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Discussion draft released on deductibility of interest expense

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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 nontaxation 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 summarizes 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. 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.

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 also should minimize distortions to competiveness and to investment decisions. These may 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 rules currently employed by tax authorities to tackle base erosion through interest deductions. Of these, three types (arm's length tests that compare the level of interest or debt that an entity could have borrowed from a third party; withholding taxes to allocate taxing rights to the source country; and rules that 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 minimize risks of tax arbitrage between jurisdictions, either alone or in combination. Countries will be permitted to complement the general rule with jurisdiction-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, so that the aggregate tax deductions do 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 the fact 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 of group-wide tests: interest allocation tests and group ratio tests. In theory, the outcome of both the interest allocation rules and the 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 carryforward or carryback of disallowed interest, or by rules that allow excess capacity to be utilized.

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 its 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 that still are under consideration include the following:

- ***Definition of group:*** The consultation document leans toward 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 recognizing that this imposes a compliance burden on groups and entities that do not already prepare consolidated financial statements. There also are concerns that related party and connected party interest, which are not included in fiscal consolidations, could be used to manipulate the tests.
- ***Definition of third party net interest:*** Again, the consultation document favors using accounting definitions.

- ***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 and 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, which all but ensures that a portion of an entity's profits remains 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 also may 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 jurisdiction 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 based on 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 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.

A combined approach

The discussion draft 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 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.

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, etc.) will be required will depend upon the final design of the general rule. Should the Action 4 working party not recommend a general rule, targeted rules will be 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 discussion draft 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 financing, 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 which the rules should apply: The discussion draft 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, based on a 25% ownership test, as in the hybrid mismatch proposals) all could be caught by the rules. 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.

Whether the rules should apply to debt or to interest: Very broadly, the discussion draft 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 average interest expense.

Whether the rules should 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 provision is made to allow disallowed interest to be otherwise utilized when conditions permit. On the other hand, a net income rule may not be triggered if the net interest expense is low, despite the fact that a low level of net interest is not necessarily indicative that base erosion is not present. The consultation document favors 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 level breached, all interest expense would come back into the scope of the rules.

Treatment of non-deductible interest: Disallowing interest may give rise to double taxation. In some situations (particularly where the disallowance arises from temporary conditions) disallowance may produce an unjust result. The

OECD does not favor recharacterizing 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 recharacterized in this way. Instead, the carryforward (but not the carryback) of disallowed interest or unused capacity is preferred. A time limit on carryforwards 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 minimize 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 on the discussion draft are invited by 6 February 2015. A public consultation meeting will be held 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).

Comments

The proposals in the consultation document are far-reaching and, if agreed to 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 limitation such as this could significantly increase the level of disallowed interest within a group, which would be an undesirable outcome.

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 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 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 the same as in the remainder of the group; and
- 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 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.

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

It is vital that business provides sufficiently detailed input to the OECD on the discussion draft, so that the economic effects of interest disallowance can be clearly understood, which hopefully will lead to an improved final proposal.