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ACTL
AMSTERDAM CENTRE FOR TAX LAW

Achim Pross
Head, International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
OECD
Submitted by email to: interestdeductions@oecd.org

Amsterdam, 5 February 2015

Public Discussion Draft: BEPS Action 4: Interest Deduction and other Financial Payments

Dear Mr. Pross,

We would like to make two comments on the public discussion draft.

1. Optimum of deemed interest rule and interest cap rule

We understand that countries engaged in Action 4 agree to structure a group-wide interest allocation rule as an *interest cap rule* instead of a *deemed interest rule*. The risk of mismatches (multiple deduction of the same interest) caused by a *deemed interest rule* may outweigh the risk of economic double taxation caused by an *interest cap rule*. The risk of multiple deduction of the same interest occurs if groups have the opportunity to raise interest – and deduct actual interest cost – in countries which do not apply the rule *deemed interest rule* (see also p. 30-31 of the report and example 4 on p. 77-78). A policy choice for the *interest cap rule* instead of the *deemed interest rule* may therefore be warranted. However, in our view it is worth trying to find an optimum, where there is no double dip and economic double taxation is kept at a minimum. This may be achieved by applying the *deemed interest rule* within a sub-group located (either through subsidiaries resident thereof or through permanents establishments located therein) in jurisdictions that apply equivalent interest allocation rules (hereinafter: qualifying sub-group). The rule could operate as follows:

Stage 1: Determination of an interest cap within qualifying jurisdictions
a) A Co calculates the total net third party interest expense for its group.
b) A Co identifies its group's total earnings or assets.
c) A Co calculates the interest cap for the qualifying sub-group, which is an allocation of part of the group's net third party interest expense, determined on the basis of the ratio of the qualifying sub-group's earnings or assets to the group's total earnings or assets.

Stage 2: Application of the interest cap within qualifying jurisdictions
d) A Co calculates the net interest income or expense of the qualifying sub-group.
e) If the qualifying sub-group has net interest income, A Co cannot deduct any interest in excess of its taxable interest income.
f) If the qualifying sub-group has net interest expense, this is compared against its interest cap. Net interest expense up to the interest cap is allocated within the qualifying sub-group.

Stage 3: Allocation of interest within qualifying subgroup
g) A Co calculates its allocation of part of the qualifying sub-group's net third party interest expense, based on the ratio of its earnings or assets to the qualifying sub-group's total earnings or assets.

2. Economic double taxation of interest spread under the interest cap rule

It is explicitly stated in the Discussion Draft that under the worldwide *interest cap rule* a group should in principle be able to claim deductions for an amount equal to its actual third party interest costs. In order to achieve this, the intra-group financing of a group must be organized in such a way that the net interest expense of each group company reflects the interest cap allocated to it. In our view this is a very theoretical approach, which neglects the practical difficulties for a group to organize its financing structure in such a way. Moreover, the arm's length principle may prevent a group from allocating intra-group debt to a group company. The result is that the cap cannot be fully utilized.[1]

But even if a group were able to set-up an arms' length intra-group financing structure reflecting the interest cap allocated to each group company, the world wide *interest cap rule* would cause economic double taxation. An example may illustrate this.

Example
A Co borrows € 10 million from the bank at a fixed interest of 5% and lends the full amount to its only subsidiary B Co at an arms' length interest rate of 6%. Hence, the spread on the intra-group loan is 1% (6% -/- 5%). The EBITDA of A Co and B Co is nil and € 100 million, respectively.

Under the *interest cap rule* B Co is allowed to deduct net interest expenses up to the level of its interest cap. On the basis of an EBITDA allocation, B Co's interest cap equals the interest A Co paid to the bank. In numbers: of the € 600.000 interest paid to A Co, only € 500.000 is deductible.

A Co is not confronted with the *interest cap rule* because its net interest position is positive (€ 600.000 -/- € 500.000). In other words: A Co can offset the interest paid to the bank against the interest received from B Co. However, the € 100.000 spread income at the level of A Co remains taxable.

The example illustrates that groups will suffer economic double taxation on spread income when using intra-group debt to re-allocate third party debt within the group. In our view this 'built in' economic double taxation on spread income is both in theory and practice undesirable. A solution that avoids this economic double taxation on a case-by-case-approach may not be viable. A viable solution may be the allowance of an additional fixed percentage of the net third party interest cost that may be added to the interest cap. By allowing such increase, the group is roughly compensated for the economic double taxation it potentially suffers on its interest spread.

Sincerely yours,

Otto Marres and Jan van de Streek, University of Amsterdam, Amsterdam Centre for Tax Law (ACTL)[2]

[1] In the Draft Discussion (p. 28) it is submitted that countries introducing a group wide rule may no longer be concerned about the at arms' length pricing of individual intra-group instruments. However, there are no guarantees that this issue will be resolved.
[2] Both authors are professor at the University of Amsterdam, Amsterdam Centre for Tax Law (ACTL). They are also practicing as tax lawyer at Meijburg & Co and Loyens & Loeff, respectively. This letter does not necessarily reflect the views of the abovementioned organizations.