Shifting interests

International Tax   Large Corporate

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Bill Dodwell outlines the main points from the OECD’s draft interest restrictions document aimed at tackling BEPS

The OECD’s action plan to counter base erosion and profit shifting is in full flow. BEPS may be split into three core areas:

- changes to transfer pricing approaches;
- lowering the threshold for taxable presence (permanent establishment); and
- limiting interest deductions.

On 18 December, the OECD released a discussion draft covering finance costs. The focus group from Working Party 11, which drew up the draft, is co-chaired by Germany and the UK.

The introduction notes that the OECD’s aim is ‘…to identify best practices in the design of rules to prevent base erosion and profit shifting using interest and financial payments…’. The first line of the document states: ‘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.' The draft rejects the idea of relying on arm's-length pricing, which may shock those who have heard the OECD defend this fundamental concept.

The core concept covered in the document is that the total of a multinational's net interest deductions should not exceed its net third party payments. This is not to prohibit deductions for intercompany debt but is intended to cap total deductions.

Having set this base parameter, the discussion focuses on three possible approaches:

- group allocation rules;
- coordinated national fixed ratio rules; and
- possible targeted rules.

In principle, a group allocation rule requires adding up the group's total third-party interest expense and then allocating it among all the group members by reference to an economic measure. The two obvious measures put forward are group earnings and group assets. The consultation does acknowledge that there are practical problems in identifying the key figures – not least because interest is often a legal and tax concept that differs from valuation-based accounting under IFRS. The draft rejects the idea of deemed deductions, apparently due to withholding tax issues. Instead, the allocation would cap the deductions that may be claimed by a group company.

Business will thus be concerned that the group allocation rule would be likely to prevent groups deducting all their third-party interest costs. It is not easy to move debt around a group. Many countries have tax rules that prevent so-called 'debt pushdown' – where debt incurred at a parent company level is moved into a different country. In some cases, company law and accounting could prevent it and the discussion draft notes that exchange control and withholding taxes can also be barriers.

Large groups with lots of relatively small activities in many countries have always shied away from the complexity of trying to manage debt in every location. Variability of profit could also deny relief for finance costs.

Germany pioneered fixed ratio tests in Europe and have been adopted by seven countries here. The German measure limits deductions to 30% of earnings before interest, tax, depreciation and amortisation (EBITDA). The OECD discusses limiting national finance deductions to a defined percentage of earnings or by reference to assets or equity. It does note that limiting interest in this way could meet other policy goals, such as setting the balance between debt and equity – which go beyond the BEPS project. They also make the point that some countries with fixed ratios consider that the current one is too high; there are indications that Germany would like to reduce significantly its 30% level.

The OECD references a PwC study of global 100 non-financial companies in nine countries, which indicates that about half have a 10% ratio and 85% no more than 20%.
The OECD concludes that the BEPS goal requires ratios below 30%. There's also a discussion of combining fixed ratios with interest allocation – perhaps by setting a low fixed ratio that would be simple to apply. More highly-leveraged groups would then be forced down the complexity of an allocation system.

A range of targeted rules is covered, such as limitations on connected party debt, the imposition of a 'subject-to-tax' condition and rules limiting the creation of debt on group restructuring. None is put forward as a particular solution.

After considering limitations, discussion moves to excess interest, noting 'the countries involved in this work are also concerned by the risk of economic double taxation and agree that this should be avoided where possible'. The main option put forward is the carry-forward of excess deductions for use in future years, with consideration of the carry-forward of excess capacity – a concept used by the US and Germany, among others.

There's discussion of specific industry factors, where it is suggested that special rules may be needed for:

- financial services;
- oil and gas exploration and production;
- real estate; and
- public infrastructure projects.

The overall flavour of the document will concern business as it moves sharply away from long-standing concepts of arm's length terms. It is important to respond with detailed explanations of issues not necessarily considered by the Working Party and, ideally, other solutions that fit the parameters set. There’s a real risk that full deductions for third-party costs could no longer be available in future.