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Ref: DISCUSSION DRAFT: BEPS ACTION 4 – "ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE"

Dear Achim,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 4 – *Elements of the Design and Operation of the Group Ratio Rule* (the Discussion Draft).

It is understood that deductibility of interest payments is a key component of the BEPS project and BIAC was pleased that the Action 4 report published in October 2015 had a clear recommendation that the proposed common approach should be a fixed ratio rule supplemented with a group ratio rule.

BIAC previously noted substantial concerns about the appropriateness and practicality of global group-wide tests, which have the potential to create significant complexity and difficulties for taxpayers and tax authorities alike. However, as an optional supplement to a fixed ratio rule, and if implemented in a consistent and practicable way, the group ratio rule has the potential to be a useful tool. It can, in those circumstances, help to ensure that a fixed ratio rule does not unduly and adversely impact highly leveraged businesses, particularly when operating in jurisdictions which have adopted a lower fixed ratio restriction.

Although we found many aspects of the Discussion Draft welcome, we would still suggest more concrete and prescriptive recommendations in certain areas. The BEPS Project has always sought to introduce consistency between different tax systems, and an overlapping system of different rules in respect of a global test would frustrate that aim. It would also create a substantial amount of work in multiple jurisdictions for some taxpayers, with no particular benefit to tax authority revenues.

Again, we thank you for the opportunity to comment on this discussion draft. We would welcome the opportunity to discuss our comments with you at a public consultation meeting, or assist in any other way that you would consider helpful.

Sincerely,

Will Morris

Will Morris,
Chair BIAC Tax Committee

Approaches to calculate a group's net third party interest expense

Comparison of the three approaches

1. Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

1. BIAC's primary position in respect of the three approaches is that, after considering the various issues, the OECD should recommend that all jurisdictions adopt approach 1, i.e. a multinational corporation (MNC) would use their interest income and expense figures from their consolidated income statements without adjustments to calculate global net interest. As noted in the draft, this would be the most straightforward approach and the easiest for business to comply with (and for tax authorities to audit).
2. Although it is recognised that there would be some differences under different accounting standards[1] that may cause the net interest figure to be slightly under or overstated as compared to an adjusted figure, we consider that the shortcomings of approach 1 are overstated in the discussion draft. On the whole, the simplicity and administrative feasibility of approach 1 make it the preferred alternative.
3. Notwithstanding this general recommendation, we note that there are differences in local tax and accounting rules (including particularly Fair Value movements). These could (in a minority of cases) result in significant timing differences if taxpayers were forced to use approach 1 (which may or may not reverse before they have expired). We therefore also recommend that taxpayers should be given the option to apply the more administratively complex approach 2 or 3.
4. We disagree with the assertion that under approach 1 groups' net interest expense could be manipulated to ensure that income items are not accounted for as interest (para 9). An MNC's interest line is scrutinised by independent accountants as part of the financial audit process and there is therefore minimal scope to understate interest income. Further, as noted in the discussion draft, this could be addressed with the inclusion of an anti-avoidance rule (which we are not clear why the discussion draft dismisses out of hand as difficult to apply in practice, particularly given the complexities of the alternative approaches offered). In particular, publicly traded companies go through extremely rigorous processes to obtain assurance over their income statements and therefore ought to be permitted to use approach 1.
5. If it is not possible for approach 1 to be applied universally, our second preference is that groups are permitted to choose themselves whether they will apply approach 2 or 3. As the discussion draft notes either approach should give rise to the same figure for a group's net third party expense (para 11) and therefore we see no reason why one of these approaches

[1] For example, the difference in the treatment of derivatives under US GAAP and IFRS.

should be favored over the other from a policy perspective, but the administrative burden could be less severe if groups are given an option of how to arrive at the figure.

6. The worst situation would be if different countries were able to choose different approaches to calculate a group's net third party interest expense on a country by country basis. Each calculation under approach 2 or 3 represents a substantial compliance cost to taxpayers and, given there is no anticipated difference in tax revenues, a requirement to use a different method of calculation that produces the same result would offer no benefit to tax authorities. The application of any a global rule inevitably requires some local work on the part of taxpayers. However, if the group ratio rule were to be implemented differently in different jurisdictions the administrative cost of compliance would mean that some MNEs will simply lack the resource to apply the rule at all.
7. If the calculation method is to be different across jurisdictions, the OECD could instead recommend that where the country of residence of an MNC's parent company has adopted a fixed ratio/group ratio approach to interest expense disallowance, other countries should follow the calculation of net interest expense, minus any uplift if the local jurisdiction does not allow that. If such a recommendation is made, then the same principle should apply to the calculation of EBITDA. This would remove the risk that a group would have to recalculate the interest expense in a number of different ways to take into account each jurisdiction's permutations to the rule.
8. Per para 6 the third party interest expense "calculation should be based on a group's consolidated financial statements, prepared using International Financial Reporting Standards (IFRS), Japanese GAAP or US GAAP, or other accounting standards as permitted by the relevant country", which we understand to mean that all group ratio calculations should be driven from the parent company's accounting standards. It is, therefore, a natural next step to further ensure that adjustments to net interest expense (and EBITDA) are in line with the relevant rules in the parent company jurisdiction.

Adjustments to a group's net third party interest expense

3. It is important that a country's tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

4. Are there any areas where a country's tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

5. Are there any other circumstances where a group's net third party interest expense should be adjusted to include the group's share of the net third party interest of an entity outside the group?

Practical issues that may prevent a group aligning net interest expense and EBITDA

9. BIAC appreciates recognition from the OECD that in some cases there will be practical or legal constraints that make aligning location of net interest expense with economic activity difficult or impossible (para 22). We agree and strongly support in principle allowing an entity to apply

an uplift to its group net third party interest expense. It is disappointing that the draft implies the uplift should be limited to a maximum of 10%.

10. The rationale behind this suggested flexibility in the group ratio is to enable groups to receive a deduction for all of their net third party interest expense, recognising that debt may not be spread exactly in line with EBITDA. For many groups, the 10% uplift will not be enough to cover third party interest expenses in some jurisdictions (and will be an unusable excess in others). The assumption appears to be that adjusting the mix of debt and equity, at least within a margin of 10%, in a group of companies is straightforward. In a minority of situations this might be so, but in many typical group scenarios this does not reflect the process that groups undertake in order to raise finance for investments.
11. Where a controlled entity has a commercial requirement for additional funding, the split between debt and equity financing will often be dictated by external structural issues such as minority interests, existing creditors, exchange controls / other local regulatory constraints and foreign exchange (including currency restrictions in certain countries). It is incorrect to assume that debt can always be shared and "pushed around" within the group such that it aligns with economic substance. Even where it can, this is unlikely to equate to an alignment with EBITDA in any given year; EBITDA fluctuates for a number of reasons, not least macroeconomic changes outside of the group's control.
12. BIAC would propose that (at the very least), where a group can demonstrate that there is a genuine non-tax reason that debt cannot be shared between entities in line with EBITDA as a proxy for economic substance, such as regulatory capital restrictions, that there should be in-built flexibility to the application of the group ratio rule.

Preventing interest capacity being increased by non-deductible payments

13. The discussion draft suggests that interest expenses which are non-tax deductible could be used to increase a group's net third party interest expense and therefore, under the rules of a particular country, may pose a material BEPS risk (para 26) if included in the net third party interest expense figure.
14. Given the payments are non-deductible in the concerned jurisdiction in any case, BIAC fundamentally disagrees that these payments should properly be considered a BEPS risk.
15. Suggesting different countries introduce their own amendments to the calculation of their relevant group ratio is unhelpful for taxpayers and would create unnecessary complexity with no material impact on tax revenues.
16. To be clear, BIAC finds it difficult to understand why any business would (or could, even if they wished to) manipulate the group ratio rule to obtain a tax benefit by incurring payments which are economically equivalent to interest but non-deductible. Introducing a debt like cost in order to get a slightly higher ratio of allowable interest deductions, the cash benefit of which would be at the marginal tax rate, would not be commercially viable.
17. If this is an issue which countries are concerned about, we suggest that the OECD makes clear the problem, as well as the exact definition of the categories of payments that will be included in the net third party interest expense.

Addressing risks posed by interest paid to related parties outside the group

18. It is not entirely clear what BEPS risks are being targeted in respect of payments to related parties outside the group, other than structured financing arrangements. If this is the case, we believe that restricting *all* interest payments by reference to related party non-group borrowing *in all cases* is excessive and BIAC would strongly suggest a more targeted recommendation is adopted.

Net third party interest of associate or joint venture entity

19. BIAC agrees with the OECD's proposals regarding the necessary adjustments for a group's share of net third party interest for joint venture enterprises (JVEs). If they have the available resources to do so, taxpayers should be able to make adjustments for the net interest expense in a JVE in proportion to their interest in the entity. We do not consider there to be a BEPS risk (by not making such adjustments), so bearing in mind the potential complexity of the calculations and the corresponding compliance burden, we believe that this should be explicitly recommended as an option of taxpayers rather than countries.

Definition of group-EBITDA

20. The key for groups who are applying these rules is consistency in the operation of them in the different countries in which they operate. BIAC is supportive of the OECD's suggestions regarding group-EBITDA and hopes that they will be presented in a prescriptive way in the Final Report so that no countries will deviate from them.

Items to be included in the adjustment for interest and income expense

6. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

21. Business values simplicity and agrees with the approaches as outlined in the discussion draft as follows:
    - The treatment of capitalised interest should follow a group's accounting treatment, as this would be the most straightforward approach.
    - Where an adjustment for net third party interest expense is required to bring it into line with the actual net interest expense funding the group's earnings, the adjustment should also be reflected in the figure for interest income and expense removed in calculating group-EBITDA.
    - Where an adjustment to net third party interest expense is required to achieve any other tax policy goal, the figure for interest income and expense removed in calculating group-EBITDA should not reflect these adjustments.
    - Fair value adjustments should be excluded in order to reduce volatility and the OECD should make a clear recommendation on this rather than leaving it open for countries to interpret.

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- Net interest on defined benefit pension schemes should be excluded for all calculations as the Action 4 Final Report recommends that there is no restriction of this expense.

Items to be included in the adjustment for depreciation and amortisation

7. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

22. BIAC supports the approach suggested by the OECD (i.e. treating other fixed asset costs such as impairments /write-off of fixed assets in the same way as depreciation for the purposes of the group-EBITDA calculation).

The treatment of dividend income and a group's share of earnings of an associate or JVE

8. Are there any practical issues raised by including all dividend income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

23. We are not aware of any practical issues that would arise if all dividend income was included in group EBITDA, particularly if para 56 is followed and all dividend income in the group's consolidated income statement is included in group-EBITDA without adjustment.

9. Are there any practical issues raised by including a group's share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

24. We are not aware of any practical issues raised by including a group's share of the earnings of equity accounted associates and JVEs in group-EBITDA. However, we refer to our comment in paragraph 19 above concerning interest payable by joint venture entities. It would appear inequitable to include income without including the appropriate expense. We would therefore suggest that the inclusion of income should be on the same basis as the inclusion of the related expense.

The treatment of non-recurring items

10. Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

25. BIAC would like first and foremost an approach which "can be applied easily and consistently in all countries" (para 64).
26. This could be achieved through recommending a rule that non-recurring items should be included in the calculation of group-EBITDA, or, alternatively by including adjustments for certain material "clearly defined and identifiable non-recurring items" (para 65).

27. If adjustments are required, it is important that there is a sensible materiality threshold to ensure it targets only those items which create volatility[2].
28. Groups should not be required to prepare a separate EBITDA calculation in each country in which they operate. This would be inefficient for taxpayers, to the point where compliance would be extremely challenging, and would not generate any significant additional tax revenues. This can be avoided in one of two ways; either, the adjustments required to EBITDA in respect of non-recurring items should be universally agreed and recommended by the OECD such that they do not vary from country to country; or, groups should be able to apply the rules set by the jurisdiction of their parent company to work out their EBITDA and this calculation should be respected by tax authorities in all of the jurisdictions in which they operate.
29. We agree with the discussion draft that if particular items must be stripped out of the group-EBITDA calculation in a particular country, this should be done consistently (i.e. in cases that would both increase and decrease a taxpayer's global group ratio).

Approaches to deal with the impact of losses on the operation of the group ratio rule.

The treatment of entities where a group has a positive group-EBITDA

11. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

12. If a country does introduce a cap on a group's net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

30. As noted in paragraph 69, calculation of entity-EBITDA for the purposes of excluding those entities with a negative EBITDA from the group EBITDA calculation would be complex and impose a significant additional burden on groups. BIAC therefore cautions strongly against this approach.
31. Instead, our preferred approach would be that, for those entities whose EBITDA is negative, an upper limit is placed on the amount of net interest that can be deducted under the group ratio rule, determined by reference to an amount equal to the group's net third party interest expense (after applying any permitted uplift).
32. The discussion draft proposes a cap which should not exceed 100% of EBITDA (para 72), and it appears that any restriction would be based on finding a level that results in some kind of restriction, rather than by reference to the amount of identified and targeted BEPS activity. We would therefore propose that no cap is imposed and, if there must be a cap, it should be at 100% rather than any lower percentage of EBITDA.

[2] We would need more information on what exactly these clearly defined and identifiable non-recurring items in respect of which any adjustments would be required in order to comment more specifically. BIAC would suggest that the significant non-recurring items that could be targeted are: gains/losses from the sale of a business; impairments; and legal/environmental settlements. It would also be useful for the OECD to provide guidance on how items that are presented separately from the main P&L, e.g. income from discontinued operations under some accounting standards, should be treated for this calculation.

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33. Para 73 proposes an additional entity level restriction so that entities cannot claim deductions for amounts that exceed the total net third party interest expense of the group, and this would apply to all entities regardless of their EBITDA. However, in practice, there are commercial reasons why certain entities may have levels of interest that exceed the group's total net interest expense in some circumstances. For example, if cash must be ringfenced for regulatory reasons (e.g. in the extractive sector) or cannot be repatriated from the country in which it has accumulated (e.g. exchange controls), it will earn interest which cannot be used to fund the group's taxable activities, and this interest will offset the group's third party borrowings which are being used to fund other (taxable) activities.
34. Whilst it may be appropriate in many circumstances to restrict an entity's interest expense in line with the amount of the group's global net interest, we do not believe that this should be a "recommended best practice". BIAC suggests that this area should be discussed in more detail to highlight what the BEPS concerns are and to highlight the potential issues that may arise where such restrictions are imposed, so that participating countries can implement appropriate and consistent rules that address these concerns whilst also taking account of all group's debt profiles.

The treatment of entities where a group has a zero or negative group-EBITDA

13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

35. It would not be practical to exclude the earnings of entities with a negative EBITDA from group EBITDA. As noted above, this would require complex calculations and place a significant additional compliance burden on groups.
36. The most practicable solution would be that entities are subject to a cap on their interest deductions set at the lower of actual entity interest or, alternatively, a percentage of entity EBITDA (using the same percentage as a restriction for losses where there is a positive group EBITDA).

14. Do you have any other comments on any of the issues covered by this discussion draft?

37. BIAC's main concern is that the group ratio rule should be as straightforward to apply as possible, such that it does not create an unnecessary and inefficient compliance burden for business (and tax authorities) and that it does not include areas of subjectivity, which leave room for disputes between tax authorities and taxpayers.
38. The rules should, therefore, be simple to apply and enacted as uniformly as possible across jurisdictions. To the extent they are not implemented uniformly and consistently there should be a recommendation that if the parent of a MNE is in located in a jurisdiction that has adopted a fixed ratio/group ratio approach to interest expense disallowance, other countries should follow the calculation of net interest expense and EBITDA adopted by the parent's jurisdiction.
39. We understand from the OECD that the calculation of the group ratio should be based on a group's consolidated financial statements, and that the reporting standard under which the

consolidated accounts are prepared can be used for the whole group. BIAC supports this approach; however, it does raise a question about how audits will work.

40. There are number of potential complexities in the auditing of a group ratio rule and it would be useful to understand how the following aspects will work:
    a. whether each country will audit net interest expense and group EBITDA under its own principles or if they will accept the principles of a parent company's jurisdiction (or another agreed set of principles);
    b. which tax authority(ies) would sign off a group-wide allocation computation; and
    c. how to manage uncertainty arising from the knock on effects of any tax audit adjustment (which could be many years later) to one of the entities in the group to all the others in the group. Under group wide rules there could be some interdependency between the ultimately agreed tax positions of each entity – a change in one has a "ripple" effect on all the others in a group.
41. We note that where individual companies or worldwide groups may have net interest income, the Fixed Ratio Rule and Group Ratio Rule may not result respectively in meaningful restrictions nor reliefs. We also note that the Action 4 recommendations in respect of Financial Services and Insurance Sector is still under consultation, and that depending on the results of this consultation, such groups may have to apply different rules to different entities within their group. We recommend that the conclusions of both of the current Action 4 consultations are aligned in this respect.