European Banking Federation

Chief Executive

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Mr Achim PROSS
Head of International Co-operation and Tax Administration Division
Centre for Tax Policy and Administration
OECD

Email: interestdeductions@oecd.org

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

Dear Mr Pross,

The European Banking Federation (EBF) welcomes the opportunity to comment on the OECD's current work on interest deduction and other financial payments as part of the Base Erosion and Profit Shifting (BEPS) project.

The EBF is committed to contributing constructively to the BEPS project, in the expectation that the final outcome will deliver fair, certain, sustainable and principled rules.

While the EBF is supportive of the efforts of the OECD we consider that Action 4 should not be implemented on the premise that interest deduction automatically leads to (abusive) base erosion and profit shifting. Many countries indeed already apply thin capitalisation rules and/or interest deductions rules to regulate the amount of interest expense that may be deducted by a company. These rules are the international norm and those that are properly crafted represent a sufficiently effective means of preventing excessive interest payments or, for instance, debt pushdowns. We thus consider that the issue of base erosion via interest deductions should be circumscribed in accordance with this reality.

To the best of our understanding, the primary concerns relating to potential profit shifting techniques involving financial arrangements are addressed by Action 2 on hybrid mismatches. Thus, it remains to be seen, whether or not the objective of preventing excessive or undue interest payments should be addressed by two, potentially overlapping, layers of rules.

## Our recommendations

- Banks are subject to strict regulation which imposes restriction on their capital structure. This regulatory environment of the banking industry, together with the level of scrutiny employed by regulators and investors, already constrains the behaviour of banking groups in a way which obviates the BEPS risks. We consider that any underlying BEPS issue is thus likely already dealt with through banking regulations and other mechanisms in the domestic tax legislation. Should the OECD in any case believe that there are specific concerns which require further consideration, the EBF considers that actual abuse in the financial sector related to interest expense be first identified and only then should targeted rules be contemplated when it has been clearly demonstrated that it would not be possible to address any concern using the arm's length principles.

- The practical significance of the issue of base erosion via interest deduction, as contemplated in the Discussion Draft, should be appraised and circumscribed by taking into consideration (1) existing thin-capitalisation rules and related anti-abuse rules currently enforced worldwide and (2) other areas of the BEPS action plan, in the first instance Action 2.

- The material scope of Action 4 should be generally restricted to what interest is effectively about, that is remuneration on money lent. Other remunerations, relating to different services, should conversely be excluded and their deduction should be granted as long as they are at arm's length. Specific/sectorial carve-outs within a broader definition of interest for the purpose of Action 4 could be difficult to apply within the European Union as these might conflict with applicable state aid rules.

### Specific points of attention for the banking sector

We welcome the recognition within the Discussion Draft that banks and insurance companies give rise to particular considerations, which do not arise in other sectors. In the meantime, we are concerned that the Discussion Draft still considers submitting banks and insurance companies to a general interest limitation rule. This approach would be to our view inappropriate. As for the latter, we would like to refer to the views expressed by HM Treasury (United Kingdom) in March 2014 in the specific context of Action 4[1]:

- *"Banks make profits from, among other things, the margin between interest paid on money borrowed and interest earned on money lent. Debt is thus part of the circulating capital of the business and the associated interest cost of servicing that debt is a core trading expense. (…) Banking and insurance groups are subject to both group capital requirements and local capital requirements in respect of those parts of their groups operating in different local markets. (…)*

- *Therefore any structural interest restriction or allocation method is likely to either create asymmetries or place disproportional burden onto the financial sector and would, in many cases, wholly undermine their business models. We do not therefore believe that it is appropriate to apply a structural interest restriction model to the financial sector, and certainly not to their day to day trading activities".*

The preceding statements make a strong case for banking activities to be considered outside the scope of application of Action 4 to the extent that it would apply a structural interest restriction upon banks.

Some concerns also arise from the broad material scope ascribed to Action 4 in the Discussion Draft, which should cover not only interest on all forms of debts but also "other financial payments which are economically equivalent to interest" and "expenses incurred in connection with the raising of finance". A literal reading of these definitions would potentially affect a series of transactions that are not set-up for base erosion purposes, such as, for instance, foreign exchange and hedging transactions. Likewise, we believe that guarantee fees and arrangement fees should not be assimilated as interest for the purpose of Action 4, as they remunerate in the first instance a commercial service and not a provision of funds.

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[1] HM Treasury and HM Revenue & Customs: Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting, March 2014, paragraphs 3.15 and 3.16

The foregoing considerations on the material scope currently ascribed to Action 4 certainly apply *mutatis mutandis* to sectors of activities other than the banking sector. In the meantime, specific/sectorial carve-outs within the definition of "interest" (and equivalent payments) for the purpose of Action 4 could be difficult to apply in practice within the European Union, considering the applicable state aid rules. The foregoing pleads for narrowing the scope of the definition of "interest" for the purpose of Action 4 to what interest is effectively about, that is remuneration on money lent. Other forms of remunerations, relating to different services, should conversely be excluded and their deduction should be granted as long as they are in accordance with arm's length principles.

The Discussion Draft further notes that measures based on gross interest expense would have distortive consequences and we believe this is particularly relevant for the banking sector. We therefore believe that measures which consider 'net interest expense' are a more accurate means of identifying and addressing issues in the banking sector.

We hope you find our comments and suggestions useful and remain at your full disposal should you wish to further discuss our letter.

Yours sincerely,

Wim Mijs