Considering the Draft Proposals on BEPS Action 4 (Interest Deductions) from a Business Perspective

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On 18 December 2014, the OECD released a discussion draft (the "Discussion Draft") on Action 4 of the Base Erosion and Profit Shifting ("BEPS") Action Plan relating to interest deductions and other financial payments for public consultation. More than 1,000 pages of public comments have been provided by multinationals, business associations and other interested parties on the Discussion Draft that considers approaches to limit the deductibility of interest (and other financial payments). This article provides a critical overview of the proposals in the Discussion Draft and considers the potential impact on cross-border business activities and investment.

I. Introduction

The corporate income tax treatment of debt and equity is fundamentally different. In most countries, interest is taxable, or tax deductible (if certain conditions are met), when received, or paid, respectively. In contrast, dividends are paid out of taxed profits and do not reduce a company`s taxable income. At the level of the shareholder, dividends may subject to a (partial) tax exemption or a tax credit. When loans are granted between different members of a multinational group, the interest charged will reduce the taxable income of the borrowing entity and increase the taxable income of the lending entity.

Thus, in a cross-border context, the income will be taxable in the State of residence of the lender and not that of the borrower. In order to limit the amount of tax deductible expenses, virtually all high-tax countries introduced different rules that set limits to the amount of allowable interest expenses (for example, thin capitalization rules, earning stripping rules).

The Discussion Draft starts with the assumption that "the use of interest (and in particular related party interest) is perhaps one of the most simple of the profit-shifting techniques available in international tax planning". Throughout the Discussion Draft, the OECD gives the impression that all MNEs arrange their financing with a view to reduce tax costs and that it is equally easy for a group to finance a subsidiary with debt or equity.

How a business finances its operations is however an important business decision that depends on a range of factors. While the deductibility of interest expenses is one of the factors to be considered, the decision as to whether a company should be financed by equity or debt is generally not tax driven. There are number of good commercial reasons why intra-group loans can be preferable to a contribution of equity. For example, loans are more flexible than equity that tends to be more formal and bureaucratic to issue and repay.

Moreover, dividend distributions are subject to limitations in terms of amount and timing and the repayment of capital is not a straight-forward exercise. In many circumstances, the split between equity and debt funding will be dictated by external structural issues such as minority interests, existing creditors, exchange controls, foreign exchange aspects or other local regulatory constraints.

II. The proposals in the discussion draft

1. Opening comments

The Discussion Draft described six approaches which are currently used by countries to limit the deductibility of interest expenses. Three of these approaches are assumed not to be suitable options for a best practice rule including (i) the application of withholding taxes, (ii) arm`s length tests and (iii) rules which disallow a percentage of the interest expenses of an entity.

The remaining three approaches which may be recommended by the OECD as 'best practice' would be either:
- Based on a group's worldwide level of external debt; or
- A fixed ratio rule based on an entity's earnings, assets or equity; or
- A combination of both approaches.

In addition, the Discussion Draft suggests that depending on the final design of any rule included in a best practice recommendation, some targeted rules may also be required.

2. Group-wide rules

The Discussion Draft suggests a group-wide rule which would limit the availability of interest deductions, within the group as a whole, to the overall third party interest expense incurred by the group. The deductible expenses of each group member would be determined by comparing a financial ratio of the individual entity with that of its worldwide group (for example, net interest to earnings or net interest to asset values).

The underlying assumption of a group-wide rule is that the indebtedness of all members of a multinational group should be at a constant rate. However, in practice the level of debt funding varies depending on a number of facts such as line of business, business cycle, level of risk, jurisdiction and other factors that do not give rise to BEPS concerns. As a matter of principle, a group-wide interest limitation would be a departure from the arm`s length principle and a significant move towards formulary apportionment.

The application of a group-wide rule would be an extremely complex – if not impossible – exercise and entail substantial measurement issues given the differences in tax and accounting principles applicable in different countries. This would mean that multinational enterprises will have to determine relevant figures for each group company and to make adjustment to account for differences in the accounting treatment. Furthermore, the group-wide rule would not be implemented consistently as countries will have a certain leeway. All this would elevate the compliance burden and related costs to an unprecedented level.

Apart from the practical challenges, the group-wide rule would result in significant uncertainty, as the amount of deductible interest expense may only be determined once all information at group level is available (this may be months after the end of the fiscal year). The introduction of group-wide rules would also result in double taxation since non-deductible interest payments will be taxed at the level of the lender.

As a consequence, multinational enterprises ("MNEs") may consider financial reorganisations in order to bring a company`s financial ratio in line with the group ratio, rather than having a business rationale. However, it will be very difficult and somehow artificial for an MNE to match third party net interest expense in exactly the way that is needed for maximum deductibility at the level of each entity. In particular, since the amount of maximum deductibility may vary from one year to another because of reasons that are not under the control of the MNE (for example, on grounds of the volatility of earnings).

This would make it impossible to forecast the interest cap per entity before the end of a fiscal year. Moreover, the reorganisation of the financing of group companies will often not be possible or trigger significant tax costs (apart from the restructuring costs). Thus it seems likely that there will be a loss of deductibility of third party interest overall.

The proposal would have a significant impact on business decisions as it would increase the effective cost of capital for businesses. This may force multinationals to raise the level of target return required on investments with the consequence that investments may be rejected that otherwise would have been approved. Apart from the negative impact on global growth and employment opportunities, the ultimate long term effect of this could be increased costs being passed onto consumers and reduced earnings realized by the shareholders.

A disturbing feature of a group-wide rule is that it would be an incentive to increase external debt funding for tax purposes, contrary to the lessons learned from the financial crisis. This is because highly leveraged groups are treated more favourably if a group-wide rule is applied (i.e. group companies would be allowed to deduct higher amounts of interest expenses). Depending on the design of the rule, it may further create an uneven playing field between multinational and purely domestic groups (in favour of domestic businesses).

A group-wide rule presents a particular issue to MNEs engaged in completely different sectors with different debt requirements. Here, multinational groups may be constrained to structure their financing in a way that is optimal from a tax perspective but which might be completely opposite to how the financing would be structured from a commercial perspective. Given that there is currently no major OECD country that applies a group-wide test as a main rule, it is hard to imagine that such rule would be supported by countries around the globe.

3. Fixed ratio rules

Another rule suggested in the Discussion Draft is a fixed ratio test that would restrict an entity`s interest expense to a specified portion of earnings, assets or equity of an individual company irrespective of the leverage of the group as a whole. As such, a fixed ratio rule would be less complex to apply for the taxpayers and tax authorities, provide for legal certainty and limit the compliance burden and costs. A fixed ratio test also has the advantage that the rule does not need to be designed identically in all countries.

The key weakness of the fixed ratio rule is that it proposes a "one size fits all" approach which does not take into account the significant differences among businesses in different sectors with different profit margins and different debt ratios; some businesses require more gearing than others. Moreover, the deductibility of interest expenses may be restricted due to the fact that a company is not profitable during certain periods or a recession. When interest expenses are not deductible, double taxation will likely arise as the lender should be taxable on the corresponding income. To deal with this obstacle, a carry-forward mechanism should be implemented in regard to both the non-deductible interest and unused capacity so as to mitigate the effect arising from the volatility in a company`s earnings over time. Nonetheless, even such carry-forward would not eliminate the problem of double taxation as companies may never be in a position to use the amounts carried forward.

While the Discussion Draft does not propose a certain percentage, it is stated that a ratio of 30% of the EBITDA as currently applied by several countries seems to be too generous. However, a recommendation regarding the fixed ratio must not be set too low in order to reduce the negative impact on the financing of investments (for example, investments in capital-intensive industries and real estate or infrastructure projects). It is also important to remember that the current interest rates are at historic lows. Hence, data on interest expense levels in the current environment is not at all representative and cannot be the basis for benchmarking an appropriate fixed ratio.

4. Combined approach

The Discussion Draft further suggests a combined approach which adopts the fixed ratio rule as the general rule and applies a group-wide rule as a carve-out from the general rule. By adding a carve-out to the fixed ratio rule, the specific circumstances of capital-intensive industries and investments relying heavily on external funding (for example, real estate and infrastructure investments) could be considered. However, it would be important that the combined approach offers an effective carry-forward mechanism, allowing the companies to carry-forward both non-deductible interest and unused capacity.

This approach would allow entities with lower levels of interest expenses to apply a simple fixed ratio test, while more highly leveraged groups would apply a more complex group-wide test. This would also reduce the distortions regarding the competitiveness of capital-rich groups (as opposed to highly leveraged groups) that could otherwise deduct less interest expense than groups that rely more on external funding. It is, however, crucial that the fixed ratio would not be set too low. Otherwise, the complex and costly group-wide rule would – by default – become a main rule.

III. Considerations regarding EU Law

The Discussion Draft acknowledges that an international approach to the deductibility of interest is unlikely to be effective unless it can be fully implemented in the EU and that further considerations need to be given to design rules that are consistent with EU treaty freedoms, Directives and State aid rules. Indeed, the majority of OECD countries (i.e. 21 of 34 countries) are Member States of the EU which have to respect EU law as interpreted by the European Court of Justice ("ECJ").

Therefore, the question as to whether the proposed approaches for limiting interest deductions within MNEs are compatible with EU law is of utmost importance. Recommendations that violate the principles of EU law (for example, the freedom of establishment or free movement of capital) may not be followed by EU Member States. The Discussion draft contains a rather cursory examination of the EU law point in Annex 2, without reaching any conclusion.

In general, the proposed interest limitation rules must apply to both cross-border loans between EU affiliates and loans between affiliates in the same Member State in order to not constitute an obstacle to the freedom of establishment. This would evidently impose a substantial additional compliance burden on mere domestic groups (not only on MNEs). However, an undue discrimination of MNEs may still exist if it is possible for domestic groups to escape from the additional compliance burden through a tax consolidation (for example, a fiscal unity regime), whereas MNEs would suffer from a (significantly) greater compliance burden.

In case the interest limitation rule would be designed in a way that it only applies to cross-border intra-group loans, this restriction on the freedom of establishment is only permissible if it is proportionate and justifiable to combat tax avoidance through the use of a wholly artificial arrangement. Considering that the interest limitation rules would target common business transactions and not allow EU companies to demonstrate that in a specific case a higher level of indebtedness was commercially justifiable, it is unlikely that the proposed interest limitation rules (applied exclusively in a cross-border context) would be compatible with EU Law.

IV. Conclusion and outlook

The Discussion Draft addresses BEPS issues around the deduction of interest and other financial payments but it fails to define what is meant by "excessive interest deductions" which is the perceived BEPS concern. Considering that this topic is already in the scope of other BEPS Actions[1], it appears to be appropriate to recommend a more targeted rule, rather than imposing substantial restrictions on all taxpayers.

The preferred option in the Discussion Draft seems to be the group-wide rule which aims at limiting the availability of interest deductions within a group to the overall third party interest expense incurred by the group. However, why would the level of internal debt funding in excess of third part debt evidence base erosion and profit shifting to another jurisdiction? This rule would cause double taxation and distortions in the competitiveness between multinational groups (i.e. capital-rich vs. highly leveraged) as well as distortions in the competitiveness between multinational and purely domestic groups. It is further concerning that the proposed rules would create an incentive for groups to increase third party debt funding.

While the fixed ratio rule would be simple to operate given its mechanistic nature, its "one size fits all" approach does not seem to be appropriate given the significant differences in the need for debt funding in different sectors. A combined approach with a fixed ratio rule as general rule (and a reasonable high ratio) and the group-wide rule as carve-out seems to be the most sensible approach as it would allow MNEs to avoid the application of the group-wide rule, whereas businesses with a higher external leverage would have the option to apply the alternative rule (for example, real estate and private equity funds). Nevertheless, none of the proposed rules is consistent with the arm`s length principle – yet, another step within the BEPS Project in the direction of formulary apportionment.

The proposals in the Discussion Draft pose significant compatibility issues with EU Law. Therefore, EU Member States should not be able to adopt the proposals in the Discussion Draft. Moreover, these proposals raise concerns from a constitutional law perspective in many countries as they put limits to the net income principle (allowing taxpayers the deduction of expenses in relation to their income generating activities). The Discussion Draft is, however, not a consensus document and the work on BEPS Action 4 will only result in best practice recommendations. Thus, countries will be free to keep their existing rules or to adopt the OECD recommendations in their domestic tax law. We can assume that Luxembourg will not introduce any overly restrictive rules in order to remain a location of choice for the structuring cross-border activities and investments.

In the authors` view, a best practice recommendation should aim at having minimal impact on investments and competition, and the avoidance of double taxation and high compliance costs. Ultimately, countries have to strike a balance between the limitation of interest deductibility to a reasonable level and remaining attractive for foreign investments.

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1) In particular, BEPS Action 2 regarding hybrid mismatch arrangements, BEPS Action 3 regarding CFC rules and BEPS Actions 8 – 10 that propose changes to the transfer pricing guidelines will have an impact on intra-group financing activities.