CONFEDERATION FISCALE EUROPEENNE

Opinion Statement FC 11/2016

on the OECD Public Discussion Draft (BEPS Action 4)

Elements of the design and operation of the group ratio rule

Prepared by the CFE Fiscal Committee

Submitted to the OECD in August 2016

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.
The CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, CFE Tax Policy Manager, at brusselsoffice@cfe-eutax.org.

1 Introduction

This Opinion Statement by the CFE Fiscal Committee relates to the OECD Discussion Draft "BEPS Action 4: Elements of the Design and Operation of the Group Ratio Rule[1] (hereinafter the "Discussion Draft"), released for public consultation on 11 July 2016.

2 General remarks

Reference is made to the Opinion Statements submitted previously, i.e.

i. Opinion Statement FC-5/2015 of February 2015 on interest deductions and other financial payments (BEPS Action 4)[2],

ii. Opinion Statements FC 4a-4f/2016 of 5 October 2015 on the OECD Final Recommendations on BEPS Actions 1, 4, 5, 8-10, 12 and 14[3], and

iii. the OECD BEPS Final Recommendations of 5 October 2015[4].

The comments below are based – and further expand – on the following comments and recommendations made in the aforementioned Opinion Statements.

2.1 As a general point, the concern was raised that the rules to limit the deduction on interest might lead to situations (i) in which not all third party interest will be tax deductible, (ii) in which the rules will lead to double taxation, and (iii) in which the rules will limit the deductibility of interest even though it concerns bona fide business situations in which the taxpayer can demonstrate that the objective to attract loans evidently was not to avoid or reduce corporate income taxes. In this respect, it was observed that the rules leave much space for different interpretation and discretion of the countries that adopt these rules, thus increasing the risks summarized above.

With respect to the group ratio rule, the hope was expressed that it would help to eliminate double taxation and to achieve a fairer system, while special attention was requested for the interaction of loss-making entities on the operation of the group ratio rule.

In view of the foregoing, CFE recommends that the group ratio rule meets the following conditions:

(i) if and to the extent that in the first round the implementation of the group ratio rule does not result in all interest on third party debt to be deductible for CIT purposes, there should be a corrective adjustment/compensating mechanism resulting ultimately in all third party interest being deductible;

(ii) the fact that dividends and/or capital gains from equity investments are exempt from CIT in the hands of the relevant group company should either not affect the deductibility of interest due by such company, or, if it is allowed to limit such deductibility, find compensation elsewhere (see (i) above);

[1] http://www.oecd.org/tax/beps/discussion-draft-beps-action-4-elements-of-the-design-of-group-ratio-rule.pdf .
[2] http://www.cfe-eutax.org/node/4175 .
[3] http://www.cfe-eutax.org/node/5136 (see FC-4b/2016 for BEPS Action 4).
[4] http://www.oecd.org/tax/beps/beps-actions.htm .

(iii) to the extent the group ratio rule provides for exceptions to the generic principles justified by "policy" considerations of the jurisdiction(s) involved, this should only be acceptable if (i) it concerns policy considerations specifically aimed at combatting base erosion and profit shifting, and (ii) the rights of the taxpayers are protected in that the aforementioned exceptions do not apply if they can demonstrate that base erosion and profit shifting was not the underlying motive for the third party borrowing.

2.2 Taking into account these recommendations, in the CFE's view, the Discussion Draft apparently does not endeavour meeting the aforementioned conditions. This observation is in particular based on the following:

(i) the discretion of a country to deviate from the rules on the basis of tax policy considerations.

In numerous cases the Discussion Draft states that countries may not apply a group ratio rule, or a different group ratio rule based on "policy" considerations. See, for example, par. 4: "*The option for a group ratio rule described in the Action 4 Report and this discussion draft represents an approach that should be suitable for most countries. However, countries may also apply a different approach to suit their domestic circumstances*". In addition, par. 21 states the following: "*So long as the adjustments [to a group's net party interest expense] required or permitted by a country are in accordance with the goals set out in the Action 4 Report, the fact that countries may make different policy choices on these issues is not inconsistent with common approach*".

In this respect it is unclear which goals specifically the Discussion Draft is referring to, taking into account that the Action 4 Report seems to be extremely "permissive" insofar it concerns the acceptability of a country's policy. See for example par. 31 of the Action 4 Report: "*It is also recognized that a country may have interest limitation rules that carry out broader policy aims such as reducing the tax bias in favour of debt finance...*". Query whether such policy is in accordance with the Action 4 Report. If it would, this would allow countries to make any adjustment they like at their full discretion. It would be very helpful if the OECD could explain in which circumstances a country's "policy" would go beyond, and therefore no longer be in accordance with, the goals set out in the Action 4 Report.

By way of illustration, it is also worth noting that in the interest limitation rule of the recently adopted EU Anti-BEPS Directive [5] all of the OECD's recommendations with respect to adjustments to the Group Ratio Rule have been ignored.

(ii) the approaches available to calculate net third party interest expense and group-EBITDA.

The Discussion Draft provides for a number of approaches to calculate net third party interest expense. Approach 2 and 3 as described in the Discussion Draft allow for adjustments to the calculation of net third party interest expense to include and exclude certain items in accordance with whether they fall within the definition of interest and payments economically equivalent to interest as described in the Action 4 Report. The CFE acknowledges the need for adjustments in certain cases as a group's consolidated financial statements alone (i.e.

[5] Directive (EU)2016/1164 of 12 July 2016: link

Approach 1) may not be appropriate to reflect the actual third party interest income paid by the group due to different accounting standards. However, the CFE notes that if flexibility were given to countries to apply any of approaches 1 through 3, this could result in (large) variances in calculations of net third party interest expense between countries. It is therefore of utmost importance that a single standardised approach is taken if such adjustments are made. The absence of a single approach could result in not all third party debt being deductible. Similarly, if the “adjustment” approach described above is accepted to bring the net third party interest expense in line with the actual third party interest paid, any corresponding adjustments made to the group-EBITDA should also take such a single standardised approach.

Furthermore, the Discussion Draft acknowledges in par. 22 that there are cases in which there will be practical or legal constraints that make the alignment of net interest expense and economic activity measured using EBITDA difficult or impossible. Although the CFE welcomes the proposal to allow countries to apply an uplift of 10% to the group’s net third party interest expense to address this issue, there may be cases in which such uplift is not sufficient to ensure that all net third party interest can be deducted. Currently, the Discussion Draft only allows countries to apply a smaller uplift than 10% or no uplift. To ensure that interest on third party debt is deductible, the CFE therefore proposes to include a flexible uplift mechanism which also allows for uplifts of more than 10% if the entities involved can demonstrate that base erosion and profit shifting was not the underlying motive of the misalignment between the net third party interest expense and the group-EBITDA.

(iii) inclusion of non-taxable dividend income in the calculation of group-EBITDA.

The Discussion Draft provides that all dividend income, including non-taxable (exempt) dividend income, should be included in the calculation of group-EBITDA but that exempt dividend should be excluded from the relevant taxpayer’s EBITDA. This approach may restrict an entity’s ability to fully deduct third party interest expenses. The CFE therefore favours the approach described in par. 55 of the Discussion Draft which proposes to exclude dividend income which is not subject to tax from group-EBITDA calculation. Although the compliance burden should be considered, the CFE believes the additional burden of this approach to be limited. As the Discussion Draft correctly notes, information on received dividend income and its tax treatment will be available to the group’s finance department. At the same time, information on a country’s treatment of dividend income should be readily available for the tax authorities as well in this ever more globalised world. In this context, the CFE wonders why on the one hand the Discussion Draft favours adjustments to the calculation of net third party interest expenses to ensure the proper operation of the group ratio rule (see par. 19 of the Discussion Draft), but on the other hand considers adjustments to the calculation of group-EBITDA to be to burdensome and complex (see par. 55 of the Discussion Draft).

(iv) the treatment of groups with zero or negative group-EBITDA.

The CFE shares the OECD’s concerns that there could potentially be a significant difference between the tax treatment of a group having a very low group-EBITDA and a group having a zero or negative group-EBITDA. To address the above issue, the Discussion Draft contains two proposals, i.e. excluding entities with negative EBITDA from the calculation of group-EBITDA (see par. 76 of the Discussion Draft) or allowing an entity with positive EBITDA in a group with negative group-EBITDA to deduct interest expenses up to the lower of the entity's actual net interest expense, the group's net interest expense and a set percentage of entity EBITDA (see par. 78 of the Discussion Draft). The CFE favours the option of excluding entities with negative EBITDA.

With respect to the issue of the carry forward that is raised in par. 79, the CFE refers to the recommendations made in the Action 4 Report, which it fully supports. As a general principle, the CFE believes that carry forward of disallowed and unused interest capacity under the group ratio rule is an important tool that would adequately address the issue of volatility in the outcome of the group ratio rule over different years due to fluctuations in a group's income and net interest expense and should therefore be allowed where possible.

Given the importance, the CFE wonders why the mechanics of the carry forward of both disallowed interest and unused interest capacity in relation to the group ratio rule have not been addressed by the Discussion Draft.

In the context of carry forward of unused interest capacity specifically, the CFE notes the following observation made in par. 79 of the Discussion Draft: "*On the other hand, where a group has negative group-EBITDA, this approach [i.e. the approach of paragraph 78 of the Discussion Draft] would prevent an entity which has deducted all of its net interest expense in the current period from carrying forward unused interest capacity…*". The meaning of this statement is unclear to the CFE. One would think that, if a group has zero or negative group-EBITDA, the group ratio rule cannot be applied and hence there will be no unused interest capacity to carry forward. To clarify this point, the CFE recommends to illustrate the mechanics of carry forward of unused interest capacity in an additional example, including an example of the alternative proposed in the last sentence of par. 79 of the Discussion Draft.

3 Responses to specific questions

The Discussion Draft poses a number of "questions for consultation" in regard to the proposed approaches to the outline of key elements of the design and operation of the group ratio rule, i.e. (i) the calculation of the group's net third party interest expense, (ii) the definition of group-EBITDA, and (iii) the impact of losses on the operation of the rule. All issues to which the questions relate, and on which the CFE would like to comment have been addressed above as follows:

(i) Questions for consultation in regard to the calculation of the net third party interest expense: We refer to the comments made under paragraph 2.2, (i) and (ii) above.

(ii) Questions for consultation in regard to the Definition of Group-EBITDA: We refer to the comments made under paragraph 2.2, (ii) and (iii) above.

(iii) Questions for consultation in regard to the impact of losses on the operation of the group ratio rule: We refer to the comments made under paragraph 2.2 (iv) above.