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Comments on the OECD Public Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments

Paris, 6 February 2015

The TUAC welcomes the opportunity to comment on the OECD Discussion Draft "Interest Deductions and Other Financial Payments" for public consultation regarding implementation of Action 4 of the Base Erosion Profit Shifting (BEPS) initiative. We have a number of observations to share on the draft with regard to (i) scoping issues (connecting parties and related parties), (ii) the basis for measuring the allocation (earnings or assets) and (iii) sector-specific treatment (other than in the banking and insurance sectors).

Application to connected parties and to related parties

We fully agree with the Draft's assertion that a "robust response to tackling base erosion and profit shifting should apply to all incorporated and unincorporated entities and arrangements, including permanent establishments, which may be used to increase the level of interest deductions claimed in a country" (#37) and, further down the text, that "some groups may attempt to reduce the impact of group-wide rules by artificially increasing the level of net third party interest expense […] through transactions with connected parties and related parties" (#139). That is why we pay particular attention to the Draft's discussion related to scoping issues (and corresponding questions), including the definition of connected parties and related parties (#38) and whether these should be included in a group-wide allocation rule, or alternatively should be subject to a targeted rule (#143-145).

Trade union experience with international businesses points to a growing diversity and complexity of corporate structures which may significantly depart from the "traditional" company group in which the accounting and reporting requirements (as required by a listed company) would match the economic perimeter of the group and of its effective sphere of control. Group structures can indeed be organised in a variety of ways – including pyramid groups and private pools of capital – in which some transactions and assets are moved off-balance sheet, with the associated risk of abusive mismatch between the accounting and the economic perimeters of the group[1].

[1] From a corporate governance point of view the excessive deduction of interest within a group can be assimilated to an abusive form of related party transaction (RTP) whereby a controlling party forces a controlled entity to conduct a transaction that has no economic rationale for or runs against the entity's interest or the interest of certain stakeholders (minority shareholders, creditors, workers, and obviously the tax collector). The OECD has developed considerable work in this area. In its most recent report on RTP, it states that "financial support for one company to another must have an economic quid pro quo and may not break the balance of mutual commitments between the concerned companies; the support from the company must not exceed its possibilities" (Related Party Transactions and Minority Shareholder Rights, OECD, 2012 http://www.oecd.org/daf/ca/50089215.pdf)

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Q 3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

Scenarios 2 (connected parties) and 3 (related parties) should consider in greater details the various "controlling enhancing mechanisms" that allow a group-wide controlling entity to separate cash flow rights from voting rights within the group with the risk of a mismatch between the reporting perimeter of the company group (covered by consolidated financial accounts) and the perimeter of effectively controlled entities. The most common form of controlling enhancing mechanisms are dual class shares (one class with voting rights, the other with limited or no voting rights), pyramid structures (cascading ownership of different entities) and cross-shareholdings. They are relatively common in continental Europe, East Asia and Latin America.

Scenario 2 (connected parties) specifically excludes companies that are controlled by a collective investment vehicle (CIV) "if there is no connection between them". In doing so, the draft does not distinguish between retail CIVs (mutual funds in the US, and as UCITS funds in Europe) and private pools of capital such as private equity and hedge funds (regulated by the AIFM Directive in Europe). There may be ground to exclude retail CIVs from the scope of the discussion. It can be argued that the asset manager of a retail CIV has a purely passive portfolio approach to the invested companies (they do not intervene in the management of the companies) and that the portfolio composition is diverse by sector (and hence by debt funding needs).

It is an entirely different story for private equity funds, the business model of which precisely rests upon the capacity of the general partner (the private equity firm) to exert management and financial responsibilities over the companies controlled by the fund. These control mechanisms are laid out in the limited partnership agreements (between the general partner and the investors) and in the covenant that binds individual companies to the fund with regard to debt finance. Contrary to what is alluded to in #143, it should not be assumed that private equity funds are operated across different sectors – in many cases the funds are sector specific. Debt plays such a central role in the private equity business model that it is in fact more than just a source of finance, it is a tool for control and for holding companies to account to the general partner[2]. Because of its overreliance on debt finance and the opacity of its governance arrangements, private equity should be considered as a business at risk of aggressive tax planning of debt finance.

Q 4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

The proposition of a fix 25% "control test" as a minimum threshold for defining significant control needs to be clarified, whether it be voting rights or cash flow rights. As argued above, with the excessive use of controlling enhancing mechanisms it is possible to exert significant influence over the company's management, including decisions on debt finance, with a comparable small amount of equity. In a pyramid structure with six layers for example, an investor controlling just above 50% at every level of the pyramid, in effect controls the entire group structure with about 2% of the overall group equity. At the opposite end, in a listed company with a free float capital ratio of 95%, a given shareholder can control the board of directors with just 5% ownership (if the remaining 95% are held by passive investors).

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[2] For OECD corporate governance experts: "*Debt is used by the general partners of a private equity fund not just as a source of finance but also as a corporate governance tool. The management team of a portfolio company has a powerful incentive to succeed but is also under strong pressure from debt repayments and the associated covenants (covenant lite does not mean no covenants) to stay on track in the shorter term*". The Role of Private Equity and Activist Hedge Funds in Corporate Governance – Related Policy Issues, OECD 2008 http://www.oecd.org/daf/ca/corporategovernanceprinciples/40037983.pdf

Design of a group-wide rule

We welcome the Draft's group-wide approach in proposing rules for interest deductions from corporate income tax base within international business groups. Tax treatment of debt interest is best dealt with on a consolidated basis – debt interest deductions are measured at group-level, and then reallocated to its various entities according to an allocation key that reflects the economic reality of the business group – rather than on the basis of the arm's length principle – which treats business groups' entities as if they were independent from one another.

Q 7. Are there any practical issues with respect to the operation of (a) interest allocation rules or (b) group ratio rules, in addition to those set out in the consultation document?

In line with the above considerations on related and connected parties, a concern for the effective observance of a group-wide rule is the possibility of a mismatch between the accounting perimeter of the business group – as reported in the consolidating accounts – and its real sphere of control. Off balance sheet transactions, including those involved in special purpose vehicles, are of frequent use in private equity funds and in joint venture investments, such as in Public-Private Partnerships. As legitimate as they may be from an investor point of view, off-balance sheet transactions should be considered as high-risk transactions from a tax collector point of view.

Q 11. What approach to measuring earnings or asset values would give the most accurate picture of economic activity across a group? Do any particular difficulties arise from this approach and how could these be addressed?

In theory a measurement based on assets would best reflect the allocation of value creation and of risks within a business group. The design of the allocation rule should however give priority to the objectively verifiable measurement methods that leaves little or no space to interpretation and manipulation by corporate insiders. Asset valuation methods however are not necessarily consistent and robust enough across jurisdictions to meet this criteria (not least because of the absence of uniformed accounting rules).

An earnings-based methodology (before depreciation, which bears the same kind of risk for accounting manipulation than asset valuation) would provide for a more robust and objectively verifiable measurement. Its volatility and dependence on external market factors might not accurately reflect the allocation of risk and value creation within the group on the long term.

One alternative measurement, that is not considered in the Draft, would consist in including the distribution of the workforce within the business group in the measurement method – be it headcount, payroll, or a combination hereof. Workforce distribution (including directly employed workers and contracted workers) would provide for both a robust, objective measurement and an adequately representative picture of where value creation and risks are located within the business group.

Sector-specific considerations

In addition to the separate treatment of the banking and insurance sectors (#203-213), the Draft considers a selected number of other "sectors" for which a group-wide allocation rule might need some form of adjustments, including the oil and gas sector, the real estate sector (#214), infrastructure projects (#215) and the banking sector.

Q 35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

At the outset we recommend strictly limiting the number of sector-specific adjustments. As is the case for exemptions, sector-based differentiated treatments bear the risk of creating new forms of arbitrage by international businesses to precisely, escape the requirements under the general rule. If some sectors deserve special considerations with regard to long term debt management, there are other means to achieve it than adding another layer of complexity in the tax code. The suggestion that "infrastructure" is a stand-alone sector is also contestable.

Apart from in the banking and insurance sectors – in which business models are indeed entirely different than that of non-financial businesses – we recommend not applying a sector-based approach and to rather focus on non-traditional forms of corporate structures and transactions. In the case of "infrastructure" for example, attention might be best placed on the tax treatment of Public-Private Partnerships, including that of special purpose vehicles.