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By email to: interestdeductions@oecd.org

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Dear Mr Pross,

BEPS Discussion Draft: Interest deductions and other financial payments

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft on Action 4: Discussion Draft on Elements of the Design and Operation of the Group Ratio Rule***.**

We have set out below some general comments on the principles which we consider are relevant to the design of the interest deductibility rules. We have also answered the questions set out in the document.

General comments

We recognise the importance of consistent approaches by territories to the rules for interest deductibility. As noted in paragraph 4 of the OECD's draft paper, to the extent that tax regimes are consistent in different territories, this tends to promote the objectives of the OECD's programme, in that it would ensure that the opportunities for Base-Erosion and Profit Shifting (BEPS) are reduced.

We agree that a consistent approach to the Group Ratio Rule (GRR) in particular will tend to simplify the compliance for international groups of companies.

However, the actual effect of Action 4 rule on interest deductibility in general, and the Group Ratio Rule in particular, will be very dependent on

- the accounting standards applied by a group of companies and/ or required to be followed by the GRR, and
- the tax law of the territory in question, and the correspondence (or lack of correspondence) between them.

We consider that this is an important factor not identified in paragraphs 4 and 5 of the paper, which means that a fully harmonised approach may not be optimal.

For example consider a situation where territory A has a tax system in which the deductibility of interest is closely aligned to IFRS accounting rules (e.g. by deducting interest on an accruals basis) and territory B does not (because interest is deductible on a paid basis). A company operating entirely in territory A would expect that the interest allowable under a GRR based on IFRS accounts would result in no timing differences. An identical company operating in territory B would likely suffer significant timing differences between the capacity to deduct interest under the GRR based on IFRS accounts, and the tax deductibility of that same interest.

These timing differences may or may not be significant, depending on whether the regime in territory B has sufficient flexibility to allow carry forward of excess capacity and excess interest expense.

This analysis is even more serious in the case of derivatives hedging debt (whether the hedge is of foreign exchange risk or interest rate risk, or both), where fair value movements may be large compared to the other profits and losses of the company. Under many accounting frameworks, such fair value movements are accounted for in the Income Statement, with limited scope for hedge accounting even where a derivative functions as an economic hedge of interest expense. However, the taxation of these instruments may, depending on the tax regime, and depending on detailed criteria, be on the basis of either fair value movements, accruals of interest, or payments.

When considering how the GRR should apply to such instruments, it should be noted that as with interest cost itself, the effect will depend on the accounting and tax treatment. If a territory enacts rules requiring the group ratio to bring in derivatives on an accruals basis, this will result in a relatively straightforward analysis where derivatives are always taxed on that basis. However, where a derivative is taxed on a fair value basis (either because specific criteria for taxation on accruals basis are not met, or because no such tax treatment is available under domestic law) this will result in significant differences between the capacity to deduct interest under the GRR, and the actual deductibility of that interest.

Similarly, if a territory enacts law requiring the group ratio to be computed following the actual accounting treatment of derivatives, this should create minimal timing differences if that is also the basis used for domestic taxation of derivatives. However, it will create significant differences where derivatives hedging debt are taxed on the basis of accruals or payments.

Given that such derivatives tend to be used by companies for major exposures over long periods of time, this means that material long-term timing differences are likely. If the ability to carry forward disallowed expense or excess capacity is limited, material amounts may be permanently disallowed. This does not appear to be an intended consequence of Action 4.

Consequently, the effect of having an internationally consistent method for computing the group ratio would be that territories whose domestic tax rules for interest and derivatives are not aligned with that method will generate significant differences between interest capacity and interest tax deductible. Those differences are likely to be material amounts for the companies concerned, and to persist over long periods of time (if not permanently, depending on the details of the carry forward / carry back mechanisms in that territory).

This would frustrate the policy objectives of Action 4 insofar as identical companies operating in different territories will experience very different consequences of the same GRR.

Groups affected may conclude that they are incentivised not to use hedging derivatives over debt instruments, and change their hedging policies accordingly. This will likely result in an increase in overall financial risk borne by business.

We would therefore suggest that it is more appropriate for territories to determine their rules for computing a group ratio in a manner which is consistent with their domestic rules for the taxation of interest and derivatives.

Subject to that overall caveat, we have the following comments on the specific questions raised in the draft paper.

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?

We have set out above a fundamental issue likely to arise in the measurement of third party interest expense for the purpose of the GRR. This suggests to us that “the importance of having an objective measure of net third party interest expense” noted in paragraph 10 of the document needs to be considered in the light of the constraints of a territory’s specific tax and accounting laws. The potential shortcomings of a single approach are, in our view, at least as significant as the potential shortcomings of allowing various accounting standards to be used.

Consequently in some cases Approach 1 (following the consolidated accounts) may be more appropriate and less subject to manipulation than other approaches.

Nevertheless, we agree that in some cases the use of different accounting standards may allow companies some flexibility in determining the figures to be used in their GRR calculation. However, in our experience most major sets of accounting standards (e.g. UK GAAP, IFRS, US GAAP) are sufficiently robust that such manipulation by choice of accounting policy may be difficult.

It is also important to note that accounting standards change over time. It would be important for the GRR methodology to have the flexibility to deal with such changes. For example, IFRS16 is due to come into effect in 2019, and this is expected to materially change the accounting treatment of leases. Lessees using IFRS will be required to capitalise leased assets on the group balance sheet, and reflect the lease obligations as if they were a debt. If the limitation on interest deductibility proposed under Action 4 is to operate as intended (as regards not only the group ratio but also the fixed ratio), it will be necessary to make adjustments for this and for any future changes to accounting standards.

Approaches 2 and 3 are likely to result in a very complex calculation which will be difficult and costly for large groups to prepare, and similarly difficult and costly for tax authorities to audit.

There will also be some challenges as to the appropriateness of the methodology in certain cases.

A large element of the complexity will arise from the suggestion that gains and losses on financial instruments (including fair value movements, foreign exchange movements, and gains or losses on disposal) should be separated into elements equivalent to interest and those which are not.

This complexity arises for two reasons:

i. It is not straightforward to propose an objective indicator of whether a gain or loss on a financial instrument is "equivalent to interest" or not.

   On financial instruments with known future cashflows, (for example a committed forward purchase of a currency or commodity) the element of discount on those cashflows can be computed. However, for instruments where the quantum of future cashflows is not known (e.g. an option to purchase a currency or commodity), it is not straightforward to determine to what extent a change in fair value should be attributed to the change in interest rate applied to possible future cashflows.

   Similarly, it would need to be determined what is meant by "future interest". If a company repays a loan liability at a discount, and that discount arises because the lender has determined that the credit risk of the company would justify a higher credit margin, it could be argued either way whether or not the company's gain is attributable to interest rates.

   Problems may also arise with financial instruments in currencies which have very high interest rates because they tend to depreciate. There are arguments that exchange movements should be classed (economically) as part of the interest return to avoid a distortive result. However, there are no clear criteria as to when this should or should not apply to a particular transaction.

ii. Even where a methodology can be found, the burden of computing the elements of financial instruments attributable to interest could be very large

   Some groups, particularly but not exclusively those in financial services and commodity sectors, may have many thousands of financial instruments outstanding with third parties. The compliance burden of separating the gain or loss on each instrument into interest and non-interest components could be very large and impractical.

The challenge to the appropriateness of the methodology may also arise where a financial instrument is used to hedge an item which is properly attributed to EBITDA. For example, where an operating company hedges turnover in different currencies with currency contracts, the implication of Approaches 2 and 3 would be to include the interest element of the currency contracts, notwithstanding that this is effectively part of the operating income or expense. A similar issue arises with groups who hedge turnover with an inflation linked derivative (e.g. because they operate in a government regulated industry where prices are determined by reference to inflation).

Similarly, any criteria based on financial instrument definitions run the risk of creating anomalous situations when financial instruments are compared to transactions which have similar characteristics but are not financial instruments, such as long term contracts, or sales on deferred terms.

These issues would be less significant under Approach 1, to the extent that non-financial instruments are accounted for purely as trading revenue, and financial instruments hedging such items may be hedge accounted (for example as cashflow hedges of turnover), which may mean the interest element

is recorded in turnover rather than group interest income or expense. However, whether this is possible will depend on individual circumstances.

Naturally, some of these issues could be reduced to the extent that groups are given flexibility to choose the approach taken.

In practical terms, it should be noted that rules which require a subsidiary to calculate taxable profits based on detailed analysis of transactions undertaken by an overseas parent tend to give rise to difficulties in some groups. For business reasons, the head office may not share confidential group information with operating subsidiaries, and this puts the subsidiary in a position where they have no right to access the information needed for their return. This situation should be avoided where possible. Therefore rules which require detailed information regarding the affairs of an overseas parent should be minimised.

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?

We agree that a country's tax policy goals should be taken into account in determining third party interest expense.

We have no objection to the suggestion that where domestic law does not allow a deduction for a specific class of expense (e.g. coupons on fixed rate preference shares) this should be excluded from the group ratio in that territory.

However, it would be important that this restriction is applied to specific and objectively defined classes of interest expense. If a country were to require that each interest expense in the consolidated financial statements had to be tested in order to determine whether it would be deductible under domestic legislation, the compliance burden would be very significant.

We have a particular concern with the proposal that related party interest should be excluded from the group ratio. Many groups of companies, particularly those structured as joint ventures, are financed by significant amounts of debt from equity investors who do not have a controlling interest. This is commonly to ensure that commercial objectives are met, for example:

- use of a mixture of debt and equity allows different investors to take different levels of risk,
- use of a mixture of debt and equity allows voting rights and funding contributions to be in different proportions, and
- use of debt in place of equity allows funding to be provided, or cash to be returned, without triggering the company law complexities of share capital subscriptions or dividend distributions.

In many cases the corresponding income in the investor will be fully taxable.

These are not transactions which the OECD's anti-BEPS programme should seek to target.

However, if the computation of external interest under a GRR excludes interest payable to related parties, it seems likely that interest on debts owed by a joint venture to investors would be excluded from the group ratio. The consequence would be that where the joint venture relies on the group ratio, a disallowance would occur.

In the absence of a "corresponding adjustment" mechanism to enable the investors to treat their interest income as non-taxable, the consequence would be a higher tax burden for investors in a joint venture. This does not appear to us to be appropriate.

It would seem more appropriate for the test of whether such interest is tax deductible to be based on domestic law tests. Most countries have tests which disallow interest where a debt cannot be justified by arm's length principles, or where a debt has a primary purpose of reducing tax. Where the investor's interest income is not taxable, countries may have rules to disallow the interest expense for that reason. Such rules would seem to strike out related party debt where it is appropriate to do so, and would be better targeted than a mechanism in the GRR.

The comments at the start of this letter related to the tax treatment of derivatives are relevant when considering the interaction of the GRR with a country's tax policy goals. Many countries have a policy of enabling hedging transactions to be conducted effectively as this promotes good risk management and financial stability. If the GRR were to disincentivise groups from hedging because it would cause large book/ tax differences (whether permanent or temporary) this would appear to be contrary to such a policy.

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

It may be appropriate for the GRR to allow adjustments for securitisation arrangements, particularly where the securitisation entity is an "orphan" i.e. not part of any group. Commonly such an entity borrows from external lenders, and either lends on to the main group at a small margin, or purchases receivables or an income stream. The securitisation entity may therefore have income which is not interest, but expense which is interest. It may or may not be in the accounting consolidation. Economically, the structure gives rise to a secured loan for the group, and the GRR should reflect this.

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?

Where it is suggested that items such as capitalised interest may be adjusted, it would be appropriate for the adjustments to follow the timing of deductions being available under a country's tax law, in order to avoid timing differences.

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?

It should be noted that as well as depreciation and amortisation of capital assets employed in the business, accounting standards such as IFRS commonly require revaluation (upward or downward) of capital assets held as investments, for example property held by a business whose main activity is not property related. It will be important for legislation to make clear whether these revaluations constitute depreciation or amortisation. Including them in EBITDA will give rise to significant timing issues if (as is commonly the case) the profit or loss on such an asset is only taxed on realisation.

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

We note the principle stated in paragraph 51 that exempt income (in particular participation in subsidiaries) should not be funded by tax deductible debt. It should be noted that care should be taken if this policy is applied to income other than participation in subsidiaries or associates. In the case of participations, the policy justification for not taxing the income is generally that it should be subject to tax at the subsidiary or associate level, and the income received is therefore “post tax”. It makes sense that in such a case, the availability of interest deduction against that income is considered at the subsidiary or associate level.

By contrast, where income is exempt from tax, or taxed at a reduced rate, because a country chooses to incentivise that type of income (for example “patent box” or “ research and development” regimes) if the consequence of Action 4 is that interest reductions are restricted as a result of the income, this reduces the incentive to invest.

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?

We make no additional comment on question 9.

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?

We make no additional comment on question 10.

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?

We agree that eliminating the results of an entity with negative EBITDA from the group ratio calculation raises a number of difficulties. As well as those specified, we note that some entities may have losses which can be eliminated on consolidation in whole or in part. These have a distorting effect. For example, a group with total EBITDA of 100 may include two entities party to a financial instrument on which one has a loss of 200 and the other has a profit of 200. Eliminating the lossmaking entity would give EBITDA of 300, which seems an odd result. Losses would therefore have to be net of consolidation adjustments, which increases the complexity and compliance burden arising from the rule.

Care would also need to be taken as to matters of entity classification, as entity recognition for entity accounting and consolidation purposes may differ from entity recognition for tax purposes.

We think it likely that a restriction which limits the group's overall interest expense carried forward from any period to the actual net interest expense incurred in the group overall would address the objective of ensuring that loss making periods, or periods of very low EBITDA do not give rise to excessive interest capacity.

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?

If a cap for the GRR is desirable, one possible measure would be a rolling average of the group's actual group ratio over a number of years. This would ensure that short term falls in EBITDA did not distort the group ratio unduly.

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?

We note above that in some cases it may be difficult to obtain information as to the detailed affairs of other group entities.

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

We make no additional comment on question 14.

We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the Discussion Draft.

Yours faithfully,

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