OECD issues final report with recommendations on a best practice approach to interest limitation rules (BEPS Action 4)

30 October 2015

In brief

The OECD has published its final report on the base erosion and profit shifting (BEPS) Action Plan item 4 dealing with interest deductibility. The aim of Action 4 is to produce recommendations for best practice rules to prevent BEPS through the use of interest expense, although they do not represent a minimum standard.

The report concludes on a recommended approach based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its EBITDA. The report suggests a range of acceptable fixed ratios between 10%-30%, with factors identified for countries to determine their appropriate fixed ratio.

Along with the fixed ratio rule, the paper identifies optional rules that territories could adopt. Principally this includes a group ratio rule that would allow an interest expense deduction in a territory up to the group net interest/EBITDA ratio, thereby potentially exceeding a territory's fixed ratio for highly leveraged groups. The paper also considers alternative group ratio rules, such as those already adopted by Germany.

Other optional elements for territories to consider include the introduction of a de minimis threshold, the carry-forward of unused capacity or disallowed interest expense, and targeted rules.

Given the flexibility afforded by the recommendations, there likely will remain a variety of different approaches to target interest deductibility. Furthermore, a number of territories (e.g., Australia and Germany) may feel little or no need to amend their current rules in this area.

The report identifies areas for further work, including more detailed work on the group ratio rule, transfer pricing aspects of financial transactions and specific rules for banking and insurance groups. It also indicates that the OECD intends to review the impact that fixed ratios have had on interest deductibility and BEPS by 2020.

In detail

Background

The final report further develops a number of key themes from the initial discussion draft released in December 2014. In addition, it does not include any of the surprising conclusions expected following interim OECD webcasts and public consultation.

The report reminds readers of the three key scenarios viewed as BEPS risks in this area:

- groups placing higher levels of third party debt in high tax countries
- groups using intragroup loans to generate interest deductions in excess of third party interest expense
- groups using debt to fund the generation of tax exempt income.

What is apparent from the final report is that whilst the territories have reached a broad consensus, it is not uniform across all areas. Consequently there is no 'minimum standard', but instead there are best practice recommendations based on a common agreed approach. It will therefore be necessary to see what changes individual governments choose to make. However, a number of territories (e.g., Australia and Germany) may feel little or no need to amend their current rules in this area.

Notably, since the release of the paper the United Kingdom has issued a consultation document regarding what measures might be appropriate in any UK adoption of such a rule. China currently plans only to refer to Action 4 in improving its thin capitalisation rule (which applies solely to related party loans) to clarify the interest to which it applies, to consider appropriate debt-equity ratios for different industries and to explore the possibility of carrying forward and carrying back any non-deductible expense (see our China News Flash).

Fixed ratio rule

The report concludes that a best practice approach to deal with BEPS risks in this area is a fixed ratio rule. The rule would limit net deductions for interest and payments economically equivalent to interest to a fixed proportion (10-30%) of tax-adjusted earnings in a territory. EBITDA or EBIT are likely to be the most commonly used earnings measures, although these should be adjusted for tax exempt income (e.g., dividends, branch profits) to prevent financing of exempt income. The paper also notes that an asset based ratio may be an acceptable alternative in limited circumstances.

The fixed ratio that a territory adopts should be determined after considering many factors, including: the level of additional rules that might allow groups to benefit from a deduction in excess of this fixed ratio (see below regarding group wide ratio rules), the level of interest rates in the relevant territory (e.g., high interest rate economies might choose a higher fixed ratio) and the number of targeted rules also in place in that territory.

The OECD notes that a country should not deliberately adopt a higher fixed ratio under a policy to attract international investment due to lenient interest deductibility rules.

Within Annex B the paper summarises the net interest to EBITDA of publicly listed groups. It attempts to justify the proposed fixed ratio range on the basis that 87% of these groups would, in principle, be able to deduct all of their net third party interest expense if a 30% fixed ratio was adopted globally. There are two keys issues with this assessment:

1. The data is based on publicly listed groups which may represent the wider business population, and
2. The data assumes that these groups are already equally leveraged in every single territory, or that they could be, i.e., that they have a 30% interest-to EBITDA ratio in each and every territory that would adopt these rules

The reality is that these issues will mean this data does not represent the vast majority of groups, and groups will have to reassess their capital structures globally in order to still obtain a deduction for this third party interest expense.

Group-wide ratio rule

The paper provides an option for a group-wide ratio rule. This would allow groups that are more highly leveraged to deduct net finance expense in excess of the fixed ratio.

Such a rule would aim to align the net finance expense within a territory to the proportion of consolidated earnings derived in that territory. It would require companies in a territory to compare their interest-to-EBITDA-ratio to that of the group.

In order to limit the risk that a group would not be able to claim a deduction for all of their external interest expense, the group could apply a 10% uplift to its external finance costs in this calculation.

As with the initial discussion draft, there remain various areas for further work. There are also areas where mismatches could arise between accounting and tax definitions in such a calculation, leading to a real risk of double taxation.

Targeted rules

The paper includes a chapter specifically on targeted rules, split between those aimed at avoidance of general rules and those aimed at addressing other BEPS risks.

One recommendation is that territories should consider rules to prevent avoidance and/or manipulation of fixed ratio or group ratio rules, e.g. introducing group companies that would 'break' a group for the purposes of determining the group ratio rule.

The list of recommended areas for targeted rules is wide-reaching. How will territories choose to introduce such rules to interact with the wider fixed ratio recommendations? Some territories already have purpose-based anti-avoidance provisions. These might make it challenging to achieve the OECD's intended aim of realigning debt within a group in proportion to earnings.

Other optional elements

With the intention of reducing the risk of double taxation and volatility in interest deductibility, the paper recommends other optional elements that territories might consider introducing alongside the fixed and group ratio rules, including:

- a *de minimis* threshold below which all net finance expense is deductible in a territory (the UK consultation document mentioned above initially suggests £1m and Australia recently increased this threshold to AUD 2m),
- carryforwards of unused interest capacity (e.g., where an entity had lower net finance expense than its earnings would have allowed), and
- carry forward or back of disallowed interest expense (e.g., where an entity is loss making in a given year but profitable in others).

The paper also includes an option for territories to exclude certain public-benefit projects from the scope of a fixed ratio rule where the finance for these projects is third party debt.

The initial discussion draft excluded arm's length tests. However, the paper states that territories may continue to apply an arm's length test along with the best practice approach.

Interest and amounts economically equivalent to interest

The OECD still intends that the rules discussed here apply not only to interest expense but also amounts economically equivalent to interest. Such a definition could be wide reaching and hard to apply in practice. This was evident when the United Kingdom introduced its 'worldwide debt cap' legislation with difficulties in how to include amounts payable under derivative contracts, for example.

The final report includes examples of amounts that should be captured by a fixed ratio rule, including payments under certain derivatives, foreign exchange in certain situations, guarantee payments and amounts payable in relation to finance leases. The report clarified that these rules should not target notional deductions on equity

Groups and related party debt

As a minimum, the OECD concludes that these rules should apply to all multinational groups. It also notes that territories should not discriminate between domestic-only groups and multinationals. In particular EU territories should heed EU law when drafting any proposals regarding interest deductibility.

There is also a question about whether to apply these rules on a company-by-company basis, or on an aggregated basis where there are multiple companies in the same territory, considering the interaction with tax groupings.

Lastly, the report considers that both the fixed ratio and group ratio rules should apply to third party and related party debt. Related party debt in this context is widely drawn, including situations where two companies are not in the same group but they are otherwise connected e.g., by an individual, or indeed situations where persons are 'acting together'. This could therefore catch a number of fund structures and family-owned businesses, such that shareholder debt will be pulled into the fixed ratio limit.

Interaction with other BEPS Actions

The report concludes that Action 4 should be applied after Action 2, which deals with hybrid mismatches. It also concludes that any disallowance under Action 4 should not recharacterise the interest (or equivalent) payment for the purposes of withholding tax.

As noted above, the paper specifically carves out of Action 4's scope any notional deductions on equity. However the paper does note that the OECD should separately consider such rules. Equally, the paper notes the need for further work on the transfer pricing aspects of financial transactions. The paper references the need to consider limiting the amount of interest payable to companies lacking appropriate substance to no more than a risk-free return on the funding provided. The OECD will undertake further work on the transfer pricing aspects of financial transactions in 2016 and 2017.

Transitional rules

The report's final section deals with implementing the best practice recommendations. Territories introducing new rules in this area should consider giving groups sufficient time to restructure their arrangements before the rules take effect. This could, for example include a grandfathering provision for third party debt for a certain period of time. This would be a welcome inclusion in any new rules given the level of restructuring that most groups may require.

The takeaway

There likely will be a wide variety of responses with regard to restrictions in the relief for interest and other financial payments. Therefore, groups should monitor proposals and legislative changes in their relevant territories, especially to reduce the risk of double taxation. Surplus cash in territories, in particular, could cause double taxation as it will not reduce the disallowance of interest.

Groups likely will need to restructure their intra-group financing arrangements in order to deduct, for taxes, any third party finance expenses. In a majority of cases there will be a number of local tax, commercial, legal and treasury considerations when trying to introduce debt into territories. Groups should therefore assess and model the potential impact of these rules on their structures now.

Groups should also consider the impact of these rules when modelling tax projections, in particular for M&A transactions, given the risk that historic assumptions regarding deductibility of third party debt may no longer be valid.

Let's talk

For a deeper discussion of how these issues might affect your business, please call your usual contact. If you don't have one or would otherwise prefer to speak to one of our global specialists, please contact:

Interest deductions (Action 4)

Bernard Moens, *New York*
+1 (646) 471 6787
bernard.moens@us.pwc.com

Neil Edwards, *London*
+44 (0) 20 721 32201
neil.edwards@uk.pwc.com

Peter Collins, *Melbourne*
+61 (3) 8603 6247
peter.collins@au.pwc.com

Krishnan Chandrasekhar, *Chicago*
+1 (312) 298-2567
krishnan.chandrasekhar@us.pwc.com

Tim Anson, *Washington*
+1 (202) 414-1664
tim.anson@us.pwc.com

Michael Urse, *Cleveland*
+1 (216) 875-3358
michael.urse@us.pwc.com

Suchi Lee, *New York*
+1 (646) 471-5315
suchi.lee@us.pwc.com

BEPS generally

Richard Collier, *London*
+44 (0) 20 7212 3395
richard.collier@uk.pwc.com

Stef van Weeghel, *Amsterdam*
+31 (0) 88 7926 763
stef.van.weeghel@nl.pwc.com

Pam Olson, *Washington*
+1 (202) 414 1401
pam.olson@us.pwc.com

Phil Greenfield, *London*
+44 (0) 20 7212 6047
philip.greenfield@uk.pwc.com