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To: Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
Date: 6 February 2015
Re: **Comments to the OECD's discussion draft on Action 4 of the BEPS Action Plan of 18 December 2014**

Dear Marlies,

Here are my comments to the above draft.

Though I am generally very impressed with and humbled by the quality of the work done through the CFA, I feel less so with regard to this particular paper. It is my impression that the drafters of this document

i. paid only lip service to avoidance of double taxation;
ii. largely ignored the taxation of interest received in all their examples; and
iii. implied that double taxation is acceptable collateral damage in the fight against BEPS (see e.g. paragraphs 184 and 199), whether the situation hit by the proposed measures actually constitutes abuse or not.

As you have enough to read already, I will keep my comments as short as possible and will not develop each point in full detail. I am however happy to expand on any point you wish.

1. Box 1, page 7. Besides the fact that these examples mix several unrelated issues together, the only real point illustrated is that if the tax rate of a group creditor is lower than the tax rate of its related debtor (e.g. 25% vs 40%), the group saves tax. Is this BEPS? Must the tax rate of the creditor always be equal to or higher than the tax rate of the debtor, for this not to be abuse?
2. Paragraphs 21 and 23. I disagree with the decision to exclude withholding taxes. I could respect that decision if the paper a) presented a viable alternative and b) legitimate reasons for this decision, but it does neither:
    a. The only real solution offered for the prevention of double tax is the – limited – carry forward of capped interest deductions. This solution completely ignores the fact that for many businesses, the causes of running into the caps in the first place, will be of a long term or permanent nature. E.g. some markets will remain outperformed by other markets for the foreseeable future, or some lines of business within a group will remain more profitable than others/more asset heavy than others.

       To the contrary the paper states that attempts to remedy these situations could amount to abuse (see paragraphs 194 and 197). I.e. the very effort to mitigate/eliminate double tax is qualified as abuse. I disagree with this and with innuendo of paragraph 194, that double taxation should become acceptable through the simple passage of time.

    b. It is simply not true that "it would also be extremely difficult for EU member states to apply withholding taxes on interest payments within the EU due to the Interest and Royalty Directive". Article 5, paragraph 2, of that Directive reads "2. Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive." What would be extremely difficult is to apply withholding taxes to transactions which do not constitute evasion, avoidance or abuse under EU law. I am OK with that, and so should the governments of the EU be, at least if they are prepared to live up to their obligations as EU members in good faith.

       Equally, with the other BEPS work being done on preventing treaty abuse and the multilateral instrument, I do not see the existence of reduced withholding tax rates under treaties as an insurmountable problem to deal with. The same applies for lower withholding tax rates on gross income.

       Finally, the argument of policy reasons against withholding taxes is unsubstantiated, half-hearted and consequently unconvincing.
3. The various group based approaches in the document largely ignore the fact that various group members may consistently underperform compared to other members for legitimate non-tax reasons and may therefore

never be able to recuperate their capped interest deductions. Underperformance can e.g. be due to geographical markets, or different lines of business within a group, such as consultancy vs. production.

I frankly cannot oversee whether either of the combined approaches under chapter X would adequately resolve this issue (though I can see that applying chapter X to a group with 500 active companies will be difficult).

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To illustrate my points of ignoring the creditor tax position, and effect of not applying an interest withholding tax to abusive cases rather than denying the deduction, I will go through examples 3 and 4 in Annex 3. I will assume that the debtor country allows a full deduction of BEPS interest to the debtor, but levies a 15% withholding tax on the creditor over its gross BEPS interest income.

Example 3:
Assume all countries levy 20% income tax. ACo, BCo and CCo have EBT of (10+24-25=) 9 mio, 39 mio and 30 mio respectively.

- Under an interest cap rule CCo's taxable income will become 35.1 mio, whilst BCo's will remain 39 mio. CCo's country will levy (5.1*20%=) 1 mio more in tax, protecting its tax base against BEPS.
- Under an interest withholding tax on abusive payments, CCo's taxable income will equal its EBT, being 30. BCo will pay a 15% withholding tax on 5.1 (=0.6 mio) of the income it receives from CCo, for which BCo may receive no credit depending on how much of its loan to CCo was financed with equity and whether it earned a spread on the interest it received from the interest it paid. However, even if BCo receives no credit, this measure only leads to 15% double tax on 5.1 instead of 20%.

EU law:
If BCo and CCo are in the same country, the interest cap rule may not apply as there is no base erosion. However, the fact that it will apply cross border, makes the rule a restriction on the fundamental EU freedoms, which can only be allowed in cases of actual abuse – to be determined on a case by case basis - under a proportionate justification. A rule cannot be proportionate when it leads to double taxation, where there is an alternative available which would lead to a lower, or no double tax. Since the withholding tax credit leads to less double tax, the interest deduction cap is not proportionate.

It may be countered that under the interest cap rule, CCo could carry forward its non-deductible interest and, IF compensated later on, this will lead to less double tax than an interest withholding tax on BCo. This argument is not effective, for two reasons:

a) under EU law, CCo country is already forced to limit its withholding tax on interest to BCo's net interest income and
b) CCo country could also apply the carry forward rule to its interest withholding tax and let BCo country know that it has done so through a spontaneous exchange of information.

Thus the tax remaining double tax will still remain 15% (at most) vs 20% plus a cash flow disadvantage.

I must underline that in the above example, the double tax relief through an interest withholding tax is immediate to the extent the interest income is sponsored with equity, or earns a spread. This is obscured in the given fact pattern of the example; see example 4 hereafter.

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Example 4:
Assume all countries levy 20% income tax. ACo, BCo and CCo have EBT of (10-25=) -15 mio, 57.9 mio and (45+3-12.9=) 35.1 mio.

- Under an interest cap rule CCo's taxable income will become 45 mio, whilst BCo's will remain 57.9 mio; CCo's country will (9.9*20%=) 2 mio more in tax, protecting its tax base against BEPS.
- Under an interest withholding tax on abusive payments, CCo's taxable income will equal its EBT, being 35.1. BCo will pay a 15% withholding tax on 9.9 (= 1.5 mio) of the income it receives from CCo, for which BCo will receive a full credit as its loan to CCo was fully financed with equity. BCo will still pay an additional 5% tax in BCo country, being the difference between the BCo country tax rate on net income and the CCo country withholding tax on gross.

CCo country thus manages to fully protect its tax base against BEPS, whilst simultaneously fully avoiding double taxation. A result impossible to achieve under an interest cap in the given fact pattern.

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Thank you for taking the time to read this and I apologise for being negative about this OECD paper; I do however believe my reasons are legitimate. I have admired the resolve with which the OECD has taken to work on the multilateral instrument and am convinced that if it tackled double taxation in this paper with the same determination a much better result could have been achieved than the one proposed so far.

If you wish me to elaborate on any of my points at the OECD public consultation of 17 February, please let me know. I am not registering for that meeting yet at this time.

Yours sincerely,

Johann H Müller