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Mr. Achim Pross
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6 February 2015

Dear Mr. Pross:

Subject: BEPS ACTION 4 - Interest Deductions and Other Financial Payments

BDO USA, LLP ("BDO" or "we") welcomes the opportunity to comment on the OECD's Discussion Draft on BEPS Action Item 4: Interest Deductions and Other Financial Payments ("Discussion Draft"). We greatly appreciate the OECD's open and collaborative approach on this important subject.

In this letter, we have incorporated our comments by topic. We understand that the OECD has and will receive several comments on this and other discussion drafts; therefore, we have kept our comments brief. We will be happy to expand on our comments and suggestions at the public consultation on February 17th, 2015.

General Comments

We support the OECD's efforts in publishing guidance around different options to address base erosion and profit shifting through the use of deductible payments, such as interest and other similar payments, in an effort to equip governments with domestic and international tools to address this challenge. Based on our review of the proposed guidance, we believe that parts of the Discussion Draft could be improved through greater clarity and consideration of established rules already in place in many jurisdictions.

Adding to the consideration of rules already in place, there seems to be a departure from the arm's length principle, and a movement towards an apportionment approach, due to a concern around the uncertainty of outcomes stemming from the use of an arm's length test. Specifically, there seems to be a sense that this type of test may be burdensome to apply and still not fully address the issue of base erosion and profit shifting. We believe that additional consideration should be given to application of arm's length principle in preventing base erosion and profit shifting using interest and financial payments which are economically equivalent to interest. While inevitable in some situations, an apportionment approach may lead to distortions that could be avoided through application of the arm's length principle. To deal with these distortions, there will likely be various exemptions to the rules, which may cause this approach to be as burdensome to implement as an arm's length approach.

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Another general comment we would like to propose is a grandfathering rule that allows companies with long-term debt in place (e.g., for a long-term infrastructure project or other pre-existing projects) a grace period for transition once this new guidance is finalized and adopted. A grandfathering rule will reduce the chances of permanent double taxation and/or unviable financial models. Careful consideration as to the terms and circumstances in which this rule would apply should be made.

We have included suggestions to select topics highlighted in this Discussion Draft that we believe could help refine the proposed guidance. Our focus is to offer practical suggestions that limit the risk of double taxation, while maintaining practical solutions to taxpayers.

<u>What is interest and what are financial payments economically equivalent to interest?</u>

The main types of financing appear to be covered, including original issue discount ("OID"), use of hybrid instruments, profit participation loans, finance leases, back-to-back financing, hedges, and guarantee fees. For groups operating in countries where currencies are volatile, consideration should be given as to how to address the treatment of foreign exchange gain or loss.

Some jurisdictions have specific anti-deferral rules that currently tax certain types of passive income including interest. In connection with the anti-deferral rules, some jurisdictions include payments or transactions other than interest as an interest equivalent. These anti-deferral rules should be considered.

The OECD proposal to include such fees in the definition of interest and payments economically equivalent to interest may be too broad in this respect and inconsistent with transfer pricing treatment in the U.S. and case law governing the nature of such fees.

<u>Who should a rule apply to?</u>

It is unclear as to whether or not the 25 percent control test is to be calculated on a basic share basis (i.e., based on the current ownership structure or shares outstanding as of a certain date) or fully diluted basis (i.e., basic share basis plus the potentially dilutive effect from any outstanding stock options, warrants, convertible preferred stock or convertible debt, etc.). This could have a substantial impact as to which relationships will be considered "controlled" or "uncontrolled." Clarification is needed with regard to this control test.

The 25 percent control test also seems over-inclusive as this threshold is much less than the control thresholds around investment activities, such as intercompany financing, currently in place in many countries. A low threshold may place an undue burden on passive investors (e.g., private equity or similarly structured entities), who do not wish to exert management control over portfolio companies, have little or no control over transactions, and little or no access to financial data to determine their level of risk. A control test that would enable investors that have access to financial information, as well as control, seems more appropriate and this is more in line with current control thresholds established in many countries. This type of control test will continue to eliminate base erosion and profit shifting, but will also reduce the compliance burden on passive investors.

The manner in which share attribution or constructive ownership of shares is treated in the application of any tests needs to be considered.

What should a rule apply to? (A) the level of debt or interest expense and (B) an entity's gross or net position?

The concept of interest expense, as defined in paragraph 34 of the Discussion Draft, could pose problems for non-interest items which can be included as interest in certain jurisdictions, such as foreign exchange gains or losses. The treatment of these items should be considered by the OECD.

Further, compliance with the definition of interest expense envisioned in Part IV. of the Discussion Draft, could pose problems in jurisdictions where that definition is narrower. For example, many jurisdictions do not consider interest paid or accrued by the taxpayer during the taxable year in the definition of interest. Too broad a definition could lead to misunderstandings and a greater risk of over or understatement of interest expense by taxpayers. More clarity is needed around the definition of interest expense.

The Discussion Draft includes "imputed interest on instruments such as…zero coupon bonds." The determination of such interest would generally mirror how the original issue discount amount is calculated in most jurisdictions; however, the potential disallowance of the original issue discount of certain financing instruments should also be considered.

Should a small entity exception or threshold apply?

Any type of threshold will require tax authorities to have perfect visibility into a controlled group's operations and consistency across accounting standards. Without visibility or consistency, the threshold falls apart and is inconsistent in its application; leading to more controversy in the future. Action Item 13, covering Country-by-Country reporting, has already demonstrated the difficulties in obtaining consistent information in a single enterprise. This difficulty only increases when you apply a threshold across a number of companies operating in a number of different industries. Further, businesses of any size will face similar problems regarding information availability, specifically if they are organized across multiple business and/or product lines. Group tests, which require perfect visibility and consistency in accounting standards to properly apply the test, are likely to pose more problems in relation to information availability.

Whether interest deductions should be limited with reference to the position of an entity's group?

The advent of innovative financial products will only serve to compound the difficulties in applying a blanket threshold on interest deductions. To truly eliminate base erosion and profit shifting and keep within the framework of the arm's length principle, interest deductions should not be limited with reference to the position of the entity's group, but should also consider industry specific characteristics. Thresholds serve as conclusions. Without a thorough economic analysis of the entity and industry in which it operates, the approaches to limit interest deductions outlined in this Discussion Draft deviate from the arm's length principle.

The term "group" is used throughout this section, but without clear determination as to what constitutes a "group," which may vary by country, particularly if hybrids or reverse hybrids are used as well as which attribution or constructive ownership rules are invoked, this term leaves this section open to uncertainty. Further, the tax definition of the term "group" may also differ from the accounting definition under GAAP. For U.S. GAAP purposes, consolidation

generally applies when ownership exceeds 50 percent. In contrast, a consolidated group for U.S. tax purposes includes only corporations organized under U.S. law and owned directly or indirectly more than 80 percent by a single U.S. corporation. IFRS utilizes a different definition of control, which focuses mainly on the amount of power the investor company has over an investee's activities, rather than the level of voting rights.

Foreign entities are not included. Thresholds used in other countries vary. Various calculations are made at the U.S. consolidated group level but would not involve consideration of foreign corporations. Under U.S. rules, results of a foreign branch or partnership (including foreign entities characterized as partnerships or disregarded entities) would have their results included with those of a U.S. owner.

The concept of an "expanded affiliated group," for example, in the context of the U.S. anti-inversion rules would include non-U.S. corporations and a lower threshold for inclusion (more than 50 percent instead of at least 80 percent). Moreover, if an inversion has occurred, the foreign company will be treated as domestic if certain ownership thresholds are met. This rule takes precedence over the determination of residence under a double taxation treaty and increases the likelihood of unrelieved double taxation and a distortion of the concept of the group for purposes of applying the rules proposed in Section VIII of the Discussion Draft.

Consideration should be given to the local rules that allow for the treatment of affiliated groups as a single taxpayer when applying rules around the deduction or accrual of interest and the extent to which these contrast with group-level rules in other contexts.

Depending on whether or not an investment entity (i.e., private equity or similarly structured entity) falls into any of the scenarios outlined in Part V. of the Discussion Draft, interest deductions could be limited in portfolio companies of investment entities that are considered to be controlled parties. Limiting the interest deductions a portfolio company could take on debt from an investment entity could have a substantial impact on the portfolio companies' ability to operate as a going concern. In addition, changes to the tax treatment of debt would make it tougher for investment entities that rely on deductible debt to structure profitable transactions. Interest deduction is a core component of many investment entities' business models. For example, investment firms, such as private equity, identify companies they want to take over and proceed to revamp their operations for the purpose of selling the company to public or private investors. In a typical deal, investment firms have the target company take on debt during the restructuring process, which increases the target company's profitability. A reduction in interest deductions will increase the target company's tax rate and reduce the amount of cash available to pay back existing obligations, fund operations, and pay dividends. If interest weren't deductible, investment firms wouldn't be able to make such large acquisitions, which could cause a slowdown in the economy.

Further, it is not the goal of most investment entities to actively manage a portfolio company's business. If the investment entity assumes management control of a portfolio company, that company is generally not doing well. Therefore, a group-wide rule may be over-inclusive and suppress the business activities of investment entities.

With regard to non-investment entities, it is quite possible that taxpayers could alter their external funding to maximize leverage within the group if there is a group-wide cap to maximize borrowing at a local level to the maximum available.

Whether interest deductions should be limited with reference to a fixed ratio?

It is often assumed that an accurate estimate of a company's financial position can be made by merely looking at a company's most recent balance sheet or income statement. In reality, this is often not the case. It is commonly accepted that financial statements prepared under GAAP or a tax basis of accounting often present a picture that is different from economic reality. The OECD acknowledges this point in paragraph 154, which states that companies with more "self-created intangibles could be treated less favorably" in the context of a linking interest deductions to assets. Self-created intangibles may have value, but this value may not show up in GAAP or tax basis accounting. Therefore, it may be useful for an entity to normalize their balance sheet, by creating an "economic balance sheet", when linking interest deductions to the levels of assets. Economic adjustments made to the GAAP or tax basis balance sheet will reflect current market values of both assets and liabilities. Thus, the issue of self-created intangibles will be factored in as adjustments will be made to include these items on an economic balance sheet. Similarly, goodwill should also be revalued to reflect the true economic estimate of value, as accounting treatment of this item will allow for write-downs for impairment, but not write-ups. This "economic balance sheet" approach will better link the value of the assets held by an entity and the amount of interest expense that entity should bear.

Similarly, under an earnings based approach an "economic income statement" may also prove to be helpful in reflecting the true economic results of operation. For example, GAAP or tax basis policies on depreciation, amortization, provision for bad debts, inventory valuation, capitalization vs. expensing policies, and executive compensation can vary from conservative to aggressive and thus, distort true economic realities. Further, contingent liabilities are often not recognized on the income statement, but can shed light as to an entity's risk profile. Adjusting these items to an industry standard can make comparisons easier and more accurate when determining an earnings threshold for interest deductions.

Applying adjustments to an entity's balance sheet or income statement to reflect economic reality will allow tax authorities to make better comparisons across industries/sectors, allow for more accurate projections of future income/growth, and serve as a basis for determining or estimating additional value from unrecorded intangible assets. Adjustments such as these could prove to be administratively burdensome and costly, however, as these types of analyses are neither quick nor easy.

Another problem that could arise with the application of a fixed ratio limitation is one in which entities may be forced to use more equity financing as a result of this rule. An excess reliance on equity financing may result in an inefficient and less productive use of capital by a company, which could stifle innovation and negatively affect the company. Both debt and equity are important ways for businesses to fund their operations and, in a post-financial crisis world where capital structure consideration has become more important, internal funding has become a beneficial and desirable option. Corporate finance departments within companies strive to achieve optimal capital structures and internal funding that is the most cost effective and expedient means to achieve this optimal structure. A capital structure that consists primarily of equity financing may cause internal hurdle rates to rise, which could lead to fewer acceptances of innovative projects.

The treatment of non-deductible interest expense and double taxation?

A five year time limit, as suggested, may be too short to correct all the timing differences between tax and financial accounting. For example, depreciation and amortization, differences in vesting/exercise for stock option deductions, and other similar concepts may not reverse within the five year time period. A business cycle may also require more than five years for a business to recover from start-up slowness, which presents a disadvantage to a taxpayer with a longer business cycle and/or greater capital needs. Further thought should be given to the nature and timing of accounting methods used by taxpayers as well as business/life cycles of entities.

Conclusion

We would like to thank the OECD again for this opportunity to comment and reiterate that we would be happy to expand on these points and contribute further if required.

For clarification of any aspects of this response, please contact the following BDO transfer pricing consultants.

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