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Submitted by email to beps@treasury.gov.au

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AUSTRALIA

RE: Comments on “Implications of the Modern Global Economy for the Taxation of Multinational Enterprises” Issue Paper

Ladies and Gentlemen:

The Toronto-Dominion Bank and its subsidiaries (together, “TD Bank Group”) provide a full range of financial products and services to approximately 22 million customers worldwide. Headquartered in Toronto, Canada, TD Bank Group employs more than 85,000 people in offices around the world.

We are writing to comment on the May 2013 issue paper, “Implications of the Modern Global Economy for the Taxation of Multinational Enterprises” (the “Issue Paper”). We appreciate the Treasury’s thoughtful examination of the interaction of current international tax rules and the evolving global economy and other issues raised in the OECD report, “Addressing Base Erosion and Profit Shifting” (the “OECD BEPS Report”). We also commend the Treasury for seeking input from stakeholders and the community more broadly. As the Issue Paper

recognizes, the fundamental policy issues being examined have important implications not only for Australia, but also for cross-border investment and trade worldwide. We look forward to a continued dialogue with and between Australia, other countries, and the OECD.

Our comments focus on four main points. First, base erosion and profit shifting (“BEPS”) must be considered within a broader examination of the role and function of the corporate income tax. Second, while changes in the global economy have led some to call for changes to the long-standing principles relevant to the taxation of cross-border profits, countries and the OECD should avoid precipitous changes. Third, countries and the OECD should take an in-depth and holistic approach to evaluating leverage, debt, and interest expense and formulating potential policy recommendations, including taking into account the special circumstances and roles of financial institutions. Fourth, the fundamental policy questions raised in the Issue Paper and the OECD BEPS Report should be addressed through a thoughtful and measured multilateral approach involving consultation with all stakeholders. Any policy responses should be adopted prospectively-only, should be phased-in and should provide businesses with clarity and certainty.

I. Base Erosion and Profit Shifting Should Be Considered in a Broader Context

The Issues Paper observes that existing data does not conclusively indicate the extent and nature of BEPS. We believe that any effort to address a perceived problem should be supported by data indicating that such a problem indeed exists, but submit that a focus on whether and to what extent BEPS is incomplete without a broader examination of the role and function of the corporate income tax.

Many countries tax corporate earnings twice; once when earned by the corporation and again when distributed to the corporation’s shareholders. This double tax creates a disparity between business income earned by corporations and business income earned by entities that are not subject to corporate income tax, such as partnerships, hedge funds, sovereign wealth funds, pension funds and REITs. The double taxation of corporate earnings creates an incentive for corporations to reduce taxes to compete with businesses not subject to an entity-level tax. Where a tax system relieves double taxation, this incentive is reduced. As the Issue Paper

recognizes, Australia's dividend imputation system, which relieves Australian shareholders from double-taxation on profits taxed at the corporate level "reduces the incentive for Australian companies to engage in tax planning strategies."¹

Corporate income taxes also impose high compliance costs despite generally raising small amounts of revenue. Further, they have a negative impact on growth and investment. As the OECD has recognized, "[c]orporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment and capital and productivity improvements."²

We believe it would be a lost opportunity to concentrate only on the narrow issue of BEPS and not the larger issue of the role and function of the corporate income tax. It is only within this broader context that BEPS can be accurately assessed and appropriate and targeted solutions be designed.

II. The International Tax Framework

Some argue that international tax principles should be updated to take into account the evolving global economy, including the increasingly digital economy. However, countries and the OECD should avoid sudden and drastic changes to fundamental international tax principles, which have provided a sound foundation for allocating taxing jurisdiction for nearly a century.

The principle that source taxation should be commensurate with the economic activity in the source jurisdiction should not be disturbed. The permanent establishment standard should continue to provide the threshold for jurisdictions to tax business profits. While some question application of that standard in an increasingly digital economy, and posit alternatives such as a market-based approach, the permanent establishment standard represents the soundest policy and most administrable approach.

¹ Implications of the Modern Global Economy for the Taxation of Multinational Enterprises, Issues Paper (May 2013), p. 12.

² OECD Tax Policy Studies, Tax Policy Reform and Economic Growth (2010), p. 22.

Second, gross basis withholding taxes on interest, royalties, and dividends should be minimized. These items, especially interest paid by financial institutions, are inappropriately taxed on a gross basis because they often are comprised of very little income when calculated net of expenses. Further, there is little policy justification for taxing the capital owner as opposed to the economic activity generated by the capital. In addition, in the case of royalties, the deductions associated with the development of the royalty are taken in the residence country, so the source country's claim to taxation is tenuous.

III. "Key Pressure Areas" Identified by the OECD

The Issues Paper asks whether the key pressure areas identified by the OECD represent the main priorities for action in the short term and what measures should be taken to address these pressure areas. Leverage, debt, and interest expense are discussed extensively in the OECD BEPS Report. However, the consideration of these issues is brief and at a high-level. We urge that an in-depth and holistic approach be taken to the evaluation of issues related to leverage, debt, interest expense and the development of potential responses and proposals.

First, a more thorough examination of the role of debt in BEPS activity is needed. The three empirical studies mentioned by the OECD in Appendix B of its report differ in their conclusions with respect to the role of leverage as a source of base erosion. Indeed, one of the studies cited (a 2012 study by Jost Heckemeyer and Michael Oversesch) concludes that "transfer pricing and licensing, not inter-company debt, is the dominant profit shifting channel." A fuller consideration of relevant empirical studies is needed to support any focus on leverage as a cause of base erosion. In addition, the potential negative economic effects of changes to the tax treatment of debt should also be considered. For example, one study not cited by the OECD ("Corporate Taxes and Internal Borrowing Within Multinational Firms" by Peter Egger et. al. [Oxford University Centre for Business Taxation, WP 12/21, August 2012]) concluded that there are important non-tax reasons for the use of related party debt (such as to compensate for differences in countries' capital markets) and have cautioned that tax policy changes with respect to leverage may have a negative impact on foreign direct investment. Targeting

leverage without a full and careful study of all empirical evidence, and economic analysis of the potential economic impact of any policy changes, would be precipitous and undesirable.

Second, the question of whether there is a tax-induced distortion between debt and equity funding merits a discussion broader than that contained in the OECD report. Corporate earnings financed by equity are often taxed twice—once in the hands of the corporation and once in the hands of shareholders—while corporate income financed by debt is not subject to the same double tax because the corporation is generally provided a deduction for interest paid. Many countries, like Australia, attempt to address this distortion by reducing the double taxation of corporate equity income. Making equity financing more attractive is the more appropriate response to addressing the differential tax treatment of debt and equity, rather than making debt financing less attractive, such as, for example, limiting interest expense deductions, which would increase the overall corporate cost of capital and thereby exacerbate the double taxation of corporate income.

Third, any policy responses to address the role of debt, leverage, and interest expense in BEPS should take into account the special circumstances of financial institutions and their key role in facilitating global trade. Interest expense is the largest operating expense of banks and other financial institutions, as interest expense on borrowing permits financial institutions to earn interest income from their lending activities. In other words, interest expense is the equivalent of cost of goods sold for non-financial businesses. Any limitations on interest deductibility considered as part of the BEPS project should take into account the nature of the business of financial institutions. For example, any limitations on interest deductibility considered should be based on net, not gross, interest. A limitation on the deductibility of gross interest expense could eliminate the profit margin in many financial services transactions, thereby making financial intermediation more expensive for borrowers, lenders, and financial institutions. Given its key role in economic growth, new impediments on borrowing and lending should be avoided. In addition, any proposals focused on cross-border interest payments should also include special rules for financial institutions. For example, many countries, including Australia, provide different debt-to-equity ratios for financial institutions in

their thin capitalization rules. Other countries exempt financial institutions from their thin capitalization rules.

Both the OECD BEPS Report and the Issue Paper express concern about hybrid mismatches and tax arbitrage. However, hybrids and arbitrage are the natural consequence of variations in countries' tax systems and laws. If governments view hybrids and arbitrage as undesirable, they should consider acting to conform their systems as appropriate. Tax treaties provide one potential mechanism for consistent rules addressing government concerns while providing increased certainty for business. Indeed, treaties already increasingly provide rules addressing specific instances of differential treatment of entities or instruments.

IV. Need for Multilateral Approach

The fundamental policy questions raised in the Issue Paper and OECD BEPS Report should be addressed through a thoughtful and measured approach. The fundamental principles of international taxation developed over the last century, which are critical to trade and investment decisions, should not be hastily upset.

We echo the OECD's warning against "unilateral and uncoordinated actions by governments responding in isolation."³ Such unilateral action would contribute to instability and uncertainty as well as lead to increased double taxation. Although each country has the right to make its own laws consistent with its own policy choices and in its own national interest, unilateral action should not, as the Issue Paper recognizes, "adversely impact on another government and/or result in double taxation."⁴ We recommend that the OECD play a key role in guarding against such unilateral action by establishing guidelines for potential actions by countries and focusing on bilateral and/or multilateral solutions.

In recognition of the fact that businesses have relied on the current long-standing international tax rules, changes to existing rules should be applied prospectively-only. Further,

³ OECD, Addressing Base Erosion and Profit Shifting (2013), p. 50.

⁴ Implications of the Modern Global Economy for the Taxation of Multinational Enterprises, Issues Paper (May 2013), p. 17.

where appropriate, changes should also be phased-in to allow businesses to adjust to the new rules.

V. Conclusion

TD Bank Group looks forward to Australia's leadership on these important issues. We appreciate the opportunity to provide our input and would be pleased to provide further information or discuss these matters further.

Sincerely



Peter van Dijk
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TD Bank