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W. PATRICK EVANS
Chief Tax Counsel

3 February 2015

Achim Pross
Head, International Co-Operation and
Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via Email: interestdeductions@oecd.org

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

Dear Mr. Pross:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to Action 4 of the Plan, on 18 December 2014 the OECD published a document entitled *BEPS Action 4: Interest Deductions and Other Financial Payments* (hereinafter the Discussion Draft or Draft). The OECD solicited comments from interested parties no later than 6 February 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,

at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.[1]

TEI Comments

TEI commends the OECD for the thorough work regarding potential base erosion and profit shifting issues with respect to interest deductions and other financial payments, as reflected in the Discussion Draft. Regrettably, the Draft is another manifestation of the OECD's move away from the arm's length principle in various respects during the course of its BEPS project. Moreover, the approaches for limiting interest deductions within a multi-national enterprise (MNE) present many difficult, if not intractable, practical problems in their interpretation and application. In addition, the Discussion Draft undermines an MNE's ability to arrange their own financing, re-characterises genuine commercial arrangements, and seemingly fails to recognise that entities may have different levels of interest expense depending on their circumstances.

Non-tax Financing Considerations

The OECD gives the impression throughout the Discussion Draft that all MNEs arrange their financing for tax purposes. The Draft also assumes MNEs can easily re-arrange their internal financing to align the actual interest expense in each entity or country to the interest limitation amounts calculated under one of the methods discussed in the Draft (deemed interest, interest cap, group ratio, *etc*.). Many considerations other than tax, however, are taken into account by an MNE when determining how an entity should be capitalised or financed. These considerations include:

- Country risk, including the stability of the economic and political environment, whether there are foreign exchange controls, the ease of repatriating funds, and the strength of the legal requirements governing return of capital and dividend payments;
- Where in the business life cycle are the company's operations, *e.g.*, a business in the start-up phase may require regular capital infusions to maintain operations, such infusions may come in the form of debt or equity;
- The type of business the entity is engaged in – whether it is a limited risk entity or a fully integrated entity with research and development,

[1] TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

manufacturing, sales, *etc.*; and whether the industry is capital or labor intensive;

- The financial market in the local country as compared to the parent company and other affiliates' countries where a member of the group may obtain reduced cost financing compared to other affiliates; and
- The business strategy for that company and the cash needs to meet that strategy.

Because of the many non-tax factors that need to be taken into account in a financing decision, it does not make commercial sense to have tax considerations drive an MNE's financing structure in most instances. Moreover, because these commercial needs often outweigh tax considerations, MNE's will in many instances incur interest expenses above the limitation required by one of the methods in the Discussion Draft and thus will likely end up being double taxed. In addition, MNEs will also be at a competitive disadvantage compared to domestic entities that will not have the same financing restrictions. For these reasons, TEI recommends that more targeted rules be used to address any perceived abuses with respect to interest expense. For example, the anti-hybrid rules proposed under BEPS Action 2, if properly implemented and coordinated, would generally be sufficient to police the use of interest expenses for base erosion and profit shifting.

Proposed Interest Limitations

Apart from the fact that non-tax commercial realities are a substantial driver of business capital decisions, the proposed general rules in the Discussion Draft are too broad and will capture many transactions that have legitimate business purposes. In addition, they will also add complexity and uncertainty to the tax compliance process.

First, determining the group ratios, interest allocations, and net interest expense will raise many difficult measurement issues, in particular whether these should be calculated based on financial accounting principles or tax principles. Tax and accounting principles also differ from jurisdiction to jurisdiction and thus a taxpayer may be required to calculate these measures in numerous, inconsistent ways, which may lead to double taxation. TEI recommends that if the measurement of the interest limitation is to be done using financial accounting principles, then consolidated financial statements should be used because the information will be more readily available, easier to audit, supportable by the taxpayer, and simpler. If tax adjustments are required, the rules between various jurisdictions should be consistent or an MNE should be allowed to use the tax rules applicable to the parent company.

Second, the use of these interest limitations creates significant uncertainty for business operations. For example, when there is earnings volatility there will be uncertainty regarding interest deductibility. Unpredictable variations in interest deductibility based on year-end calculations will impact a taxpayer's installment payments during the year, subjecting the taxpayer to potential penalties and interest (*i.e.*, corporations are required to pay taxes quarterly in many jurisdictions based on an estimate of their year-end tax liability – if the estimated payments do not reach a certain threshold of the actual tax due for the period, penalties and interest may be imposed).

Third, use of the group ratios may unduly penalise an MNE operating in different sectors. The OECD has recognised in the course of the BEPS project that base erosion and profit shifting by MNEs has at times come at the expense of purely domestic businesses. That is, the ability of an MNE to shift profits out of a local jurisdiction, or erode that jurisdiction's base, into a jurisdiction with a lower tax rate unfairly advantages the MNE over a domestic competitor that does not operate in a jurisdiction to which it might shift profits. The proposed interest limitation rules, however, appear to tip the balance too far in the other direction by favoring domestic businesses over MNEs, as demonstrated by the following example.

Assume A Co is in a capital intensive industry with earnings of €50M and net external interest expense of €40M and assume B Co (in the same affiliated group as A Co) provides consulting services with earnings of €50M and net external interest expense of €5M. Assume that the applicable tax rate is 30% for both A and B Cos. Assume A Co's domestic competitor C Co has the same earnings of €50M and net interest expense of €40M and assume B Co's domestic competitor D Co has the same earnings of €50M and net interest expense of €5M. Assuming the application of the group ratio set forth in the Discussion Draft, A Co's permitted interest would be €22.5M and B Co's permitted interest would be €22.5M (50M/100M x 45M). A Co's taxable earnings would be €27.5M (50M – 22.5M) with tax of €8.3M (27.5M x 30%). B Co's taxable earnings would be €45M (50M – 5M (deductible interest would only be €5M, the actual interest expense)) with tax of €13.5M (45M x 30%). In contrast, C Co's taxable earnings would be €10M (50M – 40M) with tax of €3M (10M x 30%) and D Co's taxable earnings would be €45M (50M – 5M) with tax of €13.5M (45M x 30%). In sum, A Co's tax would be €5.3M higher than C Co's merely because of the limitation imposed by the group ratio approach – even though A Co's leverage is identical to its domestic competitor. This is a consequence of adopting a group ratio limitation approach rather than letting interest expense be guided by the arm's length principle.

<u>Other Issues</u>

The OECD should also consider potential alternatives to address interest expense in situations where an MNE experiences losses. For example, where all companies in an MNE

have losses, how would the interest expense allocation be computed? Would the computation be done based on proportionate losses or would all the loss companies in the allocation be ignored, meaning none of the group's companies would get an interest deduction? How would the disallowed carryforward interest be determined if losses were ignored? Should asset based approaches be used as an alternative where losses are applicable in a year? If so, for practicality, it may be simpler if the accounting balance sheet is used instead of having to adjust for non-booked assets (such as intangibles), which could be complex and costly if valuations are required.

With respect to double taxation, TEI agrees that having provisions for carryforward of disallowed interest expense into future periods will help mitigate potential double taxation and address earnings volatility. The proposal in the Discussion Draft does not go far enough, however, because some taxpayers may not be able to re-arrange their financing to mitigate disallowed interest due to the various non-tax factors discussed above. Therefore, there should be no limitation on the ability to carryforward disallowed interest expense. In this regard, it is worth noting that the carryforward of disallowed interest expense will only help mitigate, and will not completely eliminate, the impact of the disallowed expense due to the time value of money.

The Discussion Draft also fails to address the withholding tax impact of the various interest limitations in sufficient detail. The Draft seems to indicate that withholding taxes would continue to be based on actual interest paid/accrued and not interest as limited by the methods discussed in the Draft. If that is the case, how would foreign tax credits then be calculated? Would they be based on net income adjusted for the interest as a result of deemed interest, interest cap, group ratio, *etc*. or would it be based on actual interest paid/accrued without regard to the limitation? These issues should at least be addressed and a preferred approach set forth in the OECD's final guidance.

Further, TEI recommends that the interest limitations only apply to entities included within an MNE's consolidated financial statements, which would be relatively easy and likely address most of the base erosion and profit shifting of concern to the OECD. It would be difficult to obtain the necessary information for non-consolidated entities, which would only complicate the various calculations necessary to determine the interest limitations. Indeed, determining the limitations applicable even to an MNE's consolidated entities will be a trying task.

TEI also recommends that, in addition to a monetary threshold that would exclude small companies from the interest limitation, the OECD exclude all entities that pose a low risk of base erosion or profit shifting from the limitation. For example, if a company pays an effective tax rate of X% of the domestic tax rate (*e.g.*, 75%) the interest limitation should not apply.

Finally, the final guidance with respect to interest limitations should address how jurisdictions will audit deductible interest that is subject to the limitation method selected. Under the proposals in the Discussion Draft, countries would need access to global interest income, expenses, earnings information, *etc.*, raising the question of how this information will be provided to local authorities. For example, will the parent company be required to provide the information to its local tax authorities, or should the local tax authorities obtain access to the information under the official exchange of information process? This process should parallel the information sharing process decided upon under BEPS Action 13 for the master file.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft under BEPS Action 4 regarding interest expense and other financial payments. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President