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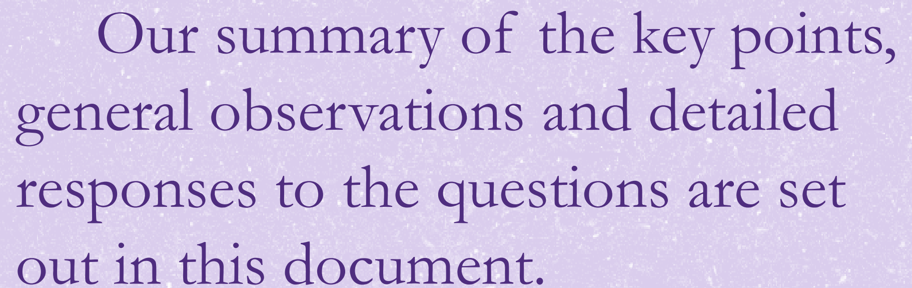
Grant Thornton discussion draft response

BEPS Action 4: Interest deductions and other financial payments

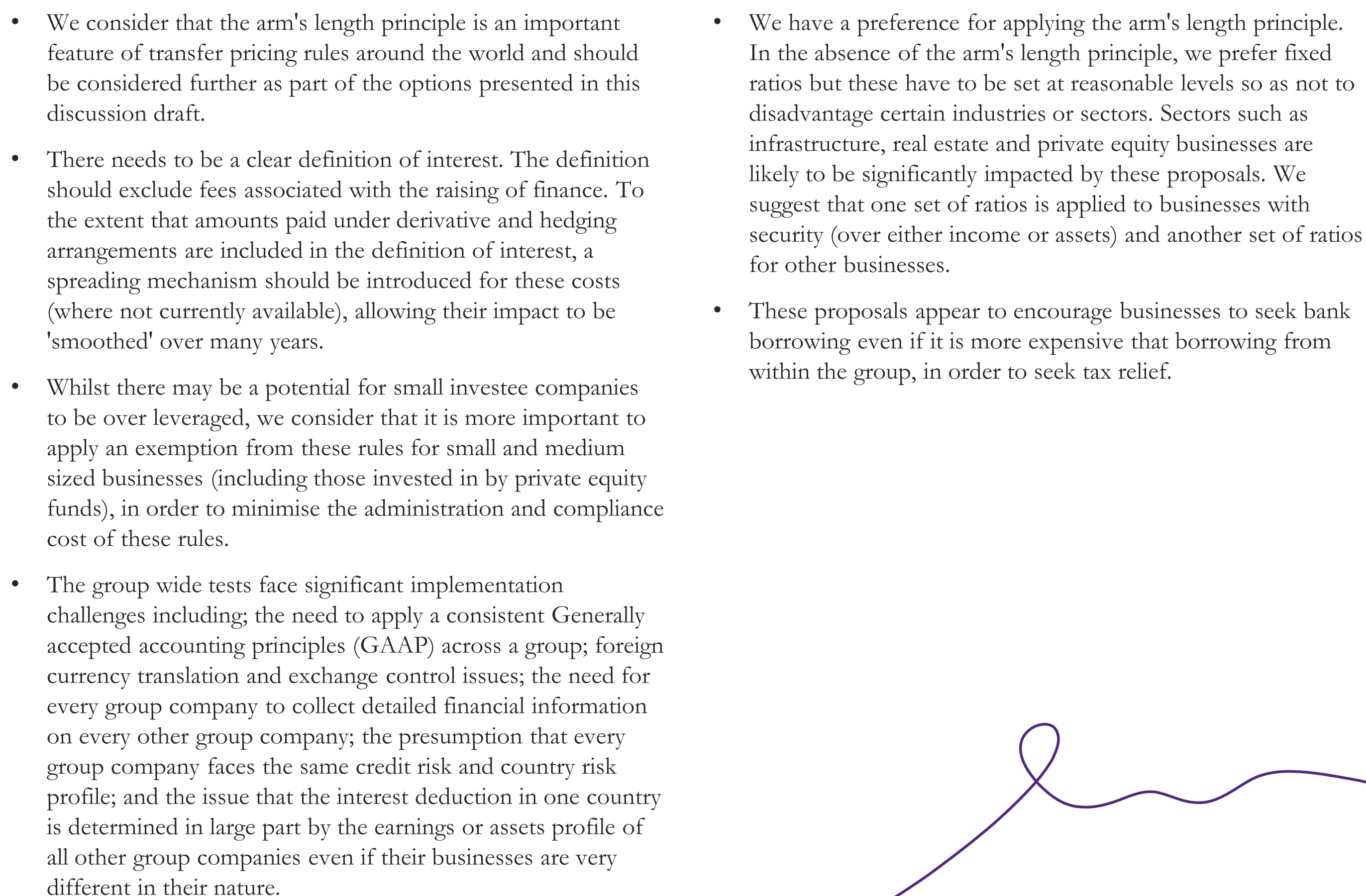
Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled BEPS action 4: Interest deductions and other financial payments, issued 18 December 2014.



Our summary of the key points, general observations and detailed responses to the questions are set out in this document.

Executive summary

- We consider that the arm's length principle is an important feature of transfer pricing rules around the world and should be considered further as part of the options presented in this discussion draft.
- There needs to be a clear definition of interest. The definition should exclude fees associated with the raising of finance. To the extent that amounts paid under derivative and hedging arrangements are included in the definition of interest, a spreading mechanism should be introduced for these costs (where not currently available), allowing their impact to be 'smoothed' over many years.
- Whilst there may be a potential for small investee companies to be over leveraged, we consider that it is more important to apply an exemption from these rules for small and medium sized businesses (including those invested in by private equity funds), in order to minimise the administration and compliance cost of these rules.
- The group wide tests face significant implementation challenges including; the need to apply a consistent Generally accepted accounting principles (GAAP) across a group; foreign currency translation and exchange control issues; the need for every group company to collect detailed financial information on every other group company; the presumption that every group company faces the same credit risk and country risk profile; and the issue that the interest deduction in one country is determined in large part by the earnings or assets profile of all other group companies even if their businesses are very different in their nature.
- We have a preference for applying the arm's length principle. In the absence of the arm's length principle, we prefer fixed ratios but these have to be set at reasonable levels so as not to disadvantage certain industries or sectors. Sectors such as infrastructure, real estate and private equity businesses are likely to be significantly impacted by these proposals. We suggest that one set of ratios is applied to businesses with security (over either income or assets) and another set of ratios for other businesses.
- These proposals appear to encourage businesses to seek bank borrowing even if it is more expensive that borrowing from within the group, in order to seek tax relief.



General observations

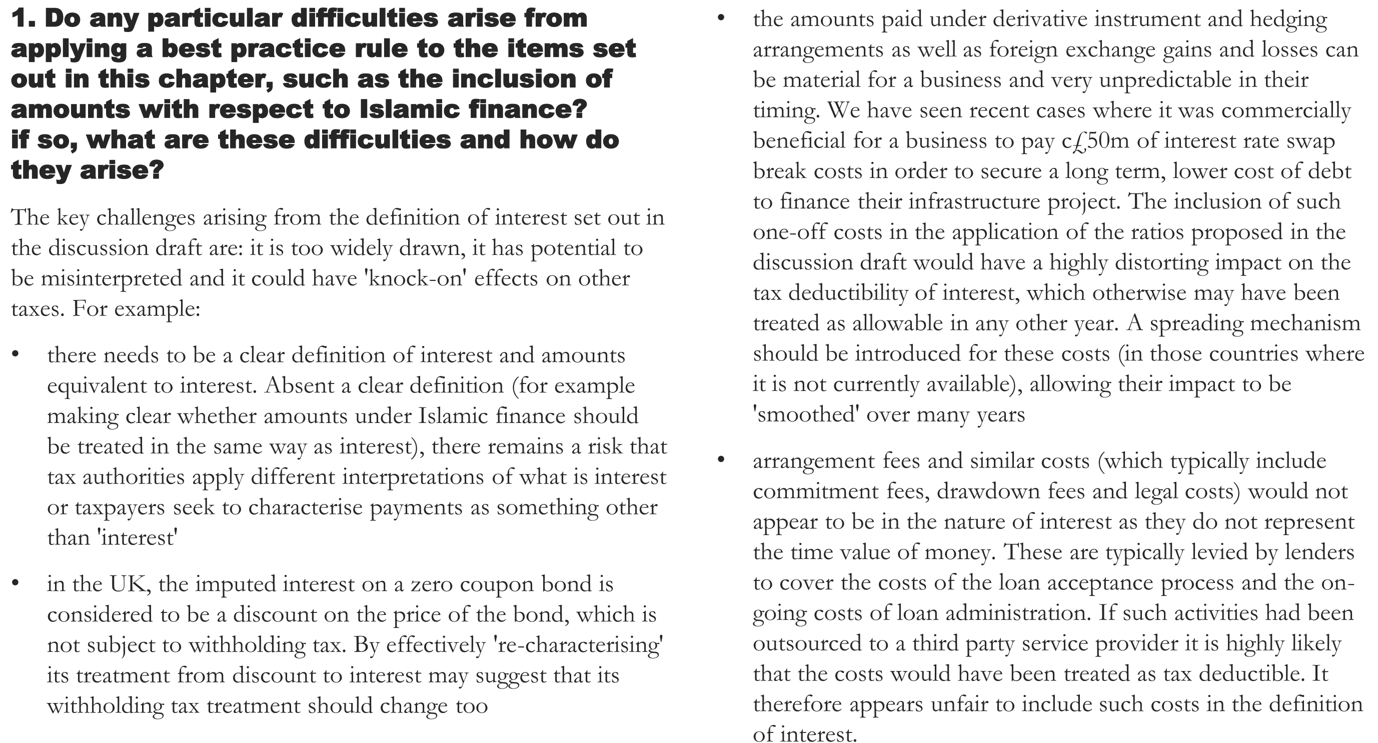
We disagree with observation that the use of (related party) interest 'is perhaps one of the most simple of the profit-shifting techniques available in respect of international tax planning'. Tax authorities should not automatically assume that associated enterprises have sought to manipulate their profits.[1] For example, debt financing (related party and third party) is used by our clients because debt:

- is a more flexible form of financing compared with equity. For example, debt can be drawn down in tranches at the point that it is needed (which is harder to do with equity)
- it is also typically easier (and quicker) to return loan principals to lenders than it is to return equity to shareholders, which in turn increases the liquidity in a market
- a range of debt instruments and equity investments allow investors to diversify their portfolio risk.

Furthermore, we strongly disagree that consideration of arm's length tests should not form part of the consultation process. Paragraph 1.8 of the OECD 2010 Transfer Pricing Guidelines, notes that there are several reasons why the arm's length principle was adopted including for example, it 'puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity …(and) the arm's length principle promotes the growth of international trade and investment'. The arm's length principle offers important benefits and should not be set aside easily.

1. Paragraph 1.2 OECD transfer pricing guidelines

Responses to specific questions



1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts with respect to Islamic finance? if so, what are these difficulties and how do they arise?

The key challenges arising from the definition of interest set out in the discussion draft are: it is too widely drawn, it has potential to be misinterpreted and it could have 'knock-on' effects on other taxes. For example:

- there needs to be a clear definition of interest and amounts equivalent to interest. Absent a clear definition (for example making clear whether amounts under Islamic finance should be treated in the same way as interest), there remains a risk that tax authorities apply different interpretations of what is interest or taxpayers seek to characterise payments as something other than 'interest'
- in the UK, the imputed interest on a zero coupon bond is considered to be a discount on the price of the bond, which is not subject to withholding tax. By effectively 're-characterising' its treatment from discount to interest may suggest that its withholding tax treatment should change too
- the amounts paid under derivative instrument and hedging arrangements as well as foreign exchange gains and losses can be material for a business and very unpredictable in their timing. We have seen recent cases where it was commercially beneficial for a business to pay c£50m of interest rate swap break costs in order to secure a long term, lower cost of debt to finance their infrastructure project. The inclusion of such one-off costs in the application of the ratios proposed in the discussion draft would have a highly distorting impact on the tax deductibility of interest, which otherwise may have been treated as allowable in any other year. A spreading mechanism should be introduced for these costs (in those countries where it is not currently available), allowing their impact to be 'smoothed' over many years
- arrangement fees and similar costs (which typically include commitment fees, drawdown fees and legal costs) would not appear to be in the nature of interest as they do not represent the time value of money. These are typically levied by lenders to cover the costs of the loan acceptance process and the on-going costs of loan administration. If such activities had been outsourced to a third party service provider it is highly likely that the costs would have been treated as tax deductible. It therefore appears unfair to include such costs in the definition of interest.

2. Are there any specific items which should be covered by a best practice rule which would not be covered by the approach set out in this chapter? What are these and how could they be included within a definition of interest and other financial payments that are economically equivalent to interest?

There are a number of situations where 'interest expenses' could arise that are not envisaged under the current broad definitions proposed. We do not consider them as interest costs and suggest that they are excluded from the proposed definition. Examples include:

- forward contracts (for example, commodity or foreign exchange) contain an element of compensation for the time value of money. These amounts are not necessarily included as 'interest' in the profit and loss (P&L) depending on the GAAP or hedge accounting approach adopted by the company
- businesses that accept delayed payment for goods ('buy now pay later'), where an element of the purchase price could be 'interest' but the 'interest expense' is accounted for as the cost of the purchase, potentially in cost of goods sold in the P&L.

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

We disagree with the inclusion of scenario 4, which does not appear to pose any base erosion risk and would only add to the compliance burden on all companies unnecessarily.

It is not clear how the 'connection' rules could apply to joint venture arrangements, particularly if the shareholder does not have 25% or in situations where one or more investment funds may have made a private equity investment in a company but where they have a less than 25% interest.

In the UK, many companies invested in by private equity houses would be considered small or medium sized businesses (SMEs) were it not for the UK 'acting together rules'. These rules broadly deem a connection between the investee company and the private equity shareholder, for the purposes of the UK thin capitalisation rules. This has meant a significant compliance burden for typically small businesses that have limited experience of such rules. In our experience, there is a high demand by these types of business to apply for an advance thin capitalisation agreement from local authority so they can have a level of certainty as to their deductions.

In line with our comments below (see question 6), we consider that these types of businesses should be excluded from the proposed measures.

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

A shareholding of 25% neither gives a shareholder control (over 50% normally represents control) nor does it necessarily convey any influence over the investee company. For example an investor with 25% shareholding has very limited power over a company where there is one other 75% shareholder. Conversely, a 25% shareholder may have significant influence over a business where all the other shareholders have a 5% shareholding.

5. What are the problems that may arise if a rule applies to net interest expense? Are there situations in which gross interest expense or the level of debt would be more appropriate?

Whilst it is possible to imagine extreme examples of businesses attempting to generate interest income (a manufacturer converting all its sales to leases in order to generate interest income), we consider this very unlikely. We therefore agree that net interest expense is a reasonable approach.

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

The simplest and most consistent approach is to apply rules similar to the European Union (EU) Commission Recommendation (2003/361/EC) on the qualification for SME status and not to apply the proposed thin capitalisation rules to such entities. We consider that it is important to minimise the amount of compliance effort and cost for SMEs (as well as tax authorities) even if that comes at the risk that some of them are highly leveraged.

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?

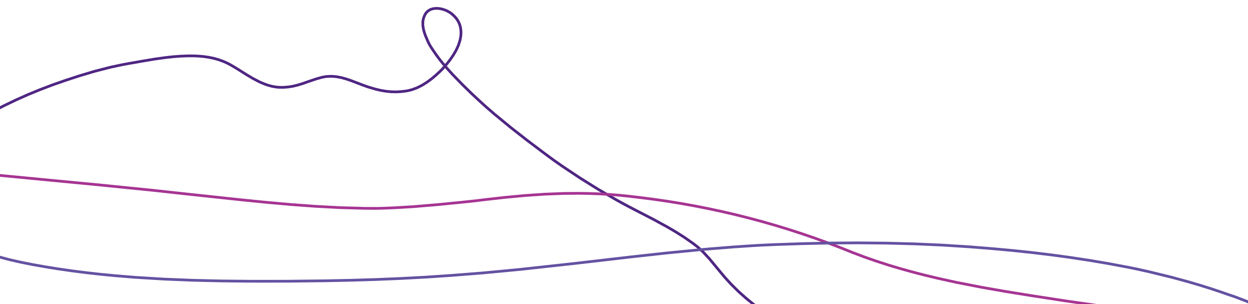
The group wide tests pose a number of practical challenges, some of which we have considered below:

- To be allowed a deduction for all a group's third party interest payments, the rules need to be adopted by all tax authorities of countries in which the group operates. Otherwise a restriction could be made in Country A (which applies the proposed group wide tests) but in Country B (which would have been entitled to the balancing amount of third party interest) no deduction is allowed because of the application of local rules on interest deductibility. Given that the proposed rules are not binding on all tax authorities, there is a low probability of all countries adopting the proposals consistently.

- Different countries apply different GAAP and consequently the calculation of third party interest and the economic base upon which it is proposed to apportioned may be the subject of controversy between countries. Inconsistent allocations between different groups of companies could arise because (a) local GAAP allows a different accounting treatment compared with say, International Financial Reporting Standards (IFRS) accounting rules or (b) where there is some choice as to how to account for a cost or income, for example, whether certain costs should be capitalised on the balance sheet or written off to the P&L or the choice a group has over its depreciation policy. There would need to be a widespread requirement to say, apply IFRS if there is to be a consistent application of

these rules. Furthermore, the impact of local exchange controls, regulatory requirements and the presence of minority interests all add complexity to these calculations.

- A group wide allocation of interest assumes that all entities have the same credit rating. In the cases of mixed conglomerate groups this is unlikely to be the case, yet a company in a territory subject to a high level of country specific risk and a low credit rating could be entitled to the same amount of interest deduction as another company in a safer country and better risk rating, if they both earned the same level of profits (which can be affected differentially by local inflation rates).
- The group wide rules also ignore the fact that different countries have different borrowing conditions and interest rates and therefore, the absolute amount of interest paid in one country may be very different from a broadly comparable company in another country. In effect there is a risk that one part of the business interest deductions become 'contaminated' by the income or asset values of other group companies. For instance it appears that a company in a joint venture may see its after tax returns impacted because of a movement in the value of an asset elsewhere in the JV partner's group, over which it has no control.
- The global allocation of interest would only become clear once the group's earnings or asset profile has become known. Particularly in seasonal businesses this may not be clear until the year end, which places significant uncertainty in calculating for example quarterly instalment payments of tax. Many group companies will find it difficult to get timely information on the whole group’s third party debt and earnings/asset values – and then to be able to allocate and enforce these among all of the relevant group companies is administratively burdensome. Furthermore, if the auditors require changes after the year end or where group companies have different accounting period end dates, there could be a subsequent impact on the local interest deductions and additional complexity in its calculation. This approach also requires in-country consolidation of data (even if no local audited consolidated accounts are prepared).



9. Do any difficulties arise from basing a group-wide rule on numbers contained in a group's consolidated financial statements and, if so, what are they?

The use of a group's consolidated, audited financial statements would appear to be a good starting point for this analysis, although this assumes that all groups prepare such statements in a form and language that other countries' tax authorities could review.

The key challenge as referred to above is the need for all companies to prepare accounts on a consistent basis and where the treatment of debts such as say convertible instruments are treated consistently across different group's accounting policies.

There would need to be agreement as to how foreign currency translations are made to convert local accounts into a single currency (see comments on question 15).

10. In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

The group wide tests could incentivise companies to adopt financial policies designed to manipulate the level of net third party expense. Naturally, this outcome is achieved through either maximising third party interest expense or reducing third party interest income in cases where such income exists.

For non-financial companies investing excess cash reserves in short-term liquid securities, an optimal level of interest deductibility may be realised by redirecting such reserves into other non-interest bearing liquid investment products with limited downside risks. There would be a natural incentive for such tax payers to redirect cash reserves into such investment vehicles (should they exist) and for investment advisors to tailor investments that do not produce income classified as interest income under the local accounting specifications.

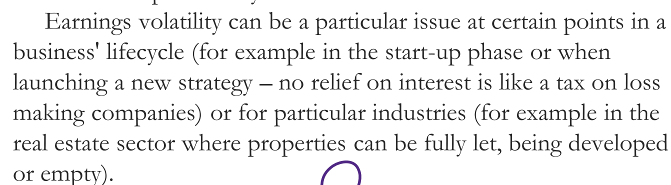
Similarly, higher third party expense could be generated by reclassifying any preferred shares into subordinated debt investments with conversion options. Alternatively, common shareholders could invest in some type of pass-through investment vehicles set up by third party banks to transform equity capital into interest bearing debt capital via an arm's length financier, with the result that the consolidated group is able to support higher levels of overall leverage than what have been attainable under normal market conditions.

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

The key issue with using earnings as a measure of economic activity is that they may be volatile, which could lead to very different allocations of interest expense in a short run of years. For example, economically nothing in a business could have fundamentally changed but the earnings of that business may have fallen because say, there was an asset write-down, yet the interest deduction could be significantly reduced.

Furthermore, volatility in the earnings of the wider group can also impact the interest deduction in a particular country. For example, if one group company has an unusually strong year, all the other companies may face a reduced interest deduction.

Earnings volatility can be a particular issue at certain points in a business' lifecycle (for example in the start-up phase or when launching a new strategy – no relief on interest is like a tax on loss making companies) or for particular industries (for example in the real estate sector where properties can be fully let, being developed or empty).



Some companies may not have earnings for a long period of time during which they are investing and growing the market. For example, Research and Development (R&D) research companies may be heavily investing in a new technology yet the fruits of that labour will not come through until many years later.

To the extent that earnings are used as an apportionment measure, we suggest that earnings before interest, taxes, depreciation, and amortisation (EBITDA) is applied (rather than EBIT) so to avoid distortions generated through companies adopting different depreciation and amortisation policies. We note however, this would benefit capital intensive businesses.

12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? if so, what are they and how could these difficulties be deal with?

The primary issue with using earning-based approaches is the level of volatility that would be experienced in the allocation of the deductible interest allowance. Furthermore, even using a broad-based earning measure such as the EBITDA is not always highly correlated to the degree of economic activity. Using an earning-based approach could also create a lot of uncertainty for estimating quarterly interest expenses. The earning results for all specific entities within the consolidated group would need to be known before the level of deductible interest can be established.

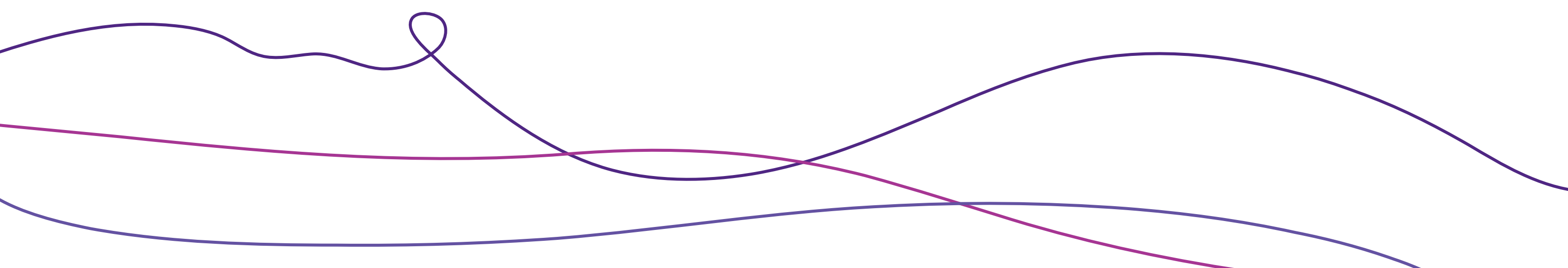
While using an asset value based approach could reduce the year on year volatility of the interest deductibility compared with an earnings-based approach, such an approach can lead to other inconsistencies, such as potentially creating a prolonged disconnect between an entity's level of economic activity and allowable interest deductibility based on group-wide asset-based rules. This could occur when new entities enter into the consolidated group structure via acquisitions, necessitating the revision of their asset values to the FMVs. At the same time, incumbent operating entities that may have experienced strong organic growth but continue to operate with an under-valued asset base, would be restricted in their level of interest deductibility, perhaps limiting their potential for obtaining capital funds (even if their level of economic activity may justify it).

13. What categories of exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

In countries with a dividend exemption, dividends could be excluded from the definition of earnings.

14. Do any particular difficulties arise from asking groups to identify entities with positive and negative balances? What other earnings approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?

The position of loss making companies is a particular issue because even if relief is given in the future (through a carry forward mechanism), the time value of money erodes the value of that deduction.



There are a number of ways that this could be mitigated including:

- allowing companies to use an average EBITDA over a number of years to minimise the peaks and troughs of the business cycle
- permitting companies to exclude one-off type costs prior to calculating its EBITDA to identify the 'core' profitability of the business
- applying a measure based on a company's average cash balance throughout the year.

15. Where an entity's earnings or asset values need to be converted into the currency used in the group's consolidated financial statements what exchange rate should be used for this conversion?

We suggest the business choose the appropriate exchange rate to apply but is required to apply a consistent measure across financial years, for the purposes of calculating interest deductions.

16. What specific issues or problems would be faced in applying a group-wide rule to a group engaged in several different sectors? Would an assets or earnings-based approach be more suitable for this kind of group?

It is common to see consolidated groups with holdings in entities operating in widely different industry sectors, with disparate capital requirements (both in frequency and overall leverage). Typically we observe that industries that tend to have a high earning to operational asset ratios, such as manufacturing businesses, are able to obtain a higher level of leverage than borrowers engaged in the business services industry and with no significant levels of tangible assets. Hence it is commonplace to see companies with similar levels of EBITDA but with significantly different levels of leverage. These differences may arise due to the following considerations:

- industries with high operational asset base have a greater capacity for borrowing at lower interest rates due to their perceived credit strength to the lenders
- asset-intensive businesses generally require a higher level of leverage, in the form of working capital facilities, due to the asset maintenance requirements.

It is important to note that the first explanation is related to the ability to raise debt, while the second is related to capital structure decision making. In this context, it would make more sense to use asset-based ratios instead of earning-based ratios in order to better align the internal capital structures with what would be seen in an arm’s length circumstance.

However, given that the consolidated group is involved in both asset-intensive and service-oriented businesses, the overall leverage offered by arm’s length lenders would be influenced by a consideration of the diverse nature of the businesses for the combined group. Typically from a credit-risk perspective, lenders are more amenable to borrowers with diversified operations. Hence, the consolidated group may be able to obtain greater leverage than the total absolute leverage that could have been obtained by its subsidiaries acting independently.

This would result in the subsidiary engaged in the services industry to be able to be able to obtain a higher level of interest deductibility (even if it is allocated based on assets) than what it would have been able to obtain acting independently.

Even though this would not, in of itself, create a transfer pricing risk if all jurisdictions in which the consolidated group operates unanimously espouse the group-wide rules. However, in instances, where certain jurisdictions do not adhere to this principle, a challenge could be posed by the taxing authority invoking the arm's length principle and denying interest deductions for entities which would not otherwise be able to obtain such high leverage (such as services companies).

17. What barriers exist which could prevent a group from arranging its intra-group loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

The potential to carry-forward surplus interest capacity is welcome although clarity is needed as to how it could be applied. For example, could a business use the current year's capacity plus any carry forward capacity in any one year ; would the interest capacity expire? However, the value of tax relief in the future is typically less than it is now (through the impact of the time value of money). Therefore, if businesses are to be entitled to a deduction for their third party interest in a financial period and to avoid surplus interest capacity in some countries and carry-forward capacity in others, they will need to 'match' their asset base/earnings or debt profile to their actual third party interest paid in each territory.

This may lead to a significant exercise undertaken prior to the year end in order to reallocate actual debt around the group in order to minimise the risk of the need to carry-forward interest deductions. Such pre-year end reorganisations of debt may encourage the use of group treasury or cost-pooling arrangements to channel third party financing across the group. It may also make it very difficult for businesses to estimate quarterly instalment payments of tax (where such regimes exist) in a country, with any certainty. The flexibility over these debt reorganisations may be limited by commercial concerns such as bank covenants.

Some of side effects of this need to reorganise debt could include:

- currently decentralised groups needing to become increasingly centralised with large tax teams probably at head office locations with reductions in non-head office personnel
- a preference to borrow funds from banks that can lend across border and are happy for funds to be channelled as needed to territories outside the location of the lending bank
- an increased need for cross group financial guarantees.

Furthermore, to the extent that dividend income is excluded from any measure of earnings for the purposes of these proposals, there may be a move to reorganise loans such that they are not routed through or into holding companies (although this will be determined by wider commercial decisions).

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

Groups could be given a choice whether to apply an asset or earnings approach in any one particular year (so long as the whole group adopted the same measure) with no requirement to use the same measure each year. However, we note that this could add complexity and additional costs of compliance.

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches.

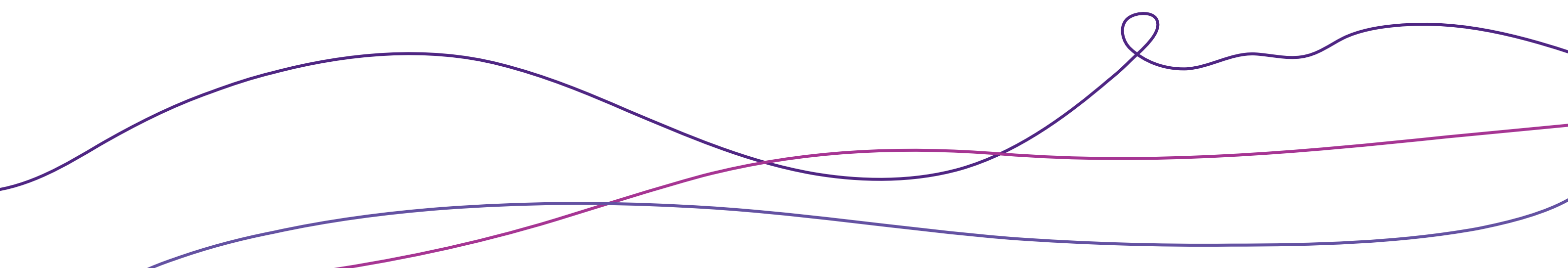
So long as there was no restriction on how capacity could be carried forward indefinitely, it should go some way to relieving timing mismatches. In the event that there is a five year time limit (as suggested in the discussion draft) on the use of that capacity, it should be allowed on a FIFO basis. Alternative methods would be to allow a group to share its unused capacity around the worldwide group to allow it relief for all its third party net interest.

What practical issues arise in applying fixed ratio rules based on asset values or earnings?

The fixed ratio is conceptually simple to implement. However, applying one ratio (either asset or profits based) regardless of industry or size of business risks benefitting some entities whilst disadvantaging others. We have considered some of the implications of the fixed ratio approach to interest deductions below.

Interest rates vary between different countries depending on the currency and the underlying macroeconomic factors that impact on the country. Interest rates may also vary between different companies even if they are in the same industry and operating in the same territory, because they may have different credit ratings. Consequently, the actual amount of third party interest charged to each company could vary widely. A single ratio (either based on assets or earnings) could lead to a different level of restriction on companies in the same industry or say, in neighbouring territories. Where a business can relocate easily and the cost of doing so is low, the availability of an interest deduction may distort the decision as to where to set up or relocate. Such a distortion could be avoided if all countries adopted the same fixed ratios in the same way. This would appear to be highly unlikely.

Setting fixed ratios on the basis of statistics of the Global top 100 companies by market capitalisation, is at best distorting. Such companies often have higher levels of free cash available by virtue of a ready market for their equity (compared with smaller public and private companies), which allows such large companies the luxury of not needing to borrow to invest. Smaller groups are facing the prospect of a continuing restrictive lending market (or borrowing on unacceptable terms) accompanied by the cost of their existing debt (which may be all third party finance) becoming



more expensive in the event that a tax deduction is not available. This may have a negative impact on the ability of these groups to grow and expand and to compete with larger rivals, in the future.

The 30% of EBITDA ratio referred to paragraphs 158 and 159 would appear to be low for many private and smaller public companies. Seeking to make the fixed ratios at this level or below is likely to make debt considerably more expensive for such groups.

Although less likely, given the comments above regarding gearing levels typically seen in groups outside the global top 100, fixed ratios can become the new 'cap' on interest deductions, whereby businesses could gear up more than they do at the moment in order to take advantage of additional interest deductions available to them. This could have a market distorting impact (because businesses seek third party debt funding to a level, which in the past, they may have used equity).

25. What would be the appropriate measure of asset values or earning under a fixed ratio rule?

As mentioned above, different businesses would need different ratios in order to limit the possibility of BEPS. Only the arm's length model allows for such flexibility whilst requiring that non arm's length deductions are denied.

26. For what reasons would the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios of the worldwide group

See comments below in respect of specific sectors.

27. Would a fixed ratio rule pose particular problems for entities in certain sector? If so, which sector would be affected and how could this be addressed?

Sectors that will be particularly impacted by the fixed ratio proposals include:

- infrastructure
- property and real estate
- private equity backed businesses
- financial services (see question 34 below)
- companies in the service sector.

We have addressed the factors impacting on these sectors below:

Companies that invest in infrastructure assets typically engage in very long term contracts (often 25 to 30 years in length). The decision to enter into such a contract is based on a detailed analysis of all the costs. Tax deductions for interest are also a key part of the financial modelling that is used to decide whether to go ahead with the project or not. The longevity of the projects mean a number of large infrastructure projects may be become more expensive than previously was understood to be the case (because the tax relief may not be available). This may cause financial stress in this sector and / or may deter new infrastructure investments.

Furthermore, infrastructure and to a lesser extent, property and real estate businesses often have the benefit of security to support their borrowing (for example unitary charge income in the case of infrastructure projects and the value of the property in the case of real estate). The security allows these sectors to have much higher levels of gearing compared with many other industries. A fixed ratio rule, applying to all industries could have a serious impact on these two industries, unless the ratios are set at such a level that high levels of gearing could be allowable. It could be possible to have one type of fixed ratios for businesses with secure income streams or assets with other ratios for those businesses with less certain income or asset values.

Many smaller businesses have benefitted from the management skills and investment funds brought to them through investment from the private equity industry. Traditionally, private equity investments have been through a leveraged structure. The potential for the disallowance of interest costs may have an adverse impact on the level of funds available to invest in smaller companies as well as pushing up prices of better quality assets, with many more businesses being unable to fund their growth and expansion plans. Furthermore, private equity has become an important industry in its own right to many countries and the possibility that such businesses leave their home territory (because they are often run by highly mobile and globally connected individuals) should be carefully reviewed.

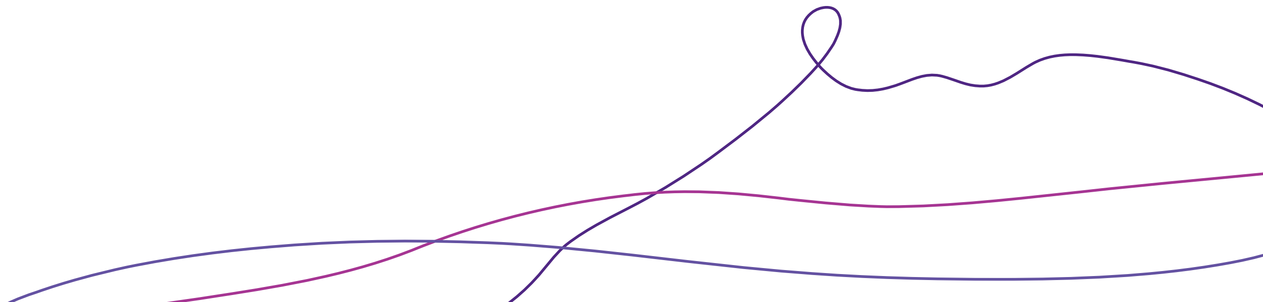
Companies in the service sector also appear to be adversely affected if the chosen ratio is assets based, as these companies typically have do not have assets that are recorded on the balance sheet (eg self-created intellectual property qualified and skilled workforce in place etc).

In general, we consider that it is better to apply targeted anti-avoidance rules to particular scenarios arising in these industries rather than creating rules that could potentially damage these important business sectors.

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital without having an undue impact on the group's regulatory position (for example, by limiting a group's net interest deduction on regulatory capital to the level of its interest expense on instruments issued to third parties)?

We welcome the recognition that banks and insurance companies are unique and that restrictions of interest expense deductions would not be consistent with the business model. Any material disallowance could easily result in taxation which inflates the effective tax rate on commercial profits of such businesses, possibly to over 100%, which would clearly create an absurd result.

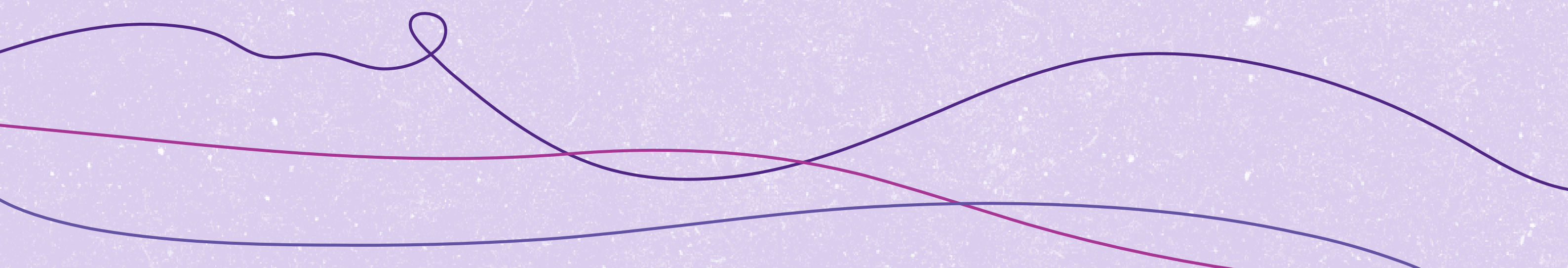
The recognition of the importance of prudential regulatory supervision in these sectors is also welcome. This presents a natural limit to the amount of permitted leverage for such businesses. We would note that prudential regulation normally applies both at an individual regulated entity level and at an overall group level. The ability within a financial services group to provide intra-group debt funding is also significantly constrained by regulatory considerations.



We are however, concerned at the statement in the discussion draft that 'the proposal is therefore to design a specific rule which would have a similar effect for banks and insurance companies but that focuses on the particular base erosion and profit shifting risks that they present'. The discussion draft does not give any detail as to what these 'particular base erosion and profit shifting risks' posed by these sectors are. We consider that these sectors should not be seen as presenting any such risks due to the strict regulatory environment in which they operate.

In particular it is unclear why regulatory capital instruments have been identified as a particular point of concern. Regulatory capital instruments range from Common Equity Tier 1 (eg ordinary share capital) through Additional Tier 1 (which may be equity or debt in legal form) to Tier 2 and other potentially loss-absorbing capital instruments (subordinated debt). Apart from the question of potential hybrid mismatches within a group, which is dealt with under Action 2, we see no reason why the tax treatment of such instruments should differ from their natural tax treatment merely because they serve a regulatory function.

We trust that this response contains useful commentary. If you would like to discuss any of these points in more detail then please contact Elizabeth Hughes, Director, Grant Thornton UK LLP at elizabeth.hughes@uk.gt.com.



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