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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

tax bias in favor of debt versus equity could be a fruitful area for the OECD to study, but that involves policy matters well beyond the scope of the BEPS project. And the solution for addressing such bias might well lie not in creating double taxation with respect to debt but rather in eliminating double taxation with respect to equity.

We are concerned that the necessary result of the group-wide approaches would be ordinary course business interest expense that would be deductible nowhere in the world. That result would conflict with longstanding international tax policy principles and would create significant double taxation. Further, the group-wide approaches would have uneven impact and would treat similar entities differently based on differences in the leverage profile of other members of the entity's corporate group. That result would be inconsistent with the arm's length principle.

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.

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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

Alex Postma