Comments to the OECD Discussion Draft on BEPS Action 4 "Interest Deductions and Other Financial Payments"

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, welcomes the opportunity to provide comments on the Public Discussion Draft BEPS Action 4 "Interest Deductions and Other Financial Payments".

ICC is concerned that the arm's length test has been discarded, without a detailed technical justification. Furthermore, while claiming to tackle tax avoidance (via profit shifting), there is no consideration of the substance of financing structures; any commercial motive, including overarching business aims to generate profits as a result of the associated investment. Even more concerning is the assumption from the outset that payment of interest is a tax avoidance device, which for the vast majority of taxpayers is simply not the case. ICC would therefore recommend that:

- Any changes to interest deductibility should be focused on tackling actual avoidance entered into by the minority, and not impede genuine commercial transactions of the vast majority of taxpayers, which contribute to growing global, and local, economies.
- The arm's length approach should not be discarded, since this, fundamentally, is the best method for judging the appropriate level of debt and interest expense of an entity on a standalone basis. In essence, this is what the rules provide for a single entity. At the more complex level of a domestic group, the allocation method starts to create distortion and for a Multinational Enterprise (MNE), the impact can be significant. The corporate structure (single entity, domestic group or MNE) does not, by itself, have any bearing on the purpose of the relevant financing arrangements.

If the real concern of the OECD is a situation where interest is deductible at a high rate of tax, and the income is subject to a low rate of tax, then that situation is better addressed under CFC rules, Harmful Tax Practices, and transfer pricing. Creating a blanket interest disallowance for all activities will impede genuine commercial transactions.

A. The choice of capital instruments in investment decisions

The choice of capital instruments takes many commercial factors into account, including ease of access; cost of capital; flexibility, ease of repayment, etc., and is not fundamentally driven by tax avoidance or base erosion purposes.

In particular, it facilitates global cash and risk management, optimising the capital structure of the group and centralizing execution of market interfaces. These activities reduce external costs and are not structured for tax avoidance purposes.

Capital is a constrained resource and is often allocated to projects with optimum risk-reward balance. Tax does not direct these decisions, but is part of the economics when deciding where to invest in long term capital projects. In order to encourage investment and economic growth the cost of capital must remain affordable. A partial or complete disallowance of interest expense will impact the cash flow needed to fund an investment, increasing the cost of such investments, and negatively impacting the overall investment climate of certain jurisdictions.

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This in turn will destroy their ability to attract foreign direct investment – which is aimed at generating profits, and increasing employment, and consequently employment and profit taxes.

Guiding Principles

As the OECD discusses options for Action 4, ICC recommends a principled approached to address whether and how to limit interest expense deductions based on the principles outlined below:

1) *Tax Avoidance* – Intra-group interest should not be deemed to be prima facie “base eroding.” This is not a valid assumption for the vast majority of taxpayers. The starting point may well be that, due to the actions of a minority of taxpayers, intragroup interest may be considered higher risk. However, ultimately that risk should not alter the technical analysis of whether an interest deduction should be available. This should be based on the commercial, economic and legal reality of what would be available between unrelated parties.

2) *Debt and Interest should both be tested and respected based on the arm’s length standard* – Any interest limitation rule should be based on the use of the arm’s length standard in order to reflect the economic and commercial reality of the transaction and thereby creating a level playing field between MNEs and domestic groups. However, world-wide level tests would ignore these realities and instead apply an artificial test to determine interest deductibility. ICC’s concern is that such a move away from the arm’s length standard is really just a step towards formulary apportionment which would irreparably damage the arm’s length standard.

   To the extent that the OECD seeks to deviate from the arm’s length standard, it should clearly articulate the mandate for such deviation, together with situations and rationale for doing so. Summarily dismissing the standard as too complex or burdensome is not an acceptable rationale.

3) *An interest limitation rule must not result in double taxation* – Any disallowed interest expense, should not be taxed on the income side. Therefore, further guidance would be needed on the application of measures that provide for corresponding (non-) taxation.

4) *An interest limitation rule should ensure financing costs remain predictable* – Mechanistic approaches (such as interest deductions based on an allocation of group debt), ignore the underlying commercial realities and are often complex and difficult to administer. Any interest limitation rule should also be simple to understand and comply with. It should provide certainty by being easy to predict the outcome from inception; and avoid unintended consequences. Finally, the target of any proposed rules needs to be made clear, and factual patterns and scenarios should be articulated to give taxpayers a clear understanding of when proposed rules would apply.

5) *An interest limitation rule must not favour one group of taxpayers or sectors over another* – Any proposed rule should be neutral to inbound and outbound companies. Proposed

rules should also consider the differences in industries and sectors such that any new rule is not discriminatory or more favourable to any group of taxpayers.

6) *Any interest limitation rules should provide transitional rules to allow for a smooth transition with minimal compliance costs* – Transition rules are needed to provide relief to all pre-existing debt in order to preserve the economics of such debt which were known to all parties at the time of making the investment. Further, any new interest limitation rule should be phased in over time to avoid disruption to financial markets and planned capital projects.

B. Conclusion - Comments on Discussion Draft Proposals

1) *Proposals do not target avoidance* – As currently envisaged, the group-wide test (as highlighted in paragraph 61) results in entities within a group with higher external interest, being able to deduct greater interest costs in a subsidiary rather than an identical MNE with lower external interest. This different treatment does not reflect any commercial realities of the entity level debt, nor does it seek to target any avoidance motive. Therefore, whilst it may be a convenient way to raise taxes, it does not address the underlying issue of tax avoidance.

2) *Arm's length test is abandoned* – The OECD has completely dismissed the use of the arm's length standard without any detailed reasoning for such move.

3) *Proposals will lead to double taxation* – The group wide approach will inevitably lead to double taxation since matching of the allocation of third party net interest expenses with the legal situation within an MNE (via intra-group loan agreements) will in practice be impossible. This will lead to an overall interest deduction within the MNE that will be lower than the total third-party net interest expense. Also fluctuations in the allocation measures around the world will lead to a change in the amount of interest that is deductible with an individual entity – even if there have been no changes at all in its legal and economic position.

   Such double taxation is an impediment to the proper functioning of the capital markets and the proposal to carry forward interest deductions may only partly provide relief (depending upon future uncertain circumstances). The instances of double taxation will also increase business costs and could result in unintended business decisions/ consequences.

4) *Proposals create complexity and uncertainty* – The group-wide allocation mechanisms in the report are presented by the OECD as relatively simple whilst in ICC's view this is not the case. For example, the reliance on accounting rules that differ significantly internationally will lead to significant complexities.

   In addition, the group wide allocation rules proposed will lead to unpredictable and volatile outcomes as allocation keys, such as earning and/or asset values will fluctuate each year. The world-wide allocation rules will create administrative challenges such as: (1) pushing interest allocations around operating companies within a group; (2)

managing foreign exchange issues in volatile currency countries; (3) accurately forecasting group operating companies' profits and correctly calculating the interest allocation on an on-going basis; and (4) imposing higher withholding taxes on interest

payments. At the same time, some countries' tax administrations will not accept the world-wide interest allocation rules for MNEs, and this will cause double taxation.

ICC also notes that a system which allows a greater interest deduction in one year compared to another, with no change in avoidance motive, cannot be tackling an underlying avoidance in a focused manner.

5) *Proposals seem to favour domestic groups over MNEs* – The group wide allocation rules seem to favour domestic groups over MNEs, potentially creating an uneven playing field. For example, a domestic group acquiring an entity in its own country using external financing would generally not be restricted due to the group wide rule, while an MNE using an acquisition vehicle in that country generally would, depending on the profit geomix.

6) *No transitional rules are discussed* – The Discussion Draft fails to mention the development of transition rules. Any significant changes like those contemplated in the Discussion Draft must include broad transition relief that would grandfather pre-existing obligations and would be implemented over time for new debt. The economic bargain in a pre-existing debt instrument should be preserved, as the lender and borrower have expectations, set by the State benefiting from the investment, as to the cost of that investment. As any new limitation rule will affect both related and unrelated party debt, transition relief is necessary to provide certainty and stability in financial markets.

7) *Industry specific concerns* – Currently, industries which require heavy upfront capital investment, with delays before profits are realised, can obtain interest deductions for the investment. This is a genuine commercial activity, with the aim of creating employment and generating profits, both of which contribute to the tax revenues of the State receiving the investment. This commercially driven structure should not be deemed to be tax avoidance in any way. Doing so will only increase the cost of capital, and cause investments to be re-evaluated, in order to re-optimise the use of scarce capital resources.

8) *Methods of tackling avoidance using interest* – Any method applied should continue to allow deductions for genuine structures. Furthermore, using current or historic profits as a basis for limiting deductions will not encourage future investment in capital intensive industries, where the profit streams are often generated a number of years after the capital investment. This in particular applies to industries such as mining, and oil and gas, but also to other industries. Any changes should tackle avoidance, and not result in a blanket disallowance for all interest.

   Some industries will be faced with many jurisdictions that do not allow a deduction of interest for the industry concerned. The group wide allocation rule will still require the allocation of net external interest to such jurisdictions, with the result of double taxation and a disturbance of the level playing field.

9) *Fixed Ratio* – While fixed ratios do not reflect actual arm's length commercial situations, they can be a useful tool to provide certainty and clarity as a means of providing a safe harbour sensible level of deduction that is deemed acceptable (ICC would suggest a

minimum of 30%, which is already at the lower end of the spectrum highlighted in the Discussion Document). However, there would need to be a route to rebut the fixed ratio for certain industries or commercial situations, in order to reflect genuine business circumstances, which are not for tax avoidance purposes.

10) *Combined approach* – ICC does not recommend using a combined approach. Not only does this add to the complexity, but it would incorporate a group allocation methodology which has significant practical difficulties and would distort genuine commercial activity.

The International Chamber of Commerce (ICC)
Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy. Founded in 1919, and with interests spanning every sector of private enterprise, ICC's global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.