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OECD releases discussion draft on interest deductions under BEPS Action 4

Executive summary

On 18 December 2014, the Organisation for Economic Co-operation and Development (OECD) released a discussion draft under its Action Plan on Base Erosion and Profit Shifting (BEPS). The document, titled *BEPS Action 4: Interest Deductions and Other Financial Payments* (the Discussion Draft or the Draft), sets forth several alternative approaches to limiting deductions for interest expense. The principal approaches discussed are (1) a group-wide rule, which would limit a company's net interest deductions to a proportion of the group's actual net third party interest expense; (2) a fixed ratio rule, which would limit 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) certain combinations of these two approaches. The Draft also discusses the use of more targeted approaches. The Discussion Draft identifies benefits and drawbacks of the approaches considered, as well as key questions raised by each approach.

The Discussion Draft also discusses a range of technical, policy and industry sector issues relevant to the consideration of these approaches. The Draft includes a series of questions for consultation and provides examples of how the approaches described could apply.

Written comments on the Draft must be submitted to the OECD by 6 February 2015. A public consultation on the Draft is scheduled for 17 February 2015.

Detailed discussion

Background

The Discussion Draft indicates that Action 4 of the BEPS project arises out of government concern that multinational companies have the ability to erode their tax bases through excessive interest deductions. The Draft states that some entities in a multinational group may be excessively leveraged and parent companies may borrow to invest in assets that generate income that is deferred or exempt for tax purposes. The Draft expresses the OECD view that country limitations on interest expense deductions in place today have not been entirely effective, perhaps because countries do not want to adversely impact their attractiveness to foreign capital investment or to impair the ability of domestic groups to compete internationally. The Draft further states that a consistent approach for rules on the deduction of interest expense should allow multinationals to plan their capital structures with greater confidence (as the risk of unilateral changes would be reduced), reduce the risk of double taxation (e.g., situations where the creditor is taxed on interest income while the obligor is to deduct related interest expense), and make it possible to introduce group-wide systems and processes to produce the information required to implement the limitations.

Overview

The Discussion Draft reiterates the OECD's intention to develop recommendations for a best practice approach or approaches for countries to use to address concerns about BEPS through interest expense. This work will be completed by late 2015.

The Draft begins with a review of existing approaches used by countries to address BEPS concerns with respect to interest expense. The Draft then discusses a series of issues that are relevant to any approach for limiting interest deductions, including what constitutes interest or an economically equivalent payment, what entities should be subject to the limitation, whether the limitation should key off debt or interest expense and whether it should apply on a gross or net basis, and whether there should be a small entity exception or threshold.

As described in more detail below, the focal point of the Draft is an extensive discussion of options for limiting interest deductions through a group-wide rule, a fixed ratio rule, or a combination of the two approaches. The Draft also discusses use of a targeted rule approach to address specific concerns.

The Draft briefly discusses the treatment of interest that is non-deductible because of application of a limitation and the avoidance of double taxation. The Draft also touches on special considerations for specific industries, with a particular focus on the issues that arise for banks and insurance companies. In this regard, the Draft describes several ways in which the role of interest expense is different for banks and insurance companies than for businesses in other sectors. The Draft indicates the OECD's intention to develop a specific rule or rules for banks and insurance companies that focuses on the particular BEPS risks associated with those businesses. In addition, the Draft suggests that special considerations may also arise for other sectors, including oil and gas, real estate, and financial businesses other than banks and insurance companies, and for public infrastructure projects.

The Draft notes that the work on Action 4 will be coordinated with the work on several other BEPS Actions, including in particular the work on hybrid mismatch arrangements (Action 2), controlled company rules (Action 3), treaty abuse (Action 6), and transfer pricing for risk (Action 9). Also, additional work will be done under Action 4 on transfer pricing guidance with respect to related party financing transactions.

Finally, included in appendices are a list of specific questions identified for the consultation on the Draft, a discussion of EU law issues, and a series of examples illustrating the application of the options.

Group-wide rules for limiting interest deductions

Group-wide rules operate on two basic premises: 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. According to the Discussion Draft, these rules have, in theory, the greatest potential to address BEPS, because base erosion is controlled when a group cannot claim deductions for interest expense in excess of its actual interest costs and profit shifting is managed by linking interest deductions to a measure of economic activity such as earnings or asset values.

Two types of group-wide rules are addressed in the Draft:

- Group-wide interest allocation rules, which operate by allocating a group's net third party interest expense between group entities in accordance with a measure of economic activity (such as earnings or asset values)
- Group ratio rules, which compare a relevant financial ratio of an entity (such as net interest to earnings or net interest to asset values) to the equivalent financial ratio of the entity's worldwide group

Because group-wide rules take into account a group's real net third party interest expense, the Draft notes that the total amount of interest that can be deducted by each entity would increase or decrease to reflect changes in the group's actual interest costs. The Draft describes this approach as flexible to accommodate the funding positions of different groups, taking into account decisions of management, market conditions and sector specific issues. Since these rules do not impose any limit on how high the net interest expense of the group can be, the Draft suggests that a group-wide rule may need to be supplemented by targeted rules to address BEPS caused by excessive interest deductions on third party debt.

The Discussion Draft states that certain issues that would arise with a group-wide rule could be addressed through provisions for the carryforward of disallowed interest expense, or unused capacity to deduct interest, into future periods. For example, in a situation where a group is engaged in a range of activities, if the positions of entities in a group are not comparable, an entity whose interest expense, earnings or assets are not in line with the rest of its group may find either that it cannot deduct its full interest expense or that it is not fully utilizing its capacity to absorb interest deductions. Further, volatility in earnings or asset values in one part of a worldwide group could impact the ability of all group entities to deduct their net interest expense (e.g., a revaluation of intellectual property in one entity could result in an increase in the capacity of that entity to absorb interest deductions while other entities in the group would be able to deduct less even though their own financial position is unchanged).

Group-wide interest allocation rule

The Discussion Draft indicates that a group-wide interest allocation rule could operate in one of two ways.

- By providing each entity with a deemed interest expense, equal to an allocation of part of the group's net third party interest expense based on earnings or assets. The deemed interest expense allocated to each entity would be deductible; all interest actually paid or received by group entities would be disregarded. This is referred to as *a deemed interest rule*.
- Alternatively, by providing each entity with an interest cap, equal to an allocation of part of the group's net third party interest expense based on earnings or assets. An entity's net interest expense on intragroup and third party debt up to this cap would be deductible. Any net interest income received by the entity would remain subject to tax. This is referred to as *an interest cap rule*.

The Discussion Draft states that countries engaged in Action 4 agreed that if an interest allocation rule is included in a best practice approach, it should be based on the interest cap rule. The Draft further states that it is anticipated that a group-wide interest allocation rule would be implemented in substantially the same way in all countries. This would mean 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. The Draft notes that countries would have some flexibility in implementing the rule (e.g., taking into account whether they tax local entities separately or on a consolidated basis). However, the Discussion Draft acknowledges that because the method for calculating an allocation-based interest cap would need to be agreed to by all countries, mismatches likely would arise where the agreed approach does not align with a country's domestic tax system.

Group ratio rule

The Discussion Draft indicates that under a group ratio rule, where an entity's ratio is equal to or below that of the group, all of its third party and intragroup interest expense would be deductible. Any interest expense that takes the entity's ratio above that of the group would be disallowed.

The Draft states that a group ratio rule would typically be applied in two stages:

- First, an entity would calculate its group's ratio specified under the rule (e.g., net interest to earnings). For the purposes of determining this ratio, the interest amount would be the group's net third party interest expense after offsetting interest income.
- Second, an entity would compare this ratio against its own position to establish the maximum amount of net interest expense which it may deduct for tax purposes. Net interest expense above this maximum amount would be disallowed.

The Draft indicates that a group ratio rule should accommodate greater design flexibility than would be the case with a group-wide interest allocation rule. For example, each country could determine the amounts used to calculate the ratio in accordance with its domestic law. However, the Draft states that this flexibility could increase compliance costs (as ratios would need to be calculated across the group according to these differing standards) and open the door to further BEPS.

The Discussion Draft notes that some countries have introduced group ratio rules as part of their overall strategy to limit excess interest expense deductions, but such rules typically operate as a "carve out" so that, for example, a company whose debt/EBITDA (earnings before interest, taxes, depreciation and amortization) ratio does not exceed that of its worldwide group would not need to comply with the (possibly stricter) debt/EBITDA ratio allowed under domestic law.

Questions

Regardless of whether a group-wide interest allocation or a group ratio rule is adopted, the Draft notes that consideration needs to be given to a series of key questions, for which the Draft discusses pros and cons of alternative approaches and provides proposals:

- Which entities should be included in an interest limitation group?
  - The Draft discusses alternatives and proposes that a group rule should apply to entities in a financial reporting group required to prepare consolidated financial statements (or that would be included in financial statements for accounting purposes).
- How should a group's net third party interest expense be determined?
  - The Draft suggests that consolidated financial statements should be a good starting point for obtaining the necessary information.
- How should economic activity be measured?
  - The Draft includes a detailed discussion of earnings and asset based measures, setting out pros and cons associated with each.
- How should mismatches between accounting and tax rules be addressed?
  - The Draft discusses issues related to currency differences, permanent and timing differences, and filing deadline differences.
- How should cash pooling arrangements be treated?
  - The Draft suggests that the application of a group rule should not affect cash pooling.
- How should risks posed by connected parties and related parties be dealt with?
  - The Draft indicates that countries involved in the work agreed that "entities should not be able to use payments to connected or related parties to limit the effectiveness of group-wide rules."

Fixed ratio test for limiting interest deductions

The Discussion Draft also sets forth a fixed ratio test that would operate by reference to a fixed benchmark ratio of an entity's earnings, assets or equity (with a particular focus on earnings and assets). The Draft notes that this test would apply equally to all group entities unless exceptions are provided, which means that the benchmark would need to be set in a manner that would apply to all entities in all sectors.

The Discussion Draft states that 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, ensuring that a portion of an entity's profit remains subject to tax in a country. The underlying benchmark ratio is determined by a country's government and applies irrespective of the actual leverage of an entity or its group. Interest expense on third party or intragroup debt up to this fixed ratio is deductible, but any interest that takes the entity's ratio above this benchmark is disallowed.

The Draft states that this approach would offer simplicity of application by groups and tax authorities, but would have the disadvantage of being inflexible and divorcing the interest deductions at an entity level from the group's third party leverage.

Assets

In terms of selecting the benchmark ratio, the Draft explores the key advantages and disadvantages of linking interest deductibility to assets or to earnings. The Draft notes that an asset approach may provide more predictable outcomes as asset values are typically more stable than earnings. The Draft states that the key disadvantage of using asset values to limit interest expense is one of valuation. Where total assets are used, the Draft states that there is a risk of manipulation as cash could be contributed to an entity to inflate total asset values and generate additional capacity to deduct interest expense.

Earnings

The Draft notes that some countries use fixed ratios that consider interest in relation to a measure of earnings and notes that a key advantage to this approach is that a group should only be able to increase net interest deductions in a particular country by increasing taxable profits in that country. The Draft further observes that volatility of earnings is an important drawback to an earnings-based rule, as an entity may have difficulty predicting the amount of interest expense that will be permitted to be deducted from year to year. The Draft notes that this drawback may be mitigated through a provision to permit disallowed interest expense to be carried forward for a limited period.

The Discussion Draft also addresses the appropriate measure of earnings and cites EBITDA as the measure most commonly used by countries with earnings tests. The Draft notes that this approach would potentially favor capital intensive sectors. The Draft also discusses in detail the difficulties in determining the most appropriate benchmark ratio. For example, the Draft analyzes the group ratios of the largest non-financial services companies and cites data that appears to show that the actual leverage ratios of these companies is significantly less than the benchmark ratios (typically around 30%) used in countries that have adopted fixed ratio limits.

Questions

The Discussion Draft poses several questions for consultation relating to the fixed ratio approach:

- What practical issues arise in applying fixed ratio rules based on asset values or earnings?
- What would be the appropriate measure of asset values or earnings under a fixed ratio rule?
- For what reasons would the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios of its worldwide group?
- Would a fixed ratio rule pose particular problems for entities in certain sectors? If so, which sectors would be affected and how could this be addressed?
- What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?

Combined approach

The Discussion 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.

The Discussion Draft suggests, for example, that a country that uses a group-wide interest allocation test as its main rule might offer a carve out from this 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.

Implications

The Discussion Draft is the first draft of the output to be produced under Action 4 of the OECD BEPS project. The Draft focuses on the use of some type of group-wide rule (interest allocation or group ratio) or a fixed ratio rule. Either type of rule, if widely adopted, could have a significant effect on the cost of financing. Global businesses should evaluate how the proposed options may impact them, stay informed about developments in the OECD and in the countries where they operate or invest, and consider participating in the dialogue regarding the BEPS project and the underlying international tax policy issues.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services – Capital Markets, New York

- Lee Holt +1 212 773 9636 Lee.Holt@ey.com
- Karla Johnsen +1 212 773 5510 Karla.Johnsen@ey.com
- Colleen Zeller +1 212 773 6463 Colleen.Zeller@ey.com

Ernst & Young LLP, International Tax Services – Capital Markets, Washington, DC

- David Golden +1 202 327 6526 David.Golden@ey.com

Ernst & Young LLP (UK), International Tax Services, London

- Shaun P Lucey +44 797 970 8371 Slucey@uk.ey.com

Ernst & Young LLP, International Tax Services, Washington, DC

- Barbara Angus +1 202 327 5824 Barbara.Angus@ey.com

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