212

18. Question 34 of the discussion draft asks: "Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital
without having an undue impact on the group’s regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)? Two possible approaches are then proposed in paragraph 211 and paragraph 212.

19. Paragraph 211 proposes the design of a group-wide allocation rule which limits total net deductions on regulatory capital (ignoring the interest income generated from using the capital to write business).

20. Insurance Europe believes that the option described in Paragraph 211 would not be suitable to address the specific conditions in the insurance sector. Our understanding of the proposed rule is that it would limit a group’s total net deductions on its regulatory capital to the amount of interest paid on these instruments to third parties and that in the respective calculation the interest income generated from using the capital to write business should be excluded.

21. Insurance Europe would first point out that such an approach would not be feasible as it is not possible to build up a link between the liability side and specific asset position. Therefore, it would not be possible to assign interest income from capital used to write business to specific position of the regulatory capital. The prime purpose of regulatory capital is to ensure that the insurer, across a range of the most severe loss scenarios it is potentially exposed to, has both sufficient capital and liquid funds to be able to pay all claims due to all entitled policyholders under all those scenarios.

22. But more importantly, Insurance Europe must emphasise that tax relief for interest on regulatory debt is of great importance to the insurance sector. Tax relief on the interest cost of issuing regulatory debt is a key factor in an insurer’s calculation of its cost of regulatory capital. Control by regulators over the amount of capital held and the impact of the quantity and quality of regulatory capital on ratings make it an unlikely arena for BEPS activity — whereas uncertainty over the deductibility of interest on regulatory debt financing would likely increase the cost of insurance, and potentially create an impediment for the sector in accessing capital markets.

23. Finally, there would be a risk that the findings of the OECD report on action 2 “neutralise the effects of hybrid mismatch arrangements” would be contradicted. This is because it would easily be possible that instruments which had been excluded intentionally from any restriction under action 2 would fall under the new rule proposed in paragraph 211 of this discussion draft.

24. Paragraph 212 proposes that a best practice approach could focus on a group’s interest expense other than that on its regulatory capital. This may comprise targeted rules to address risks posed by specific transactions.

25. It also raises the possibility that existing non-tax regulatory capital requirements imposed by banking and other regulators on banks and insurance companies could “act as an effective general interest limitation” both in preventing excessive leverage and shaping the financing structures of insurance groups. Insurance Europe strongly agrees that this is the case and suggests that (at least regulated) insurance groups, sub-groups and companies should be excluded from a tax rule that limits interest deductibility.

26. Then, targeted rules could apply, as suggested on page 63 of the discussion draft, but they would only cover interest paid by non-insurance affiliates.

27. Insurance Europe reiterates that its first preference is for interest paid as part of insurers’ ordinary capital structures and business operations to be excluded from any limitation. If there are any specific
transactions relating to interest expense which are seen as posing BEPS risk other than in respect of regulatory capital, best practice should require these are addressed by specific targeted rules.

28. Given that insurers are usually recipients of net interest income (as noted in the discussion draft at paragraph 205 as well), Insurance Europe think that this allows insurers to be covered by a general approach, such as a fixed ratio rule, without an undue impact on a group’s regulatory position but only as long as the rule is applied on a territory by territory basis, is set at the right level and by reference to the right measure and provided that the ratio test is not so restrictive that it effectively abandons the arm’s length principle. Where this ratio is exceeded, a carve-out should be applied where it can be demonstrated that the level of interest paid satisfies an arm’s length test. Targeted rules could then address any remaining issues, by reference to specific transactions which are perceived as posing a BEPS risk.

29. It should also be borne in mind that some potential risks may be addressed by approaches developed under other BEPS Actions — in particular through the development of the CFC rules or via the treaty abuse rules, that would prevent treaty relief from withholding tax on interest paid for abusive reasons. Insurance Europe would also recommend that any such rules are developed to apply on a territorial, rather than an entity basis, not only to help provide consistency across different territories but also to reduce any disproportionate compliance burden both for companies and government officials.

30. Insurance Europe believe that such an approach would be commensurate with the very limited BEPS risk posed by interest payments made by the insurance sector given the particular regulatory and commercial environment in which it operates.

For further information and/or clarification please contact:

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Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, e.g. pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe’s economic growth and development. European insurers generate premium income of more than €1 100bn, employ almost one million people and invest over €8 500bn in the economy.
To: Mr Achim Pross,
Head, International Cooperation and Tax Administration Division,
OECD/CTPA

(sent via email to interestdeductions@oecd.org)

19 January 2015

Dear Mr Pross,

**BEPS Action 4: Interest Deductions and other Financial Payments**

IHG welcomes the opportunity to submit comments on the OECD Discussion Draft ‘BEPS Action 4: Interest Deductions and Other Financial Payments’ (‘The Consultation Document’).

**About IHG**

IHG (InterContinental Hotels Group) [LON:IHG, NYSE:IHG (ADRs)] is a global organisation with a broad portfolio of nine hotel brands, including InterContinental® Hotels & Resorts, Hotel Indigo®, Crowne Plaza® Hotels & Resorts, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites®, Candlewood Suites®, EVEN™ Hotels and HUALUXE® Hotels and Resorts.

IHG manages IHG® Rewards Club, the world’s first and largest hotel loyalty programme with over 82 million members worldwide. The programme was re-launched in July 2013, offering enhanced benefits for members including free internet across all hotels, globally.

IHG franchises, leases, manages or owns over 4,700 hotels and 697,000 guest rooms in nearly 100 countries, with almost 1,200 hotels in its development pipeline.

InterContinental Hotels Group PLC is the Group’s holding company and is incorporated in Great Britain and registered in England and Wales.

1. **Overview of the Structure and key conclusions of our submission**

1.1. Our comments are structured so as to first consider (in section 2) key criteria which we believe are relevant to evaluating the proposed options. This includes the need to consider whether, in principle, they are well-targeted so as to address BEPS while not distorting competition by also penalising a broad range of normal commercial situations and approaches. It also includes consideration of what are key features of a good or bad system so that proposals can be measured against those criteria. Section 2 also considers and comments on key background factual issues which seem relevant to evaluating the proposals, including some key background which is not currently taken into account in The Consultation Document.
1.2. We note that interest flows by their very nature base erode and profit shift. The general OECD view however is that interest flows per se are a normal feature and requirement of domestic and international trade and are not offensive as such. Notwithstanding that technically all interest flows might therefore be viewed as BEPS, for convenience we use ‘BEPS’ as shorthand for offensive or targeted interest flows—and we understand that to also be the intention and approach of The Consultation Document.

1.3. As explained in section 2, in our view, proposals which adopt the principle of limiting interest deductions according to a share of net consolidated group external interest expense are not well targeted in the sense of limiting BEPS while also not penalising and distorting normal commercial arrangements and competition. We believe that that is most simply illustrated by considering a circumstance where a multinational acquires a third party domestic group in a given jurisdiction, and where the level of the target group’s pre-existing third party debt means that the target’s relevant interest/EBIDTA or other ratio is higher than that of the acquiring group. All interest allocation proposals would seem to result in a partial disallowance of the target’s post acquisition interest expense even though these generic types of circumstances do not involve BEPS.

1.4. We of course recognise that, for domestic policy reasons, countries may choose to impose limitations on the level of permitted interest deductions but we feel it is important to distinguish those policy choices from action to counter BEPS and not seek to impose uniform policy choices in relation to non BEPS matters.

1.5. We also recognise that there is a genuine issue of BEPS in relation to interest which should be countered. Our point concerns targeting and not the underlying objective of addressing BEPS. In our view BEPS relates to the inappropriate exploitation of mismatches and asymmetries between tax systems. Well targeted action will therefore focus primarily on those features and not on effects which can result from both BEPS arrangements and normal commercial arrangements. The corollary of this is that we support the approach set out in Part XI of the Consultation Document of using targeted rules suitable for generic types of BEPS problems (and focussing work on developing best practise in those areas) although as set out in 1.13 and 1.14 we believe that many of the features or areas actually listed in Para 181 of Part XI are features which exist in commercial arrangements (and thus better targeting is needed).

1.6. Countries may of course choose to combine targeted approaches with general limitation rules. That will provide a form of protection by placing a cap on interest deductions and thus limiting the total available pool which BEPS (or commercial arrangements) may tap into. As that is indirect protection rather than well targeted protection we suggest that that should act as a backstop for targeted rules rather than vice versa. If such rules are to act as a backstop rather than a corset however then they need to leave room for commercially driven variation (ie. looser than interest allocation or low fixed ratio approaches do).

1.7. Section 3 considers and evaluates the interest allocation proposals set out in Part VIII of The Consultation Document using the criteria set out in Section 2. As we believe that substantially similar issues would arise using both Group-wide interest allocation rules and Group ratio rules we do not consider these alternatives separately.

1.8. Section 3 concludes that an interest allocation approach carries very significant disadvantages. It would be likely to result in significant interest disallowances and competitive distortions and would thus potentially damage international trade. It would also potentially be impractical from a tax compliance or tax audit perspective and would thus carry broader risks of undermining international tax systems. Key points are:
1.9. Section 4 considers and evaluates the proposal set out in Part IX of The Consultation Document to limit interest deductions by reference to a fixed ratio.

1.10. Our conclusion is that these are familiar approaches which are relatively simple to apply from both a taxpayer and tax authority perspective. A Fixed Ratio approach does (and should) apply equally to all taxpayers and, if set at too low a level, will result in substantial levels of normal commercial interest disallowance for many taxpayers. It would effectively operate in a similar way to the partial interest disallowance discussed in paras 15 and 25 of The Consultation Document. Para 25 expresses the view that such approaches are not aimed at BEPS - and we believe that conclusion applies more broadly to approaches with similar effects. In our view non arms-length limitation approaches are primarily non BEPS policy matters which should be a matter for national policy decisions.

1.11. We have not provided separate detailed comment concerning other parts of The Consultation Document, either because they are sector specific and not of direct relevance to IHG, or because the issues concerned are narrow issues which we feel are most constructively commented on when giving specific consideration in the limitation context to which they apply. We do however give summary comment here concerning key points and areas.

1.12. One such key area is of course relief for double taxation as discussed in Part XII. We understand the conclusion of part XII to be that the only form of relief for double taxation that would be given would be carry-forwards of disallowed interest or unused capacity. There would be no associated relief for corresponding withholding taxes or interest income. Such in country flexibility would of course be welcome. It may however be a fairly peripheral issue in the context of the broad ranging and extensive structural problems of disallowance of normal commercial interest costs and which would arise from interest allocation proposals (and potentially from fixed ratio limitations- although to a much lesser extent assuming ratios are set at levels which act as a backstop rather than a corset).

1.13. Another key area is of course the nature of any generic targeted rules of types such as those considered under Part XI. Whereas we believe that the use of targeted rules is the right approach for targeting BEPS we believe that care is also needed here to focus on features (and probably combinations of features) which are sufficient to distinguish BEPS from normal commercial operations in a group context which mirror those carried out in a third party context.
1.14. Many or most of the circumstances actually listed in Part XI seem to us to fall into this category. It should for example be actively discouraged that rules should disallow interest payments simply by reference to the fact that payments are made to connected parties or because external fund raising is centralised and thus internal funds come via an intermediate entity. Similarly the concept of ‘artificial or circular’ funding is a problematic concept in isolation as any form of shareholder return within a group will typically not involve new external funds. Equally, at an external level, groups will frequently go through cycles where they pay down debt and later pay large dividends or return capital in order to reset their capital structure at levels considered to be appropriate in the context of the blended group business model, market conditions, and group objectives.

1.15. It seems likely that well targeted provisions would need to consider a number of tests and hallmarks appropriate in the context of both the issue and the broader tax profile of the particular jurisdiction- and probably some form of purpose test also.

1.16. In summary our conclusion is that global interest allocation proposals would not address BEPS in a targeted fashion. They would be damaging to international trade by introducing significant competitive barriers and distortions, and they would risk undermining tax systems and audit processes by introducing requirements of doubtful practicality which compliant taxpayers will struggle to meet and tax authorities will struggle to audit. If limits, other than arms-length limits, are required, then fixed ratio limits set at levels which operate as a backstop are relatively simple and practical. Work should focus on developing generic, targeted, best practise measures in order to deal with BEPS mismatches. BEPS Actions in other areas (particularly Action 2 and Action 9, but also Action 3 to the extent countries do not already have CFC rules) also play a significant role- and it should be considered to what degree they will in themselves address interest related BEPS concerns.

1.17. We note that we have some hesitation in following an approach of question by question answering of the Consultation questions because the over-arching issues set out above and below are so fundamental- in particular in relation to interest allocation proposals. Thus, as highlighted above, and again here, our view in relation to the question raised as Consultation question 17 as to whether barriers exist which mean that taxpayers cannot arrange intragroup loans so that net interest expense matches with economic activity, is quite emphatically that taxpayers cannot fully do that, either at a snapshot in time or, on a rolling basis, as circumstances change.

1.18. Notwithstanding these concerns we have for convenience listed the consultation questions in the Appendix to this letter and we give brief comments and cross-references concerning where issues are addressed in the main body of our letter.

2. Comments concerning key background and policy areas

2.1. IHG is supportive of the BEPS Action Plan in general and of the specific BEPS Action 4 objective of:

‘Development of 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 debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are automatically equivalent to interest payments…..’  
[Methodological aspects of the Action omitted].

2.2. In our view consideration of this area would be helped by fleshing out a number of the policy
related areas and what their implications are in terms of two key questions:

a) What is, and what is not, considered to be acceptable corporate practise in this area (and, correspondingly, what are the features which are unacceptable and are thus the intended target)?; and

b) What are the features of a good tax system for preventing excessive or otherwise inappropriate deductions for interest expense (including what are bad features to be avoided)?

2.3. We note for example that, as touched on in parts II and III of The Consultation Document, some countries may impose ratio based limitations, or partial disallowances of all interest, because, as a non-tax policy matter, they wish to discourge excessive leveraging. Other countries may have more lenient rules because they believe that that will help support inward investment. In each case, the approach adopted is a tax approach which is intended to have an incentive or disincentive effect. From a broader perspective tax rate differences per se are recognised and accepted as having similar component purposes and effects.

2.4. If, as an OECD policy matter, it should be considered acceptable for countries to use tax policy to incentivise or dis-incentivise particular types of behaviour, then it cannot be objectionable per se for companies to respond to those incentives or disincentives. The questions must surely concern instead what are the acceptable bounds of countries’ tax policy in this area, and what are the acceptable bounds of companies’ responses to those incentives and dis-incentives.

2.5. Expanding slightly further on the question of what is or is not acceptable corporate practise in this area, we take it as at least implicit from The Consultation Document (and perhaps explicit from paragraph 10) that it is perfectly proper for companies to seek to obtain full tax relief for all of their external interest costs.

2.6. There are however numerous obstacles to achieving this objective over and above the tax policy based limitations touched on in 2.3, and expanded upon in The Consultation Document. We think it is worth listing a number of these because we believe that there is an inaccurate assumption that there is significantly more flexibility for companies to decide how much interest falls where (and flex that on a year by year basis) than is in fact the case. Constraints include:

i. Non tax restrictions on borrowing in given jurisdictions (for example, banking, foreign exchange or other regulatory restrictions);

ii. Corporate law constraints on pushing debt down into subsidiary jurisdictions (for example, associated with a lack of retained earnings or other distributable reserves or capital). It is important to note in this respect that lending to a company does not in itself relocate a net debt burden unless that company, for example, uses those funds to return capital;

iii. Specific tax legislation designed to prevent such debt ‘relocation’; or

iv. Structural limitations on tax capacity to relieve interest expense. This may arise for example due to deficiencies in international tax systems which result in effective double taxation or more than single taxation. A particular problem area in our industry is one caused by foreign withholding taxes on active income streams in conjunction with systems which limit credit to the direct counterparty (rather than extending credit through to material contributing jurisdictions).

There are many more practical restrictions (including transactional cost and complexity).
2.7. We are not suggesting that (other than with respect to the double taxation aspect of item (iv)) these are constraints which should not exist, but it is important to have an understanding of the significance of these limitations in order to better understand the impact of the type of global proposals considered in The Consultation Document. In particular, whether and where options are likely to result in no relief at all being obtained for a material proportion of a group’s external interest expense. For example, because of the type of constraints listed in 2.6., it is very unlikely that a pro-rata share of interest costs could be pushed into each operating jurisdiction and deducted. Significant levels of non-deductible group interest expense would therefore seem to be an automatic consequence of the interest allocation methodology proposed (or of any method which aims to indirectly achieve a similar result).

2.8. We note the suggestion that rules to enable carry-forward or carry-back of interest relief will provide protection against double-taxation or other damaging effects of excessive interest disallowance. This is however of little or no assistance where the obstacle to interest relief is a structural or systemic obstacle such as those detailed in 2.6 above.

2.9. Turning to the issue of what are the features of a good or bad system for interest limitation, we suggest that one criterion which should be considered is how effective the system is in rewarding the changes in behaviour which it is intended to encourage. Where, for example, the policy approach adopted is intended to use interest disallowances to encourage taxpayers to reduce external debt levels (because of non-tax policy reasons) that system will be a poor one if such reductions in debt levels would reduce both allowable and disallowable interest deductions pro-rata rather than solely reducing disallowable deductions.

2.10. We have used this example of pursuing a non-tax policy objective because we think it is a simple one to use for explanatory purposes but the same principle applies when considering the BEPS objectives which we understand the OECD aims to achieve under Action 4. It needs to be clear what the targeted BEPS is, and it needs to be considered whether or not the action proposed provides an effective incentive to reduce targeted BEPS.

2.11. A critical aspect of a good system for interest limitation (or indeed any compliance obligation) is that it is practical for taxpayers to comply with it, and practical for tax authorities to audit compliance –in each case at a proportionate cost. A system which is so complex or incoherent that accurate compliance (or tax audit) becomes impossible as a practical matter can play as significant a role in subverting tax systems as egregious tax avoidance does. It not only undermines confidence and respect in international tax systems but, if error (including unintentional error) becomes all pervasive, then a significant proportion of tax collected becomes an arbitrary matter which is more dependent on the audit and enforcement approach of tax authorities than on the underlying law. We have significant concerns (as further elaborated below) in relation to the practicality of the interest allocation methods proposed.

2.12. A further feature of a good system is that it is predictable. For the purpose of making investments a company needs to be able to forecast with reasonable confidence whether or not it will be able to obtain tax relief for its costs of financing its investments.

2.13. The Action 4 objective implicitly requires consideration of what is ‘excessive interest’ in a BEPS context. The Consultation Document appears to take the view [e.g. in the final sentence of paragraph 27 and in the principles underlying the interest allocation method] that ‘excessive interest’ is interest which exceeds some form of pro-rata measure of the interest costs of the overall group. We believe that that is a fundamentally mistaken view. It ignores the significant differences in business profile, cash-flow profile, country risk or currency profile, commercial risk profile (e.g. for joint ventures), or multiple other factors which, in an arms-length situations, may drive significant differences in capital structure for particular entities or investments. Ignoring
these differences for tax purposes in a group situation would not be a well-targeted BEPS approach. Neither would it support competitive neutrality—as it would slant the playing field in favour of domestic or third party investment to which these constraints did not apply.

2.14. We do have greater sympathy with the second leg of the BEPS Action which focusses on use of interest to fund exempt or deferred income. Our understanding of BEPS is as having much more to do with structures which arbitrage between the component features of tax systems so as to either achieve unintended results of profits falling out of charge, or to magnify or multiply intended differences. Thus, whereas we understand and accept that non-arms-length limitations on absolute levels of interest relief in a particular jurisdiction can have proper local political or policy objectives, their BEPS impact seems to us to be an indirect one of limiting the total pool of deductions available rather than a targeted one. It is somewhat similar to limiting the amount of cash held at a bank— that limits the exposure to robbery but may also limit the capacity to meet commercial demands from customers.

2.15. We note the comments in paragraph 27 of The Consultation Document that ‘there is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group’s actual third party interest expense’. At one level this is of course a statement which would automatically be true—in wholly non offensive circumstances—simply by virtue of the principles of accounting consolidation. For example a purely domestic UK group with multiple entities is likely to have many intra-group loan balances in connection with its short term or long term funding and cash management arrangements. As a consequence its gross internal interest deductions will be a multiple of its external interest expense—but so will its taxable interest income. Thus although, where there is interest related BEPS, it may well be true that internal interest deductions will exceed external ones, we do not believe that the reverse implication holds.

2.16. Finally we note that paragraph 27 (and Chapter IX) include data concerning the Global top 100 companies, and concerning the 10 largest non-financial groups headquartered in 9 surveyed countries—and suggesting net interest expense to EBIDTA ratios of less than 20% (and often less than 10%). We do not believe that this is particularly informative data. As it is top groups which have been surveyed it probably says little more than that ‘companies with strong credit ratings have low interest/EBIDTA ratios’. It is also true however that companies with weaker credit ratings (which will typically be smaller companies than those surveyed) will have higher interest/EBIDTA ratios. We would imagine that it should not be difficult to gather data concerning the profile/distribution of credit ratings and of the range of interest/EBIDTA ratios which correspond to each rating.

3. **Limitation of interest deductions by reference to the position of an entity’s group —interest allocation approaches**

3.1. We set out in this section our comments concerning the proposals in part VIII of the Consultation Document for limiting interest deductions by reference to the position of an entity’s group. We assume, based on the Consultation Document, that an interest cap, rather than a deemed interest basis would apply.

3.2. Whereas we always try and be constructive in our comments we find that particularly difficult with this proposal. We believe that it is wrong in principle; would be impractical for companies to operate or tax authorities to audit; and would create damaging barriers and distortions in international trade.

3.3. For the reasons set out in 2.13 we do not believe that a limitation by reference to consolidated group interest figures is an approach which accurately targets BEPS rather than applying more broadly to penalise intra-group financing approaches which reflect genuine commercial needs
and distinctions. The perverse impact of the approach can perhaps be illustrated by considering the case where one group acquires another group which has existing third party debt (for simplicity assume the target group operates in a single jurisdiction and so will not already be subject to the interest limitation rules under discussion). If the interest ratios of the target group exceed those of the acquiring group then there will start to be a limitation of on-going deductions for interest on the existing debt of the target group simply by virtue of it having been acquired by another group.

3.4. This illustrates that interest disallowances will arise in inappropriate circumstances. For the reasons set out in paragraph 2.6 above the broad ranging result of group based limitations using an interest allocation and interest cap methodology will be very significant levels of interest disallowance- and resultant double taxation or other tax penalisation of debt financing. Given that those practical effects would not apply to purely domestic groups that would provide a competitive distortion in favour of domestic investors (or other investment outside a group context).

3.5. We do not believe that the approach passes the test of a good system set out in paragraph 2.9 of efficiently rewarding the actions which it is intended to encourage. The only way of efficiently eliminating interest disallowances arising from reasons such as those set out in paragraph 2.6 would seem to be by disposing of the underlying investments where local rules or practicalities make it impossible to obtain relief via debt push-down. In turn, the only theoretical way of addressing the interest disallowance arising from an acquisition circumstance such as that outlined in 3.3. above would seem to be by putting additional equity into the target group and then trying to push-down/reallocate the associated debt into other subsidiaries to rebalance the limitation formula. Given that that may involve hundreds of other subsidiaries, including those in the paragraph 2.6 category that seems neither realistic nor desirable.

3.6. We do not believe that the system meets the test of a good system of being predictable. There are various components of that unpredictability. One fundamental aspect is that forecasting the extent of interest deductibility would depend on an ability to accurately forecast both the group results as a whole and the relative scale of each entity or country component of earnings directly or indirectly impacted by the investment-and the impact of paragraph 2.6 type disallowances. That in itself is likely to be impractical. There are however additional practical aspects- for example it seems unlikely that a group’s accounting systems will be set up to readily produce forecasts by reference to the entity or sub-grouping distinctions which seem likely to be needed. That is even before considering aspects such as required adjustments or exclusions.

3.7. This perhaps leads naturally on to the most fundamental problem of the method which is that it is so complex, and is likely to need so many tweaks and adjustments to try and accommodate fundamentally different measurements used in different jurisdictions or for different purposes, that it is quite likely to prove impractical as a compliance methodology—and at worst would be incoherent and impossible to apply without ad hoc country by country agreements with tax authorities. For the reasons set out in paragraph 2.11 that would have a very undermining effect on both domestic and international tax systems and introduce aspects which essentially amount to arbitrary taxation at the discretion of tax authorities.

3.8. From a review of The Consultation Document and brief reflection the obstacles to be over-come in order to operate an interest allocation approach include the following:

i. Entity versus country group issues—as Paragraph 54 recognises it cannot really be practical to apply these rules and principles on an entity by entity basis. There is thus some requirement to group (e.g. by country). Such groupings may not however match to groupings for which some form of aggregated or consolidated accounting data is
prepared;

ii. Accounting GAAP differences—it is commonplace that different GAAPs are required for local purposes than that used for consolidated accounting purposes. As not all accounting consolidation processes start with local legal entity accounts and then consolidate upwards (e.g. IHG’s doesn’t) local accounts may only be available in local GAAP and not the GAAP used for consolidation;

iii. Differences between the accounting computation of profits and the tax computation of profits under local rules;

iv. How to deal with dividends or other investment income (e.g. from foreign subsidiaries) in computing the ratios and limitations (and perhaps differences depending on whether or not that is taxable or exempt);

v. Issues of double-taxation (i.e. there are likely to be large levels of disallowances, and yet corresponding interest income remains taxable, and withholding taxes still apply);

vi. EU law issues—which would at least require consideration of whether in country flexibility is possible within the EU;

vii. How to deal with loss companies-i.e. the Document focuses on simple computational distortions caused by loss companies but the position in reality will often be more complex (e.g. involving a number of the other measurement or inclusion/exclusion issues considered above);

viii. Currency and translation issues- these would need to also incorporate foreign exchange hedging or similar issues (i.e. where to include/where to exclude and what to translate at);

ix. Classification differences between group and local accounts-e.g. some items may be reserves items for consolidation purposes but P&L items locally; and

x. Other consolidation differences.

This list would expand substantially as development and investigation or implementation of such a proposal proceeded. In practise such a proposal would be breathtakingly complex and possibly, in our view, not capable of being used without extensive ad hoc non statutory practical agreements between taxpayers and tax authorities in each jurisdiction concerned. That should not be a generic structural requirement for the practical application of tax law.

3.9. We have significant doubts concerning the practicality of tax audit requirements for such a system. A significant number of the items listed in 3.8. would potentially involve analysing and adjusting for complex accounting or other differences which are driven by consolidated accounting issues, or losses or other items arising in other jurisdictions and where information and technical understanding may not be available in the local jurisdiction (for either tax authorities or taxpayers). This would present substantial tax audit and compliance challenges.

3.10. We believe that the above issues present fundamental difficulties and disadvantages for the use of an interest allocation approach. Whereas a group ratio approach to applying such an allocation rule may provide a degree of compliance simplification we do not believe that it fundamentally alters the evaluation in any of the areas discussed.

4. Limiting interest deductions by reference to a Fixed Ratio
4.1. As set out in Part IX of The Consultation Document (and Box 3 in paragraph 158) the use of fixed ratio approaches is already well established in many jurisdictions and is well understood. It sets a cap which is relatively easy to operate from a compliance perspective. As The Consultation Document notes they apply generally to all interest whether or not an entity is part of a larger group and are thus neutral rather than creating a competitive distortion.

4.2. As set out above we view such measures as tax or non-tax policy measures designed to limit the pool of available interest relief generally rather than as targeted BEPS measures. They apply to limit both the relief available to accommodate normal commercial arrangements and that which can be tapped into under BEPS arrangements. Given that the limits affect interest deductions whether or not BEPS is present we do not think it is appropriate for the BEPS process to seek to impose a consistent Fixed Ratio approach rather than leaving that as a policy matter for each country concerned.

4.3. A key issue in the context of a Fixed Ratio approach is the decision as to at what level to set the ratio. If the ratio is set too low then significant levels of interest disallowances will apply. The rules then have a similar effect to the rules discussed in paragraph 15 of The Consultation Document which disallow a percentage of the interest expense of an entity. This approach presents a tax bias towards lower geared business models, which may sometimes be favoured as a general policy matter but can also disproportionately impact certain sectors which are more highly geared due to their different commercial profile (e.g. infrastructure and property sectors). We note that paragraph 25 of The Consultation Document indicates that these approaches may not be aimed at BEPS. We believe that that is consistent with our more general comments above.

4.4. As indicated, where a Fixed Ratio approach is used we believe that it is used most suitably as a backstop measure to limit leverage at the extremes (for both non tax and tax reasons) and also contain the total cost of tax relief. As set out in paragraph 2.16 above the data referred to in paragraph 27 and Part IX of The Consultation Document does not seem to us to be representative data and would, we believe, set Fixed Ratios too low for the normal commercial business models of the generality of taxpayers in given jurisdictions.

We trust that our above comments and suggestions are constructive. We would be happy to provide additional explanation and comment whether within the forum of the proposed public consultation or otherwise.

Yours faithfully,

C.P. Garwood
Head of Group Tax
APPENDIX 1 - SUMMARY OF QUESTIONS FOR CONSULTATION

What is interest and what are financial payments economically equivalent to interest?

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?

We think issues of simplicity need to be balanced against issues of completeness. There should thus not be an approach of trying to artificially separate all financing components of transactions. That should only be done where that is essentially for BEPS protection and even then only where the primary underlying transaction is best viewed as a pure income profit financing transaction.

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?

No comments.

Who should a rule apply to?

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

No comments.

4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

We believe that the use of a 25 per cent control test is inappropriate as it means that anti-avoidance rules will apply in a broad range of arms-length joint venture arrangements not involving avoidance.

What should a rule apply to? (A) the level of debt or interest expense and (B) an entity’s gross or net position

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

We agree that it is most appropriate to consider net interest expense.

Should a small entity exception or threshold apply?

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

No comments.
**Whether interest deductions should be limited with reference to the position of an entity’s group**

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?**

   See comments in 1.3, 1.7, 1.8 and 3.1 to 3.10, with particular reference to 3.8. We believe that there would be very substantial practical difficulties with using an interest allocation approach from both a taxpayer and tax audit perspective.

8. **Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?**

   We are not aware of group-wide rules (other than narrow group based fixed ratio over-rides) currently being applied by countries. We believe that these will previously have been rejected due to practical difficulties and reasons of principle of the types detailed in 3.1 to 3.10.

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?**

   See our comments in 3.8.

10. **In what ways could the level of net third party interest expense in a group’s consolidated financial statements be manipulated, and how could a rule address these risks?**

    No comments.

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?**

    See comments in 1.3, 1.7, 1.8 and 3.1 to 3.10. We believe that what is the appropriate measure of economic activity will vary according to the primary business model or models of the groups concerned and is not something where a uniform generic conclusion can be drawn.

12. **Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?**

    See our comments to 11 above.

13. **What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?**

    As these categories will not be uniform globally we do not think that a generic answer can be given to this question. It illustrates the practical difficulty of an interest allocation approach.

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?**

    Difficulties of consistent measurement, consistent grouping of information and other practical aspects as discussed in 3.8 of our response will arise. We highlight in particular our comment in 3.8 vii.
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?

For a group approach based off consolidated accounting this would have to be the relevant translation rate used for consolidated accounting purposes. We note our comments in 3.8 viii. to x. of our response.

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?

See our comments to question 11. above and our broader comments in 1.3, 1.7, 1.8 and 3.1 to 3.10. We also highlight in particular the problem of principle commented upon in 2.13 of our response.

17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

See our comments in 1.17 and, in particular, the practical issues and obstacles detail in paragraph 2.6 of our response. As a general matter it is not possible for a group to arrange its intra-group loans so that net interest expense is matched pro-rata with economic activity in the sense set out in the document. That is neither possible on a snapshot basis at a given instant in time or on a rolling basis over time. The latter would of course require a process of continuous annual global reorganization, which, even ignoring the types of constraints listed in para 2.6, would be unrealistic and impractical.

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

The problems of an interest allocation approach (see above) apply equally to most aspects of a group’s operations including centralized treasury functions. Issues relating to foreign exchange hedging and translation are of course of particular narrower relevance.

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

A combined approach would add even further complexity- e.g. additional issues of measurement and consistency.

20. In what situations could significant permanent or timing mismatches arise if an entity’s interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

As set out in para 1.8 and 3.1 to 3.10 (3.4 in particular) we believe that the use of an interest allocation approach would lead to very significant levels of interest disallowances (i.e. permanent mismatches) in inappropriate circumstances. One contributing component (but by no means the most significant) would be measurement differences between accounting and
tax rules.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

See our comments in para 1.12. Carry-forward provisions, while helpful, are a fairly peripheral issue in the context of the scale of the level of interest disallowance and double taxation which is likely to arise from interest allocation provisions.

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group’s consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

We believe that competition concerns apply more broadly with respect to the interest allocation proposals. See our comments in para 1.16.

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

No comments.

**Whether interest deductions should be limited with reference to a fixed ratio**

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?

See our comments in 1.10 and 4.1 to 4.4. We believe that fixed ratio rules are normally relatively simple to apply as a practical matter.

25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?

See our comments in 1.10 and 4.1 to 4.4. We believe that this is a policy matter most appropriately addressed at a national level. In our view absolute limitation approaches are not well targeted BEPS measures (see our comments in paras 1.4 to 1.6).

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?

See our comments in para 2.13. There are numerous local country and business model differences which can arise between the local entity profile and the group profile which can result in such differences. Any limitations must apply equally to group and non-group situations (and domestic and cross-border) so as to avoid competitive distortion in favour of domestic businesses or investment by non-corporate shareholders.

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?

See our comments in para 4.3.
28. What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?

See our comments in para 2.16. Our understanding is that generic credit rating ratio data will provide relevant information.

**Whether a combined approach could be applied**

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?

No comments.

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?

See our comments in paras 1.4 to 1.6.

**The role of targeted rules**

31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed though a general interest limitation rule and where would a general rule need to be supported by targeted rules?

See our comments in paras 1.4 to 1.6 and 1.13 to 1.15.

**The treatment of non-deductible interest expense and double taxation**

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

See our comments in para 1.12. Carry-forward provisions, while helpful, are a fairly peripheral issue in the context of the scale of the level of interest disallowance and double taxation which is likely to arise from interest allocation provisions (and fixed ratio tests if limits are set at low levels).

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?

See our comments to question 32. Carry forward provisions will help to address issues which are timing issues rather than disallowances caused by structural double-taxation or similar issues. Timing issues are often themselves structural however (ie. Recurring year on year). A long limit may help to damp that effect by extending the time available for the timing profile to reverse.
Considerations for groups in specific sectors

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group’s regulatory capital without having an undue impact on the group’s regulatory position (for example, by limiting a group’s net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

No comment.

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

No comment.
VIA E-MAIL

Mr. Achim Pross
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France
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Re: Comments on Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments

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, mining, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, entertainment, software, IT systems, publishing, 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: Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; A.P. Moller-Mærsk A/S; AstraZeneca plc; Baker Hughes, Inc.; Barrick Gold Corporation; BP plc; Chevron Corporation; Cisco Systems, Inc.; Exxon Mobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Microsoft Corporation; Procter & Gamble Co.; Reed Elsevier plc; Repsol S.A.; Sony Corporation; Texas Instruments, Inc.; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
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
IAPT Comments on the December 18, 2014 Discussion Draft

Action 4: Interest Deductions and Other Financial Payments

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 combatting 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.

24. The Discussion Draft fails to articulate the problem for which it is seeking a solution. As a result, the different best practice options solve different perceived problems (and at the same time create new problems). Action 4 states that the OECD is to design best practices to address “excessive interest deductions,” yet this term is not defined in the Discussion Draft. Based on the explanation in Discussion Draft paragraph 4, it appears that the concern is that some multinational corporations (MNCs) have more internal leverage than external leverage. It is unclear how the level of internal leverage in excess of third party leverage is proof of base erosion or profit shifting to another jurisdiction. As described more fully below, an MNC with accumulated cash has an option for how to fund operations in other locations, and the existence of internal leverage in excess of external leverage does not necessarily give rise to base erosion. Because it appears that this is the issue the Discussion Draft will attempt to solve, the IAPT recommends that third party debt be exempt from limitations.

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).

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2 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.5

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 lines of businesses and entities that perform different functions (e.g., active trade or business, holding

3 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.
4 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.
5 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.
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.⁶

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:

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⁶ 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).
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\(^7\)). 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:

$$\text{ROIC}^8 \times \text{Investment} > \text{WACC} \times \text{investment} \text{ or } \text{ROIC-WACC}>0$$

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:

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

$^8$ 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.

9 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,10 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.

10 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.

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11 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.\(^\text{12}\)

- 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).\(^\text{13}\) However, interest income and deductions are reduced or eliminated if the note is an applicable high yield

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\(^{12}\) Treas. Reg. § 1.61-7(a).

\(^{13}\) IRC § 163(e).
obligation, and payments therefrom may be treated as dividends in certain circumstances.\textsuperscript{14}

- 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.\textsuperscript{15} A contract has unstated interest unless it provides for “adequate stated interest”.\textsuperscript{16} 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 issues in the event of a credit crisis, among other issues. If there is a concern that the parent jurisdiction is

\textsuperscript{14} IRC § 163(e)(5).
\textsuperscript{15} IRC § 483(c)(1)(B).
\textsuperscript{16} Treas. Reg. § 1.483-2(a)(1).
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 apportionment of profits is not a viable way forward.” 17 The group rule effectively uses formulary apportionment to derive a significant component of the base in computing profits.

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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.

**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

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18 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.
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.

\textbf{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.

\textbf{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.

\textbf{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 on 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.  

**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

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21 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.
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.

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:

and Bank of England interest rates since 1991:

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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.

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.\(^\text{24}\) Disqualified interest

\(^{24}\) 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.
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**

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.

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.

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 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.

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.

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.25 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

25 Société de Gestion Industrielle SA (SGI) v. Belgium (c-311/08) [2010] 2CMLR 1017.
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.

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. 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.

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26 For example, NV Lammers & Van Cleef v. Belgische Staat (C-105/07) [2008] ECR I-173.
27 For example, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue (C-524/04).
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 29;

   (b) if there is a preferential tax regime specifically for related party interest income in the lender jurisdiction (e.g. group “interest box”) 30;

   (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 31;

29 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.

30 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.

31 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

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32 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.

33 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 disallowance of interest relief, such as “excessive” or “inappropriate”, should be avoided at all

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34 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.
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.
[ ] February 2015

OECD
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France

Sent via e-mail: interestdeductions@oecd.org

Re: Public Discussion Draft- BEPS Action 4: Interest Deductions and Other Financial Payments

Dear Messieurs & Mesdames,

The Taxes Committee of The International Bar Association would like to take this opportunity to comment on the Public Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments, released on 18 December 2014.

As a committee, with over 1000 members worldwide, we have formed a Working Group to respond to the OECD BEPS Action Plan initiatives and members of this Working Group, under the IBA Taxes Committee, have developed the enclosed draft.

We submit our comments on behalf of the International Bar Association Taxes Committee. The comments made in this report are the personal opinions of the Working Group participants, and should not be taken as representing the views or opinions of the IBA as an association, nor the participants' firms, employers/employees or any other person or body of person apart from the individuals who have formed the Working Group.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world's top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.

Sincerely

Simon Yates   Ricardo Leon Santacruz
Co-chairs, IBA Taxes Committee Working Group
IBA Taxes Committee Comments on the OECD Public Discussion Draft

BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

18 December 2014 – 6 February 2015

The IBA Taxes Committee Working Group (“the Group”) includes

Simon Yates, Travers Smith LLP, UK
Antonio Barba de Alba, Cuatrecasas Gonçalves Pereira, Spain
Peter Blessing, KPMG LLP, US
Francesco Capitta, Macchi di Cellere Gangemi, Italy
Peter Maher, A&L Goodbody, Ireland
David G. Shapiro, Saul Ewing LLP, US
Mark van Casteren, Loyens & Loeff, Netherlands
Wolf-Georg von Rechenberg, CMS Hasche Sigle, Germany

Introduction

We are grateful for the opportunity to provide comments on the public discussion draft on BEPS Action 4 (the “Discussion Draft”). Our headline conclusions are as follows (in all cases elaborated in our response):

- We do not consider a group-based test to be the right approach to limiting the quantum of interest relief. If it is not possible to rely on transfer pricing, an entity by entity approach should be adopted and we suspect that a fixed ratio rule, whilst crude, would be the best solution.

- We agree that if a group-based test is adopted, an interest allocation rule is not the right approach for the reasons identified in the Discussion Draft.

- We believe that a group ratio rule of the type suggested in the Discussion Draft is unsuitable as the sole rule to limit interest relief because it gives rise to contrary results, in that an improvement in a group’s financial performance will worsen the ratio and so lead to interest disallowance in companies which are doing well and where, commercially, borrowing capacity will have increased.

- A fixed ratio rule of the type most often discussed will (in common with either of the types of group ratio rule considered in the Discussion Draft) have the potential to disallow interest on genuine third party loans, in relation to which the risk of BEPS is at most minimal. We question whether this is the right policy outcome, although it could perhaps be seen as a legitimate trade-off against the simplicity and ease of enforcement of a fixed ratio rule. That said, either a fixed or group ratio rule could easily be adapted so it only limited interest paid to related parties (related party interest costs would only be relieved to the extent that third party interest costs – which would be fully...
allowable - fell below the limit set by the ratio), and if such a rule were adopted that would be our preferred approach.

Before moving on to the specific questions identified by the Discussion Draft, we would make a number of general points applicable to the proposals as a whole. To a significant extent these reflect the experience in the UK of the "World Wide Debt Cap", a regime which limits interest deductibility of UK resident group members by reference to their groups' overall global interest cost. In our view it would be fair to say that the UK's regime has not been a success: it has greatly increased compliance burdens by imposing complex tax calculations on many groups which previously did not have to do this, whilst raising little tax and changing behaviour only marginally. That said some of the defects in the UK regime are not shared by the new OECD proposal and so the UK experience cannot in all respects be said to be illustrative.

We generally would prefer that all intercompany dealings be dealt with under the arm's length principle under transfer pricing rules, and we do not believe that relief for genuine third party interest payments should be subject to limitations based on quantum (as opposed to ones based on the nature or purpose of the loan). We acknowledge that transfer pricing rules have not been as effective as hoped in the past to prevent base erosion through interest payments, but in our view that is not the fault of the concept, although in some cases the rules could be tightened. In our view the correct response to this problem is for governments to improve their rules where necessary, but critically also their resources, not to inflict an extremely complicated new regime on international business.

If transfer pricing rules truly cannot be relied on to be effective or administrable, our view is that a German-style or US-style entity by entity restriction by reference to income levels (perhaps with a US-style safe harbour based on asset levels) would be preferable to the approach set out in the discussion draft. Although a blunt instrument, this approach has the considerable advantage of simplicity.

Of course it may be appropriate to have special regimes to limit interest relief by reference to its nature or the purpose for which it was incurred, and this is reflected in the later parts of the Discussion Draft. It is only in relation to the question of quantum where our view is that transfer pricing rules (whether in the traditional sense, or via the blunt proxy of a fixed ratio rule) should be the sole answer.

The remainder of our response proceeds on the assumption that there will be some kind of non-transfer pricing based formulaic restriction on the quantum of deductibility as discussed.

**Key issues with the proposal to adopt a group based approach of whatever type**

*Companies joining and leaving groups*
The Discussion Draft does not address at all the fact that the members of multinational groups are regularly changing. Companies are frequently bought and sold. The UK experience is that dealing with this in the context of a group-based interest relief restriction is extremely challenging. At best it leads to extremely complex calculations; at worst it can even be unworkable.

The simplest problem is practical and commercial. Where a company is sold out of a group, absent any contractual agreement, its new owners will not have access to financial information relating to the wider selling group. Yet under the proposals the new owners will be unable to determine the level of interest relief available to their newly acquired company without that information, much of which may well be commercially sensitive such that the selling group will be unprepared for good reason to share it with a buyer. A buying group in such a position would thus not be able to prepare its new member’s tax returns in compliance with any rule based on the selling group’s overall interest levels.

Even if the practical issue of information sharing can be overcome, there are still real difficulties associated with how any computation for the sold company will work. It would not be appropriate to use the figures from the selling group’s end of year consolidated accounts on a time apportioned basis in order to determine the group level interest cost which will be the basis of any restriction, because the sale itself will in very many cases change those figures materially (if the proceeds of sale are applied in repaying borrowings, as will frequently be the case). Also, the departure of the sold company may lead the selling group to change its overall borrowing policy. Conceptually therefore it would be necessary to reach a determination of the selling group’s overall interest position on a part-year basis as at the date of sale. This is potentially an extremely burdensome task for the selling group, and may well be out of proportion to the value of the company being sold.

This issue applies in reverse to an acquiring group, especially if (as it quite probably will) it incurs borrowing to fund the acquisition with the result that it is again clearly inappropriate to use a simple time apportionment of the year-end figures due to the acquisition in question leading to a material change in those figures.

That said, while it is in our view clearly inappropriate to address the issue of the part-year through time apportionment of year end results for the reasons set out above, in highly seasonal businesses an extremely distorted outcome may arise through the use of part of a year only. In such businesses an accurate picture of the real borrowing position can only be obtained by looking at the year as a whole. It is not clear to us how one might construct a rule which operates fairly in such cases.

We cannot emphasise strongly enough that any new rule must be able to function to deliver fair results in the context of company sales and purchases without requiring commercially unrealistic degrees of cooperation between buyer and seller and/or excessively burdensome compliance costs, as such sales and purchases are happening all the time. We are very concerned that these extremely difficult issues have not so far been addressed in the discussion draft, and doubt that a satisfactory outcome can be delivered by the proposals in their current form.
Currency fluctuations

The Discussion Draft acknowledges that currency fluctuations are an issue and suggests some possible ways to deal with them. However, in our view the difficulty created by this issue is too great to address fairly in a group-based system.

The first problem is conceptual. Currency fluctuations can cause a rule of this type to have entirely arbitrary effects. In our view it is entirely inappropriate for the tax position of (say) a French company, which trades solely in France and conducts all its business in Euros, to be affected by fluctuations in value of other currencies. This is however an unavoidable result of any regime which limits interest relief on a company by company basis by reference to a global interest cost.

To take a topical recent example, if a group contains a Russian company with significant rouble denominated borrowing costs, then over the last few months the global interest cost of that group measured in the currency of any non-Russian member will have materially reduced. In consequence, under the proposals, all other group members would potentially face significant rises in their tax costs. We cannot see how this is fair. Those companies' businesses, financial results and financing arrangements are entirely unchanged. Of course in the counter-example where a given currency appreciates in value significantly, an equally undeserved tax saving is potentially delivered to group members around the world.

In the case of both the interest allocation and interest cap rules, the effect may be mitigated to some degree by the equity component of the allocation mechanism also being in the fluctuating currency. In particular, if an interest cap rule is adopted instead, as the Discussion Draft notes, the effect is likely to be less pronounced if one assumes that the group will also have assets and/or income denominated in the fluctuating currency, such that the impact of the currency fluctuation on the overall ratio (whatever ratio is chosen) is restricted to a degree. However this assumption will not be valid in all cases and even where it is there could still be a significant impact. Similarly with the allocation rule, if the company which has borrowed in the depreciated currency also largely does business in that currency, its allowable share of the reduced group interest cost will reduce along with its actual share (although again there is no reason to assume that the reductions will be proportionate). And to reiterate: we do not believe that conceptually a company's tax liability should be impacted by fluctuations in a currency in which it has no dealings.

Even if these conceptual issues are ignored, the practical issues associated with monitoring currency fluctuations are real. Whilst this of course ultimately has to be done in the course of preparing consolidated group accounts, we would refer back to the point above in relation to the sale of companies part-way through accounting periods, which in a coherent regime would appear to require an assessment of the position as at the point of sale/purchase. For many groups this would be extremely, and unduly, burdensome.

Impact on overall decision making
The discussion draft acknowledges that a defect of the deemed interest rule proposal is that groups would be incentivised to borrow only in jurisdictions which had not adopted the proposals, thereby obtaining unrestricted relief in those jurisdictions while also increasing their allowable deductions elsewhere.

We see this as a problem in the same way as with the interest cap rule. Under that proposal, group companies in jurisdictions which adopt the proposals will not be concerned as to where borrowing is incurred as their own relief position is a pure function of group borrowing. Groups would thus be incentivised in exactly the same way to incur borrowing where restrictions are not in force, so obtaining a full deduction in those jurisdictions while also improving their overall group interest deductibility position.

These issues lead on to a wider, more fundamental point. As things stand the tax systems of the world generally substantially incentivise the use of debt finance over equity finance, since typically debt finance costs are deductible while equity finance costs are not. Many consider this to be a problem, and an important contributory factor to the over-leveraging which played a fundamental part in the financial crisis. The impact of proposals of this type is to multiply the tax incentive to use third party debt, since not only does it lead to a deduction in the borrowing company, but it also allows greater levels of tax relief throughout the rest of the group. We would strongly question whether it is sensible policy making to introduce a tax measure which further distorts the debt vs equity funding decision in favour of debt.

**Difficulty of avoiding double taxation**

The Discussion Draft identifies the issue that where a general interest limitation rule is applied, interest is not disallowed on any specific financing instrument. Instead the entity in question is only allowed to claim a deduction for a given proportion of its total financing costs.

This issue is very difficult to resolve. Logically the best answer must be for the disallowance to be treated as proportionate across all the entity's financing arrangements, but as the Discussion Draft notes this may be unduly complex. Also other jurisdictions may well not recognise a disallowance of this nature as meriting a corresponding reduction in taxable income for the recipient of the payment (especially where in the view of the other jurisdiction a given financing arrangement is at arm's length and so not one to which a transfer pricing adjustment should apply: for instance, it could even be a simple third party loan from a bank).

Of course if, as we believe should be the case, the issue is addressed through transfer pricing rules, then each financing arrangement is tested against the arm's length standard in turn with the result that any disallowances are clearly attached to given arrangements.

**Responses to the questions for consultation**

Note: we have not responded to all the questions, only to those where we feel that we have sufficient knowledge and expertise to comment. As lawyers we are naturally less able to provide useful input into questions of accounting and/or economics and that is reflected in our responses.
Numbering follows that of the questions in the Discussion Draft.

1. In our view in order to be conceptually coherent in its application to any given country, only those amounts of "interest" cost borne by the group which would be treated as deductible interest in the country in question should count as interest for the purposes of the rule, so increasing potential local deductibility.

For example, the finance costs of profit participating loans are currently proposed to be included as counting towards a group's interest costs. However in many countries these costs would be treated as non-deductible dividends for tax purposes. In our view such amounts should not count towards the total interest cost of the group when considering the maximum allowable interest amount in a jurisdiction which does not allow them as deductible interest.

Our view is that if it is possible for "interest" which would be non-deductible in a given country to count at group level as interest when considering the quantum of the limit on interest relief in that country, there is scope for manipulation of the rules. However, considerable practical complexity would result from the need to analyse all group-level interest payments for deductibility in each jurisdiction in which the group had a presence.

Similarly whilst it must be correct to include the finance charge element of a leasing transaction as part of a group’s interest cost, it is rather less obvious how one might count rent under finance leases when quantifying any disallowable amounts at local level. It is largely the point of finance leasing that its tax treatment follows its legal form not how it is accounted for, and as a general matter the entirety of the rental payments – not just the finance charge component – are expected to be deductible for the lessee and taxable for the lessor.

Derivative contracts present their own challenges. We do not consider that payments under a standalone derivative contract should be regarded as interest. However, where a floating rate loan is fully hedged with a fixed for floating interest rate swap, there is clearly a case for regarding the post-hedging combined cost of the two instruments as the amount of interest paid. Partial hedging is more challenging however and also in order to ensure consistency any of the great majority of jurisdictions which would tax derivative instruments under a separate regime to debt would probably need to unite the two regimes in order to make the entity level interest calculation make sense. Again, though, the key would be to ensure consistency between the group-level and entity-level calculations for the purposes of each jurisdiction, as to do otherwise raises the possibilities of both manipulation and outcomes unfair to taxpayers.

2. Depending on the resolution of the point above, consideration should be given to including the cost of preference share financing where that financing is accounted for as debt. If this is the accounting treatment, it would follow that such financing costs should be regarded as economically
equivalent to interest. Clearly in most countries such costs would not be deductible, but the same could be said of the costs of profit participating loans.

Finally, if the country implementing the proposed rule follows the Belgian or Italian model of allowing a notional cost of equity funding against tax, this would need to be addressed. Again, consistency is key: if the notional interest deduction in the entity allowing it is to form part of the interest calculation which is tested against the group level interest cost with denial of deductions a possible result, then a group level notional interest deduction would also have to be ascertained in order for the rule to operate fairly. This could potentially be onerous in practice. Alternatively the notional interest deduction at local entity level could be left outside the scope of the new rule, which might be attractive as a policy matter to any jurisdiction which was attempting actively to promote equity over debt actively rather than merely lessening the bias in favour of debt. Either way, the point should be addressed.

3. No.

4. It may be appropriate to treat entities as connected where no single person owns at least 25% of each, but where there is absolute or substantial commonality of ownership. For example, if the same five shareholders each owned 20% of each of two companies, one would expect to treat them as connected. However, there must be a high degree of commonality of ownership before entities are treated as connected, and even then it may not be appropriate to treat them as connected for all purposes (most notably different investments of a given private equity fund should not be treated as grouped in the overwhelmingly likely case where they are run independently; likewise where investments are owned by different funds with material commonality of investor bases no group should exist for the purposes of the rule). See also our response to question 22.

5. If net as opposed to gross interest is adopted as the key base number for any rule, the potential distortive effect of payment types which have the economic character of interest but which are not deductible or taxable as such in some jurisdictions is doubled, since the inconsistencies can occur both in relation to payments out and payments in.

6. The UK's World Wide Debt Cap contains a "gateway test" which is applied by reference to the principal amount of debt (even though the rule itself runs off interest payments as is proposed here). Since a test based on principal amounts is typically much less burdensome to operate, it is possible for many taxpayers to demonstrate that they are outside the scope of the rules fairly simply. However if the gateway test is failed – and of necessity there is a material margin of error between the threshold needed to satisfy it and the relative levels at which the interest restrictions come into play – then the full interest-based calculation comes into play.
The degree of compliance work involved in carrying out the interest calculations should not be underestimated, and the UK's gateway test is extremely useful in allowing a lot of groups to whom the rules are clearly not going to apply to escape carrying out the full workings required.

7. We agree that the interest allocation rule is highly vulnerable to manipulation. Also as already noted it in all likelihood will lead to currency movements having even larger arbitrary effects on tax liabilities than would be the case with other rules.

However, as noted in our general remarks, even the group ratio rule will inevitably lead to groups choosing to incur their external debt in countries which have not adopted these proposals, thereby obtaining a type of double dip through getting the direct benefit of relief where the interest is incurred, while also opening up the possibility of more relief elsewhere in the group.

There is in our view a much more fundamental problem with the group ratio rule which makes it inherently unsuitable for use as the sole rule restricting deductibility. We note from the Discussion Draft that those countries that have implemented group ratio rules generally use them as a filter to enable some companies to escape the limitations of a fixed ratio rule, not as a standalone measure. As such the role it is performing is allowing some groups to demonstrate that the fixed ratio applicable under the relevant local rule is insufficiently generous to reflect the commercial borrowing potential of a given group. The problem with a group ratio rule of the type envisaged operating alone is that it penalises success and rewards failure, thereby delivering results which directly oppose commercial reality. By way of example:

Take a simple group comprised of a holding company with two subsidiaries. Each subsidiary has an interest cost of 100 and an equity-type value for the ratio of 100 (we note that it is an open matter for consultation as to what the equity-type measure should be but in order to illustrate the fundamental problem with the rule it does not matter what it is). So at this point the group ratio is 200:200 (i.e. 1:1) and each subsidiary's ratio is 100:100 (i.e. also 1:1). The proposed rule would not operate to deny any relief as neither subsidiary's ratio would exceed the group's overall ratio.

Now suppose that the group does well. In a year's time the first subsidiary's equity measure is 150, and the second subsidiary's is 250. Debt levels are unchanged – given the success of the business, no further borrowing has been required.

When we apply the rule one year on we find that the group's ratio is now 200:400 (i.e. 1:2). This sets the cap on borrowing relief applicable to each subsidiary. The second subsidiary is unaffected by the proposed rule since its own ratio is 100:250, so lower than the overall group level. However the first subsidiary's ratio is 100:150 – more than the overall group level. Under the proposals it will therefore suffer a disallowance of 25% of its interest relief (its 100 being cut to 75 for tax purposes), even though both its own and the group's financial positions (and hence borrowing capacities) have improved and even though its own debt levels are unchanged.
It will be apparent from the above example that the proposed rule will operate to reduce the tax interest capacity of any group member which performs at a level below the average level of the group – even if that company is in isolation performing extremely well and where there can be no valid policy reason to deny interest relief.

Conversely it will be apparent that if the group as a whole is performing badly this will allow increased interest deductibility for any companies in the group doing less badly than average – even if their individual positions (and hence borrowing capacities) have substantially worsened.

The proposed group ratio rule is therefore operating to reduce interest deductibility for companies and groups whose commercial borrowing capacity is increasing, whilst increasing it for groups whose commercial borrowing capacity is reducing. Quite simply as a policy outcome this must be the opposite of what is intended. Mathematically this appears to us to be an inevitable result of a rule of this type, rendering it entirely inappropriate as a single rule (albeit perhaps viable in the way in which it has been used by some countries, as a filter to turn off the application of a fixed ratio rule in certain circumstances).

Clearly in the example above the second subsidiary would not be utilising its full capacity to deduct interest for tax purposes, but it is not an answer to the issue to say that the group might reorganise its financing to transfer some debt from the first subsidiary to the second. Most obviously the tax rates in the jurisdictions in question may not be the same so this might not give rise to equivalence of outcome (this of course is also a problem with an interest allocation rule). But more fundamentally, we do not see how it can be right to reduce an entity's borrowing capacity for tax purposes when in commercial terms it has increased. Equally groups should groups be required to reassess all their financing on an annualised basis in order to optimise their tax outcomes against rules such as this. Where debt is external this is likely to involve a time consuming and costly process of negotiating with banks.

8. We have already discussed many issues arising from the UK's World Wide Debt Cap. In summary we see the key problems as being:

8.1 A further tax incentive is created to use debt rather than equity finance, exacerbating the wider economic problem of over-leveraging;

8.2 Great complexity and associated practical difficulties for groups in getting it right (and revenue authorities in checking the position);

8.3 Real problems are created when companies are bought and sold by groups to which the rules apply, where it is genuinely hard to see what the right policy solutions are (let alone how they might be implemented in a workable manner);
8.4 Inconsistency of rules as to the nature of payments qualifying as deductible interest in different countries, making it difficult to identify the correct comparator numbers at group and at local level;

8.5 Arbitrary and unjustifiable impact of currency fluctuations on the tax positions of entities with no dealings in the currencies in question.

We are not convinced that these points can be overcome, which is why we do not support a rule based on the application of group-wide tests.

9. As already noted we think the Discussion Draft underplays the significance of currency movements, and the unfair and arbitrary outcomes which they can lead to in companies within international groups on which they have no direct impact.

The accounting policies used at a group-wide level may not be consistent with those used (and maybe required to be used for tax purposes) at a local level. Where this is the case, the rule will not be comparing like with like when it looks at group level ratios and compares them to local level ratios.

10. As already noted, manipulation would be possible by using profit participating loans or similar instruments to deliver an equity-style performance based return while retaining accounting treatment as interest. This would enable group level interest levels to be increased (so increasing local deductibility) without taking on true debt obligations.

11. There can be no generalised answer to this question. Trading businesses will more commonly be valued by reference to a multiple of earnings, reflecting the fact that a large part of their value is likely to be comprised in intangible assets which are not reflected on the balance sheet. Investing entities such as property holding companies will on the other hand be better valued by reference to net asset value. Of course it follows from this that the correct answer will not necessarily be the same for all companies in a group.

That said, in our view it is not necessarily the right question to be asking what approach to measuring economic activity gives the most accurate picture. It is better to ask what measure of economic performance is most appropriate to test against interest costs. In our view when the question is put this way it becomes clear that an earnings measure should be used: interest payments are a revenue-type expense, and so should be compared to revenue-type returns.

Conversely if the rule were to apply by reference to the principal amount of debt, the other half of the ratio should be asset values. Otherwise one is not comparing like with like.

In particular, interest costs and earnings are both measures which only really make sense when considered over periods of time. By contrast, principal amounts of debt and asset values only really make sense when assessed on a snapshot basis at a given point in time. This is reflected in the former items appearing in the profit and loss account of an enterprise, with the latter in the
balance sheet. If asset values were to be tested against interest cost, some form of annualised average asset value would therefore be required in order to prevent manipulation and unfairness.

From a mathematical perspective a ratio obtained by comparing interest amounts with asset values is not terribly meaningful. Commercial lenders will generally look at two factors: interest cover (i.e. comparing the proposed interest cost against the borrower's turnover from which it will be met) and loan to value (comparing the amount of the loan against the value of the borrower's asset base). The interest restriction rule should reflect this.

12. If earnings become negative the inevitable consequence of the rule would be that all interest deductibility is lost (save for carry-forward measures), and a possible consequence could be that an entity which has positive earnings before interest but which is loss-making overall has to pay tax. This feels like an extremely harsh outcome, not least as it may be the case that all of an entity's interest cost is paid on entirely arm's length terms to unconnected lenders so there is no tax planning or risk of BEPS in play. In such a circumstance it feels to us the wrong policy answer for interest relief to be denied. This of course is a problem with any non-transfer pricing based rule of a type which has been considered in the Discussion Draft.

It is also possible that a company's net asset value will become small or negative so the problem is equally applicable if that is the test. However as noted above we do not think it would be correct for this to be the test.

13. None. There are no grounds to exclude any particular types of income from the test, since all types of income contribute to a company's borrowing capacity in commercial terms. If some types of income are considered "bad" for interest purposes (such as tax exempt income), then the right approach is to deny interest relief in full on borrowings incurred in order to derive that income as is done in numerous existing ways around the world.


15. See general discussion on currency issues. This is an extremely difficult question which we do not believe has a satisfactory answer.

16. The most appropriate measure of economic activity may well differ between group members. However, as discussed above, our view is that earnings based measure is the only conceptually correct choice if the limitation rule operates by reference to the quantum of interest payments rather than the principal amount of debt.

17. We do not believe that groups should be forced to undertake this exercise annually purely for tax purposes when there is no commercial reason to do it. The most obvious potential issue is whether such adjustments could be made in accordance with all applicable corporate law since by definition
they will involve companies incurring extra borrowing which they do not need for their own purposes, so issues of corporate benefit and distributions to shareholders are likely to be in play.

18. Not answered.

19. The proposal is complex enough with a purely earnings based rule. Attempting a blended rule incorporating earnings and assets would be even more so. Of course if one simply applies transfer pricing rules effectively each entity's overall asset and turnover position will be considered in determining the amount of lending it can stand, just as a commercial lender would do.

20. We have substantially covered this point already. Most obviously the point would arise in relation to permanent mismatches where a group level expense is accounted for as interest but not allowed against tax due to its nature.

21. Carry forward provisions are an option, but any solution other than testing the interest cap according to local tax rules is by its nature flawed and so capable of leading to erroneous results. However, requiring recomputation of group level finance costs under the tax rules of every jurisdiction in which a group has a presence is clearly far too burdensome to impose in practice. We do not think that this issue is soluble.

22. Targeted rules would be preferable. For example, we believe that it would be wrong for all the different investments of a given private equity fund to be treated as a group for the purposes of the global tests when in practice they will be run completely independently of one another.

23. We see this issue as raising significant administrative challenges. If this point is to be addressed at all it must necessarily involve a departure from simply using the numbers in a group's consolidated accounts to determine the total level of group interest payments. Of course if one instead relies on a well-crafted set of transfer pricing rules, those rules will catch such situations. This is a further reason why we believe that the use of transfer pricing to limit the quantum of deductions is far preferable to a test of the type being put forward here.

24. The key practical issue is that the fixed ratio is being used as a proxy for a proper determination of the arm's length interest payable, and may in fact bear little resemblance to the arm's length interest payable. It therefore potentially restricts relief in respect of genuine third party interest where any risk of BEPS is minimal (unless it is crafted so as to bite only on connected party payments), as well as potentially disallowing relief for interest paid to connected parties at arm's length levels. However, if that is accepted in the context of wider fiscal policy, the practical issues with an earnings-based approach are very limited as long as a number which can straightforwardly be extracted from a company's accounts is used as the basis for the ratio calculation. A fixed ratio rule based on assets poses significant challenges for businesses that rely heavily on self-created intangibles because such a business would be forced either to revalue the intangibles on a regular
basis (if this is even permitted by applicable accounting principles) or rely on cost basis (typically zero), resulting in a fixed ratio significantly lower than its true borrowing base.

25. Not answered.

26. Most obviously it is in a different business sector from other companies in the group. Highly cash-generative businesses can routinely borrow a greater percentage of their value than those whose value is comprised to a significant degree of illiquid assets. For example, a group that includes both manufacturing and banking subsidiaries will have significantly different asset values in those subsidiaries. We note that the Discussion Draft does separately consider financial institutions, but even within non-financial businesses there is huge variation in borrowing capacity between business sectors.

Local economic conditions may also be a factor. Banks in some jurisdictions may apply tighter lending criteria than in others, which will be a factor in how much debt can be taken on.

27. Any sector whose typical leverage levels are materially away from the average would not obtain a correct result under a rule of this type. Of course this effect could work to the advantage of an entity if it is in a sector where borrowing is highly restricted, just as it could work to the disadvantage of an entity in a sector where high leverage is the norm.

28. Not answered in detail. However we would note that one of the key attractions of a fixed ratio rule is simplicity, and we would counsel against attempts to have different ratios for different sectors such that confusion could arise as to which sector a given company should fall into (especially if its business is diverse). If the fixed ratio model is adopted, in our view it should be accepted that it is imprecise and in some cases delivers rough justice, but since this will be the same for all entities operating in the jurisdiction any conceptual unfairness should not distort competition. It may be appropriate to separate regulated financial institutions from other types of businesses, but to maximise simplicity and ease of administration) no more than a few separate categories should be allowed.

29. If the same measures of economic activity are used in a general rule and a carve-out then it can be difficult to deliver the hoped-for simplification benefit of the carve-out since by definition much of the same work must be done in relation to the carve-out as would be the case for the main rule.

By contrast if different measures are used the risk is that the carve-out lets out groups which should as a policy matter be caught. However, this can be addressed in practice by allowing a significant margin of error – i.e. in order to fall within the carve-out, it would have to be substantially impossible to be paying interest at levels which should be of concern.

If this approach is followed, minimal effort should be required to test the availability of the carve-out, otherwise little is gained.
We would reiterate the point made in reply to question 7, that we do not consider that a group-wide ratio test of the type proposed can be the solution on its own since it will inevitably deliver tax outcomes that are diametrically opposed to the commercial position (as, paradoxically, improvements in the group's balance sheet will worsen the ratio by reference to which all individual group members' deductibility position is tested and vice versa).

30. As noted above, the UK, with some success, employs a carve-out based on the principal amounts of debt which are much easier to determine than ongoing interest costs.

31. As already discussed, our view is that all questions as to the quantum of interest deductions which should be available should be dealt with through transfer pricing rules. A well-crafted set of transfer pricing rules will address all such questions, including (of the examples in the Discussion Draft) the routing of funds through intermediate entities, artificial debt and excessive debt pushdowns. We were surprised to see the example of interest being paid to related parties listed as potentially requiring a targeted rule, since in our view that is exactly what transfer pricing rules do.

However, our view is that targeted rules are appropriate where it is the nature of a debt, or the motive behind its existence, that call into question whether interest should be relieved as a policy matter. In the examples cited in the Discussion Draft, stapled stock (or indeed debt with other equity-like characteristics such as profit-dependent coupons) might not qualify for interest relief even where paid to a wholly independent third party under a fully arm's length deal. Similarly debt used to fund tax-exempt income also might not qualify for relief.

In turn it follows from this that in our view a targeted rule is likeliest to deny interest relief in full in relation to any given debt, on the basis that either the debt is not really debt-like or alternatively that it is being used for a purpose which makes it inappropriate for relief to be granted. Targeted rules would apply before any general interest limitation rule, and if the general rule is working properly – see above – any interest that is not allowed for tax purposes (or not treated as taxable, if received) due to the operation of the targeted rule should be disregarded in any calculations necessary to operate the general rule.

Targeted rules and general rules should, therefore, in our view, perform very different functions. As such, neither should really be seen as supporting the other.

32. Any ability to carry forward or back disallowed interest or unused interest capacity would be welcome in order to smooth out the effects of mismatches or just simple sudden changes in circumstances. Beware however making the rules too complex.

33. We would urge against time limits, on the assumption that it would not be possible in any given year to obtain interest relief of a greater amount than the threshold set by the general rule. If that
assumption is correct it is not as if these rules could result in long periods of companies paying no tax at all. However if a time limit is to be included, we would have thought that five years would be reasonable. That said, if a fixed ratio test were to be applied based on asset value, a significant economic downturn could result in dramatic reductions in allowable interest expense and significant carry-forwards, and it may be appropriate to allow a longer period (perhaps ten years) if such a test were applied.

34. Not answered.

35. Not answered.