USCIB
UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
Achim Pross
Head, International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(interestdeductions@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments

Dear Mr. Pross,

USCIB[1] is pleased to have this opportunity to provide comments on OECD's discussion draft on interest deductions and other financial payments.

USCIB generally supports the comments submitted by BIAC. We write separately in order to emphasize certain points, note some differences, and highlight our member's perspective on the discussion draft.

The December discussion draft is focused on the first part of the Action 4 work stream. That is:

> 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.[2]

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.
[2] Action Plan on Base Erosion and Profit Shifting, page 17.

In USCIB's view the discussion draft is not targeted at practices described above that lead to BEPS and is instead attempting to get interest allocation "just right".[3] That should not be the goal of Action 4. Rather the goal of Action 4 should be the elimination of practices that lead to BEPS. That goal should determine the best practices that the OECD adopts.

Key Policy Aims

Paragraph 10 (page 10) of the discussion draft provides that the work on interest deductibility should:

> Encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group. Overall, however, in general groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost.

USCIB welcomes that acknowledgement that groups should be able to obtain tax relief for third party interest expense. We believe, however, that parts of this statement of key policy aims are misguided.

As to the notion that interest expense of individual entities should be more closely aligned with the overall group, is both conceptually flawed and difficult to achieve in practice. The conceptual premise underlying this conclusion is that money is fungible across national borders, between different currencies, across multiple lines of business, and between different markets.[4] Money may be fungible in narrower circumstances, but it is not true that companies can simply shift earnings, assets, and debt among related entities without regard to these concerns. Multinational groups are not monoliths. Tax is not the only or even the most important determinate of where an MNE locates debt. Non-tax considerations determine the capital structure of MNEs; how and where they borrow money, and how equity and debt funding is allocated to particular members of the group. Different parts of a business may have different funding needs; some parts of a business may be more capital intensive than others.

MNEs may, in many cases, centralize third-party debt in the parent entity or an affiliate resident in the parent country. There are many reasons for this including the desire to borrow in the home country currency or creditors' desire to have the assets of the group available to fund the repayment of the debt. The proposals in the discussion draft, particularly the group wide ratio, would essentially require MNEs to establish financing entities to manage their interest expense by pushing debt down to affiliated entities. The financing entities may neither need nor have full time employees. The discussion draft on risk, characterization and special measures may be read as not recognizing these transactions or applying special measures to them. Thus, the proposals in the two discussion drafts may be working at cross purposes. That is, if MNEs must

[3] Goldilocks and the Three Bears or Voltaire, "the perfect is the enemy of the good".

[4] Paragraph 5 of the discussion draft asserts the fungibility of money as part of the reason for the approach of the discussion draft.

establish financing entities to manage their interest deductions to the extent possible[5], then those entities must be permitted to earn a time value of money return regardless of whether they are considered "minimally functional". Both the discussion draft on interest deductibility and the discussion draft on risk, recharacterisation and special measures should be clear that such entities earning a time value of money return do not raise issues under non-recognition or special measures notwithstanding their passive nature.

In some situations, for example project financing, MNEs may not have any choice with respect to which entity is required to borrow. Third party lenders may require an entity that is acquiring a valuable asset to take on the debt being used to acquire that asset because they want recourse to the asset and the earnings from that asset in the event of a default. This may be the case regardless of whether this entity is more or less leveraged than other entities in the group. For example, it would be unrealistic to expect an Australian mining group that is borrowing money to develop a new property in Chile to spread the costs of developing that property across 50 subsidiaries located in other countries. The lenders are likely to require covenants concerning the Chilean assets in recognition that those assets will be the source of repayment while other assets of the group may be off-limits to the lenders because they are in separate legal entities and are protected by the limited liability available to corporate entities and the loans funding those purchases contain covenants restricting the transfer of those assets or the encumbering of those assets with additional debt.

The discussion draft fails to acknowledge its potential impact on creditors' rights. At least with respect to existing debt, creditors have entered into creditor/debtor relationships based on expectations with respect to cash flow sufficient to fund debt. To the extent that interest expense disallowances undercut those assumptions (and the actual ability to make payments on pre-existing debt), then third party rights might be compromised. The discussion draft ought to prescribe transition/grandfather rules to deal with this issue.

Action 4 relates to the coherence pillar of the BEPS project. That is the notion that expenses in one jurisdiction ought to result in income inclusions either in that jurisdiction or in another jurisdiction. Countries are of course concerned when deductions are taken in a high tax jurisdiction and income is included in a no or low tax jurisdiction (see box on page 7). However, there is no acknowledgement that in many cases interest income will be deductible in one high-tax country and includable in that same country or another high-tax country and that such a payment and inclusion does not raise BEPS coherence issues. Coherence is maintained whether the income is taxable in the entity that receives the interest or by that entity's parent under appropriate CFC rules. Thus the proper scope of these rules cannot be determined without reference to the CFC design principles. A common example of high-tax deduction and inclusion would be an entity in a high-tax jurisdiction has a revolving line of credit with a local bank which it uses to fund working capital needs. The entity may use this line of credit more when business is down and therefore incur more interest expense when it would have less cap (under an earnings measure).

[5] See the BIAC comment letter for detailed comments on why this is very difficult to achieve in practice.

The key policy aims only acknowledge the need to permit a deduction for third-party interest expense. Related-party debt serves important functions. As the OECD acknowledges, earnings can be volatile and inter-company debt can address some of that volatility at less cost to companies. That is, a company with excess cash may make a loan to a related entity that needs cash. This may be the result of business cycles and may be between high-tax jurisdictions such that BEPS concerns are not raised. Nevertheless such a loan could result in a disallowance even though there should be no BEPS concern. Related party debt may also be the only cash available in a liquidity constrained market place. Encouraging third-party debt (which this rule clearly does) is contrary to much recent economic advice that attributes at least part of the recent financial crisis to over leveraging. Thus rules that encourage third-party debt should not to be favored.

For all these reasons, the goal of Action 4 should not be to align the interest expense within the group, but to determine what level of interest deduction limitation appropriately protects countries against BEPS practices.

Best Practices

USCIB believes that best practices should be determined by the goal of preventing BEPS. Thus, Action 4 should function as an anti-abuse rule and the policy choices should flow from that. Because any broad interest limitation has the potential to disallow interest expense that is unrelated to BEPS and such disallowance would have a negative impact on investment, the thrust of the rule should be to allow interest up to a relatively high threshold. Thus, a relatively high fixed ratio applied to a consolidated group within a particular jurisdiction should be the primary rule.[6] Particular abuse cases could be addressed by targeted rules.

Existing ratios in countries that currently have fixed ratio approaches should not be reduced until there is better information on actual ratios.[7] The Global 100 ratios, even if they are correct, are not likely indicative of ratios for other entities. USCIB also believes that a global approach adopting a fixed ratio – even one that the OECD perceives as high – will likely have an impact simply because it is a global approach and taxpayers cannot avoid its impact by moving debt to a jurisdiction that does not have a disallowance rule.

Taxpayers should have an option whether to use earnings or assets to determine the fixed ratio as long as they apply that choice consistently. As the OECD acknowledges there are difficulties

[6] The discussion draft appears to contemplate allowing a consolidated approach. USCIB believes a consolidated approach better achieves the anti-abuse goals of BEPS. That is, if the consolidated group as whole is below the threshold, then business decisions on where to locate debt within the group should not be second guessed.

[7] USCIB has asked members to look at these numbers. We may provide feedback on this as it becomes available. We have attached a spread sheet prepared by S & P Capital IQ Leveraged Commentary and Data (2014). The universe represented in this spread sheet is non-investment grade (rating below BBB) US SEC filers with outstanding debt as of 9/30/2014. We think that it is important for the OECD to look not just the world's largest companies, but a range of companies that may be affected by these fixed ratios. Non-investment grade filers will have much less access to equity markets and, therefore, will rely more on debt to fund their businesses.

with both approaches and those difficulties will affect MNEs differently. Taxpayers are in the best position to know which approach works from their company.

The world-wide group ratio will be very difficult for taxpayers to apply and tax administrations to audit (particularly developing countries with capacity constraints).

World-wide group ratios also have the substantial practical problems (only a few of which are raised here) that are worse under a deemed interest rule.[8]

Assuming that a world-wide rule applies on the basis of earnings, if earnings are adjusted on audit does that have a ripple effect on the world-wide allocation? Do the caps in all countries need to be recomputed? Obviously, this would be unnecessarily burdensome for routine adjustments, but at some level would this be required?

A world-wide ratio especially one that is not very high, will almost certainly result in the denial of interest deductions. This would be the case even if the MNE made its best efforts to get the interest allocation "just right" because it will be impossible to know in advance what "just right" is. A fixed ratio, on the other hand, gives MNEs more certainty concerning whether their level of debt in a particular country will be allowable and the interest therefore deductible.

If the world-wide group rules are not adopted universally, how do such rules interact with jurisdictions that do not adopt such rules? Does interest expense in that jurisdiction create or reduce cap depending on how leveraged that entity is?

USCIB appreciates the opportunity to comment on the discussion draft and looks forward to working with the OECD to achieve appropriate outcomes.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

[8] USCIB believes that a deemed interest rule would be a very bad choice. We are pleased that the OECD has rejected it, but raise these concerns because this is not a consensus document and countries may still be considering this option. This letter does not identify the difficulties with an interest allocation approach, but USCIB would be happy to do that if the interest allocation approach is being seriously considered.