B.E.P.S. ACTION 4: LIMIT BASE EROSION VIA INTEREST PAYMENTS AND OTHER FINANCIAL PAYMENTS

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Action 4 of the B.E.P.S. Action Plan focuses on best practices in the design of rules to prevent base erosion and profit shifting using interest and other financial payments economically equivalent to interest. Its stated goal is described in the following Action:

> Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.

On December 18, 2014, the O.E.C.D. issued a discussion draft regarding Action 4 (the "Discussion Draft").[1] The Discussion Draft stresses the need to address base erosion and profit shifting using deductible payments such as interest that can give rise to double non-taxation in both inbound and outbound investment scenarios. It examines existing approaches to tackling these issues and sets out different options for approaches that may be included in a best practice recommendation. The identified options do not represent the consensus view of the Committee on Fiscal Affairs, but are intended to provide stakeholders with substantive options for analysis and comment. This article discusses the Discussion Draft for Action 4 of the B.E.P.S. Action Plan.

INTRODUCTION

Most countries tax debt and equity differently for the purposes of their domestic law. Interest on debt is generally a deductible expense of the payer and taxed at ordinary rates in the hands of the payee.

Dividends, or other equity returns, on the other hand, are generally not deductible and are typically subject to some form of tax relief (an exemption, exclusion, credit, etc.) in the hands of the payee. While, in a purely domestic context, these differences in treatment may result in debt and equity being subject to a similar overall tax

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1 O.E.C.D. (2014) "BEPS Action 4: Interest Deductions and Other Financial Payments."

burden, the difference in the treatment of the payer creates a tax-induced bias, in the cross-border context, towards debt financing. The distortion is compounded by tax planning techniques that may be employed to reduce or eliminate tax on interest income in the jurisdiction of the payee.

The policy concerns surrounding interest expense deductions relate to debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis. The result is a net reduction of tax revenue. At the same time, subsidiary entities may be heavily debt financed, bearing a disproportionate share of the group's total third party interest cost and incurring interest deductions used to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market. According to the Discussion Draft, this has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by overseas groups rather than domestic groups.

Base erosion and profit shifting techniques include the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions; the development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income; the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense; and the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income.

To illustrate the planning opportunity in an outbound context, a multinational group consists of two companies, A Co (the parent) and B Co (the subsidiary). A Co is resident in a country with a 35% rate of corporate income tax. It relieves double taxation through a territorial system under which foreign source dividends are exempt from tax. B Co is resident in a country with a 15% corporate tax rate. B Co borrows €100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and an after-tax profit of €4.25.

Alternatively, A Co could borrow the €100 from the bank and contribute the same amount to B Co as equity. In this case, B Co has no interest expense and its full operating profit of €15 is subject to tax. B Co now has a pre-tax profit of €15 and an after tax profit of €12.75. Assuming A Co can set its interest expense against other income, A Co has a pre-tax cost of €10 and an after tax cost of €6.50. Taken together, A Co and B Co have a total pre-tax profit from the transaction of €5 and a total after-tax profit of €6.25 reflecting a rational group treasury decision. The Discussion Draft describes this as a negative effective rate of taxation (*i.e.*, the group's after tax profit exceeds its pre-tax profit). Management would, however, describe this as an effective tax rate reduction.

A similar result can also be achieved in an inbound investment context. In this case, A Co (the parent) is resident in a country with a 15% rate of corporate income tax and B Co (the subsidiary) is resident in a country with a 35% corporate tax rate. B Co borrows €100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and an after tax profit of €3.25.

Alternatively, A Co could replace €50 of existing equity in B Co with a loan of the same amount. In this case, B Co has a pre-tax and after-tax profit of nil. A Co has interest income on its loan to B Co, and has a pre-tax profit of €5 and after-tax profit of €4.25. The group has reduced its effective tax rate from 35% to 15% by shifting interest costs from B Co to A Co. Again, this is a rational business decision, but is viewed by the Discussion Draft as profit shifting. This can be taken one additional step by having A Co replace €100 of existing equity in B Co with a loan of the same amount. Assuming B Co can set its interest expense against other income, from this transaction B Co now has a pre-tax cost of €5 and an after tax cost of €3.25. A Co receives interest income from B Co, and has a pre-tax profit of €10 and after-tax profit of €8.50. Taken together, A Co and B Co have a pre-tax profit of €5 and after-tax profit of €5.25. As a result of thinly capitalizing B Co and shifting profit to A Co, the group is now subject to a negative effective rate of taxation. Again, the group treasury function has made a rational decision and reached a rational result.

"Action 14 is intended to encourage multinational groups to adopt funding structures that more closely align the interest expense of individual entities with that of the overall group."

In all examples, B is resident in a country that has chosen to impose high rates of tax in relation to the country where A is resident and operates. One rational result of this tax policy choice by that country is the encouragement of corporations to remove high profit items from companies subject to tax in that country and to increase discretionary expenses to that country. A second rational decision is to disinvest in that country, removing jobs and all related income from that country's tax base.

The Discussion Draft maintains a different view regarding these potential reactions. According to the Discussion Draft, a consistent approach utilizing international best practices is essential to address base erosion and profit shifting arising from intercompany loans. This will promote group-wide systems that produce required information and remove opportunities for base erosion and profit shifting.

POLICY CONSIDERATIONS

Action 4 is intended to encourage multinational groups to adopt funding structures that more closely align the interest expense of individual entities with that of the overall group. Overall, groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost. However, the opportunity of stuffing interest expense into countries based in in high-tax jurisdictions will be removed. This result reflects various government concerns including (i) addressing base erosion and profit shifting, (ii) minimizing distortions to competition and investment when comparing tax outcomes of groups operating in a solely domestic environment with other groups operating globally, (iii) avoiding double taxation that might arise from unilateral action of one or more countries, (iv) reducing administrative and compliance costs, (v) promoting economic stability by de-emphasizing tax benefits from over-leveraged structures, and (vi) providing certainty of outcome.

Certain arrangements are targeted to prevent circumvention of Action 4. These include (i) the use of orphan entities or special shares to disguise control of an entity or break a group relationship, (ii) arrangements to disguise payments through back-to-back loans, (iii) structures to convert other forms of taxable income into an interest-like return in order to reduce an entity's net interest expense below the level of a limit or cap, and (iv) the use of foreign exchange instruments to manipulate the outcome of rules. Action 4 is intended to adopt rules that are consistent with E.U. rules in order to be fully implemented on a global basis.

EXISTING APPROACHES

Rules currently applied by countries fall into six broad groups, with some countries currently applying combined approaches. These are:

- Rules that limit the level of interest expense or debt in an entity with reference to a fixed ratio. Examples of these rules include debt to equity ratios, interest to E.B.I.T.D.A. ratios and interest to assets ratios. This approach is relatively easy to apply and links the level of interest expense to a measure of an entity's economic activity. However, the same ratio is applied to entities in all sectors and as a tool, these rules are relatively inflexible. Finally, the Discussion Draft comments that the ratios may be set too high to be an effective tool in addressing base erosion and profit shifting.

- Rules that compare the level of debt in an entity by reference to the group's overall position. Existing rules that compare the level of debt in an entity to that in its group often operate by reference to debt to equity ratios. Again, these are reasonably easy to apply, but the Discussion Draft expresses the view that the amount of equity in an entity is not a good measure of its level of activity and equity levels can be easily subject to manipulation.

- Targeted anti-avoidance rules that disallow interest expense on specific transactions. These can be an effective response to specific base erosion and profit shifting risks. However, as new tax planning opportunities are exploited, new targeted rules may be required. Ultimately, this may result in a more complex system that is costly to administer.

"Rules currently applied by countries fall into six broad groups."

- Arm's length tests that compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties. This approach is not considered in the Discussion Draft. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognizes that entities may have different levels of interest expense depending on their circumstances, and should not disturb genuine commercial behavior. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules.

- Withholding tax on interest payments that are used to allocate taxing rights to a source jurisdiction. This approach is not considered in the Discussion Draft. Withholding taxes are primarily used to allocate taxing rights to a source country, but by imposing tax on cross-border payments they may also reduce the benefit to groups from base erosion and profit shifting transactions. Withholding tax has the advantage of being a relatively mechanical tool which is easy to apply and administer. However, unless withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. Where withholding tax is applied, double taxation can be addressed by giving credit in the country where payment is received, although the effectiveness of this is reduced if credit is only given up to the amount of tax on net income. In practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. It would also be extremely difficult for E.U. member states to apply withholding taxes on interest payments made within the E.U. due to the Interest and Royalty Directive.

- Rules that disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or the identity of the lender. This approach is not considered in the Discussion Draft. While this approach reduces the general tax bias in favor of debt financing over equity, it does not address base erosion and profit shifting issues.

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In recent years many countries have made significant changes to their approaches to combating base erosion and profit shifting through interest deductions, either through the introduction of new rules or through amendments to their existing rules. This suggests that countries have struggled to fully address the issues that they are actually seeing. There is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expense. A limited survey based on published data indicates that for the largest non-financial sector groups, the vast majority has a net interest to E.B.I.T.D.A. ratio of below 10% and many do not have any net interest expense. However, the majority of countries which currently seek to address base erosion and profit shifting using earnings-based ratios allow entities to gear up to the point where net interest to E.B.I.T.D.A. reaches 30%.

International debt shifting has been established in a number of academic studies[2] which show that groups leverage more debt in subsidiaries located in high tax countries. Academics have shown that thin capitalization is strongly associated with multinational groups[3] and that multinational groups use more debt than comparable widely held or domestically owned businesses.[4] Additional debt is provided through both related party and third party debt, with intragroup loans typically used in cases where the borrowing costs on third party debt are high.[5]

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2 Møen *et al.*, 'International Debt Shifting: Do Multinationals Shift Internal or External Debt?' (2011) University of Konstanz Department of Economics Working Paper Series 2011-40, 42; Huizinga et al., 'Capital structure and international debt shifting' (2008) 88 Journal of Financial Economics 80, 114; Mintz and Weichenrieder, Taxation and the Financial Structure or German Outbound FDI' (2005) CESifo Working Paper No. 1612, 17; Desai et al., 'A Multinational Perspective on Capital Structure Choice and Internal Capital Markets' (2004) 59 The Journal of Finance 2451, 2484.

3 Taylor and Richardson, 'The determinants of thinly capitalized tax avoidance structures: Evidence from Australian firms' (2013) 22 Journal of International Accounting, Auditing and Taxation 12, 23.

4 Egger *et al.*, 'Corporate taxation, debt financing and foreign-plant ownership' (2010) 54 European Economic Review 96, 106; Mintz and Weichenrieder (n 4) 17.

5 Buettner *et al.*, 'The impact of thin-capitalization rules on the capital structure of multinational firms' (2012) 96 Journal of Public Economics 930, 937.

Academics have also looked at the effectiveness of thin capitalization rules and illustrated that such rules have the effect of reducing the total debt of subsidiaries.[6] Where thin capitalization rules relate solely to interest deductions on related party debt, such rules are effective in reducing intragroup debt but lead to an increase in third party debt, although not to the same extent. Theoretical studies on the impact of interest limitation rules on investment reach similar conclusions.[7] However, the empirical analysis that has been done does not support this theory. Two studies, both analyzing the effect of German interest limitation rules on investment, find no significant evidence of a reduction of investment either in relation to thin capitalization rules[8] or interest barrier rules based on a ratio of interest expense to income.[9]

WHAT ARE INTEREST AND INTEREST EQUIVALENTS?

At its simplest, interest is the cost of borrowing money. However, if a rule restricted its focus to such a narrow band of payments, it would raise three broad issues:

- It would fail to address the range of base erosion and profit shifting that countries face in relation to interest deductions and similar payments;
- It would reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements; and
- Its effect could be easily avoided by groups re-structuring loans into other forms of financing.

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To address these issues, rules to tackle base erosion and profit shifting using interest should apply to interest on all forms of debt as well as to other financial payments that are economically equivalent to interest. Payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time. A rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees.

- Interest equivalent payments include:
- Payments under profit participating loans;
- Imputed interest on instruments, such as convertible bonds and zero coupon bonds;

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6 Blouin *et al.*, 'Thin Capitalization Rules and Multinational Firm Capital Structure' (2013) 26-27; Buettner *et al.*, *Id.*, 937.

7 Ruf and Schindler, 'Debt Shifting and Thin Capitalization Rules - German Experience and Alternative Approaches' (2012) 21.

8 Weichenrieder and Windischbauer, 'Thin-capitalization rules and company responses - Experience from German legislation' (2008) CESifo Working Paper No. 2456, 29.

9 Buslei and Simmler, 'The impact of introducing an interest barrier Evidence from the German corporation tax reform 2008' (2012) DIW Discussion Papers 1215, 29.

- Amounts under alternative financing arrangements, such as Islamic finance;
- The finance cost element of finance lease payments;
- Amounts recharacterized as interest under transfer pricing rules, where applicable;
- Amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity's borrowings;
- Foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- Guarantee fees with respect to financing arrangements; and
- Arrangement fees and similar costs related to the borrowing of funds.

TARGETS OF THE RULE

A robust rule addressing base erosion and profit shifting should apply to all incorporated and unincorporated entities and arrangements, including permanent establishments, which may be used to increase the level of interest deductions claimed in a country. Four scenarios are identified:

- Companies and other entities in a group, including permanent establishments. Entities are in a group where one entity has direct or indirect ownership or control over another entity or both entities are under the direct or indirect ownership or control of a third entity.
- Connected parties. For these purposes entities are connected parties where they are under common ownership or control but are not part of a group. This may arise where (i) an individual, fund, or trust exercises control over the entities or (ii) a shareholder agreement exists which has the effect of bringing the entities under common control. The proposition is that collective investment vehicles under the control of the same investment manager should not be treated as connected parties if there is no other connection between them.
- Payments made to related parties. Related parties include (i) significant shareholders and investors (and members of their family), (ii) entities where there is a significant relationship but which is not sufficient to establish control, and (iii) third parties where the payment is made under a structured arrangement. A significant shareholding or a significant relationship is a 25% or greater holding.
- Standalone entities. Entities not otherwise described above.

Companies and entities in each of the foregoing fact patterns pose different risks. Consequently, the Discussion Draft proposes that different interest limitation rules may be applied. For example, risks posed by international groups may be addressed through rules which link interest expense deductions in each group entity to the position of the worldwide group, while risks posed by connected and related parties may be addressed through targeted rules which apply to specific arrangements. Whichever rule is applied it is the intent of the Discussion Draft to avoid rules that provide a competitive tax advantage regarding interest expense deductions to certain entities and the way they are held.

WILL THE TARGET BE EXCESSIVE INTEREST OR EXCESSIVE DEBT? WILL EXCESSIVE RELATE TO GROSS OR NET POSITIONS?

As a preliminary matter, two key questions exist in formulating a rule to combat base erosion and profit shifting arising from excessive interest expense.

- Should the target be excessive levels of interest expense in relation to income or excessive amounts of debt in relation to assets?
- Whichever target is used, should the rule apply to an entity's gross position with regard to interest or debt, by looking only at the liability or expense item, or should the rule apply to an entity's net position, by offsetting interest expense with interest income and offsetting the debt obligations it issued with debt securities it holds?

As to the first question, the Discussion Draft concludes that rules to tackle base erosion and profit shifting should operate directly by reference to the level of interest expense in an entity and not the level of debt. Factors that support that approach include:

- Financial liabilities may be difficult to identify and value.
- The level of debt in an entity may fluctuate throughout a period, which means that the amount of debt on a particular date, or an average for the period, may not be representative of an entity's true position. On the other hand, the level of interest expense in an entity will reflect all changes in borrowings throughout the period.
- Because the target of the provision is excessive interest, a rule that refers to the level of deductible interest will directly address the key risk factor.
- A rule to limit interest expense deductions by reference to the value of the debt would still require a determination of the level of interest expense that is to be disallowed if a limit is exceeded. Also, cases of excessive interest on acceptable debt levels will be problematic.

"Should the target be excessive levels of interest expense in relation to income or excessive amounts of debt in relation to assets?"

Factors that favor the testing of debt levels, which were not persuasive, include:

- A rule based on the level of debt may provide leeway to allow an entity subject to high interest rates on its borrowings to deduct more interest expense than an entity with the same level of debt but subject to a lower interest rate.
- The level of debt in an entity is under the control of the entity's management and may be stable and easier to predict. The amount of interest expense, however, may vary reflecting market interest rate fluctuations.

Regarding the second question – net or gross valuations of interest expense – the Discussion Draft concludes that a general interest limitation rule should apply to the entity's net interest expense after offsetting interest income. The rule could be supplemented by targeted interest limitation rules to prevent groups avoiding the effect of a rule or which disallow gross interest expense on specific transactions identified as posing base erosion and profit shifting risks.

A gross interest rule may have the benefit of simplicity and is also likely to be more difficult for groups to avoid through planning. However, a gross interest rule could lead to double taxation where interest is paid on intragroup loans, and each entity is subject to tax on its full gross interest income, but part of its gross interest expense is disallowed. In comparison, a net interest rule will reduce the risk of double taxation, as interest income will already be taken into account before the interest limitation is applied.

SMALL ENTITY EXCEPTION

The Discussion Draft suggests that smaller entities may pose a lower risk to base erosion and profit shifting using interest and it has been suggested that these low risk entities be excluded from the interest expense limitation rules. Action Plan 4 suggests two thresholds for exclusion:

- Size Threshold. Using a combination of indicators such as number of employees and turnover, the size threshold assumes that a "smaller" entity poses less risk. However, it ignores the fact that a highly leveraged small entity may have a high level of interest expense.

- Monetary Threshold. The monetary threshold looks at the level of net interest expense in an entity and would be simple to apply. The level of interest expense is at the heart of the issue. The threshold amount will be set based on the economic situation and interest rate in a country because it will consider the effect profit shifting using interest will have on its environment. It will consider entities of the same group as a single unit to prevent companies from forming smaller entities to escape the threshold. Current thresholds range from €0.5million to €3 million.

Introducing thresholds could make them a consideration in reducing interest expenses or raising them to reach a limitation. The Discussion Draft comments that thresholds are not part of the best practice recommendation. Where adopted, they should be designed to exclude low risk entities based on their net interest expense computed on a local country group basis in order to avoid fragmenting.

LIMITING BASED ON GROUP POSITION

Group-wide Tests

Group-wide rules limit an entity's deductible interest expense based on factors applied on a worldwide basis. This approach is based on several premises. First, the best measure for total net interest deductions for a group is the difference between the interest expense paid to unrelated parties and interest income received from unrelated parties. Second, within a group, interest expense should be matched with economic activity. Groups will receive tax relief equivalent to their third party interest cost where the two premises match up.

Group-wide tests are viewed to be advantageous because they allow the centralization of third party borrowings and may be the most effective in tackling base erosion and profit shifting using interest. Consistently applied among countries, this approach avoids problems arising from contradictory application of rules by two or more countries. Nonetheless, the Discussion Draft suggests that they may need to be supplemented by more targeted limits based on specific factors within a group. For example, specific rules could prevent base erosion and profit shifting interest expense on debt held by unrelated parties is excessive. Or they might be necessary to deal with groups in which members are engaged in different business lines having different leverage rules that tilt the computation.

The cost of compliance and administration is something that must be considered under the groupwide rule.

Different Rule Options

Two variations of groupwide tests may be considered:

1. Groupwide Interest Allocation Rule. This variation allocates a worldwide group's net third party interest expense between entities of that group in proportion to economic activity in one of two ways. The first is a deemed interest rule in which allocation would be made according to earnings or asset values and this deemed interest expense would be tax deductible. The interest actually paid or received by the group as a whole would be disregarded. This rule is easy to apply. However, some countries have expressed concerns about introducing rules that allow deductions for amounts not paid or accrued by an entity.

   The second variation is an interest cap rule. Here, each entity would be provided an interest cap based on the allocation made according to earnings or asset values. Interest expense on intragroup and third party debt up to the cap would be tax deductible and any interest income received by the group would be taxed.

2. Group Ratio Rule. This rule compares a relevant financial ratio of an entity with the equivalent financial ration of the entire group. Third party and intragroup interest expense is deductible where the ratio is equal to or less than the ratio of the group. To stay with or under the ratio, groups may reorganize their intragroup financing.

Although similar, consistency is the key distinguishing factor between both approaches. While the interest allocation is more consistent, the group ratio would be more flexible for different countries that continue to apply existing laws. Furthermore, group ratios would work well for countries with volatile currencies as group ratios can also be applied directly to the earnings or asset value in its functional currency and an interest cap is more likely to be calculated in the reporting currency. Though the flexibility is a benefit for different economies, this would give a rise to a spectrum of rules. Therefore, it can be expected to increase compliance costs.

Entities to be Included

It is important to define the group when designing a group-wide rule as this will identify the companies that are considered in computing the ratio or cap and the companies affected by the ratio or cap. It is important for the group to be easily verifiable by entities and tax authorities in order to facilitate the collection of financial information. The Discussion Draft cautions that control and composition of the group may change based on differing accounting standards among several affected countries.

Membership should be based on one of two methods. The first is to apply the highest and most inclusive level of consolidated financial statements prepared by the parent of the group so as not to have contradictory statements and to ensure that all of the entities have been accounted for. If an entity isn't part of a group that prefers consolidate financial statements, the entity would need to obtain financial information on the group in order for the rule to be applied. Alternatively, a single standard definition of an interest limitation group could be applied for all entities, disregarding the actual composition. This would ensure that the same definition would be used by all entities but may require accounting if the interest limitation group differs from the financial reporting group.

Determining Net Third-party Interest Expense

Financial statements are a good starting point for information on the group's net interest position. These statements should be adjusted to include any income or expenses economically equivalent to interest not included in these financial reporting figures and exclude any income to expense treated as interest that wouldn't be taken into account for tax purposes.

"Under the group wide rule, the net interest expense of an entity is linked to net third party interest expense based on earnings and assets values that are used as a measure of economic activity."

An interest allocation rule would require agreement on the items that should be excluded. A group ratio rule would allow each country to decide based on its own tax law.

Measuring Income Activity

Under the group-wide rule, the net interest expense of an entity is linked to net third party interest expense based on earnings and assets values that are used as a measure of economic activity.

Economic activity can be measured using accounting or tax figures which would reduce compliance costs. Earnings or asset values can also be determined using tax principles by basing the economic activity on taxable profits or the tax value of an entity's assets. But using tax figures poses an administrative burden on tax authorities of the different countries.

The most obvious measure of economic activity is earnings and asset values. This indicator yields a fairer result for mixed groups that include entities engaged in activities requiring different levels of investment in assets. The levels of earnings are direct measures of an entity's obligation to pay interest and determining the amount of debt that can be borrowed.

Earnings as a Measure

The Discussion Draft states that a direct correlation exists between earnings and profit shifting. Entities that shift profits out of a country will reduce available net interest deductions. The measure of earnings used is most commonly known as "earnings before interest, taxes, depreciation and amortization" ("E.B.I.T.D.A."). It measures the cash flow of an entity that can be used to meet its interest expense obligations.

Gross profit is another measure of earnings that has the advantage of being calculated on a broadly comparable basis across most accounting standards, with greater differences introduced as an entity works down its income statement. However, the use of gross profit could lead to problems where one entity in a group provides, for example, marketing or distribution services to other group entities. This is because the entity providing the service will include its income within its own gross profit whereas the entity paying for services will deduct the corresponding expense further down its income statement, making the comparison of entities difficult.

Intercompany transactions within a group may mean that there are fact patterns where an individual entity recognizes earnings that are not included in the consolidated earnings of the overall group. For example, this may arise where an entity sells components to another entity in its group. The purchaser uses the components to manufacture products for sale to customers. At an entity level, the seller will recognize revenue from these intragroup sales, but on a consolidated level, this should not be recognized until a sale takes place outside the group. Other consolidation adjustments may be required to strip out payments between entities for intragroup services.

Entity earnings may be relatively volatile compared with asset values and there is a limit to the extent this can be controlled by a group. This means that under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year. A rule could be designed to include features to reduce the impact of this volatility. One such feature would entail averaging of income over a designated period. Another possible feature would entail carryforwards of disallowed interest expense or unused capacity in order to deduct interest expense in future periods.

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A particular aspect of earnings volatility is the possibility that individual entities or an entire group may be in a negative earnings position. Three issues arise as a result. First, under an earnings-based approach, loss-making entities will not be able to deduct any net interest expense, though a rule may allow disallowed interest to be carried into future periods. Second, the aggregated earnings of profitable entities in the group will exceed the group's actual total earnings. Therefore a group-wide rule could allow these entities to deduct an amount of net interest expense that exceeds the group's total net third party interest expense. Third, unless a rule takes account of the impact of losses, a group-wide rule based on earnings would become impossible to apply where a group is in a loss-making position overall.

Alternative potential solutions are provided to address this issue. One is that a group's total earnings could be determined using only the results from entities that have positive earnings. This would remove the risk that entities would be able to deduct an amount of interest expense in excess of the group's actual net third party interest expense. Alternatively, a rule could provide that, to the extent an interest limitation group includes loss-making entities, the protection offered by a group-wide rule is reduced or eliminated.

Earnings should be calculated applying the same standards that are used in preparing the group's consolidated financial statements. Where local G.A.A.P. is substantially similar to the accounting standards used in preparing the group's consolidated financial statements, a rule could provide for an entity's earnings to be calculated under local G.A.A.P. as a cost saving measure.

Asset-based Approaches

Third-party debt is often raised to fund the group's revenue generating assets. Valuing these assets determines the amount of debt they can garner. However, the link between asset valuation and taxable income is not as strong as that of earnings and therefore an asset based approach is the less preferred method of measure under the Discussion Draft.

A wide range of assets should be taken into account to reflect a group's activities. These include land and buildings, plant and equipment, goodwill and other intangible assets, inventory or stock, trade receivables, and financial assets which do not give rise to amounts treated as interest. However, financial assets that give rise to interest income and equity instruments yielding dividend income should not be considered. The ability to deduct interest expense should be allocated to entities with economic activity and not by reference to the location of debt instruments.

The advantages of asset values are that they are more stable than earnings and reduce compliance costs. Furthermore, an asset value approach means that entities with losses would still be able to deduct an amount of net interest expense.

Intangible assets, including trademarks, patents and trade secrets, can be among a group's most valuable assets. This is particularly the case for major brands and for hi-tech groups. However, accounting standards typically impose stringent requirements on groups before they are able to recognize an intangible asset on their balance sheet, particularly where the asset has been internally created. Even where an intangible asset can be recognized, its carrying value is usually at historic cost, which may be only a fraction of its actual fair market value. Revaluations of intangible assets are generally only possible by reference to a fair value on an active market, and as such will rarely be permitted for most types of intangibles.

The impact is that for a number of large groups, an approach to limiting interest deductions based on asset values for accounting purposes will ignore the group's most valuable assets.

Groups are allowed to offset derivative assets and liabilities carried at fair value if two parties owe each other a determinable amount and there is a right to offset.

Accounting and Tax Mismatches

In most cases an entity's interest cap under an interest allocation rule will have been calculated in the currency of the group's consolidated financial statements. However, an entity's taxable income will generally be calculated in its functional currency. Therefore, under an interest allocation rule, the interest cap will need to be translated into the entity's functional currency before it can be applied. This translation may be performed at the average exchange rate for the period, although a rule could allow a different exchange rate to be used if this would give a more reasonable result.

Some differences between the amount of net interest expense allowable under a group-wide rule and an entity's taxable net interest expense will be the result of mismatches in how interest is recognized for accounting and tax purposes. These will include timing mismatches and permanent mismatches. Timing mismatches arise because the interest expense is recognized in different periods for accounting and tax purposes, and in most cases these should correct over the life of a debt.

“Related parties ... are, however, in a relationship that means they may enter into transactions to generate a tax benefit, which is typically shared between the parties.”

Permanent mismatches arise where the payments treated as interest or economically equivalent to interest in the group consolidated financial statements are different to those treated as such for tax purposes. For example, where an instrument is treated as debt for accounting purposes but equity for tax purposes, payments on that instrument are likely to give rise to permanent mismatches. Permanent mismatches could be taken into account by allowing a small uplift in the amount of net interest expense that would be deductible under a group-wide rule.

The Discussion Draft acknowledges that the time for filling entity and group financial statements will be determined under local law applicable to the entities. As a result, an entity may be required to file its tax return and pay tax before the group financial statements are audited and published.

Cash Pooling

Cash pooling arrangements are a common part of treasury management in an international group. They allow a group to reduce its net third party interest expense by setting surplus cash balances in certain entities against borrowing needs in other entities so the group only pays interest on the net position. The interest expense is then allocated based on transfer pricing mechanisms. A group-wide rule will take into account the benefits obtained from the cash pool and the interest paid and received.

Connected and Related Parties

The Discussion Draft cautions that net third party interest expense can be artificially increased through transactions with connected and related parties. Connected parties include entities under a common control but not part of the group. Related parties include entities where there is a relationship below that required to establish control, and third parties which are party to structured arrangements. Related parties are not in the same economic position as members of a group. They are, however, in a relationship that means they may enter into transactions to generate a tax benefit, which is typically shared between the parties.

Targeted provisions are required to deal with risks posed by all connected and related parties. One option could be for interest payments to connected and related parties to be excluded from net third party interest expense in applying a group-wide rule. This could apply to all interest paid to connected and related parties, or to payments which meet certain conditions. The Discussion Draft views this approach as administratively cumbersome within a group and for tax authorities. An alternative approach would entail removing these payments from a group-wide rule. The entity making a payment to a connected or related party would reduce its interest cap or the amount of interest deductible under a group ratio rule by the value of the payment. At that point, a separate targeted rule would apply. It could disallow all interest payments to connected or related parties or allow payments subject to a limit based on a fixed ratio or a requirement that the recipient must be subject to a minimum level of taxation on the corresponding income. It is likely that this approach would be simpler to apply, as only the entity making a payment to a connected or related party would be required to make an adjustment. However, this approach also has disadvantages.

LIMITING INTEREST DEDUCTIONS WITH REFERENCE TO A FIXED RATIO

Fixed Ratio Approach

Fixed ratio rules are premised on the assumption that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets, or equity. This ensures that a portion of an entity's profit remains subject to tax in a country. The government determines the ratio that is applied irrespective of the actual leverage of an entity or its group.

Fixed ratio rules are relatively simple to apply because they do not require the financial information on the whole group; the tests are based entirely on the entity's own financial position. In addition, the test may use tax figures or any other figures that makes compliance easier.

The approach doesn't take into account the fact that groups operating in different sectors may require different amounts of leverage, which makes determining the correct level difficult. There is a risk that the ratio may be set too high for some entities and too low for others.

Interest Deductions and Level of Assets of Earnings

Borrowing funds and paying interest enables funding a group's assets and activities. Therefore, the Discussion Draft comments that there is a natural link between the value of assets held and the interest expense of the entity.

"Fixed ratio rules are relatively simple to apply because they do not require the financial information on the whole group."

Because the Discussion Draft acknowledges that asset values are more stable than earnings, using asset values as a basis to determine deductible interest expense would increase certainty and reduce compliance costs. Additionally, asset tests may also be suitable for tackling base erosion and profit shifting involving the use of debt to fund tax exempt or deferred income, which would stop entities from claiming a higher level of deductible interest expense. The disadvantage with using asset values is the valuation. Using asset values as a base leaves a possibility of cash manipulations and artificial inflation.

Linking fixed ratios to a measure of earnings means that a group will only be able to increase their level of net interest deductions by increasing taxable profits in that country. Excluding dividend income will help address base erosion and profit shifting using interest to fund tax exempt or deferred income. Nonetheless, as discussed before, an earnings based rule would be volatile and influenced by outside market factors. In addition, there are different types of earnings that include or don't include certain deductions.

Existing Fixed Ratio Levels

The next questions is whether the group ratio rules and fixed ratio rules described above could be combined in a way that reduces administrative and compliance costs by applying simpler rules to entities that pose less risk.

Two possible options for a combined approach are presented.

- Under the first option, a country could provide for a monetary threshold that establishes a *de minimis* level of net interest expense below which an entity will not be required to apply a general interest limitation rule. This threshold should apply to the aggregate net interest deductions in all group entities in a country. As a result, an entity with deductible net interest expense (above the monetary threshold) would come within the group-wide interest allocation rule. The entity could deduct interest expense up to an interest cap that is equal to an allocated portion of the group's net third party interest expense, based on a measure of earnings or assets. A country may allow disallowed interest expense to be carried forward and set against unused interest cap in a future period.
- Under the second option, entities with levels of deductible interest expense above any monetary threshold would come within a fixed ratio test, whereby an entity would be able to claim relief for deductible net interest expense up to a fixed percentage of its earnings or assets. To be effective in addressing base erosion and profit shifting and to remove the risk of entities gearing up and claiming further interest deductions to the point where the fixed ratio is reached, this ratio should still be at a level that is lower than that which is currently applied in many countries. The rule would be subject to an exception under which entities in more highly leveraged groups may apply a carve-out so that where an entity's ratio is (i) higher than the fixed ratio, but (ii) does not exceed the ratio of its group, the entity does not need to apply the fixed ratio rule. Again, disallowed interest expense may be carried forward and set off against unused interest cap in a future period.

SUPPLEMENTAL RULES FOR TARGETED TRANSACTIONS

Some countries do not currently apply a general interest limitation rule to address base erosion and profit shifting risks, but rely solely on targeted rules. One benefit of such an approach is that it reduces the risk that a rule negatively impacts on entities which are already appropriately capitalized. However, this approach has some drawbacks. Targeted rules will always be a reactive response, requiring countries to be aware of specific base erosion and profit shifting risks as they emerge. There is a risk that some groups may consider all arrangements not covered by targeted rules to be acceptable, meaning that over time new targeted rules may be required. Targeted rules also require active application, meaning the tax administration must be able to recognize situations where a rule could apply, often as part of a complex transaction, and then engage with a group to determine the correct result. In contrast, a general rule could provide an effective response to a broad range of base erosion and profit shifting issues.

Nonetheless, the Discussion Draft suggests that there could be a role for some targeted provisions to prevent entities from avoiding the effect of the general rule or to address specific risks not covered by the general rule, for example, if the general rule only applies to groups. Overall, targeted rules hold the potential to address specific base erosion and profit shifting risks. However, an approach based entirely on targeted rules may result in a large number of rules that will increase complexity and compliance and administrative costs. If the rules are not comprehensive then they are unlikely to deal with all base erosion and profit shifting risks.

NON-DEDUCTIBLE INTEREST EXPENSE AND DOUBLE TAXATION

As discussed above, deductions interest above any limit or cap will be denied if an interest limitation rule is applied. The Discussion Draft presumes that entities will comply with the limitation rules and will attempt to rearrange financing terms to avoid problems. Nonetheless, situations will exist where interest expense deductions are disallowed and double taxation will exist within a group. To rectify the problem, certain provisions may be included to reclassify nondeductible interest or to allow it to be used in other periods.

"Situations will exist where interest expense deductions are disallowed and double taxation will exist within a group."

Permanent disallowance may work for certain transactions but not all. Under targeted rules, items of interest expense that give rise to permanent base erosion or profit shifting should be disallowed. Where nondeductible interest expense is a result of a timing mismatch due to fluctuating levels of earnings, a permanent disallowance may introduce an undesirable uncertainty.

Recharacterization of Disallowed Interest as a Dividend

If recharacterizing a disallowed interest expense as a dividend is accepted by the country of the recipient, the risk of double taxation can be reduced. However, several problems could arise:

- Under a general interest limitation rule, the disallowance of interest expense will not be allocated to specific payments. If the recharacterization is applied on a *pro-rata* basis to all interest payments made by an entity, a large number of very small deemed dividends would be created.
- Disallowed expenses may be financial payments that are not interest in legal form and the reclassification of which may pose issues in the countries of the payer and recipient.
- Dividend withholding rates may be different from interest withholding rates and reclassification could reduce the impact of a disallowance.

While reclassification as a dividend may not be the best approach, reclassification under a specific targeted role may still be advisable.

Carryforward of Disallowed Interest or Unused Capacity

Some countries already allow disallowed interest expense to be carried forward for relief. However, an indefinite carryforward could reduce the overall impact of an interest limitation rule and introduce planning opportunities that would negate the effect of the interest limitation rule that was implemented in the first place.

One way to tackle this problem would be to restrict the number of years the carry forward could apply. It has also been suggested that a disallowed interest expense shouldn't be deductible at any point.

GROUPS IN SPECIFIC SECTORS

- Banks and Insurance Companies. Banks and insurance companies present unique issues that do not arise in other sectors. Interest expense is the largest cost on a bank's income statement, but this is less so for insurance companies. Interest expense in banking and insurance groups is closely tied to their ability to generate income, more so than for groups operating in other sectors. Therefore, any rule that restricts deductions for general gross interest expense will have a significant impact on a bank's business model. Moreover, financial sector businesses typically are subject to strict regulations on their capital structure. The 2011 Basel III agreement is an example for banks, and the Solvency II Directive in the E.U. is an example for insurers in the E.U. Specific rules will be required for the banking and insurance sectors that may differ in the treatment of regulatory capital and other borrowing. Limits could be placed on net deductions regarding regulatory capital (ignoring the interest income generated from using the capital to write business), so that only amounts of interest paid to third parties would be deductible. Alternatively, a best practice approach could focus on a group's interest expense other than the expense related to regulatory capital.

- Oil and Gas; Real Estate. Companies operating in these sectors may be subject to special tax regimes that are designed to ensure that a country shares in the benefits derived from the extraction of natural resources. These regimes may include specific features that limit interest expense deductions.

- Infrastructure Projects. These projects are often highly leveraged using a mixture of bond issues and bank debt. Special rules may be required in light of the impact of limitations on large public infrastructure projects.

- Other Businesses in the Financial Services Sector. Entities such as asset management, leasing, and the issuance of credit cards have their own unique issues that must be addressed to ensure an appropriate result in preventing base erosion and profits shifting.

CONCLUSION

B.E.P.S. Action 4 evidences a view that internal manipulation of capital within a group between equity and debt is an evil that must be dealt with harshly. To the drafters, all internal debt is abusive if the amount of the debt is not tied to the third party borrowing of the group. Presumably, this approach is intended to prevent internal manipulation. However, as in other anti-abuse rules designed to prevent certain action, taxpayers have found relief by adjusting business models to put actual substance in places where none previously existed. There is little doubt that the first action as contemplated in the Discussion Draft of Action 4 will beget a reaction by groups that is unexpected by the drafters.