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BEPS Action 4: Interest Deductions and Other Financial Payments

On 18 December 2014, the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (‘BEPS’), released a Discussion Draft on Action 4 in relation to the deductibility of interest expense and economically equivalent financing payments. The Discussion Draft outlines three main alternatives to tackle non-taxation through the use of interest deductions – deduction limitations based on group attributes; deduction limitations based on fixed economic ratios; and targeted anti-avoidance measures. It 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 CFC proposals in Action 3. Notably, it does not cover the transfer pricing aspects of interest deductibility, which will be covered in a separate consultation document.

As with other Discussion Drafts, the proposals do not represent a consensus view from the G20/OECD governments but are designed to provide preliminary but substantive proposals for public analysis and comment.

Deloitte Comments and Business Next Steps

The proposals in the consultation document are far-reaching and, if agreed by the G20/OECD, will make a major change to multinational financing. The proposals suggest that total interest deductions should be limited to the multinational group’s third party financing costs – which would be achieved through some form of allocation.

It is clear that the introduction of a group-wide limitations such as this could significantly increase the level of disallowed interest within a group, which must be an undesirable outcome.

Situations likely to be adversely affected include:

- Cash rich or minimally leveraged groups who nevertheless create intragroup debt to fund subsidiaries’ activities
- Groups with subsidiaries in territories where it is not possible to push down interest (e.g. as a result of exchange control, future repatriation restrictions, commercial constraints, etc.)
- Groups with significant head office interest deductions but relatively small economic activity at head-office level, where the proposed allocation will result in only a small head-office interest allocations.
- Groups which contain subsidiaries in regulated industries, where the regulatory model calls for a certain level of debt financing which may not the same as in the remainder of the group
- Groups that have historically made or are expected to make significant acquisitions. For example, if a parent company choses to acquire a target financed through bank debt then in order to obtain a full deduction for the interest expense it would be obliged to push the debt down to each of its subsidiaries on a proportionate basis, and each of those subsidiaries would need to have ability to absorb the interest deduction. In practice, a number of countries have in place rules which limit deductions for acquisition debt.

Group-wide limitations would also make forecasting and in-year tax payments more problematic, as entities would not know their interest deductions until the worldwide financial statements were available.

It will be vital that business provides sufficiently detailed input to the OECD, so that the economic effects of interest disallowance can be clearly observed and hopefully lead to a better final proposal.

Proposals to limit excess interest deductions – the 'general rule'

The objective of Action 4 is to identify coherent and comprehensive solutions to address base erosion through interest deductions and economically equivalent payments, for both inbound and outbound investments. The paper acknowledges 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. These might arise, for example, if different financing arrangements give rise to differing tax outcomes for transactions that are otherwise economically similar.

The Working Party identified six types of rule currently employed by tax authorities to tackle base erosion through interest deductions. Of these, three – arm's length tests which compare the level of interest or debt which an entity might have borrowed from a third party; withholding taxes to allocate taxing rights to the source country; and rules which automatically disallow a percentage of interest irrespective of the facts and circumstances – have been rejected on grounds of impracticality, evidence of ineffectiveness or inflexibility.

The remaining three types of rules are discussed as possible candidates to form the basis of a general deduction limitation rule, which the OECD intends to be widely adopted as a means to minimise risks of tax arbitrage between jurisdictions, either alone or in combination. Countries will be permitted to complement the general rule with jurisdictional specific anti-avoidance measures that take account of each country's domestic tax system.

Group wide tests to limit interest deductions

Group wide tests aim to match net interest expense within a group to economic activity, s that the aggregate tax deductions should not exceed the group's actual third party interest expense. The main advantages of group wide tests over other alternatives include flexibility to take account of specific facts and circumstances (whether for countries, industries or groups) and that they link interest deductibility to underlying economic activities. However, disadvantages include the need to collect group-wide data, and the fact that volatility in one part of the group will have a knock-on effect on other members of the group.

There are two types – interest allocation tests and group ratio tests. In theory, the outcome of both interest allocation rules and group ratio rules should be similar. One significant issue is that, in either case, many groups will find that the aggregated interest deductions across their group are less than their external third party interest costs as a result of disallowances in individual entities. This may be tackled in part by permitting the carry forward or backward of disallowed interest, or rules that allow excess capacity to be utilised.

Interest allocation tests work by calculating a cap on each entity's interest deductions ('interest cap') by comparing that entity's economic activity (measured by either its earnings or assets) with the group's overall position. There were strong policy objections to deemed interest allocations, which will not be considered further.

Group ratio tests compare a relevant financial ratio of an individual entity (such as net interest to earnings or net interest to asset values) with that of its worldwide group.

Issues which are still under consideration include:

- *The definition of group*: The consultation document leans towards the definition of group used for accounting purposes, to allow consolidated financial statements and local entity accounts to form the basis of the relevant tests, while recognising that this imposes a compliance burden on groups and entities which do not already prepare consolidated financial statements. There are also concerns that related party and connected party interest, which are not included in fiscal consolidations, could be used to manipulate the tests.

- *The definition of third party net interest:* Again, the consultation document favours using accounting definitions.
- *The measure of economic activity:* There are good economic arguments to support either an asset or an earnings based measure. Earnings measures are directly linked to the ability to pay interest expenses, but suffer from volatility. Asset based measures are less closely aligned to interest expenses, may involve complicated valuation issues particularly for internally generated assets, but are a more stable measure that is more readily within the control of an entity's management.

Fixed ratio tests to limit interest deductions

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, all but ensuring that a portion of an entity's profits remain subject to tax. The key advantage of a fixed ratio rule is that it is relatively simple to operate, relying only an entity's own financial position. Further, the test may be based on tax figures rather than book figures, so taxpayers do not need to incur additional compliance costs. It may also be possible to structure a fixed ratio test to take account of structured payments to non-group entities more readily than for a group wide test.

However, fixed ratios are a blunt tool; they do not flex for different industry segments or market conditions. Their success as a measure of tackling base erosion is dependent on the level at which the ratio is set. There is some evidence that ratios currently employed by countries unilaterally are too high to discourage base erosion.

As with the group-wide tests, a key question is whether the ratio should apply to a balance sheet measure or an earnings measure, and broadly similar considerations apply. Asset based measures may be particularly appropriate for inbound investment scenarios, which often involve the recipient not taxing income. For example, an asset based test that excluded equity investments would prevent many entities with tax exempt dividend income from claiming full interest deductions. Valuation remains a key concern.

Earnings-based measures, assumed in the consultation document to be EBITDA or EBIT based on historic precedent, have the key benefit 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 fitted 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.

A combined approach

The consultation document considers that a group-wide test could be combined with a fixed ratio test to achieve the 'best of both', perhaps supported by targeted rules. 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 apply a more complex group-wide test. This could also provide a solution for groups which 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 role of targeted rules

The extent to which targeted rules (e.g. in respect of stapled stock, excess push downs, interest payments to connected or related parties, and similar) will be required will depend upon the final design of the general rule. Should the Action 4 work not recommend a general rule, targeted rules will required. Targeted rules offer flexibility for different market conditions and industry sectors, but are inevitably reactive, requiring changes over time.

Other areas for consultation

Definition of interest and payments economically equivalent to interest

The consultation document takes the view that rules to tackle base erosion should apply to interest arising on all forms of debt, plus financing payments economically equivalent to interest and other expenses directly incurred in raising finance, while allowing countries some discretion in adopting appropriate local definitions. Payments economically equivalent to interest are those that are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal. The consultation document provides various examples, such as imputed interest on zero coupon bonds.

Entities to whom the rules should apply

The consultation document proposes that payments within a group, between connected parties (i.e. between entities under common control, such as private equity portfolio companies) and between related parties (broadly, a 25% ownership test, as in the hybrid mismatch proposals) could all be caught. It notes there are issues for both taxpayers and tax authorities in identifying related parties, and unhelpfully suggests that if related party information is too difficult to gather then the rules could be extended to unconnected parties.

Should the rules apply to debt or to interest?

Very broadly, the consultation document proposes that earnings-based limitation rules should apply to interest expense, while asset-based limitation rules should apply to debt. It prefers limitations to interest expense, with the corollary that the limitation rules should therefore be based on a measure of earnings. The rationale for this is that limiting the deductibility of interest most directly tackles base erosion risk, and that debt levels vary throughout a financial period and therefore may not be representative of an entity or group's interest expense.

Should the rules apply to entities' gross or net position?

The proposed rules could apply to gross or net interest. A gross income rule would be simpler, but risks double taxation (i.e. because a paying entity could suffer a disallowance while the recipient is taxed in full) unless allowance is made to allow disallowed interest to be otherwise utilised when conditions allow. On the other hand, a net income rule may not be triggered if the net interest expense is small despite the fact that a low level of net interest is not necessarily indicative that base erosion is not in place. The consultation document favours net interest rules.

Low-risk exemptions

The OECD rejects the idea of a blanket exemption for small and medium-sized entities on the grounds that such entities may nevertheless be heavily indebted. It recommends that a *de minimis* net interest level should be adopted, but once the *de minimis* is breached then all interest expense would come back into scope.

Treatment of non-deductible interest

Disallowing interest may give rise to double taxation. In some situations (particularly where the disallowance arises from temporary conditions) it may produce an unjust result. The OECD does not favour recharacterising disallowed interest as a distribution, due to withholding tax implications and the possibility that payments equivalent to but not actually interest may be included within the disallowance, which may not meaningfully be recharacterised in this way. Instead, the carry forward (but not backward) of disallowed interest or unused capacity is preferred. A time limit on carry forward may be needed.

Interaction with other areas of the BEPS action plan

There is clear interaction with Action 2 (hybrid mismatches), where a strong interest limitation rule may protect against hybrid mismatches. The OECD recommends that anti-hybrid rules should apply in priority to interest limitation rules to minimise the risk that entities will suffer two disallowances under the combined effect of both rules.

Effective interest limitation rules should encourage groups to spread interest expense more fairly and with more transparent links to economic activity. This should result in less interest expense in CFCs. Taken together, interest limitation rules and CFC rules may complement transfer pricing rules.

Timetable

Comments are invited by 6 February 2015. A public consultation meeting will be held on the Discussion Draft at the OECD in Paris on 17 February 2015 and registration details are available on the OECD website. 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).

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