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Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "BEPS Action 4: Interest Deductions and Other Financial Payments" 18 December 2014 - 6 February 2015

The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 4: Interest Deductions and Other Financial Payments" 18 December 2014 - 06 February 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise appreciates the efforts by the OECD to develop recommendations regarding best practice in the design of rules to prevent base erosion through the use of interest expense.

The Confederation of Swedish Enterprise would like to outline the foundation on which any suggestion regarding rules that aims to eliminate base erosion through interest expenses should be based. That is that the vast majority of interest payments are not made with the intention of tax avoidance, but rather as a valid business expense without concerns of the possible effects on taxation. Any suggestion of best practices in this field must consider this, and seek to resolve the problem of base erosion with minimal impact on all valid interest payments made by companies.

It must also be stressed that in many situations, for commercial reasons, a loan can be preferable to contribution of equity. A loan can often be obtained at lower cost, and offer more flexibility and require less administrative work than equity. In some

situations a company may not have an alternative, for commercial reasons, but to finance an activity with a loan.

With the starting point that the vast majority of all payments of interest are legitimate and that there are a number of commercial reasons for a company to choose a loan over equity, it is important to adopt well-balanced recommendations regarding best practice in the design of rules to prevent base erosion through the use of interest expense. The best practice should aim to have a minimal impact on investments and competition, and to avoid double taxation and high compliance costs.

The Confederation of Swedish Enterprise do acknowledge that there is a problem with base erosion through some interest deductions and understand the need to act in this area. We support the development of best practice through analyzing the practices currently applied by countries and reaching consensus on which practice is the preferred one.

In the work on reaching best practice, the EU Treaty Freedoms and relevant EU-legislation such as the Parent-Subsidiary Directive should be considered, in order to make sure the OECD BEPS interest deductibility recommendations are compatible with EU law.

Any rule with the purpose of preventing base erosion through the use of interest expense should be neutral in its design, not disfavoring certain countries or sectors. One situation where neutrality issues may arise is when comparing companies only operating in one country and companies active in several countries. For a company active in more than one country any type of tax rule discussed in the Draft will almost certainly lead to a limitation on the amount of deductible interest, while a company only operating in one country in many cases will not be affected by such limitations.

It should also be noted that the different alternatives discussed in the Draft will have different consequences for both countries and companies. Applying e.g. a group wide-rule would mean a clear disadvantage for many companies from small economies compared to companies from large economies, given the current corporate tax regimes. It is therefore important that neutrality issues are given significant weight when deciding best practice.

The Draft presents six existing approaches currently applied by different governments to limit deductibility of interest expense. Three of these are concluded not to be suitable options for a best practice rule; these are withholding taxes, arm's length tests and rules which disallow a percentage of the interest expense of an entity. The Confederation of Swedish Enterprise shares the concerns regarding these three approaches and agrees that they should not be considered as best practice.

We are also concerned about the lack of “transitional rules” within the draft. The suggestions set forth in the Draft might, if adopted, for some countries and entities lead to significant changes of deduction of interest expense. This should be acknowledged in order to ensure certainty and stability for affected companies.

Specific Comments

In the Draft it is concluded that three approaches should be considered more closely in the evaluation of best practices. The Confederation of Swedish Enterprise has found that the Combined Approach 2 based on EBITDA should, when compared to the other alternatives suggested in the Draft, be considered as best practice. The reasons leading up to this conclusion will be developed in the following.

Group-wide rules

The Draft suggests a group-wide rule to address base erosion through interest expense. Such a rule would be based on some relevant financial ratio, such as earnings or asset values. A group-wide rule could either be an interest allocation rule or a group ratio rule. The Confederation of Swedish Enterprise does see two major flaws in a group-wide rule. That is a lack of neutrality between small and large economies and technical/practical difficulties.

The Confederation of Swedish Enterprise is of the opinion that a group-wide interest allocation rule is not a feasible alternative for best practice, considering technical issues related to the implementation and major difficulties in applying such a rule. The other alternative, a group ratio rule, has similar drawbacks, but is not as complicated to implement as a group-wide allocation rule.

We would once again like to emphasize the fact that the vast majority of loans are not intended to create tax advantages. Hence, businesses should be able to arrange their financial structure in a way that is most efficient without concerns of tax rules. A group-wide rule would mean that this possibility is not given to companies, as they will be pressured into arranging their financial structure not in the most cost efficient way, but in the way most favorable in a taxation perspective. This could e.g. be the case when different entities within a group may be engaged in completely different sectors, which can have different debt requirements. A group-wide rule would put pressure on companies to structure their financing in such a way that might be completely opposite how they would have structured it from a commercial perspective.

In addition, a group-wide rule would encourage some groups to incur external debt that would not have been incurred otherwise. This is because highly leveraged group are treated more favorably if a group-wide rule is applied. It would also, as acknowledged in the Draft, cause complexities for both companies and tax authorities, which would increase compliance costs.

Any limitation to the right to deduct interest expenses increases the risk of double taxation. With a group-wide approach the risk of double taxation would be clearly present, since it is very difficult for an MNE to match third party net interest expenses in exactly the way that is needed for maximum deductibility. This leads to double taxation since part of the interest payment will be taxed at the third party and at the same time not be deducted by the MNE.

In theory, it might seem easy to move around assets within an MNE group to achieve maximum deductibility. However, there are a number of obstacles related to the matching process. By way of example, let us assume there is a need to transfer assets from one entity within an MNE group to another entity within the same group to be able to deduct all incurred interest expenses. This transfer of assets can be related to a number of obstacles, including withholding taxes and stamp duties. In addition the two entities may be operating their businesses in different currencies. Fluctuations in a currency can make it very expensive for owners to conduct a capital injection into a company. A relatively new example of such a situation is the Russian Ruble weakening compared to other currencies. If a Russian entity needs to transfer assets to another entity for the purpose of interest deductions it could be very expensive considering the weak Ruble.

A group-wide rule would, in addition to the mentioned problems, mean that there is not neutrality between small and big countries. Big economies can, due to the size of their economy, have relatively high corporate taxes, contrary to small economies. One consequence of this is that, e.g. groups established in big economies generally are financed by debt to a higher degree. A group-wide rule would thus lead to disadvantages for companies from small economies compared to companies from large economies.

With all obstacles a wide-group rule would mean, we find it not to be suitable as best practice.

Fixed ratio rules

Another rule suggested in the Draft is a fixed ratio test. Such a test has the advantage compared to a group-wide test that it has good potential to be simple for companies and tax authorities to apply and control, as the rule is mechanistic. A fixed ratio test also has the advantage that the rule does not need to be identically designed in all countries.

An important issue regarding a fixed ratio rule is to what base interest deductibility should be linked. The Draft discusses earnings or assets as potential grounds for deductibility. We believe that deductibility should be based on earnings, as set forth in the Draft. To use assets as a base would give rise to valuation problems and a number of other concerns as outlined in the Draft. Earnings are therefore the preferred base.

The next issue arising is how earnings should be calculated. It could either be earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA). We recommend the latter alternative to be used, since EBITDA takes different capital-needs and capital-intensity into account, which is not the case with EBIT. EBITDA does also provide stability in the system, since amortization and depreciation are relatively stable over time. This also gives better predictability. It should also be noted that EBITDA is used when assessing creditworthiness in the commercial market and in loan covenants. It is therefore natural also from a commercial point of view to use EBITDA as a base for interest deductibility.

A fixed ratio rule requires that a percentage is set to determine the size of the interest deduction. No recommendation is given in the Draft regarding the size of this percentage. The Confederation of Swedish Enterprise encourages OECD not to set the percentage too low, as this would lead to more situations where double taxation will occur. A low percentage also increases the risk of distorting the financing of investments. A percentage at a reasonable level would on the other hand mean an effective and simple rule. We believe that a fixed percentage of EBITDA should be at least 30 % in order for the fixed ratio rule not to be harmful. It is crucial that a recommendation of the fixed ratio is not set too low. If the combined approach 2 would be chosen as best practice is it even, from a neutrality perspective described above, more important that the fixed ratio is not set too low.

The mechanistic nature of a fixed ratio rule does entail a rule that is simple to operate. A weakness with this kind of rule is that, during some parts of business cycle, a company may be unable to deduct interest due to low profits, even if the interest is not used for tax planning. The same issue may arise due to a recession in the economy that makes the company not making profit. To deal with this obstacle, a carryover rule must be implemented to neutralize this effect arising from the volatility in a company's earnings over time. It is essential that it is possible to carry forward both non-deductible interest and unused capacity. Such carryover rule could be unlimited or limited to a number of years. The Draft asks about issues arising from a 5 year limit on a carryover rule. We support an unlimited carryover rule as time limitations increase the risk of non-deduction. If a time limit indeed are to be applied we believe it should be at least 10 years considering the very long period of time it sometimes may take for a company to turn around a loss making business into a profitable and thus be able to deduct the carryover debt. Considering the possibility that a recession could follow after such a low profit period in the business cycle, it is obvious that there is a need for a generous carryover.

Combined Approach 2

When comparing group-wide rules and fixed ratio rules, we find the fixed ratio approach to be the preferred one as it is a much simpler rule to operate and gives the companies the needed predictability.

The Draft suggests a Combined Approach 2 which would complement the fixed ratio rule with a carve-out in form of a group ratio rule. By adding a carve-out to the fixed ratio rule, an additional measure of economic activity could be added to the model. This could be important in avoiding double taxation. A group ratio carve-out could, as set forth in the Draft, apply to an entity which can demonstrate that its indebtedness does not exceed that of the group. Since it is a carve-out rule and therefore voluntary to use, the difficulties that follows with applying such a rule is acceptable.

It is important that the combined approach 2 offers an effective carry forward opportunity, allowing the companies to carry forward both non-deductible interest and unused capacity within the EBITDA.

The Confederation of Swedish Enterprise therefore concludes that the combined approach 2 have such attributes that it should be considered best practice.

On behalf of the Confederation of Swedish Enterprise

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