31 janvier 2015

The French Association of Corporate Treasurers

BEPS Action 4
Comments on the Public Discussion Draft of 18 December 2014

The AFTE welcomes the opportunity to comment on the OECD's Discussion Draft on Action 4 (Interest deductions and other financial payments) (hereinafter referred to as the "**Draft**").

Please find below:
- certain General Comments in relation to the current version of the Draft ; and
- the AFTE's proposed alternatives to those suggested within the Draft to resolve the perceived BEPS[1] issues in relation to interest deductions and other financial payments .

I. General Comments

- **MNEs[2] choose to finance their operations through intragroup financing for many reasons unrelated to the potential tax consequences.** For example,
  - using internal debt as opposed to equity increases the number of projects / investments that can be undertaken, regardless of the tax impact, as the use of debt lowers the required cost of capital/WACC[3] in assessing and realising projects ;
  - internal debt is used to ensure that local management are suitably disciplined in their spending ;
  - use of debt in financing a subsidiary is often important in order to meet rapidly evolving local working capital needs, particularly when operating in territories with relatively limited local financial market sophistication or capital availability ;
  - more generally, intra-group debt is used as a risk management tool to better manage the significant risks associated with any material investment and notably to help mitigate risk factors such as operational risk, country risk, cash trap risk and foreign exchange exposure[4]. Reducing these risks all help to ensure a suitable, lower, return on monies put at risk by the company providing the capital.

All these reasons are strong drivers for industrial and commercial development and, consequently, economic growth. However, **the non-tax reasons to prefer debt financing to equity financing are entirely ignored in the Draft**.

[1] Base Erosion and Profit Shifting
[2] Multinational Enterprises
[3] Weighted Average Cost of Capital
[4] Joint venture investments pose their own particular issues, and an individual's shareholders external financial strategy should not dictate the overall appropriate level of indebtedness

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- The Draft, and all of its conclusions, are based on the premise that "*The existence of base erosion and profit shifting using interest expense by international groups has been established through a number of academic studies,…*"[5]. The level of this presumed impact is not considered – it is taken as a given based on this statement that the issue exists, and then by implication that it is a material issue, sufficient to rework international treasury practice and to reject the "arm's length" principle. We feel necessary to draw your attention to the fact that, on the first hand, the statement itself is, at best, overstating the level of conformity in the academic literature on the topic and that, on the second hand, those studies that do suggest some form of profit shifting via interest expense within Groups indicate that the impact is limited. Given that the starting diagnosis is incorrect, the proposed remedies are unfortunately inappropriate.

- **The Draft is disconnected from fundamental financial and treasury realities**. It also represents a significant shift away from the arm's length principle and constitutes a "special measure" which would not be covered by double tax treaties.

- **The double taxation consequences of such a re-characterisation of interest as dividends are materially underestimated**. The Draft also explicitly rejects the possibility of a re-characterisation in one country by Action 4 inspired rules tying automatically to treatment in the other impacted country (see §186), a solution that would have helped relieve the double taxation burden.

- **The non-tax consequences of this draft are entirely ignored**. This draft will raise the cost of capital globally and will reduce investment, subsequently damaging the growth of the "real economy". The hardest hit countries will be developing countries or any country with thin or limited financial markets – the link between internal debt financing and FDI into developed countries is well supported. Further, the complexities of reorganising existing internal financing set-ups are considered as minor or unimportant, which is simply not the case.

- **Most of the proposals are unworkable**, notably those that propose to use assets as a base for the "apportionment" of interest expense.

- Last but not least, we draw your attention to the fact that the proposals related to limiting internal interest expense to external interest expense would create a vicious spiral. The greater the overall external group gearing is, the higher the tax advantage – essentially it changes the equilibrium position of the pre-existing Modigliani-Miller "MM" equilibrium to a higher gearing / higher risk of bankruptcy balance point. **Groups that prefer prudent levels of gearing will be rendered uncompetitive**.

[5] § 10

II. Proposed alternatives or solutions to perceived BEPS issues in relation to interest expense

- The economically preferable alternative to rebalancing treatment of debt and equity (and hence resolving in a stroke the BEPS issue) via the introduction of some element of equity tax deduction (either in the form of an ACE[6] or ACC[7]) is not even considered mentioning in the Draft, which we view as a missed opportunity.

- Properly structured thin capitalisation rules have been shown to work to achieve the overall aim of the report, with a lower impact on investment issues.

- Thin capitalisation rules tied to anti-hybrid regulations that limit interest deduction in the paying country to the interest income being brought into taxable income in the recipient entity would deal with most of what are considered the most "egregious" examples of BEPS issues associated with interest expense.

- If completed with appropriate CFC[8] rules, the entire issue of BEPS related to interest expense would be solved via the combination of thin capitalisation rules, anti-hybrid rules and CFC rules, without the need to negatively impact worldwide investment and FDI, breach the arm's length principle as the core international tax principle, and whilst avoiding the risk of massive re-characterisation of cross-border flows with the associated double tax and dispute issues.

- If a solution based on a combination of thin capitalisation, anti-hybrid and CFC rules (all existing tools within the remit of the OECD[9], the BEPS project and sovereign states apparently concerned with resolving BEPS issues) was for some reason not considered workable, the use of a combined approach based on a standard and common Fixed Ratio based on earnings, depending on the company's activity, at a reasonable level[10], with a carve-out rule if a Group has gearing or interest expense above the Fixed Ratio, should allow for a solution that is at least workable for businesses and administrable for tax authorities. This combined approach should be designed in a way that takes into account the specificities of each industry. Therefore, we would further suggest that:

    - The Fixed Ratio should include the possibility to have specific industry ratios, as necessary, to reflect industries with greater than average gearing, for example infrastructure or utilities ;
    - Businesses should have the ability to fall back on the application of the standard arm's length principle if necessary to justify a specific commercial or entity issue ; and
    - Businesses should be entitled to an indefinite period carry-forward of any interest expense disallowed based on such rules.

[6] Allowance for Corporate Equity
[7] Allowance for Corporate Capital
[8] Controlled Foreign Company
[9] Organisation for Economic Co-operation and Development
[10] Should the fixed ratio be set too low, it would make the rule meaningless and would have the same significant detrimental double taxation consequences as the other proposals

Finally, we strongly reiterate our general concerns in relation to the current Draft. As currently written, it represents a fundamental degradation in the worldwide tax system as well as a significant step back for rational economic decision-making and the free movement of capital.
It can also only be seen as a precursor to formulatory apportionment, directly contrary to the OECD's purported continued support for the "arm's length" principle.

We remain fully available to discuss and further comment on this Draft, and strongly encourage the OECD to consider closely and assess the impacts on its' proposals on the real economy before any further Draft is circulated or proposed. We consider that it is essential that the fundamental effects of financing, cash management and treasury decisions within corporate organisations be appropriately taken into account when proposing such a major change in the international tax system.

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Chairman of the AFTE

Co-signed by the AFTE's Fiscal Technical Committee