

Public Discussion Draft

BEPS ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

18 December 2014 - 6 February 2015



WORK IN RELATION TO INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

In July 2013, the *Action Plan on Base Erosion and Profit Shifting*¹ directed the OECD to commence work on 15 actions designed to ensure the coherence of corporate income taxation at the international level.

Action 4 of this plan stresses the need to address base erosion and profit shifting using deductible payments such as interest that can give rise to double non-taxation in both inbound and outbound investment scenarios. From an inbound perspective, concerns focus on excess interest deductions reducing taxable profits in operating companies even in cases where the group as a whole has little or no external debt. From an outbound perspective a company may use debt finance to produce tax exempt or deferred income, thereby claiming a deduction for interest expense while the related income is brought into tax later or not at all. Similar concerns are raised by payments under financial instruments such as guarantees and derivatives.

Working Party No. 11 of the Committee on Fiscal Affairs (CFA) has examined existing approaches to tackling these issues in order to identify best practices in the design of rules to prevent base erosion and profit shifting using interest and financial payments which are economically equivalent to interest. This consultation document sets out different options for approaches that may be included in a best practice recommendation, and in particular considers issues including:

- What is interest and what are payments economically equivalent to interest.
- Who a rule should apply to.
- Whether a rule should apply to the level of debt or interest expense, and to a gross or net position.
- Whether a small entity exception or threshold should apply.
- Whether interest deductions should be limited with reference to the position of an entity's group.
- Whether interest deductions should be limited with reference to a fixed ratio.
- Whether a combined approach could be applied.
- The role of targeted rules.
- The treatment of non-deductible interest expense and double taxation.
- Considerations for groups in specific sectors.
- Interaction with other areas of the BEPS Action Plan.

¹ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, available at <http://www.oecd.org/ctp/BEPSActionPlan.pdf>

The options included in this consultation document do not represent conclusions on the content of any best practice recommendations, but are intended to provide stakeholders with substantive options for analysis and comment.

The CFA invites interested parties to send written comments on this consultation document. Comments should be sent by email to interestdeductions@oecd.org in Word format, by no later than 6 February 2015. Please note that all comments received regarding this consultation document will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective, or the person(s) on whose behalf the commentator(s) are acting.

Persons and organisations who submit comments on this consultation document are invited to indicate whether they wish to speak in support of their comments at a public consultation meeting on Action 4 that is scheduled to be held in Paris at the OECD Conference Centre on 17 February 2015. Persons selected as speakers will be informed by email.

This consultation meeting will be open to the public and the press. Persons wishing to attend this public consultation meeting will be able to register on line. Due to space limitations, priority will be given to persons and organisations who register first and we reserve the right to limit the number of participants from the same organisation.

This meeting will also be broadcast live on the internet and can be accessed on line. No advance registration will be required for this internet access.

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I. INTRODUCTION

A. Base erosion and profit shifting using interest and payments economically equivalent to interest

1. 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 fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity. Against this background, Action 4 of the Action Plan on Base Erosion and Profit Shifting calls for the:

[Development of] recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.²

2. Most countries tax debt and equity differently for the purposes of their domestic law. Interest on debt is generally a deductible expense of the payer and taxed at ordinary rates in the hands of the payee. Dividends, or other equity returns, on the other hand, are generally not deductible and are typically subject to some form of tax relief (an exemption, exclusion, credit, etc.) in the hands of the payee. While, in a purely domestic context, these differences in treatment may result in debt and equity being subject to a similar overall tax burden, the difference in the treatment of the payer creates a tax-induced bias, in the cross-border context, towards debt financing. The distortion is compounded by tax planning techniques that may be employed to reduce or eliminate tax on interest income in the jurisdiction of the payee.

3. The main tax policy concerns surrounding interest deductions relate to the debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution. On the other hand, subsidiary entities may be heavily debt financed, bearing a disproportionate share of the group's total third party interest cost and incurring interest deductions which are used to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market. This has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by overseas groups rather than domestic groups.

4. The use of interest deductions to fund income which is exempt or deferred for tax purposes, and obtaining relief for interest deductions greater than the actual net interest expense of the group, can also

2. OECD Action Plan (n 1) 17.

contribute to base erosion and profit shifting. Techniques to achieve these outcomes include the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions; the development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income; the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense; and the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income. Box 1 below contains simple examples of how an international group can generate a benefit based on the location of its third party debt, in both outbound and inbound investment scenarios.

Box 1. Example of the impact of tax on the location of interest expense

Outbound investment

Consider a simple group structure,³ including two companies (A Co and B Co). A Co is resident in a country with a 35 per cent rate of corporate income tax, and that operates a territorial system under which foreign source dividends are exempt from tax. B Co is resident in a country with a 15 per cent corporate tax rate.

B Co borrows €100 from a third party bank at an interest rate of 10 per cent. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and a post-tax profit of €4.25.

Alternatively, A Co could borrow the €100 from the bank and contribute the same amount to B Co as equity. In this case, B Co has no interest expense and its full operating profit of €15 is subject to tax. B Co now has a pre-tax profit of €15 and a post-tax profit of €12.75. Assuming A Co can set its interest expense against other income, A Co has a pre-tax cost of €10 and a post-tax cost of €6.50. Taken together, A Co and B Co have a total pre-tax profit from the transaction of €5 and a total post-tax profit of €6.25.

As a result of transferring the interest expense from B Co to A Co, the group is now subject to a negative effective rate of taxation (ie. the group's post-tax profit exceeds its pre-tax profit).

Inbound investment

The example above illustrates how the location of interest expense can be used to obtain a tax benefit in an outbound investment scenario. A similar result can also be achieved in an inbound investment context.

In this case, A Co is resident in a country with a 15 per cent rate of corporate income tax and B Co is resident in a country with a 35 per cent corporate tax rate.

B Co borrows €100 from a third party bank at an interest rate of 10 per cent. B Co uses these funds in its business and generates additional operating profit of €15. After deducting the €10 interest cost, B Co has a pre-tax profit of €5 and a post-tax profit of €3.25.

A Co could also replace €50 of existing equity in B Co with a loan of the same amount. In this case, B Co has a pre-tax and post-tax profit of nil. A Co has interest income on its loan to B Co, and has a pre-tax profit of €5 and a post-tax profit of €4.25. The group has reduced its effective tax rate from 35 per cent to 15 per cent by shifting profit from B Co to A Co.

Taking this one step further, A Co could replace €100 of existing equity in B Co with a loan of the same amount. Assuming B Co can set its interest expense against other income, from this transaction B Co now has a pre-tax cost of €5 and a post-tax cost of €3.25. A Co receives interest income from B Co, and has a pre-tax profit of €10 and a post-tax profit of €8.50. Taken together, A Co and B Co have a pre-tax profit of €5 and a post-tax profit of €5.25. As a result of thinly capitalising B Co and shifting profit to A Co, the group is now subject to a negative effective rate of taxation.

3. The first part of this example is adapted from Michael Graetz, 'Multilateral Solution for the Income Tax Treatment of Interest Expense' (2008) 62 Bulletin for International Taxation 486.

5. Countries have introduced a wide range of rules to address these issues. These include general interest limitation rules which put an overall limit on the level of interest deductions that an entity can claim, as well as targeted rules which address specific planning risks. These have been successful to varying degrees, but as set out in Chapter III of this consultation document, there is a sense that unilateral action by countries is failing to tackle some of the issues at the heart of this problem. Partly, this is because the fungibility of money and the flexibility of financial instruments have made it possible for groups to bypass the effect of rules and replicate similar benefits using different tools. It is also because of a concern that a robust approach to restrict interest deductions by a single country could adversely impact the attractiveness of the country to international business and the ability of domestic groups to compete globally. It has therefore become increasingly apparent that a consistent approach utilising international best practices is essential if concerns surrounding the use of interest in base erosion and profit shifting are to be addressed. Groups should also benefit from a consistent approach between countries. Similar rules based on the same principles should make the operation of rules more predictable, enabling groups to plan their capital structures with greater confidence. It could also make it possible to introduce group-wide systems and processes to produce required information, making compliance with rules in multiple countries simpler and cheaper. A consistent approach should also remove distortions, reduce the risk of unintended double taxation and, by removing opportunities for base erosion and profit shifting, increase fairness and equality between groups.

B. The BEPS project and interest expense

6. In 2012 the G20 called on the OECD to analyse the issue of base erosion and profit shifting and develop an action plan to address these issues in a co-ordinated and comprehensive manner. The BEPS Action Plan was delivered by the OECD in July 2013 and contains 15 actions. Several of these address different aspects of base erosion and profit shifting using interest. Arrangements using hybrid financial instruments or hybrid entities to generate two tax deductions for the same payment, or payments which are deductible in the payer but are not taxed as ordinary income in the recipient, are addressed through model rules developed under Action 2 (*Neutralise the effects of hybrid mismatch arrangements*). Action 3 (*Strengthen CFC rules*) is developing recommendations regarding the design of controlled foreign company rules, which among other things will address the issue of interest income in controlled companies in low tax jurisdictions. Action 4 (*Limit base erosion via interest deductions and other financial payments*), which is the focus of this paper, will develop recommendations for best practices in the design of rules to address base erosion and profit shifting using interest. Action 4 also refers to the development of transfer pricing guidance for related party financial transactions, which will be carried out as a separate project and is not addressed in this paper. The two topics covered by Action 4 (interest deductibility and transfer pricing guidance) will be closely co-ordinated to ensure an overall coherence between the outputs. Action 9 (*Risks and capital*) focuses on base erosion and profit shifting in situations where an entity is overcapitalised or assumes excessive contractual risks, resulting in taxable income including for example interest income being attributed to a low tax country.

C. Overview of consultation document

7. This consultation document considers and seeks input on a number of key issues concerning the design of rules to address base erosion and profit shifting using interest and financial payments economically equivalent to interest. The consultation document looks at a number of different options for approaches to tackle base erosion and profit shifting, including general interest limitation rules which set an overall limit on the amount of interest expense in an entity, by linking interest deductibility to the position of a group or to fixed ratios, as well as targeted interest limitation rules which address specific base erosion and profit shifting risks.

8. This consultation document also includes three Annexes: Annex 1 includes a summary of the questions for consultation; Annex 2 contains a consideration of a number of key EU law issues, including the impact of EU treaty freedoms, directives and State aid rules; and Annex 3 includes a number of examples of how different types of interest limitation rule could apply, for illustrative and discussion purposes.

9. The outcomes of this consultation will feed into ongoing work by the OECD to develop recommendations for a best practice approach or approaches for countries to tackle base erosion and profit shifting using interest expense. Together with the other 2015 deliverables under the BEPS project, the results of this work will be presented to the G20 Leaders and Finance Ministers in late 2015.

II. POLICY CONSIDERATIONS

A. Key policy aims

10. The existence of base erosion and profit shifting using interest expense by international groups has been established through a number of academic studies, discussed in Chapter III of this consultation document. The critical objective of the work on Action 4 is to identify coherent and consistent solutions to address base erosion and profit shifting using interest on third party and related party loans, to fund both inbound and outbound investment. The work also covers other financial payments economically equivalent to interest. Countries engaged in the action agree that this aim is a key priority and may be best achieved through rules which encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group. Overall, however, in general groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost.

11. The design and scope of the rules to limit interest deductibility described in this consultation document reflect government concerns in relation to a variety of policy issues including addressing base erosion and profit shifting, minimising distortions to competition and investment, avoiding double taxation, reducing administrative and compliance costs, promoting economic stability and providing certainty of outcome.

- ***Addressing base erosion and profit shifting. The critical objective of this work is to identify solutions to address base erosion and profit shifting using interest and economically equivalent payments. This has been agreed as the priority by countries engaged in the work.***
- *Minimising distortions to the competitiveness of groups.* Unlimited deductions for interest expense introduce a number of competitive distortions between companies operating cross-border and those operating domestically. These may arise in both inbound and outbound investment scenarios. Rules to limit interest deductibility may reduce these issues, but if introduced by one country acting alone they may introduce other distortions, potentially damaging the competitiveness of domestic groups and reducing inbound investment. Other potential concerns arise if a best practice approach treats groups differently depending upon how they are structured. For example, where possible a rule should not give either a competitive advantage or disadvantage to entities held by a parent company compared with those held by a trust, fund or individual.
- *Minimising distortions to investment in a country.* Rules to limit interest deductions could increase the cost of capital of groups which exceed any limit. This could result in groups reducing their level of debt funding (either overall or in particular entities), or shifting investment to countries with less restrictive rules.
- *Avoiding double taxation.* Rules to limit relief for interest deductions may result in double taxation where (i) the entity remains taxable on income funded by the interest, or (ii) the recipient of the interest remains taxable on the corresponding receipt. This double taxation may however

be reduced or eliminated by the inclusion of specific features in a rule, such as provisions for the carry forward of disallowed interest expense into future periods.

- *Minimising administrative costs to countries and compliance costs to groups.* Where possible an interest limitation rule should be relatively straightforward to apply and cost-effective to administer. However, this needs to be balanced with other policy aims.
- *Promoting economic stability.* Interest limitation rules may promote economic stability by encouraging groups towards less highly leveraged capital structures. However, depending upon their design rules may also impose an additional burden on entities under stress.
- *Providing certainty of outcome.* There are two aspects to this aim. Firstly, groups in the same economic position with respect to their funding should be treated consistently. Secondly, groups should understand how a rule operates and the implications for their capital structure.

12. A best practice approach to tackling base erosion and profit shifting should be robust against attempts by groups to avoid the impact of a rule. Techniques could include (among others): the use of orphan entities or special shares to disguise control of an entity or break a group relationship; arrangements to disguise payments made to connected parties by routing them through a third party intermediary (back-to-back arrangements); structures to convert other forms of taxable income into an interest-like return in order to reduce an entity's net interest expense below the level of a limit or cap; and the use of foreign exchange instruments to manipulate the outcome of rules. Countries may therefore need to consider whether specific provisions are required to protect a rule against this type of planning.

B. EU law issues

13. Throughout this work, European Union (EU) law requirements imposed on Member States of the EU have been considered, and in particular the need for recommended approaches to be in accordance with EU treaty freedoms, directives and State aid regulations. Although countries outside the EU are not required to comply with these obligations, the need for a consistent international approach outlined above means that any approach which cannot be fully implemented by the 28 EU Member States is unlikely to be effective in tackling the global issue of base erosion and profit shifting. Specific issues related to EU treaty freedoms, directives and State aid rules are set out in Annex 2 to this paper.

III. EXISTING APPROACHES TO TACKLING BASE EROSION AND PROFIT SHIFTING USING INTEREST EXPENSE

14. The options discussed in this consultation document are underpinned by significant discussions and analyses undertaken by member countries and associates engaged in this work. This prior work considered: the advantages and disadvantages of different types of rules; countries' experiences as to how rules operate in practice and in particular any impacts on taxpayer behaviour; empirical data on the leverage of groups and entities in countries which do and do not currently apply rules to limit interest deductions; and the results of academic studies.

A. Existing approaches

15. Rules currently applied by countries fall into six broad groups, with some countries currently applying combined approaches including more than one type of rule. The advantages and disadvantages of these rules are considered briefly below (in addition the rules set out under 1-3 are considered in more detail later in the document.)

1. Rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio. Examples of these rules include debt to equity ratios, interest to EBITDA ratios and interest to assets ratios.
2. Rules which compare the level of debt in an entity by reference to the group's overall position.
3. Targeted anti-avoidance rules which disallow interest expense on specific transactions.
4. Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.
5. Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction.
6. Rules which disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who it is made to.

16. Rules which limit interest expense by reference to a fixed ratio are relatively easy to apply and they do link the level of interest expense to a measure of an entity's economic activity. On the other hand, as they apply the same ratio to entities in all sectors they are a relatively inflexible tool, and there is also evidence that the rates at which these ratios are currently set are too high to be an effective tool in addressing base erosion and profit shifting. This is considered below (see section III.B).

17. Existing rules that compare the level of debt in an entity to that in its group often operate by reference to debt to equity ratios. Again, these are reasonably easy to apply as debt and equity figures may be easily obtained, but the amount of equity in an entity is not a good measure of its level of activity and equity levels can be easily subject to manipulation, for example by a controlled entity issuing new share capital to its parent which does not correspond with any increase in economic activity.

18. Many countries have targeted anti-avoidance rules and these can be an effective response to specific base erosion and profit shifting risks. However, as new base erosion and profit shifting

opportunities are exploited, new targeted rules may be required. Therefore there is a tendency over time for further rules to be introduced, resulting in a more complex system which may be more costly to administer and comply with.

19. Countries engaged in this work agreed that fixed ratio rules, group-wide rules and targeted rules should all be given further consideration and so these are covered in more detail later in the document. At the same time, it was acknowledged that not all approaches hold the same potential for addressing base erosion and profit shifting.

20. For example, the majority of countries currently applying fixed ratio rules link interest deductibility to the level of equity in an entity, typically through debt to equity tests. The main advantage of such a test is that it is relatively easy for tax administrations to obtain relevant information on the level of debt and equity in an entity and they also provide a reasonable level of certainty to groups in planning their financing. However, set against this are a number of important disadvantages, particularly in relation to the critical objective of identifying solutions to address base erosion and profit shifting. A rule which limits the amount of debt in an entity may still allow significant flexibility in terms of the rate of interest that an entity may pay on that debt. Also, an equity test allows entities with higher levels of equity capital to deduct more interest expense. As pointed out above, this makes it relatively easy for a group to manipulate the outcome of a test by increasing the level of equity in a particular entity. It was therefore agreed by countries involved in this work that fixed ratio debt to equity tests should not be included as part of a general interest limitation rule in a best practice recommendation. However, this is not intended to suggest that these approaches cannot play a role within an overall approach to tackling base erosion and profit shifting.

21. It was also agreed that arm's length tests and withholding taxes should not form part of this consultation process.

22. An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances, and should not disturb genuine commercial behaviour. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules. The concerns are that existing arm's length tests may not be fully effective against base erosion and profit shifting because they only apply to intra-group payments and they permit deductible interest to be supported by non-taxable assets or income, such as investments in subsidiaries. While it might be possible to introduce new arm's length tests without these limitations (for example, by applying an arm's length rule to all of an entity's debt and by disregarding non-taxable assets and income when assessing whether an arm's length test is met), such rules would be burdensome to apply and enforce, and may still prove ineffective.

23. Withholding taxes are primarily used to allocate taxing rights to a source country, but by imposing tax on cross-border payments they may also reduce the benefit to groups from base erosion and profit shifting transactions. Withholding tax has the advantage of being a relatively mechanical tool which is easy to apply and administer. However, unless withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. Where withholding tax is applied, double taxation can be addressed by giving credit in the country where payment is received, although the

effectiveness of this is reduced if credit is only given up to the amount of tax on net income. In practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. It would also be extremely difficult for EU member states to apply withholding taxes on interest payments made within the EU due to the Interest and Royalty Directive. In addition, there are policy reasons why some countries do not currently apply withholding tax to interest payments, which could make the introduction of new taxes difficult. Taken together, these factors mean that withholding taxes would not be a suitable tool for tackling base erosion and profit shifting in many situations.

24. For these reasons it was agreed that neither arm's length tests nor withholding taxes should be included as options for a best practice recommendation. Again, this is not intended to suggest that these approaches cannot play a role within an overall approach.

25. Some countries have rules which disallow a percentage of all interest paid by an entity. Such rules can be used by countries to reduce the general tax bias in favour of debt financing over equity, but they may not be aimed at addressing base erosion and profit shifting. Therefore they are also not considered further in this consultation document. This does not suggest that these rules cannot play a role as part of a country's more general tax policy.

B. Success of existing approaches in tackling base erosion and profit shifting using interest expense

26. In recent years many countries have made significant changes to their approaches to combating base erosion and profit shifting through interest deductions, either through the introduction of new rules or through amendments to their existing rules. This suggests that countries have struggled to fully address the issues that they are actually seeing and changes that incorporate additional "layers" of rules are likely to produce more complex systems, without necessarily fully addressing the underlying issues.

27. This view is supported by the input from countries involved in this work which indicates that existing approaches may have had limited success in fully addressing BEPS issues involving interest expense. There is a general view that in many cases international groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expense. A limited survey based on published data and set out in Chapter IX indicates that for the largest non-financial sector groups, the vast majority have a net interest to EBITDA ratio of below 10 per cent and many do not have any net interest expense. However, the majority of countries which currently seek to address base erosion and profit shifting using earnings-based ratios allow entities to gear up to the point where net interest to EBITDA reaches 30 per cent. Therefore, at least for large groups, it appears these rules are unlikely to encourage groups to move towards funding structures where the net interest cost of individual entities reflects the position of the group overall.

C. Academic studies

28. The ongoing existence of international debt shifting has been established in a number of academic studies which show that groups leverage more debt in subsidiaries located in high tax countries.⁴

4. For example: Møen et al., 'International Debt Shifting: Do Multinationals Shift Internal or External Debt?' (2011) University of Konstanz Department of Economics Working Paper Series 2011-40, 42; Huizinga et al., 'Capital structure and international debt shifting' (2008) 88 *Journal of Financial Economics* 80, 114; Mintz and Weichenrieder, 'Taxation and the Financial Structure of German Outbound FDI' (2005) CESifo Working Paper No. 1612, 17; Desai et al., 'A Multinational Perspective on Capital Structure Choice and Internal Capital Markets' (2004) 59 *The Journal of Finance* 2451, 2484.

Debt shifting does not only impact developed countries, but is also an issue for developing countries, which, according to academic research are even more prone to debt shifting.⁵

29. Academics have shown that thin capitalisation is strongly associated with multinational groups⁶ and that multinational groups use more debt than comparable widely held or domestically owned businesses.⁷ Additional debt is provided through both related party and third party debt,⁸ with intragroup loans typically used in cases where the borrowing costs on third party debt are high.⁹

30. Academics have also looked at the effectiveness of thin capitalisation rules and illustrated that such rules have the effect of reducing the total debt of subsidiaries.¹⁰ Where thin capitalisation rules relate solely to interest deductions on related party debt such rules are effective in reducing intragroup debt but lead to an increase in third party debt, although not to the same extent.¹¹

31. The impact of interest limitation rules on investment has also been the subject of academic studies and the topic has been approached using two different methodologies: theoretical models and empirical analysis. Analysing the impact of interest limitation rules on investment from a theoretical standpoint, academics suggest that such rules would increase effective capital costs thus reducing real investment.¹² The theoretical approach is supported by studies which suggest that certain countries set lenient thin capitalisation rules in order to protect foreign direct investment.¹³ The limited empirical analysis that has been done does not, however, support this theory. Two studies, both analysing the effect of German interest limitation rules on investment, find no significant evidence of a reduction of investment either in relation to thin capitalisation rules¹⁴ or interest barrier rules based on a ratio of interest expense to income.¹⁵ At the same time, lack of empirical support may be due to a number of factors including the fact that multinational groups may avoid the application of the interest limitation rule by using loopholes in the

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5. Fuest et al., 'International debt shifting and multinational firms in developing economies' (2011) 113 *Economic Letters* 135, 137.
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 12. Ruf and Schindler, 'Debt Shifting and Thin Capitalization Rules - German Experience and Alternative Approaches' (2012) 21.
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 14. Weichenrieder and Windischbauer, 'Thin-capitalization rules and company responses - Experience from German legislation' (2008) CESifo Working Paper No. 2456, 29. This study analysed the effect of the 2001 tightening of the former thin capitalisation rule.
 15. Buslei and Simmler, 'The impact of introducing an interest barrier - Evidence from the German corporation tax reform 2008' (2012) DIW Discussion Papers 1215, 29. This study analysed the effect of the introduction of Germany's current interest limitation rule in 2008.

legislation or by adjusting their capital structure.¹⁶ However, summarising the above, there does not seem to be enough empirical evidence to reach conclusions on the actual impact of interest limitation rules on foreign investment.

16. Ruf and Schindler (n 12) 21.

IV. WHAT IS INTEREST AND WHAT ARE PAYMENTS ECONOMICALLY EQUIVALENT TO INTEREST?

32. Interest cost is treated as a tax deductible expense in most countries, but each country applies its own approach to determine what expenses are treated as interest and therefore deductible for tax purposes. It is not the aim of this work to agree a definition of interest that is applied by all countries for all tax purposes. Differences will continue to exist between countries as to the items treated as deductible interest expense and countries will continue to use their own definitions of interest for other tax purposes, such as for withholding taxes. However, in identifying best practices for the design of rules to address base erosion and profit shifting, there are benefits in countries taking a broadly consistent approach to the items that should be covered by such rules, improving certainty for business and ensuring a coherent approach to tackling the issue across countries. The level of consistency and coherence which is required may also, at least to a certain extent, depend on the type of interest limitation rule being applied. This chapter therefore considers the items which countries have agreed should be included in a definition that appropriately addresses base erosion and profit shifting issues.

33. At its simplest, interest is the cost of borrowing money. However, if a rule restricted its focus to such a narrow band of payments, it would raise three broad issues:

- it would fail to address the range of base erosion and profit shifting that countries face in relation to interest deductions and similar payments;
- it would reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements; and
- its effect could be easily avoided by groups re-structuring loans into other forms of financing arrangement.

34. To address these issues, rules to tackle base erosion and profit shifting using interest should apply to interest on all forms of debt as well as to other financial payments that are economically equivalent to interest. Payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time. A rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees. This chapter includes a non-exhaustive list of examples of the types of payment that should be covered by a rule, but it is left to each country to determine how this should be reflected within its domestic law, taking into account existing definitions of interest and other payments. In deciding whether a payment is economically equivalent to interest, the focus should be on its economic substance rather than its legal form.

35. A best practice rule to address base erosion and profit shifting using interest expense should therefore apply to: (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance. These payments should include, but not be restricted to:

- payments under 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;
- amounts re-characterised as interest under transfer pricing rules, where applicable;
- amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity's borrowings;
- foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees with respect to financing arrangements; and
- arrangement fees and similar costs related to the borrowing of funds.

36. An illustration of how this definition could be applied in practice is included in example 1 in Annex 3. This definition is intended to ensure that countries take a consistent approach in terms of the payments covered by a best practice approach to tackling base erosion and profit shifting.

Questions for consultation

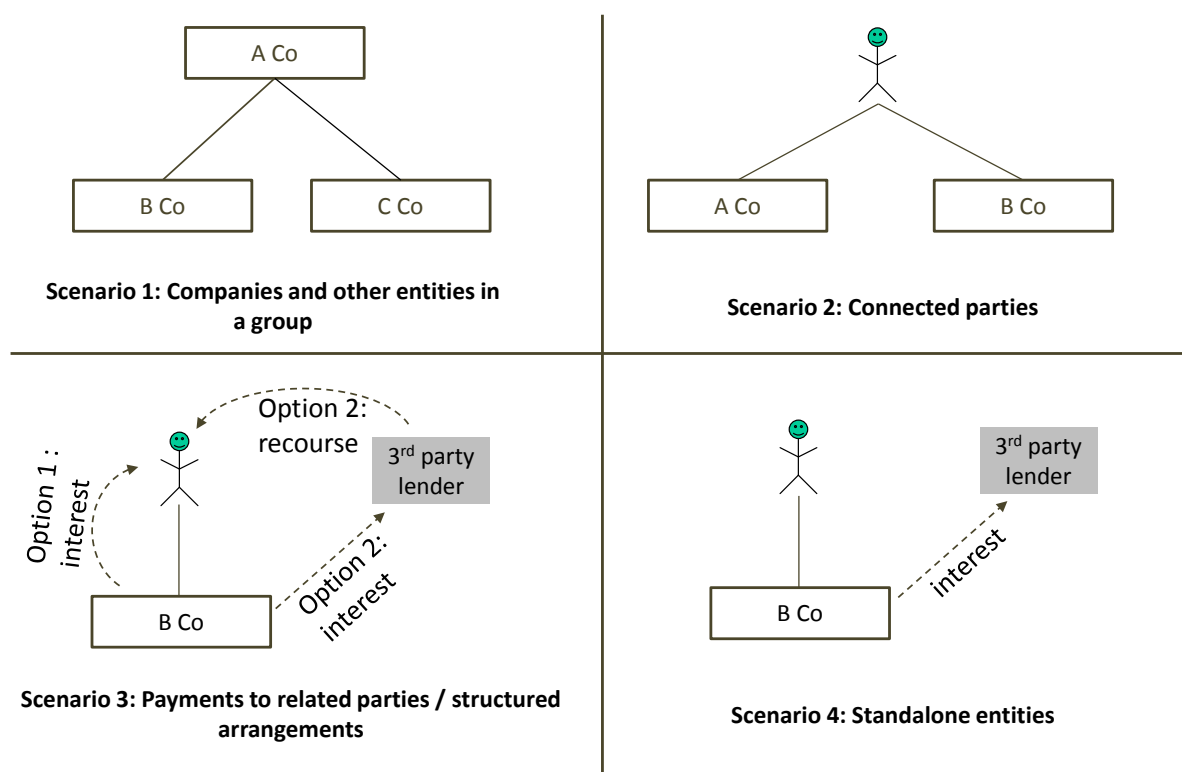
1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?
2. Are there any specific items which should be covered by a best practice rule which would not be covered by the approach set out in this chapter? What are these and how could they be included within a definition of interest and other financial payments that are economically equivalent to interest?

V. WHO SHOULD A RULE APPLY TO?

37. Base erosion and profit shifting can arise in a range of situations, including within a corporate group, with connected parties outside a group and through the use of structured arrangements with third parties. A robust response to tackling base erosion and profit shifting should apply to all incorporated and unincorporated entities and arrangements, including permanent establishments, which may be used to increase the level of interest deductions claimed in a country.

38. The countries involved in this work looked at four scenarios, set out below, and considered the extent to which they present base erosion and profit shifting risks and whether they should be covered by an interest limitation rule or rules.

- *Scenario 1:* Companies and other entities in a group, including permanent establishments. For these purposes entities are in a group where either (a) one entity has direct or indirect ownership or control over another entity, or (b) both entities are under the direct or indirect ownership or control of a third entity.
- *Scenario 2:* Connected parties. For these purposes entities are connected parties where they are under common ownership or control, but are not part of a group. This may arise, for example, where (a) an individual, fund or trust exercises control over the entities, or (b) a shareholder agreement exists which has the effect of bringing the entities under common control. The proposition is that collective investment vehicles under the control of the same investment manager should not be treated as connected parties if there is no other connection between them.
- *Scenario 3:* Payments made to related parties. For these purposes related parties include (a) significant shareholders and investors (and members of their family), (b) entities where there is a significant relationship but which is not sufficient to establish control, and (c) third parties where the payment is made under a structured arrangement. A significant shareholding or a significant relationship exists if one of the two parties concerned directly or indirectly holds a 25 per cent or greater investment in the other party. This is similar to the definition of related parties for the purposes of anti-hybrid rules recommended under Action 2.
- *Scenario 4:* Standalone entities. This would include all entities not falling into any of scenarios 1 to 3.



39. It is proposed that an approach to tackling base erosion and profit shifting using interest should apply to all companies and entities which fall within any of scenarios 1, 2 or 3, including partnerships taxed as separate entities and permanent establishments. Entities which are treated as transparent for tax purposes, including partnerships in many jurisdictions, should be taken into account to the extent they are owned or controlled by companies or other entities. However, it is recognised that companies and entities in each of these scenarios pose different risks and so different interest limitation rules may be applied. For example, risks posed by international groups may be addressed through rules which link interest deductions in each group entity to the position of the worldwide group, while risks posed by connected and related parties may be addressed through targeted rules which apply to specific arrangements. Applying a different set of rules should not, however, provide a competitive advantage to certain entities and the way they are held, for example in the context of private equity. Different types of rules are considered in Chapters VIII, IX and XI of this consultation document.

40. Although it is proposed that rules to limit interest deductions should be applied to entities in scenarios 1, 2 and 3, this would not prevent countries from applying an approach more widely if base erosion and profit shifting risks in their jurisdiction arose in a wider variety of situations. In particular, because of the difficulty tax administrations may have in identifying companies and entities that fall within scenario 3, some countries may wish to apply interest limitation rules to all companies and entities operating in their jurisdiction (ie. including those in scenario 4). This would reduce the risk of a rule missing possible base erosion and profit shifting, but could result in some companies and entities incurring an interest disallowance when in fact they pose little real risk.

Questions for consultation

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.
4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

VI. WHAT SHOULD A RULE APPLY TO?

(A) THE LEVEL OF DEBT OR INTEREST EXPENSE AND (B) AN ENTITY'S GROSS OR NET POSITION

41. There are two key questions that need to be answered with respect to the subject of an approach to tackling base erosion and profit shifting using interest expense. First, whether a rule should operate by reference to the level of interest expense in an entity or the level of debt. Second, whether a rule should focus on an entity's gross position (ie. only its interest expense or debt liabilities) or its net position (ie. also taking into account interest income or debt assets).

A. Application by reference to the level of interest expense or the level of debt

42. Rules to address base erosion and profit shifting using interest may operate directly, by restricting the amount of interest an entity may deduct for tax purposes, or indirectly, by restricting the amount of debt with respect to which an entity may claim deductions for interest.

43. To an extent, the answer to this question may depend upon the design of an interest limitation rule. For example, countries which currently limit interest deductions using an income statement test (for example, by reference to an entity's EBITDA) apply the rule directly to the level of interest expense. On the other hand, most countries that use a balance sheet test (which considers an entity's assets or equity) apply the rule to the level of debt. Countries which have more than one rule may take both approaches.

44. In considering whether a rule should operate by reference to the level of interest expense or debt, a number of factors have been taken into account. These include the following.

Factors in favour of referring to the level of interest expense:

- Action 4 requires that an approach should apply to interest expense and other financial payments which are economically equivalent to interest. For some of these payments there may be no existing requirement for an entity to separately identify a financial liability linked to the payment. This would make it difficult to apply a rule which adequately addresses risks posed by these instruments. Even where a specific financial liability can be identified, issues may arise surrounding the valuation of the liability. Payments for which tax relief is being claimed should be easier for entities and tax authorities to identify and value.
- The level of debt in an entity may vary throughout a period, which means that the amount of debt on a particular date, or an average for the period, may not be representative of an entity's true position. On the other hand, the level of interest expense in an entity will reflect all changes in borrowings throughout the period. This is therefore likely to give a more accurate picture of the entity's actual position over a period of time.
- Base erosion and profit shifting using interest is driven by the level of tax deductible interest expense incurred by an entity. Therefore a rule which refers to the level of deductible interest will directly address this key risk factor.
- A rule to limit interest deductions by reference to the value of the debt would still need some way to determine the level of interest expense which is to be disallowed if a limit is exceeded. In

addition such a rule may fail to deal with cases where the nominal level of debt in an entity is not excessive, but this debt carries high levels of interest.

Factors in favour of referring to the level of debt:

- A rule based on the level of debt may allow an entity subject to a high interest rate on its borrowings to deduct more interest expense than an entity with the same level of debt which is subject to a lower interest rate. An entity could be subject to a higher interest rate because, for example, it operates in a high interest rate environment or it poses a greater credit risk.
- The level of debt in an entity is under the control of the entity's management and may be stable and easier to predict. The amount of interest expense, however, may vary reflecting market interest rate fluctuations. Where an entity has its debt based on floating interest rates it may be difficult to plan its financing structure to ensure it stays within any limits set by a rule that refers to the level of interest expense.

45. Taking into account the factors set out above, it is proposed that rules to tackle base erosion and profit shifting should operate directly by reference to the level of interest expense in an entity and not the level of debt.

B. Application to an entity's gross position or net position

46. Another key question in the design of an interest limitation rule is whether it should apply to the interest an entity incurs on its borrowings without any offset for interest income (gross interest expense) or after offsetting the interest income it earns on any loans and deposits (net interest expense). In this consultation document, 'interest income' includes receipts corresponding to the payments treated as interest or economically equivalent to interest in Chapter IV.

47. A gross interest rule may have the benefit of simplicity and is also likely to be more difficult for groups to avoid through planning. However, a gross interest rule could lead to double taxation where interest is paid on intragroup loans, and each entity is subject to tax on its full gross interest income, but part of its gross interest expense is disallowed. Therefore even where an interest limitation rule applies to gross interest, countries may look to introduce some form of tax relief for interest income in certain situations. Alternatively, countries may consider allowing an entity to carry forward disallowed interest expense into future periods or leave it to groups to restructure their internal funding arrangements to avoid double taxation.

48. A net interest rule will reduce the risk of double taxation, as interest income will already be taken into account before the interest limitation is applied. However, the fact that an entity has a relatively low net interest expense does not mean that base erosion and profit shifting are not taking place, if for example the entity would be in a net interest income position were it not for excessive levels of debt. Also, a rule which applies to net interest expense could be ineffective if groups can avoid the rule by converting other forms of taxable income into interest income, reducing the level of net interest to which the rule can apply. In addition, applying a rule to net interest expense would mean it has no impact on entities, such as banks, which are recipients of net interest income (see Chapter XIII).

49. However, based on the above considerations, it is proposed that a general interest limitation rule, which limits the overall level of interest deductions in an entity, should apply to the entity's net interest expense after offsetting interest income. Such a rule could be supplemented by targeted interest limitation rules to prevent groups avoiding the effect of a rule or which disallow gross interest expense on specific transactions identified as posing base erosion and profit shifting risks.

Question for consultation

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

VII. SHOULD A SMALL ENTITY EXCEPTION OR THRESHOLD APPLY?

50. All general interest limitation rules involve some level of compliance burden on entities and administrative burden on tax authorities. While the main policy goal of the work set out in this consultation document is the design of rules to address base erosion and profit shifting using interest, it is recognised that certain entities may pose a sufficiently low risk that excluding them from a rule would be appropriate. Reducing the number of entities covered would also reduce the costs of administering a rule. This paper considers two ways to set a threshold below which entities would not be expected to apply a rule: an entity's size (a size threshold); or its level of net interest expense (a monetary threshold).

51. A size threshold would typically be based on a combination of factors such as the number of employees, turnover and total assets. This type of test is currently used by countries for a range of tax purposes, a number of which are discussed in a 2009 OECD Tax Policy Study on the taxation of small and medium-sized enterprises¹⁷. However, although in the broadest terms it may be correct to say that larger businesses typically pose a greater risk of base erosion and profit shifting, size thresholds ignore the fact that a highly leveraged small or medium sized entity may also have a high level of interest expense.

52. Alternatively, given that the proposal is that a general interest limitation rule will apply to limit deductions for interest expense, a more appropriate test for determining whether an entity should fall within the ambit of a rule could be the level of net interest expense in the entity. A monetary threshold would also be relatively simple to apply. This would ensure that small and medium sized entities which are highly leveraged are required to apply a general interest limitation rule to determine how much interest they may deduct, while larger entities with low levels of debt and interest expense are exempted from a rule.

53. The purpose of a monetary threshold would be to exclude entities with low levels of net interest expense, and which therefore pose a low risk of base erosion and profit shifting, from a general interest limitation rule. However, where the level of net interest expense in an entity exceeds the monetary threshold, it seems appropriate that a rule should apply to all the net interest expense in the entity. That is, it is not intended that a threshold will provide all entities with an amount of interest expense which is exempt from limitation.

54. A country should set the level of a monetary threshold to reflect its economic and interest rate environment and this may be reviewed periodically and updated to reflect changes in this environment. However, as the intention is to exclude only those entities which pose the lowest threat of base erosion and profit shifting, the threshold should be kept at a level which is appropriate to achieve this aim. Where a group has more than one entity in a country, it is preferable that the net interest expense of these entities should be considered together when determining whether a monetary threshold is reached. This ensures that local groups with the same amount of net interest expense are treated consistently, and that a group cannot avoid application of an interest limitation rule by atomising its operations into a large number of entities each applying a separate monetary threshold. For these purposes, countries which tax on a separate entity basis would apply the threshold to the aggregate net interest expense of all group entities in the

17. OECD 2009, *Taxation of SMEs – Key Issues and Policy Considerations*, OECD Publishing

country. Where a country operates a group taxation regime, the interaction of a threshold with this regime would need to be considered.

55. Box 2 below provides an overview of the monetary thresholds applied in selected countries.

Box 2. Overview of monetary thresholds in selected countries

Australia:	Thin capitalisation rule only applies if total debt deductions exceed AUD 2 million (EUR 1 300 000).
Denmark:	Limitation of deduction of net financing expenses (paid on related and unrelated party debt) exceeding DKK 21.3 million (EUR 2.85 million).
Finland:	Limitation of deduction of net interest expenses (paid on related and unrelated party debt) exceeding EUR 500 000 .
France:	Cap on interest deductions applies to net interest expenses exceeding EUR 3 million .
Germany:	Limitation of deduction of net interest expenses (paid on related and unrelated party debt) exceeding EUR 3 million .
Portugal:	Limitation of deduction of net interest expenses (paid on related and unrelated party debt) exceeding EUR 1 million .
Spain:	Limitation of deduction of net financial expenses exceeding EUR 1 million .

56. Countries considering the introduction of a threshold should be aware of possible impacts on commercial decisions by entities on their level of debt funding, particularly by entities which are close to a threshold. For example, an entity may reduce its net interest expense to fall within a threshold and avoid an interest disallowance. An entity may also increase its borrowings and net interest expense to breach a threshold and force an interest limitation rule to apply. This is most likely to be a consideration where a country has introduced provisions to allow the carry forward or carry back of disallowed interest expense or unused capacity to deduct interest expense. For example, where the result of a rule applying would be the creation of unused capacity to deduct interest expense, which could be carried forward or carried back and utilised in other periods. Carry forwards and carry backs of disallowed interest and the capacity to deduct interest are considered in Chapter XII.

57. It is not proposed that a threshold will be required as part of a best practice recommendation. However, countries involved in this work agree that if a country does wish to introduce a threshold, it should be designed to exclude only those entities which pose the lowest risk of base erosion and profit shifting using interest. This is likely to be best achieved using a monetary threshold linked to net interest expense. Also, where a threshold is introduced, it should be set at an appropriate level, taking into account the economic and interest rate environment in the country. In addition, it is preferable that the threshold should apply to the total level of net interest expense in the local group to avoid groups fragmenting into multiple entities each applying a separate threshold.

Question for consultation

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

VIII. WHETHER INTEREST DEDUCTIONS SHOULD BE LIMITED WITH REFERENCE TO THE POSITION OF AN ENTITY'S GROUP

A. Group-wide tests as an approach to addressing base erosion and profit shifting

58. Rules to tackle base erosion and profit shifting by limiting interest deductions balance two objectives: allowing entities to claim tax relief for the real cost of their funds, while at the same time protecting a country from excessive interest deductions. As described in Chapter II, this may be best achieved through an approach which encourages groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group. This document considers a number of approaches which may be adopted by countries to achieve this aim, each of which has different advantages and disadvantages. This chapter considers general interest limitation rules which link overall interest deductibility in an entity to the position of its group. Later chapters look at rules which apply fixed ratios to limit interest deductions and targeted rules to tackle specific risks.

59. Group-wide rules limit an entity's deductible interest expense with reference to the actual position of its worldwide group. This chapter focuses on two types of group-wide rule which work on two basic premises. Firstly, that the best measure for total net interest deductions within a group is the group's actual net third party interest expense (ie. total interest paid to third parties less total interest income received from third parties). Secondly, that within a group interest expense should be matched with economic activity. Where net interest expense is matched with economic activity, groups will obtain tax relief for an amount equivalent to their actual third party interest cost. A key benefit of group-wide tests is that they enable a group to centralise its third party borrowings in the country and entity (including a group treasury company) which is the most efficient, taking into account non-tax factors such as credit rating, currency and access to capital markets, and then lend these borrowings within the group. As set out in section VIII.B below, a number of countries currently include other forms of group-wide rule within their existing approaches to tackle excess interest deductions.

60. Group-wide tests in theory have the greatest potential to tackle base erosion and profit shifting using interest. By limiting interest deductions to a part of the group's actual net third party interest expense, a group-wide test directly addresses issues of base erosion where a group claims relief for interest expense in excess of its actual interest costs. A group-wide test also reduces the risk of profit shifting, where taxable income is separated from economic activity, by directly linking the level of interest deductions available to earnings or asset values. Group-wide tests are suitable for dealing with issues arising from inbound and outbound investment and, if they are applied consistently by countries, they have the potential to reduce complexity for international groups which would otherwise need to comply with different, sometimes overlapping, rules in countries where they operate.

61. Because these rules take into account a group's real net third party interest expense, the total amount of interest which can be deducted by each entity increases or decreases to reflect changes in the group's actual interest cost. This approach is therefore flexible to the funding position of different groups, taking into account decisions of management, market conditions and sector specific issues. This means that group-wide tests should be suitable for groups operating in most sectors, and remain suitable as a group's funding needs change throughout its economic cycle. However, while a group-wide test ensures that an entity's net interest deductions reflect the position of its group, it does not impose any limit on how high the net interest expense of the group can be and hence the amount of interest deductions that can be claimed across the group. Where the funding needs and financial position of entities in a group are comparable, a group-wide test applied consistently in the countries where the group operates should ensure

that a group can deduct all of its net third party interest expense. This means, however, that a group-wide rule may need to be supplemented by targeted rules to address base erosion and profit shifting caused by excessive interest deductions on third party debt, as required under Action 4 of the BEPS Action Plan.

62. Some groups are engaged in a range of different activities and, if the positions of entities in a group are not comparable, an entity whose interest expense, earnings or assets are not in line with the rest of its group may find either that it cannot deduct its full net interest expense or that it is not fully utilising its capacity to absorb interest deductions. To an extent these issues may be addressed through provisions for the carry forward of disallowed interest expense, or unused capacity to deduct interest, into future periods. Also, where a group does not have any net third party interest expense (ie. its interest income received from third parties exceeds its interest expense paid to third parties), entities within the group would be restricted from deducting any net interest expense, although they should be able to deduct interest expense to the extent they also have interest income.

63. Another concern with group-wide tests is that volatility in earnings or asset values in one part of a worldwide group could impact the ability of all group entities to deduct their net interest expense. For example, under a group-wide rule which links the ability to deduct interest expense to asset values, a revaluation of intellectual property in one entity could result in an increase in the capacity of that entity to absorb interest deductions. Assuming the group's overall net interest expense remains unchanged, other entities in the group would find themselves able to deduct correspondingly less interest expense, even though their own financial position has not altered. Again, a rule could smooth the effect of this volatility by allowing an entity to carry forward disallowed interest expense or unused capacity to deduct interest into future periods.

64. The compliance cost to groups of complying with a group-wide rule will be largely driven by the availability of group data and the similarity of a rule with that applicable in other countries where the group operates. To the extent information can be obtained from consolidated financial statements, compliance costs may be relatively low. In practice however, it is likely that some additional information will be required. Reliance on group information which cannot be verified by reference to the consolidated financial statements will also increase administrative costs to tax authorities, which may need to exchange information with tax authorities in other countries for tax audit purposes. Where countries introduce consistent rules with the same information requirements, the overall compliance cost to a group should be substantially reduced, but it is likely that compliance costs to groups and administrative costs to tax administrations will be higher under a group-wide rule than under a fixed ratio rule based entirely on local entity numbers.

65. Countries where the tax treatment of interest follows the accounting treatment should be able to compare the amount of interest expense allowable under a group-wide test with the interest expense claimed by an entity without significant adjustment. However, where accounting and tax rules for recognising interest expense are different, a country will need to consider how a limit based on accounting principles can be applied to an entity's actual tax position, or if any special provisions are required to compensate for any mismatches.

66. Under a group-wide test, an entity can still claim a deduction for interest paid on intragroup debt. However, the overall level of interest expense that the entity can deduct is limited by reference to the group's third party interest expense. This means that in practice countries introducing a group-wide rule may no longer be concerned about the pricing of individual intragroup instruments, which could reduce the need for transfer pricing rules in this area. Similarly, where a group-wide rule applies a country may decide that there is less need for certain targeted rules, such as rules to address artificial debt (where there is no additional funding raised by the borrower) though this would be a question for each country to consider. A group-wide rule establishes a limit on the amount of net interest expense that an entity can deduct, but it

does not change the treatment of interest payments for other tax purposes (unless a country decides to make such changes). Therefore, even where a restriction is applied, interest paid by an entity may remain subject to withholding tax in accordance with a country's law. Other practical considerations with respect to group-wide rules are set out in the following sections of this chapter. These, together with any constitutional issues for countries which may arise, will need to be considered as this work progresses.

B. Options for group-wide rules: interest allocation rules and group ratio rules

67. This chapter considers two variations of group-wide tests:

- a group-wide interest allocation rule which operates by allocating a worldwide group's net third party interest expense between group entities in accordance with a measure of economic activity (such as earnings or asset values); and
- a group ratio rule which compares a relevant financial ratio of an entity (such as net interest to earnings or net interest to asset values), with the equivalent financial ratio of the entity's worldwide group.

68. In principle, these two approaches are very similar and could be used by countries to give the same result. However, when considering the design of a group-wide rule within a best practice approach to tackle base erosion and profit shifting, a key factor is the degree of consistency between the rules applied in different countries. Therefore, for the purposes of this consultation document, it is anticipated that an interest allocation rule would be applied consistently, with all countries applying the rule reaching agreement on the main elements (such as the definition of a group, the calculation of the group's net third party interest expense, and the allocation of interest expense between group entities). On the other hand, a group ratio rule would be applied more flexibly, with greater scope for a country to use its own approaches for determining each of these elements, for example to reflect existing domestic tax principles. This could give rise to a spectrum of rules, with some countries adopting a consistent approach while others incorporate narrow differences (such as excluding from a group's net third party expense certain items which would not be deductible under domestic tax law) or broad differences (such as using a domestic law definition of a group or calculating group earnings or asset values on domestic law principles).

i) Group-wide interest allocation rules

69. An interest allocation rule could operate in one of two ways.

- Firstly, by providing each entity with a deemed interest expense, equal to an allocation of part of the group's net third party interest expense. This allocation would be made in accordance with either earnings or asset values. The deemed interest expense allocated to each entity would be tax deductible. All interest actually paid or received by group companies would be disregarded. This is referred to as a *deemed interest rule*.
- Secondly, by providing each entity with an interest cap, equal to allocation of part of the group's net third party interest expense. This allocation would be made in accordance with either earnings or asset values. An entity's net interest expense on intragroup and third party debt up to this cap would be tax deductible. Any net interest income received by the entity would remain subject to tax. This is referred to as an *interest cap rule*.

70. The question of whether an interest allocation rule should allocate a deemed interest expense to group companies or an amount which acts as a cap on the amount of interest expense an entity may deduct is fundamental to the operation of a rule.

71. A deemed interest rule could be applied through the following steps.
- a) A Co calculates the total net third party interest expense for its group.
 - b) A Co identifies its group's total earnings or assets.
 - c) A Co calculates its allocation of part of the group's net third party interest expense, determined based on the ratio of its earnings or assets to the group's total earnings or assets.
 - d) A Co's interest allocation is deductible for tax purposes. All interest expense paid or received by A Co is disregarded for the purposes of calculating its taxable profit (other than for the purposes of completing the above calculation). Interest expense paid or received by A Co may not however be disregarded for other tax purposes, such as for withholding taxes.
72. An illustration of how these steps would operate in practice is included as example 2 in Annex 3 to this paper.
73. An interest cap rule would be applied in two stages: firstly to calculate the entity's interest cap; and secondly to apply the interest cap to the entity's actual interest position.

Stage 1: Determination of an interest cap

- a) A Co calculates the total net third party interest expense for its group.
- b) A Co identifies its group's total earnings or assets.
- c) A Co calculates its interest cap, which is an allocation of part of the group's net third party interest expense, determined based on the ratio of A Co's earnings or assets to the group's total earnings or assets.

Stage 2: Application of the interest cap

- d) A Co calculates its taxable net interest income or expense under domestic tax rules. This should include financial payments economically equivalent to interest.
- e) If A Co has taxable net interest income, this income remains subject to tax under normal domestic rules.
- f) If A Co has taxable net interest expense, this is compared against its interest cap. Net interest expense up to the interest cap should be deductible for tax purposes. Net interest expense in excess of the interest cap is disallowed.

74. An illustration of how these steps would operate in practice is included as example 3 in Annex 3.

75. A deemed interest rule could be slightly simpler for countries to administer and groups to apply. It also has the advantage that, to the extent that all countries introduce a rule, this approach should ensure that all net third party interest expense is deductible within a group. However, countries have expressed serious policy concerns about introducing new rules which deem deductions for amounts which are not paid or accrued by an entity. There are also concerns this could give rise to unanticipated complications or opportunities for abuse. For example, a deemed interest rule could operate as an incentive for groups to raise third party borrowings in countries which do not apply the rule and have the fewest protections against base erosion and profit shifting. A group could then benefit from a deduction for its actual interest

cost which accrues in the entity which enters into the borrowing, and a second deemed deduction in group entities which are subject to an interest allocation rule. This risk is illustrated in example 4 in the Annex 3. In contrast, under an interest cap rule there is greater correlation between economic reality and the ability of companies to deduct interest expense. This approach is therefore likely to have fewer unintended consequences and is the approach favoured by countries.

76. Under an interest cap rule, an entity would be able to deduct net interest expense up to the level of its interest cap. Depending on its funding structure, a group should in principle be able to claim total deductions for an amount equal to its actual third party interest cost. However, in practice it is likely that many groups will not currently be in a position to do so. This is because some group entities may have interest expense in excess of the interest cap allocated to them, while others have an interest expense lower than their interest cap. To resolve this issue some groups may seek to re-organise their intragroup financing so that the net interest expense in each entity reflects the interest cap allocated to it. However, it is recognised that there may be tax and non-tax considerations (such as increased withholding taxes or exchange controls) that restrict a group's ability to re-organise its intragroup loans or impose a cost on it doing so.

77. Based on the issues outlined above, countries engaged in Action 4 agreed that if an interest allocation rule is included in a best practice approach to tackling base erosion and profit shifting, it should be structured as an interest cap rule. For the remainder of this consultation document, references to an interest allocation rule should be taken to mean an interest cap rule.

ii) Group ratio rules

78. A group ratio rule compares a relevant financial ratio of an individual entity (such as net interest to earnings or net interest to asset values) with that of its worldwide group. Where an entity's ratio is equal to or below that of the group, all of its third party and intragroup interest expense is deductible. Any interest expense which takes the entity's ratio above that of the group is disallowed.

79. A group ratio rule would typically be applied in two stages:

- Firstly, an entity calculates its group's ratio specified under the rule. For the purposes of determining this ratio, the interest amount would be the group's net third party interest expense (including financial payments which are economically equivalent to interest) after offsetting interest income (including financial receipts which are economically equivalent to interest).
- Secondly, an entity compares this ratio against its own position to establish the maximum amount of net interest expense which it may deduct for tax purposes. Net interest expense above this maximum amount is disallowed.

80. An illustration of the application of a group ratio rule is included as example 5 in Annex 3. As under an interest cap rule, some group entities may currently have interest expense that takes their financial ratio above that of their group (which would be disallowed), while others have interest expense below that which would be allowed. Groups may therefore seek to re-organise their intragroup financing to bring each entity's ratio more in-line with that of the group, subject to any barriers preventing them from doing so.

81. A number of countries have introduced group ratio rules as part of their overall strategy to address excess interest deductions.¹⁸ However, in these countries the group ratio rule generally does not

18. For example: Australia, Finland, France, Germany and New Zealand.

operate to limit interest deductions, but instead operates as a ‘carve-out’ which allows companies to escape application of a main fixed ratio rule. These carve-outs typically apply where the gearing of an entity (for example measured using a debt to equity ratio or equity to total assets ratio) does not exceed that of its group. The advantages and disadvantages of this approach are considered in Chapter X.

iii) Comparison of the two approaches

82. Group-wide interest allocation rules and group ratio rules share the same overall aim of ensuring that net interest expense within a group is matched with economic activity and that in total it should not exceed the value of the group’s actual net third party interest expense. These rules may therefore limit the ability of certain entities to deduct their net interest expense, but they do not change the nature of the payments made by an entity for other tax purposes, such as for withholding taxes.

83. In designing a best practice rule under either approach, consideration needs to be given to the same key questions.

- Which entities should be included in an interest limitation group?
- How should a group’s net third party interest expense be determined?
- How should economic activity be measured? (This will determine how an interest cap should be allocated or which group ratio should be used)
- How should mismatches between accounting and tax rules be addressed?
- How should cash pooling arrangements be treated?
- How should risks posed by connected parties and related parties be dealt with?

84. To the extent the same answers are reached with respect to these questions, an interest allocation rule and a group ratio rule should give the same result. However, in considering how the rules might be incorporated into a possible best practice, the degree of consistency in how countries design their rules could be different under the two approaches.

85. It is anticipated that an interest allocation rule would be implemented in substantially the same way by all countries. This would mean that countries would agree an approach to defining which entities are covered by a rule, how net third party interest expense of a group would be calculated and how an interest cap would be allocated between entities. Countries may still have some flexibility in terms of how an interest cap would be applied to an entity’s net interest expense for tax purposes, taking into account their domestic tax system (for example whether they tax local entities separately or on a consolidated basis). This high level of consistency between countries means that an interest allocation rule should provide a coherent and effective solution to the issue of base erosion and profit shifting by international groups. However, because the method for calculating an interest cap needs to be agreed by all countries, mismatches are likely to arise when an entity’s interest cap calculated in accordance with an internationally agreed approach is compared against the entity’s taxable net interest expense calculated under domestic tax law. These mismatches will need to be addressed within the design of a rule.

86. On the other hand, it is expected that countries would have greater flexibility in the design of a group ratio rule. This could give rise to a spectrum of approaches: some countries could adopt consistent rules based on an agreed standard; some countries could incorporate narrow differences (such as excluding from a group’s net third party interest expense certain items which would not be deductible under domestic

tax law); while other countries could include broader differences (such as using a domestic law definition of a group, or calculating group earnings or asset values based on domestic tax principles). Because a group ratio rule can be designed with a country's tax law in mind, mismatches between a group's ratio and an entity's ratio may be reduced. However, to the extent this means groups must comply with different rules in each country, this could significantly increase compliance costs. There is also a risk that differences between group ratio rules in different countries could create opportunities for base erosion and profit shifting (where total net deductions available exceed the group's actual net third party interest expense) or problems of double taxation (where total net deductions available are lower than the group's actual third party interest expense), and it may be impossible for a group to adjust its intragroup financing to comply with a different rule in every country. A simple illustration of this is included as example 6 in Annex 3. These potential problems under a group ratio rule are likely to be greater if countries introduce more differences between their rules.

87. Group ratios can also be applied directly to the earnings or asset value of an entity in its functional currency, whereas an interest cap is more likely to be calculated in the reporting currency of the group and would require translation into an entity's functional currency. This means that a group ratio rule may have advantages for countries with relatively volatile currencies.

88. As mentioned above in section VIII.A, where a group does not have any net third party interest expense, entities within the group would only be able to deduct interest expense to the extent they also have interest income. Example 7 in Annex 3 includes an illustration of this, under both an interest cap and a group ratio rule.

Questions for consultation

7. Are there any practical issues with respect to the operation of (a) interest allocation rules or (b) group ratio rules, in addition to those set out in the consultation document?
8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?

C. What entities should be included in an interest limitation group?

89. The first key question in the design of a group-wide rule is the definition of the group among which the rule will be applied (the 'interest limitation group'). This will determine the types of base erosion and profit shifting transaction that a rule will address and also the information that an entity will need to obtain to apply a rule. The composition of an interest limitation group should be easily verifiable by entities and tax authorities and should ideally facilitate the collection of financial information for use in applying the rule, including details of the group's net third party interest expense and the level of earnings or asset values.

90. In many countries groups are required to prepare and file audited group financial statements. For public companies, this information is typically published. This means that group financial statements, and the underlying records used to produce those statements, should be readily available to a group's finance function and would be an extremely useful source of information on the financial position of the group overall. This information could then be provided to entities making up the financial reporting group. An implication of using financial statements as a source of information is that the operation of a group-wide rule will be influenced by future changes in accounting standards.

91. Designing a group-wide rule which applies to entities in a financial reporting group should therefore make it significantly easier for an entity to obtain information about its group. Generally, a financial reporting group will include a parent and all entities over which it has control. Control will typically be assumed where the parent has power over more than 50 per cent of the voting rights but may also exist under other circumstances. However, there are differences in the definition of control used in different accounting standards. It is recognised that in some cases this may mean that the composition of a financial reporting group may vary depending upon the accounting standards applied in preparing consolidated financial statements. Consideration needs to be given as to whether this variation is acceptable in order to make a rule easier to apply and administer.

92. Where a group is required to prepare consolidated financial statements at different levels of the group (for example, where a holding company is required to file consolidated financial statements including its subsidiaries, but the holding company is also included in the consolidated financial statements of its parent group), membership of the interest limitation group should be based on the highest level of consolidated financial statements prepared by the parent of the overall group. Where an entity is part of a group (in that it directly or indirectly controls or is controlled by another entity) which does not prepare consolidated financial statements, the entity would need to obtain financial information on the group in order for a rule to be applied. A rule could specify that these group numbers should be based on International Financial Reporting Standards ('IFRS') or other generally accepted accounting principles ('GAAP'), such as that applicable in the country of the group's parent entity.

93. Alternatively, in applying a group-wide rule, the actual composition of an entity's financial reporting group could be disregarded. Instead, a single standard definition of an interest limitation group could be applied to all entities. This could be based upon an existing definition (for example, the existing definition under IFRS) or a new definition could be developed based on an ownership and control test agreed by countries. This approach would have the benefit of ensuring that the same definition of an interest limitation group is used by all entities wherever their group is located. However it would mean that, to the extent the composition of an entity's interest limitation group differed from its financial reporting group, the entity would be required to prepare new group numbers for use in applying the rule.

94. Because of these practical difficulties, and because a rule needs to be workable for groups and tax administrations, it is proposed that any group-wide rule included in a best practice recommendation should apply to entities in a financial reporting group required to prepare consolidated financial statements. Where an entity is in a group which is not required to prepare consolidated financial statements, the composition of the interest limitation group should contain the entities that would be included in consolidated financial statements under IFRS or other specified GAAP. To limit the opportunity for arbitrage (for example where a group chooses to apply the accounting standard which gives it a beneficial outcome) the choice of accounting standard could be limited, for example to IFRS or the GAAP applicable in the country of the group's parent entity.

95. Under this approach, a group-wide rule should apply to entities which are under the common control of an ultimate parent company. It will not apply to entities which are under the ultimate control of the same individual, trust or fund (which are described as 'connected parties' in Chapter V). However, in this case the rule may apply to a sub-group which is headed by a company held by the individual, trust or fund. Section VIII.H below considers how risks posed by connected parties can be addressed within a best practice approach that includes a group-wide rule.

D. How should a group's net third party interest expense be determined?

96. Action 4 requires that best practice rules are developed to address base erosion and profit shifting using interest expense and also other financial payments economically equivalent to interest. It will

therefore be necessary for an entity applying a group-wide rule to obtain information on the total net third party interest expense, including amounts economically equivalent to interest, for its interest limitation group.

97. As an interest limitation group corresponds with an entity's financial reporting group, the consolidated financial statements should be a good starting point for obtaining information on the group's net interest position. A group's net third party interest expense, including amounts economically equivalent to interest, may be able to be determined on the basis of information contained in notes to the consolidated financial statements (for example, amounts included within investment income and finance costs in financial statements prepared under IFRS). This should provide an accurate reflection of the group's actual net interest expense position taking into account group borrowings and deposits with third parties. However, two adjustments may be required:

- to include any income or expense of the group which is economically equivalent to interest and is not included in these financial reporting figures; and
- to exclude any income or expense of the group which is treated as interest in the group's consolidated financial statements, but where the nature of the payment is such that it would not generally be taken into account for tax purposes.

98. Because it is anticipated that an interest allocation rule should be applied consistently by countries, under this type of rule the items excluded in the second bullet point above would need to be agreed by all countries applying a rule. Therefore, these are likely to be only those items which are not deductible in any country or in a significant majority of countries. Under a group ratio rule, a country would have greater flexibility to include amounts which would not be deductible under its own tax law.

Questions for consultation

9. Do any difficulties arise from basing a group-wide rule on numbers contained in a group's consolidated financial statements and, if so, what are they?
10. In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

E. How should economic activity be measured?

99. Under a group-wide rule, the net interest expense of an entity is linked to the net third party interest expense of its group in accordance with a measure of economic activity. Earnings and asset values are two measures of economic activity which are also measures of an entity's borrowing capacity. A group-wide rule could therefore compare a measure of earnings or asset values of an individual entity against the corresponding measure for the entire allocation group.

i) Measuring economic activity using accounting or tax figures

100. A comparison of economic activity between an entity and its group could in principle be based on either accounting or tax figures.

101. Accounting figures for the earnings or asset values of a group could be determined using the consolidated financial statements. This has an additional benefit that the published figures and underlying records will generally have been subject to independent audit. Where an interest limitation group does not prepare consolidated financial accounts, a rule may require an entity to provide group numbers prepared in

accordance with IFRS or other specified GAAP, which would impose a cost on groups if these numbers are not already prepared for any other reason.

102. In theory, earnings or asset values could also be determined using tax principles. This would allow the economic activity of an entity to be based on taxable profits or the tax value of its assets. However, in practice it is hard to see how tax principles could be used to measure the level of economic activity for a worldwide group without imposing a significant compliance burden on groups and an administrative burden on tax authorities.

103. It is therefore proposed that a comparison of economic activity should be based on an accounting measure of earnings or asset values. However, there may be some areas where these accounting figures can be adjusted to take into account key differences between accounting and tax rules (for example, by excluding categories of tax exempt income from a measure of earnings).

ii) Measuring economic activity using earnings or asset values

104. The key issues arising from the use of earnings or asset values as a basis for measuring economic activity are set out below.

a) Earnings-based approaches

Linking interest expense to value creation and the ability of an entity to raise borrowings

105. The level of earnings in different entities is usually the clearest indicator of value creation across a group, though there may be exceptions to this (for example, where an entity incurs losses while entering a valuable new market). Therefore a measure based on earnings could be the most effective way to ensure that net interest expense is matched with economic activity. An approach based on earnings may also give a fairer result for mixed groups which include entities engaged in activities requiring different levels of investment in assets.

106. In addition to reflecting value creation, the level of earnings is a direct measure of an entity's ability to meet its obligations to pay interest, and is a key factor in determining the amount of debt an entity is able to borrow.

Correlation between earnings and tackling base erosion and profit shifting

107. Where interest expense in an entity is linked to the level of earnings, a group can only increase net interest deductions in a particular country by increasing earnings in that country. Similarly, any restructuring to move profits out of a country will also reduce net interest deductions in the country. On the assumption that an increase in earnings will also give rise to an increase in taxable income, it is unlikely that the level of earnings will be manipulated in order to increase the interest deductions in a country.

108. Action 4 also specifically refers to addressing base erosion and profit shifting using interest expense to fund tax exempt or tax deferred income. In part, this may be addressed through a group-wide rule by using a measure of earnings that excludes dividend income (except possibly portfolio dividend income which is taxed on the same basis as ordinary income). This would ensure that a high interest cap was not allocated to an entity because of a high level of dividend income, which is often taxed on a preferential basis.

The measure of earnings

109. In principle, a group-wide rule could be designed using any measure of earnings, but the choice will directly influence how a rule will impact entities operating in different sectors. The most common measure of earnings currently used by countries with earnings-based fixed ratio tests is earnings before interest, taxes, depreciation and amortisation (EBITDA), although another possible measure that could be used is earnings before interest and taxes (EBIT). By excluding interest expense and also the two major non-cash costs in a typical income statement (depreciation of fixed assets and amortisation of intangible assets), EBITDA is a guide to the ability of an entity to meet its obligations to pay interest, which is an important consideration in determining how much interest expense an entity can reasonably afford to bear. On the other hand, this approach potentially favours entities operating in capital intensive sectors with high levels of fixed asset investment. This is because EBITDA does not include the write down of capitalised costs such as investment in plant and machinery, whereas it does take into account revenue costs which are the majority of the cost base for entities in other sectors. This could mean that if two entities have identical profits before tax, the entity in a more capital intensive sector could have a higher EBITDA and thus be allocated a higher interest cap under a rule which uses this as a measure of earnings, which may be appropriate to the extent it reflects the ability of entities to borrow against these assets.

110. Another possible measure of earnings would be revenue less cost of sales (gross profit). This has the advantage that gross profit is calculated on a broadly comparable basis across most accounting standards, with greater differences introduced as an entity works down its income statement. However, the use of gross profit could lead to problems where one entity in a group provides for example marketing or distribution services to other group entities. This is because the entity providing the service will include its income within its own gross profit whereas the entity paying for services will deduct the corresponding expense further down its income statement, making the comparison of entities difficult. This mismatch should not arise under an EBITDA measure.

111. As mentioned above, in order to address base erosion and profit shifting using interest to fund tax exempt or deferred income, any measure of earnings used may exclude dividend income.

Impact of consolidation adjustments

112. Intercompany transactions within a group mean that there may be cases where an individual entity recognises earnings that are not included in the consolidated earnings of the overall group. This may arise for example where an entity (A Co) sells components to another entity (B Co) in its group, which B Co will use to manufacture products for sale to customers. At an entity level A Co will recognise revenue from these intragroup sales, but on a consolidated level this should not be recognised until a sale takes place outside the group. Other consolidation adjustments may be required to strip out payments between entities for intragroup services.

113. An earnings-based approach may deal with this type of consolidation adjustments in three ways.

- Firstly, group and entity earnings could be compared without adjustment. So long as the measure of earnings used takes into account both sides of an intragroup transaction (ie. income in A Co is offset by expense in B Co), this should reflect the location of earnings across a group. However, where the measure of earnings used does not take into account both sides of an intragroup transaction (for example, where earnings is measured using gross profit, which does not include payments for marketing and distribution services), this approach could lead to an over-allocation of capacity to deduct interest expense among group entities. This is because the aggregated earnings of the group's entities would exceed the earnings in the group's consolidated financial statements. In principle, this approach could also lead to intragroup transactions being used to

manipulate the outcome of a rule (for example, where intragroup payments are made to increase the level of earnings in one entity and reduce the level of earnings in another entity), although in practice this may be unlikely to happen as it should also give rise to more taxable income in the entity to which earnings are being shifted.

- Secondly, the total earnings of the group could be calculated using non-consolidated figures (ie. before intragroup transactions are stripped out). The main advantage of this approach is that it would reduce the risk of an over-allocation of capacity to deduct interest expense, as described in the bullet above.
- Thirdly, group earnings could be based on consolidated figures, but individual entities could adjust their earnings to strip out the effect of intragroup transactions. This would prevent manipulation using intragroup transactions. However, these adjusted figures would not typically be produced by entities, which could find such an approach difficult to apply. This would also mean that entities which transact entirely within their group would not recognise any earnings and would not be able to deduct any net interest expense.

114. Other consolidation adjustments, such as those required under purchase accounting and impairment accounting rules, will also need to be taken into account in the design of a possible best practice rule. The extent to which these adjustments will impact on the application of a group-wide rule will depend in part upon the measure of earnings used. For example, consolidation adjustments which result in a higher level of depreciation in a group's consolidated financial statements will impact a group's earnings measured by EBIT, but should not affect earnings measured by EBITDA.

Earnings volatility and losses

115. Entity earnings may be relatively volatile compared with asset values and there is a limit to the extent this can be controlled by a group. This means that under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year. A rule could be designed to include features to reduce the impact of this volatility. For example, a rule could be based on average earnings (over a period of say three years), or an entity could be allowed to carry-forward disallowed interest expense or unused capacity to deduct interest expense into future periods. Features of a possible carry-forward provision are considered in Chapter XII.

116. A particular aspect of earnings volatility is the possibility that individual entities or an entire group may be in a negative earnings (ie. loss-making) position. Three issues arise as a result of a group including loss-making entities.

- Firstly, under an earnings-based approach, loss-making entities will not be able to deduct any net interest expense, though a rule may allow disallowed interest to be carried into future periods.
- Secondly, the aggregated earnings of profitable entities in the group will exceed the group's actual total earnings. Therefore a group-wide rule could allow these entities to deduct an amount of net interest expense that exceeds the group's total net third party interest expense.
- Thirdly, unless a rule takes account of the impact of losses, a group-wide rule based on earnings would become impossible to apply where a group is in a loss-making position overall.

117. There appear to be two ways in which this situation could be dealt with, which are illustrated in examples 8 and 9 in Annex 3.

- A group's total earnings could be determined using only the results from entities which make a positive contribution to the group position. Entities with losses would be excluded from a calculation. This would remove the risk that entities would be able to deduct an amount of interest expense in excess of the group's actual net third party interest expense. However, this would require groups to be able to separately identify profitable and loss-making entities.
- Alternatively, a rule could accept that, to the extent an interest limitation group includes loss-making entities, the protection offered by a group-wide rule is reduced (and is removed completely where a group is in a loss-making position overall). For example, a group could use this situation to shift net interest expense to entities in higher tax jurisdictions (illustrated in examples 8 and 9 in Annex 3). However, it is not clear that in practice a group would include loss making entities in its consolidated financial statements in order to achieve limited flexibility in allocating its net interest expense.

Calculation of entity earnings

118. Under a group-wide rule, entity earnings should ideally be determined using the same accounting standards as are applied in preparing the group's consolidated financial statements. This would ensure a consistent approach across the group. However, the work on County-by-Country reporting under Action 13 identified the difficulties in producing consistent entity information across an international group. Therefore, where local GAAP is substantially similar to the accounting standards used in preparing the group's consolidated financial statements, a rule could provide for an entity's earnings to be calculated under local GAAP. For example, in a number of countries local GAAP has been largely aligned with IFRS and these countries may decide to accept the use of entity numbers based on local GAAP. This would reduce the compliance cost to groups and make auditing an allocation easier for authorities.

119. Many entities will operate and maintain accounting records in a currency which is different to the presentation currency in the group's consolidated financial statements. In these cases, an entity's earnings should be translated into the group's presentation currency using the exchange rate applied in preparing the group's financial statements. Where group financial statements are not prepared, a rule could provide for translation using the exchange rate for the dates of transactions or may allow the use of an average rate where this is not materially different.

b) Assets-based approaches

Linking interest expense to asset values

120. An important purpose of raising third party debt is to directly or indirectly fund the group's assets, which are used to generate revenue and earnings. The value of an entity's assets is also a key factor in determining the amount of debt it is able to borrow. Therefore an approach which uses asset value as a measure of economic activity within a group also has a good economic rationale. However, while there is a clear link between the level of earnings and the level of taxable income in an entity (depending on the measure of earnings used), the link between the level of assets and the level of taxable income in an entity may be less strong. Therefore an approach based on assets may not directly address base erosion and profit shifting risk to the same extent as an earnings-based approach.

Categories of assets to include in a calculation

121. An assets-based approach should take into account the value of a broad range of balance sheet assets, in order to accurately reflect a group's activities. However, this should not include financial assets which give rise to interest income. This is to ensure that the ability to deduct interest expense is allocated

to entities with economic activity and not by reference to the location of debt instruments. Also, in order to tackle base erosion and profit shifting from the use of interest to fund tax exempt and tax deferred income, equity investments which give rise to dividend income may be excluded (except possibly portfolio investments giving rise to dividend income which is taxed on the same basis as ordinary income).

122. Therefore, an assets-based approach could take into account the value of assets such as land and buildings, plant and equipment, goodwill and other intangible assets, inventory or stock, trade receivables, and financial assets which do not give rise to amounts treated as interest. But assets such as equity investments, cash and deposits, intragroup and third party loans, other intragroup balances, finance lease assets and other financial assets giving rise to amounts treated as interest could be excluded.

Stability in asset values

123. Compared with earnings, asset values are typically more stable (except in the case of revaluations and write-downs, and assets which are marked to market under accounting rules). This means that using asset values as a basis for measuring economic activity within a group should give rise to a relatively steady and predictable limit on the level of relief that can be claimed. This would improve certainty for groups and could also reduce compliance costs. In addition, an approach based on asset values would mean that entities with losses would still be able to deduct an amount of net interest expense, which would not be possible under an earnings-based approach.

Valuation of assets

124. The key issue surrounding an assets-based approach is achieving a consistent and acceptable model for valuing assets across an international group. A requirement to use market values of assets would appear to be impractical and impose an excessive compliance burden on groups. However, historic cost can give rise to inconsistencies across a group depending upon the age of assets and is subject to influence by decisions of management, for instance on depreciation and amortisation periods and the timing of revaluations and write downs. Differences between accounting standards also mean that under an assets-based model, it may be more difficult for countries to accept results which compare numbers based on different accounting standards.

Internally generated assets and intangibles

125. Intangible assets, including trademarks, patents and trade secrets, can be among a group's most valuable assets. This is particularly the case for major brands and for hi-tech groups. However, accounting standards typically impose stringent requirements on groups before they are able to recognise an intangible asset on their balance sheet, particularly where the asset has been internally created. Even where an intangible asset can be recognised, its carrying value is usually at historic cost, which may be only a fraction of its actual fair market value. Revaluations of intangible assets are generally only possible by reference to a fair value on an active market, and as such will rarely be permitted for most types of intangible.

126. The impact of this is that for a number of large groups, an approach to limiting interest deductions based on asset values for accounting purposes will ignore the group's most valuable assets.

Netting of derivative positions

127. A specific area of difference in the treatment of assets under accounting standards is in the recognition of derivative balances under IFRS and US GAAP, and in particular the ability of groups to report positions on a gross or net basis. This issue arises primarily in financial services groups, groups which have financial operations, and other groups which use derivatives to manage positions for example

in commodity markets. Where a group has offsetting asset and liability positions under derivatives with the same counterparty, these positions will generally be reported separately (ie. on a gross basis) by groups accounting under IFRS, except where an entity has a legally enforceable right of set-off and intends either to settle on a net basis or to realise the financial asset and settle the financial liability simultaneously. Where these conditions are met, IFRS requires the two positions to be reported as a single net asset or liability figure.

128. On the other hand, US GAAP allows groups to offset derivative assets and liabilities carried at fair value wherever two parties owe each other determinable amounts and there is a right of offset enforceable by law. This right of offset is typically found in master agreements which are in place between groups to provide protection in the event of insolvency.

Questions for consultation

11. What approach to measuring earnings or asset values would give the most accurate picture of economic activity across a group? Do any particular difficulties arise from this approach and how could these be addressed?
12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?
13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?
14. Do any particular difficulties arise from asking groups to identify entities with positive and negative earnings balances? What other approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?
15. Where an entity's earnings or asset values need to be converted into the currency used in the group's consolidated financial statements, what exchange rate should be used for this conversion?
16. What specific issues or problems would be faced in applying a group-wide rule to a group engaged in several different sectors? Would an assets or earnings-based approach be more suitable for this kind of group?
17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?
18. Do any particular difficulties arise from the application of a group-wide allocation rule to groups with centralised treasury functions? If so, what are these difficulties and do they vary depending upon how the treasury function is structured and operates?
19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

F. How should mismatches between accounting and tax rules be addressed?

129. A number of mismatches between the accounting and tax treatment of specific items have been considered above, when looking at the calculation of net third party interest expense and the measurement of economic activity. This section focuses on issues that arise when an entity compares its interest cap or the amount of interest expense deductible under a group ratio rule, against its actual net interest expense for tax purposes.

i) Currency

130. In most cases an entity's interest cap under an interest allocation rule will have been calculated in the currency of the group's consolidated financial statements. However, an entity's taxable income will generally be calculated in its functional currency. Therefore, under an interest allocation rule, the interest cap will need to be translated into the entity's functional currency before it can be applied. This translation may be performed at the average exchange rate for the period, although a rule could allow a different exchange rate to be used if this would give a more reasonable result.

131. Under a group ratio rule, a ratio calculated using group numbers in one currency may be applied directly to an entity's earnings or asset value in a second currency without the need for translation.

ii) Permanent and timing mismatches

132. Under either type of group-wide rule, an entity should compare the amount of net interest expense allowable under the rule against its actual taxable net interest expense. An entity's taxable net interest expense includes financial payments economically equivalent to interest (as described in Chapter IV) and, where applicable, other payments which are re-characterised and treated as interest under transfer pricing rules. Where an entity's taxable net interest expense is lower than or equal to the amount permitted under a group-wide rule, the full net interest expense is deductible. Where an entity's taxable net interest expense exceeds the amount permitted under a group-wide rule, the excess is disallowed. The treatment of this disallowed interest expense is considered in Chapter XII.

133. Some differences between the amount of net interest expense allowable under a group-wide rule and an entity's taxable net interest expense will be the result of mismatches in how interest is recognised for accounting and tax purposes. These will include timing mismatches and permanent mismatches. Timing mismatches arise because the interest expense is recognised in different periods for accounting and tax purposes, and in most cases these should correct over the life of a debt. Permanent mismatches arise where the payments treated as interest or economically equivalent to interest in the group consolidated financial statements are different to those treated as such for tax purposes. For example, where an instrument is treated as debt for accounting purposes but equity for tax purposes, payments on that instrument are likely to give rise to permanent mismatches. As discussed in section VIII.D above, this is more likely to arise under an interest allocation rule, where all countries must agree which amounts in the group's consolidated financial statements will be taken into account in calculating net third party interest expense. Under a group ratio rule, a country can more closely link the definition of net third party interest expense to the amounts that will be included in the taxable interest expense of a local entity. This could reduce the number of permanent mismatches, though some they may still arise, for example where interest expense is valued differently for accounting and tax purposes. It is not possible to identify every mismatch which could arise between different accounting and tax rules in all countries, but as part of this consultation comments are invited on where significant mismatches are likely to arise.

134. Timing and permanent mismatches between tax and accounting rules can be addressed in several different ways. For example, timing mismatches could be addressed through provisions for the carry

forward of disallowed interest expense or unused capacity to deduct interest into future periods. The use of carry forwards is discussed in Chapter XII. On the other hand, permanent mismatches could for instance be taken into account by allowing a small uplift in amount of net interest expense deductible under a group-wide rule (so for example an entity would be permitted to deduct net interest expense up to say 105 per cent of its interest).

135. Under an interest allocation rule, where there are significant mismatches between the calculation of interest for accounting and tax purposes, these could be addressed by comparing the interest cap with the entity's net interest expense for accounting purposes and calculating the percentage of the accounting net interest expense which falls within the interest cap. This percentage may then be applied to the entity's net interest expense for tax purposes to determine how much should be allowable (up to 100 per cent). This option would avoid the need for a direct comparison of an interest cap calculated using accounting rules with an interest expense figure calculated using tax rules. A simple example of this approach is included as example 10 in Annex 3. A similar approach could be taken under a group ratio rule, though whether this would be required would depend upon the design of the rule.

iii) Deadlines for filing financial statements

136. Requirements to file entity and group financial statements will be determined under the law in the relevant jurisdiction. In some cases, an entity may be required to file its tax return and pay tax before these financial statements are audited and published. Countries should take into account the timing of the availability of financial information in the design of a group-wide rule, but in many cases groups will prepare and publish their consolidated financial statements significantly earlier than the date required under company law. In some countries entities are already used to using accounting information in the calculation of their tax liability before the publication of financial statements, and it is not anticipated that this should cause significant problems for groups.

Questions for consultation

20. In what situations could significant permanent or timing mismatches arise if an entity's interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?
21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

G. How should cash pooling arrangements be treated?

137. Cash pooling arrangements are a common part of treasury management in an international group. They allow a group to reduce its net third party interest expense by setting surplus cash balances in certain entities against borrowing needs in other entities, so essentially the group only pays interest on the net position. Interest income or expense is then allocated to individual entities in accordance with transfer pricing principles. Cash pooling can be structured in different ways, including notional arrangements (whereby each entity holds its own position and these are offset by the bank) and zero-balancing or cash-concentration arrangements (whereby each entity's position is swept into a single centralised bank account on a daily basis). International groups may also operate a separate cash pool for each currency in which they have significant operations.

138. The application of a group-wide rule should not impact the ability of a group to manage its third party balances through cash pooling. It is recognised that money is a fungible asset and, even where a group is engaged in different activities, there are significant commercial benefits from a centralised treasury function with responsibility for managing the group's financing. When applying a group-wide rule, the group's net third party interest expense will be calculated taking into account the benefits obtained from the cash pool. This will be used to establish a limit on net interest deductions for each entity in the group based on the level of earnings or asset values, using an interest cap or group ratio. Any interest that an entity pays to or receives from third parties and group entities (including as part of a cash pooling arrangement) will be taken into account in determining whether the entity's actual net interest expense is within the limit permitted under the rule. As mentioned above in section VIII.B, there may be cases where groups seek to reorganise their intragroup financing arrangements so that each entity's net interest expense more closely reflects its level of economic activity.

H. How should risks posed by connected parties and related parties be dealt with?

139. An aim of the work under Action 4 is to encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group. The group-wide rules described in this chapter achieve this aim by linking a group's total deductions to the level of net third party interest expense, and matching these deductions with economic activity. However, some groups may attempt to reduce the impact of group-wide rules by artificially increasing the level of net third party interest expense, thus increasing the net deductions that can be claimed across the group. This may be achieved through transactions with connected parties and related parties, which are outside of the group, for example by making excessive interest payments or by converting interest income into a form which is treated differently for accounting purposes.

140. Connected parties include entities which are under common control but which are not part of a group. This would include for example entities controlled by the same individual or by a private equity fund. As connected parties are not part of a financial reporting group, they will not be included in a group-wide rule unless a special provision is included to bring them within the definition of an interest limitation group. However, as connected parties are under a control relationship, they are in a similar economic position to members of a group. This means connected parties may enter into transactions with each other on terms they would not agree with third parties, without any requirement for the benefits from the transaction to be shared between the parties. For example, an entity within a group may pay excessive interest to a connected party, as the value of the payment is transferred between two investments controlled by the same individual, fund or trust.

141. Related parties include entities where there is a relationship below that required to establish control, and third parties which are party to structured arrangements. Related parties are not in the same economic position as members of a group. They are however in a relationship which means they may enter into transactions to generate a tax benefit, which is typically shared between the parties. For example, an entity within a group may pay excessive interest to a related party, but this is likely to be part of a wider arrangement whereby part of the value of the excess interest is passed back to the group, on terms that split the tax benefit of the excess interest between the group and the related party. A similar arrangement which may be more difficult for tax authorities to detect would involve an entity within a group making a payment to a related party, with part of the value of the payment being passed to a connected party of the group. This type of 'back to back' arrangement could also be used to disguise payments to a connected party by effectively routing them via a related party, such as a bank under a structured arrangement.

142. Countries involved in this work agree that entities should not be able to use payments to connected and related parties to limit the effectiveness of group-wide rules, as this would allow them to

gain a competitive advantage over other groups. A best practice approach to tackling base erosion and profit shifting could therefore include provisions aimed at dealing with these risks.

143. Risks posed by entities which are connected parties could be addressed by including them within an interest limitation group. However this raises two issues. Firstly, in applying a group-wide rule an entity would need to obtain financial information on the position of its connected parties which would not be included in the group's consolidated financial statements. This could impose a significant burden on entities and tax administrations. Secondly, under this approach, the total third party interest expense of two connected groups (for example, those held by the same private equity fund) would be combined and allocated between entities in both groups. This could lead to undesirable results, particularly where the two groups operate in different sectors and have different funding needs.

144. An alternative approach to dealing with risks posed by all connected parties and related parties (including through indirect payments to connected parties made through back to back arrangements described above) would be through targeted provisions. One option could be for interest payments to connected and related parties to be excluded from net third party interest expense in applying a group-wide rule. This could apply to all interest paid to connected and related parties, or to payments which meet certain conditions. This would reduce the impact on groups which do not make payments to connected and related parties, as they would not be required to make any adjustment. It would also address the risk posed by payments made by a group entity located in a country which does not apply interest limitation rules. However, it would require all entities in a group to obtain details of the payments to connected and related parties and make adjustments to net third party interest expense. Similarly, tax authorities in all countries where the group operates would need to be able to audit these adjustments, which may be difficult where a payment is made in another country.

145. A second option could be for payments to connected and related parties to be stripped out of a group-wide rule in the entity where the payment is made. The entity making a payment to a connected or related party would reduce its interest cap or the amount of interest deductible under a group ratio rule by the value of the payment. However, the payment to the connected or related party would not be subject to restriction under the group-wide rule. Instead, a separate targeted rule would apply to these payments. As set out in Chapter XI, a targeted rule could disallow all interest payments to connected or related parties, or allow payments subject to a limit based on a fixed ratio or a requirement that the recipient is subject to a minimum level of taxation on the corresponding income. It is likely that this approach would be simpler to apply, as only the entity making a payment to a connected or related party would be required to make an adjustment. However, this approach also has disadvantages. For example, it relies on the entity making the payment to be in a country which applies targeted rule which imposes a disallowance. This means that a secondary rule may be required to allow other countries to make an adjustment in these circumstances.

146. Group-wide rules limit an entity's deductible interest expense with reference to the actual position of its worldwide group. As such, these rules will not impact the position of standalone entities which, as described in Chapter V, are not part of a group, have no connected parties and make no payments to related parties.

Questions for consultation

22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group's consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

IX. WHETHER INTEREST DEDUCTIONS SHOULD BE LIMITED WITH REFERENCE TO A FIXED RATIO

A. Fixed ratio rules as an approach to addressing base erosion and profit shifting

147. The premise underlying a fixed ratio rule is that an entity should be able to deduct interest expense up to a specified proportion of its earnings, assets or equity, ensuring that a portion of an entity's profit remains subject to tax in a country. The underlying benchmark ratio is determined by a country's government and applies irrespective of the actual leverage of an entity or its group. Interest expense on third party or intragroup debt up to this fixed ratio is deductible, but any interest which takes the entity's ratio above this benchmark is disallowed. Illustrations of how a fixed ratio rule might operate in practice are included as examples 11 and 12 in Annex 3.

148. The key advantage of a fixed ratio rule is that it is relatively simple for groups to apply and tax administrations to administer. Unlike group-wide tests, which require an entity to have access to certain information on the position of its worldwide group, fixed ratio tests are based entirely on the entity's own financial position. This also means that a test may be constructed using tax figures (such as EBITDA using taxable profits and definitions of interest, depreciation (or capital allowances) and amortisation established under tax law) rather than financial reporting figures. This may be particularly useful in countries where the taxation of interest or the tax system more broadly does not closely follow the accounting treatment. For example, a tax EBITDA is used by a number of countries (see Box 3).

149. However, this approach does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector groups may adopt different funding strategies for non-tax reasons. Unless exceptions are made, a country must therefore identify the benchmark ratio which represents an appropriate level of interest expense for all entities operating in all sectors. Compared with group-wide rules, this significantly reduces the ability of a fixed financial rule to address base erosion and profit shifting. Where a fixed ratio is used as a main rule for addressing excess interest deductions, there is therefore a risk that the benchmark ratio will be set too high for some entities (giving rise to opportunities for base erosion and profit shifting) and at the same time too low for others (giving rise to double taxation). So long as a rule takes into account the issues discussed in this consultation document (such as excluding dividend income from the measure of economic activity), a fixed ratio rule can be targeted to address risks arising from both inbound and outbound investment, although the problem of setting a benchmark ratio at the correct level remains.

150. In discussing fixed ratio rules it is important to note that in some cases these tests were also introduced to play a wider tax policy role rather than with a focus on combating base erosion and profit shifting. For example, a number of countries introduced such rules specifically to reduce existing distortions between the tax treatment of debt and equity.

B. Linking interest deductions to the level of assets or earnings

i) Linking interest deductibility to assets

151. One purpose of raising borrowings and paying interest for most groups is to fund the group's assets and activities. There may therefore be a natural link between the value of assets held by an entity and the amount of interest expense it should bear.

152. Compared with earnings, asset values are typically more stable (except in the case of revaluations and write-downs, and assets which are marked to market under accounting rules). This means that using asset values should give rise to a relatively steady and predictable limit on the level of relief that can be claimed. This would improve certainty for entities and could also reduce compliance costs.

153. Linking interest deductibility to the level of assets in an entity means that asset tests may be suitable for addressing base erosion and profit shifting in an inbound investment context. Asset tests may also be suitable for tackling base erosion and profit shifting involving the use of debt to fund tax exempt or deferred income. For example, excluding equity investments from the types of asset taken into account by a test, would prevent many entities with assets which yield tax exempt or deferred dividend income from claiming a higher level of deductible interest expense. This could apply in an outbound investment context (for example where a parent entity invests equity in a foreign subsidiary) and also in an inbound investment context (for example where a local holding company borrows from its foreign parent entity in order to invest equity in a local subsidiary).

154. In practice, the key disadvantage of using asset values to limit interest expense is one of valuation. Where total assets are used there is a risk of manipulation as cash could be pumped into an entity to inflate total asset values and generate additional capacity to deduct interest expense. Another issue concerns the treatment of assets which may not be recognised on an entity's balance sheet. For example, an entity with self-created intangibles could be treated less favourably than a similar entity which acquired intangibles and so is able to recognise an asset on its balance sheet. However, many issues concerning asset valuations may be addressed if a rule uses the tax value of specified asset classes as the basis for a calculation, where these are available. This approach may not resolve the issue around self-created intangibles, which may not have a value for tax purposes or, where a tax value is available, the value may be unreliable because it may not properly reflect the current position.

ii) Linking interest deductibility to earnings

155. Over the past few years a number of countries have introduced fixed ratio rules that consider interest in relation to a measure of earnings. This means that, so long as the measure of earnings used broadly corresponds to taxable income, a group should only be able to increase net interest deductions in a particular country by increasing taxable profits in that country. This is a key advantage of an earnings-based rule. In addition, excluding dividend income from the definition of earnings would also make a rule suitable for addressing a significant proportion of base erosion and profit shifting using interest to fund tax exempt or deferred income.

156. An important drawback of an earnings-based rule is, however, that entity earnings are relatively volatile, as they can be influenced by market factors outside an entity's control. This means it may be difficult for an entity to anticipate the amount of interest expense which will be permitted from year to year as a result of which there may be circumstances where an entity which is loss making in economic terms still has to pay tax as a result of an interest disallowance. To some extent this effect may be mitigated through a provision to allow disallowed interest expense to be carried forward for a limited period. This is considered in more detail in Chapter XII.

The measure of earnings

157. The measure of earnings used in a test is important, as this will directly affect how a rule impacts on entities operating in different sectors. EBITDA is the most common measure of earnings currently used by countries with earnings test, though EBIT is used by a small number of countries. As described in Chapter VIII at paragraph 109, by excluding interest expense, depreciation and amortisation, EBITDA is a guide to the ability of an entity to meet its obligations to pay interest. On the other hand, this approach potentially favours entities operating in capital intensive sectors with high levels of fixed asset investment, as EBITDA does not include the write down of capitalised costs such as investment in plant and machinery, whereas it does take into account revenue costs which are the majority of the cost base for entities in other sectors.

C. The level of fixed ratios in existing rules

158. Setting the benchmark ratio at the correct level will be a key issue when implementing a fixed ratio rule. Box 3 below contains details on the current ratios applied by a cross-section of countries in their interest to earnings rules. From this it can be seen that most countries with an earnings-based rule apply a benchmark ratio that allows an entity to deduct interest expense up to 30 per cent of EBITDA (or alternatively countries have introduced rules that will move to this rate over a number of years).

Box 3. Fixed interest to earnings (EBITDA) ratios in selected countries

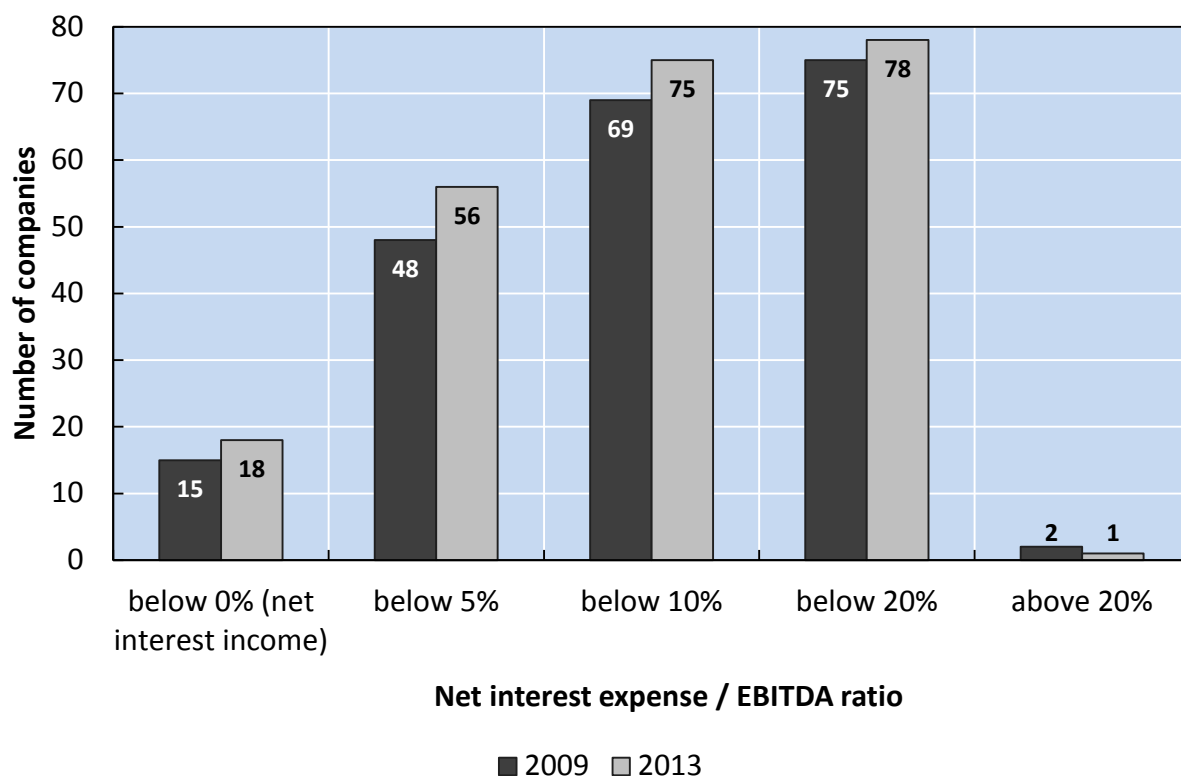
Finland:	25 per cent of EBITD calculated based on the taxable profit and loss account. The calculation is made by entity and adjusted by taking into account group contributions received or made.
Germany:	30 per cent of taxable EBITDA.
Greece:	30 per cent of EBITDA. Phased-in system according to which the percentage will reduce from 60 per cent in 2014 to 30 per cent in 2017.
Italy:	30 per cent of EBITDA, adjusted by adding rental payments under finance lease transactions.
Norway:	30 per cent of taxable EBITDA.
Portugal:	30 per cent of EBITDA, adjusted by excluding certain items such as income resulting from shares eligible for the participation exemption or attributable to a permanent establishment outside Portugal to which the option for exemption is applied. Phased-in system according to which the percentage will reduce from 70 per cent in 2013 to 30 per cent in 2017.
Spain:	30 per cent of operating profits adjusted by adding certain items such as depreciation and amortisation and financial income from equity investments.
United States:	50 per cent of adjusted taxable income, ie. EBITDA plus specific deductions taken into account when calculating the taxable income.

159. However, anecdotal evidence from a number of sources, including companies and advisers, indicates that those benchmark ratios may be too high to be effective in preventing base erosion and profit shifting. To get a better understanding of how these benchmark ratios compare to the actual net interest to EBITDA ratios of groups taken from consolidated financial statements, an analysis was carried out in relation to the position of large multinational companies (see Box 4).

Box 4. Third party interest of large multinational companies

The analysis covered the 79 non-financial sector companies from the list of the “Global top 100 companies by market capitalisation” published by PricewaterhouseCoopers in March 2014.¹ The relevant data was taken from published consolidated financial statements for the years 2009 and 2013. For the year 2013, data was available for all companies. However, two companies were first listed after 2009 and therefore the analysis covers 77 companies for that year. For companies with an accounting date earlier than 30 June, data was taken from the consolidated financial statements for the period ending in the following year (for example if a company’s financial year ends on 30 April, data for 2009 was taken from the consolidated financial statements for the year ended 30 April 2010).

Results show that for the year 2009, 69 out of 77 companies had a net interest expense to EBITDA ratio below 10 per cent, including 15 companies which had net interest income. In 2013, 75 out of 79 companies had a net interest expense to EBITDA ratio below 10 per cent, including 18 companies which had net interest income.



The results were confirmed through similar analysis carried out by 9 countries that participate in this work. These countries also looked at the net interest expense to EBITDA ratios for the 10 largest non-financial groups headquartered in their country. Fifty-five per cent of those groups have a ratio below 10 per cent and eighty-five per cent have a ratio below 20 per cent.

1. PricewaterhouseCoopers, ‘Global Top 100 Companies by market capitalization – March 2014 Update’ (<http://www.pwc.com/gx/en/audit-services/capital-market/publications/assets/document/pwc-global-top-100-march-update.pdf>)

160. The ratios in Box 4 are based on information taken from financial statements. It is recognised that differences will exist between an entity’s EBITDA based on accounting profits and that based on tax figures (which are used in many countries when applying an interest limitation rule). This needs to be taken into account when considering the benchmark ratios in Box 3 and the actual group ratios in Box 4.

However, these ratios appear to indicate that actual net interest to EBITDA ratios of large groups may be significantly below the current benchmark ratios provided for under countries' laws.

161. In this context, another aspect which needs to be taken into consideration when looking at the different benchmark ratios provided for in countries' laws is that interest rates vary between countries and currencies. Therefore, groups with debt in certain currencies, and in particular those operating in developing countries, may be subject to higher interest rates. These differences should be taken into account in setting a benchmark ratio appropriate to a country's economic environment.

D. Addressing risks posed by connected and related parties

162. As set out in Chapter V, a comprehensive approach to tackle base erosion and profit shifting risks needs to address risks posed by entities in groups, connected parties and payments to related parties (scenarios 1 to 3, see Chapter V). Fixed ratio rules can be applied and deal directly with risks posed by entities in each of these scenarios.

163. Standalone entities (ie. entities which do not fall within scenarios 1 to 3) should generally not pose any base erosion and profit shifting risk. However, where a country wishes to apply an interest limitation rule to all entities, a fixed ratio rule should also be suitable for standalone entities. This situation could for instance arise where a country uses fixed ratio rule to achieve a broader tax policy objective, for example to reduce the existing tax bias in favour of debt financing.

Questions for consultation

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?
25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?
26. For what reasons would the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios of its worldwide group?
27. Would a fixed ratio rule pose particular problems for entities in certain sectors? If so, which sectors would be affected and how could this be addressed?
28. What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?

X. WHETHER A COMBINED APPROACH COULD BE APPLIED

164. This chapter considers whether the interest allocation rules, group ratio rules and fixed ratio rules described in Chapters VIII and IX could be combined in a way that enables them to tackle base erosion and profit shifting and also reduces administrative and compliance costs by applying simpler rules to entities which pose less risk. A combined general approach could be supported by targeted rules discussed in Chapter XI to provide a robust overall strategy to combating base erosion and profit shifting using interest expense.

165. Two possible options for a combined approach are set out below. Although structured differently, each of these approaches allows entities with a lower level of interest expense to apply a simple fixed ratio rule, while more highly leveraged entities apply a more complex group-wide test which could permit them to deduct more interest expense in line with the position of their group. In designing a combined approach, the primary aim must be to include a robust general rule which tackles base erosion and profit shifting in the majority of groups. A carve-out from this may be included which complements the general rule, but this should be limited in scope to ensure that it does not compromise the effectiveness of the general rule.

166. As discussed in Chapter VII, to reduce compliance and administrative costs for entities with very low leverage and which pose the lowest risk of base erosion and profit shifting, a country could include a monetary threshold which sets a *de minimis* level of net interest expense below which an entity will not be required to apply a general interest limitation rule. This threshold should be set at a sufficiently low level to apply only to those entities which pose the lowest threat of base erosion and profit shifting. To ensure it applies consistently and to avoid abuse, any threshold should apply to the aggregate net interest deductions in all group entities in a country.

	Approach 1	Approach 2
General rule	Group-wide interest allocation rule	Fixed ratio rule
Carve-out from general rule	For entities which meet a low fixed ratio test	For entities which meet a group ratio test

Approach 1

167. An entity with deductible net interest expense (above any monetary threshold if one is applied by a country) would come within the general rule, which is a group-wide interest allocation rule and is intended to apply to the majority of international groups. This enables an entity to deduct interest expense up to an interest cap, equal to an allocation of the group's net third party interest expense based on a measure of earnings or assets. A country may allow disallowed interest expense to be carried forward and set against unused interest cap in a future period.

168. An interest allocation rule should be an effective deterrent against base erosion and profit shifting. However, such a rule may be complex to apply, particularly for lower risk groups which are above the threshold but still have a relatively low level of interest expense. Therefore a carve-out is included whereby an entity is not required to apply the interest allocation rule if its net interest expense is lower than

a fixed percentage of its earnings or asset value. This fixed ratio would be deliberately set at a low level as it is intended that the majority of entities will apply the interest allocation rule and the carve out will only apply to entities which pose little risk of base erosion and profit shifting. A rule could also allow other entities to opt into the carve-out and disallow any net interest expense that would take them above the fixed ratio, avoiding the need to apply the group-wide rule.

169. The intention under this approach is that the majority of entities in international groups should be required to apply the interest allocation rule, which is more robust in terms of dealing with base erosion and profit shifting but should also allow higher interest deductions based on the position of their group. However, low risk entities will simply be required to demonstrate compliance with the less complex, low fixed ratio. This combination could also provide a solution for groups which have no overall net third party interest expense, as it would still allow entities within the group to deduct net interest expense up to the level of the low fixed ratio.

Approach 2

170. Under approach 2, entities with levels of deductible interest expense above any monetary threshold would come within a fixed ratio test, whereby an entity would be able to claim relief for deductible net interest expense up to a fixed percentage of its earnings or assets. As this is the main rule, which should apply to a significant proportion of entities, the benchmark fixed ratio should be set at a slightly higher rate than in the carve-out under approach 1. However, to be effective in addressing base erosion and profit shifting and to remove the risk of entities gearing up and claiming further interest deductions to the point where the fixed ratio is reached, this ratio should still be at a level that is lower than currently applied in many countries and below that at which more highly leveraged entities operate. As under approach 1, within this rule, a country may introduce a provision for disallowed interest expense to be carried forward and set against unused interest cap in a future period.

171. The fixed ratio rule under this approach should be set at a level lower than that at which some entities currently operate. However, entities in more highly leveraged groups may apply a carve-out, which under this approach is a group ratio rule. This means that where an entity's ratio is (a) higher than the fixed ratio, but (b) does not exceed that of its group, the entity does not need to apply the fixed ratio rule. In contrast to approach 1, the carve-out here is not intended to reduce an entity's compliance costs, but may be used by an entity to obtain a higher level of net interest deductions.

172. This approach would allow a country to apply the main fixed ratio test to all entities, including standalone entities. It may therefore be used by countries to address policy issues outside of tackling base erosion and profit shifting, by also reducing the general tax preference for debt financing over equity.

173. In designing a combined approach, it is vital that a carve-out does not undermine the effectiveness of the general rule in tackling base erosion and profit shifting. For example, there are advantages where a general rule and a carve-out apply the same basis for measuring economic activity in an entity, to ensure a consistent approach to all groups. However, there are also benefits from a combined approach which includes different measures of economic activity. For instance, under approach 2 the general rule could contain a net interest to earnings test, while the carve-out could apply to an entity which can demonstrate that its net interest to asset value ratio, net interest to equity ratio or gearing ratio (for example measured using a debt to equity ratio or equity to total assets ratio) does not exceed that of its group. This would ensure that a loss-making entity, which would not be able to deduct any net interest expense under a fixed ratio rule based on earnings, could claim relief for its interest expense if it fell within the carve-out.

174. A carve-out based on an equity ratio could be relatively straight-forward to apply, as the level of equity in an entity and group is reasonably easy to establish. However, a simple equity-based test is not a good measure of economic activity in an entity and can be easily manipulated, for example through the issue of new equity by a controlled subsidiary to its parent. On the other hand, a carve-out based on a net interest to asset value ratio may be more effective in tackling base erosion and profit shifting, but could be complex to apply due to the concerns regarding the use of book values or fair market values of assets as the basis for a group-wide test, discussed in Chapter VIII. Ultimately, a country would need to be confident that basing a general rule and a carve-out on different measures of economic activity does not weaken its overall approach to tackling base erosion and profit shifting, for example by introducing a risk that entities will ‘cherry pick’ between the tests depending upon which gives them a more favourable result.

Questions for consultation

29. What particular issues arise for groups if a combined approach uses (a) the same measure of economic activity in a general rule and a carve-out or (b) different measures of economic activity? In particular, what issues arise where a carve-out uses a test based on (i) earnings, (ii) asset values or (iii) equity?
30. A combined approach should provide an effective solution to base erosion and profit shifting using interest, while allowing lower risk entities to apply a simpler test. What other options for combined approaches which meet this objective should be considered as possible best practices?

XI. THE ROLE OF TARGETED RULES

175. The previous chapters focus on general rules which impose an overall limit on an entity's interest deductions. The extent to which targeted rules will also be required and what risks these should address will depend upon the final design of any general rule included in a best practice recommendation, but some targeted rules may be required. However, assuming that a best practice recommendation does include some form of general rule or rules, the decision on whether this needs to be supported by targeted rules and what these targeted rules should be will involve reaching a balance between ensuring an approach is effective and not open to manipulation and developing an approach that is workable and not overly complex or unduly burdensome for taxpayers.

A. Targeted rules as an overall approach or as part of an approach together with a general rule

176. A number of countries do not currently apply a general interest limitation rule to address base erosion and profit shifting risks, but rely solely on targeted rules. One benefit of such an approach is that it reduces the risk that a rule negatively impacts on entities which are already appropriately capitalised and also avoids any incentive, such as that, that may exist under a fixed ratio rule, for groups to increase the gearing of local entities up to the benchmark ratio.

177. The use of targeted rules also allows countries to address specific areas of concern, potentially minimising compliance costs for entities in particular those which do not engage in base erosion or profit shifting. However, such an approach has some drawbacks. Most importantly, to some extent targeted rules will always be a reactive response, requiring countries to be aware of specific base erosion and profit shifting risks as they emerge. There is a risk that some groups may consider all arrangements not covered by targeted rules to be acceptable, meaning that over time new targeted rules may be required. Targeted rules also require active application, meaning the tax administration must be able to recognise situations where a rule could apply, often as part of a complex transaction, and then engage with a group to determine the correct result.

178. In contrast, a general rule could provide an effective response to a broad range of base erosion and profit shifting issues. There could however still be a role for some targeted provisions either to prevent entities from avoiding the effect of the general rule, or to address specific risks not covered by the general rule for example if the general rule only applies to groups. But as indicated above in considering the role of general and targeted rules there needs to be a balance between effectiveness on the one hand and complexity and compliance costs on the other.

179. Overall, targeted rules hold the potential to address specific base erosion and profit shifting risks. However, an approach based entirely on targeted rules may result in a large number of rules which will increase complexity and compliance and administrative costs. If the rules are not comprehensive then they are unlikely to deal with all base erosion and profit shifting risks. On the other hand, an approach which uses a general rule supplemented by targeted rules in key areas should provide countries with the comfort that the main risks posed by base erosion and profit shifting are addressed, while ensuring that groups are able to obtain relief for their real net third party interest expense.

B. Targeted rules to address specific base erosion and profit shifting risks

180. As described in Chapter VI, the effect of targeted rules may vary depending upon the risk in question. For example, in some cases it may be appropriate for a rule to deny a deduction for a gross

interest payment under a transaction. In other cases it may be more appropriate for a rule to apply to part of a payment, or to net interest payments after taking into account income under the same transaction. Additionally as mentioned above the role of targeted rules will depend on the approach adopted in terms of a general interest limitation rule. If there is a broad interest limitation rule then the role of targeted rules may be lessened or substantially reduced and the following section needs to be considered in that context.

181. In the course of discussions on targeted rules, countries have suggested that targeted rules may have a role to play in some of the following situations:

- Interest payments made to connected and related parties: If risks posed by connected and related parties are not addressed within general rules then these risks could be dealt with through targeted rules that either: (i) disallow all interest payments to connected and related parties; (ii) allow tax deductions for interest paid to connected and related parties subject to a condition that the recipient is subject to a minimum level of taxation on the receipt; or (iii) limit the amount of interest payments to connected and related parties which may be deducted for tax purposes based on a fixed ratio.
- Artificial debt, where no additional funding is in fact raised by the 'borrower': Debt can be created in a number of ways which do not give rise to new funding for the borrower. This is particularly easy within a group relationship. Arrangements could involve no payment of money (for example, where a dividend or other obligation is left outstanding) or a circular flow of money where an entity indirectly funds a loan back to itself. A targeted rule could disregard arrangements which create a debt in the absence of new funding and disallow any interest expense on such a debt.
- The routing of funds through intermediate entities to obtain tax benefits: In many groups, it is more efficient for non-tax purposes for third party borrowings to be raised through a single entity and on-lent to the group entity where funds are needed for business purposes. However, where this on-lending stage is routed through intermediate group entities in order to give rise to additional tax benefits, a tax deduction may be denied for interest paid by the ultimate borrower.
- Excessive debt push-downs: Thin capitalisation rules based on debt to equity ratios are not recommended as a best practice in the context of a general interest limitation rule for tackling base erosion and profit shifting. This is because they do not focus directly on the level of interest expense in an entity (which is the main risk area in base erosion and profit shifting using interest expense) and the level of equity is not a good measure of an entity's economic activity. However, thin capitalisation provisions could be used as targeted rules aimed at specific transactions. For example, debt push-down is a common technique used in cross-border acquisitions, whereby the interest expense on borrowings raised in order to fund an acquisition are offset against taxable income in the newly acquired entity. A thin capitalisation rule could be used to limit the extent to which interest expense could be set against the target's income, where the effect would be that the target would be bearing an excessive level of debt.
- Stapled stock: Stapled stock refers to equity and debt instruments issued simultaneously by a company which must also be traded together. To the extent a country views coupons paid on the debt instrument as a substitute for dividends on equity, a deduction for these payments may be denied.
- The use of debt to fund tax exempt or tax deferred income: As mentioned in Chapters VIII and IX, general rules could be designed to exclude common classes of exempt income (such as dividends) or assets giving rise to exempt income (such as equity investments) from the relevant

measure of economic activity. This would ensure that a group-wide rule or fixed ratio rule did not take this income or assets into account when setting a limit for interest deductions. However, a targeted rule which specifically disallows interest expense used to fund other forms of tax exempt income could also be designed.

182. The examples above are only for illustrative purposes and it is not proposed that countries would have to introduce targeted rules addressing all of those situations.

Question for consultation

31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed through a general interest limitation rule and where would a general rule need to be supported by targeted rules?

XII. THE TREATMENT OF NON-DEDUCTIBLE INTEREST EXPENSE AND DOUBLE TAXATION

183. Where an interest limitation rule applies, interest deductions in an entity above any limit or cap will be denied for tax purposes. Academic research and countries' experience has shown that, following the introduction of rules to limit interest deductions, entities will review and adapt their existing financing arrangements to reduce the impact of these rules. However, there will still be cases where a rule operates to deny a deduction for interest expense. In some cases, this may result in double taxation if the recipient of the interest payment continues to be taxed on its income. While the critical aim of this work is to prevent base erosion and profit shifting, 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. At the same time it is recognised that double taxation may arise as a result of structures that were implemented to achieve base erosion and profit shifting outcomes. To reduce the risk of economic double taxation, provisions could be included in an interest limitation rule either to re-classify non-deductible interest as a distribution, or to allow non-deductible interest (or unused capacity to deduct interest) to be used in other periods.

184. Interest limitation rules are intended to address base erosion and profit shifting risks using interest and financial payments economically equivalent to interest. Therefore, where an item of interest expense relates to a specific transaction intended to give rise to a permanent base erosion or profit shifting effect, the permanent disallowance of this expense may be an appropriate result. In particular, this is likely to be the case under the majority of targeted rules, which focus on tackling specific risks.

185. However, there may be cases where the amount of interest expense in an entity exceeds that which is allowable as a result of a timing mismatch which will correct in a future period. As set out in Chapter VIII, this may arise for example where interest expense is recognised in different periods for financial accounting and tax purposes. Alternatively, there may be cases where, as a result of factors outside an entity's control, the maximum amount of interest that may be deducted under a rule changes from year to year. This may arise, for example, where profitability fluctuates as a result of market conditions, impacting on the application of a rule linked to earnings (as considered in Chapters VIII and IX). An entity with a constant level of interest expense may therefore find itself subject to an interest disallowance in one year, whereas it may have the capacity to deduct more interest expense in earlier or later years. In these cases, a permanent disallowance of interest expense may introduce a level of uncertainty for groups which is undesirable.

A. Re-characterisation of disallowed interest as dividend

186. One alternative to a simple disallowance of interest expense could be to re-characterise the disallowed interest as a payment of a dividend. From an international perspective, if the re-characterisation is accepted by the country of the recipient, the risk of double taxation could be reduced. However, in the absence of an international agreement the re-characterisation of income on the basis of the application of another country's interest limitation rule may be difficult to agree. Even if this was possible, there are a number of practical and policy issues which mean this may not be the best approach.

187. Firstly, where a general interest limitation rule applies, the disallowance of interest expense will not be allocated to specific payments. From a domestic perspective this may not be particularly problematic. However, it raises an issue if it is expected that the re-characterisation will be recognised in

the country where a payment is received. One option would be to apply a re-characterisation on a pro-rata basis to all interest payments made by an entity, but given this could result in a large number of very small deemed dividends, this is not a practical solution. Other approaches to allocate the re-characterisation to specific items of interest expense are likely to include an arbitrary element which would be inappropriate to the extent other countries may be expected to exempt income as a result.

188. Further, the expenses which may be disallowed under the interest limitation rules discussed in this paper include financial payments which are economically equivalent to interest, but are not interest in terms of their legal form. The reclassification of some of these items as dividend may pose issues both in the country of the payer and the country of the recipient.

189. The re-characterisation of payments may also raise a number of issues in relation to withholding taxes. On the one hand, the re-characterisation of a payment as a dividend could trigger the payment of a dividend withholding tax in a country where no withholding tax would have been due on a payment of interest. However, as the payment would legally be interest (or a financial payment economically equivalent to interest) the entity making the payment may not be able to deduct this withholding tax from the payment under its loan agreements. Instead, it could be required to gross up the payment, incurring the full cost of the disallowed interest expense, plus withholding tax in addition. If the country of the recipient continues to tax the corresponding income as interest, it may not give credit for this dividend withholding tax. Therefore, the net result could be a disallowed payment and withholding tax in one country, and a taxable receipt with no withholding tax credit in the other country. Therefore, rather than reducing the risk of double taxation, re-characterisation could make a group worse off than under a simple disallowance.

190. On the other hand, there may also be instances where the dividend withholding tax rate, in particular that on related party dividends, is lower than the withholding tax on interest payments. This could reduce the impact of an interest disallowance which may not be desirable from the perspective of the country of the payer.

191. In addition, re-characterising an interest payment as a dividend could have implications for the operation of other rules, including anti-hybrids rules recommended under Action 2 of the BEPS Action Plan.¹⁹

192. Based on the analysis above, it was agreed by countries involved in this action that the re-characterisation of disallowed interest payments as dividends should not be included in a best practice. However, this is not intended to imply that re-characterisation can never play a role for instance as the result of the operation of a specific targeted rule.

B. Carry forward of disallowed interest or unused capacity to deduct interest

193. A number of countries already include provisions allowing disallowed interest expense to be carried forward for relief in subsequent years in their current interest limitation rules.

194. To the extent interest disallowed under a general interest limitation rule is carried forward and set against unused capacity to deduct interest in future years, a carry forward provision may be in line with a policy of permitting interest expense deductions up to a specified level. This is particularly the case where the ability of an entity to deduct interest expense varies from year to year as a result of volatility outside the entity's control. However, an indefinite carry-forward could reduce the overall impact of an interest limitation rule, give rise to planning opportunities, and increase the complexity of a rule. Countries may

19 . OECD 2014, *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD Publishing.

balance these issues through the introduction of a carry forward which is limited to a specified number of years, or under which the disallowed interest expense carried forward is reduced by a certain percentage each year.

195. It may also be necessary for a country to introduce further provisions to prevent a carry forward from being abused for tax planning purposes (for example involving a change in ownership or control).

196. Countries may also consider providing the possibility for an entity to carry-back disallowed interest expense into earlier periods, or to carry-forward unused capacity to deduct interest into future periods. Unused capacity to deduct interest would arise where an entity's actual interest expense in a period is below the available limit or cap. The carry back of disallowed interest expense and the carry forward of unused capacity achieve similar effects. Both result in an immediate tax deduction for interest expense that would not otherwise be deductible in the current year, and a corresponding unpredictable impact on revenue receipts to the country in question.

197. These two approaches give rise to potential planning opportunities and risks that do not necessarily arise with a carry forward of disallowed interest expense, and therefore also add complexity to a rule in ensuring these risks are addressed. For example, an entity with unused capacity to deduct interest could accelerate the use of this capacity by increasing the amount of debt and interest expense. A similar result could be achieved using a carry back of disallowed interest expense, by purposely pushing excess debt and interest expense into an entity, accepting a disallowance and then carrying this back to be set off against unused capacity in prior years. The effect of either of these transactions would be to shift taxable profits out of one country and into another to achieve a better outcome. However, there may be instances where as a result of volatility outside an entity's control, an entity has surplus capacity to deduct interest expense in some years and insufficient capacity to deduct its interest expense in other years. In such circumstances it may be appropriate to allow a time limited carry forward of unused capacity to smooth the effect of this volatility. As described in Chapter VIII, there may also be situations where a group chooses to reorganise its internal financing arrangements to match net interest expense with economic activity (measured using earnings or asset values). However, for practical reasons it may take some time for a group to adjust its financing in response to changes in economic activity. Again, the ability to carry forward unused capacity to deduct interest expense for a limited period would reduce the negative impact of this on groups, although there may be a risk that planning opportunities could also be introduced.

198. Based on the above considerations and taking into account any possible planning by groups, the countries involved in this work suggest that general interest limitation rules may include provisions for the carry forward of disallowed interest expense and possibly for the carry forward of unused capacity to deduct interest, to smooth the effect of volatility and timing mismatches in the application of a rule and reduce the risk of double taxation. If a country does introduce such provisions these should be subject to restrictions in terms of the number of years a carry forward can apply and possibly also the amount of the carry forward. It is not currently suggested that a carry back of interest expense should be included in a general interest limitation rule, but if a country wishes to introduce such provisions these should also be limited in scope.

199. Also, it is suggested that there is less of a case for carrying forward interest expense disallowed under targeted rules. If an item of interest expense is disallowed because of the specific transaction under which it is paid, there does not appear to be any reason why the payment should be treated as deductible in a future period.

200. Box 5 below contains an outline of the time limits for carry forward provisions currently applied in a number of countries.

Box 5. Time limits for the carry forward of disallowed interest and unused capacity to deduct interest under fixed ratio rules (EBIT or EBITDA tests) in selected countries

Denmark:	Unlimited interest carry-forward for financing expenses which are disallowed by the EBIT limitation.
Finland:	Unlimited disallowed interest carry-forward. Change of ownership does not impact the disallowed interest carry forward.
Germany:	Unlimited disallowed interest carry-forward. Time-limited (5 years) unused EBITDA carry-forward. Change of ownership impacts the disallowed interest carry forward but not the unused EBITDA carry-forward.
Italy:	Unlimited disallowed interest carry-forward and unused EBITDA carry-forward.
Portugal:	Time limited (5 years) disallowed interest carry-forward and unused EBITDA carry-forward.
Spain:	Time limited (18 years) disallowed interest carry-forward. Time-limited (5 years) carry-forward of unused 'adjusted operating profit'. The 'adjusted operating profit' is similar to EBITDA. [Note that at the time of writing this document the Spanish government is considering changing the time limit for the disallowed interest carry-forward from 18 years to unlimited.]
United States:	Unlimited disallowed interest carry-forward. Time-limited (3 years) carry-forward of 'excess limitation'. A corporation has 'excess limitation' to the extent that 50 per cent of a corporation's adjusted taxable income (tax-based EBITDA) exceeds its net interest expense in a given taxable year.

Questions for consultation

32. To what extent could a carry forward of disallowed interest or unused capacity to deduct interest help to smooth the effects of a general interest limitation rule?
33. Working on the assumption that countries would like to limit carry forwards in terms of the number of years what would be the issues presented by say a five year limit? If this does present problems what are they and how and when do they arise?

XIII. CONSIDERATIONS FOR GROUPS IN SPECIFIC SECTORS

201. It is intended that the approaches set out in this consultation document, and in particular group-wide tests such as interest allocation rules and group ratio rules, should provide an effective solution to base erosion and profit shifting using interest expense by groups across the majority of sectors. However, there are a number of sectors with specific characteristics which may mean they require particular attention.

202. This chapter considers issues concerning the application of an approach to groups operating in the banking and insurance sectors, as well as those in sectors subject to special regimes or engaged in infrastructure projects.

A. Banks and insurance companies

i) Specific issues faced by banks and insurance companies

203. Banks and insurance companies present particular issues that do not arise in other sectors.

204. First, interest expense is for example typically the largest cost on a bank's income statement. Therefore, any rule which restricts deductions for general gross interest expense will have a significant impact on a bank's business model. For an insurance company gross interest costs will generally be much smaller than for banks and the largest costs on an insurance company's income statement will typically be benefits and claims under policies.

205. Second, taking into account interest received, banks and insurance companies will usually be recipients of net interest income. Therefore, a rule which caps net interest expense will have no direct impact on a bank or insurance company, although such a rule could disallow net interest expense in other group entities.

206. Third, the role interest plays in a banking or insurance business is different to that in other sectors. Banks and insurance companies raise debt finance in order to write new business. Interest expense in banking and insurance groups is therefore much more closely tied to their ability to generate income than for groups operating in other sectors.

207. Fourth, banks and insurance companies often operate different businesses in different parts of the world. For example, a number of large banking groups operate both retail and investment banks in their home market but may focus primarily on one of these sectors when developing their business overseas. This can have significant implications for the level of debt and interest expense in different parts of a group.

208. Finally, financial sector businesses in most countries are subject to strict regulations which impose restrictions on their capital structure. In 2011 Basel III introduced a leverage ratio standard intended to constrain leverage in the banking sector, helping to mitigate risks which in the past have damaged the financial system and the economy. The Solvency II Directive introduces a similar system for insurers in the EU. It should be noted however that, although banking and insurance groups are subject to

regulation, not all entities within a group are subject to the same obligations and the treatment of branches for regulatory purposes will need to be taken into account.

ii) Applying a general interest limitation rule to banks and insurance companies

209. Because of the focus on net interest expense, the general interest limitation rules set out in this consultation document will not be effective at addressing any base erosion and profit shifting risks presented by banks and insurance companies.

210. The proposal is therefore to design a specific rule which would have a similar effect for banks and insurance companies but that focuses on the particular base erosion and profit shifting risks that they present. This may involve separate rules for each of these sectors.

211. For example, one option could be to focus on the net interest expense attributable to regulatory capital instruments, which provide a bank or insurance company's core funding and play a role comparable with debt in other sectors. A group-wide interest allocation rule could be designed which limits a group's total net deductions on its regulatory capital (ignoring the interest income generated from using the capital to write business) to the amount of interest expense paid on these instruments to third parties. Within the group, an interest cap could be allocated in accordance with regulatory requirements, so long as this provides an effective solution to base erosion and profit shifting. Any general rule which takes into account the accounting position of a group may also need to take into account that financial statements of banking and insurance groups may use a different format to those of groups in other sectors.

212. Alternatively, if existing regulatory requirements act as an effective general interest limitation rule, and prevent excessive leverage in group entities, a best practice approach could instead focus on a group's interest expense other than that on its regulatory capital. This may comprise targeted rules to address risks posed by specific transactions.

213. A separate issue is posed by banks established within non-financial sector groups, including those in the retail and manufacturing sectors. The possible rules described in this consultation document should be capable of being applied to these groups generally, but special provisions may be required to ensure that the presence of a bank within the group does not impact the ability of a rule to address base erosion and profit shifting risk.

B. Other sectors and activities

i) Sectors taxed under special regimes

214. Groups operating in certain sectors, including oil and gas, and real estate, may be subject to special tax regimes, for example to ensure that a country shares in the extraction of its natural resources while encouraging inward investment by international groups. These regimes may include specific features which impact an entity's ability to deduct interest expense. Countries should consider the interaction of such regimes with any best practice rules to tackle base erosion and profit shifting using interest expense.

ii) Infrastructure projects

215. Another area which may require some further consideration is the impact of interest limitation rules on large public infrastructure projects. These projects are often structured as joint ventures, but may be under the control of a single group, and are typically highly leveraged (up to 95 per cent in some cases) using a mixture of bond issues and bank debt. Debt finance is typically used to fund infrastructure because this minimises the financial risk for investors, who are willing to lend against the secure, predictable cash flows of the project or company. The characteristics of infrastructure projects are such that their financing

may be sensitive to changes in the tax treatment of financing costs, in part because of the very long term nature of the projects. Depending upon how a group-wide rule is designed, these rules could provide an appropriate solution for groups engaged in infrastructure projects. However, if the final design of any rules for an effective response to base erosion and profit shifting does not provide an appropriate solution for this particular sector, special provisions may need to be considered. Any special provisions that are introduced would need to be targeted to ensure that they address the specific needs of the sector and do not create arbitrage opportunities or a possible competitive advantage for certain groups.

iii) Financial sector businesses other than banks and insurance companies

216. Section XIII.A above considers specific issues with respect to banking and insurance which may need to be considered in the design and application of interest limitation rules for groups in these sectors. Entities involved in other financial sector activities, including asset management, leasing, and the issuance of credit cards may also be impacted by specific issues (including the ones described in this chapter) which may need to be taken into account in to ensure that rules introduced to address base erosion and profit shifting have an appropriate effect. These entities may be part of a specialised group focusing on a particular activity, or could be part of a broader financial services (or non-financial services) group, and the implications of this may also need to be taken into account.

Questions for consultation

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital without having an undue impact on the group's regulatory position (for example, by limiting a group's net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?
35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

XIV. INTERACTION WITH OTHER AREAS OF THE BEPS ACTION PLAN

217. As mentioned in Chapter I, work on interest limitation rules has potential interactions with a number of other actions, including in particular Action 2 (hybrid mismatch arrangements), Action 3 (CFC rules) and the second part of Action 4 (guidance on the pricing of related party financial transactions). There are also overlaps with Action 6 (prevent treaty abuse), Action 9 (risks and capital), Action 11 (establish methodologies to collect and analyse data on base erosion and profit shifting and the actions to address it), Action 13 (transfer pricing documentation and country-by-country reporting) and Action 14 (make dispute resolution mechanisms more effective).

A. Hybrid mismatch arrangements (Action 2)

218. There is a clear interaction between work on interest and that on hybrid mismatch arrangements, as both seek to prevent base erosion and profit shifting using instruments that give rise to interest deductions. There are two key questions which need to be considered with respect to this interaction.

219. First, the extent to which a strong interest limitation rule provides protection against intragroup hybrid mismatch arrangements. Having both sets of rules is likely to provide a more robust response to base erosion and profit shifting, but depending on the type of interest rule adopted there will be an overlap so that not all of the recommendations under Action 2 need to be implemented in addition to best practice recommendations under Action 4. For example, a group-wide interest allocation rule introduced consistently by countries would significantly reduce (although not entirely eliminate) the risk posed by hybrid financial instruments. However, certain risks, such as those resulting from hybrid financial instruments or entities outside a group relationship would still need to be addressed through specific anti-hybrid rules.

220. Second, if a country does introduce interest limitation rules and anti-hybrids rules, which should apply first. There are two options.

- *Option 1:* Anti-hybrids rules apply first. A general interest limitation rule may then further restrict interest deductions if the entity's interest expense (after applying an anti-hybrids rule) is still higher than the limit under a group-wide test or fixed ratio test.
- *Option 2:* A general interest limitation rule applies first, limiting interest deductions by reference to the group position or a fixed ratio. Anti-hybrids rules may then further restrict interest deductions if the entity is party to hybrid mismatch arrangements.

221. The main difference between these options is that under option 1, an entity would in effect only suffer one disallowance (ie. whichever disallowance is greater under the two sets of rules), whereas under option 2 an entity would suffer two disallowances (ie. the combined effect of disallowances under both sets of rules). It is suggested that option 1 should be sufficient to address base erosion and profit shifting risk in most cases.

B. CFC rules (Action 3)

222. Effective interest limitation rules should encourage groups to spread interest expense more fairly between entities, with greater links to the level of economic activity. This should result in less interest income arising in CFC's: partly because there should be less interest received by the CFC; and partly because CFC's may need to bear more of the group's overall interest burden in order to maximise deductions under a group-wide rule. By reducing the level of income in CFC's, this should also reduce pressure on CFC rules.

223. Taken together, interest limitation rules, in particular a group-wide interest allocation rule, and CFC rules may complement transfer pricing rules in dealing with some of the issues considered under Action 9 (*risks and capital in groups*), such as the use of cash box companies in low tax jurisdictions. Interest limitation rules should reduce the amount of intragroup interest paid by group entities into cash box companies, while CFC rules should ensure that income arising in the CFC is attributed to its parent and taxed.

C. Guidance on the pricing of related party financial transactions (Action 4)

224. Action 4 is a shared action with Working Party No. 6, which is to consider transfer pricing guidance in respect of related party financing transactions. However, the extent to which this guidance is required will be dictated in part by the types of interest limitation rule included in a best practice recommendation and how widely these are adopted. For example, under a group-wide test an entity can still claim a deduction for interest expense on intragroup debt, but as the total amount of interest that can be deducted is limited, countries adopting a rule may view the pricing of individual instruments as less of a base erosion and profit shifting risk. Countries which do not adopt a group-wide test on the other hand may still require guidance on the pricing of related party financing.

D Prevent treaty abuse (Action 6)

225. Arrangements by groups to obtain excessive interest deductions may also be combined with structures to secure inappropriate treaty benefits, such as the use of a conduit entity to gain a treaty exemption from withholding tax on interest. The impact and interaction of recommendations under Actions 4 and 6 on preventing treaty abuse, and any risk of potential double taxation, must therefore be fully understood. It should be also recognised that following the introduction of best practice rules to combat base erosion and profit shifting using interest expense, some groups may look to other available planning opportunities, which could place greater pressure on anti-abuse clauses in treaties and domestic law.

E. Risks and capital (Action 9)

226. Action 4 focuses on the use of interest expense in base erosion and profit shifting, including arrangements where an entity has an excessive level of interest expense which does not reflect its economic activity. The effect of this is that taxable profits are reduced and transferred out of a country, either to a lower tax country or out of the charge to tax completely. Action 9 focuses more on income, that is, where an entity is overcapitalised or assumes excessive contractual risks, resulting in too much taxable income being attributed to that entity which may be located in a low tax country. Although looking at the problem from different perspectives, both Action 4 and Action 9 seek to ensure that taxable profits are matched with economic activity giving rise to value creation. As mentioned above, a group-wide interest allocation rule together with effective CFC rules could complement transfer pricing in dealing with some of the issues specifically considered under Action 9, such as the use of cash box companies with financial assets.

F. Establish methodologies to collect and analyse data on base erosion and profit shifting and the actions to address it (Action 11)

227. The BEPS Action Plan is clear that improving the availability and analysis of data on base erosion and profit shifting is critical. Action 4 and Action 11 should be co-ordinated to ensure that appropriate tools to monitor and evaluate the impact of interest limitation rules can be introduced.

G. Transfer pricing documentation and country-by-country reporting (Action 13)

228. The template for Country-by-Country reporting was published in September 2014 as part of the first round of deliverables within the BEPS project. In conducting Action 13, significant work was undertaken to engage with business to understand the practical implications of requirements for groups to provide information on their financial position at a consolidated and entity level. Input received from business and other stakeholders in the course of this work will be used to directly inform work on Action 4, in particular with respect to the design of possible group-wide rules.

H. Make dispute resolution mechanisms more effective (Action 14)

229. As set out in the BEPS Action Plan, all actions to counter base erosion and profit shifting including Action 4 must be complemented with actions that ensure certainty and predictability for business. Therefore, Action 14 provides that work will be undertaken to examine and address obstacles that prevent countries from solving treaty related disputes under the mutual agreement procedure.

ANNEX 1 - SUMMARY OF QUESTIONS FOR CONSULTATION

What is interest and what are financial payments economically equivalent to interest?

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?
2. Are there any specific items which should be covered by a best practice rule which would not be covered by the approach set out in this chapter? What are these and how could they be included within a definition of interest and other financial payments that are economically equivalent to interest?

Who should a rule apply to?

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.
4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

What should a rule apply to? (A) the level of debt or interest expense and (B) an entity's gross or net position

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

Should a small entity exception or threshold apply?

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

Whether interest deductions should be limited with reference to the position of an entity's group

7. Are there any practical issues with respect to the operation of (a) interest allocation rules or (b) group ratio rules, in addition to those set out in the consultation document?
8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?
9. Do any difficulties arise from basing a group-wide rule on numbers contained in a group's consolidated financial statements and, if so, what are they?
10. In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

11. What approach to measuring earnings or asset values would give the most accurate picture of economic activity across a group? Do any particular difficulties arise from this approach and how could these be addressed?
12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?
13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?
14. Do any particular difficulties arise from asking groups to identify entities with positive and negative earnings balances? What other approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?
15. Where an entity's earnings or asset values need to be converted into the currency used in the group's consolidated financial statements, what exchange rate should be used for this conversion?
16. What specific issues or problems would be faced in applying a group-wide rule to a group engaged in several different sectors? Would an assets or earnings-based approach be more suitable for this kind of group?
17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?
18. Do any particular difficulties arise from the application of a group-wide allocation rule to groups with centralised treasury functions? If so, what are these difficulties and do they vary depending upon how the treasury function is structured and operates?
19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?
20. In what situations could significant permanent or timing mismatches arise if an entity's interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?
21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?
22. It is proposed that any group-wide rule included in a best practice recommendation should apply to the entities included in a group's consolidated financial statements. This could introduce competition concerns where a group-wide rule applies to entities held under a parent company (which typically would prepare consolidated financial statements) but does not apply to those held under a trust, fund or individual (which may not prepare consolidated financial statements). Would these concerns be more effectively addressed by including connected parties within an interest limitation group, or through targeted rules?

23. Payments to connected parties may be disguised through back to back arrangements, where the payment is effectively routed via a related party (such as a bank under a structured arrangement). In applying a group-wide rule, how might payments made through such arrangements be detected?

Whether interest deductions should be limited with reference to a fixed ratio

24. What practical issues arise in applying fixed ratio rules based on asset values or earnings?
25. What would be the appropriate measure of asset values or earnings under a fixed ratio rule?
26. For what reasons would the interest to earnings or interest to asset value ratios of an individual entity significantly exceed the equivalent ratios of its worldwide group?
27. Would a fixed ratio rule pose particular problems for entities in certain sectors? If so, which sectors would be affected and how could this be addressed?
28. What objective information is available to evidence the actual interest to EBITDA ratios of entities and groups across different countries and sectors?

Whether a combined approach could be applied

29. What particular issues arise for groups if a combined approach uses (a) the same measure of economic activity in a general rule and a carve-out or (b) different measures of economic activity? In particular, what issues arise where a carve-out uses a test based on (i) earnings, (ii) asset values or (iii) equity?
30. A combined approach should provide an effective solution to base erosion and profit shifting using interest, while allowing lower risk entities to apply a simpler test. What other options for combined approaches which meet this objective should be considered as possible best practices?

The role of targeted rules

31. Which situations do you think would need to be covered by targeted rules to effectively and comprehensively address base erosion and profit shifting risks posed by interest expense? Which of these could also be addressed through a general interest limitation rule and where would a general rule need to be supported by targeted rules?

The treatment of non-deductible interest expense and double taxation

32. To what extent could a carry forward of disallowed interest expense or unused capacity to deduct interest help to smooth the effects of a general interest limitation rule?
33. Working on the assumption that countries would like to limit carry forwards in terms of the number of years what would be the issues presented by say a five year limit? If this does present problems what are they and how and when do they arise?

Considerations for groups in specific sectors

34. Regulatory capital may be described as performing a function for financial sector groups comparable to that of equity and debt for groups in other sectors. How could a general rule be made to apply to the interest expense on a group's regulatory capital without having an undue

impact on the group's regulatory position (for example, by limiting a group's net interest deductions on regulatory capital to the level of its interest expense on instruments issued to third parties)?

35. Do any particular difficulties arise from the application of general interest limitation rules to entities (a) operating in sectors subject to special taxation regimes; (b) engaged in infrastructure projects; or (c) entities engaged in financial activities other than banking or insurance? If so, how do these difficulties arise and how could they be addressed?

ANNEX 2 - EU LAW ISSUES

A. EU treaty freedoms

230. The treaty freedoms that need to be considered in the context of interest limitation rules are the freedom of establishment, and the free movement of capital. The freedom of establishment applies to cases where the shareholder would be able to exercise a significant influence over the entity,²⁰ while the free movement of capital applies to cases where the shareholder acquired the shares for the sole purpose of making a financial investment without participating in the decision making process of the entity. In addition, the freedom to provide services, which also has to be analysed from the perspective of the service recipient, may be restricted.

231. The scope of an interest limitation rule determines which freedom applies and there are a number of approaches that the countries involved in this work have discussed in order to avoid any restriction of EU treaty freedoms. In this respect, consideration should also be given to the circumstances in which EU Member States could justify a restriction of EU treaty freedoms, for example:

- the need to preserve the balanced allocation between EU Member States of the power to impose taxes; or
- the need to prevent tax avoidance and to combat artificial arrangements.

B. EU directives

232. There are two EU directives with relevance to interest deduction limitation rules within the EU: the Parent Subsidiary Directive²¹ and the Interest and Royalty Directive.²² The Parent Subsidiary Directive eliminates cross-border withholding taxes on dividend payments made by a subsidiary to a parent company and also eliminates double taxation of such income at the level of the parent company. The directive may be relevant in cases where excessive interest is re-qualified as a dividend. In such cases, the re-qualified interest should be granted the benefits of the Parent Subsidiary Directive.

233. The Interest and Royalty Directive provides that interest and royalty payments arising in an EU Member State shall be exempt from any taxes imposed on those payments in that State, whether by

20. So far the Court of Justice of the European Union has not provided clarity on what significant influence means. In *Beker* (Case C-168/11) the court highlighted that shareholding below 10 per cent does not give a significant influence, and in *Itelcar* (Case C-282/12) the court pointed out that shareholding above 10 per cent does not necessarily imply that the holder exerts significant influence. In this respect, attention should also be given to other case law referred to in both decisions.

21. Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2003] OJ L007/41.

22. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2003] OJ L157/49.

deduction at source or by assessment. Disallowing a deduction for excessive interest could be considered as taxation of interest and, thus, fall within the scope of the directive. However, the Court of Justice of the European Union clarified that the directive only concerns the tax position of the interest creditor.²³ It seems to follow that the deductibility of interest expenses at the level of the debtor entity may therefore be restricted.

C. EU State aid

234. EU State aid issues may arise if interest deductibility rules include specific industry exceptions. The relevant treaty provision considers ‘any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States’ as being in conflict with the treaty.²⁴

235. The European Commission has provided guidance on how it will apply the State aid provisions in relation to direct business taxation.²⁵ According to this guidance an exception to a specific tax rule without any justification is considered State aid. However, the EU treaty provides EU Member States with options to introduce exceptions to the State aid provisions, for instance categories of State aid may be specified as being deemed compliant with the treaty.²⁶

236. As the work on Action 4 progresses, further consideration will be given to these EU law issues and how they impact on the design of interest limitation rules.

23. *Scheuten Solar Technology* (Case C-397/09).

24. Art 107 Treaty on the Functioning of the European Union (TFEU).

25. Commission notice on the application of the State aid rules to measures relating to direct business taxation [1998] OJ C384/3.

26. Art 107(3)(e) TFEU.

ANNEX 3 - EXAMPLES

A. Interest and payments economically equivalent to interest

Example 1: Interest and payments economically equivalent to interest

237. In 2015, A Co and its subsidiary B Co enter into the following arrangements.

- a) A Co issues €50 million of bonds carrying a fixed interest rate of five per cent.
- b) A Co enters into an interest rate swap with a third party bank (Bank), under which A Co receives fixed rate payments and pays floating rate payments on a notional principal of €50 million.
- c) B Co borrows €10 million from Bank at a floating interest rate linked to Euribor.
- d) B Co's borrowing from Bank is covered by a guarantee from A Co. In return, B Co pays a guarantee fee to A Co.
- e) B Co also obtains a short term credit facility with Bank whereby it can borrow up to €500 000 for small periods at short notice. B Co pays an arrangement fee for this facility.
- f) B Co enters into a finance lease over new plant and machinery for use in its business.
- g) A Co enters into an operating lease for new office equipment.
- h) B Co enters into a contract to provide 10 million widgets per year to Customer for the next three years. This contract is covered by a performance guarantee from A Co, in return for which B Co pays a guarantee fee.
- i) B Co buys a series of aluminium futures contracts to protect itself against movements in the price of aluminium, a key ingredient in the manufacture of widgets.
- j) A Co declares and pays a dividend of €1 million to holders of its ordinary shares.

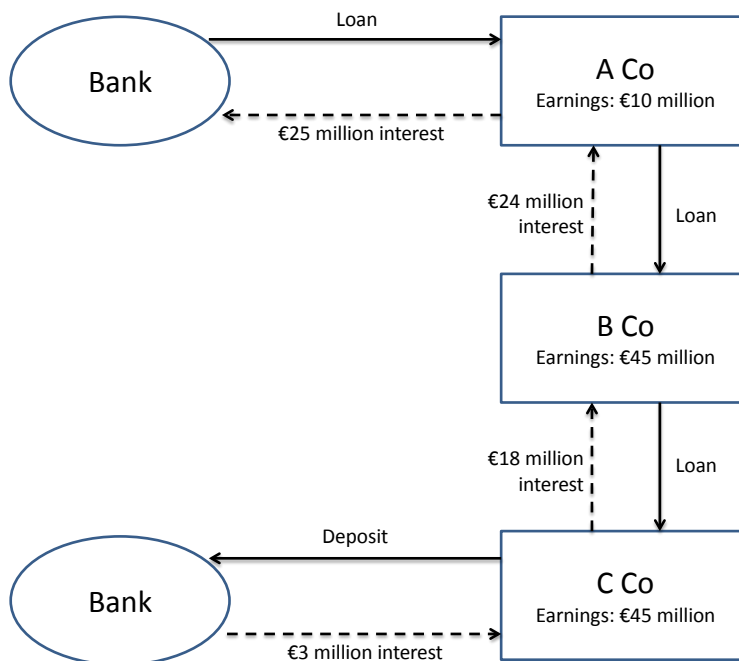
238. The amounts payable by A Co and B Co under a), b), c), d), e) and f) are all interest on a debt, payments economically equivalent to interest, or expenses incurred in connection with the raising of finance. It is therefore proposed that these payments would be subject to rules to tackle base erosion and profit shifting using interest expense. The amounts payable under g), h), i) and j) do not fall within these categories (based on this specific fact pattern) and would not be subject to interest limitation rules.

B. Group-wide rules

Example 2: Deemed interest rule

239. The example below illustrates the application of a deemed interest rule by A Co and its subsidiaries, B Co and C Co. In this example, A Co has raised third party borrowings from Bank and pays

interest of €25 million. Part of this borrowing is on-lent within the group at interest. C Co also has an amount of surplus cash, which is placed on deposit and earns interest income of €3m.

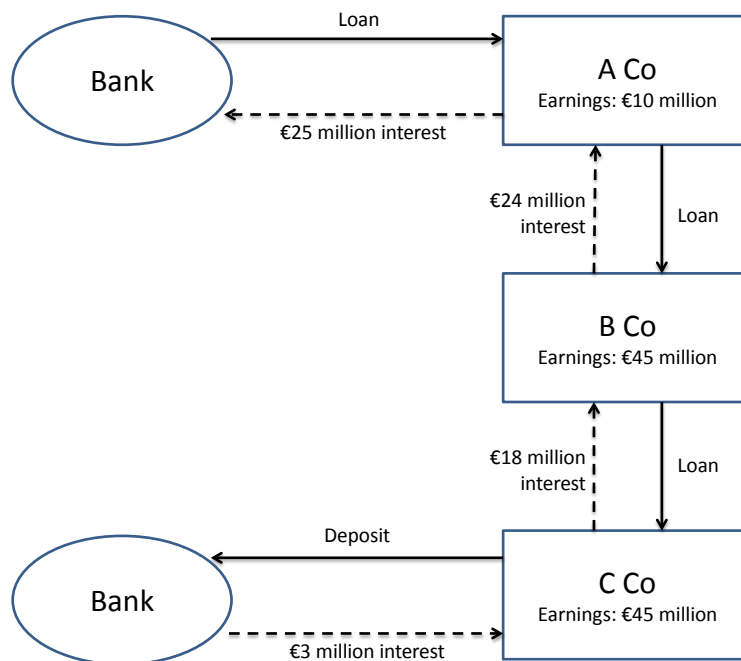


240. In the table below A Co, B Co and C Co each receive an allocation of the group's €22 million of net third party interest expense. For the purposes of this example, the allocation is made on the basis of each company's contribution to the group's earnings. This interest allocation is deemed to be deductible in each company irrespective of the company's actual interest expense. Actual interest paid or received by each company is disregarded. The group's full net third party interest expense of €22 million is therefore deductible across the group.

	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	10%	45%	45%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Allocation of net 3 rd party interest expense	(€2.2m)	(€9.9m)	(€9.9m)	
Taxable net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)

Example 3: Interest cap rule

241. The example below illustrates the calculation and application of an interest cap rule by A Co and its subsidiaries, B Co and C Co. As in example 2, A Co has raised third party borrowings from Bank and pays interest of €25 million. Part of this borrowing is on-lent within the group at interest. C Co also has an amount of surplus cash, which is placed on deposit and earns interest income of €3m.

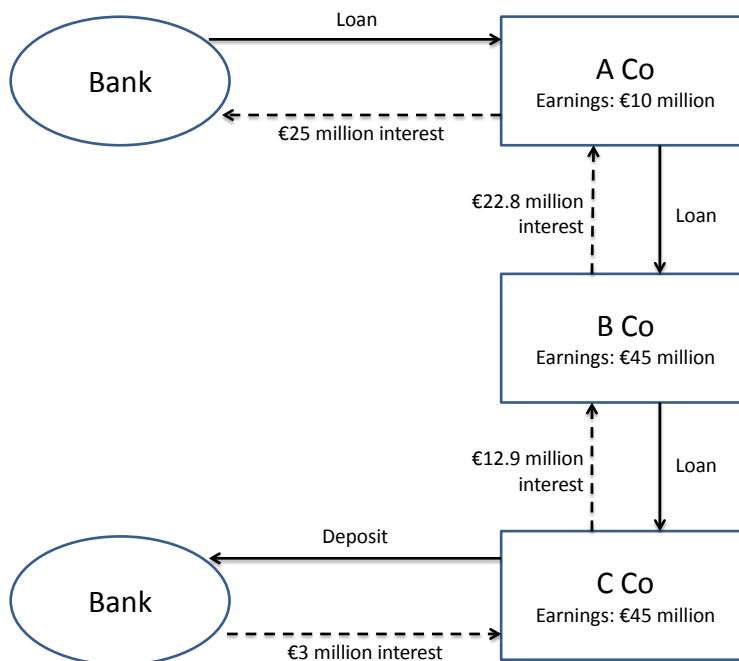


242. In the table below A Co, B Co and C Co each receive an interest cap equal to an allocation of the group's €22 million of net third party interest expense. For the purposes of this example, the allocation is made on the basis of each company's contribution to the group's earnings. This interest cap is compared against each company's actual net interest expense (which is lower than their interest cap). A Co and B Co are able to deduct their full interest expense (which is lower than their interest cap). C Co is able to deduct €9.9 million of its total net interest expense of €15 million, with the remaining €5.1 million disallowed. Depending upon the design of a rule, this disallowed interest expense may be carried forward into future periods (see Chapter XII).

	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	10%	45%	45%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	(€2.2m)	(€9.9m)	(€9.9m)	
Stage 2: Application of interest cap				
Net Interest income/(expense)	(€1m)	(€6m)	(€15m)	
Interest cap	(€2.2m)	(€9.9m)	(€9.9m)	
Taxable net interest income/(expense) (after application of interest cap)	(€1m)	(€6m)	(€9.9m)	(€16.9m)
Interest expense disallowed	-	-	(€5.1m)	(€5.1m)

243. In this example, the interest disallowance in C Co and the unused interest cap in A Co and B Co arise because the actual net interest expense in these entities is not matched with activity measure by

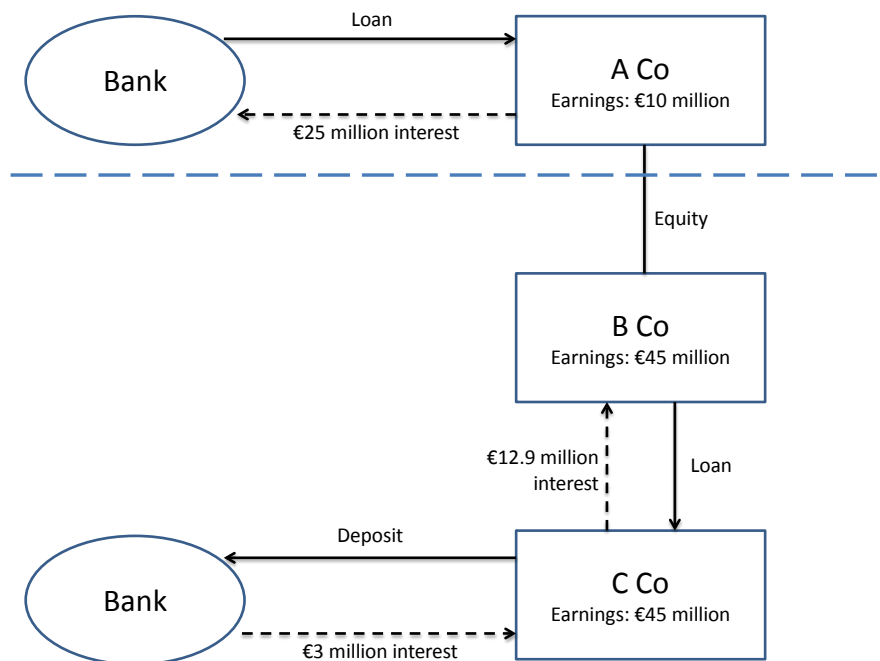
earnings. The scenario below illustrates how a funding structure which matched net interest expense with earnings would have removed these mismatches.



	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	10%	45%	45%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	(€2.2m)	(€9.9m)	(€9.9m)	
Stage 2: Application of interest cap				
Net Interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	
Interest cap	(€2.2m)	(€9.9m)	(€9.9m)	
Taxable net interest income/(expense) (after application of interest cap)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Interest expense disallowed	-	-	-	-

Example 4: Risk of double deductions under a deemed interest rule

244. In the example below, B Co and C Co are in countries where an interest allocation rule applies. However, A Co is in a country which does not apply interest allocation. As in examples 2 and 3, A Co raises €25 million external borrowing from a third party bank, but this time uses this to inject equity into B Co. B Co makes an intragroup loan to C Co and receives interest income. As before C Co places part of this on deposit and earns interest income of €3 million.



245. The table below illustrates that, where a deemed interest rule applies, 90 per cent of the group's total net third party interest expense is allocated to B Co and C Co and is deductible in these entities. However, because A Co is in a country which does not apply an interest allocation rule, it is assumed that A Co is able to deduct its entire €25 million interest expense. Therefore, in total the group has been able to deduct €44.8 million of net interest expense even though the group has a total net third party interest cost of just €22 million.

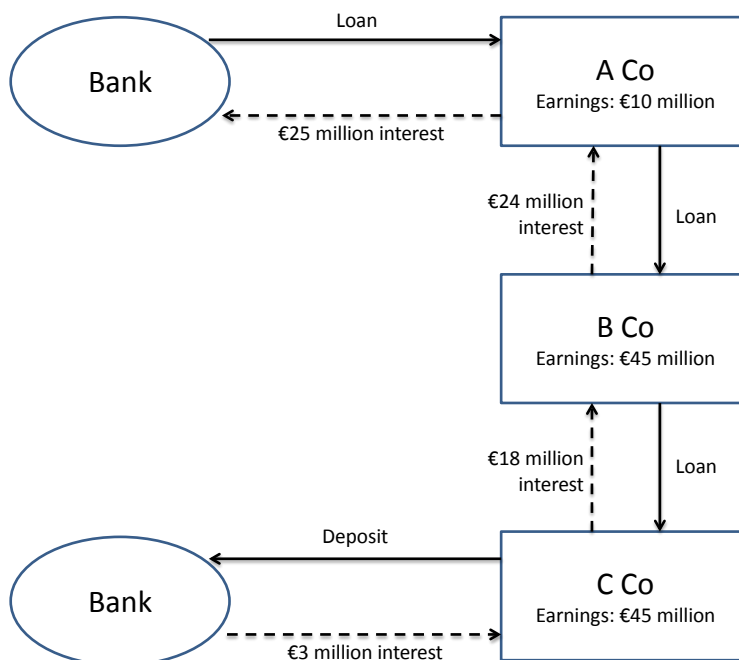
	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	n/a	45%	45%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Allocation of net 3 rd party interest expense	n/a	(€9.9m)	(€9.9m)	
Taxable net interest income/(expense)	(€25m)	(€9.9m)	(€9.9m)	(€44.8m)

246. On the other hand, the table below shows that the problem of double deductions should not arise where an interest cap rule applies. The key factors making a difference are that an entity can only deduct interest expense to the extent it actually incurs an interest cost, and net interest income received by an entity remains subject to tax. This means that, whereas under a deemed interest rule B Co could claim a tax deduction of €9.9 million, under an interest cap rule it has taxable income of €12.9 million. Therefore, in total the group has net tax deductions of €22 million, which equals its actual third party interest expense.

	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	n/a	45%	45%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	n/a	(€9.9m)	(€9.9m)	
Stage 2: Application of interest cap				
Net Interest income/(expense)	(€25m)	€12.9m	(€9.9m)	
Interest cap	n/a	(€9.9m)	(€9.9m)	
Taxable net interest income/(expense) (after application of interest cap)	(€25m)	€12.9m	(€9.9m)	(€22m)
Interest expense disallowed	-	-	-	-

Example 5: Group ratio rules

247. This example is based on the same fact pattern as example 3. A Co has raised third party borrowings from Bank and pays interest of €25 million. Part of this borrowing is on-lent within the group at interest. C Co also has an amount of surplus cash, which is placed on deposit and earns interest income of €3m.

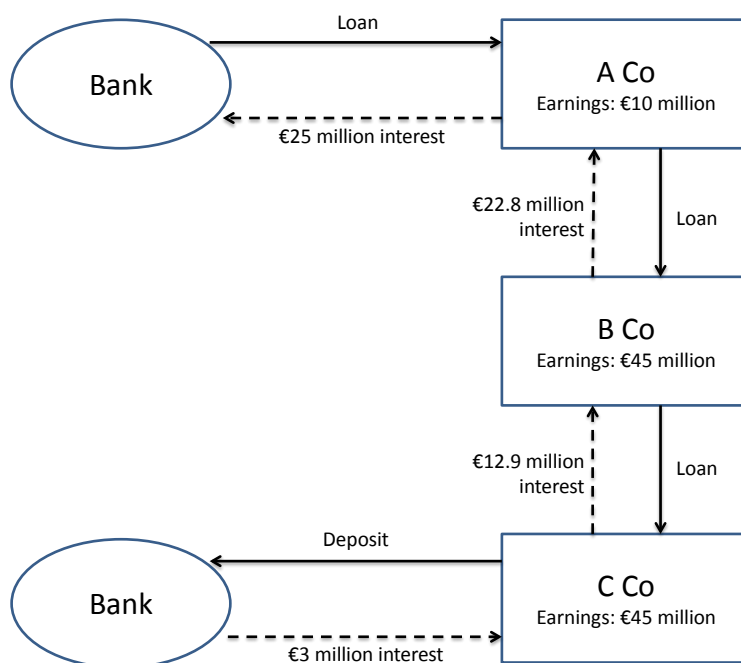


248. The table below shows the impact of a group ratio rule in this scenario. It is assumed that the rule uses earnings as a measure of economic activity. It can be seen that where earnings and interest expense at entity and group level are measured using the same approach as under an interest cap rule, a group ratio approach will give the same result. Therefore, as in example 3, A Co and B Co are able to deduct their full

net interest expense, while C Co can deduct €9.9m of its actual interest cost of €15m (ie. C Co incurs an interest disallowance of €5.1 million).

	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€100m
Permitted net interest/earnings ratio	22/100	22/100	22/100	22/100
Entity earnings	€10m	€45m	€45m	
Permitted net interest deductions	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Actual net interest income/(expense)	(€1m)	(€6m)	(€15m)	(€22m)
Taxable net interest income/(expense)	(€1m)	(€6m)	(€9.9m)	(€16.9m)
Interest expense disallowed	-	-	(€5.1m)	(€5.1m)

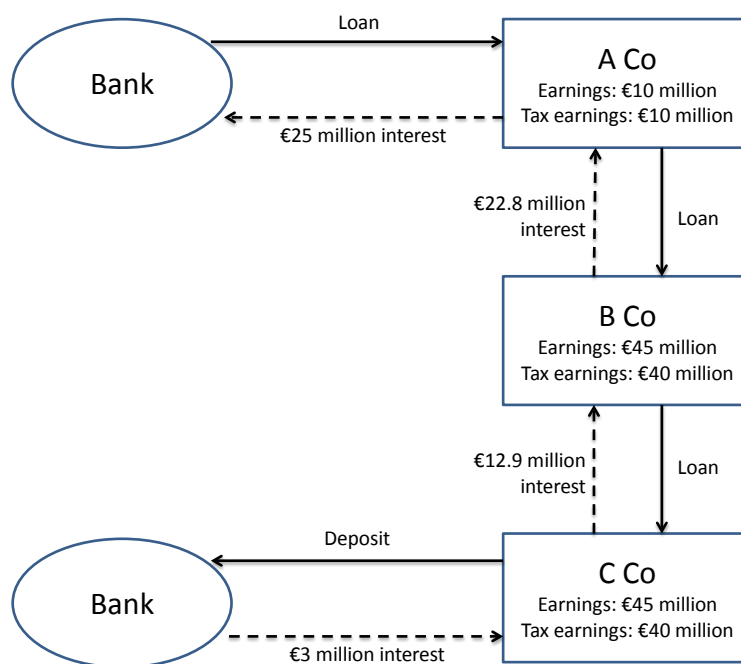
249. As in example 3, this disallowance in C Co would be avoided if net interest expense within the group was matched with earnings. This is shown below.



	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€100m
Permitted net interest/earnings ratio	22/100	22/100	22/100	22/100
Entity earnings	€10m	€45m	€45m	
Permitted net interest deductions	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Actual net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Taxable net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Interest expense disallowed	-	-	-	-

Example 6: Impact of different approaches by countries in applying a group ratio rule

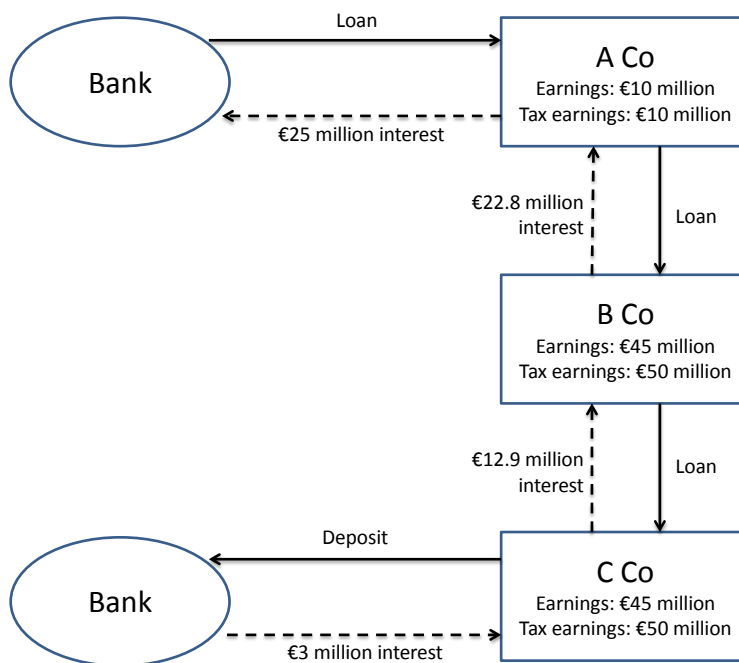
250. Where countries introduce different group ratio rules, the results begin to diverge from those under an interest cap rule. This example is based on the same facts as in example 5, but now assumes that countries apply a group ratio rule by calculating local entity earnings based on domestic tax principles. This is not the only way in which rules could differ, but it illustrates the issues which could arise.



251. The table below shows that this change in the method of calculating an entity's financial ratio has impacted the ability of the group to deduct its net interest expense. From each country's perspective, the use of entity earnings using local tax information may be preferred. However, the fact that each country calculates the ratio differently means that the total level of permitted net interest deductions is now lower than the group's actual net interest expense. Therefore in this particular scenario it would not be possible for the group to deduct its full net third party interest expense even if interest costs in different entities were matched with economic activity.

	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€100m
Permitted net interest/earnings ratio	22/100	22/100	22/100	22/100
Entity earnings for tax purposes	€10m	€40m	€40m	
Permitted net interest deductions	(€2.2m)	(€8.8m)	(€8.8m)	(€19.8m)
Actual net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Taxable net interest income/(expense)	(€2.2m)	(€8.8m)	(€8.8m)	(€19.8m)
Interest expense disallowed	-	(€1.1m)	(€1.1m)	(€2.2m)

252. Similarly, depending on how earnings are calculated for tax purposes in the countries where the group operates, these differences could result in total permitted net interest deductions exceeding the group's actual net third party interest expense, potentially reducing the impact of a rule.

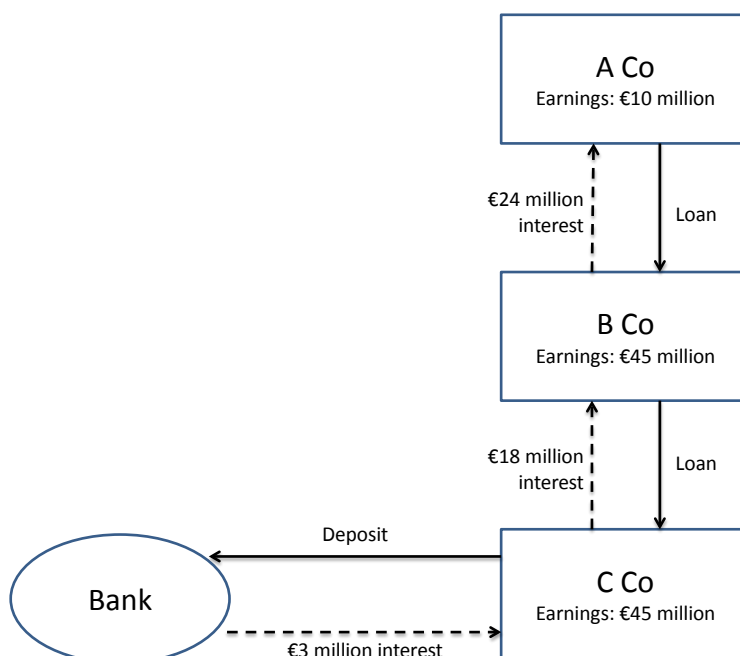


	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€100m
Permitted net interest/earnings ratio	22/100	22/100	22/100	22/100
Entity earnings for tax purposes	€10m	€50m	€50m	
Permitted net interest deductions	(€2.2m)	(€11m)	(€11m)	(€24.2m)
Actual net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Taxable net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Interest expense disallowed	-	-	-	-

Example 7: Application of a group-wide rule to groups with net third party interest income

253. Group-wide rules link an entity’s ability to deduct net interest expense to the actual net third party interest expense position of its group. An implication of this is that where a group does not have any net third party interest expense (ie. its interest income received from third parties exceeds its interest expense paid to third parties), entities within the group would be restricted from deducting any net interest expense, although they should be able to deduct interest expense to the extent they also have interest income. This is illustrated in the examples below.

254. In this example, A Co has surplus cash which it on-lends within its group. Therefore A Co does not raise any borrowings from Bank. As in previous examples, C Co places cash on deposit with Bank and receives interest income.



255. The table below shows the position under an interest allocation rule. As the group has no net third party interest expense (it has net third party interest income of €3 million), each entity receives an interest cap of nil (€0). B Co and C Co are able to deduct interest expense to offset their interest income, but are

not able to deduct any net interest expense. This means B Co can deduct €18 million out of its total interest expense of €24 million, and C Co can deduct €3 million out of its total interest expense of €18 million. The remaining interest expense (of €6 million in B Co and €15 million in C Co) is disallowed. A Co remains subject to tax on its net interest income of €24 million.

256. The interest disallowances in B Co and Co arise because these entities have a net interest expense in excess of the actual third party net interest expense of the group. These disallowances could therefore be avoided by reducing the level of net interest expense in these entities, for example by replacing debt funding with equity.

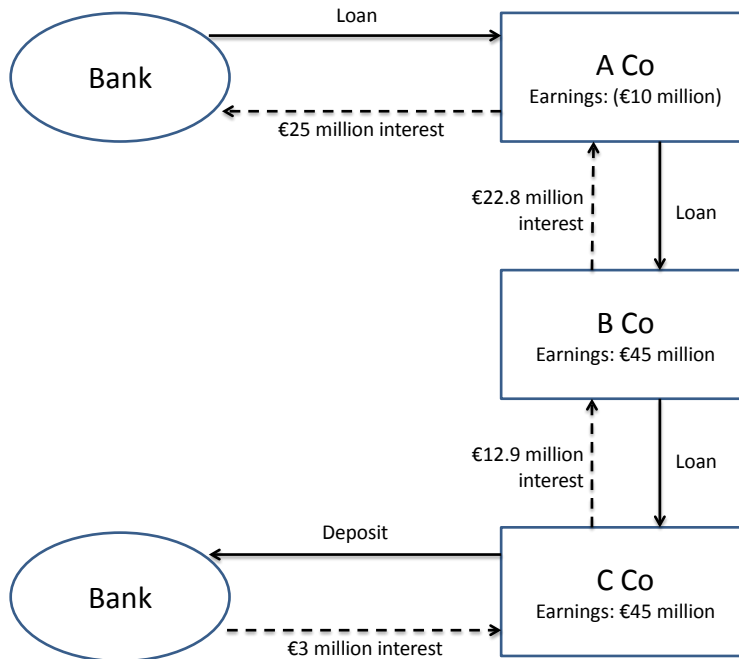
	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	10%	45%	45%	
Net third party interest income/(expense)			€3m	€3m
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	€0	€0	€0	
Stage 2: Application of interest cap				
Net Interest income/(expense)	€24m	(€6m)	(€15m)	
Interest cap	€0	€0	€0	
Taxable net interest income/(expense) (after application of interest cap)	€24m	€0	€0	€24m
Interest expense disallowed	-	(€6m)	(€15m)	(€21m)

257. The table below shows that the same result arises under a group ratio rule. As under an interest allocation rule, B Co and C Co are able to deduct interest expense to offset their interest income, but cannot deduct any interest expense in excess of this amount. Therefore out of a total gross interest expense of €24 million, B Co is able to deduct €18 million and disallows €6 million. Out of a total gross interest expense of €18 million, C Co is able to deduct €3 million and disallows €15 million. A Co remains subject to tax on its net interest income of €24 million. Again, the disallowances in B Co and C Co could be avoided by reducing the level of net interest expense in these entities.

	A Co	B Co	C Co	Group
Net third party interest income/(expense)				€0
Group earnings				€100m
Permitted net interest/earnings ratio	0/100	0/100	0/100	0/100
Entity earnings				
Entity earnings	€10m	€45m	€45m	
Permitted net interest deductions	€0	€0	€0	€0
Actual net interest income/(expense)	€24m	(€6m)	(€15m)	€3m
Taxable net interest income/(expense)	€24m	€0	€0	€24m
Interest expense disallowed	-	(€6m)	(€15m)	(€21m)

Example 8: Impact of entities with losses under an interest allocation rule

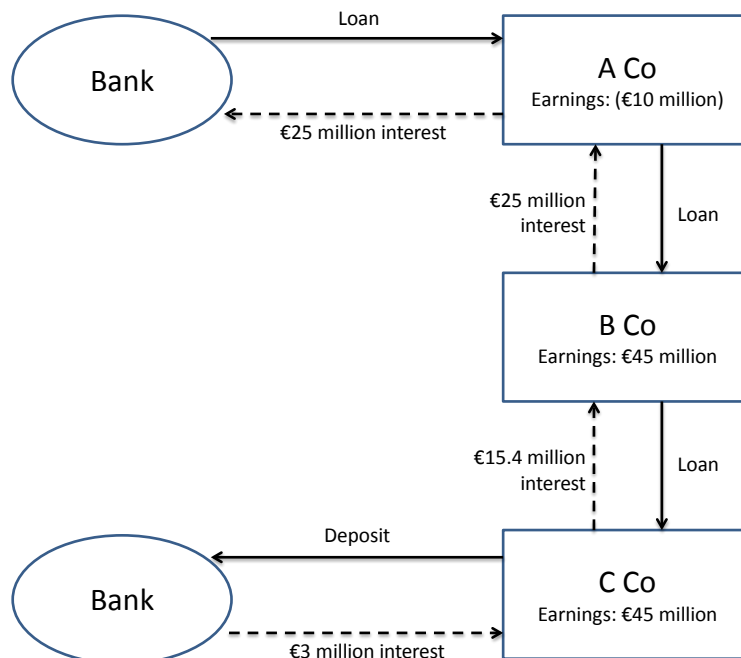
258. This example contains a simple illustration of the impact of entities with losses in a group which is subject to an interest allocation rule which allocates third party interest expense on the basis of earnings. In this example, instead of having positive earnings of €10 million A Co has losses of €10 million. B Co and C Co still have earnings of €45 million each.



259. The table below shows the position under an interest allocation rule if no provisions are applied to take account of the losses in A Co. As interest cap is allocated on the basis of earnings, A Co receives an interest cap of nil (€0) and cannot deduct any of its net interest expense. The losses in A Co also have an impact on the treatment of B Co and C Co. Because A Co’s losses reduce the group’s total earnings, B Co and C Co taken together have earnings that exceed those of the group. Therefore in this example, B Co and C Co each receive an interest cap equal to 56.25 per cent of the group’s actual total net interest expense (which add to 112.5 per cent). This means that in principle, B Co and C Co could deduct net interest expense up to €12.4 million each (totalling €24.8 million) even though the group’s actual total net interest expense is only €22 million.

	A Co	B Co	C Co	Group
Earnings	(€10m)	€45m	€45m	€80m
Allocation factor	-	56.25%	56.25%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	€0	(€12.4m)	(€12.4m)	
Stage 2: Application of interest cap				
Net Interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	
Interest cap	€0	(€12.4m)	(€12.4m)	
Taxable net interest income/(expense) (after application of interest cap)	€0	(€9.9m)	(€9.9m)	(€19.8m)
Interest expense disallowed	(€2.2m)	-	-	(€2.2m)

260. So long as any interest expense on intragroup loans is subject to tax in the recipient, actual total net tax deductions within the group should not exceed the group's net third party interest expense. However, some of the protection offered by the interest allocation approach is removed. This is illustrated below, where it is assumed that C Co is in a higher tax country. In this scenario, the group has taken advantage of the increased interest cap to shift net interest expense from A Co and B Co into C Co. Total net interest deductions do not exceed the group's net third party interest expense, but the group is now able to benefit from the greater value of tax deductions in a high tax country.



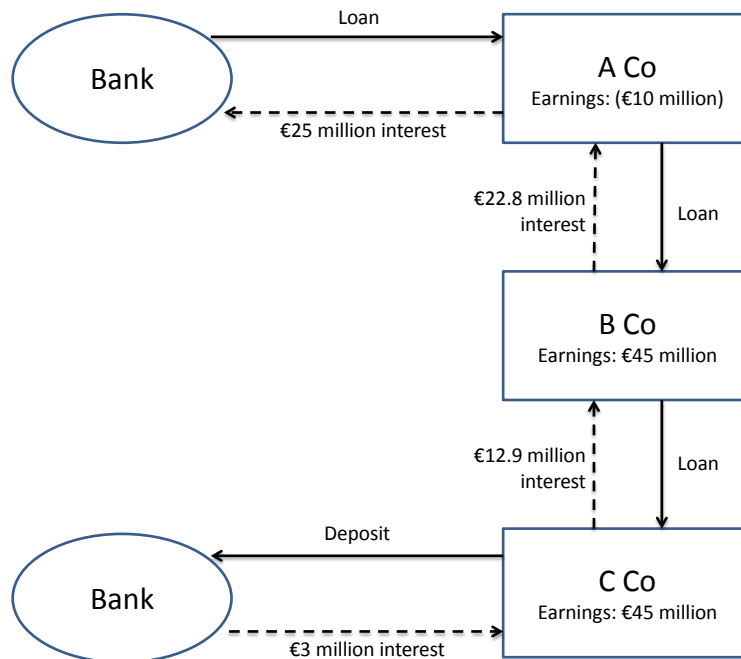
	A Co	B Co	C Co	Group
Earnings	(€10m)	€45m	€45m	€80m
Allocation factor	-	56.25%	56.25%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	€0	(€12.4m)	(€12.4m)	
Stage 2: Application of interest cap				
Net Interest income/(expense)	€0	(€9.6m)	(€12.4m)	
Interest cap	€0	(€12.4m)	(€12.4m)	
Taxable net interest income/(expense) (after application of interest cap)	€0	(€9.6m)	(€12.4m)	(€22m)
Interest expense disallowed	-	-	-	-

261. Alternatively, a rule could provide that in calculating total earnings, the position of loss-making entities is ignored. In this example, the losses in A Co would not be taken into account and the group would be treated as having total earnings of €90 million arising in B Co and C Co. In this case, B Co and C Co each receive an interest cap of €11 million, which in total equates to the group's actual third party interest expense of €22 million.

	A Co	B Co	C Co	Group
Earnings	(€10m) ignored	€45m	€45m	€90m
Allocation factor	-	50%	50%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	€0	(€11m)	(€11m)	
Stage 2: Application of interest cap				
Net Interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	
Interest cap	€0	(€11m)	(€11m)	
Taxable net interest income/(expense) (after application of interest cap)	€0	(€9.9m)	(€9.9m)	(€19.8m)
Interest expense disallowed	(€2.2m)	-	-	(€2.2m)

Example 9: Impact of entities with losses under an group ratio rule

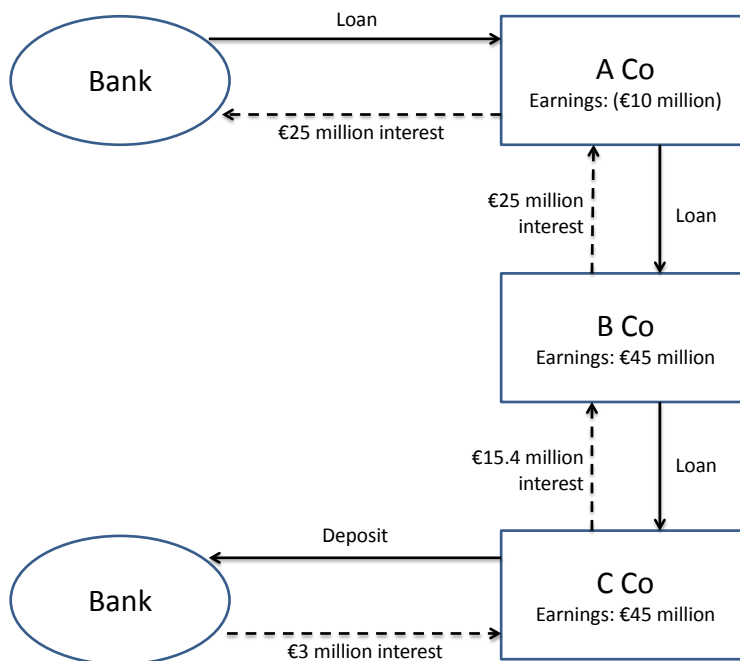
262. This example illustrates how the outcomes in example 8 would be the same under a group ratio rule (assuming a rule is applied consistently by countries). As in example 8, A Co has losses of €10 million. B Co and C Co have earnings of €45 million each.



263. The table below shows the position under a group ratio rule if no provisions are applied to take account of the losses in A Co. As in this example the group ratio rule is based on a net interest/earnings measure, A Co cannot deduct any of its net interest expense. The losses in A Co also have an impact on the treatment of B Co and C Co. Because A Co's losses reduce the group's total earnings, they have the effect of increasing the group's net interest to earnings ratio, from 22/90 to 22/80. This in turn increases the amount of net interest expense that B Co and C Co are allowed to deduct. This means that in principle, B Co and C Co could deduct net interest expense up to €12.4 million each (totalling €24.8 million) even though the group's actual total net interest expense is only €22 million.

	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€80m
Permitted net interest/earnings ratio	22/80	22/80	22/80	22/80
Entity earnings	(€10m)	€45m	€45m	
Permitted net interest deductions	€0	(€12.4m)	(€12.4m)	(€24.8m)
Actual net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Taxable net interest income/(expense)	€0	(€9.9m)	(€9.9m)	(€19.8m)
Interest expense disallowed	(€2.2m)	-	-	(€2.2m)

264. So long as any interest expense on intragroup loans is subject to tax in the recipient, actual total net tax deductions within the group should not exceed the group's net third party interest expense. However, some of the protection offered by the group ratio rule is removed. This is illustrated below, where it is assumed that C Co is in a higher tax country. In this scenario, the group has taken advantage of the increased group ratio to shift net interest expense from A Co and B Co into C Co. Total net interest deductions do not exceed the group's net third party interest expense, but the group is now able to benefit from the greater value of tax deductions in a high tax country.



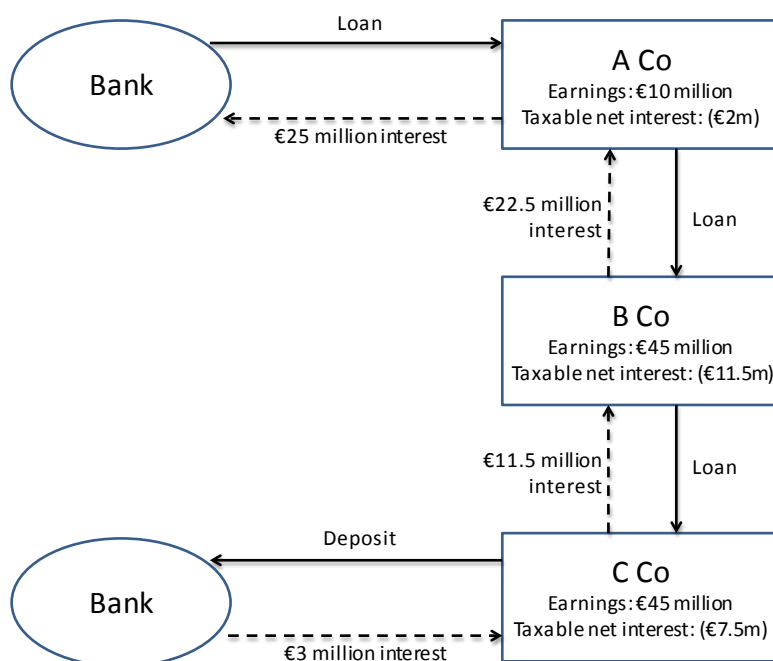
	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€80m
Permitted net interest/earnings ratio	22/80	22/80	22/80	22/80
Entity earnings	(€10m)	€45m	€45m	
Permitted net interest deductions	€0	(€12.4m)	(€12.4m)	(€24.8m)
Actual net interest income/(expense)	€0	(€9.6m)	(€12.4m)	(€22m)
Taxable net interest income/(expense)	€0	(€9.6m)	(€12.4m)	(€22m)
Interest expense disallowed	-	-	-	-

265. Alternatively, a rule could provide that in calculating total earnings, the position of loss-making entities is ignored. In this example, the losses in A Co would not be taken into account and the group would be treated as having total earnings of €90 million arising in B Co and C Co. Compared with the scenarios above, this reduces the group's net interest to earnings ratio. In this case, B Co and C Co would each be able to deduct net interest expense up to €11 million, which in total equates to the group's actual third party interest expense of €22 million.

	A Co	B Co	C Co	Group
Net third party interest income/(expense)				(€22m)
Group earnings				€90m
Permitted net interest/earnings ratio	-	22/90	22/90	22/90
Entity earnings	(€10m) ignored	€45m	€45m	
Permitted net interest deductions	€0	(€11m)	(€11m)	(€22m)
Actual net interest income/(expense)	(€2.2m)	(€9.9m)	(€9.9m)	(€22m)
Taxable net interest income/(expense)	€0	(€9.9m)	(€9.9m)	(€19.8m)
Interest expense disallowed	(€2.2m)	-	-	(€2.2m)

Example 10: Addressing mismatches between the accounting and tax treatment of interest

266. Under an interest allocation rule, an entity's interest cap may be compared directly with its net interest expense for tax purposes to determine how much of the entity's interest expense is deductible. However, this comparison may be difficult where there are significant differences between the approaches used to calculate interest expense under accounting and tax rules. This issue may be addressed by instead comparing the interest cap with the entity's net interest expense calculated under accounting rules, and calculating the percentage of the accounting net interest expense which falls within the interest cap. This percentage may then be applied to the entity's net interest expense for tax purposes, to determine how much should be allowable for tax (up to 100 per cent). This avoids the need to make a direct comparison between an interest cap calculated under tax rules and a net interest expense figure calculated under tax rules.



267. In this example, the group has a total net third party interest expense of €22m. This is allocated between the three group entities in accordance with earnings, to provide each entity with an interest cap.

268. For each entity, the interest cap is compared against its net interest expense calculated under accounting principles. This gives an “allowable percentage” figure of 88 per cent for A Co, 90 per cent for B Co and 116 per cent for C Co. These allowable percentages are then applied to the net interest expense for tax purposes of each entity.

- A Co is able to deduct 88 per cent of its taxable net interest expense of €2m, equal to €1.76m. This limitation is applied even though A Co’s taxable net interest expense of €2m is below its interest cap of €2.2m, because it is assumed this difference arises because of mismatches in the measurement of interest for tax and accounting purposes.
- B Co is able to deduct 90 per cent of its taxable net interest expense of €11.5m, equal to €10.35m. The fact that these deductions exceed B Co’s actual interest cap of €9.9m is not relevant, as again it is assumed this difference arises because of mismatches in the measurement of interest for tax and accounting purposes.
- C Co is able to deduct 100 per cent of its taxable net interest expense of €7.5m. Although C Co’s interest cap represents 116 per cent of its net interest expense for accounting purposes, C Co cannot deduct more than 100 per cent of its net interest expense for tax purposes.

	A Co	B Co	C Co	Group
Earnings	€10m	€45m	€45m	€100m
Allocation factor	10%	45%	45%	
Net third party interest income/(expense)	(€25m)		€3m	(€22m)
Stage 1: Calculation of interest cap				
Allocation of net 3 rd party interest expense	(€2.2m)	(€9.9m)	(€9.9m)	
Stage 2: Application of interest cap to accounting net interest expense				
Accounting net Interest income/(expense)	(€2.5m)	(€11m)	(€8.5m)	
Interest cap	(€2.2m)	(€9.9m)	(€9.9m)	
Allowable % (interest cap/net interest x 100)	88%	90%	116%	
Stage 3: Application of allowable % to taxable net interest expense				
Taxable net interest income/(expense)	(€2m)	(€11.5m)	(€7.5m)	(€21m)
Allowable % (capped at 100%)	88%	90%	100%	
Allowable net interest expense	(€1.76m)	(€10.35m)	(€7.5m)	(19.61m)
Interest expense disallowed	(€0.24m)	(€1.15m)	-	(€1.39m)

C. Fixed ratio rules

Example 11: Fixed net interest to earnings ratio rule (15 per cent of EBITDA)

	Single entity taxation			Group taxation
	A1 Co	A2 Co	Total	A1 Co + A2 Co
Earnings before tax	70	10	80	80
+ net interest expense	+10	+50	+60	+60
+ depreciation and amortisation	+20	+40	+60	+60
= EBITDA	100	100	200	200
x benchmark ratio (15%)	x 15%	x 15%	-	x 15%
= maximum allowable deduction	15	15	-	30
Interest expense disallowed (exceeding maximum allowable deduction)	0	35	35	30

269. Determining whether an entity has an amount of interest expense which is non-deductible under a fixed net interest to earnings ratio rule involves a three stage process: firstly, calculating the appropriate measure of earnings; secondly, applying the benchmark ratio to the measure of earnings to determine the maximum deductible interest expense; and thirdly, comparing this with the actual interest expense of the entity. The information required to undertake this calculation would, typically, be found in the entity's accounts and income tax calculation.

270. In the above example, A1 Co and A2 Co incur a total disallowance of 30 where they are taxed under a group taxation regime. However, where they are taxed separately under a separate entity taxation regime, they incur a total disallowance of 35 (which arises in A2 Co). This is because A1 Co is not fully utilising its capacity to absorb interest deductions and this excess capacity cannot be used to offset excess interest expense in A2 Co.

Example 12: Fixed net interest to assets ratio rule (5 per cent of total assets)

	Single entity taxation			Group taxation
	A1 Co	A2 Co	Total	A1 Co + A2 Co
Total assets	4 000	6 000	10 000	10 000
x benchmark ratio	x 5%	x 5%	-	x 5%
= maximum allowable deduction	200	300	-	500
Actual interest expense	100	500	-	600
Interest expense disallowed (exceeding maximum allowable deduction)	0	200	200	100

271. Determining whether an entity has an amount of interest expense which is non-deductible under a fixed net interest to assets ratio rule involves a three stage process: firstly, calculating the appropriate measure of assets; secondly, applying the benchmark ratio to the measure of assets to determine the maximum deductible interest expense; and thirdly, comparing this with the actual interest expense of the entity. The information required to undertake this calculation would, typically, be found in the entity's accounts and income tax calculation.

272. In the above example, A1 Co and A2 Co incur a total disallowance of 100 where they are taxed under a group taxation system. However, where they are taxed separately under a separate entity taxation system, they incur a total disallowance of 200 (which arises in A2 Co). This is because A1 Co is not fully utilising its capacity to absorb interest deductions and this excess cannot be used to offset excess interest expense in A2 Co.