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# BEPS ALERT

Briefings on Base Erosion and Profit Shifting (Tax)

## BEPS Action 4: Proposals on interest deductibility

*The OECD's discussion draft on interest deductions under BEPS Action 4 could have a significant effect on the cost of financing.*

**Summary**

- *The OECD's discussion draft is intended to develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense.*
- *The draft focuses on the use of a group-wide rule and a fixed ratio rule for limiting interest deductions, as well as a combination of these two approaches.*
- *Whichever rule, if adopted, may have significant implications on the multinational financing costs.*

On 18 December 2014, the OECD released a public discussion draft entitled *BEPS Action 4: Interest Deductions and Other Financial Payments* ("the Draft"), which outlines a number of different options that may be included in a best practice recommendation to combat base erosion through interest deductions and other financial payments.

The Draft, which does not represent a consensus among the OECD/G20 participants, is intended to

> *Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.*

It is important that Action 4 is viewed in the context of the above. The taxation of interest is a fundamental issue in BEPS and other actions will also be addressing the implications of interest deductions (hybrid mismatches, CFCs and treaty abuse) although not as specifically as Action 4. It is therefore not necessarily certain that the suggested best practices will ultimately be implemented.

The Draft considers a number of options, including general interest limitation rules which set an overall limit on the amount of interest expense in an entity, linking interest deductibility to the position of a group or fixed ratios and, finally, targeted interest limitation rules to counter specific base erosion and profit shifting risks.

Transfer pricing guidance for related party financial transactions, which also forms part of Action 4, will be addressed separately at a later stage.

## Background

BEPS Action 4 originates from OECD concerns that the use of interest (and particularly related-party interest) is one of the most simple and widely used profit-shifting techniques in international tax planning and that multinational companies are able to erode the tax base through excessive interest deductions that often exceed the actual third-party interest expense. Furthermore, members of multinational groups may be over-leveraged and their parents may often borrow to invest in assets that generate income that is either deferred or exempt for tax purposes.

The Draft expresses the view that unilateral, general interest limitations have had varied degrees of success. This may be ascribed to the fact that countries, acting on their own, do not want to adversely affect their attractiveness to international business as well as hindering the ability of domestic corporate groups to compete globally.

Consequently, it is suggested that a consistent approach, following global best practices, should be implemented in order to properly address the use of interest in base erosion and profit shifting. Consistency, it is felt, will result in greater certainty and enable multinationals to design their capital structures with greater confidence and reduce the risk of double taxation.

## Overview

The Draft sets out different approaches that may be considered best practice, while also considering a number of issues including: what is interest and its economic equivalent; who will these rules apply to; the treatment of non-deductible interest expense; double taxation; and the interaction with other BEPS initiatives.

The recommendations concentrated on the following proposed rules:

1. **Group-wide rules**: limiting a company's net interest deductions to a proportion of the group's actual net third party interest expense;
2. **Fixed ratio rules**: limiting a company's interest deductions to an amount determined by applying a fixed benchmark ratio to an entity's earnings, assets or equity; and
3. **Combinations** of the above two approaches (this would appear to be the preferred OECD approach, where one would be used as a default rule and the alternative only applied where the first test led to non-deductibility).

The Draft also discusses use of a targeted approach to address specific BEPS concerns particularly excessive interest deductions on third-party debt.

In addition, countries will be permitted to complement the above general rules with specific anti-avoidance measures that consider each country's domestic tax regime.

The draft is lengthy and includes appendices that give examples of interest and equivalent payments, group-wide and fixed ratio rules, related EU law issues and, perhaps most importantly, a list of specific questions identified for the consultation.

### 1. Group-wide rules for limiting interest deductions

The draft suggests that group-wide rules offer, in theory, the best approach to tackling base erosion and profit shifting while allowing a group to centralize its third-party borrowing in the country and entity that is most efficient. These rules, and their potential effectiveness, operate on two fundamental principles: first, that a group's total interest deductions should be limited to its actual net third party interest expense and, second, that within a group, interest expense should be matched to economic activity. There are disadvantages to this approach: the need to collect group-wide data and the possibility that volatile earnings or asset values in one part of the group could affect the ability of the group to deduct their net interest expense.

With regard to the above, the draft considers two types of group-wide rules:

- ***Group-wide interest allocation***: allocating a group's net third-party interest expense between group entities in accordance with a measure of economic activity. This would work by calculating an interest cap per entity by comparing the entity's economic activity (based on earnings or assets) within the group's overall position.

- ***Group ratio***: compares relevant financial ratio of an entity (for example the net interest to earnings or net interest to asset value) to the equivalent financial ratio of the entity's worldwide group. Where an entity's ratio is equal to or below that of the group, all of its third-party and intra-group interest expense would be deductible. Any interest expense that increases the entity's ratio beyond the group's ratio would be disallowed.

The above approaches both aim to ensure that net interest expense within a group is matched with economic activity and they should deliver similar outcomes. It is likely, however, that in either of the above and as a result of disallowed deductions in some entities, it may occur that the total interest deductions throughout a group may be less than their external third-party interest costs. This can be addressed to an extent by allowing the carry-forward or carry-back of disallowed interest, or by alternative rules that allow excess capacity to deduct expense to be used in the future.

The Draft anticipates that a *group-wide interest allocation rule* would be implemented in fundamentally similar ways in all participating countries. What this means is that countries would have to agree to an approach defining which entities are covered by the rule, how net third party interest expense of a group would be calculated, and how an interest cap would be allocated between entities. Countries may have some flexibility in implementing the rule (for example, taking into account whether they tax local entities separately or on a consolidated basis). However, it is acknowledged in the Draft that the interest cap method may result in mismatches where the approach agreed by countries is not aligned with a country's domestic tax system.

The *group ratio rule*, on the other hand, gives countries greater design flexibility than the *group-wide interest allocation rule,* which may also result in a reduction in mismatches between group and entity ratios. This flexibility may, however, result in increased compliance costs, difficulties in adjusting intra-group financing to comply with domestic rules, further opportunities of base erosion and profit shifting and the possibility of double taxation.

Irrespective of whether a *group-wide interest allocation* or a *group ratio rule* is ultimately adopted, a number of key questions remain to be considered:

- **Definition of an interest limitation group**: The Draft proposes that a group rule should apply to entities in a financial reporting group.
- **Determination of a group's net third-party interest**: The Draft regards the consolidated financial statements as an appropriate starting point to gather this information.
- **Measurement of economic activity**: The Draft has a discussion of both earnings and asset values being measures of economic activity as well as an entity's borrowing capacity. There appear to be good arguments in favour of either of them.
- Other questions requiring resolution include: potential accounting and tax mismatches; the treatment of cash and the risks posed by connected and related parties.

## 2. Fixed ratio test for limiting interest deductions

The Draft sets out a *fixed ratio test* that would apply in relation to a benchmarked ratio of an entity's earnings, assets or equity. This ratio is determined by a country's government and will apply irrespective of the actual leverage of an entity or its group. Interest expense on third party or intragroup debt up to this fixed ratio should be deductible, but any interest that takes the entity's ratio beyond this benchmark is disallowed.

The assumption underlying a *fixed ratio rule* is that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets or equity thereby ensuring that a portion of an entity's profits remains subject to tax in a country.

A critical issue for consideration is whether the ratio should apply to a balance sheet or earnings measurement:

- ***Asset-based measures*** are likely to be more suitable regarding inbound situations, which often results in the recipient of interest not being taxed. For example, an asset-based test that excluded equity investments would prevent many entities with tax-exempt dividend income from claiming a higher level of interest deductions.
- ***Earnings-based measures***, referred to in the Draft as related to EBITDA or EBIT, have the advantage that additional interest expense can only be supported by additional taxable income. It would be possible to exclude exempt income, such as dividends, and so can be adapted to both inbound and outbound contexts. However, earnings are volatile compared to balance sheets, in that they are more influenced by factors outside the entity's control.

The benefit of the *fixed ratio rule* is that it is relatively simple for groups to apply as it reliant on an entity's own financial position. In addition, the test may be based on tax rather than financial reporting. This will be particularly welcome in countries where the taxation of interest, and the tax system in general, doesn't closely follow the accounting treatment.

This methodology does not, however, take into account the fact that groups operating in different sectors and under different market conditions may require different levels of leverage and that groups may adopt different, non-tax, funding strategies. A country should, therefore, have to determine the benchmark ratio which represents an appropriate level of interest expense for all entities operating in all sectors.

The Draft raises a number of issues for consultation, including:

- Practical consequences of applying fixed ratio rules based on asset values or earnings
- The appropriate measure of asset values or earnings under a fixed ratio rule

## 3. Combined approach

The Draft considers whether a combination of the approaches discussed above could be a way to address BEPS while reducing administrative and compliance costs by applying simpler rules to entities that pose less risk.

It suggests, for example, that a country that uses a group-wide interest allocation test as its main rule might offer a carve-out for groups that have entities that meet a low fixed ratio test or that just prefer the option of the simpler fixed ratio approach. The Draft indicates that the intention under this approach is that the majority of entities in international groups would apply the group-wide rule which is considered more robust in terms of dealing with BEPS but which should also allow higher interest deductions based on the specific position of the group.

Alternatively, a country that adopts a fixed ratio test as its main rule could offer a carve out for companies that exceed this fixed ratio but that can demonstrate that they are within specified group ratios, similar to the approach used by some countries today.

The draft considers whether the combination of a group-wide test and a fixed ratio test would result in tackling base erosion and profit shifting while reducing administrative and compliance costs.

In essence, a combined approach would involve a general rule based on either a group-wide test or a fixed ratio test, with a "carve out" based on whichever test was not selected for the general rule. This approach would allow entities with lower levels of interest expense to apply a simple fixed ratio rule, while more highly leveraged entities would apply a more complex group-wide test. This also could provide a solution for groups that have no overall third party interest expense, as it would still allow entities within the group to deduct a certain level of interest expense, but there would be an inevitable increase in compliance costs.

## The Implications of the Draft

The Draft focuses on the use of a group-wide rule (interest allocation or group ratio) or a fixed ratio rule. Either rule, if adopted, may have significant implications on multinational financing costs. Although there is a lot of further work to be done on this action, the Draft appears to indicate the likely route the OECD will adopt.

The draft rules propose that total interest deductions should be limited to the multinational group's third party financing costs, which would be achieved through a manner of allocation. It would seem that such a group-wide limitation could greatly increase the level of disallowed interest within a group, which would be a disproportionate outcome.

It is difficult to accurately anticipate the consequences of the Draft although consideration should be given to some general issues and potentially adverse consequences:

- These developments will need to be considered in light of the specific interest deduction rules Hong Kong. Unless there are changes to the existing deduction provisions, any changes proposed at the global level will still need to comply with the specific interest deductibility rules in Hong Kong.
- The impact on deductions in multiple jurisdictions, significant restrictions on where debt may be allocated and deductions taken and limitations on debt-pushdowns upon acquisitions. This can also affect cash-rich multinationals that use intra-group debt to fund group operations;
- The negative impact on external and internal debt management, for example multinationals with significant interest deductions at headquarter level with relatively little economic activity and the resultant minimal allocation of interest to the headquarter;
- The risk of double taxation in certain sectors, for example infrastructure or certain regulated industries that have restrictions on interest deductibility.
- An additional compliance burden on multinationals including the gathering of necessary information, managing debt and currency positions and the increased burden on tax reporting on a global basis.

In the short term, corporates should assess the impact of the current proposals on their business, including understanding worse case scenarios and identifying possible restrictions as well as any areas of concern. The options in the Draft should also be factored into any long-term planning and financing decisions and any future acquisitions funded by debt should also be mindful of these options.

It is equally important that business contributes to the debate on the proposals, particularly with regard to the disallowance of interest and the economic impact it may have on their businesses. There is widespread concern that the introduction of rules contained in the Draft could result in disproportionate compliance requirements and effective double taxation and that, through further consultation, the proposals may ultimately be improved.

Written comments on the Draft closed on 6 February 2015 and a public consultation on the Draft will take place in Paris 17 February 2015.

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