BUSINESSEUROPE

Achim Pross
Head, International Co-operation and
Tax Administration
Division, OECD/CTPA
2, rue André Pascal
75775 Paris
France

6th of February 2015

Submitted by email: interestdeductions@oecd.org

Comments on the OECD Public Discussion Draft entitled "Release of a discussion draft on Action 4 (Interest deductions and other financial payments)" 19 December 2014 – 6 February 2015

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