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By email to: interestdeductions@oecd.org

6 February 2015

Dear Mr. Pross,

BEPS Discussion Draft: Interest deductions and other financial payments

PricewaterhouseCoopers LLP ("PwC") welcomes the opportunity to comment on the OECD's *Public Discussion Draft on Action 4: Interest Deductions and Other Financial Payments* (the "Discussion Draft" or "Draft").

We recognize the difficulty of the task being addressed in Action 4, and accordingly, we commend the Working Group for its efforts in developing different options for approaches that may be included in a best practice recommendation, along with challenges associated with such options. We have concerns in a number of areas, however, in which we believe further consideration and effort should be undertaken.

We appreciate your consideration of our comments on the Discussion Draft and we would be pleased to assist the OECD further in its efforts under Action 4.

The response in the pages that follow reflects the views of the PwC network of firms, and we offer our observations on several key aspects of the Discussion Draft.

1. Summary of comments on the Discussion Draft

1. We are concerned that the group-wide test suggested in the Discussion Draft is impractical and will commonly lead to double taxation for a wide variety of taxpayers. In particular, it will dictate that groups must align their internal debt in a way that is likely to be inconsistent with a group's commercial treasury requirements. The group-wide test also unrealistically assumes groups will be able to obtain a deduction for their external interest expenses through a combination of a carry forward rule and regular re-organisation of intragroup financing. In particular, we believe that the Discussion Draft understates the numerous barriers and costs associated with regularly recalibrating debt levels across the globe.

2. The fixed ratio test as put forth in the Discussion Draft is overly restrictive and does not adequately take into account different industries, different levels of external leverage, and different policy considerations that countries may have in determining what threshold ratios should be used.

3. We caution that the recommendations in the Discussion Draft need to be considered in light of the other BEPS Actions, such as the actions addressing hybrid mismatches, treaty anti-abuse, and controlled foreign companies, that we believe will go a long way towards preventing base erosion through the deduction of interest and other financial payments in inappropriate circumstances.

4. Attempts at achieving consistency across jurisdictions will not be successful since there are fundamentally different tax and accounting rules in each territory in terms of interest deductibility, and, as acknowledged in the Discussion Draft, there will continue to be specific additional interest limitations which will not be applied consistently. In addition, there will undoubtedly be territories which do not adopt the proposals.

5. Of the seven policy aims articulated by the Discussion Draft, the proposals in the Draft address only the first policy aim – addressing base erosion and profit shifting – while largely ignoring the other six, including minimising distortions to the competitiveness of groups, minimising distortions to investment, avoiding double taxation, minimising administrative and compliance costs, promoting economic stability, and providing certainty of outcome. In particular, we consider that the group-wide test cannot be implemented without creating significant uncertainty, complexity and double taxation. Additionally, and of critical importance in relation to how a best practice rule should be designed, we believe that a more detailed assessment needs to be made, with the input of relevant economic/capital markets specialists, of the impact that these proposed approaches could have on commercial business decisions. We have a significant concern that such proposals could distort decisions with regard to the raising of finance and investment in organic growth or acquisitions. Ultimately, linking interest deductibility by territory to the third party borrowing of a group risks encouraging groups to choose debt funding over equity and over-leverage, a behaviour that could have negative consequences for the overall global economy. Further, given the uncertainty created and the likelihood that a group will not obtain full relief for third party interest expense under such rules, this could give rise to an increase in the cost of capital, acting as a disincentive to future investments.

In light of the above comments, we consider that the final proposals should recommend that:

1. There may be a role in limiting BEPS through a general restriction on interest deductibility as part of an overall package of measures which might include anti-hybrid rules, CFC provisions, arm's length tests and specific targeted anti-avoidance provisions; and that

2. A combined approach is likely to be the most appropriate restriction, involving a fixed ratio approach as the primary measure, supplemented by one or more additional measures (such as a group-wide ratio approach, or an arm's length test) which could be applied by groups that exceed the basic fixed ratio. It would be important in any such system that the fixed ratio is

not set at an overly restrictive level, so that the majority of groups would not need to apply the alternative measures, since this would simply result in the many drawbacks of the group-wide test being encountered.

2. General comments on the Discussion Draft

The Discussion Draft notes that BEPS Action 4 will interact with the other BEPS workstreams. However, the extremely restrictive approaches suggested by the Discussion Draft indicate that the other workstreams were not sufficiently taken into account.

The Discussion Draft describes techniques that use interest expense deductions that can contribute to base erosion and profit shifting and specifically mentions the following techniques: the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions, the development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income, the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense, and the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income.

Of the listed techniques, all but the first are already being addressed by the BEPS Action on hybrid mismatches. If the rules that are implemented as a result of that Action work, the need for significant additional limitations on interest deductions may be greatly reduced.

Similarly, the BEPS Action addressing controlled foreign companies may alleviate other concerns regarding payments that generate a deduction in one country without a corresponding income inclusion in another.

We recognize that even if these other BEPS Actions are successful, there may still be an incentive to make interest payments from a high tax jurisdiction to a low tax jurisdictions, and countries may therefore find it appropriate to limit the deduction for interest expense. However, when considering Action 4 in light of the other Actions, it becomes clear that impractical tests, such as the group-wide test, or ratio tests using exceedingly restrictive ratios that are not sensitive to different industries, may not be necessary. Moreover, in this case, it may not be appropriate for countries to wholly abandon the arm's length standard and adopt a formulatory approach.

As a result, there should be a greater emphasis on crafting rules that will work in practice, with priority given to ensuring any restrictions do not result in any realistic possibility of denying third party interest expense which will result in double taxation, do not distort commercial decisions regarding financing and deployment of cash around a group, and are reasonably simple to administer.

We understand that one of the concerns with the arm's length standard is that companies can maximize their debt in a country by including tax-exempt assets in their debt capacity calculations (e.g., foreign subsidiaries, the income of which may not be taxed by the parent company's jurisdiction). While we appreciate this concern, we believe that there are ways to address it that may be more practical and less distortive. For example, some countries, such as Australia, Germany and New Zealand, have enacted rules that permit using only in-country assets in the leverage calculations. Other countries, such as the United States, have proposed restrictions on the ability to deduct interest where such interest is allocated to income taxed outside the United States. In any case, we note that

provisions have been widely adopted to exempt dividends in order to prevent double taxation, and measures which have the effect of limiting deductions for external interest expense recreate the double taxation problem.

3. Comments addressing the group-wide test

Several countries have in recent years adopted a group-wide test as part of their thin capitalization rules. The experience of multinationals that do business in these countries illustrates the practical difficulties interpreting and applying a group-wide test can entail. The Discussion Draft understates the practical problems that the group-wide test poses.

For example, Germany is one of the countries that have adopted a group-wide test, although it has adopted it as a test taxpayers may utilize to avoid being subject to the other thin capitalization rules (i.e., as an exception from its usual thin capitalization rules). Our experience with the German test is that multinationals rarely use it because it is simply too complex to apply in practice.

Any rules that restrict the potential to deduct interest should not sacrifice practicality and stability. In this regard, we note that the United Kingdom worldwide debt cap regime, which bears a number of similarities to the way a group-wide test would need to be constructed, is largely successful because, whilst the worldwide debt cap rules are potentially very complex, the cap is set at a level which is targeted at high risk entities only, with a combination of arm's length rules, anti-hybrid rules, withholding taxes and targeted anti-avoidance rules resulting in an overall regime which can target BEPS on multiple levels without causing widespread distortions and double taxation.

A group-wide test will inevitably lead to double taxation unless all countries adopt the test – an unrealistic expectation – and as deductions will be disallowed by one country even while another country taxes the interest income received. We believe that the ability to carry forward disallowed deductions will not adequately prevent this result. Rather, some entities will find themselves in a perpetual state of disallowance.

A particular problem with a group-wide test is the volatility and uncertainty that it introduces. First, a given taxpayer's ability to deduct interest fluctuates as that entity's profitability fluctuates. Second, and even more out of that taxpayer's control, a taxpayer's ability to deduct interest expense will fluctuate as the profitability of affiliates in other countries fluctuates. For example, assume that a subsidiary of a multinational group has a certain amount of interest expense and interest expense limitation. The group then acquires an unrelated company elsewhere in the group that is highly profitable. In this case, even though nothing has changed with the operations of the subsidiary, its interest limitation would be reduced because it now contributes a lower proportion of earnings to the worldwide group.

The Discussion Draft suggests that groups might effectively be expected to regularly reallocate their debt around the group in order to minimise the amount of non-deductible interest expense. We do not consider that this is a realistic prospect for a number of reasons. This proposition ignores that groups use intercompany debt to fund their operations, and the need for cash will not typically follow pro rata with earnings – for example, the most profitable operations are likely to be the most cash generative and least in need for borrowing, whereas the borrowing requirement may well be in entities which are making investments, undertaking research and development or loss making. Additionally, in many territories it is likely to prove extremely difficult to effectively increase debt levels up to the allocated

cap if there is no actual need for cash in that business, for example due to minority interests, exchange controls, distributable reserve restrictions, rules limiting interest deductibility and withholding taxes.

One potential solution to this problem, as noted in the Discussion Draft, is to permit a deemed deduction for the allocated interest rather than have the rule operate as a cap. We note that the Discussion Draft dismisses this option due to the possibility that there may be potential BEPS opportunities if some territories do not adopt the same approach, but this simply illustrates the problems with the proposed cap not being operated consistently (i.e. the resulting double taxation). An alternative option is to permit companies to monetize these carryforwards after a sufficient period of time has passed. Sufficient passage of time before a company is permitted to utilize the deduction should ensure that the relevant debt was not put in place to erode the tax base. At the same time, if the Discussion Draft is correct that carryforwards normally would prevent double taxation, then permitting the monetization of the carryforwards after a sufficient time should be acceptable. For either alternative, however, it is important to note that it would not solve the other problems with the world-wide test described above. Finally, it will be critically important that the rules provide for a generous rule allowing excess limitation incurred in a particular year to be carried forward.

4. **Comments addressing the fixed ratio test**

While the fixed ratio test may not suffer from the same inherent impracticalities as the group-wide test, any fixed ratio test would need to take account of the realities of how business is conducted. The Discussion Draft indicates that under a fixed ratio approach, each country would have the ability to select its own ratio. However, the Draft implies that any net interest expense to EBITDA expense in excess of 10% may be excessive. In doing so, the Discussion Draft cites data that most of the 100 companies in the world with the highest market capitalization have a net interest expense to EBITDA ratio below that amount. We believe that this data may potentially be misleading, as it is not realistic to suggest that the net interest expense to EBITDA ratio of the 100 largest, and presumably most profitable and cash generative, companies in the world is indicative of worldwide debt levels. The data wholly fails to account for smaller companies, or privately held companies, both of which may have vastly different debt profiles for reasons wholly unrelated to tax. Additionally, it is important to underscore that the data sample reflects the borrowing costs in a low interest rate environment and at a point in the economic cycle where there are relatively low levels of corporate debt, and setting the ratio must also take into account the realistic possibility that taxpayers' borrowing costs as a percentage of earnings will increase in the future.

Even taking the Discussion Draft's data regarding the top 100 companies at face value, the fact that the majority of such companies have low net interest expense to EBITDA ratios does not indicate that any higher ratio is abusive and inappropriate.

A "one size fits all" fixed ratio test fails to account for differences in industries. An artificially low fixed ratio would unfairly penalize capital-intensive industries such as infrastructure, which generally have higher debt ratios for non-tax reasons. Moreover, different countries may well have good policy reasons to set limitations at different ratios. For example, a country whose main industry is mining may decide that the ratio at which interest expense is excessive is higher than a country with an economy that is heavily focused on less capital-intensive industries. We believe that the Discussion Draft does not sufficiently recognize that different countries may choose to use different ratios for valid policy reasons, including a reasoned decision that a higher threshold adequately serves the prevention of base erosion through excessive interest deductions in that country.

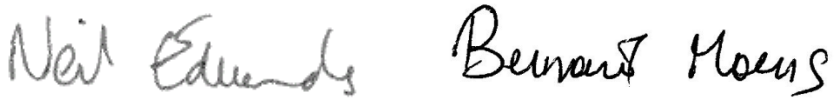
A fixed ratio test also penalizes external borrowing, in that it could lead to companies losing the deduction for external debt. As a general matter, external borrowing does not present the same BEPS concerns as intercompany borrowing.

We therefore consider that, to the extent a fixed ratio approach was part of a recommended solution, it would have to be accompanied by override rules to ensure that groups with external leverage which is higher than the fixed ratio should continue to be able to deduct their external interest cost. We note that this approach is commonly adopted in countries which currently apply a fixed ratio test, although, as noted above, there can be a number of practical difficulties in applying any group-wide test and so it is important that only a small proportion of companies would need to rely on this fall back approach.

5. Specific questions raised in the Discussion Draft

We have responded to the specific questions raised in the Discussion Draft in the attached appendix.

Yours sincerely,



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What is interest and what are financial payments economically equivalent to interest?

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?

Practical difficulties arise with regard to the inclusion of amounts in relation to foreign exchange and derivative instruments which are intended to hedge an entity's borrowings. Multinational groups will often have a variety of derivative instruments hedging various exposures and it will not necessarily always be clear which derivative instrument is hedging an entity's borrowings, as opposed to other exposures of an entity (for example currency exposures in relation to purchases). There is also a question about which derivative instruments should be included in a best practice rule. For example, a forward contract may contain an element which is economically equivalent to interest but may not be included in a best practice rule that only targets derivatives hedging debt if the forward is hedging future expenditure.

Difficulties arise in relation to the inclusion of foreign exchange amounts of entities in a group in territories which only tax foreign exchange on a realised basis, or where specific tax hedging rules apply which could create mismatches between amounts included in accounts and tax.

Difficulties also could arise in relation to the inclusion of the finance cost element of finance lease payments where lease classification varies depending on the GAAP. If an entity is in a territory that classifies a lease as an operating lease under local accounting and therefore tax rules, this could give a different answer to a situation where the group accounts classify the lease as a finance lease.

As a general matter, the broader the category of financial payments that are included within the cap, the greater the number of variations that are likely to arise both between GAAP and tax, and across different jurisdictions.

2. Are there any specific items which should be covered by a best practice rule which would not be covered by the approach set out in this chapter? What are these and how could they be included within a definition of interest and other financial payments that are economically equivalent to interest?

We don't consider there are other items which should be covered.

Who should a rule apply to?

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

The main scenarios posing base erosion or profit shifting risks have been identified in the Discussion Draft.

4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

Issues are likely to arise in joint venture relationships where a minority shareholder holds more than 25% of an investment but not enough to control. It could become very cumbersome in such situations for the respective entities to obtain the necessary information to undertake an interest cap allocation calculation. The joint venture company would need to be incorporated into the interest cap allocation

and its interest deductibility would be impacted by the results of other joint ventures to which it has no active connection. Furthermore, presumably it is possible that such a joint venture company could end up being included in two (or more) groups for the purposes of a group-wide allocation, making such a rule difficult to administer.

Additionally, we note that a 25% control test is significantly below the typical level required to be included in consolidated accounts, so this would likely cause practical difficulties and increase compliance issues.

What should a rule apply to? (A) the level of debt or interest expense and (B) an entity's gross or net position

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

The level of debt would not seem an appropriate measure for a rule to apply to as it could lead to significant distortions depending on the interest rate of a relevant territory, and it is also more of a point in time, rather than annual, test. The use of net interest rather than gross interest appears the only way of minimising the risk of double taxation with such an allocation rule.

Should a small entity exception or threshold apply?

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

We would support both a de minimis threshold below which interest expense would be deductible in a territory and a small entity threshold for those groups below a set size to reduce the compliance burden for smaller groups.

We believe that third party interest expense should be considered low risk from a BEPS perspective. As such, we believe that a best practice rule could operate on an allocation or fixed ratio basis but with a carveout that would prevent groups from receiving a deduction for less than the external interest expense in the local territory. This would have the advantage of not limiting the commercial options available to a group as to where it raises its external debt.

Whether interest deductions should be limited with reference to the position of an entity's group

7. Are there any practical issues with respect to the operation of (a) interest allocation rules or (b) group ratio rules, in addition to those set out in the consultation document?

We see significant practical issues in relation to the suggestion in the paper that, in order to reduce the risk of double taxation under an interest allocation rule, a group could realign its debt profile across territories. Even ignoring the cost of having to realign debt profiles and the volatility arising annually (which may in part be alleviated by carry forwards), there are a number of territories with other interest restriction rules which would prevent debt being introduced into territories to match the allocation of a group's interest expense. For example, those territories with purpose-based anti-avoidance provisions would likely deny an interest deduction.

Where a group does not have external borrowings, it is also not practical to suggest that intra-group financing would not be used (as such financing would lead to non-deductibility of interest expense but

taxation of interest income). There are often many non-tax reasons why debt is used as a funding mechanism, not least because of the costs and time constraints of continually increasing/decreasing equity.

Other practical issues arise where group companies have different accounting period ends to the group year end when comparing ratios.

Furthermore, the uncertainty created by a group-wide rule on the level of deductible interest in each territory would make tax forecasting incredibly difficult and naturally lead to prudence in assumptions, which could distort investment decisions.

8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?

Group-wide rules based on a comparison of accounting finance expense and tax deductible interest expense can give rise to mismatches. In designing the UK debt cap, a number of difficulties arose regarding the inclusion of derivative amounts; ultimately these were overcome by excluding such amounts from the rules.

There are potential practical difficulties of such a rule where accounting standards change given the reliance of such a rule on accounting definitions. This would cause territories to consider mismatches arising from accounting changes compared to the tax definition of amounts. There has been recent experience of this in the UK in relation to the application of the worldwide debt cap following the introduction of IFRS 10 for private equity groups. This is by no means an isolated example, as a number of anomalies have been identified since the rules were introduced, which has led to the need to introduce numerous regulations that seek to align the tax and accounting comparison required under the rules. This only results in increased complexity.

Practical difficulties have also arisen for groups in obtaining the necessary information to prepare the required calculations for such a rule. For example, in private equity scenarios, portfolio companies would not typically have access to information regarding other portfolio investments of the private equity house. Similarly, often consolidated financial statements are not required to be prepared at the private equity house level and therefore additional work has been required to prepare calculations for such a rule.

In Germany there is a group-wide rule which can be used as an escape clause from other interest restriction rules. As noted in our main response, this is rarely used because of a number of practical difficulties with the rule including:

- Determination of the entities that belong to the group - often it is difficult to determine which entities should be included in the group. The German rules make reference to consolidated financial statements under IFRS or similar rules - i.e. each entity consolidated under such rules should form part of the relevant group. However, often it is difficult to determine which entities would be included in a consolidation, in particular with respect to private equity situations. Furthermore, not every entity which could be included in consolidation is actually consolidated. Hence, it may be necessary to separately determine (just for tax purposes) whether an entity is included or not included in the consolidation.

- Determination of relevant company – partnerships have caused difficulties identifying amounts that should be included in the calculation and preventing debt being included twice.

- Use of common figures - the group-wide rules require a common basis for determining the ratios. To come to the right result from a tax perspective one should use tax figures - which are, however, not unified amongst the countries and therefore are not suitable. Hence, the ratios need to be drawn from IFRS or similar standardized figures. However, there may be significant differences between IFRS and tax figures, which result in a misallocation of interest or an unjustifiable disallowance of interest.

- Point in time for equity/debt/asset, etc. ratio determination – different year ends within a group give rise to the need to prepare interim financial statements purely for tax purposes. Further, debt figures will vary throughout a year meaning that the calculation will vary depending on the point at which it is calculated.

- Language of financial statements – whilst it may seem like a small point, German groups have had to incur the cost of translating financial statements, which only have to be produced in the relevant language of the local territory, purely to be able to prepare this calculation.

9. Do any difficulties arise from basing a group-wide rule on numbers contained in a group's consolidated financial statements and, if so, what are they?

Primarily we would note that a number of groups that it is proposed a best practice rule would apply to will not be required to prepare consolidated accounts (in particular privately held groups, including groups held by private equity). Furthermore, those groups which do prepare consolidated accounts may be required to make adjustments to those accounts because they will not include all "connected parties" that the Discussion Draft envisages should be caught.

As set out above, based on experience of group-wide rules already in existence, difficulties arise where groups are not required to prepare consolidated financial statements. This can occur for example depending on the requirements of the territory of the ultimate parent company, where an individual has common ownership of a number of companies, or in a number of private equity scenarios.

Difficulties arise with regard to how to deal with acquisitions and disposals if balance sheet information is used, and even where earnings based information is used, it will be difficult to compare the results an entity or subgroup acquired/disposed of to the group results.

Mismatches will arise between accounting under local accounting frameworks and group consolidated financial statements. To the extent that local territories use accounting profits as a starting point for taxable profits, this will give rise to mismatches.

10. In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

We think that it would be difficult to manipulate such a rule and commercially it would be unlikely that groups would seek to do so. We would envisage that targeted rules might be appropriate for related party/connected party debt to counter any situations where groups would seek to enter into arrangements to increase third party interest expense with related parties that were not caught by the group definition of any rule.

11. What approach to measuring earnings or asset values would give the most accurate picture of economic activity across a group? Do any particular difficulties arise from this approach and how could these be addressed?

The measure which would be most appropriate depends on the nature of an individual group, such as the industry in which it operates. For example, an asset based approach might be more appropriate for capital intensive businesses, whereas this may be less appropriate for services companies. Different approaches may also have regional implications, for example because countries in certain regions may have economies more focused on capital intensive industries than others. However, as a general rule we would expect an earnings-based approach to give a more accurate picture of economic activity across a group, not least because an asset values approach is likely to fail to deal adequately with fair values. This would also be best aligned with how third parties would typically look at lending to groups, with debt covenants based on earnings multiples. If earnings were to be used as the measure, we believe that EBITDA would be the most appropriate measure, again being the measure most commonly used by third party lenders. This would also help to reduce the distortion of depreciation and amortisation policies.

Regardless of the approach to earnings or asset values, our view is that such an approach should be applied on a territory by territory basis, i.e. based on data from a fiscal unity for tax purposes rather than on an entity by entity basis, to reduce the compliance burden for groups.

12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

Our comments regarding difficulties in applying these approaches have been covered in the responses to the other questions in this consultation.

13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

Dividend income could be excluded to the extent this is exempt under domestic rules. This would help reduce any potential distortion from intra-group payments of dividends. Further, other income from participations which is exempt (such as branch income or chargeable gains arising on disposals where there is a participation exemption) could also be excluded. Any such exclusions would need to be made at both the territory and group earnings/asset value level to ensure consistency. For example, a large profit/loss arising on a disposal should be eliminated from both the territory results and the group results so as not to skew the ratios.

14. Do any particular difficulties arise from asking groups to identify entities with positive and negative earnings balances? What other approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?

Requiring groups to identify those entities with negative earnings is impractical as it would require a new consolidation to be prepared eliminating those entities. Accounting systems would have to be redesigned to identify loss making entities and reverse out consolidation adjustments with those entities to prepare effectively a new set of consolidated financial accounts simply for this purpose. Such accounts would also not be subject to audit.

We believe the risk of base erosion and profit shifting by the use of loss making entities would be limited such that a best practice rule should not be required to eliminate those entities from the computation.

15. Where an entity's earnings or asset values need to be converted into the currency used in the group's consolidated financial statements, what exchange rate should be used for this conversion?

It would seem most appropriate to use the average exchange rate for the year where an earnings based approach is adopted. Where an asset value approach is adopted, an average of opening and closing assets could be used with the opening and closing assets figures translated at the prevailing exchange rate at the beginning and end of the accounting period, respectively.

16. What specific issues or problems would be faced in applying a group-wide rule to a group engaged in several different sectors? Would an assets or earnings-based approach be more suitable for this kind of group?

There could be a potential harmful impact on investment decisions if a group-wide rule would adversely affect deductions in a scenario where a multi-sector group is competing against a group operating in only one sector as the inability to obtain full relief for external interest expense would likely increase the cost of capital for an acquisition. This concern is present regardless of whether an assets or earnings-based approach is used.

17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

A very significant issue with groups arranging their intragroup loans so that net interest expense is matched with economic activity is the application of other domestic interest deductibility rules. A number of territories have rules which consider the purpose of introducing debt. To the extent there is a tax purpose, interest deductions can be denied. To the extent any group has to put debt into any such territory, it is likely that full relief for the group's external interest will not be available because a domestic provision such as this will deny relief for the additional debt. This could be addressed, at least in part, by a recommendation that on adoption of any best practice rule, territories eliminate, or substantially reduce, other interest restriction rules. We note that the consultation paper even considers the role of targeted rules such as those restricting interest relief where a debt has arisen from a leveraged dividend. This would likely be one of the means by which groups could realign debt profiles so it would seem irrational to then restrict interest relief under another rule.

Depending on the capital structure of a group and the legal framework of a territory in which debt would need to be introduced, it could be difficult to introduce debt altogether. For example, take a group that has minimal equity and debt which has grown organically but borrows to make an acquisition. It is difficult to see how debt could be introduced into the existing territories. For example, there may not be distributable reserves, there is no capital to reduce, so it would seem a relatively artificial transaction would have to be entered into to achieve the aim which surely cannot be a desired outcome of introducing a best practice interest allocation rule. This is without considering regulated companies which may not be able to increase debt because of regulatory requirements.

In addition, introduction of cross border internal debt into many jurisdictions with volatile currencies makes such loans impractical if not impossible. Unless such debt can be appropriately hedged (and in some cases hedges cannot be obtained or are too costly), many groups will simply not suffer the volatile swings in the income statement caused by marking a non-functional currency loan to market. In addition, in many cases the added withholding taxes on interest payments can be prohibitively costly (for example because of a lack of a treaty, failure to qualify for a treaty due to diverse ownership of an investment fund, or lack of creditability of withholding taxes in the recipient jurisdiction).

Furthermore, many territories operate exchange controls which could restrict the ability to introduce debt, especially where the purpose of the arrangement is simply to align an entity's debt with the cap rather than because of a commercial need for the funds.

Additionally, a group's commercial requirements for funds, and therefore need to create intercompany debt, is unlikely to actually align with any of the measures of economic activity suggested.

For groups with little or no external debt, the position is particularly exacerbated. In effect, such a group would not be able to lend money generated in one part of the group to fund the activities in another part of the group without the result being non-deductible interest in the borrower despite the taxable interest income in the lender.

Groups may also have other external restrictions/covenants impacting the ability to introduce debt into certain territories, for example in the case of a securitised group.

18. Do any particular difficulties arise from the application of a group-wide allocation rule to groups with centralised treasury functions? If so, what are these difficulties and do they vary depending upon how the treasury function is structured and operates?

A significant difficulty arises with centralised treasury functions where hedging is undertaken by a treasury function on behalf of the wider group. Practically it will be very difficult for groups to separate out contracts which are involved in hedging arrangements related to debt from those which are not, and this will be common in the case of treasury functions. A centralized treasury center often works with a single lender or a lead bank in a consortium and uses that relationship to more quickly and cheaply gain access to needed funds. Under a group-wide approach, the most realistic way to maintain interest expense deductibility is to borrow from third parties in many countries (rather than to use cross-border internal debt, interest expense on which may be subject to disallowance).

Cash pooling arrangements will also be adversely impacted. Typically, groups will have entities with surplus cash positions and other entities with net debt. Any version of cash pooling will result in effective double taxation because the taxable interest income in the surplus cash territory will result in interest expense elsewhere in the group which will effectively be non-deductible.

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

An approach allowing for groups to elect for either an asset based or earnings based approach to apply to them could help alleviate the risk of distortion of results across sectors, where for example a capital intensive business could elect to use an asset based approach. The possibility of alternative or combined approaches would, however, lead to further complexity.

20. In what situations could significant permanent or timing mismatches arise if an entity's interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

Mismatches could arise in relation to foreign exchange gains and losses on borrowings where there is a different local tax treatment to the group accounting, or even where local accounts differ to group accounts. Permanent mismatches could arise where tax hedging rules disregard foreign exchange movements or where the functional currency for tax purposes differs from the accounts functional currency.

Timing mismatches will arise in situations where interest relief is only allowed under domestic tax rules on a paid basis, rather than accruals. This would need a carry forward of unused capacity to alleviate.

Where interest is capitalised onto the balance sheet, mismatches could arise depending on how the accounting finance expense is determined (i.e. including balance sheet amounts), or how local rules allow tax relief for such interest.

Mismatches would also be likely to arise where entities are recognised in consolidated accounts in a different manner to which they are taxed (e.g. partnerships).

There are likely to be a significant number of differences arising in practice, and these will obviously vary by territory depending on the underlying deductibility rules and GAAP adopted in the group accounts.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

Carry forwards will only alleviate positions where a group can eventually realign its debt profile to utilise these, or where the carry forwards have only arisen as a consequence of volatility of earnings that will correct itself. This fails to recognise that overlaying a group-wide rule to well established group structures will likely never allow a group to utilise carry forwards. For example, groups will typically commercially need to debt fund loss making/developing territories, whereas there is less of a need for debt in profitable territories. This means that, in order to utilise carry forwards, commercial debt profiles would have to be amended.

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group's consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

In practice it could be very difficult for such connected party situations to be dealt with via a group-wide rule, as such companies would not necessarily be required to prepare an accounting consolidation and therefore would not have group information available. Furthermore, it would likely not be

possible to realign debt profiles in such situations between connected companies (in particular where there are minority shareholdings) such that the risk of double taxation would be very high. In light of this we believe that targeted rules would be more appropriate to deal with the base erosion and profit shifting risk here.

However, even targeted rules may not be appropriate for private equity. Private equity vehicles are forms of pooled investments with a wide variety of unrelated investors that typically act at arm's length from each other and from a fund manager and so may not necessarily appropriately be viewed as acting together for this purpose. As noted in our responses to other questions, it is not appropriate to aggregate separate portfolio investments made by a private equity or other collective investment vehicle underneath these types of regulated investment companies into a single consolidated group.

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

We believe that the most appropriate approach to a group-wide rule is to start with the consolidated set of accounts. If there is a concern that related party debt could be outside of these accounts (such as shareholder debt in a private equity context) this could be dealt with by targeted anti-avoidance rules which include some form of arm's length and/or purpose test. With country by country reporting, authorities will get more information and will be able to more effectively implement such targeted anti-avoidance rules.

Whether interest deductions should be limited with reference to a fixed ratio

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?

As noted above, as a general rule we would expect an earnings-based approach to give a more accurate picture of economic activity across a group, not least because an asset values approach is likely to fail to deal adequately with fair values. An asset value basis could give rise to issues in relation to the valuation of assets to be used, with potential distortive effects across industries and depending on accounting policies.

Regardless of the approach to earnings or asset values, our view is that such an approach should be applied on a territory by territory basis, i.e. based on data from a fiscal unity for tax purposes, to reduce the compliance burden for groups of having to prepare calculations on an entity by entity basis.

25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?

We believe the most appropriate measure for earnings would be EBITDA. This is the most commonly used measure in third party scenarios when it comes to lending. Furthermore, the exclusion of depreciation and amortisation should help to limit the bias that would arise in results dependent on acquisitions, the timing of investments and internally generated positions. We would note that it might still be appropriate for certain adjustments to be made to EBITDA, in particular in a situation where one off adjustments arise, for example on disposals.

The market value of assets would be the most appropriate measure to use for an asset based fixed ratio rule; however this would likely be impractical to apply.

26. For what reasons would the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios of its worldwide group?

Entities which are part of private equity groups or conglomerate multinationals operating in a number of sectors, or even simply carrying out different types of activities in different territories, could have significantly different earnings or asset ratios to the worldwide group.

Businesses with a financial services element to their business will also have entities with significantly different ratios. Further, groups with joint venture interests could well have different earnings profiles to each other.

27. Would a fixed ratio rule pose particular problems for entities in certain sectors? If so, which sectors would be affected and how could this be addressed?

The fundamental issue with a fixed ratio rule is that levels of external leverage vary between industries and between different types of investor. Industries such as infrastructure, utilities, etc. are an obvious example, but by no means exhaustive. Applying an arbitrary ratio, adjusted for certain sectors perhaps, is likely to lead to distortive effects across sectors. It will be important that, as a minimum, companies which exceed the fixed ratio but are in line with their overall group ratio should not be subject to a disallowance.

28. What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?

We believe that the sample of data included in the discussion draft is distortive, as it is based on the largest 100 multinationals by capitalisation. Whilst we accept that there is difficulty in identifying comparable data of privately owned groups, there are databases which include certain information which could be used.

Whether a combined approach could be applied

29. What particular issues arise for groups if a combined approach uses (a) the same measure of economic activity in a general rule and a carve-out or (b) different measures of economic activity? In particular, what issues arise where a carve-out uses a test based on (i) earnings, (ii) asset values or (iii) equity?

The biggest difficulty that we see with a combined approach as proposed in the discussion draft is that any initial carve-out rule would be set at such a low level that it would be meaningless and effectively require the majority of groups to consider the general rule, giving rise to the issues identified above. Provided that an initial limit was set at an appropriate level, a combined approach could offer a more effective solution of minimising the compliance costs for groups whilst still tackling the biggest BEPS risks.

30. A combined approach should provide an effective solution to base erosion and profit shifting using interest, while allowing lower risk entities to apply a simpler test. What other options for combined approaches which meet this objective should be considered as possible best practices?

We believe that an option with an arm's length carve-out acting as an additional safe harbour, based on including only taxable assets, could be an appropriate mechanism to carve out lower risk entities. Excluding from an arm's length carve-out those assets which are not taxable (such as exempt

participations) should reduce the risk of base erosion and profit shifting as it will align deductions with taxable income.

The role of targeted rules

31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed though a general interest limitation rule and where would a general rule need to be supported by targeted rules?

As set out above, the risk of a general interest limitation rule is that double taxation arises where other domestic rules deny a deduction for interest which has been allocated to a territory under a cap. The only way to avoid this from occurring would be to adopt a deemed allocation rule, combined with exempting/disallowing all intra-group interest income/expense actually arising. This would effectively arrive at a formulary apportionment, removing the ability of individual territories to determine their tax policy.

The alternative to such an approach is adopting a less restrictive general interest limitation rule combined with other rules regarding hybrids and CFCs. In adopting such an approach, consideration should be given to the need to maintain purpose based rules to target specific avoidance, but with a carve-out to allow for situations where a group is seeking to realign its intra-group debt profile to match a group-wide allocation.

The treatment of non-deductible interest expense and double taxation

32. To what extent could a carry forward of disallowed interest expense or unused capacity to deduct interest help to smooth the effects of a general interest limitation rule?

A carry forward of disallowed interest expense and unused capacity should help to alleviate the effects of volatility in the underlying metric used in a general interest limitation rule; however, we have a doubt about how these could smooth the effects in structural situations such as those where a group already has profitable entities which do not have a need for debt and less profitable entities which do. Naturally, a carry forward will not address this situation.

Consideration should also be given to allowing a "compensating adjustment" such that interest income is not taxable if it is subject to disallowance in another company (whether it the same or a different territory).

33. Working on the assumption that countries would like to limit carry forwards in terms of the number of years what would be the issues presented by say a five year limit? If this does present problems what are they and how and when do they arise?

A five year limit would be too short a time limit to allow groups to utilise carry forwards of disallowed interest expense or unused capacity. This is likely to mean that in modelling a group's future interest deductibility position for tax, a significant risk weighting would have to be allocated to interest deductions, increasing the cost of capital.

Considerations for groups in specific sectors

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital without having an undue impact on the group's regulatory position (for example, by limiting a group's net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

As the paper recognises, the role interest plays in the banking or insurance business is different to that in other sectors. Loan finance is raised to write new business and interest expense is an integral part of income generation. Most banks and insurance companies are also recipients of net interest income. There is therefore a case that no rule is needed for banks and insurance companies and there seems to be no logical basis, in the context of thinking about the paper's concerns, for distinguishing between the role of regulatory capital and other forms of interest expense. This has been acknowledged by the UK tax system in the UK worldwide debt cap, which has an exclusion for financial services.

As acknowledged in the Discussion Draft, these are already heavily regulated industries whose financial stability is now closely monitored. There are regulatory constraints on the level of leverage throughout a banking or insurance group and particular attention is already paid to leverage ratios. There is concern that there could be damaging impacts on regulatory capital adequacy and financial stability of banks and insurance companies should such a rule be introduced.

Given that Action 2 is also proposing action against hybrid regulatory capital in banks and insurance groups and several options for this have been developed by UK Treasury in their December 2014 discussion document, we question the need for an additional rule applying to other forms of debt counted as regulatory capital. We believe that much more work would need to be done to show that intragroup borrowing is in fact used for profit shifting and base erosion in these sectors, and work would also be needed to show that it can be countered by any form of rule without damaging risks to financial stability.

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

Entities operating subject to special regimes, for example oil and gas, regularly are not able to deduct interest as part of the calculation of taxable income. As a result, these industries would effectively suffer a restriction on their external interest cost.

Infrastructure groups are typically relatively highly leveraged compared to other sectors and with longer investment return profiles. They also undertake projects which often involve long term modelling of the tax profile of a project and require certainty over the tax position. The volatility and unpredictability arising from a group-wide rule is therefore very likely to cause these types of groups significant problems and distort investment decisions.

Infrastructure (and other sectors) may also often operate in split ownership structures where there are minority equity investors. In this situation there is no certainty over tax relief for interest if a group wide rule were to be introduced along the lines in the Discussion Draft, because interest relief in one company could be impacted by activity effectively unconnected in the minority investor.