



## OECD releases final report on limitations on interest deductions under Action 4

### Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on recommended limitations on interest expense deductions (Action 4) under its Action Plan on Base Erosion and Profit Shifting (BEPS). This report was released in a package that included final reports on all 15 BEPS Actions.

The document, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (the Interest Limitation Report or Final Report) largely reflects the choices made by the OECD between the various alternatives that were included in the discussion draft released on 18 December 2014.<sup>1</sup> In the Final Report, the OECD recommends that countries implement a “fixed ratio” rule that would limit net interest deductions claimed by an entity (or a group of entities operating in the same country) to a fixed percentage of earnings before interest, taxes, depreciation and amortization (EBITDA). This ratio should be somewhere between 10% and 30% of applicable EBITDA. The Final Report further recommends that countries adopt a “group ratio” rule to supplement (but not replace) the fixed ratio rule and to provide additional flexibility for highly-leveraged groups or industry sectors. Under the group ratio rule, for example, an entity with net interest expense above a country’s fixed ratio could deduct such interest expense up to the level of the net third-party interest/EBITDA ratio of the worldwide group to which it belongs. Countries could also apply an uplift of up to 10% to the group’s net third party interest expense to help prevent double taxation. Beyond this basic framework, the Final Report also recommends that countries consider the following: (i) adopting an “equity escape” rule, which allows interest expense so long as an entity’s debt-to-equity ratio does not exceed that of its worldwide group; (ii) providing for carryforward and/or carryback of disallowed interest expense and/or unused interest capacity, within limits; (iii) providing for exclusions for interest paid to third party lenders on loans used to fund public-benefit

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(infrastructure) projects and for entities with net interest expense below de minimis thresholds; and (iv) providing targeted rules that would close down any remaining BEPS opportunities.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final report on Action 4 will be addressed in a webcast on Financial Payments and BEPS Actions 2 and 4 on 3 December, 2015, at 10am EST.

## Detailed discussion

### Introduction

The Interest Limitation Report justifies the need for agreement on limiting deductions for net interest expense by pointing to the ability of multinational enterprises to selectively place higher levels of third party debt in high tax countries, to use intercompany loans to generate interest deductions in excess of the group's actual third party interest expense, and to borrow to generate tax-exempt income such as dividends from subsidiary corporations, all of which are BEPS techniques that give multinationals an unjustified advantage relative to groups operating only in one country. To deal with this perceived problem the Final Report adopts an approach founded on the twin pillars of a fixed ratio rule and a group ratio rule, with certain modifications and enhancements.

### The Fixed Ratio Rule

Regardless of whether other recommendations in the Final Report are adopted, all countries

are encouraged to limit the net interest expense of an entity (or a group of related entities operating in that country) to a fixed percentage of EBITDA.

Application of the fixed ratio rule is described as a relatively straightforward process:

1. Determination of the entity's EBITDA, beginning with taxable income as determined under applicable country law, and adding back net interest expense, net payments equivalent to interest, and depreciation and amortization. Tax-exempt income is not to be included in this calculation; the Final Report raises but does not resolve the question of how to treat tax-sheltered income, such as dividend income sheltered by foreign tax credits.
2. Application of the statutory benchmark ratio, between 10% and 30%, to the EBITDA figure, to determine maximum allowable interest expense.
3. Determination of the allowable net interest deduction as the lower of actual net interest expense or the maximum amount as calculated above.

The recommended benchmark ratios are between 10% and 30% because, the Final Report indicates, around half of publicly traded multinational groups with positive EBITDA have a net third party interest/EBITDA ratio of 5% or less. Even at the 10% benchmark, the data cited by the Final Report indicates that 62% of such groups would be able to deduct all their net third party interest

expense, and 87% of such groups could do so at the 30% benchmark. Thus, although it received a number of comments to the effect that benchmark ratios in this range would be too low, the Final Report bases its recommendation on the concerns noted in the discussion draft, that benchmark ratios set too high would not be effective in preventing BEPS. However, the Final Report does note a number of factors that should guide a country in choosing between the high and low ends of the recommended ratio. For example, countries that do not also adopt a group ratio rule should consider adopting a benchmark ratio at the upper end of the range, as should those that do not permit the carryover of unused interest capacity or disallowed interest expense, that have a robust system of rules targeted at interest-related BEPS activity, or that have higher interest rates than those generally found in other countries. Countries should also consider setting a higher benchmark ratio for smaller groups, as they are typically more leveraged than larger multinationals.

The fixed ratio rule was chosen as the linchpin of the interest limitation recommendations because it was felt to most efficiently link a group's net interest deductions to its income-producing activities. However, it also has a number of drawbacks. Most obviously, average leverage ratios differ for companies in different industries and at different stages of their life cycle, and a fixed benchmark ratio cannot accommodate these variations. In addition, earnings can be

volatile and groups cannot always reasonably predict, let alone control, earnings of future years. Countries are encouraged to consider using an average EBITDA figure, say from the current and two prior years, to deal with the latter problem.

### **Group ratio rule**

Because the recommended benchmark ratios are set low, the Final Report recommends adoption of a group ratio rule to offer relief to companies in groups that are, for non-tax reasons, more highly leveraged. An entity that exceeds the benchmark fixed ratio would be allowed to deduct net interest expense up to its group's net third party interest expense/EBITDA ratio, if this is higher. Only net interest expense that exceeds both the benchmark fixed ratio and the ratio of the group should be disallowed.

### ***Determination of group leverage ratio***

Use of a group ratio rule raises a number of practical questions. First, because the tax authorities in one country cannot audit the net interest expense or EBITDA figures for the entire multinational group, it is recommended that consolidated financial statements be used to determine the group leverage ratio. Adjustments may be needed where the companies included in consolidated financial statements (generally, under 50% common control) do not correspond with those in the tax consolidated group (usually based on a higher level of control). The report does not propose that adjustments generally be made to reflect other differences between tax and financial statement

principles. However, third party interest expense as reported on the financial statements may be adjusted to account for interest capitalized into assets or included in cost of goods sold or the tax expense line, and to exclude items that are not properly viewed as interest, such as dividends, gains and losses on the disposition of financial instruments, and notional interest amounts (e.g., payments on swaps).

### ***Application of group leverage ratio to in-country/entity EBITDA***

Although the group leverage ratio should be determined on the basis of financial statement information (that being the only practical approach), countries may apply that ratio to an entity's EBITDA determined on either a tax or a financial statement basis. Using an entity's tax-basis EBITDA is more consistent with the fixed benchmark ratio method and is viewed as easier to audit and administer. Non-taxable income such as branch profits and dividends eligible for the participation exemption should be excluded from tax-basis EBITDA, and "appropriate adjustments" should be made for other items of income subject to a special tax regime, such as foreign source income shielded by foreign tax credits. On the other hand, using an entity's accounting-basis EBITDA is more consistent with the determination of the group leverage ratio, even where local GAAP differs from the accounting rules used in preparing the consolidated financial statements. Accounting-basis EBITDA should not be adjusted to eliminate profit or loss arising from

intragroup transactions, so the aggregate of separate company EBITDAs may exceed the EBITDA of the consolidated group as a whole.

### ***Impact of loss-making entities***

Where one or more members of a group operate at a loss, but the group as a whole has positive EBITDA, the losses reduce the group's EBITDA and the ratio of net third party interest to EBITDA is increased. The group ratio rule could then yield an artificially high result when applied to those group members that are profitable. To manage this effect, the Final Report suggests that interest expense allowable under the group ratio rule to any single entity could be capped at the net third party interest expense of the entire group. Where the group as a whole has negative EBITDA, however, the group ratio cannot be calculated at all. In these circumstances the report suggests that an entity with positive EBITDA could be allowed interest expense equal to the lower of the entity's actual net interest expense or the net third party interest expense of the group. Other approaches may also be considered, and the report indicates that further work will be conducted on how to deal with the impact of loss-making entities.

### **Carryovers and carrybacks**

Because both the fixed benchmark ratio and the group ratio rule rely on EBITDA, the amount of interest expense an entity may deduct will be impacted by changes either in its earnings or in those of other members of its group, or by differences between financial statement and taxable income.

The Final Report acknowledges that earnings volatility could make long-term planning difficult and that permanent disallowance of interest expense could result in double taxation, because in most cases the lender will be taxed on the corresponding interest income. Countries may therefore wish to allow entities to carry forward unused interest capacity and to carry forward and/or carryback disallowed interest expense. Interest eligible for carryforward or carryback should be limited to interest disallowed under the fixed ratio and group ratio rules, since interest disallowed under targeted rules may be presumed to arise from base erosion and profit shifting transactions. The report suggests limits be applied to all carryovers, however, and in particular to carrybacks of disallowed interest expense. Such limits could include limits on the number of years that disallowed interest expense or unused interest capacity may be carried forward or disallowed interest expense may be carried back; a fixed reduction in the amount of carryforward (e.g., 10% each year); capping the amount of the carryover at a fixed amount (e.g., US\$1 million); and/or eliminating carryforwards where there is a change in ownership. Countries would need to consider how these carryovers would operate where interest limitations are applied on a group rather than a separate entity basis. Those familiar with the US earnings stripping rules of Section 163(j) will recognize many of these issues.

### **Targeted rules**

Rules targeted at transactions giving rise to BEPS may be necessary to counteract planning undertaken by groups to reduce the impact of the fixed ratio and group ratio rules. For example, entities may attempt to convert interest expense into a different form of deductible expense, or to convert other taxable income into interest; entities may enter into structured arrangements with third parties to increase the amount of net third party interest expense taken into account under the group ratio rule; or groups may be restructured, for example by placing an unincorporated holding entity at the top of a structure to create two groups. Beyond noting a few further types of possible responses to the limitations of the fixed ratio and group ratio rules, the Final Report does not give much guidance on the design of targeted rules, presumably because such rules would be greatly influenced by the particular features of each country's existing tax system.

### **Special rules for certain industries**

The Discussion Draft on Action 4 noted that special consideration might be needed for banks and insurance companies; for other financial businesses such as leasing, asset management, and credit card issuance; for public infrastructure projects; and for companies that might be subject to special tax regimes, such as those in the oil and gas and real estate sectors. Of these, oil and gas and real estate businesses appear to have fallen by the wayside; no mention of them

is made in the Interest Limitation Report. The report effectively reserves on the treatment of banks and insurance companies, indicating that the fixed ratio and group ratio rules may not be effective because these companies typically have net interest income rather than net interest expense. Additional work is to be carried out in 2016 to identify best practice rules for banks and insurance companies. Other financial businesses, however, are not to be given special treatment.

The only other exception to the general rules recommended by the Final Report is for public-benefit projects that meet a number of specified criteria, because such projects are considered unlikely to present any BEPS risk. Countries may choose not to limit interest expense on third party loans relating to projects where the operator undertakes to provide, operate, and/or maintain assets for at least 10 years; there is a general public interest in such projects and the operator contracts with a public sector body or public benefit entity to provide the goods or services; the loans in question are non-recourse, secured only by the assets of the project, and do not exceed the value or estimated value of the project assets; the operator, the interest, the project assets, and the income arising from the project are all in the same country, where the income is subject to tax at ordinary rates; and the third-party debt of the project does not exceed that attributable to other, similar projects undertaken by the operator or its group. If this exception applies, the earnings and

related interest expense should be excluded from the determination of the fixed ratio rule and the group ratio rule for the operator and its group.

### **Interplay with other Actions; definition of interest expense**

The Final Report specifically provides that rules to address hybrid mismatch arrangements under Action 2 should be applied to determine an entity's total net interest expense before the fixed ratio rule or group ratio rule are applied. Where a country applies controlled foreign company (CFC) rules alongside interest limitation rules, CFC income that is subject to tax at the parent company level may be included in the calculation of the parent's EBITDA when applying the fixed ratio rule and group ratio rule. Where this CFC income includes interest income or expense, the country should consider including the interest in the calculation of the parent's net interest expense and excluding that interest from the calculation of the parent's EBITDA. Targeted rules and country-specific limitations on interest expense, such as those arising from application of the arm's-length principle, should also generally be applied before the fixed ratio and group ratio rules, but the decision on ordering here is left to the individual countries, who should take into account the particular features of their tax systems.

The Interest Limitation Report recommends that all countries should include items economically

equivalent to interest in the scope of their interest limitation rules. Such items may include, but are not limited to, profit participating loans; imputed interest on instruments such as convertible bonds and zero coupon bonds; amounts under alternative financing arrangements, such as Islamic finance; the finance cost element of finance lease payments; capitalized interest; amounts measured by reference to a funding return under transfer pricing rules, where applicable; notional interest amounts under derivative instruments or hedges of a company's debt; and certain foreign exchange gains and losses on debt instruments. In addition, expenses incurred in connection with borrowing, such as guarantee fees and debt issuance costs, should be subject to the interest limitations.

Further work on the transfer pricing aspects of financial transactions is to be undertaken in 2016 and 2017. However, the Final Report notes that Revisions to Chapter 1 of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations under Actions 8-10 of the BEPS Action Plan limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided.

Finally, the Interest Limitation Report clarifies that any interest disallowed under the rules implemented in response to Action 4 remains interest expense for other purposes and should still be subject to withholding tax.

### **Transitional rules**

The Final Report leaves open the timetable for adopting new rules in response to Action 4, but acknowledges the costs associated with changing existing financing arrangements and recommends that countries introducing the fixed ratio rule and group ratio rule should give taxpayers a reasonable period of time to restructure such arrangements. Countries may wish to grandfather existing debt, but the report recommends that any grandfathering provisions should primarily apply to third party loans outstanding on the date the new rules are announced.

### **Implications**

While it is not possible to predict exactly how or when various countries will adopt the recommendations of Action 4, companies should expect additional limitations on interest expense and should arrange any new financing transactions with an eye towards flexibility and the possible need to unwind or alter such transactions before maturity. Thus, decisions on whether and how to hedge currency and interest rate risk, whether to choose fixed rate or floating rate debt, and whether or not to make intercompany loans prepayable without penalty, will be impacted by this need for flexibility. Companies may also wish to comment on how the Action 4 framework might best be implemented in their home country.

## Webcasts

EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

- ▶ OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10am EDT
- ▶ New Reporting under BEPS Action 13 - 20 October, 10am EDT
- ▶ Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT
- ▶ Permanent Establishment Developments and BEPS Action 7 - 5 November, 10am EST

- ▶ Transfer Pricing and BEPS Actions 8-10 - 12 November, 10am EST
- ▶ Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10am EST
- ▶ Financial Payments and BEPS Actions 2 and 4 - 3 December, 10am EST
- ▶ Dispute Resolution and BEPS Action 14 - 10 December, 10am EST

For more information and to register for the webcast series, [click here](#).

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## Endnote

1. See EY Global Tax Alert, [OECD releases discussion draft on interest deductions under BEPS Action 4](#), dated 23 December 2014.

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