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Tax insights
BEPS Action 4 Discussion draft: deductibility of interest and other financial payments

Snapshot

On 18 December 2014, the OECD released a discussion draft on Action 4 in relation to the deductibility of interest expense and economically equivalent financing payments ('the Draft') as part of its base erosion and profit shifting ('BEPS') initiative.

The Draft outlines the following approaches to tackle BEPS issues arising from the use of interest and other financial payments:

1. Group-wide tests under which the allowable interest deductions for a particular entity are determined based upon the debt position of the group
2. Fixed-ratio tests applied on an entity by entity basis limiting a company's interest deductions by reference to a benchmark ratio of earnings, assets or equity
3. A combination of the above two tests

In each case, the rules would likely be supported by specific targeted rules

Notably, it does not cover the transfer pricing aspects of interest deductibility, which will be covered in a separate consultation document.

The Draft also summarises a number of areas where further work is needed, and sets out how Action 4 may interact with other BEPS measures, such as the hybrid mismatch proposals in Action 2 and the controlled foreign company ('CFC') proposals in Action 3.

Consistent with other BEPS discussion drafts, the proposals do not represent a consensus view from the G20/OECD governments, but are designed to provide preliminary proposals for public analysis and comment.

Action 4

The objective of Action 4 is to identify comprehensive solutions to address base erosion through interest deductions and other financial payments, for both inbound and outbound investments. The Draft proposes the **general principle that groups should be able to obtain tax relief for an amount equivalent to their actual third party interest costs**.

Although the critical objective is to counter base erosion, the OECD acknowledges that whatever solution is ultimately adopted should also minimise distortions to competiveness and to investment decisions.

The proposal is that countries should adopt a new general rule, complemented by jurisdiction-specific anti-avoidance measures as appropriate. The alternatives considered are as follows:

1. Group-wide tests under which the allowable interest deductions for a particular entity are determined based upon the debt position of the group
2. Fixed-ratio tests applied on an entity by entity basis limiting a company's interest deductions by reference to a benchmark ratio of earnings, assets or equity (eg, similar to Australian thin capitalisation rules or rules that limit interest deductions to a proportion of EBITDA)
3. A combination of the above two tests

In each case, the rules would likely be supported by specific targeted rules

Group-wide tests

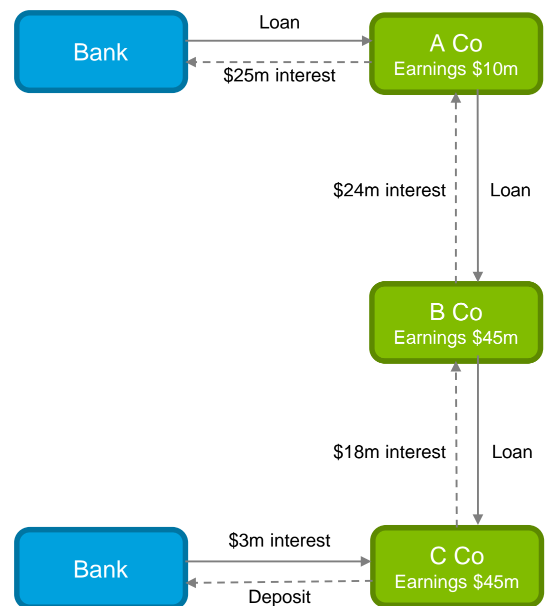
There are two types of group-wide tests considered.

Interest allocation

These tests work by way of a two-step process.

- First, by providing each entity in a group with an "interest cap" which is a proportional allocation of the group's net third party interest expense. The allocation is determined by comparing that entity's economic activity (measured, for example, by either its earnings or its assets) with the group's earnings or assets;
- Second, the cap allocated to a particular entity, represents the entity's maximum allowable deduction for interest and other financial payments in the particular period. The entity's actual expense must then be compared to its allocated cap, with expenses in excess of the cap being disallowed (but potentially able to be carried forward)

Example: The interest allocation or interest cap method is illustrated in a simple example below.



Interest Cap rule – "earnings based" allocation

- A Co has borrowed from a Bank and on-lent some of this amount to B Co
- B Co has on-lent some of these funds to C Co
- C Co also has some surplus cash on deposit with a Bank

	A Co	B Co	C Co	Group
Earnings	$10m	$45m	$45m	$100m
Allocation factor (earnings)	10%	45%	45%	100%
Net third party interest income/ (expense)	($25m)		$3m	($22m)
Stage 1: Calculation of interest cap				
Allocation of net 3rd party interest expense of $22m	($2.2m)	($9.9m)	($9.9m)	($22m)
Step 2: Application of interest cap				
Actual net interest income/ (expense)	($1m)	($6m)	($15m)	($22m)
Interest cap	($2.2m)	($9.9m)	($9.9m)	($22m)
Permitted net interest income/ (expense)	($1m)	($6m)	($9.9m)	($16.9m)
Disallowed interest expense	*-*	*-*	*(5.1m)*	

As illustrated by the example above, in the absence of planning, it may be that the permitted interest deductions across the group are less than the external third party interest costs as a result of disallowances which may arise in individual entities and unused capacity in other entities.

If such rules are introduced, taxpayers will need to carefully assess the potential impact on their tax profile. The rules have the potential to impact a group's cash treasury management, cash tax position, effective tax rate and the ability to recognised deferred tax assets for disallowed or carried forward interest.

Group ratio

An alternative group test uses a particular financial ratio of a group (such as net interest to earnings, net interest to asset values or debt to equity) as the basis for determining the deductibility of interest expense and other financial payments of the group's members, as follows:

- Identify the group's financial ratio
- Where a group member's own ratio is below, or equal to, the group's ratio, all of its relevant expenses for interest and other financial payments should be deductible;
- To the extent the ratio is exceeded, deductions will be proportionately denied.

As a practical matter, both group-wide tests require the collection of group-wide data, and volatility in one part of the group may have a "knock-on" effect on the tax position of other members of the group.

Fixed ratio tests

The group-wide tests are designed to ensure that a particular entity's net interest deductions reflect the actual debt position of its group. These tests do not limit the interest deductions which are available to the group.

The Draft proposes that such group-wide rules may need to be supplemented with rules which impose an overall limitation on the quantum of allowable deductions for interest or other payments.

The premise 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. In Australia, taxpayers are already familiar with a fixed ratio approach: the safe harbour debt amount calculations in the thin capitalisation provisions. Other countries limit interest deductions to a percentage of say, EBITDA.

The Draft suggests there is some evidence that ratios currently employed by countries unilaterally are too high to discourage base erosion (perhaps supported by the recent tightening of the safe harbour debt levels in the Australian thin capitalisation provisions).

An integrated approach

The Draft considers that a combination of a group-wide test and a fixed ratio test, potentially supported by specific targeted rules, could be used to achieve the intended aims of Action 4.

	Approach 1	Approach 2
General rule	Group-wide interest allocation rule	Fixed ratio rule
Carve-out from general rule	For entities which meet a low fixed ratio test	For entities which meet a group ratio test

Approach 1: The general rule would permit each entity in the group to deduct interest expense up to its proportional interest cap. However, a particular entity within the group would not apply the interest cap if its debt levels meet the fixed ratio test.

Approach 2: The fixed ratio test could be adopted as a general rule. If the group is more highly leveraged and a group member fails the fixed ratio test, the entity could apply the group ratio, in which case, the interest expense would remain deductible provided that the particular entity's debt ratio did not exceed the group ratio.

Targeted rules

The OECD has a number of particular areas of concern such as

- interest payments to connected or related parties
- artificial debt, where no new funding is raised (eg, debt funded dividend)
- debt push downs
- certain stapled arrangements
- the use of debt to fund exempt or tax deferred income

Targeted rules may be required to address some or all of the above.

Questions for consultation

The Draft identifies 35 further issues on which consultation is sought by the OECD.

Timetable

Comments on the Draft are invited by 6 February 2015. A public consultation meeting will be held at the OECD in Paris on 17 February 2015. The second consultation document covering the transfer pricing aspects of debt will be published during 2015, but no date has yet been set (and that part of the Action is due for completion in December 2015).

Comment

The proposals in the consultation document are far-reaching and, if agreed to by the G20/OECD, will have major impacts upon traditional approaches to multinational financing.

It is clear that the introduction of group-wide tests could result in significant disallowed interest within a group.

Situations likely to be adversely affected include the following:

- Cash-rich or minimally leveraged groups that, nevertheless, create intragroup debt to fund subsidiaries' activities;
- Groups with subsidiaries in jurisdictions where it is not possible to push down interest (e.g. as a result of exchange control, future repatriation restrictions, commercial constraints, etc.) In this case "allocated" debt capacity remains unused;
- Groups with significant head office interest deductions but relatively small economic activity at the head office level, where the proposed allocation will result in only a small head office interest allocation;
- Groups that contain subsidiaries in regulated industries, where the regulatory model calls for a certain level of debt financing that may not be the same as in the remainder of the group; and
- M&A transactions. For example, if a parent company chooses to acquire a target financed through bank debt, then to obtain a full deduction for the interest expense, the parent would be required to push the debt down to each of its subsidiaries on a proportionate basis, and each of those subsidiaries would need to have the ability to absorb the interest deduction. In practice, a number of countries have rules in place that limit deductions for acquisition debt.

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