Irish Tax Institute

Leaders in Tax

Irish Tax Institute

Response to OECD Discussion Draft:

Interest Deductions and other Financial Payments

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About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Summary of the Institute's observations

Action 4 of the OECD's Base Erosion and Profit Shifting (BEPS) project is entitled "Interest Deductions and other Financial Payments".

Broadly, the Discussion Draft suggests that some form of general rule limiting the availability of tax deductions for interest expense should be recommended by the OECD as 'best practice'. This recommended rule would be either:

- Based on a group's worldwide level of external debt, or
- A fixed ratio rule based on an entity's earnings, assets or equity, or
- A combination of both approaches.

The Discussion Draft also suggests that, depending on the final design of any general rule included in a best practice recommendation, some targeted rules may also be required.

The Irish Tax Institute fully appreciates the work of the OECD in tackling base erosion and we have participated actively in the BEPS consultations to date. We have made 8 formal submissions, have met OECD officials on a number of occasions to discuss the Action Plan and have worked extensively in Ireland to raise awareness of the issues. Where we believe that positive changes can be made to deal with base erosion issues we have provided detailed and constructive input.

However, we have a number of concerns with the issues raised in this Discussion Draft which, if implemented, could have significant and far-reaching consequences for all parties.

1. *The base erosion activity that is being targeted by the OECD will be very effectively dealt with through a number of other BEPS Actions, in particular Action 2 and Action 3. The combination of targeted anti-avoidance measures and the option of a supplementary fixed ratio rule would be a more appropriate response to any remaining BEPS concerns.*

A number of the other OECDs BEPS Actions will target the BEPS concerns outlined in this Discussion Draft, particularly the proposed actions targeting hybrids and CFCs and the proposals to change transfer pricing guidelines to target abusive transactions.

Given the difficulties with a group-wide rule or an overarching fixed ratio rule identified below, we suggest that a more appropriate solution to addressing any remaining BEPS concerns would be the use of specific targeted measures with the option for countries to apply a fixed ratio test as a supplementary measure, rather than as a primary mandatory limitation rule. This measure would be available to countries which consider that specific measures do not target base erosion from interest deductions sufficiently. We discuss this suggestion in further detail in Section D.

2. The introduction of a group-wide rule, in particular, would have very damaging consequences for genuine business funding.

We are not in favour of such a measure, which we believe amounts to formulary apportionment and runs contrary to core arm's length principles. We outline our concerns with this proposal in further detail below in Section A.

3.	*The changes being suggested have the potential to fundamentally change the way multi-national companies transact their business, which could inhibit growth and global trade. The changes that would result are based on a number of assumptions that are simply invalid, in particular the assumption that businesses use debt primarily for tax purposes*

The Discussion Draft suggests in its introduction that debt and equity is fungible and easy to change within a corporate structure. In reality this is not the case, and the proposals fail to reflect the reality that capital structure in a group is determined by a range of factors, of which tax is only one. We appreciate that the OECD would be knowledgeable about these reasons but in the interest of completeness we have highlighted some of these reasons below.

A group may prefer to use debt in many circumstances and for a number of commercial, legal and regulatory reasons. Equity financing may not allow for flexibility as the needs of a group change over time (e.g. as a result of markets or political environments changing). Equity also tends to be more formal and is bureaucratic to issue and unwind. This can be of concern particularly where the needs of a business may change quickly, or where funding is only needed for a short period of time to address a particular issue. For example, many countries have local capital maintenance rules or other restrictions on the repatriation of equity or capital that require formal legal procedures, court approvals, or a winding-up before equity can be returned. Debt funding typically provides much greater repayment flexibility and is therefore often preferred from a global liquidity management perspective. Flexibility in the management of global cash and liquidity is important in any group, even for groups that have no or very little net external borrowings. Opportunities, risks and markets change rapidly in the current global environment necessitating swift capital redeployment. Groups investing for the first time in an emerging market are especially likely to rely more heavily on debt than equity due to the potential riskiness of the market and difficulties in repatriating capital.

In addition to the inflexibility that equity funding can cause, it should be borne in mind that the return on equity is dividends. Many countries have strict legal restrictions on the payment of dividends (e.g. sufficient distributable profits are often required, or restrictions may apply to the distribution of pre-acquisition reserves) which typically do not apply to the payment of interest.

Debt funding, however, may not be preferable in all circumstances and there are obstacles that would prevent groups from simply placing debt in certain jurisdictions as appears to be suggested by Example 3 at paragraph 243 of the Discussion Draft. As acknowledged in the Discussion Draft, local exchange control restrictions may inhibit the desirability of debt funding in certain markets. Also, foreign exchange risk, the cost of debt, and other local legal and / or regulatory factors can make it undesirable to have excessive levels of debt in certain jurisdictions.

In other words, there are a number of reasons (entirely unrelated to tax) that heavily influence a group's decision to fund subsidiaries with either equity, debt or an optimal combination thereof. We would have a concern that the tax law changes being suggested would make tax a disproportionately important factor in deciding on the manner in which global operations should be funded, which ultimately could inhibit investment into certain jurisdictions for the wrong reasons.

4. *We are concerned that the proposals would lead to:*

- *uncertainty and volatility both in terms of group wide tax liabilities and Earnings per Share,*
- *significant additional compliance costs for business, and*
- *further levels of double taxation.*

Double taxation is likely to arise if these proposals are implemented, particularly if the rules are implemented inconsistently worldwide. The Discussion Draft expressly recognises this concern noting that "*Rules to limit relief for interest deductions may result in double taxation where (i) the entity remains taxable on income funded by the interest, or (ii) the recipient of the interest remains taxable on the corresponding receipt*". This is highly likely to occur in many situations. In some cases, the interaction of a general interest rule with CFC rules may even result in triple taxation on intra-group interest (tax arising for the creditor on receipt of the interest, a denial of an interest deduction for the debtor and tax in the parent company under CFC rules). At a minimum, significant compliance costs may be incurred by businesses seeking to prevent this triple taxation from arising.

A business which prefers to use debt finance for certain investments could undoubtedly be denied tax deductions for their legitimate economic cost of doing business. It could be faced with higher costs of capital and a knock on impact on Earnings Per Share, even though the financing decisions were not tax motivated nor the cause of BEPS concerns. We elaborate on these issues further below in the context of both group-wide and fixed ratio rules.

The proposals would also make it very difficult for businesses to forecast tax liabilities and the associated in-year tax payments required. Not only would this prove to be problematic but it is likely to add to the cost of compliance. The overall complexities with the rules would also add considerable cost to businesses.

The Discussion Draft recognises that "*Rules to limit interest deductions could increase the cost of capital of groups which exceed any limit. This could result in groups reducing their level of debt funding (either overall or in particular entities)".* The additional targeting of interest deductions in the wide manner suggested in the Discussion Draft would likely cause businesses to adopt less efficient funding models and have consequences for activities far beyond BEPS. For example, inefficiencies and costs would likely be introduced through groups replacing intercompany debt with external debt in overseas local entities, where currently debt can be raised more efficiently centrally.

The Discussion Draft makes a number of references to restrictions being placed on the carry forward of interest. Any such restrictions would likely result in double taxation. Restrictions would also cause significant issues for businesses in terms of recognising deferred tax assets and could significantly impact a business's Effective Tax Rate if deductions are ultimately time barred. It is important to note that equity analysts and investors pay particular attention to the stability of the Effective Tax Rate of a group and such restrictions could lead to volatility in the Effective Tax Rate.

5. *The publication of general limitation rules on interest in the form of "best practice guidance" would lead to the layering of these rules on top of current domestic restrictions. Inconsistent application by countries would lead to huge uncertainty and cost for businesses and tax administrations as disputes arise. The potential inconsistent application of any general rule can be seen from the huge diversity in thin capitalisation rules in existence today.*

This submission also addresses the need for carve-outs for specific sectors from any general limitation rule (at Section C) and the need for foreign exchange movements and derivative instruments related to foreign currency to be excluded from the measure of interest subject to any general limitation on deductions rule in (Section E) below.

The Discussion Draft proposes very fundamental reforms to tax principles that have existed for decades, with complex consequences for commercial activity. Yet these far reaching proposals are being published for consideration at a time when many multi-national companies are dealing with their year-end work and also trying to deal with the other BEPS consultations on hand right now. Measures as fundamental as these need time to be fully thought through and debated or the consequences will be far reaching and costly for everyone.

Section A Group-wide rules

The Discussion Draft proposes that countries introduce group-wide rules which would limit the availability of interest deductions within a group as a whole to the worldwide third party interest expense incurred by the group. Different methods are suggested as to how the deductible expense would be split among group members.

The practicality of administering a worldwide group rule is of concern given the reality that many countries currently adopt differing approaches to limiting interest deductions. Attempts to introduce such rules would likely lead to many approaches applying worldwide, and significant confusion and uncertainty would arise as a result. The suggestion in the Discussion Draft that the OECD's ultimate recommendations will constitute a 'best practice' may mean that some countries will not amend their rules.

The Institute has significant concerns with the proposals to introduce such group-wide rules.

1. *Double taxation is likely to arise*

The introduction of group-wide rules would result in double taxation, particularly in circumstances where the rules are not introduced and applied consistently in every country.

As a rule of thumb, it is cheaper to raise debt at the group parent level than for individual subsidiaries. Allocating group debt on a formula basis to subsidiaries within the group will always mean a mismatch and a disallowance of entity level third party interest on debt which is borrowed on an entirely commercial basis with no reference to BEPS.

Groups would likely not be able to deduct the full amount of their external interest expense due to a number of other factors including:

- Existing interest restriction rules that are likely to remain in place in many countries.
- Apportionment of interest expense across a group is likely, as the Discussion Draft recognises, to result in interest deductions being allocated to entities which are unable to utilise them in the current year (or even in future years). For example, if a group takes on debt for an acquisition, group-wide rules could apportion the revised interest burden over the expanded group but some of the group entities may have no actual debt on their balance sheets or earnings capacity to support that level of debt. While the group bears the full cost of the debt, full relief may not be available. For highly acquisitive groups, it is not practicable to expect remaining group members to continually restructure their capital and debt funding flows to replicate the revised and adjusted debt levels of the combined group post acquisition.
- Depending on the allocation basis applied, the level of interest apportioned to different entities may vary each year resulting in interest becoming attributable to different entities in different years. This would make it difficult for groups to manage their capital structure to avoid double taxation arising.

Additionally, seeking to allocate expense based on a net income approach means that even in circumstances where there are equivalent tax rates for a group lender and borrower (so that it is unlikely that BEPS is at issue) a group which has no external debt but manages intra group cash flows efficiently may bear tax on intercompany interest in one country but be denied a tax deduction in the payor country due to the lack of any external interest expense. This is despite the tax neutral outcome within the group for the intra group debt financing flows.

The Discussion Draft suggests that allowing the carry forward of excess interest or the unused capacity to deduct interest would alleviate this problem. Such measures, however, are likely to only partially reduce double taxation. There will be many circumstances where a deduction carried forward is ultimately not usable by the business – such as if the group performance or economy subsequently deteriorates.

2. *Significant volatility would arise and there would be a knock-on impact on business performance*

Significant volatility and uncertainty will arise for businesses as to what tax deductions are available to which entities. The potential impact of annual changes in how the allocation of interest across a group is determined would create uncertainty regarding the level of interest deductible in each entity each year. This significant uncertainty and volatility would be reflected in the stability of key accounting ratios such as Earnings Per Share.

The proposal would also likely lead to an increase in the effective cost of capital for business – through reduced tax deductions for debt financing, a change in where and how debt is located or a move to more costly equity finance.

3. *Impact on business decision making and international trade*

A key question posed by the Discussion Draft is the potential impact the proposals would have on business investment decisions. As noted above, the proposal would also likely lead to an increase in the effective cost of capital for businesses. As well as decreasing profitability of a business, this would also impact business investment decisions by raising the level of returns required on investments.

It also appears possible that the proposed group-wide test could create an uneven playing field between multinational and purely domestic groups in relation to debt financing an acquisition in the same country. This uneven playing field would operate in favour of purely domestic businesses. For example, purely domestic operations would not face the possibility of interest deductions being attributed by group-wide rules to operations in a country where sufficient profits do not arise to use the deduction.

This inherently favours business based in larger economies where businesses of a certain scale might reasonably operate within a single jurisdiction. Business of that size based in a smaller economy will need to expand beyond their local market in order to reach an equivalent size. It is also more likely that businesses based in smaller economies with a smaller pool of capital available from banks and more limited capacity available in local debt markets will need to raise finance from foreign lenders. This means, in practice, they are more likely to face an additional barrier to engaging in cross border trade in the form of the complexity of the proposed measures.

4. *Increase in compliance costs for business*

Compliance costs will undoubtedly increase for businesses which would have to apply the new rules, particularly if a consistent approach is not adopted worldwide. The compliance burden associated with any best practice rule will vary depending on how it is implemented.

The additional relative cost of compliance with additional measures is likely to fall heaviest on groups that operate internationally but on a smaller scale of profitability. To increase further the cost burden associated with raising debt finance would further disadvantage those companies already disadvantaged by their relative size in raising third party debt in a cost effective manner.

There is a little clarity on issues such as how a worldwide test would interact with transfer pricing rules where intercompany interest expenses get disregarded and how the interest should be documented/supported for transfer pricing documentation purposes.

5. *Rejection of arms-length principle*

The use of such a worldwide test is akin to formulary apportionment, which has been rejected repeatedly by OECD throughout the BEPS process. This disregard of the arm's length approach runs contrary to all of the other BEPS proposals to date.

6. *Groups engaged in different sectors*

Commercial lending arrangements are sector specific and look both to earnings and asset based ratios, depending on the sector. This is explored in more detail below. It would be very difficult for a manufacturing group with an in-house 'bank' or asset financing division (providing sales aid finance to customers for the group's products) to apply a common ratio to these separate although intertwined parts of its group. A group-wide approach will always result in a blended, and therefore meaningless, result which would not address BEPS. It would also make it difficult for groups to understand the tax treatment of financing arrangements. A preferred approach would be to allow such groups to take an entity based and sector specific approach using ratios appropriate to each sector.

7. *Rearranging intra group loans so that net interest expense is mapped with economic activity*

It will not always be possible to move equity/and or debt to where assets or earnings capacity is located. Even when lending to large groups, lenders and investors in debt markets will choose particular asset classes and cash flows to provide the security over the borrower's obligations for the debt. In many cases, loans will be advanced to the entity which holds the assets so as to perfect the security of the lender over those assets. In many cases, this cannot be moved, so the debt must remain there, but monies borrowed (which are surplus to the borrower's requirements), can be advanced and used by other members of the group.

Commercial lenders to large diversified groups can take additional comfort from diversity afforded by those groups in repaying debt cash flows and often take security over, and lend to, specific sub groups within an overall group. The credit risk associated with these loans is evaluated by different lenders based on their understanding of the business factors and risks associated with that sub group. Multinational groups will seek to maintain a range of relationships with international banks and will use different classes of assets and related cash flows to support the borrowings advanced by different banks - matching the capacity of the lender to lend with those parts of the business most attractive to specific lenders.

It must also be borne in mind that subsidiaries within multinational groups may have to meet local exchange control and currency control as well as regulatory requirements on borrowing. This can mean that, in practice, third party debt financing is not available to the local subsidiary but must be drawn down from within the group and within approved limits set by local authorities, so as to obtain the relevant approvals to advance and repay the debt in local currency. These procedures can be found in countries such as South Africa, Brazil, India, China, etc. At a group-wide level, debt can be raised in markets which have a deep capital base e.g. the US, with a view to advancing those monies to meet the funding requirements of subsidiaries based in countries which have a complex web of foreign currency controls and ceilings already imposed so as to limit the debt levels and interest rates borne by the local entity.

The political environment in a country may mean that groups will be reluctant to provide funding in the form of equity to local subsidiaries which require denomination in local currency and is subject to the tightest capital controls. There is greater inflexibility in recovering equity in circumstances where the possibility of sudden currency depreciations, change of local government, etc. create a greater risk of non recovery on the group's investment in the local subsidiary.

In more developed economies and economies without currency controls or fear of sudden break up of a currency bloc, it may well be possible to put in place equity instead of debt funding for longer term capital investment. However, for working capital investment it is not practicable or desirable to equity fund the subsidiary. This is due to the complexity typically associated with legal protections on equity. In many countries, in order to repay equity, a company must have available a set of audited financial statements for the most recent accounting period, obtain local court approval for capital reductions or proceed with complex solvency analyses to justify a repayment of capital. In contrast, where finance is required to meet working capital requirements of payroll, debtors etc, fluctuating debt facilities represent a much sounder and flexible mechanism to fund the local entity.

Lenders at group level will seek assurance that there are no obstacles to the free movement of cash flows intra group which are anticipated to service the debt. In many circumstances, the group will only be in a position to meet lender requirements where monies are advanced intra group in the form of debt.

8. Potential wider impact of group-wide limitation rules

The level of third party interest could be increased by a group issuing debt instruments rather than equity to investors. Where this is implemented across jurisdictions a possible (but surely unintended) result of the introduction of such tax rules is that groups could move to borrow more at a consolidated level. This is likely to have a wider market impact for the group and its shareholders as it would give rise to the need to service debt which is likely to reduce dividends or suspend dividends to existing equity investors.

Section B. Fixed Ratio rules

The Discussion Draft suggests recommending a fixed ratio test operating to restrict an entity's interest expense to a specified proportion of earnings, assets or equity of a company, as an alternative to group-wide interest rules. While perhaps of slightly less concern to the Institute than the proposals to introduce group-wide rules, the proposed fixed ratio rules also raise significant concerns:

1. *'One ratio fits all approach' is inappropriate*

The ratio approach is a very blunt instrument that fails to take into account significant differences among businesses in terms of their scale, their credit ratings, the industries and countries in which they operate, etc. Differing levels of leverage will clearly be appropriate for different businesses. The approach also does not adequately take into account different policy considerations that countries may have in determining what threshold ratios should be used.

A methodology that looks to economic ratios as a means of determining interest deductibility is likely to be more 'workable' in practice that a group-wide allocation approach and has been tested in practice by a number of country regimes. However, we consider that a single fixed ratio approach set by each jurisdiction is likely to be too simplistic and is unlikely to address sector specific debt levels.

Take for example sectors that are very capital intensive and require a significant level of debt. These include energy, transport, waste management, water and other infrastructure such as schools and hospitals. These sectors require long-term capital funding and debt has the lowest cost of financing. It is common for these projects to involve both private sector and public sector investment and to have government backing e.g. revenue flows guaranteed or supported by government counterparties. These projects do not give rise to base erosion concerns as the debt is serviced from the specific project cash-flows and so, by definition, is not excessive. Costs are kept low by public and competitive tenders for these projects. They typically also involve regulatory oversight to provide value for money in the end use of the assets by members of the public.

If at the time of arranging finance there is uncertainty as to whether tax relief will be available for any element of the debt finance, then no relief can be assumed. This will increase the after tax cost of borrowing to fund these projects and will impact on the eventual price charged to governments and the end consumer. Investment in infrastructure is an important platform for growth. Caution should be exercised to ensure that general debt limitation provisions do not operate so as to increase the uncertainty of the costs of funding infrastructure assets - both for future projects and for existing projects. This might be avoided by adopting a mix of asset ratios and interest cover tests that are appropriately benchmarked to these sectors.

Similar concerns arise for the general property construction sector where market practice is also to fund projects/properties by reference to project/property specific cash flows. A single fixed ratio test does not take account of the role that asset specific security arrangements play in these financing arrangements where a lender appraises the asset value and its recoverability when setting appropriate loan to asset value covenants for financing. The analysis of a lender providing finance which is secured on defined property assets and their cash flows where the underlying assets have a determinable market value upon sale is very different to the position of a lender to a corporate group where the monies are to be deployed within the borrower group for "general corporate purposes". The latter seems to be the starting point which is implicit in the approach set out in the OECD proposals but does not reflect the reality of many of the financing arrangements that exist in today's market.

The suggestion in the Discussion Draft that the 30% ratio adopted in many countries is too high is based on data which is not representative of the true economy. Suggestions in the referenced report that *"the vast majority have a net interest to EBITDA ratio of below 10 per cent and many do not have any net interest expense"* is based on a narrow subset of companies and is not indicative of all businesses. A ratio based on the referenced report would be far too low and not reflect the real debt levels required by most groups. Many organisations would not have as much flexibility as others in the manner in which they raise funds or have as easy access to equity markets as others.

2. *Double taxation would be likely to arise*

Double taxation would be likely to arise if these proposals are implemented. Similar to the comments above regarding group limitation rules, the operation of a ratio cap would create a real risk of groups not being able to achieve a full deduction for their external interest expense. The Discussion Draft acknowledges the difficulty in setting an appropriate benchmark ratio that is low enough to address BEPS concerns without giving rise to significant double taxation risk.

3. *Fixed ratios may not reflect changes to the economic environment over time*

There is a danger that ratios would be fixed at a level that reflects the current historically low interest rate environment. At a minimum, the interest component of a fixed ratio percentage would need to be benchmarked across a period of time taking account of cyclical movements so as to ensure they balance and reflect market conditions but do not require perpetual revision. Additionally, even in the current low interest environment, many businesses still face higher debt finance costs in order to access sufficient finance. This highlights the unsuitably of one overarching fixed ratio that applies to all businesses.

A ratio set at a local country level should also take into account the realities of access to banking and debt markets available to business in that country. Market perceptions of political and geographic risk play a part in driving measures of credit risk and the higher costs of finance for business based in smaller economies.

Section C Carve-outs for specific sectors

The Discussion Draft notes that some sectors with specific characteristics need to be considered separately. It is undoubtedly true that significant carve-outs would be required for any general rule and these carve outs would need to be applied consistently globally. A one-size fits all approach for all sectors would simply not be appropriate and would result in significant double taxation arising

The level of debt raised, for example, by companies in the asset finance sector can vary considerably. New assets leased to strong credits will typically attract higher advance rates from lenders compared with older assets to weaker credits. The rate of interest charged also varies. A 30% EBITDA ratio would be breached in many circumstances. Placing such a low cap on the level of interest that is deductible would be detrimental to the efficient functioning of this market. Given the volatility in an EBITDA ratio within this market, a general carve-out from the rule would be most appropriate. If a limit was to be imposed, it should be at least 50% of EBITDA.

The securitisation industry is another financing market that should have a general carve-out from the proposed rules. This industry requires tax neutrality in order to operate efficiently in the packaging of assets for financing. For example, the securitisation industry employs securitisation vehicles that are predominantly debt financed and the Action 4 report could have a significant effect thereon. Further clarification is also needed on what constitutes a "group" for the purposes of the group wide test and in particular how it would apply in the context of a share investment held by a private equity or other fund. On the basis that the rules proposed as part of the OECD BEPS project will be sufficient in preventing base erosion and profit-shifting occurring within a multi-national group, there should be no reason to extend such rules to the level of the investors in such groups.

There is limited detail in the Discussion Draft which suggests significant consideration has not yet been given to this important area. While the Discussion Draft suggests fairly major carve outs, significantly more carve-outs (and more detail) would be required to address all of the sectors and scenarios where higher leverage would be necessary and appropriate for business before any general rules are recommended.

Section D Specific targeted measures

The theory might suggest that a group-wide rule provides good protection from base erosion. However, for the reasons outlined above, we are not in favour of the implementation of group-wide measures which are fundamentally extremely complex to operate in practice and will have such negative implications on the commercial activities of businesses.

When the effect of BEPS measures arising from Action 2 (hybrid mismatches) and Action 3 (CFC rules) are taken into account together with revised transfer pricing guidelines which should result in the better alignment of profits and substance, the scope for undue base erosion from interest deductions should be reduced. Our concern is that, in this context, the adoption of a single fixed ratio approach as an overarching mandatory general limitation rule represents too blunt an instrument and is likely to result in denial of legitimate interest expense deductions.

Given the expected outturns from other BEPS actions which should significantly reduce the scope in future for base erosion from interest deductions, a fixed ratio rule would be preferable, which could be adopted to supplement domestic rules which target BEPS specifically. This measure would be available to countries which consider that their existing specific measures do not target base erosion from interest deductions sufficiently. Many countries, including Ireland have a comprehensive suite of targeted domestic measures which:

- Do not permit offset of financial expense against exempt income or gains.
- Do not allow deductions for borrowing on group debt used to acquire existing group subsidiaries or where there are group circular arrangements for third party debt flows.
- Confine tax deductions for interest on debt borrowed intra group to interest on borrowings deployed wholly and exclusively for the purposes of active trading activities
- Apply withholding tax on interest advanced by non tax treaty counterparties.
- Have a general anti avoidance rule which denies a tax relief which represents an abuse or misuse of a relief.
- Deny tax deductions for interest where the sole or main benefit of a debt arrangement is to obtain a tax deduction.

When the existence of existing specific targeted measures are taken into account, it is questionable whether the applicability of an overarching fixed ratio rule would achieve further protection from base erosion without the cost of denial of deduction for legitimately incurred interest expense on debt.

Section E Financial payments economically equivalent to interest

We suggest that foreign exchange movements and derivative instruments related to foreign currency should be excluded from the measure of interest subject to any general limitation on deductions rule.

In the current global environment, there is not a straightforward link between the value of a currency and interest rates applying on debt denominated in that currency. The affect of the policies adopted by Central Banks and policies adopted by the governments of major economies seeking to stimulate economic growth has seen significant volatility in exchanges rates between major currencies which has had a knock on impact and caused volatility in earnings for business operating in multicurrency environments. Introducing additional general limitation rules on deductions for foreign currency movements on debt would only exacerbate that volatility and the risk and uncertainty it creates for business operating in a multicurrency environment.

There are also considerable practical complexities in identifying foreign currency movements associated with debt liabilities and separating those from currency movements related to assets whether at a group-wide or single entity level. In addition, foreign currency movements may arise at a consolidated level which do not arise in the local currency accounts of a subsidiary and, vice versa, where the subsidiary recognises a foreign currency movement in local currency accounts but this movement is not recognised in the consolidated accounts which have a different functional currency for accounting purposes. The practical challenge of identifying and allocating any such movements is made more difficult by the use of derivative instruments which can convert third party debt raised in one currency at a parent level to a currency which matches the currency of denomination of the revenue and expenditure flows of a subsidiary.

Different accounting standards recognise the close interrelationship between derivatives which hedge foreign currency exposure for business and the underlying asset or liability that is hedged by that derivative instrument. This can mean that under many accounting standards, the impact of derivatives is not seen separately from cash flows on the underlying asset or liability. Even where the effect is recorded separately, the impact can ‘net off’ in the income statement of the company so as to result in a nil net result. This can prove impossible to disaggregate both of the level of the company and the consolidated group accounts.