Tax Policy Bulletin
Tax Insights from International Tax Services

OECD releases discussion draft on interest deductions in banking, insurance sectors

9 August 2016

In brief

On 28 July the OECD released a discussion draft relating to deductions for interest in the banking and insurance sectors. This is part of the ongoing work for BEPS Action 4, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, which was released as a final report in October 2015.

The discussion draft does not set forth overly prescriptive rules, but rather describes potential ways to address interest for two basic categories: the first category consists of banks and insurance companies, and the second category consists of entities in a group that includes a bank or insurance company.

The first category recognizes that the banking and insurance sectors differ markedly from other industries with respect to interest. To banks, interest essentially is cost of goods sold. To the insurance sector, while having a different business model with lower leverage than banks, interest income is generated by investment of premiums. Both sectors are highly regulated, and while the discussion draft considers whether the increased focus on more robust regulatory capital requirements should be sufficient to provide an ordinary-course type exception, the discussion draft does not propose this. Moreover, the rationale for separate treatment of the banking and insurance sectors appears to be because the rules prescribed in the final report would be ineffective, not because such rules could have commercial implications and other government agencies are regulating the balance sheet. At the same time, there are several changes that could be made to the discussion draft to improve the final product, some of which are discussed in the observations below.

The second category – groups that include a bank or insurance company, along with a significant non-bank or insurance group – occupies much of the draft, including all five examples in the Annex.

Comments are due by 8 September 2016. Groups with, and groups of, banks or insurance affiliates should consider the implications of the proposals and respond accordingly. Note that the draft is not a consensus view of the OECD' Committee of Fiscal Affairs (CFA) or its subsidiary bodies; rather, it is meant to trigger comments to the OECD to advance its work.

In detail

Background – October 2015 final report

The final report recommends an approach based on a fixed ratio rule that limits an entity's net deductions for interest (and payments economically equivalent to interest) as a percentage of its EBITDA (earnings before interest, taxes, depreciation, and amortization) and suggests a range of acceptable ratios between 10% - 30% (see our 30 October 2015 Tax Policy Bulletin). The fixed ratio rule can be supplemented by a group ratio rule to allow flexibility and address certain situations where the fixed ratio rule inappropriately would limit interest expense. Since a formula-based anti-abuse rule can pose challenges and limitations even if viewed as straightforward, another discussion draft on the application of the group ratio rule was published on 11 July 2016 to gather comments from stakeholders (see our 29 July 2016 Tax Policy Bulletin).

Chapter 10 of the final report recognizes that the circumstances of the banking and insurance sector require special caution, and careful study and deliberation, in the context of developing rules with respect to debt-equity issues and the deductibility of interest on debt, in order to avoid unintended adverse regulatory and commercial consequences. Paragraph 16 of the final report states that the fixed ratio rule should not prevent businesses from raising the debt finance needed for their business. The discussion draft reflects some of these additional considerations uniquely required for banking and insurance companies.

In the final report on Action 4, Chapter 10, the OECD describes the need for a separate discussion draft for the banking and insurance sector:

"183. In developing a best practice approach to combat base erosion and profit shifting involving interest, a number of particular features of groups in the banking and insurance sectors need to be taken into account.

"184. An important consideration is that the role interest plays in a banking or insurance business is different to that in other sectors. Banks and insurance companies hold financial assets and liabilities as an integral part of their main business activities. In addition financial sector businesses in most countries are subject to strict regulations which impose restrictions on their capital structure….

"190. It is not intended that entities operating in the banking and insurance sectors, or regulated banking or insurance entities within non-financial groups, should be exempted from the best practice approach to tackle base erosion and profit shifting involving interest. Instead, in order to tackle base erosion and profit shifting by groups in all sectors, it is essential that a best practice approach include rules which are capable of addressing risks posed by different entities. Further work will therefore be conducted to be completed in 2016, to identify best practice rules to deal with the potential base erosion and profit shifting risks posed by banks and insurance companies, taking into account the particular features of these sectors. This will include work on regulated banking and insurance activities within non-financial groups (such as groups operating in the manufacturing or retail sector). In particular, it is crucial that any recommended interest limitation rules do not conflict with or reduce the effectiveness of capital regulation intended to reduce the risk of a future financial crisis…."

Furthermore, while not a stated reason for a carve-out for banks and insurance companies, paragraph 57 of the final report states that the artificial separation of taxable income from the underlying activities that drive value creation is a key cause of base erosion and profit shifting. The goal of the fixed ratio rule is to link the amount of interest expense to the income produced by the value creation. ***Observation:*** This approach is not relevant for banks as interest expense is part of their core business and not peripheral.

Discussion draft of 28 July

After the introduction, the draft is made up of two segments:

- Banks and Insurance Companies
- Entities in a Group with a Bank or Insurance Company

The draft contains three Annexes:

- Annex 1 – Summary of questions where the OECD is seeking consultation
- Annex 2 – Short summary of the capital regulation for banks and insurers
- Annex 3 – Five examples, all focused in entities in group with a bank or insurer

Banks and insurance companies

Regulatory regimes and excessive leverage

The draft's discussion for regulated banks and insurance companies describes the non-tax regulatory regime, which largely is targeted at ensuring that there is not excess leverage, but that there is sufficient liquidity, in the entities. The draft also explains the inherent leverage in the banking model for using short-term deposits to make loans, and the likelihood that banks, despite the high

leverage, will generally have net interest income, as necessary to remain viable. The draft concludes that it is not expected that BEPS risk from excessive leverage in banks or insurance companies is expected to be an issue for the majority of countries; hence, there is no need to develop a single common approach to deal with the risk. Instead, the final report on BEPS involving interest in banks and insurance companies will include a summary of the approaches currently applied by countries.

Observations: Non-tax financial regulators, focus more on the balance sheets than on the tax impacts of debt that occur in the income statements and tax return. The regulators' concern is on the solvency and soundness of the bank and insurance company institutions that they regulate. When the financial regulators reach a conclusion on the required amount of capital, they are validating an institution's capacity to borrow. There is no industry in which the composition of the balance sheet is more carefully reviewed and stress-tested than banks and insurance companies. In addition, after the financial crisis, the banking and insurance industries have become subject to more scrutiny, rules, and restrictions.

The implications of many central banks' expansionary monetary policies of NIRP and ZIRP (negative interest rate policy and zero interest rate policy) have not been factored into BEPS Action 4. However, the overall low-rate environment created by government officials with monetary policy authority may have the effect of reducing the BEPS Action 4 pressure on their government colleagues (the tax authorities) responsible for enforcing the fiscal health of the government. At the same time, this environment is causing other problems, such as the need for more assets (and therefore debt) in order to produce equivalent income levels, a decrease in profits overall, and a unique US issue with Federal Reserve deposits (the Treas. Reg. sec. 1.882-5 issue).

Regulated investment banks and securities dealers

The draft also discusses the possibility of regulated investment banks and securities dealers having net interest expense, since these entities may be debt funded. However, the income they generate will not be similar to a commercial bank's loan interest. Rather, the investment bank will generate principal transaction revenue from trading, and other non-interest fees and commissions.

***Observation*s**: This is an interesting point, although a quick examination of investment bank balance sheets and income statements still shows a slight positive interest margin. One approach might be to distinguish, and remove, the collateralized securities-based financing activities of banks and dealers. The GAAP rules generally require a balance sheet gross-up of both assets and liabilities, despite the general over-collateralisation provided in securities loans and repos. Removing the collateralised securities-based financing would significantly reduce the leverage in both banks and dealers.

One issue that also may impact net interest income, and put pressure on the margin, is the need to maintain high-quality liquid assets (HQLA) in a liquidity buffer. The regulated bank's or dealer's cost of funding the HQLA will have a negative impact on the net interest margin. If this is the case, this is another reason to provide an industry carve-out, since the negative yield created by the regulatory mandated liquidity buffer is a reason for having, at least directionally, net interest expense.

Permanent establishments of banks and insurance companies

The discussion draft addresses the impact of Action 4 on permanent establishments (PEs) and seeks comments on whether other issues should be considered that might impact the free capital for banks and insurance companies. However, it does so after already concluding that the initial BEPS risk with respect to the fact that PEs do not have legal capital is limited due to the OECD's 2010 Report on Attribution of Profits to Permanent Establishments (which outlines how to deal with free capital through several alternatives).

The Authorized OECD Approach (AOA) outlined in the 2010 report is not overly prescriptive in providing how to mechanically adjust the balance sheet and resulting interest expense after the attribution of capital, which can lead to varying interpretations and results. The AOA also gives effect to inter-branch transactions, which presumably are not of concern to financial regulators. Paragraph 25 of the discussion draft points out that the regulatory capital rules in the home and host countries may vary. In the AOA, the host country generally determines the attributed profit, and the home country has to decide how best to deal with this via either its exemption or credit system. The OECD invites comment on this home versus host country differential.

The discussion draft acknowledges that each country should assess its own BEPS risk to PEs, which could be important especially as not all countries have incorporated the AOA into their domestic law. For example, while the United States has adopted the AOA in some of its income tax

treaties, US domestic law still provides for a safe harbor of five-percent capital and allocates global interest expense to the PE, which is not subject to the arm's-length standard.

Interest expense funding non-taxable income in a bank or insurance company

This section of the discussion draft summarizes how equity is less flexible than debt, and how regulators limit the use of equity double leverage or double gearing used by banks and insurance companies. Despite these regulatory limits, the draft expresses concern with, and seeks feedback on, cases where a bank incorporates equity-funded vehicles in low-tax jurisdictions that are used to invest in portfolio investments. Income in these vehicles is subject to low or no taxation, while the interest expense on the debt funding the subsidiary is set against taxable interest income in the banks. The OECD encourages countries that have identified such a concern to consider introducing measures to deal with this kind of risk.

Observations: One tool that could be used here is BEPS Action 3, a controlled foreign company (CFC) regime that would include the income earned by the subsidiary in the low-tax jurisdiction, unless there were sufficient substance and people functions in the low-tax jurisdiction. It is somewhat instructive that Action 3 was not mentioned; there seems to be a view, especially in the EU, that no CFC regime is fit for the BEPS purpose, as opposed to the best available tool. By contrast, in 1998 the OECD's preferred option to deal with harmful tax competition was a CFC regime.

The draft puts forth several options, including:

- Disallowing the interest expense at the bank parent level insofar as used to fund non-taxable income
- Reducing the income that benefits from a participation exemption or other beneficial tax regime to reflect the value of the interest funding the income
- Turning off the participation exemption or beneficial regime in certain circumstances, and
- Looking to link up the regulatory capital rules to inform the tax treatment.

Observations: A CFC regime would seem to be the most direct route. Each alternative described in the report would add additional complexity to an already overly complex international tax regime. Disallowing the interest expense at the parent level raises the question of how that would be done — direct tracing, some pro-rata test, or what to include exclude from a pro-rata test.

Entities in a group with a bank or insurance company

The discussion on how best to apply the EBITDA ratio to a group that includes a bank or insurance company centers on how to ensure that the net interest income of such an entity is not used to reduce or eliminate the effectiveness of the fixed ratio rule for entities operating other types of businesses. While BEPS risks in regulated banks and insurance companies might be mitigated by reliance on the non-tax regulatory regime, as discussed above, the BEPS Action 4 risks in non-regulated entities may not be easily mitigated, or could present a higher hurdle.

The draft acknowledges that in the context of the fixed ratio rule, an entity-by-entity approach poses little risk. However, if a country chooses to adopt a consolidated local group fixed ratio rule or to allow surrender or unused interest capacity or disallowed interest expense within a group, modifications may be required.

In this instance, the draft suggests a country should consider applying the rule to the local group excluding banks and insurance companies or split the entities into regulated and non-regulated groups. Problems still may arise if there are other entities with net interest income, such as those engaged in providing finance leases to customers, or that incur interest expense on third-party loans used to support regulated activities in a bank or insurance company within the group while the income of those activities is excluded. The draft broadly advocates that countries should aim to match the treatment applied to regulatory capital and to the income arising from the associated investment activities.

The draft also discusses the practical difficulties of extracting the data necessary to properly produce a group ratio calculation, especially if certain items are excluded, such as regulated entities and regulatory debt funding. However, the paper does not address whether it is correct to exclude interest income and expense from the EBITDA calculation where interest forms a fundamental part of 'earnings.'

Observations: The examples in Annex 3 show how this approach would work; however, they are hypothetical, and assume significant levels of EBITDA excluding the interest income of the financial services business. It remains to be seen how realistic the examples are. If the five examples in Annex 3 emerge in a final report, they also could be a road map to refinance the global

group without crossing the line of base erosion and profit shifting.

The inclusion in Example 5, in which all the debt funding is external and therefore presumably at arm's length, may seem unusual. However, the final October 2015 report views higher levels of third-party debt in high-tax countries as a BEPS risk. That said, Example 5 does not disclose the tax rates in the borrower and lender jurisdiction. Arguably without this rate differential, and only arm's-length third-party debt involved, there should be no BEPS Action 4 issue present in Example 5. In addition, in the 1998 Harmful Tax Competition report, merely having different tax rates was not deemed an indication of harmful competition. The OECD, as part of the BEPS process, seems to have evolved its position on this rate differential issue.

Recent unilateral developments regarding interest expense or debt vs equity

United Kingdom

The HM Treasury document, *Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation* (May 2016) notes, among other things, that the UK government is considering the case for 'modified or any bespoke' interest restriction rules for banking and insurance activities. It also suggests that any such rules would 'need to recognise the integral role of interest within a banking group and the potential for a restriction on its tax deductibility to have unintended consequences or to create significant administrative burdens.'

United States

In April 2016, the US Treasury issued proposed regulations under Section 385 that would have serious adverse consequences for banks with inter-company lending. For a discussion of the detrimental impact on the banking sector of those regulations, see the *PwC 197-page comment letter that was submitted on 7 July 2016*. The proposed Section 385 regulations, if adopted in their current form, would significantly exceed the interest deductibility limits agreed to as part of the BEPS process, as well as create a new category of hybrids under BEPS Action 2.

The takeaway

The discussion draft on Action 4 for 'pure' banking or insurance groups is helpful in that it is well thought-out and contains the potential for a carve-out, perhaps if the BEPS working group can be convinced between now and the end of the year (target for completion) that the regulatory rules focused on sufficient capital, liquidity, resolution, and recovery are robust enough to ensure that the risks addressed by Action 4 are significantly diminished. If not, there should be more input to carve out over-collateralised securities based financing and securitization entities.

The discussion draft can be viewed as an opportunity for a group with a bank or an insurance company to engage the OECD BEPS working group with a practical solution on how to deal with these organizations. The five examples in Annex 3 may signal that this area is giving the Action 4 drafters most of their concerns.

Annex 1 contains the 17 questions raised in the draft, though many overlap and are somewhat open-ended requests to resolve practical problems. The business community and tax advisors should view this as an opportunity to explain the industry in more detail, which may assist the BEPS working group to move to a reasonable carve-out for regulated groups.

Comments are due by 8 September 2016. We encourage groups with, and groups of, banks or insurance affiliates to consider the implications of the proposals and respond accordingly.

Let's talk

For a deeper discussion of how the BEPS Action 4 discussion draft on interest in the banking and insurance sector might impact your business, please call your usual PwC contact. If you do not have a contact or would prefer to speak to one of our global specialists, please contact one of the individuals listed below:

Global Tax Policy Contacts

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

Aamer Rafiq, *London*
+44 (0) 20 721 28830
aamer.rafiq@uk.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

Edwin Visser, *Amsterdam*
+31 (0) 887923611
edwin.visser@nl.pwc.com

Other Contacts

Mike Gaffney, *New York*
+1 (646) 471 7135
mike.gaffney@pwc.com

Christine Cataldo, *New York*
+1 (646) 471 0155
christine.cataldo@pwc.com

Matthew Barling, *London*
+44 (0) 20 721 25544
matthew.barling@uk.pwc.com

Robin G Palmer, *London*
+44 (0) 20 721 35696
robin.g.palmer@uk.pwc.com

David A Schenck, *Washington*
+1 (202) 549 9412
david.a.schenck@pwc.com

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