
OECD seeks comments on use of a group ratio to determine limit on interest deductibility

29 July 2016

In brief

A company may be able to deduct more of its debt finance costs if discussion draft proposals published for comment 11 July 2016, by the Organisation for Economic Co-operation and Development (OECD) are finalised and adopted by the company's residence territory. The discussion draft considers debt finance costs in light of the company's worldwide group position.

In the October 2015 Report on the Base Erosion and Profit Shifting (BEPS) Action Plan, recommendations under Action 4 would limit the deductibility of interest and payments economically equivalent to interest. The limitations would apply to related and unrelated party interest expense. The G20 countries endorsed the Report and many can be expected to implement these restrictions as will other countries involved in the BEPS project. Other developing countries are being encouraged to consider the BEPS Action Plan recommendations.

The Report included a 'fixed ratio rule' which would limit an entity's net interest deductions to a set percentage of its taxable earnings before interest income and expense, depreciation and amortisation (tax-EBITDA) calculated using tax principles. However, the Report recognised that higher limits may be warranted in some groups, and provided that further work would be conducted on elements of the design and operation of a 'group ratio rule'. The alternative approaches being considered, the determination of potentially important components like a group's net third party interest expense and 'group-EBITDA' plus the impact of losses are considered in the new discussion draft published on 11 July 2016.

The views and proposals included in this discussion draft do not yet represent consensus views of the OECD's Committee on Fiscal Affairs or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment. The OECD considers that stakeholder comments are essential to advancing this work.

Comments should be submitted by 16 August 2016. We encourage groups to consider the practical implications of the proposals and respond accordingly.

In detail

Introduction

An 11 July 2016 discussion draft from the OECD deals with elements of the design and operation of a group ratio rule to determine limits on interest and payments economically equivalent to interest under Action 4 of the BEPS Action Plan.

In October 2015, the BEPS Action 4 Report *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* set out a common approach to agree limits to the deductibility of interest and payments economically equivalent to interest. This included a 'fixed ratio rule' which limits an entity's net interest deductions to a set percentage of its taxable earnings before interest income and expense, depreciation and amortisation (tax-EBITDA) calculated using tax principles. The limitations would apply to related and unrelated party interest expense.

Recognising that groups may be leveraged differently for non-tax reasons, the Report also recommended that countries consider introducing a 'group ratio rule' to allow an entity to claim higher net interest deductions, based on a relevant financial ratio of its worldwide group.

To arrive at a workable version of this common group ratio rule, further analysis was to be carried out on the working party's most detailed approach and, partly by implication, on comparing alternative allowable methods.

Observations: The group ratio rule will be of interest to companies that are likely to exceed the fixed ratio rule. That will include those which are heavily loan financed and probably most with large property portfolios.

Choice of group ratio

The October 2015 Action 4 Report recommended countries have a choice to implement a rule based on:

- the net third party interest/ EBITDA ratio of a consolidated financial reporting group, or
- another relevant financial ratio of an entity's worldwide group, such as a different net interest/ earnings ratio or an equity/ total assets ratio similar to that currently applied in Finland and Germany.

Observations: The new report encourages countries considering anything other than the net third party interest/ EBITDA approach to think about the benefits of an approach consistent with other countries. It doesn't provide further analysis of those alternative methods, but does discuss detailed elements of the net third party interest/ EBITDA approach.

Net third party interest expense

Where a country adopts it, the calculation of net third party interest expense would be based on the group consolidated financial statements (the accounts). Accounts that can be used would be those prepared using standards permitted by the relevant country or certain widely accepted standards, including International Financial Reporting Standards (IFRS). The draft recommends that the accounts should be audited by an independent regulated accountant although unaudited accounts may be permitted.

The items which should be taken into account are, the draft suggests, interest or income/ expenses that are economically equivalent to interest as defined in Chapter 2 of the Action 4 Report. It also suggests that a country may require or allow an entity to adjust the figure for net third party

interest expense to reflect specific policy goals (both as discussed below).

In particular, the draft recommends that the calculation should include:

- capitalised interest
- interest included within other categories of income or expense in the consolidated income statement
- interest income on financial instruments carried at fair value.

It also recommends that the calculation should exclude:

- fair value gains or losses on financial instruments (to the extent these are not economically equivalent to interest)
- gains and losses on the sale or redemption of financial instruments (to the extent these are not economically equivalent to interest)
- foreign exchange gains or losses (to the extent these are not economically equivalent to interest)
- net interest on a group's defined benefit pension liability and similar post-retirement benefits
- accrued interest on accounting provisions.

The three approaches previously outlined were broadly:

- use accounts figures without adjustments (Approach 1)
- show the figures as per the accounts together with the necessary adjustments (Approach 2)
- show the composition of each element, 'from the bottom-up' (Approach 3).

Underlying accounting records can be used to help validate particular figures. The overall figures produced using Approach 2 or Approach 3 should be the same, but the draft notes that is less likely using Approach 1.

The specific policy goal adjustments which a country may require or allow are not exhaustively described but are said to include, for example:

- an uplift of a group's interest capacity of up to 10% for practical or legal constraints preventing alignment with activity
- excluding expenses paid to related parties (as defined by reference to effective control, 25% common ownership, or them being 'associated enterprises' under Article 9 of the OECD Model Convention, i.e., broadly, with commercial or financial conditions directly or indirectly resulting from common participation as regards management, control or capital) to prevent possible manipulation of the group ratio
- including a group's share of the net third party interest expense of an associate or joint venture entity (JVE); this is designed to eliminate a distortion that can be created by equity accounting principles because group EBITDA includes only the group's share of the net earnings of associates and JVEs

Observations: While the draft recognises the simplicity and impact on the compliance burden of Approach 1, and asks for comments on all three approaches, the working party seems to be discouraging it. To ensure consistency, under Approach 1 the accounts figures would need to be manipulated to take into account the various recommended inclusions and

exclusions, which may well not comply with the required accounting standards.

The inclusion of capitalised interest would sensibly be done on an accruals basis as per the accounts. However, a separate issue then arises where interest is not deductible on an accruals basis as in where it is capitalised as stock (e.g., in the case of a property trader).

The draft clarifies various exclusions so that they are only left out 'to the extent not economically equivalent to interest'. In some countries (e.g., the UK) there are significant 'book to tax differences' such as revaluation gains and losses where this equivalence would need to be tested, which could increase the compliance burden significantly.

An alternative to the approach for JVEs might be for countries with policy concerns to grandfather such arrangements. This might have advantages over a 'compensating adjustment' at the shareholder level because this would not extend to non-UK ownership (those not within the charge to UK tax). It is perhaps arguable that some non-recourse loans should be excluded on similar investment-related arguments.

Group EBITDA

There are a number of specific elements to determining the relevant group's earnings figure. Those identified in the draft include:

- items to be excluded from or included in the adjustment for interest income and expense (in the same way as noted earlier in relation to net interest expense)
- items to be included in the adjustment for depreciation and amortisation, including charges on the impairment or write-off of a

fixed asset, and gains or losses on the disposal of a fixed asset outside the group

- the inclusion of dividend income even if it is non-taxable (e.g., benefiting from a participation exemption) and the group's share of the earnings of an associate or JVE
- the inclusion of non-recurring items (unless a country wishes to require or permit specific treatment of particular items), which is a pragmatic solution to a difficult definitional problem.

Observations: There is a certain amount of flexibility involved in the draft. It is very difficult to anticipate all the situations which might arise. Therefore the draft asks fairly open questions about any practical issues which might arise and how they might be dealt with.

As well as specific reference to non-taxable income, the draft mentions countries potentially excluding from expenses in other countries amounts of a type which are not deductible in the country. In some countries, to ensure that full relief is available for third party debt the group ratio may need to be based on profits calculated in accordance with tax principles of that country though the burden this places on business would need to be considered. The different treatment of investment activities in some countries also seems to be ignored in the draft (particularly relevant in the UK where capital gains are taxed on a different basis to income).

Impact of losses

There are two main scenarios to consider in relation to the impact of losses:

- where a group has positive group-EBITDA but includes loss-making

entities, the draft discourages but doesn't bar countries from excluding these entities, instead suggesting capping the group ratio (a percentage higher than the entity fixed ratio but less than 100%) and limiting each entity's interest capacity to the group's net third party uplifted by 10% as discussed above where relevant

- where a group has zero or negative group-EBITDA, the draft suggests that excluding entities with negative contributions would lead to practical problems (without listing them) and recommends countries consider allowing positive contributors an entity-EBITDA limit above the fixed ratio (probably the same as for the group cap) up to the amount of the lower of its own and the group's net third party interest expense.

Observations: There could be a significant difference between a group having a very low group-EBITDA and one having a zero or negative group-EBITDA, if the only alternative is the entity fixed ratio route. There is a passing reference to countries facing concerns potentially to limit the carry forward of unused interest capacity to amounts arising under the fixed ratio rule, but this doesn't appear to be sufficiently justified.

Treatment of dividend income

The use of interest expense to fund tax-exempt or deferred income was a key BEPS risk identified in Action 4.

To address this, it is proposed that entity EBITDA should not include income to the extent it is not subject to tax due to a participation exemption or foreign tax credit (no reference is made to exempt branch income). However, as explained above, group EBITDA is to include all income including income which is not subject to tax. The operation of this rule is explained by a number of examples in the draft.

The takeaway

At this stage, Action 4 recommendations and the group ratio elements of them do not amount to a minimum standard. Their application in practice will be reviewed at least by 2020 and potentially thereafter but it is uncertain whether consensus will be reached that they become a minimum standard. This is of particular relevance to the EU's anti-tax avoidance directive, where some Member States with alternative targeted rules can delay following the directive's mandate as to a slightly different set of rules on interest deductibility to see whether the OECD agrees a minimum standard before 2023.

The discussion draft does not change any of the conclusions agreed in the October 2015 Action 4 Report. Nor does it address many of the issues we previously raised as regards the practical operation of those recommendations and the likely double taxation which will arise. It does examine alternative approaches to applying a group ratio rule to

increase deductibility limits for various group situations. The options included in the draft do not yet represent the consensus view of the Committee on Fiscal Affairs (CFA) or its subsidiary bodies, but are intended to provide stakeholders with substantive options for analysis and comment.

Annex 1 summarises the 14 questions raised in the draft, though many of them are open-ended requests for practical problems and suggested solutions. Annex 2 sets out 22 examples with figures and helpful narrative to explain how the recommended approach would apply in practice.

The deadline for comments is 16 August 2016. We encourage groups to consider the practical application of the recommendations and respond accordingly. While some groups may not be ready and able to do detailed calculations, most groups will be in a position to make a broad assessment of how some of the flexible options being offered to countries may affect them. If groups have been or are able to discuss the likely response of particular tax administrations the process may be somewhat easier.

It is expected that in many cases group ratios computed using group EBITDA could increase deductibility of interest expense over and above local country fixed ratios. Accordingly highly leveraged groups should pay particular attention to developments that follow from this workstream.

Let's talk

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

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