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BEPS action 4: Interest deductions and other financial payments

On 5 October 2015, ahead of the G20 Finance Ministers' meeting in Lima on 8 October, the OECD published 13 papers and an explanatory statement outlining consensus actions under the base erosion and profit shifting (BEPS) project (for prior coverage, see the tax alert dated 5 October 2015). These papers include and consolidate the first seven reports presented to, and welcomed by, the G20 Leaders at the Brisbane Summit in 2014.

The output under each of the BEPS actions 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 treaty and transfer pricing guidelines. The output is broadly classified as "minimum standards," "best practices" or "recommendations" for governments to adopt. The OECD will be continuing its work on some specific follow-up areas in future years.

As part of the 2015 output, the OECD has published a final report on action 4, which sets out a best practice approach for countries to prevent erosion of the tax base through the use of interest expense. Action 4 is focused on the use of third-party, related party and intragroup debt to obtain "excessive" deductions or to "finance the production of exempt or deferred income." Notably, the report does not cover the transfer pricing aspects of financial transactions, which will be addressed in a separate project during 2016 and 2017.

The final report on action 4 recommends an approach based on a fixed ratio rule, with a potential range of ratios to take into account that not all countries are in an equivalent position. The fixed ratio approach can be supplemented by a worldwide group ratio rule, as well as certain targeted rules.

The report acknowledges that, due to the potential costs to companies arising from changes to the interest deductibility rules, transition and grandfathering provisions are appropriate. More technical work will be carried out on specific areas of the recommended approach, such as details of the worldwide group ratio rule and specific rules to address risks posed by banking and insurance groups, which is expected to be finalized in 2016.

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Proposals to limit excess interest deductions: The recommended approach

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). Using the EBITDA approach will ensure that a portion of an entity's profit remains subject to tax in a country.

The percentage restriction should be set by each jurisdiction at a single benchmark fixed ratio of between 10% and 30% of EBITDA. Factors that may indicate that a higher benchmark EBITDA ratio would be appropriate (within the 10%-30% range) include the following: (i) the country intends to operate the fixed ratio rule in isolation, rather than operating the rule in combination with a group ratio rule; (ii) the country disallows the carryforward of excess interest capacity or carryback of disallowed interest expense; (iii) the country has higher interest rates compared to other jurisdictions; (iv) the country has other targeted rules that address BEPS concerns under action 4; and (v) the country is obliged for other reasons (e.g. constitutional reasons, EU law) to treat different types of comparable legal entity on similar terms, even where they pose differing levels of risk.

The final report on action 4 recognizes that entities in large groups are in a different position than other entities when raising third-party debt and, therefore, to create a level playing field there may be reasons to justify a higher ratio for small and medium-sized groups. Conversely, sectors making excess profits may 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 then should 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 figure.

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 be the case under EBITDA) or, in exceptional circumstances, an assets-based measure.

Group ratio rule: Recognizing that some groups are highly leveraged with third-party debt for nontax reasons, and that the fixed ratio rule is a "blunt tool," the final report goes on to propose a group ratio rule "fall-back."

The group ratio rule could be introduced as a separate rule or as an integral part of an overall rule that includes a fixed ratio rule. A country may choose not to introduce a group ratio rule. However, where it does implement such a rule, it may 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 may be subject to disallowance.

A group ratio rule aims to match *net* interest expense within a 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 also could 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 EBIDTA figures from 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 create 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: The recommended approach also allows countries to supplement the fixed ratio rule and any group ratio rule with targeted rules to prevent their circumvention, such as where payments are made to related parties and back-to-back arrangements are 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 to play within a jurisdiction's tax system in supplementing the best practice approach.

The final report proposes various exemptions 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

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

A group is a multinational group if 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 this may be affected by EU law.

Once entities to which the best practice approach applies have been identified, the final report states that the fixed ratio rule generally should 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) will be deemed to be related if they are not in the same group but they satisfy any of the following conditions:

- The first person has an investment that provides that person with effective control of the second person, or there is a third person that holds investments that 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
- The two persons can be regarded as associated enterprises under article 9 of the OECD model tax treaty.

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 broadly to include family situations, funds and circumstances where equity investors proportionately lend into the group that could impact shareholder debt in consortia where none of the noncontrolling investors are connected to each other.

Addressing volatility and double taxation

There may be cases where the amount of interest expense in an entity exceeds that which is allowable, merely because of a timing mismatch that 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 only disallowed interest expense; (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 could otherwise be restricted. Interest disallowances that arise under any targeted rules (including hybrid and other BEPS restrictions that are applied in priority to action 4) should not be carried back or forward.

Where a country applies withholding tax on interest payments, this should not be affected 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 that links net interest deductions to the level of an entity's EBITDA is how to address volatility in earnings. One possibility proposed is the use of average figures over, for example, a three-year period, which would make the rules more complex, but 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" also include accruals of income or expense. This includes 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 generally are 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 the 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, because of specific features of those industries. However, it is not intended to exempt such entities from the best practice approach, and further work will be completed during 2016 to identify targeted rules for banks and insurers. These will include rules for regulated banks and insurance companies within nonfinancial groups.

A country may choose to exclude interest expense incurred on specific third-party loans, 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).

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 a group ratio rule should give entities reasonable time to restructure existing financing arrangements before the rules come into effect. A country also may apply transitional rules that exclude interest on existing third-party loans from the scope of the rules, either for a fixed period or indefinitely.

Comments and business next steps

As became clear from the public consultations, the G20/OECD have concluded that the action on interest deduction 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, although countries adopting action 4 will have considerable range of options to achieve the intended objective.

Reactions of governments should be monitored to see whether and how they intend to take forward this action. Australia's government has indicated in its initial reaction to the BEPS package that it does not intend to implement action 4. A number of continental European countries already have interest deduction limitation rules that operate in a manner similar to the G20/OECD approach. It is possible that the UK will consult in the near future on whether and how to adopt action 4, given that it does not have general interest deduction limitation rules.

The options available to countries, as outlined in the final report on action 4, 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 measures, to try to ensure that effective tax relief is provided for third-party debt.

The measures are planned to apply to groups and related parties. Where EU law or other approaches apply, the rules also could 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 final report recognizes that the importance of financing means that transition and grandfathering provisions are appropriate. The recommendation is that multinationals should be given “reasonable time” to restructure existing financing arrangements. The grandfathering provisions for existing third-party loans also are welcome.

The optional exemption for public-interest infrastructure projects represents a negotiation between the countries involved. Nevertheless, it is hoped that most private finance initiative projects and certain borrowings for regulated utilities should be capable of qualifying for the exemption.

Action 4 is intended to apply after disallowances for hybrid mismatch arrangements (action 2) and the recognition of income under controlled foreign company rules (action 3). Transfer pricing rules will be developed in 2016 and 2017 that could limit interest payments where entities lack appropriate substance (actions 8-10).

Groups will need to assess the extent to which the rules might require them to restructure during the transitional period. This will be difficult given the different approaches that jurisdictions may take to the various optional measures, and the uncertain timing of adoption by different jurisdictions; however, the basic framework should allow groups to consider the possible impact and necessary actions.

The G20 leaders are expected to give final approval to the content of the final report on action 4 in November 2015. It then will be up to countries to adopt some version of these measures into their domestic legislation.
