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Briefing note

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BEPS Action 4 - proposed limits on interest deductions: what do they mean for businesses?

The deductibility of interest is a critical issue for most businesses. With the release of the OECD's final reports on Base Erosion and Profit Shifting (BEPS), recommendations are being made for the introduction of limits on the ability of businesses with cross-border financing to claim interest deductions.

We look at the OECD's recommended rules for limiting interest deductions and ask: what might they mean for businesses?

What is being proposed?

The OECD's final report on BEPS Action 4 recommends a three tiered approach to limiting interest deductions: a "core" maximum net interest to EBITDA ratio; an "optional" group ratio concession; and specific targeted rules / concessions.

What is being targeted?

The OECD has concerns about the use of loans to shift profits into lower-taxed jurisdictions.

The proposals are designed to target **all** debt funding, including:

- within groups (including permanent establishments);
- between related parties (proposed 25% direct or indirect investment threshold); and
- with third parties.

The proposed rules would apply to traditional interest on debt, as well as to payments economically equivalent to interest (such as imputed interest on zero coupon bonds or amounts treated as interest by transfer pricing rules) and expenses incurred in connection with the raising of finance (such as forex gains and losses on financing instruments and guarantee and arrangement fees). On the positive side, the rules apply only to the **net interest** of an entity.

Who will be affected?

Subject to a *de minimis* threshold, the rules will potentially affect a wide range of entities, with multinational groups included as standard in the proposed rules and the option for the rules to apply to domestic groups and/or standalone entities. They will apply to both **existing** and **new** funding arrangements, although the OECD recognises the need for transitional arrangements.

However, the rules for **banks and insurance companies** may apply differently, with final proposals to be released in 2016.

Key issues

- Likely problematic for a range of businesses – however we expect the UK and a number of other jurisdictions will not adopt the proposals in their current form
- The proposed rules would limit interest deductions to certain earnings ratios
- Applies to interest on all debt, including third party debt
- No "grandfathering" – proposals apply to existing and new arrangements (subject to potential transitional rules)
- No exclusion for real estate, securitisation issuers or SPVs, which could cause serious problems in those sectors
- We recommend mapping potential problem areas and monitoring implementation carefully

The core rule: net interest to EBITDA ratio

Entities would be able to claim interest deductions up to a fixed percentage of EBITDA (as defined for tax purposes). The OECD has given a recommended range of acceptable ratios of between 10 and 30 per cent., and accepts that different jurisdictions may apply different fixed ratios, depending on what other targeted measures or reliefs are introduced.

The optional group ratio concession

The recommended group ratio rules allow an entity to claim interest deductions up to a percentage of EBITDA, with that percentage determined by the group's total percentage of net **third party** interest expense against the group's total EBITDA. The group's net third party interest can be uplifted by 10% to account for any double taxation.

This is intended to be a concession where the group is genuinely highly leveraged from third party debt and the debt is allocated based on the earnings contribution of group entities.

The concession would only apply to group entities (as defined for financial accounting purposes). The OECD proposals also recognise the potential for countries to adopt alternative group concessions (i.e. equity ratios).

Carry forward/back provisions

The proposals include options to allow (subject to a time limits):

- interest that was not able to be deducted in a financial year to be carried forward (subject to the interest deduction limits not being exceeded in any year);
- any spare "capacity" to be carried forward to increase the available deductions in future years; and
- disallowed interest deductions to be carried back to years with spare capacity.

Additional targeted rules / concessions

The proposals also suggest a number of targeted anti-avoidance rules designed to apply over and above the general rules, such as to prevent interest payments to related parties to alter the ratios or group splitting.

On the other hand and in a somewhat positive step, there is a carve-out from the general rules for "public benefit projects" (but subject to onerous conditions). However, no concessions have not been extended to real estate, securitisation issuers, and SPVs generally.

It is in areas like real estate and securitisation that the proposed rules would have perhaps the most profound impact, as here one sees high levels of leverage for good commercial reasons (i.e. because of the high quality of the underlying assets) and not because structures are driven by tax considerations. There would be significant consequences for the wider economy if interest deductibility were restricted in these sectors - indeed we do not believe the securitisation market could operate if securitisation issuers (typically almost 100% debt funded) were denied interest deductions.

Interaction with other rules

The rules on interest deductibility clearly interact with a range of OECD BEPS proposals (all of which have now been finalised and released), particularly in relation to the proposed hybrid rules (see our separate client briefing) and changes to the transfer pricing rules.

In relation to both transfer pricing and the hybrid rules, it is proposed that rules would apply first to determine what expense, in effect, is permitted to be treated as interest and therefore notionally deductible, before applying the interest deductibility rules to potentially further limit the actual interest deductions.

Where to from here?

At this stage these are only proposals and would need to be legislated domestically. Whilst they have the general support of the OECD and G20 countries, one of the key issues will be the different approaches by the various OECD member countries.

We are likely to see a wide variance in whether countries adopt these rules at all and, even where they are adopted, variances in the timeframe within which the measures are introduced, the fixed ratio adopted and whether the group ratio concession is adopted. Not only could this add significant complexity to the funding structures of multinational groups, but also create incentives for tax arbitrage and/or risk double tax.

A number of countries already have rules which impose some limits on the deductibility of interest, either on a fixed ratio basis (for example, Finland, Germany and the United States) or on group basis (the UK's worldwide debt cap). The OECD view is that many of these regimes are too generous, but it may be that those jurisdictions consider the current rules are sufficient and further measures are not a high priority.

For the reasons mentioned above, we expect cautious adoption by countries (such as the UK) which have (or seek to develop) a significant securitisation,

capital market, SPV or real estate investment infrastructure.

What should you be doing?

The most important first step will be to ensure a good understanding of countries in which the new rules might pose problems, and monitoring the implementation of the rules.

There is also an opportunity to continue to work with authorities so that the rules introduced take into account financing arrangements that might be affected by the rules but which are not tax motivated.

In the real estate and SPV / securitisation space, there is also the opportunity to continue to seek targeted exemptions, particularly for countries where these sectors are of significant importance but where there are indications that the tax authority may be seeking to implement the proposed rules.

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