Interesting cap

International Tax

05 December 2015

Bill Dodwell considers the UK's consultation on interest deductions

The G20/OECD published its report, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* on 5 October, as part of the final package of BEPS actions. The report starts: ‘It is an empirical matter of fact that money is mobile and fungible. Thus, multinational groups may achieve favourable tax results by adjusting the amount of debt in a group entity … it is well-known that groups can easily multiply the level of debt at the level of individual group entities via intra-group financing.’

The working group is clear that, on its own, the arm’s length rule is not enough to limit potential base erosion. Accordingly, it proposes a system-wide limit on total financing deductions by using a fixed ratio. Financing costs in excess of the set ratio are disallowed for tax purposes – although there are optional recommendations that may offer additional deductions.

The objective of the recommendations is not to limit deductions for net third party interest costs. Yet this could be the result of using a ratio-based test. The Business and Industry Advisory Committee to the OECD stated: ‘Any dramatic and overly-restrictive changes to interest deductibility could significantly, and adversely, affect cross-border trade and investment.’

The UK has launched an open consultation on interest deductions. The government said it hoped to include its proposals for this area when it released the Business Tax Roadmap. This is due to be announced at Budget 2016 and is intended to set the framework for business tax until 2020.

The UK consultation acknowledges that the UK has not had a system-wide limit on interest deductions before – and that interest deductions are a valued part of a competitive tax system. In 2010 the coalition government decided not to introduce limits on interest deductions after conducting a review. Yet the value of interest deductions today is much lower due to the combination of low interest rates and much lower corporation tax.

The basic ratio put forward in the BEPS action plan is that financing deductions should be limited to 10–30% of tax-based earnings before interest, tax and depreciation (EBITDA). The range of the percentage is left to a country to select, although the report gives guidance on factors to be taken into account. Evidence put forward by business to the G20/OECD working party, based on data from 20,000 companies over five years from Standard & Poor’s Global Vantage database (excluding financial companies), suggested that a 20% level would limit interest deductions for 27–32% of that sample. A 30% level would hit 20–24% of the sample.

The G20/OECD report recommends a range of measures to moderate the impact of interest restrictions. These include:

- The use of a group ratio, where this is higher than the selected national ratio. This would be helpful if all countries in the group bear similar levels of debt, but would not be effective if the group had a mixture of high and low leverage.
- The use of carry-forward of disallowed deductions (and possibly also unused capacity to deduct interest) for use in future years.
- The exemption of third-party debt secured on public benefit projects.
- A *de minimis* exclusion for low amounts of debt, primarily to benefit SMEs.

The UK consultation points out that group ratios may be complex to apply. Experience from Germany – the first country to introduce a ratio-based limitation – is that a group calculation is difficult in practice to apply. This is partly because the group ratio must be based on an accounting measure, whereas the national ratio is planned to be based on taxable earnings. Yet it must be right to allow higher group ratios, which are of course based on third-party debt deductions, in an effort to avoid disallowing third party debt in individual countries.

The public benefit project debt exclusion was a late addition to the BEPS proposal and seems to have been developed by the UK. Respondents to the OECD public consultation pointed out that projects whose revenues are governed by government decisions bear a higher level of debt. PFI projects in the UK, for example, are designed with a high level of debt finance to deliver the intended outcome. The revenue guarantees reduce risk. The challenge is that the wording of the exemption is restrictive. Including an exemption along these lines in a UK regime would recognise the importance to the UK economy of many public/private projects, but it must be hoped that a wider interpretation would be allowed.

The final complexity discussed by the UK concerns whether it might be possible to aggregate all UK companies in a multinational group for the purpose of calculating interest restrictions. This sounds sensible – and is how the worldwide debt cap rules operate – but compatibility with EU law is unclear.

The UK consultation closes on 14 January and the government has indicated that any new rules would not be introduced before 1 April 2017. Business needs to model the implications of possible change and ensure that the Treasury has enough information to target new rules at base erosion and not at economic investments.