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**BEPS Action 4 : Interest Deductions and
Financial Payments**

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Non tax reasons to debt financing

- **Equivalence of financing by debt and by equity but for tax reasons (Modigliani-Miller theorem)**
- **Reimbursement of loan is easier than reduction of capital**
- **No dilution of shareholders**
- **Discipline on management**

Techniques of profit shifting

- **Inbound investments**
 - **Parents finance subsidiaries through disproportionate debt : transfer of income from source country to**
 - **parent's country**
 - **low-tax jurisdiction**
- **Outbound investments**
 - **Parents finance with debt assets generating tax exempt income (dividends)**

History

- **OECD Model art. 11.6**
- **OECD 1986 Report on Thin Capitalization**
- **OECD 1998 Report on Harmful Tax Competition**
- **Three IFA Congresses**
 - **1966 Geneva**
 - **2008 Brussels**
 - **2012 Boston : « debt equity conundrum »**

Domestic legislation

1. Transfer pricing

UK

2. Debt/equity – Interest/earnings ratios

- **Debt/equity : debt incurred to acquire assets**
 - Generally between 4/1 and 1.5/1
 - **Interest/profits – Interest/EBITDA**
- = earnings stripping rule**
- Generally +/- 30 %
 - Sometimes = safe harbour
 - Higher ratio may be applied
 - Under transfer pricing rules
 - If indebtedness < level of the group

Domestic legislation

3. Interest barriers

- Compares ratio equity/assets of
 - Local company
 - group
- Sometimes = escape clause

4. Withholding taxes

Kemmeren : withholding tax should be equal to corporate tax rate

EU Law limits

Treaty law

Fundamental freedoms

- **Lankhorst-Hohorst (2002) : German thin cap rule applying only to foreign lenders infringes upon freedom of establishment**
- **Result**
 - Extension to domestic situations
 - Then adoption of earnings stripping rule
- **Test-Claimants in the Thin Cap Group Litigation (2007)**
 - Transfer pricing rule allowing to identify purely artificial arrangements

EU Law limits

Directives

- **Interest and Royalties Directive (2003)**
 - No withholding in 25 % group
 - Does not deal with deductibility of interest in source country
- **Parent-Subsidiary Directive (2011)**
 - Should apply if interest is reclassified as dividends
- **Deduction of (notional or actually paid) interest on equity**
 - Belgium
 - Brazil

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- **Prevent base erosion**
 - **Give transfer pricing guidance : no draft so far**

- **Rejects**
 - **Arm's length test : too cumbersome**
 - **Withholding taxes :**
 - **often reduced to zero by treaties or interest-royalty directive**
 - **problem of crediting in residence country**

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Definition of interest

- **Interest on all forms of debt**
- **Economic equivalent of interest (interest element of derivatives)**
- **Arrangement and guarantee fees**

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Level of the rules

- **Rule applying to interest**
 - Interest : key risk factor of tax avoidance
 - Debt not always linked to assets
 - Generates volatility
- **Rule applying to assets**
 - Valuation of assets is a problem (historical cost ?)
 - Intangibles are hard to value
- **Choice for net interest**
 - After deduction of interest received

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1. Group-wide rule

- **Possibility to deduct interest within the group should correspond to the net third party interest cost of the group**
- **The basket would be allocated between group entities in proportion to their economic activity**

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1°. *Interest allocation rules*

Distribute basket of interest deduction according to activity of entities, measured by earnings or assets

a) Deemed interest rule

- **The net third party interest of the group is allocated to each company based on the ratio of its earnings or assets to those of the group**
- **Deductible irrespective of actual interest paid**

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b) Interest cap rule

- The allocation functions as a maximum allowance (cap) applicable to actual interest paid
- Some interest deduction may be lost. The group may have to reorganize debt
- Preference for interest cap rule

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2. Group ratio rules

- **The ratio of the group between net interest and earnings or assets is compared to the ratio of the entity**
- **It functions as a maximum**
- **Often used as a « carve-out » rule**

Problems

1. Definition of interest limitation group

a) Consolidated statements

- Defined by control
- If no consolidated statements, the group must provide comparable figures

b) Ad hoc definition of reporting group

- Would require preparation of statements different from consolidated statements
- Preference for consolidated statements

Problems

2. Measurement of economic activity

a) Accounting or tax figures

- Accounting
- Adjustments to tax differences : exclusion of tax exempt income (dividends)

b) Earnings or assets

1°. Earnings

- Best measure of capacity to meet obligations and of borrowing ability
- Increase of earnings to increase interest deduction : would increase taxable income

Problems

Measure of earnings

- EBITDA : favours capital intensive industries
- Rather than Gross Profit (revenue less cost of sales) : mismatch if an entity provides services to another one

Consolidation adjustments

- Recreate difficulty against apparent simplicity

Volatility

- Carry-over of
 - disallowed interest
 - unused capacity to deduct
 - losses
- No deduction ?

Problems

2°. Assets

- Debt is generally incurred to acquire assets
- Asset values are more stable : deduction is more predictable
- Relief in the event of losses
- Categories of assets
 - Tangible
 - Intangible
 - No financial assets

Criticisms

- **Limit to State sovereignty in the field of taxation**
- **Inducement to increase external debt and create risk**
- **Mismatch vs actual treasury requirements**
- **Double taxation : disallowed interest taxed to the lender**

2. Fixed ratios

- **Fixed ratio between**
 - **interest and earnings**
 - or**
 - **debt and equity**
- **PWC study : ratio to EBITDA of 30 % in excess of actual ratios but concerns only very large companies**

3. Combination of methods

Options

1. Group-wide allocation with interest cap

- **Carve-out : fixed ratio if low interest expense**

2. Fixed ratio

- **Option for highly leveraged groups to adopt group-wide method**

4. Targeted rules

- **Debt push-down in reorganizations**
- **Use of debt to fund tax exempt income**
- **No recharacterization as dividend of disallowed interest**

Conclusion

From Comments

- **No reason to abandon transfer pricing rules : arm's length principle**
- **Advocated by OECD since decades**
- **Otherwise : fixed ratios rather than groupwide rule**