European Business Initiative on Taxation (EBIT)

Comments on the OECD Public Discussion Draft on
BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS
18 December 2014 - 6 February 2015

At the time of writing this submission, EBIT Members included: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, GSK, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROBECO, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.

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Submitted by email to: interestdeductions@oecd.org

Brussels, 6 February 2015

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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