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Final report on BEPS Action 4: Interest deductions and other financial payments

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On October 5, 2015, ahead of the G20 finance ministers' meeting in Lima on October 8, 2015 the Organisation for Economic Co-operation and Development (OECD) Secretariat **published** thirteen papers and an Explanatory Statement outlining consensus Actions under the base erosion and profit shifting (BEPS) project. The output is intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the OECD Model Tax Convention and transfer pricing guidelines. They are broadly classified as "minimum standard", "best practices" or "recommendations" for governments to adopt. The OECD will be continuing its work on some specific follow-up areas in future years.

Included in the package is a final report on Action 4, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, which sets out a best practice approach for countries. Notably, it does not cover the transfer pricing aspects of financial transactions, which will be the subject of further work during 2016 and 2017.

Deloitte's comments

As became clear from the public consultations, the G20/OECD have concluded that the Action on interest restrictions should be a "best practice", which means that the Action will not be adopted by all countries participating in the BEPS project. The basic proposal is for a ratio-based cap using tax-adjusted earnings – but significant optionality is offered to countries adopting the Action.

It remains to be seen whether and how governments will implement this Action. Australia's government, for example, has suggested that it does not intend to do so. A number of continental European countries already have interest limitation rules which operate in a similar manner to the G20/OECD approach. It is thought possible that the United Kingdom could consult in the fall on whether and how to adopt the Action, given that it does not have general limitation rules.

The deductibility of interest relating to international operations has been a controversial issue in Canada for decades, and the subject of numerous studies and proposals. Canada ultimately chose to tighten its thin capitalization rules for inbound investment by non-residents and to introduce foreign affiliate dumping rules that have the effect of discouraging borrowing by Canadian subsidiaries of non-resident corporations if the borrowing relates to investments in foreign affiliates. However, proposed rules to restrict the deductibility of interest by all Canadian taxpayers in respect of investments in foreign affiliates were enacted but repealed before their effective date. Whether or not a Canadian government would be willing to revisit this debate and adopt this Action remains to be seen.

The options available to countries who do choose to adopt the Action are intended to ensure that full deductions are obtained for a group's net third party interest expense. It is clear from public data that many groups have third party debt in excess of the approved fixed ratio "corridor" or range. It is to be hoped that countries will take up the range of optional reliefs, albeit supplemented with targeted anti-avoidance rules, so as to try to ensure that effective tax relief is given for third party debt.

The measures are planned to apply to groups and also related parties. Where EU law or other similar approaches apply, the rules could also be applied to domestic or to standalone entities (especially where controlled by complex structures). The extent to which shareholder debt is brought into the limits will be important.

The G20/OECD countries have recognized that the importance of financing means that transition and grandfathering are appropriate. The recommendation is that multinational enterprises should be given "reasonable time" to restructure existing financing arrangements. The grandfathering provisions for existing third party loans are also welcome.

The optional exemption for public-interest infrastructure projects represents a negotiation between the countries involved – and may been seen as less generous that some would have preferred.

This Action is intended to apply after disallowances for hybrid mismatch arrangements (Action 2) and the recognition of income under controlled foreign corporation rules (Action 3). Transfer pricing rules will be developed in 2016 and 2017 which could limit interest payments to entities lacking appropriate substance (Actions 8-10).

It will be necessary for multinational enterprises to assess the extent to which the rules might oblige them to restructure during the transitional period. This will be difficult given the different approaches that jurisdictions may take to the various optional measures referred to above, and the uncertain timing of adoption by different jurisdictions. However the basic framework should allow groups to consider the possible impact and necessary actions.

Proposals to limit excess interest deductions

Fixed ratio rule

The recommended approach is based on a fixed ratio rule, to limit an entity's net deductions for interest and economically equivalent payments to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA).

The percentage restriction should be set by each jurisdiction at a single benchmark fixed ratio of between 10% and 30% of EBITDA. Factors which might indicate that a higher benchmark EBITDA ratio is appropriate – within the 10% to 30% corridor – include (i) the intention to operate the fixed ratio rule in isolation without a group ratio rule fallback; (ii) no carryforward or carryback of excess interest or capacity; (iii) higher interest rates compared to other jurisdictions; (iv) the existence of targeted rules; and (v) the obligation of a country to treat different types of comparable legal entities on similar terms even where they pose differing levels of risk.

The final report recognizes that entities in large groups are in a different position to other entities when raising third party debt and, therefore, there may be reasons to justify a higher ratio for small and medium sized groups. Conversely, sectors making excess profits might be subject to a lower benchmark fixed ratio.

It is notable that for these purposes, EBITDA is recommended to be a tax concept rather than an accounting concept. The starting point in calculating an entity's EBITDA is its taxable income, which should then be adjusted for (i) net interest expense and net payments equivalent to interest payments; and (ii) depreciation and amortization. Tax-exempt income, such as dividend income or foreign earnings that are tax-exempt, should not form part of the entity's EBITDA.

Jurisdictions have the option to choose an earnings measure other than EBITDA such as EBIT (in which case the ratio should be adjusted to arrive at broadly the same disallowance level as would the case under EBITDA) or, in exceptional circumstances, an assets-based measure instead.

Group ratio rule

Recognizing that some groups are highly leveraged with third party debt for non-tax reasons, and that the fixed ratio rule is a "blunt tool", the final report proposes a group ratio rule fallback.

A country may choose not to introduce any group ratio rule. However, where it does implement such a rule, it can choose to uplift net third party interest expense by up to 10%, to reduce the risk that some of a group's third party interest might be subject to disallowance.

A group ratio rule aims to match <u>net</u> interest expense within its consolidated group to economic activity, so that the group's aggregate tax deductions should not exceed its actual third party interest expense. The final report notes that a group ratio rule could be based on EBITDA, which has the advantage of equivalence with the fixed ratio rule. However, an assets-based measure could also be used.

The first stage in applying the group ratio rule is to calculate the worldwide group's net third party interest/EBITDA ratio, using third party interest and EBITDA figures from the audited, consolidated financial statements. Further work is required to determine the extent to which, if at all, the figures should be adjusted for tax items. Loss-making entities bring additional complexity, and more work is to be undertaken by the OECD to assess the most feasible options to deal with companies in this situation.

Other considerations

Finally, the recommended approach also allows countries to supplement the fixed ratio rule and any group ratio rule with targeted measures to prevent their circumvention through activities such as payments to related parties and back-to-back arrangements designed to inflate the group's finance costs with no equivalent economic cost. The OECD notes that other existing interest restrictions in individual jurisdictions – such as arm's length requirements – could have a role in supplementing the best practice approach.

Various exemptions are proposed in the final report to reduce the administrative burden on entities or situations deemed to pose lower BEPS risk, including a *de minimis* threshold to carve out entities with low levels of net interest (with jurisdictions given autonomy over setting the level of the threshold).

Entities to which the best practice approach should apply

At a minimum, the best practice approach should apply to all entities that are part of a multinational group. (Countries are encouraged to extend the rules to domestic groups and standalone entities.)

A group is a multinational group where it operates in more than one jurisdiction, and an entity is part of a group where it is included on a line-by-line basis in the consolidated financial statements of any company, or would be so included if that company prepared consolidated financial statements. Where a group has more than one entity in a particular country, the final report permits the ratio tests to be applied to the overall position of all group entities in the same jurisdiction - although EU law considerations may affect this.

Once entities to which the best practice approach applies have been identified, the final report states that the fixed ratio rule should generally be applied consistently to all interest paid to third parties, related parties and group entities.

For the purposes of the group ratio rule, countries are encouraged to adopt targeted rules to prevent group ratios from being inflated artificially by interest paid outside the group to related parties. Two persons (including individuals and entities) are related if they are not in the same group but they meet any of the following conditions:

- The first person has an investment that provides that person with effective control over the second person or there is a third person that holds investments which provide that person with effective control over both persons;
- The first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both; or
- They can be regarded as associated enterprises under Article 9 of the OECD Model Tax Convention.

Further, for the purposes of this related party definition, a person who “acts together” with another person in respect of the ownership or control of any voting rights or equity interests, will be treated as owning or controlling all of those voting rights and equity instruments. Acting together is defined widely, including family situations, funds and circumstances where equity investors proportionately lend into the group – which could impact shareholder debt in consortia where none of the non-controlling investors is connected to the other.

Transitional rules and grandfathering

Acknowledging that any rule to limit tax deductions for an entity’s interest expense could involve a significant cost for some entities, the OECD expects that a country introducing a fixed ratio rule and group ratio rule should give entities “reasonable time” to restructure existing financing arrangements before the rules come into effect. A country may also apply transitional rules which exclude interest on existing third party loans from the scope of the rules, either for a fixed period or indefinitely.

Addressing volatility and double taxation

There may be cases where the amount of interest expense in an entity exceeds that which is allowable merely as a result of a timing mismatch which will correct in a future period. This may arise, for example, where an entity incurs interest expense to fund a project or investment that will give rise to earnings in a future period. Under the best practice approach, there is no requirement for a country to allow an entity to carry forward or carry back disallowed interest expense or unused interest capacity. However, a country may choose to allow an entity: (i) to carry forward disallowed interest expense only; (ii) to carry forward disallowed interest expense and unused interest capacity; or (iii) to carry forward and carry back disallowed interest expense. The value of carryforwards could reduce over time (e.g., by 10% each year) or be otherwise restricted. Interest disallowances which arise under any targeted rules (including hybrid and other BEPS restrictions which are applied in priority to Action 4) should not be carried back or forward.

Where a country applies withholding tax to payments of interest, this should not be impacted by the application of the proposals in the final report. Where the best practice approach limits an entity’s net interest deductions, leading to an interest disallowance, there is no intention that the interest expense disallowed should be recharacterized for any other purpose.

An important issue under a best practice approach which links net interest deductions to the level of an entity's EBITDA is how to deal with volatility in earnings. One possibility proposed is to use average figures over, for example, a three-year period. This would make the rules more complex, but it could help address volatility.

Definition of interest and economically equivalent payments

The final report states that the best practice approach should be applied to: (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance. References to "payments" include accruals of income or expense. This encompasses payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, the finance cost element of finance lease payments, capitalized interest, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings, and certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance.

The final report is silent on the matter of preference shares, which are generally treated as economically equivalent to interest under most accounting practices. Interest imputed on funding transactions under transfer pricing rules should be included, but deemed deductions on equity are not within scope – the final report suggests that these should be the subject of separate work by the OECD.

Specific sectors – financial and infrastructure

It is recognized that the fixed ratio and group ratio rules are unlikely to be effective in addressing BEPS involving interest in the banking and insurance sectors. This is because of specific features of those industries. It is not, however, intended to exempt such entities from the best practice approach, and further work will therefore be completed during 2016 to identify targeted rules for banks and insurers. These will include rules for regulated banks and insurance companies within non-financial groups.

A country may choose to exclude interest expense incurred on specific third party - but not related party or group - loans to build or acquire privately-owned public-benefit assets financed using a high proportion of debt (e.g., infrastructure assets).

Next steps

It is expected that the G20 leaders will give final approval to the content of the paper in November 2015. It will then be for countries to consider whether to adopt some version of these measures into their domestic legislation.

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