Mexico City, February 6, 2015

Via e-mail

**interestdeductions@oecd.org**

**Mr. Achim Pross**
**Head of the International Co-operation**
**and Tax Administration Division OECD/CTPA**

Dear Mr. Pross,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below the comments to the Public Discussion Draft on BEPS Action 4 –"*Interest Deductions and Other Financial Payments*" (the "Draft").

**Overview**

The discussion draft focuses on the OECD's intention to develop a best practice for addressing base erosion and profit shifting via deductions of interest expense.

The draft is an extensive discussion of options for limiting interest deduction through a group-wide rule, a fixed ratio rule or a combination of the two approaches.

**Comments**

*Group-wide rules for limiting interest deductions*

This rule is founded on two basic premises: a) group´s total interest deductions should be limited to its actual net third party interest expense and b) the interest expense within a group should be matched to economic activity.

The draft concludes that the rules in question do have the potential to address BEPS.

*Group-wide interest allocation rule and group ratio rules*

The starting point for this rule is an allocation of the third party net interest expense among the companies of a group. The allocation will be measured based on the economic activity, such as earnings or asset values.

We believe that, while it is true that this rule offers an improvement in addressing BEPS risk, it is also true that in practice a group may be made up of several companies that are involved in various different economic activities and so this measurement may end up being less precise than intended. To analyze this in more detail, we must start with how we should understand the term "group". Based on the above we may believe that a group could have a so-called "super holding company" at the top, with two sub-holding companies through which different types of activities are carried out. In this light, it is important to be clear on what a group should be understood as and how the rules would apply.

Although the report mentions that the proposed alternatives may be applied in a group that is required to prepare consolidated financial statements, the draft recognizes that the consolidated financial statements may also be a starting point for measuring net interest paid to third parties. For some groups this may be very simple if they are public companies, since there would be a universal language in this regard (IFRS). However, for other groups this measure could be complex and expensive in terms of performing a financial statement conversion if standard language is required, not to mention the concepts of materiality, unconsolidated joint ventures and other types of arrangements such as trusts or partnerships, which the draft does not address accordingly.

A potential solution is to first determine the nature (industry to which each of the entities belongs) and then, based on the industry in question and provided there is interest paid to a third party or a related party, apply targeted rules. In view of the above, for example, for investment projects that require significant leveraging, specific measures may be established to allow for the deduction. For example, this may apply to infrastructure projects such as Oil & Gas and Power, residential developments, etc.

It is important to also consider that not all companies of a group have the same capacity. Although the document under analysis recognizes this point, it is important that a specific rule be established addressing the possibility that such company may be excluded from this limitation.

Special emphasis must be placed on companies in the pre-operating period and on companies whose primary assets are liquid assets. We believe that the issue of liquid assets has no bearing on limiting BEPS when the entity in question is a treasury company whose principal activity is providing funding for related parties. The rule on net interest paid to third parties must therefore be reviewed considering the effects of intra-group financing structure (even though the draft states that the cash pooling structure will not be affected by the new rules, it is important to clarify how treasury entities will be affected). This would seem to be the case in the group-wide interest allocation rules and not in the group ratio rules; more clarity is needed in this regard. In this case, the proposed rules could work with the addition of specific targeted rules. The draft proposes establishing carry-forward rules for disallowed interest under interest limitation rules. It suggests that deduction periods (interest carry-forward) be established in all cases, while considering the deduction of intra-group interest where applicable.

It is also important to have a clear definition of “earnings”. In order to apply a universal language, we may be tempted to turn to standard principles such as IFRS, however, we do not consider taxable earnings to be the best definition of earnings, given the effects of reconciling items, among other aspects that may distort the amount of reported interest. The draft mentions that EBITDA could also be used as a basis for earnings; however, would that mean EBITDA under local GAAPs? US GAAPs? IFRS? According to the draft some countries are already doing it this way and so we recommend reviewing how successful this method has been in those jurisdictions. We would recommend that both earnings and asset values be determined based on book values, considering an entity’s obligation to prepare financial statements.

There also needs to be a definition of assets and specifics on how to consider assets in the calculation. This is relevant because certain assets are eliminated in consolidated financial statements; however, for purposes of taking on debt from third parties, it is often the individual financial statements that are used to measure the debt capacity of the entity asking for the loan and so the elimination of assets through consolidation is not necessarily the best option. Again, there must be a universal language in this regard. As mentioned above, the high liquidity of a group does not always mean that it has a higher probability of having deductible interest.

We also believe that the group ratio rules need to be clearer on how the proportion is to be determined. While group ratio rules are based on either net interest to earnings or net interest to asset values to the equivalent financial ratio of the entity’s worldwide group, the actual ratio (or proportion) does not consider specific factors related to all possible industries represented in the group. This means that each country will have to determine the amounts that they will use to calculate the ratio, and will need to do so considering the external factors for each industry and/or the nature of each company in question. Accordingly, although this determination may offer flexibility, as the report discusses, it may also become an overwhelming task for companies, particularly for those in the process of taking their business international. In fact, the suggested rules are quite focused on fully mature companies with the financial wherewithal to adopt these types of rules; however, in our opinion, the rules fail to address other types of groups (just once does the draft mention the potential need to evaluate the capacity of small enterprises). We believe that safe-harbor rules should be established to provide more legal certainty in this regard. Also, it is not clear how the position of a company subject to this test should be measured when, for example, the ratio is primarily influenced by activities that differ from those of the company being tested. The fact that the rule is based on assets and that the assets in question are subject to valuations is a matter of some concern. This issue could give rise to discussions down the road and even more importantly, it could cause differences, since the methods and comparables used may not necessarily be the same as those determined by the tax authority.

The draft concludes that there should be a certain degree of coordination between countries; however, we believe that this would be very difficult to achieve in practice. In fact, both rule options should be considered viable alternatives for countries. A specific targeted rules approach could be a possible solution where a specific country does not adopt either the group-wide or ratio rules.

With regard to the question of whether to consider a net or gross interest position, we believe that a net position is the best option and that this determination should consider factors not only related to payments to third parties, but also the fact that the debt may be intra-group but with the basis for substantiating that the loan would have been obtained between independent parties in a similar fashion (not only in terms of the market value, but also based on the terms and conditions of the loan). Again, targeted rules could be of great help in this area.

The scope and definition of interest could create very deep distortions and so the concept of “interest and payments economically equivalent to interest” needs to be defined. In practice, this uncertainty has led to double taxation.

As regards to group-wide rules, something mentioned in the Draft (para. 66) is in connection to Constitutional limitations for the adoption of these types of rules. In the case of Mexico, we consider the group-wide rule would be a challenge in terms of the Constitutional principles governing taxation.

Under the Mexican Constitution, the principle of tax proportionality governs the manner in which taxpayers are supposed to contribute to the public expenses. The Mexican Supreme Court of Justice has established in several decisions the notion of this principle, which has evolved over time. In general, the proportionality principle states that taxpayers shall pay taxes based on their contributing capacity, or their ability to effectively contribute to the public finances based on their circumstances.

As regards to authorized deductions, the Mexican Supreme Court of Justice has also stated that deductions are categorized between structural and non-structural. The former ones relate to costs or expenses inherently related to the activity of the taxpayer, allowing the application of the tax to a particular circumstance in a proportional manner. The latter refer to benefits granted through tax breaks, which are meant to foster a particular activity for certain taxpayers.

The distinction made above is important as they relate to new intended rules bound to limit the deductibility of interest expenses on Mexican taxpayers (likely to be seen as structural deductions), based not on their individual contributing capacity, as the proportionality principle mandates, but on the overall capacity of an entire group, as related to a third party debt only and based on an allocation mechanism, or a ratio of the entire group. In this regard, the Mexican Supreme Court of Justice has ruled on the constitutionality of fixed ratios as part of thin capitalization rules, based on the intention to avoid an artificial erosion of the Mexican tax base; however, a substantially more complex mechanism as the one described in the group-wide rules, with many additional financial elements and information not readily available to the Mexican subsidiaries; or distorting elements such as different accounting standards, currency conversion and inflationary issues and the like, will likely encounter a stronger constitutional opposition in Court from Mexican taxpayers than the fixed ratio alternative also being proposed; thus our inclination for this latter approach.

*Combination of rules*

A combination of the rules could be an effective approach; however, until the issues discussed in the preceding paragraphs are resolved, both rules have the potential to create distortions. The purpose of this proposal is to prevent BEPS, but the proposal does not really address any external factors beyond a passing consideration of concepts such as EBITDA. Countries with a net capital inflow will have to design targeted rules that help them better address more concrete and specific cases of base erosion. There are questions that need to be answered, such as: how should exchange losses be addressed? Could a functional currency approach be effective? Should there be definitions of all the concepts involved? If a company has a tax loss but has earnings in terms of EBITDA it is not clear what to do. What should happen in this case? How can the interests between countries be reconciled?

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The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano A.C.