The interest ratio

Large Corporate

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Bill Dodwell considers the future of interest deductibility

One action from the G20/OECD Base Erosion and Profit Shifting project – Interest Restrictions (action 4) – potentially affects every multinational – and some variants could affect domestic businesses.

The original discussion draft put forward a global allocation system – where a group's net interest expense is added up and then allocated around all its subsidiaries, using some sort of economic measure. The US Treasury Department owned up recently to being the force behind this idea which, fortunately for global commerce, has been rejected. The fundamental problem is that there is no mechanism to move the debt, or the interest, to the location of group profits.

That left the German plan – a ratio-based test that limits interest deductions to a percentage of earnings. Half a dozen European countries have followed Germany down this path. The ratio could well be lower than the actual third party interest expense, though – possibly going much further than countering base erosion.

The Working Group preferred a ratio-based test, with the option to add on a fall-back, in the form of a cap set by reference to a worldwide allocation. Recent comments by an OECD official suggested that the countries wanted to choose a ratio from an agreed range, or 'corridor', as it seems to be known in Paris. We don't yet know how far the corridor will stretch but early indications favoured a 10–20% range, lower than the current German 30% of EBITDA ratio.

One suggestion is that countries might be able to pick different ratios according to the size of the company. This is based on evidence that the world's very largest companies have lower gearing than the next tier down. The feeling from the countries seems to be that they want the ratio to disallow some third-party debt so that the fall-back to the group-wide cap has some impact. A US Treasury official told the recent OECD/USCIB conference in Washington that the US favoured a 10% ratio.

Other optional features include the ability to carry forward excess interest and indeed excess capacity to future tax years.

One significant concern in the UK – and no doubt elsewhere – relates to infrastructure and other long-term projects. Typically long-term projects attract their own financing, commonly at higher levels, since the revenues from the project provide the lenders with assurance that the loan will be repaid.

In the UK we have a large number of PFI and PPP projects where the revenue model required significant levels of debt to deliver the required return. We also have infrastructure needs, where there is perhaps a floor under the revenues (such as the carbon floor for electricity generation). It seems highly unlikely that there could be base erosion in this area. It seems that the Working Group is discussing whether to exempt from the overarching rules long-term project debt on the basis that it is third party and secured only on the project. It seems clear that any such exemption would need to apply to all long-term projects; limiting the exemption to specific sectors would give rise to state aid issues within the EU.

What should we take from all this? First, it is clear that many countries are concerned by the base eroding potential of group debt. There is recognition that a range of options should be put to the G20/OECD countries so that there is some permitted tailoring to suit differing economies. This means that the output from the action will be classified as a 'best practice' rather than the higher level 'minimum standard'. It also means that not all countries will adopt this.

Australia announced at its May Budget that it would not be adopting the best practice, preferring instead the combination of tough thin capitalisation rules for inward investors, with no restrictions on Australian multinationals expanding internationally.

The Republican chairs of the two tax-writing committees of the US Congress issued a letter recently to the US Treasury Department, making it clear that the enactment of US tax law was a matter solely for Congress. Given that Congress would like to reduce the high headline rate of US corporate income tax, it is likely that limiting interest deductions will be required to balance the books.

The newly-elected UK government hasn't made any comment about its approach, although the coalition did commit to keeping the current rules during the life of that parliament.

Another common question concerns grandfathering. The G20/OECD has rejected grandfathering as a general principle. The group has agreed that existing patent box regimes could continue until 2021, but that’s seen as an exception. If we do not get an exclusion for project debt, there will be obvious pressure for grandfathering in that area – but it seems unlikely anything wider will be offered. Instead, they may be a transitional period to allow business to adapt.

The final question is when changes might be made. There is more work to do to produce the final recommendations and it also seems that countries are keen to act together – so perhaps this will be one of the later actions adopted.