

# ACTION 4: LIMIT BASE EROSION

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INTEREST PAYMENTS  
AND OTHER FINANCIAL  
PAYMENTS

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# Stated goals of Action 4

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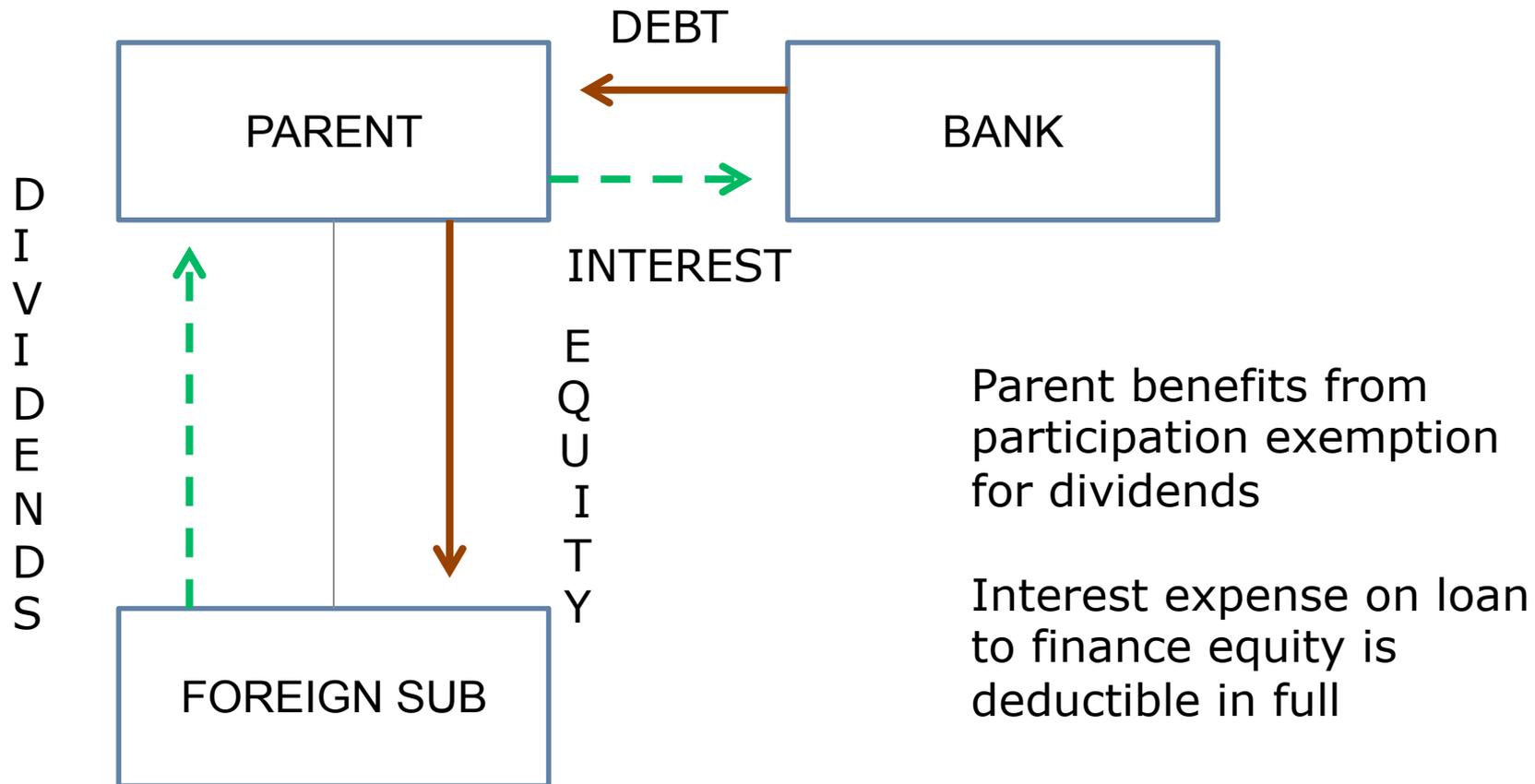
- Develop best practices in rules to prevent base erosion through the use of interest expense
- Identified abuse is the use of related-party and third-party debt:
  - To achieve excessive interest deductions
  - To finance the production of exempt or deferred income
- Transfer pricing guidance will be developed regarding the pricing of related party financial transactions for:
  - Financial and performance guarantees,
  - Derivatives (including internal derivatives used in intra-bank dealings), and
  - Captive and other insurance arrangements

# Base Erosion and Profit Shifting Techniques

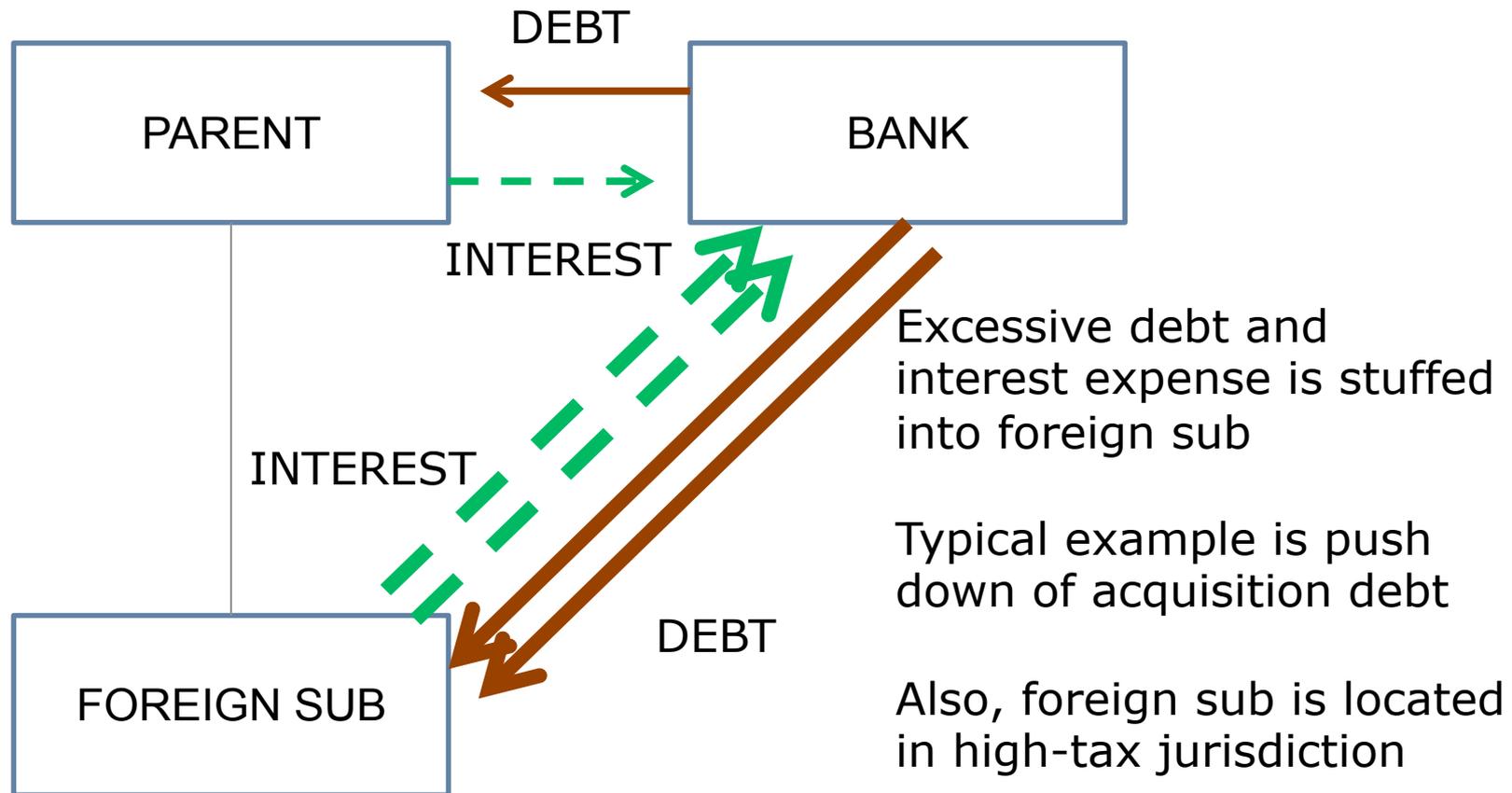
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- The use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions
- The development of hybrid instruments which give rise to deductible interest expense but no corresponding 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

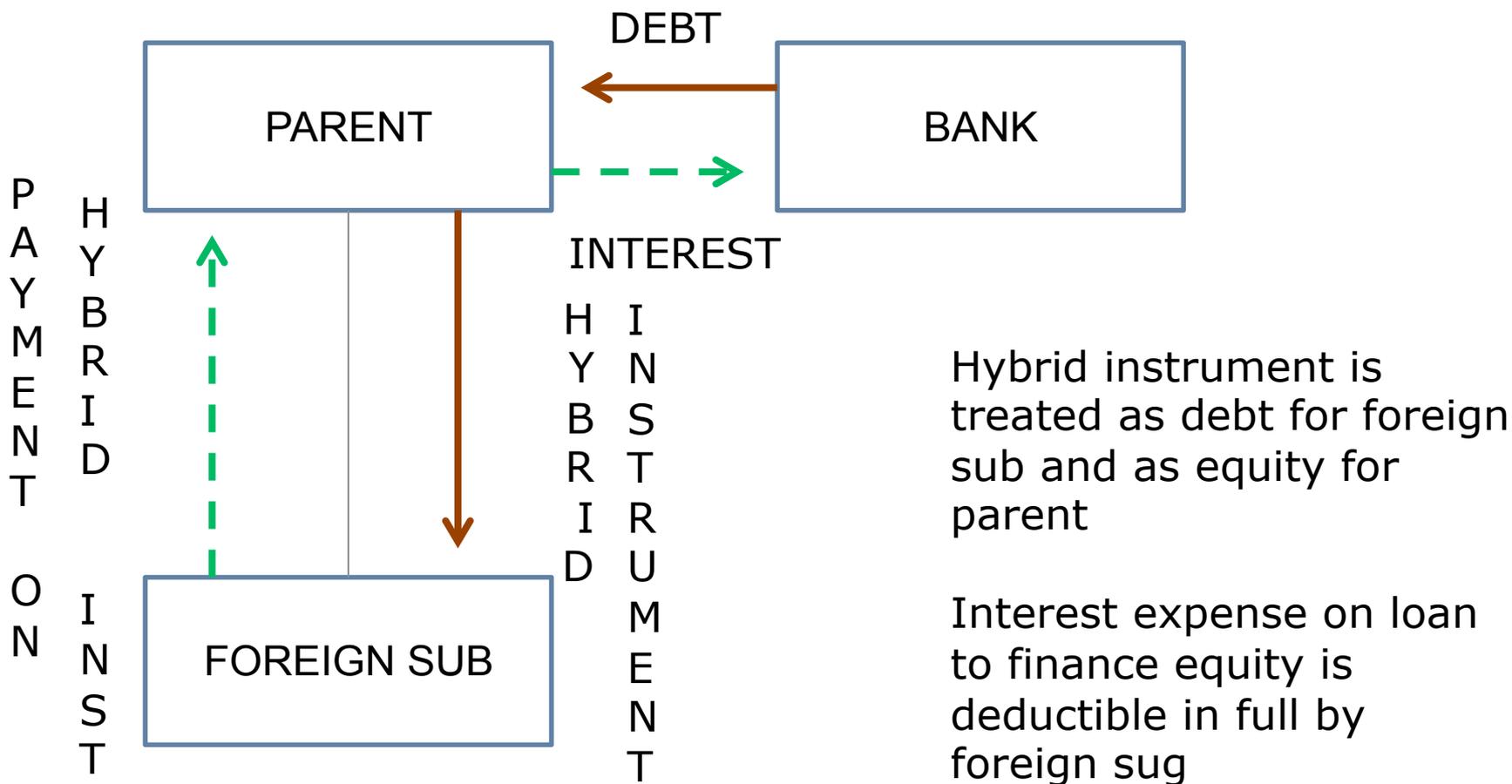
# Debt Financing for Equity in Foreign Subs



# Excessive Debt Stuffed into Foreign Sub



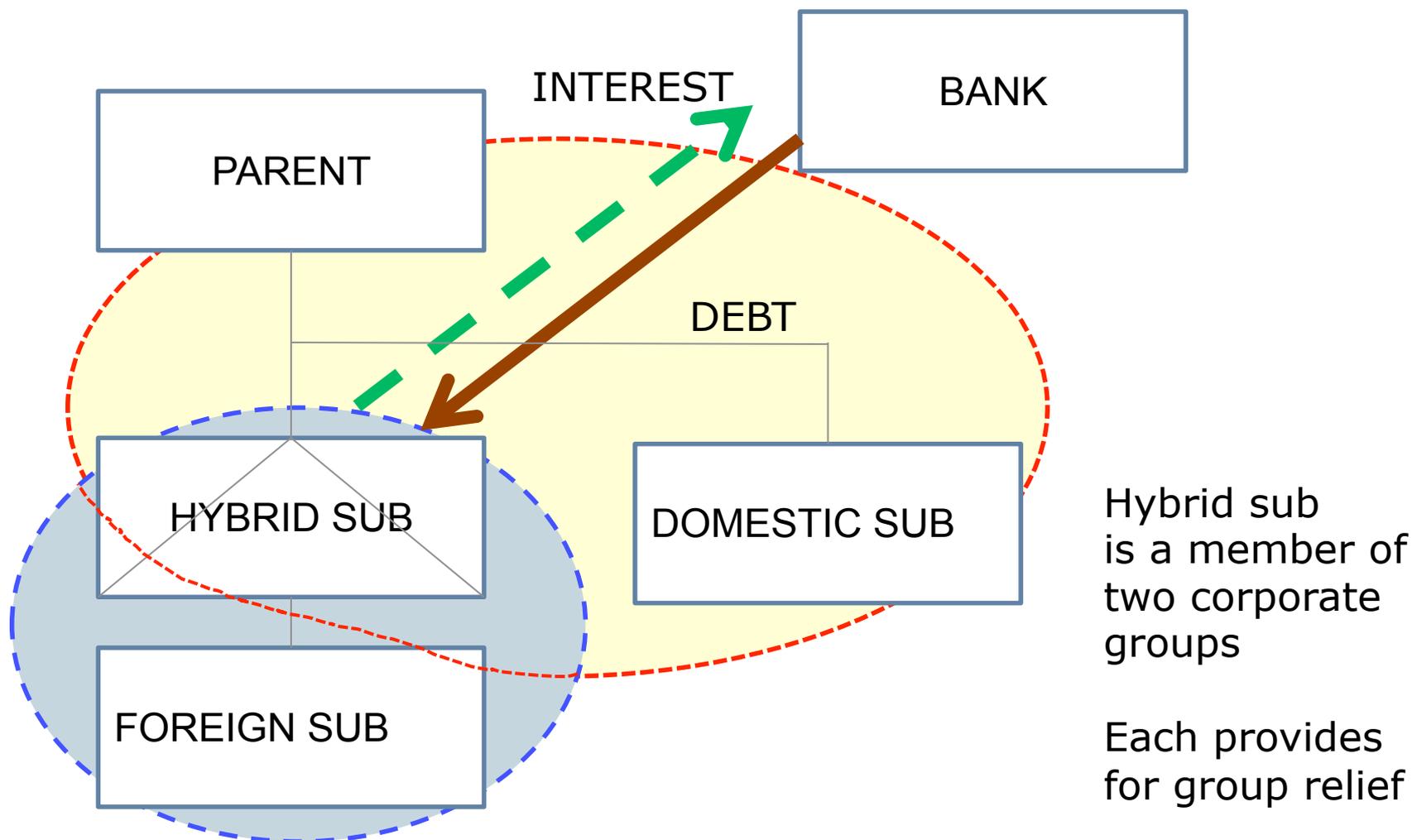
# Hybrid Debt held by Parent



Hybrid instrument is treated as debt for foreign sub and as equity for parent

Interest expense on loan to finance equity is deductible in full by foreign sug

# Double Deduction Globally for Interest



# Existing Approaches

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- Limit the level of interest expense or debt in an entity with reference to a fixed ratio
- Rules that compare the level of debt in an entity by reference to the group's overall position
- Arm's length tests that compare the level of interest or debt with the position that would have existed had the entity been dealing entirely with third parties
- Withholding tax on interest payments that are used to allocate taxing rights to a source jurisdiction
- Disallowance of a percentage of the interest expense of an entity, irrespective of the nature of the payment or the identity of the lender

# Recommendations

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- Focus on excessive interest expense as a percentage of revenue, rather than excessive debt
- Net interest expense with interest income
- Small entity exception, as defined
- Treat groups as a global entity
- Approaches:
  - Allocate global net interest of the group, ignoring actual interest expense of a member
  - Compute a global cap on interest expense
  - Apply global ratio for the group, based on interest paid to third parties

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