Public Discussion Draft

BEPS ACTION 4

ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE

11 July 2016

OECD
BETTER POLICIES FOR BETTER LIVES

BEPS ACTION 4 – DISCUSSION DRAFT ON ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE

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Paragraph 117 of the final version of the report on Action 4 *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* indicates that the OECD will continue to conduct detailed work on the design and operation of the group ratio rule, to be completed in 2016. This discussion draft has been produced as part of the follow-up work on this issue, which focuses on -

- approaches to calculate a group's net third party interest expense,
- a definition of group-EBITDA, and
- approaches to deal with the impact of losses on the operation of the group ratio rule.

The discussion draft includes a number of specific questions (which appear in boxes) related to particular aspects of these topics. The CFA invites interested parties to send written responses to these questions, in order to facilitate the analysis of the issues covered by the discussion draft. As indicated in the final question, interested parties may also offer additional comments on any of the issues raised in the document. Responses should be sent by email to interestdeductions@oecd.org in Word format, by no later than **16 August 2016**. They should be addressed to the International Co-operation and Tax Administration Division, OECD/CTPA.

Please note that all responses to this consultation document will be made publicly available. Responses submitted in the name of a collective "grouping" or "coalition", or by any person submitting responses on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

The views and proposals included in this discussion draft do not represent consensus views of the Committee on Fiscal Affairs or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment. It is considered that stakeholder comments are essential to advancing this work.

BEPS ACTION 4 – DISCUSSION DRAFT ON ELEMENTS OF THE DESIGN AND OPERATION OF THE GROUP RATIO RULE

Introduction and background

1. International tax issues have never been higher on the political agenda. The integration of national economies and markets has increased substantially in recent years, putting a strain on international tax rules which were designed more than a century ago. Weaknesses in existing rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created. Following the release of the report Addressing Base Erosion and Profit Shifting in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS by multinational groups. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty. Against this background, the BEPS package of measures for a comprehensive, coherent and co-ordinated response by countries was adopted by the OECD Council on 1 October 2015, endorsed by G20 Finance Ministers at their meeting on 8 October 2015 in Lima, Peru and endorsed by G20 Leaders at their summit on 15-16 November 2015 in Antalya, Turkey.

2. The use of interest is one of the simplest 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 an entity. The BEPS report *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (the Action 4 Report or the Report) includes a common approach to tackling BEPS involving interest and payments economically equivalent to interest. At the heart of the common approach is a fixed ratio rule which restricts an entity's net interest deductions to a fixed percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA) calculated using tax principles.

3. The Action 4 Report also recommended that countries consider introducing a group ratio rule which will allow an entity in a highly leveraged group to deduct net interest expense in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of its worldwide group. The Report contains a description of such a group ratio rule which permits an entity to deduct net interest expense up to the net third party interest expense/EBITDA ratio of its group. The Report includes a detailed outline of the key elements of the design and operation of this rule, and highlights that further work will be conducted in 2016 on approaches -

- to calculate a group's net third party interest expense
- to define group-EBITDA
- to address the impact of losses on the operation of the rule.

4. The option for a group ratio rule described in the Action 4 Report and this discussion draft represents an approach that should be suitable for most countries. However, countries may also apply a different approach to suit their domestic circumstances. Therefore, as set out in the Report, a country may apply a group ratio rule based on another relevant financial ratio of an entity's worldwide group, such as a different net interest/earnings ratio or an equity/total assets ratio similar to that currently applied in Finland and Germany.

5. Where countries apply a group ratio rule based on a net third party interest expense/EBITDA ratio, as described in the Action 4 Report, there are benefits from this being applied in a consistent manner, both in terms of providing protection for countries and reducing compliance

costs for groups. In designing its rule, a country should consider these benefits before introducing any provisions which mean that its rule might differ from those in other countries. In all cases, a country should ensure that the group ratio rule applied provides effective protection against BEPS involving interest, in line with the principles set out in the Action 4 Report.

Calculation of net third party interest expense

6. A group's net third party interest expense includes all of the group's interest income and expense for the period, as well as other items of income or expense that are economically equivalent to interest as defined in Chapter 2 of the Action 4 Report. The Report provides that this calculation should be based on a group's consolidated financial statements, prepared using International Financial Reporting Standards (IFRS), Japanese GAAP or US GAAP, or other accounting standards as permitted by the relevant country (e.g. taking into account the geographical region and main sources of foreign investment). It is recommended that these should be audited by an independent regulated accountant, although unaudited financial statements may be permitted. The Report includes three possible ways in which these may be used to determine a group's net third party interest expense.

- Using interest income and expense figures taken from the consolidated income statement without adjustment (approach 1).
- Using interest income and expense figures taken from the consolidated income statement, but adjusting these figures to reflect items included in the definition of interest and payments economically equivalent to interest in Chapter 2 of the Action 4 Report (approach 2).
- Identifying the group's items of income or expense which fall within the definition of interest and payments economically equivalent to interest in Chapter 2 of the Action 4 Report, and measuring these items based on how they are treated in the consolidated financial statements of the group (approach 3).

7. The Action 4 Report concluded that each of these approaches were currently considered acceptable in determining net third party interest expense, but further consideration was required of the feasibility of each approach.

Approach 1

8. The most straightforward approach to calculate a group's net third party interest expense would be to use unadjusted figures from the face of a group's consolidated income statement. Consolidated financial statements may include a single figure for net interest expense or separate figures for interest income and interest expense which would be netted off. Interest income and expense, and amounts economically equivalent to interest, may also be included with other items within broader categories of income and expense, in particular by groups which prepare financial statements using IFRS.

9. The significant downside to this approach is that there can be substantial differences in the items which groups treat as interest income or expense in their consolidated financial statements and the level of information that is disclosed. Some of these arise due to differences between accounting standards, while others are the result of groups adopting different accounting policies permitted under the same accounting standard. These differences mean that using figures taken directly from the consolidated income statement without adjustment could result in comparable groups having a different net third party interest expense. This could lead to an overstatement or understatement of net third party interest expense for some groups. Where an item of expense is economically equivalent to interest, but a group does not currently account for it as interest in its consolidated financial statements, it would be necessary for the group to change its accounting policies to ensure that the expense is taken into account in calculating the group ratio. However, in some circumstances, such a

change in accounting treatment may not be permitted under the relevant accounting standard. On the other hand, there is also a risk that such an approach could be manipulated to ensure that income items are not accounted for as interest and so are not included in net third party interest expense. The risk of manipulation could be reduced by the inclusion of an anti-avoidance provision, but this could be difficult to apply in practice if a particular accounting treatment is permitted under the relevant accounting standard.

10. It is inevitable that there will be some variance between calculations of net third party interest expense based on consolidated financial statements prepared under different accounting standards. However, given the importance of having an objective measure of net third party interest expense which is broadly consistent between groups, approach 1 has important shortcomings.

Approaches 2 and 3

11. Approach 2 and approach 3 reduce the risks posed by approach 1 by applying a definition of interest and payments economically equivalent to interest taken from the Action 4 Report. This may include certain items which are not treated as interest in a group's consolidated financial statements, and exclude certain items which a group does account for as interest. In practice, approach 2 and approach 3 are variants on the same approach and should give rise to the same figure for a group's net third party interest expense figure.

Approach 2

12. Approach 2 uses the interest income and expense figures in a group's consolidated income statement as the starting point for calculating net third party interest expense. However, unlike under approach 1, these figures are then adjusted to include or exclude items in accordance with whether they fall within the definition of interest and payments economically equivalent to interest in Chapter 2 of the Action 4 Report.

13. The adjustments that will be required are likely to vary from group to group, depending upon the types of funding arrangements the group is party to, the accounting standards applied in preparing consolidated financial statements, and the accounting policies adopted. In each case, entities should adjust the interest income and expense figures in the consolidated income statement, as required, to ensure that the following items are included in net third party interest expense -

- capitalised interest
- interest included within other categories of income or expense in the consolidated income statement
- interest income on financial instruments carried at fair value.

14. In addition, adjustments should be made, as required, to ensure that the following items are excluded from net third party interest expense -

- fair value gains or losses on financial instruments, to the extent these are not economically equivalent to interest
- gains and losses on the sale or redemption of financial instruments, to the extent these are not economically equivalent to interest
- foreign exchange gains or losses, to the extent these are not economically equivalent to interest

- net interest on a group's defined benefit pension liability and similar post-retirement benefits.

- accrued interest on accounting provisions

- non-interest income and expense, to the extent this is not economically equivalent to interest.

15. Where an adjustment is required, this may be made based on information contained in the group's consolidated financial statements, including notes to the financial statements, or in underlying accounting records. Where an adjustment is not required (e.g. because the relevant item is already included in or excluded from interest income and expense in the consolidated financial statements as required) an entity may simply confirm this is the case and provide the relevant supporting evidence.

Approach 3

16. As mentioned above, approach 3 to calculating a group's net third party interest expense is a variant on approach 2 and so should give the same result. However, rather than making adjustments to the interest figures in a group's consolidated financial statements, approach 3 requires an entity to identify all of the group's items of income or expense which fall within the definition of interest and payments economically equivalent to interest in Chapter 2 of the Action 4 Report, and then measure these items based on how they are treated in the consolidated financial statements for the group. In some cases these values may be taken directly from the group's consolidated financial statements but in others it may be necessary for an entity to refer to underlying accounting records.

Comparison of the three approaches

17. Approach 1 to calculating a group's net third party interest expense has the benefit of apparent simplicity. However, this simplicity also gives rise to substantial concerns that a group's net third party interest expense could be overstated or understated. This could lead to adverse tax consequences for some groups, encourage groups to adopt different accounting policies to avoid these tax consequences, provide opportunities for manipulation, and reduce the effectiveness of the group ratio rule as a tool to combat BEPS. In addition, where countries apply either approach 2 or approach 3, these should result in a consistent figure for a group's net third party interest expense. However, where some countries apply approach 1, this may result in a different figure for net third party interest expense in these countries. As described below, there may be policy aims which lead to a country making specific adjustments to net third party interest expense, but there are benefits for groups from countries using a consistent starting point for this figure before these adjustments are made.

18. Approach 2 and approach 3 avoid these concerns and either should result in a figure for a group's net third party interest expense which captures the items covered by the definition of interest and payments economically equivalent to interest in Chapter 2 of the Action 4 Report. Therefore, it is suggested that both of these approaches should be preferred over approach 1.

19. Calculations of net third party interest expense under approach 2 and approach 3 would be presented differently. However, the information that an entity would be required to obtain in order to prepare these calculations should be the same, and they should give rise to the same outcome. In some cases, in order to verify specific items within a calculation, a tax authority may request information from a tax authority in another country, but this should be consistent under each of these approaches. A country may have reasons for preferring one of these approaches over the other, but there does not appear to be any specific factors which are sufficiently significant for one to be recommended in preference to the other. Therefore it is suggested that both approach 2 and approach 3 should be considered preferred approaches to define net third party interest expense in designing a group ratio rule.

Questions for consultation

1. Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

Adjustments to a group's net third party interest expense

20. Where countries apply either approach 2 or approach 3, entities in a multinational group should be able to produce, as a starting point, a single calculation of net third party interest expense for use in all countries in which it operates and where a group ratio rule in the form described in the Action 4 Report is applied. The calculation may be presented differently depending on whether approach 2 or approach 3 is applied in a particular country, but the outcome should be the same. However, in order to reduce the risk that a group is not able to deduct an amount equivalent to its actual net interest expense, and to ensure that BEPS is appropriately and adequately addressed, a particular country may require or allow an entity to adjust the figure for net third party interest expense to reflect specific policy goals, including those set out below.

21. So long as the adjustments required or permitted by a country are in accordance with the goals set out in the Action 4 Report, the fact that countries may make different policy choices on these issues is not inconsistent with the common approach. The aim of the group ratio rule is to enable countries to take into account the position of entities in highly leveraged groups, and allow an entity to claim net interest deductions in excess of the limit under the fixed ratio rule in particular circumstances. It is therefore appropriate for certain tax policies to be taken into account in setting a limit on net interest deductions under the rule. However, it is also recognised that a benefit of the common approach is to allow multinational groups to apply consistent rules in different countries where they operate, reducing overall compliance costs. Therefore, in deciding whether to require or permit an entity to make adjustments to the common figure for net third party interest expense described above, a country should balance its domestic policy goal against the benefits of applying a consistent approach to limiting net interest deductions across different countries.

To recognise practical issues that may prevent a group aligning net interest expense and EBITDA

22. The common approach encourages groups to align the location of net interest expense and economic activity, measured using EBITDA. However, the Action 4 Report recognises that in some cases there will be practical or legal constraints that make this difficult or impossible. To reduce the likelihood that this could prevent a group from deducting an amount equivalent to its third party interest expense, countries may allow an entity to apply an uplift to its group's net third party interest expense of up to 10%.

23. On the other hand, in cases where a group is able to more closely align the location of its net interest expense and EBITDA, such an uplift could enable entities in the group to claim net interest deductions in excess of the group's net third party interest expense. Therefore a country may also choose to allow entities to apply a smaller uplift or no uplift. The operation of an uplift to net third party interest expense is illustrated by Example 1 in Annex 2.

To prevent interest capacity being increased by certain non-deductible payments

24. The approaches to determine a group's net third party interest expense set out above are based on consolidated financial reporting figures, rather than tax figures. A group may make

payments which are interest or economically equivalent to interest, but which would not be tax deductible if paid by an entity in a particular country. For example, dividends paid on fixed rate preference shares may be economically equivalent to interest, but many countries do not allow a tax deduction for these payments.

25. If these payments are included in a group's net third party interest expense, they will increase the group's net third party interest expense/EBITDA ratio and the interest capacity of all entities in the group. If a country has decided that for policy reasons these payments should not be tax deductible, it may also take the view that payments of this type made by other member of the group should not be used to increase the limit on net interest deductions that an entity in the country may claim. A country may therefore choose to require an entity to exclude some or all of these payments from net third party interest expense in applying the group ratio rule. This is illustrated by Example 2 in Annex 2. However, it is noted that, as this would require an entity applying the group ratio rule to make adjustments for payments made by group entities in other countries, it could increase the complexity of the rule for entities to apply and for tax authorities to audit.

26. In order to ensure that the group ratio rule is as simple as possible to apply and administer, a country may choose not to require any adjustment to net third party interest expense, even where this includes payments that would not be tax deductible in that country. If a country does decide to require such adjustments, it is suggested that these should be limited to specific identifiable categories of payments which, in the assessment of the country, pose a material BEPS risk.

To address risks posed by interest paid to related parties outside the group

27. The Action 4 Report explains that entities may use interest paid to related parties outside a group to increase the group's net third party interest expense and inflate the interest capacity of all entities in the group. In order to ensure the integrity of the group ratio rule and protect countries against BEPS involving interest, countries should introduce measures to prevent this happening. The Report gives countries flexibility in how this is done, but one possible approach would be for a country to exclude net interest expense paid to related parties from the definition of net third party interest expense. If this approach was adopted by a country, entities in a group which is funded using only related party debt (i.e. where the group's net third party interest expense is zero) would be able to apply the fixed ratio rule to deduct net interest expense up to the benchmark fixed ratio, but would not be able to rely on the group ratio rule to deduct net interest expense above this amount. This approach is illustrated by Example 3 in Annex 2.

28. The term 'related parties' for these purposes is defined in Chapter 9 of the Action 4 Report. Broadly, two persons (including two entities or an entity and an individual) are related if they are not in the same group, but they meet any of the following conditions.

- The first person has an investment that provides that person with effective control of the second person or there is a third person that holds investments which provide that person with effective control over both persons.

- The first person has a 25% or greater investment in the second person or there is a third person that holds a 25% or greater investment in both.

- They can be regarded as associated enterprises under Article 9.

To take into account a group's share of the net third party interest expense of an associate or joint venture entity

29. As discussed later in this discussion draft, in calculating a group's net third party interest expense/EBITDA ratio, group-EBITDA includes the group's share of the earnings of any associates or joint venture entities (JVEs) included in its consolidated financial statements under equity

accounting principles. However, because a group's consolidated income statement does not specifically include a share of an associate or JVE's net interest expense, where the associate or JVE raises debt directly from third party lenders, the interest expense on this debt will not be included in the group's net third party interest expense determined under the approaches described above. This means that in these cases the group's ratio would take into account its share of the associate or JVE's earnings, but not the interest expense funding those earnings. This puts entities in the group at a disadvantage compared with a scenario where the third party debt is raised by a group member and so the interest on the debt is included in net third party interest expense.

30. To address these concerns, a country may allow an entity to adjust net third party interest expense so as to include the group's share of the net third party interest income or expense of an associate or JVE. This is illustrated by Examples 15 and 16 in Annex 2. However, obtaining information on an associate or JVE's third party interest position would make a rule more complex to apply, and in many cases the impact on a group's ratio may not be material. Therefore it is suggested that, even where a country permits such an adjustment, entities should have the option not to make an adjustment. Where a country does permit such an adjustment, it may verify the net third party interest expense of an associate or JVE in another country using evidence provided by the entity, or it may use exchange of information provisions in tax treaties and other instruments to obtain the information from the relevant foreign tax authority. It should also consider including safeguards, such as -

- requiring consistent adjustments to be made for all material holdings (i.e. to require adjustments to include a group's share of net third party interest income as well as expense)
- limiting a group's net third party interest expense/EBITDA ratio to the ratio the group would have had if both the net third party interest expense and EBITDA of the associate or JVE were excluded.

Questions for consultation

3. It is important that a country's tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?
4. Are there any areas where a country's tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?
5. Are there any other circumstances where a group's net third party interest expense should be adjusted to include interest income or expense of an entity outside the group?

Definition of group-EBITDA

31. The group ratio rule operates by comparing a group's net third party interest expense with its earnings, measured using EBITDA. This gives a ratio which can be applied to an entity's EBITDA, to calculate the entity's interest capacity under the rule. The section above looked at how a group's net third party interest expense is calculated, based on the group's consolidated financial statements and reflecting a country's tax policy choices. This section will now consider the calculation of group-EBITDA.

32. In simple terms, a group's EBITDA is equal to its profit before tax after making adjustments to remove interest income and expense, depreciation and amortisation. However, there are a number of specific elements with respect to this definition which need to be considered. These are -

- items to be included in the adjustment for interest income and expense

- items to be included in the adjustment for depreciation and amortisation
- the treatment of dividend income and a group's share of the earnings of an associate or JVE
- the treatment of non-recurring items.

Items to be included in the adjustment for interest income and expense

33. The calculation of group-EBITDA includes an adjustment to remove a group's interest income and interest expense. This is done in order to ensure that a group's earnings are measured without taking into account how the group is funded. In other words, two comparable groups should have the same EBITDA irrespective of whether they are funded using equity, debt or any mix of the two.

34. The approach set out below should result in a measure of interest income and expense which is substantially the same in all countries applying the group ratio rule. However, there are two particular areas where flexibility is provided to countries. Firstly, with respect to the treatment of capitalised interest it is suggested that countries should consider simply excluding capitalised interest from the adjustment for interest income and expense, as a more straightforward approach than the ongoing adjustments to depreciation and amortisation described in the Action 4 Report. Secondly, it is suggested that, in order to give an accurate calculation for group-EBITDA and to reduce volatility in earnings, the adjustment for interest income and expense may also include fair value gains and losses on a group's debt instruments and instruments directly connected to its debt funding, and interest on defined benefit pension liabilities and similar post-retirement benefits.

Capitalised interest

35. Where a group has incurred an interest expense related to the construction or development of a fixed asset, accounting standards may require or permit this expense to be capitalised and added to the cost of the fixed asset in the group's balance sheet. This interest expense is not charged directly to the consolidated income statement. Instead, as the fixed asset is depreciated over time, the annual depreciation charge includes amortisation of the capitalised interest. In effect, the capitalised interest is taken through the consolidated income statement over the life of the fixed asset.

36. The Action 4 Report suggests that capitalised interest may be included in the group's interest income and expense figure which is removed from earnings in calculating group-EBITDA. As the group's figures for depreciation and amortisation also include amortisation of its capitalised interest expense, this would need to be stripped out in order to avoid double counting (i.e. to avoid capitalised interest being included in both the adjustment for interest income and expense and the adjustment for depreciation and amortisation). In practice, a requirement to adjust depreciation and amortisation could be difficult for entities to apply and tax authorities to audit. Groups may not currently record the amortisation of capitalised interest and this would need to be introduced. Adjustments to depreciation and amortisation would also need to be made each year over the life of the relevant fixed assets, adding to the complexity.

37. An alternative approach would be to exclude capitalised interest from the adjustment for interest income and expense in calculating group-EBITDA. This should be much more straightforward for entities to apply and for tax authorities to audit, as it would involve simply following the accounting treatment of the capitalised interest, disregarding any adjustment to include capitalised interest in the calculation of net third party interest expense. There would be no need to make any ongoing adjustments in future years.

38. Countries are free to apply the approach in the Action 4 Report and require entities to include capitalised interest in the adjustment for interest income and expense in the year when the interest is incurred, and make ongoing adjustments to strip capitalised interest out of depreciation and

amortisation. However, in light of complexity of this approach, countries should consider instead requiring an entity to follow the accounting treatment of capitalised interest when calculating group-EBITDA.

Adjustments to net third party interest expense to reflect a country's tax policy goals

39. As set out in the section of this discussion draft on 'calculation of net third party interest expense', it is proposed that a country may require or permit an entity to make adjustments to its group's net third party interest expense, to achieve specific policy goals, including the below -

i) to apply an uplift of up to 10%

ii) to exclude payments which would not be tax deductible if paid by an entity in the country

iii) to exclude net related party interest

iv) to include a group's share of the net third party interest expense of an associate or JVE.

40. The first three of these possible adjustments are not concerned with determining the actual level of interest expense funding a group's activities, but reflect other tax policy goals that a country may have. Therefore, while these adjustments may be made in calculating a group's net third party interest expense, if they were also made to the interest income and expense that is removed in calculating group-EBITDA, this would give a misleading picture of a group's actual results. It would also undermine a country's tax policy goals in allowing or requiring adjustment to net third party interest expense. This is illustrated by Examples 4, 5 and 6 in Annex 2.

41. On the other hand, the fourth possible adjustment listed above is directly concerned with ensuring that a group's net third party interest expense accurately reflects the actual net interest cost incurred in funding the earnings in the group's consolidated income statement. Therefore, as set out above, a group's net third party interest expense may also include the group's share of the net third party expense of an associate or JVE. Where this is done, the group's share of the associate or JVE's net third party interest expense should also be included in the adjustment for interest income or expense in calculating group-EBITDA. This is to ensure that group-EBITDA includes all of a group's earnings before taking account of the net interest expense funding those earnings.

42. It is proposed therefore that:

a) where an adjustment to net third party interest expense is required or permitted to bring it into line with the actual net interest expense funding the group's earnings, the adjustment should also be reflected in the figure for interest income and expense removed in calculating group-EBITDA

b) where an adjustment to net third party interest expense is required or permitted to achieve any other tax policy goal, the figure for interest income and expense removed in calculating group-EBITDA should not reflect these adjustments.

Fair value movements on financial instruments directly connected to a group's debt finance

43. Under accounting standards, groups may be required or permitted to account for financial assets and liabilities at fair value, with any movements in this value recognised as a gain or loss in the group's consolidated income statement. These gains and losses may include amounts which are not economically equivalent to interest and so are not included in the group's net third party interest expense.

44. However, the purpose of using group-EBITDA as a measure of earnings is to determine a group's position before taking into account is capital structure. Therefore where a group's consolidated financial statements include fair value gains and losses which arise on a group's debt financing or instruments directly connected to the group's debt financing (e.g. instruments used to hedge exposures under fixed rate or foreign currency loans), a country may take the view that these items should be removed in calculating group-EBITDA even though they are not economically equivalent to interest.

45. This approach also has an additional benefit for entities applying the group ratio rule, in that it is likely to reduce volatility in group-EBITDA. This may make it easier for a group to deduct its full net third party interest expense as the expense arises. This is illustrated by Example 7 in Annex 2. As set out in the Action 4 Report, the impact of volatility in group-EBITDA may also be reduced through the use of provisions which allow the carry forward or carry back of disallowed interest expense and/or unused interest capacity.

Net interest on a group's defined benefit pension liability and similar post-retirement benefits

46. The Action 4 Report provides that net interest on a group's defined benefit pension liability and similar post-retirement benefits should not be included in the net interest expense which is subject to restriction under the fixed ratio rule and group ratio rule. As this net interest expense is not subject to limitation, it is also not taken into account when calculating a group's net third party interest expense. However, in order to ensure an accurate measure of earnings, a country may still include this net interest expense in the adjustment for interest income and expense when calculating group-EBITDA.

Question for consultation

6. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

Items to be included in the adjustment for depreciation and amortisation

47. Under accounting rules, groups capitalise tangible and (where permitted) intangible fixed assets at cost, and depreciate or amortise this cost through the consolidated income statement over the life of the relevant asset. Depreciation and amortisation are a mechanism to allocate the cost of a group's fixed assets to different periods. In calculating group-EBITDA, an adjustment is made to remove these costs from a group's earnings.

48. A group's consolidated income statement may also include other items to allocate a group's fixed assets costs to different periods, which arise in specific circumstances. These items might include charges on the impairment or write-off of a fixed asset, and gains or losses on the disposal of a fixed asset outside the group. It is suggested these items should be treated consistently with the group's charges for depreciation and amortisation. They should therefore be included within the adjustment for depreciation and amortisation and removed from group-EBITDA.

Question for consultation

7. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The treatment of dividend income and a group's share of the earnings of an associate or JVE

49. For the purposes of applying the group ratio rule, a group includes a parent company and all entities that are fully consolidated on a line-by-line basis in the parent's consolidated financial statements. There are two broad scenarios where a group's consolidated financial statements will include income derived from economic activity carried on by entities which are not part of the group -

- the group receives dividend income
- the group recognises a share of the earnings of an associate or JVE under equity accounting principles.

The treatment of dividend income

50. Where an entity is part of a group, its individual items of income and expense are included in the group's consolidated financial statements on a line-by-line basis. Payments between group entities, including intra-group dividends, are removed on consolidation. In practice, dividend income is only included in a group's consolidated income statement if it is received from an entity which is neither (a) part of the consolidated group, nor (b) included in the consolidated financial statements under equity accounting principles (considered further below). This will arise where a group does not have significant influence over the entity. In general terms this will be where the group's interest in the entity is less than 20%, although this may vary depending on the specific facts.

51. The BEPS Action Plan provides that one of the key BEPS risks to be addressed by Action 4 is the use of interest expense to fund tax-exempt or deferred income. The Action 4 Report therefore recommends that in calculating EBITDA at the level of an entity (i.e. entity-EBITDA), countries do not include non-taxable income such as dividend income that benefits from a participation exemption. Where dividend income is subject to tax, but this tax is wholly or partly sheltered by underlying tax credits, the level of dividend income included in entity-EBITDA should be reduced accordingly. This is to prevent an entity benefiting from a higher level of interest capacity as a result of receiving non-taxable income.

52. Entity-EBITDA should not include any non-taxable dividend income. On the other hand, when calculating group-EBITDA, all of a group's income in its consolidated income statement should be included, including income which is not subject to tax. This is to ensure that the group ratio rule effectively apportions a group's net third party interest expense across all of its sources of income. To the extent a group's income is subject to tax, the entity receiving the taxable income will be able to claim net interest deductions corresponding to the proportion of the group's net interest expense funding this income. In order to achieve the specific goals identified in the BEPS Action Plan, where part of a group's income is not subject to tax, the corresponding portion of the group's net interest expense that is funding that income should be disallowed.

53. Examples 8 to 11 in Annex 2 illustrate the importance of this approach in ensuring an appropriate outcome for groups and countries. Example 8 shows that where dividend income in a group's consolidated income statement is received by entities which are subject to tax on the income (e.g. because the entity's holding is below any threshold required to benefit from a participation exemption or claim underlying tax credits) then in principle all of the group's net third party interest expense used to fund this income should be deductible in the appropriate entity. However, to the extent that the dividend income is not subject to tax, Example 9 shows how the part of the group's net third party interest expense which is funding the group's tax-exempt dividend income will be disallowed. This approach therefore gives the correct result for a group whether dividend income is taxable or non-taxable in the entity which receives the income, and also where dividend income is taxed in part. For example, if a country exempts 95% of an entity's dividend income and taxes the remaining 5%, then the part of the group's net third party interest expense which is funding this taxable element should be deductible. This result is also consistent with the outcome should a group

receive any other type of income which is included in group-EBITDA but which is not subject to tax and so is not included in the entity-EBITDA of the relevant entity.

54. In order to test the benefits of this approach, Examples 10 and 11 in Annex 2 illustrate the impact if dividend income is not included in group-EBITDA. As seen in Example 10, this would enable a group to raise third party debt to fund equity investments and claim a deduction for all of its net third party interest expense while receiving dividend income tax-free. This result would be contrary to one of the goals of the BEPS Action Plan, and would reduce the effectiveness of the group ratio rule in tackling BEPS involving interest. Where not all of a group's dividend income is tax-exempt, Example 11 shows how this approach could also result in a group being able to deduct net interest expense in excess of the group's net third party interest expense, which is not the aim of the rule.

55. Another approach would be to include dividend income in the calculation of group-EBITDA where the group entity receiving the income is subject to tax on the income. Dividend income which is not subject to tax would be excluded from group-EBITDA. This would address the risk that a group would be able to claim net interest deductions in excess of its net third party interest expense. However, it would not deal with the concern that a group could deduct net interest expense which is being used to fund tax-exempt income. This would also increase the complexity of the rule for groups to apply and for tax authorities to audit. From the perspective of a group, this additional complexity may not be too great as it is likely that in most groups only a limited number of entities will receive dividends from outside the group and the tax treatment of these dividends should be known to the group's finance function. On the other hand, the difficulties for tax authorities are likely to be more significant. In many cases, the total amount of dividend income received may be taken from a group's consolidated financial statements, but it would then be necessary to identify in which entity and country the dividends are received and to understand the tax treatment of dividend income in that country or submit a request for information from the relevant foreign tax authority. Particular difficulties would arise where dividends are received in a country which taxes dividends with credit for underlying tax, as information on the level of tax credits that may be claimed would also be required.

56. In light of the considerations set out above and the statement in the BEPS Action Plan that recommendations under Action 4 should address BEPS risk where a group uses interest expense to fund tax-exempt or deferred income, all dividend income in a group's consolidated income statement should be included in group-EBITDA without adjustment.

Question for consultation

8. Are there any practical issues raised by including all divided income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The treatment of a group's share of the profit or loss of a joint venture entity or associate under equity accounting principles

57. Equity accounting principles apply where a group has a significant influence over an entity but this is not sufficient to establish control. This will typically be the case where a group has an interest in an entity of between 20% and 50%, although this can vary depending on the facts of a particular case. This may include JVEs (where the group together with other investors has joint control over the entity) and associates (where the group does not have joint control over the entity with any other investor). Associates may also be referred to as affiliates.

58. An associate or JVE is not part of the group for the purposes of applying the group ratio rule. The group's share of the associate or JVE's earnings does not arise directly in any member of the

group, but is included in a single line in the group's consolidated income statement. Instead, the group member holding the investment in the associate or JVE will receive a return in the form of dividends or capital gains.

59. As mentioned above, group-EBITDA should include all of a group's sources of income, regardless of whether or not the income is subject to tax in the entity receiving it. Therefore a group's share of the earnings of an associate or JVE, as contained in its consolidated income statement, should be included in group-EBITDA without adjustment. Example 12 in Annex 2 shows that, where dividends received from an associate or JVE correspond with the group's share of the entity's profits, and the relevant group member is taxable on the dividend income, then in principle the group should be able to deduct all of its net third party interest expense funding this income. However, to the extent the group is not taxed on this income (because the dividends benefit from a participation exemption or are sheltered by underlying tax credits) or taxation is deferred (because dividends are not declared), then Examples 13 and 14 illustrate how the part of the group's net third party interest expense which is funding this exempt or deferred income will not be deductible. This approach gives the correct outcome for a group irrespective of whether dividends received by the group are taxable in the entity receiving them. In practice, the recognition of a group's share of the results of an associate or JVE may not correspond with the timing of the receipt of dividends from that entity. The impact of this timing difference may be reduced by the use of provisions for the carry forward or carry back of disallowed interest expense and/or unused interest capacity.

60. Countries should therefore include a group's share of the earnings of an equity accounted entity within group-EBITDA. A country may also require or permit the group's share of the associate or JVE's earnings to be adjusted to remove interest income and expense, depreciation and amortisation (i.e. so group-EBITDA includes the group's share of the associate or JVE's EBITDA). In particular, where an entity is permitted to adjust group net third party interest expense to include the group's share of the net third party interest income or expense of an associate or JVE, it would be consistent for the entity also to make adjustments to the group's share of the associate or JVE's earnings. In many cases, however, this could lead to a level of complexity that is unnecessary where the amounts concerned are not material and so a country may choose not to require such an adjustment in cases where the impact on group-EBITDA would be small (e.g. less than 5%).

Question for consultation

9. Are there any practical issues raised by including a group's share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The treatment of non-recurring items

61. Non-recurring items include any income, expenses, gains or losses which relate to one-off events, rather than to a group's normal activities. From the perspective of the group ratio rule including non-recurring items in group-EBITDA gives rise to two risks -

- non-recurring items may distort group-EBITDA as a measure of a group's ongoing economic activity

- non-recurring items have the potential to increase volatility in earnings.

62. These risks are exacerbated by the fact that non-recurring items are often specific to an event in a particular part of a group, but including them in group-EBITDA could impact the ability of all entities in the group to deduct interest expense under the group ratio rule. For example, costs incurred in restructuring a group's business in a particular region will increase the group's net third

party interest expense/EBITDA ratio and so increase the interest capacity of entities in other parts of the group. The downside of requiring or permitting the removal of non-recurring items from group-EBITDA is that it may be difficult to define precisely what a non-recurring item is and in what circumstances items should be excluded.

63. As set out above, losses arising as a result of the impairment or write-off of fixed assets, and gains and losses on the disposal of fixed assets outside the group should be included in the adjustment for depreciation and amortisation and removed from group-EBITDA. The argument for removing other non-recurring items from group-EBITDA appears to be less strong. In particular, while it may be clear when certain events such as an acquisition or merger take place, other restructurings and reorganisations are likely to be less apparent. In addition, the allocation of income, expenses, gains and losses to these events may be subjective and not specifically subject to statutory audit. This could lead to lengthy discussions between entities and tax authorities to identify which items should be included in or removed from group-EBITDA, and could result in comparable groups being treated differently.

64. In light of these factors, with the exception of those which are included within the adjustments for interest income and expense or depreciation and amortisation, non-recurring items should in general be included in group-EBITDA without adjustment. This is a simple approach, which can be applied easily and consistently in all countries. Including non-recurring items in group-EBITDA does have the potential to increase volatility in the ability of entities to deduct net interest expense under the group ratio rule, but this can be addressed through the use of averaging and/or provisions for the carry forward or carry back of disallowed interest expense and unused interest capacity, as described in the Action 4 Report.

65. Despite this general approach, a country may require or permit certain specific categories of non-recurring income and expense to be removed from group-EBITDA in applying the group ratio rule. This could have the benefit of more closely aligning the deductibility of net interest expense with the location of ongoing economic activity and reduce the impact of volatility in earnings. It could also be used for more targeted tax policy goals, such as to avoid an excessive interest restriction in cases where a group is under financial stress. However, in order to limit complexity in applying and auditing a rule, these adjustments should be restricted to clearly defined and identifiable non-recurring items, they should be applied consistently (e.g. if a certain category of income or gains is removed from group-EBITDA, the corresponding category of expenses or losses should also be removed), and clear guidance should be issued to taxpayers. These adjustments should also be limited to cases that do not pose a BEPS risk.

Question for consultation

10. Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The impact of losses on the operation of the group ratio rule

66. As set out in the Action 4 Report, the presence of loss-making entities within a group (i.e. those with negative EBITDA) will have an impact on the operation of the group ratio rule. The extent of this impact will depend upon the size of these losses compared with the positive EBITDA of other entities in the group. In designing a group ratio rule, a country therefore needs to consider the treatment of entities in two scenarios -

- where a group has positive group-EBITDA, but includes loss-making entities (i.e. the positive EBITDA of profitable entities exceeds the negative EBITDA of loss-making entities)

- where a group has zero or negative group-EBITDA (i.e. the negative EBITDA of loss-making entities equals or exceeds the positive EBITDA of profitable entities).

The treatment of entities where a group has positive group-EBITDA

67. So long as a group has a positive group-EBITDA, the group ratio rule can be applied to calculate the net third party interest expense/EBITDA ratio of the group. However, where the group includes entities with negative-EBITDA, the inclusion of these losses will reduce group-EBITDA and increase the group's ratio. The effect of this is that the aggregate interest capacity of all group entities could exceed the actual net third party interest expense of the group. This arises because, although the calculation of group-EBITDA includes the results of entities with positive and negative EBITDA within the group, the group ratio is only used to calculate interest capacity for entities with positive EBITDA (i.e. entities with negative EBITDA do not have "negative interest capacity"). This is illustrated by Example 17 in Annex 2. Countries may adopt different approaches to deal with this risk, and are encouraged to consider the following as options -

- excluding entities with negative EBITDA from the calculation of group-EBITDA

- restricting the interest capacity of entities with positive EBITDA.

Excluding entities with negative EBITDA from the calculation of group-EBITDA

68. Excluding entities with negative EBITDA from the calculation of group-EBITDA would mean that the denominator in a group's net third party interest expense/EBITDA ratio only includes the results of entities with positive EBITDA in the group. This would enable these entities, taken together, to deduct net interest expense equal to the group's actual net third party interest expense. This is illustrated by Example 18 in Annex 2. Net interest expense in excess of this amount is disallowed, but may be carried forward for use in future periods where this is permitted.

69. There are downsides to this approach. Where an entity with negative EBITDA is located in the country where the group ratio rule is being applied, it should be relatively easy for entities in the country to make the necessary adjustments to the calculation of group-EBITDA and for these to be audited by the tax authority. However, where the entity with negative EBITDA is in a different country, this would be more difficult. In effect, this approach could oblige a multinational group to have systems in place to calculate entity-EBITDA each year for every entity in the worldwide group, including those in countries which do not apply the group ratio rule, in order to ensure that any with negative EBITDA can be identified. This could impose a significant additional burden on groups. From the perspective of a tax authority, it would also be very difficult for tax auditors to confirm whether a group has any such entities and to ensure that losses have been correctly removed from group-EBITDA. This information is not typically contained in a group's consolidated financial statements, and so tax auditors would need to rely on information provided by the entity applying the rule or obtained from foreign tax authorities. In addition, although this approach should be effective in addressing the impact of entities with negative EBITDA on the operation of the group ratio rule, it would not deal with the impact of entities with a very low positive EBITDA, which could also potentially inflate a group's ratio to very high levels. It is suggested that a country carefully considers these issues before adopting this approach.

Restricting the interest capacity of entities with positive EBITDA

70. Irrespective of whether a country includes the results of entities with negative EBITDA in the calculation of group-EBITDA, it should consider placing an upper limit on the amount of net interest expense that an entity can deduct under the group ratio rule by -

- capping a group's net third party interest expense/EBITDA ratio to a set percentage which is higher than the benchmark fixed ratio but which is no more than 100%
- limiting an entity's interest capacity to an amount equal to the group's net third party interest expense (after applying an uplift of up to 10%, where permitted).

71. The group ratio rule allows an entity in a highly leveraged group to claim net interest deductions based on the net third party interest expense/EBITDA ratio of its worldwide group. However, where a group includes entities with negative EBITDA, the group's ratio may be inflated to levels that may not be sustainable on an ongoing basis. It is therefore suggested that a country should consider imposing a cap on a group's ratio so that an entity's interest capacity cannot exceed a set percentage of EBITDA.

72. In order for the group ratio rule to operate as intended, this cap should be set at a level which is higher than the benchmark ratio under the fixed ratio rule. However, it is suggested that this should not exceed 100%. In setting a cap, a country may choose to take into account available data on the proportion of groups which would in principle be able to deduct all of their net third party interest expense if the cap was set at different levels, including data contained in Annex B of the Action 4 Report. Other considerations may also be relevant and may be taken into account in setting a cap. Where the presence of loss-making entities means that a group's net third party interest expense/EBITDA ratio is very high, group entities with positive EBITDA would be able to apply the group ratio rule subject to this cap, while any net interest expense in excess of the cap would be carried forward, if permitted under a country's rules. Entities with negative EBITDA in the group would also carry forward their disallowed interest expense, if permitted. This is illustrated by Example 20 in Annex 2.

73. In addition to placing a cap on a group's ratio, it is suggested that an entity's interest capacity should be restricted so that it cannot exceed the total net third party interest expense of the group as a whole. This is illustrated by Example 19 in Annex 2. In certain circumstances this would still allow more than one entity in a group to claim net interest deductions up to the full amount of the group's net third party interest expense. However, in some groups one entity could carry on all of the group's economic activity (e.g. where a group comprises a holding company and a single operating entity). In order to ensure that such an entity does not incur an undue restriction on its net interest deductions, it is not suggested that a country impose a monetary limit below this level.

74. An illustration of these limitations operating together is included as Example 21 in Annex 2. Where a country imposes these limits, they should be applied to all entities making use of the group ratio rule and not only to those in groups which include entities with negative EBITDA. This simplifies the operation of the group ratio rule by imposing clear limits on an entity's interest capacity without the need to determine whether or not a group contains any entities with negative EBITDA. This should protect countries from the worst impact of entities with losses or very low profits in a group with positive group-EBITDA, while not being overly complicated or excessively restricting net interest deductions for entities with positive EBITDA.

Question for consultation

11. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

12. If a country does introduce a cap on a group's net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

The treatment of entities where a group has zero or negative group-EBITDA

75. In some cases, losses in group entities will be so significant that the group as a whole has a zero or negative group-EBITDA. In this scenario, the group ratio rule cannot be applied as it is not possible to calculate a meaningful net third party interest expense/EBITDA ratio. However, there may still be profitable entities within the group making a positive contribution to group-EBITDA.

76. In designing a group ratio rule, a country may decide that this is the correct outcome from the operation of a rule. An entity with positive EBITDA in a loss-making group may still apply the fixed ratio rule and deduct net interest expense up to the benchmark fixed ratio. The downside to this approach is that it creates a cliff-edge effect where a group moves from having a very low group-EBITDA to having a zero or negative group-EBITDA. Where an entity with positive EBITDA is in a group with a low group-EBITDA it would be able to deduct net interest expense up to the group ratio, subject to a possible cap on the group ratio and an upper limit equal to the group's net third party interest expense. However, if losses elsewhere in the group meant that the group moved to having zero or negative group-EBITDA, the same entity would be unable to apply the group ratio rule and would have to rely on the fixed ratio rule to obtain relief. This could lead to lengthy discussions between an entity and a tax authority in cases where group-EBITDA is close to zero, as the impact of having group-EBITDA of zero rather than just above zero could be significant. It could also have a distortive impact on a group's behaviour as it seeks to avoid a zero or negative group-EBITDA, placing additional pressure on statutory auditors. If a country wishes to address this issue, it may do so in a number of different ways. Possible options include excluding entities with negative EBITDA from the calculation of group-EBITDA and/or restricting the interest capacity of entities with positive EBITDA.

77. Where a country excludes the earnings of entities with negative EBITDA from group-EBITDA, this would enable a group's net third party interest expense/EBITDA to be calculated and the group's net third party interest expense to be allocated among profitable entities in the group. This approach would remove the cliff-edge effect where a group moves from positive group-EBITDA to zero or negative-EBITDA, and would ensure that a group with negative group EBITDA would still be able to deduct an amount equivalent to its actual net interest expense. However, as noted earlier, there are a number of practical issues that would need to be taken into account by a country in adopting such an approach.

78. A country should also consider allowing an entity with positive EBITDA in a group with negative group-EBITDA to utilise interest capacity up to the lower of the entity's actual net interest expense, the group's net third party interest expense and a set percentage of entity-EBITDA. In this case, it is suggested that the set percentage of entity-EBITDA should be the same as the cap on the group ratio described above (i.e. it should be higher than the benchmark fixed ratio under the fixed ratio rule, but should not exceed 100%). This approach is illustrated by Example 22 in Annex 2.

79. In terms of the ability of an entity with positive EBITDA to deduct net interest expense in the current period, the outcome would be consistent with that from the approach set out above with respect to entities in a group with positive group-EBITDA. This removes the cliff-edge effect described above, where an entity in a group with negative group-EBITDA is required to apply the fixed ratio rule, and so would reduce pressure on groups and tax authorities. On the other hand, where a group has negative group-EBITDA, this approach would prevent an entity which has deducted all of its net interest expense in the current period from carrying forward unused interest capacity, even where this would generally be permitted. This is to prevent entities in loss-making groups accumulating potentially large carry forwards of unused interest capacity which could be monetised in future periods by increasing the level of net interest expense or reducing the level of taxable income in an entity. Alternatively, this risk for all groups could be addressed by limiting the carry forward of unused interest capacity to amounts arising under the fixed ratio rule.

Questions for consultation

13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

14. Do you have any other comments on any of the issues covered by this discussion draft?

ANNEX 1 – SUMMARY OF QUESTIONS FOR PUBLIC CONSULTATION

Calculation of net third party interest expense

1. Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

2. What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest expense?

3. It is important that a country's tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

4. Are there any areas where a country's tax policy goals should be taken into account in determining net third party interest expense which are not set out in the discussion draft?

5. Are there any other circumstances where a group's net third party interest expense should be adjusted to include the group's share of the net third party interest of an entity outside the group?

Definition of group-EBITDA

6. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

7. Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for depreciation and amortisation in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

8. Are there any practical issues raised by including all divided income in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

9. Are there any practical issues raised by including a group's share of the earnings of equity accounted associates and JVEs in group-EBITDA? If so, what are these issues and how could they be addressed by a country?

10. Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group-EBITDA? If so, what are these issues and how could they be addressed by a country?

The impact of losses on the operation of the group ratio rule

11. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

12. If a country does introduce a cap on a group's net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtained?

13. Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so, what are they?

14. Do you have any other comments on any of the issues covered by this discussion draft?

ANNEX 2 – EXAMPLES

Example 1 – Applying an uplift to net third party interest expense

	A Co USD	B Co USD	Group USD
EBITDA	60 million	200 million	260 million
Net interest	(10 million)	(55 million)	(65 million)
Group net third party interest expense/EBITDA ratio	-	-	25%
Interest capacity	15 million	50 million	-
Deductible interest expense	(10 million)	(50 million)	-
Disallowed interest expense	-	(5 million)	-
Unused interest capacity	5 million	-	-

80. In the table above, a group consists of two entities: A Co and B Co. A Co has EBITDA of USD 60 million and net interest expense of USD 10 million. B Co has EBITDA of USD 200 million and net interest expense of USD 55 million. The group has total EBITDA of USD 260 million and net interest expense of USD 65 million. The group's total net third party interest expense/EBITDA ratio is 25%.

81. A Co has interest capacity of USD 15 million. It can deduct all of its net interest expense of USD 10 million and has unused interest capacity of USD 5 million. B Co has interest capacity of USD 50 million. It can deduct net interest expense of USD 50 million, and incurs an interest disallowance of USD 5 million. This disallowance arises because the net interest expense in the two entities is not precisely aligned with where EBITDA is earned. If the two entities are in the same country, a rule could allow the interest disallowance in B Co to be set against the unused interest capacity in A Co. However, this would not be possible if the entities are in different countries.

	A Co USD	B Co USD	Group USD
EBITDA	60 million	200 million	260 million
Net interest	(10 million)	(55 million)	(65 million)
Net third party interest expense (after uplift)	-	-	(71.5 million)
Group net third party interest expense/EBITDA ratio	-	-	27.5%
Interest capacity	16.5 million	55 million	-
Deductible interest expense	(10 million)	(55 million)	-
Disallowed interest expense	-	-	-
Unused interest capacity	6.5 million	-	-

82. The table above concerns the same group, but in this case the countries where the entities are located allow an uplift to net third party interest expense of 10%. Therefore, the group now has net third party interest expense of USD 71.5 million (i.e. USD 65 million x 110%) and a net third party interest expense/EBITDA ratio of 27.5%.

83. B Co is now able to deduct all of its net interest expense of USD 55 million with no interest disallowance. The application of the uplift to net third party interest expense has reduced the impact on the group of net interest expense not being fully aligned with the location of EBITDA.

84. On the other hand, unused interest capacity in A Co has increased from USD 5 million to USD 6.5 million. To the extent this unused interest capacity can be carried forward, this may create a greater incentive in the future for A Co to take on more debt to the point where its net interest expense/EBITDA ratio is higher than that of the group as a whole.

Example 2 – Excluding non-deductible payments from net third party interest expense

	A Co USD	B Co USD	Group USD
EBITDA	100 million	100 million	200 million
Fixed rate preference dividends	(25 million)	(15 million)	(40 million)
Other net interest expense	(20 million)	(30 million)	(50 million)
Net interest expense (consolidated financial statements)			(90 million)
Group net third party interest	(90 million)	(50 million)	
Group net third party interest expense/EBITDA ratio	45%	25%	-
Interest capacity	45 million	25 million	-
Deductible interest expense	(45 million)	(25 million)	-
Disallowed interest expense	-	(5 million)	-
Unused interest capacity	-	-	-

85. In the table above, a group consists of two entities: A Co and B Co. A Co has EBITDA of USD 100 million and a net interest expense of USD 20 million. A Co also pays dividends on fixed rate preference shares of USD 25 million. B Co has EBITDA of USD 100 million and net interest expense of USD 30 million. B Co also pays dividends on fixed rate preference shares of USD 15 million. The group has total EBITDA of USD 200 million. In the group's consolidated financial statements, fixed rate preference share dividends are treated as an interest expense and so the group has a total net interest expense of USD 90 million.

86. A Co is resident in Country A, which allows a tax deduction for dividends on fixed rate preference shares as interest. Based on the total net third party interest expense in the group's consolidated financial statements of USD 90 million, the group has a net third party interest expense/EBITDA ratio of 45%. A Co therefore has interest capacity of USD 45 million. This means that all of A Co's net interest expense and fixed rate preference share dividends are deductible with no disallowance.

87. B Co is resident in Country B, which does not allow a tax deduction for dividends on fixed rate preference shares. Country B takes the view that, as these payments are not tax deductible if paid by a resident entity, they also should not be able to be used by group to increase the level of a resident entity's interest capacity. Therefore, in applying the group ratio rule, B Co must deduct the group's fixed rate preference share dividends from net third party interest expense. The group now has net third party interest expense of USD 50 million and a net third party interest expense/EBITDA ratio of 25%. Out of B Co's total net interest expense of USD 30 million, USD 25 million is deductible and USD 5 million is disallowed.

Example 3 – Excluding net related party interest expense from net third party interest expense

	A Co USD	B Co USD	Group USD
EBITDA	100 million	100 million	200 million
Net interest expense paid to related parties	-	-	-
Other net interest expense	(25 million)	(25 million)	(50 million)
Net interest expense (consolidated financial statements)	-	-	(50 million)
Group net third party interest expense/EBITDA ratio			25%
Interest capacity	25 million	25 million	-
Deductible interest expense	(25 million)	(25 million)	-
Disallowed interest expense	-	-	-
Unused interest capacity	-	-	-

88. In the table above, a group consists of two entities: A Co and B Co. A Co and B Co each have EBITDA of USD 100 million and net interest expense paid to third parties of USD 25 million. The group has total EBITDA of USD 200 million and total net third party interest expense of USD 50 million, with a net third party interest expense/EBITDA ratio of 25%. Under the group ratio rule, A Co and B Co would each be able to deduct all of their net interest expense of USD 25 million with no disallowance.

	A Co USD	B Co USD	Group USD
EBITDA	100 million	100 million	200 million
Net interest expense paid to related parties	(50 million)	(50 million)	(100 million)
Other net interest expense	(25 million)	(25 million)	(50 million)
Net interest expense (consolidated financial statements)	-	-	(150 million)
Group net third party interest expense/EBITDA ratio	75%	25%	-
Interest capacity	75 million	25 million	-
Deductible interest expense	(75 million)	(25 million)	-
Disallowed interest expense	-	(50 million)	-
Unused interest capacity	-	-	-

89. In the table above, the group has been acquired by investors who have replaced part of the group's equity with shareholder debt. A Co and B Co now each have an additional net interest expense payable to related parties of USD 50 million. The group's consolidated financial statements now show a total net interest expense of USD 150 million.

90. A Co is resident in Country A. Under the group ratio rule in Country A, A Co calculates the group net third party interest expense/EBITDA ratio using a figure for net third party interest expense which includes net interest expense to related parties. This gives a group ratio of 75%. A Co has net interest expense of USD 75 million, and in principle is able to deduct all of this net interest expense without limitation. As set out in the Action 4 Report, Country A should introduce rules to prevent related party debt being used to increase net third party interest expense, which may apply in this case.

91. B Co is resident in Country B. Under the group ratio rule in Country B, B Co calculates the group net third party interest expense/EBITDA ratio using a figure for net third party interest expense which excludes net interest expense to related parties. This gives a group ratio of 25%. Out of its total net interest expense of USD 75 million, B Co is able to deduct USD 25 million and incurs an interest disallowance of USD 50 million.

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	100 million	200 million	400 million
Net interest expense paid to related parties	-	-	(200 million)	(200 million)
Other net interest expense	(50 million)	(50 million)	-	(100 million)
Net interest expense (consolidated financial statements)	-	-	-	(300 million)
Group net third party interest expense/EBITDA ratio	75%	25%	25%	-
Interest capacity	75 million	25 million	50 million	-
Deductible interest expense	(50 million)	(25 million)	(50 million)	-
Disallowed interest expense	-	(25 million)	(150 million)	-
Unused interest capacity	25 million	-	-	-

92. The table above shows a different group including three entities: A Co, B Co and C Co. A Co and B Co each have EBITDA of USD 100 million and net interest expense paid to third parties of USD 50 million). C Co has EBITDA of USD 200 million and net interest expense paid to related parties of USD 200 million.

93. A Co is resident in Country A, which includes related party interest in the definition of net third party interest expense. Therefore under the group ratio rule in Country A, because of the high level of related party interest in C Co, the group's net third party interest expense/EBITDA ratio is 300 million/400 million or 75%. A Co therefore has interest capacity of USD 75 million. It is able to deduct all of its net interest expense of USD 50 million with unused interest capacity of USD 25 million.

94. B Co is resident in Country B, which does not include related party interest in the calculation of net third party interest expense. Under the group ratio rule in Country B, the group's net third party interest expense/EBITDA ratio is 100 million/400 million or 25%. B Co therefore has interest capacity of USD 25 million. It is able to deduct net interest expense of USD 25 million and incurs an interest disallowance of USD 25 million.

95. C Co is resident in Country C, which does not include related party interest in the definition of net third party interest expense. Under the group ratio rule in Country B, the group's net third party interest expense/EBITDA ratio is 100 million/400 million or 25%. C Co therefore has interest capacity of USD 50 million. Out of C Co's total net related party interest expense of USD 200 million, USD 50 million is deductible and USD 150 million is disallowed.

Example 4 – Excluding an uplift to net third party interest expense from the adjustment for interest income and expense when calculating group-EBITDA

	A Co USD	B Co USD	Group USD
Net profit (before adding back net interest expense)	50 million	145 million	195 million
EBITDA	60 million	200 million	-
Net interest	(10 million)	(55 million)	(65 million)
Net third party interest expense (after uplift)	-	-	(71.5 million)
	Scenario 1 B Co USD	Scenario 2 B Co USD	
Group net profit (before adding back net interest expense)	195 million	195 million	
Group Net interest	(65 million)	(71.5 million)	
Group EBITDA	260 million	266.5 million	
Group net third party interest expense/EBITDA ratio	27.5%	26.8%	
Interest capacity	55 million	53.7 million	
Deductible interest expense	(55 million)	(53.7 million)	
Disallowed interest expense	-	(1.3 million)	
Unused interest capacity	-	-	

96. This example is based on the same fact pattern as in Example 1, but focuses on the treatment of B Co in Country B. Country B has adopted a policy that in calculating a group's net third party interest expense/EBITDA ratio, the group's net third party interest expense may be subject to an uplift of 10%. Therefore, while the group has an actual net third party interest expense of USD 65 million, for the purposes of calculating the group's ratio, this is increased to USD 71.5 million.

97. In Scenario 1, group-EBITDA of USD 260 million is calculated on the basis that the adjustment for interest income and expense does not include the uplift of 10%. This was the approach taken in Example 1. This gives rise to a group net third party interest expense/EBITDA ratio of 27.5%. As shown in Example 1, this increases B Co's interest capacity by 10%, from USD 50 million to USD 55 million. B Co is therefore able to deduct all of its net interest expense with no interest disallowance.

98. In Scenario 2, group-EBITDA has been re-calculated on the basis that the adjustment for interest income and expense includes the uplift of 10%. Therefore, group-EBITDA is increased by USD 6.5 million to USD 266.5 million. This gives rise to a net third party interest expense/EBITDA ratio of 26.8%, which is lower than that in Scenario 1. B Co now has interest capacity of USD 53.7 million and incurs an interest disallowance of USD 1.3 million.

99. It is suggested that the approach in Scenario 2 does not achieve the intended policy goal of Country B. Although Country B has adopted a policy that a group's net third party interest expense should be subject to an uplift of 10%, the increase in the group's net third party interest expense/EBITDA ratio is just 7.2%. This is because the 10% uplift has also been applied to the adjustment for interest income and expense in calculating group-EBITDA. Therefore as set out in this discussion draft, it is proposed that where a country allows an uplift of up to 10% to be applied to a group's net third party interest expense, this uplift should not be applied to the adjustment for interest income and expense in calculating group-EBITDA.

Example 5 – Including non-deductible payments in the adjustment for interest income and expense when calculating group-EBITDA

	A Co USD	B Co USD	Group USD
EBITDA	100 million	100 million	200 million
Fixed rate preference dividends	(25 million)	(15 million)	(40 million)
Other net interest expense	(20 million)	(30 million)	(50 million)
Net interest expense (consolidated financial statements)			(90 million)
Group net third party interest	(90 million)	(50 million)	
	Scenario 1 B Co USD	Scenario 2 B Co USD	
Group EBITDA	200 million	160 million	
Group net third party interest expense/EBITDA ratio	25%	31.25%	-
Interest capacity	25 million	31.25 million	-
Deductible interest expense	(25 million)	(30 million)	-
Disallowed interest expense	(5 million)	-	-
Unused interest capacity	-	1.25 million	-

100. This example is based on the same fact pattern as in Example 2, but focuses on the treatment of B Co in Country B. Country B has adopted a policy that dividends paid on fixed rate preference shares, which are not tax deductible in the country, should not be used to increase an entity's interest capacity under the group ratio rule. In applying the group ratio rule, B Co is required to exclude fixed rate preference dividends from the group's net third party interest expense. Therefore, the group has net third party interest expense of USD 50 million.

101. In Scenario 1, group-EBITDA of USD 200 million is calculated on the basis that the adjustment for interest income and expense still includes the fixed rate preference dividends paid by the group. This was the approach taken in Example 2. This gives rise to a group net third party interest expense/EBITDA ratio of 25%. Out of its total net interest expense of USD 30 million, USD 25 million is tax deductible and USD 5 million is disallowed. This approach reflects the fact that in economic terms, the group has incurred net interest payments of USD 90 million (including fixed rate preference dividends that are economically equivalent to interest). However, USD 40 million of this is paid in a form that would not be tax deductible in Country B.

102. In Scenario 2, group-EBITDA has been re-calculated on the basis that the adjustment for interest income and expense does not include fixed rate preference dividends paid by the group. Therefore, group-EBITDA is reduced by USD 40 million to USD 160 million. This gives rise to an increased net third party interest expense/EBITDA ratio of 31.25%. B Co may now deduct all of its net interest expense and also has unused interest capacity of USD 1.25 million.

103. It is suggested that the approach in Scenario 2 does not achieve the intended policy goal of Country B, as the calculation of group-EBITDA does not recognise the full extent to which the group is debt funded in economic terms, albeit that part of this is in a form that Country B does not treat as debt for tax purposes. Therefore as set out in this discussion draft, it is proposed that payments which are interest or economically equivalent to interest should still be included in the adjustment for interest income and expense in calculating group-EBITDA, even if for policy reasons a country chooses to exclude them from net third party interest expense.

Example 6 – Including net interest paid to related parties in the adjustment for interest income and expense when calculating group-EBITDA

	A Co USD	B Co USD	Group USD
EBITDA	100 million	100 million	200 million
Net interest expense paid to related parties	(50 million)	(50 million)	(100 million)
Other net interest expense	(25 million)	(25 million)	(50 million)
Net interest expense (consolidated financial statements)			(150 million)
Group net third party interest	(150 million)	(50 million)	
	Scenario 1 B Co USD	Scenario 2 B Co USD	
Group EBITDA	200 million	100 million	
Group net third party interest expense/EBITDA ratio	25%	50%	-
Interest capacity	25 million	50 million	-
Deductible interest expense	(25 million)	(50 million)	-
Disallowed interest expense	(50 million)	(25 million)	-
Unused interest capacity	-	-	-

104. This example is based on the same fact pattern as in Example 4, but focuses on the treatment of B Co in Country B. Country B has adopted a policy that net interest expense paid to related parties should not be used to increase an entity's interest capacity under the group ratio rule. In applying the group ratio rule, B Co is required to exclude net interest paid to related parties from the group's net third party interest expense. Therefore, the group has net third party interest expense of USD 50 million.

105. In Scenario 1, group-EBITDA of USD 200 million is calculated on the basis that the adjustment for interest income and expense still includes the net related party interest paid by the group. This was the approach taken in Example 4. This gives rise to a group net third party interest expense/EBITDA ratio of 25%. Out of its total net interest expense of USD 75 million, USD 25 million is tax deductible and USD 50 million is disallowed. This approach reflects the fact that in economic terms, the group has incurred net interest payments of USD 150 million (including net payments to related parties). However, USD 100 million of this is related party interest which Country B believes should not be taken into account to increase the interest capacity of entities.

106. In Scenario 2, group-EBITDA has been re-calculated on the basis that the adjustment for interest income and expense does not include net related party interest paid by the group. Therefore, group-EBITDA is reduced by USD 100 million to USD 100 million. This gives rise to an increased

net third party interest expense/EBITDA ratio of 50%. B Co may now deduct net interest expense of USD 50 million with a reduced disallowance of USD 25 million.

107. It is suggested that the approach in Scenario 2 does not achieve the intended policy goal of Country B, as the calculation of group-EBITDA does not recognise the full extent to which the group is debt funded, albeit that part of this is with related party debt. Therefore as set out in this discussion draft, it is proposed that net interest paid to related parties should still be included in the adjustment for interest income and expense in calculating group-EBITDA, even if for policy reasons a country chooses to exclude these payments from net third party interest expense.

Example 7 – Including fair value adjustments in the calculation of group-EBITDA

	Period 1			Period 2		
	A Co USD	B Co USD	Group USD	A Co USD	B Co USD	Group USD
Fair value gain/(loss) on swap	40 million	-	40 million	(40 million)	-	(40 million)
Taxable EBITDA	100 million	100 million	200 million	100 million	100 million	200 million
EBITDA	140 million	100 million	240 million	60 million	100 million	160 million
Interest expense on loans	(15 million)	(25 million)	(40 million)	(35 million)	(25 million)	(60 million)
Notional interest on swap	(10 million)	-	(10 million)	10 million	-	10 million
Net third party interest expense	(25 million)	(25 million)	(50 million)	(25 million)	(25 million)	(50 million)
Group net third party interest expense/EBITDA ratio	-	-	20.8%	-	-	31.25%
Taxable entity-EBITDA	100 million	100 million	-	100 million	100 million	-
Interest capacity	20.8 million	20.8 million	-	31.25 million	31.25 million	-
Deductible interest expense	(20.8 million)	(20.8 million)	-	(25 million)	(25 million)	-
Disallowed interest expense	(4.2 million)	(4.2 million)	-	-	-	-
Unused interest capacity	-	-	-	6.25 million	6.25 million	-

108. The table above shows the position of a group which consists of two entities: A Co (resident in Country A) and B Co (resident in Country B). A Co raises third party borrowing to fund the acquisition of assets which give rise to a fixed income stream. Under the loan, A Co incurs interest expense based on a floating interest rate. Interest rates in Country A are currently volatile and, as the loan is funding a fixed level of income, A Co enters into an interest rate swap with a third party bank, to swap this floating interest expense into a fixed interest expense. The swap is not a designated hedge of the loan for financial reporting purposes, and fair value movements on the swap are taken through A Co's income statement. Country A and Country B include fair value movements on financial instruments within group-EBITDA in applying the group ratio rule.

109. In period 1, A Co has taxable EBITDA of USD 100 million and a fair value gain on the swap of USD 40 million. A Co incurs an interest expense of USD 15 million on the floating rate loan and has a notional interest expense of USD 10 million on the swap, giving a total net interest expense of USD 25 million. B Co has taxable EBITDA of 100 million and a net interest expense of USD 25 million.

110. In period 2, A Co has taxable EBITDA of USD 100 million and a fair value loss on the swap of USD 40 million. A Co incurs an interest expense of USD 35 million on the floating rate loan and has notional interest income of USD 10 million on the swap, giving a total net interest expense of USD 25 million. B Co has taxable EBITDA of 100 million and a net interest expense of USD 25 million.

111. Because Country A and Country B include the fair value movements on the swap within group-EBITDA, the group has a net third party interest expense/EBITDA ratio of 20.8% in period 1 and 31.25% in period 2. This means that in period 1, A Co and B Co each incur an interest disallowance of USD 4.2 million, and in period 2 they have unused interest capacity of USD 6.25 million. To the extent Country A and Country B allow the carry forward and/or carry back of disallowed interest expense and/or unused interest capacity, the impact of these fluctuations may be reduced. However, this may not always provide groups with full relief, and even where all net interest expense can be claimed over the life of a loan, there could still be a serious cash flow impact for groups. Because fair value gains and losses on the swap should net to nil over the life of the instrument, a country may decide to address this volatility by excluding fair value gains and losses from group-EBITDA, where these arise on financial instruments which are directly linked to the group's debt funding. The impact of this is illustrated below.

	Period 1			Period 2		
	A Co USD	B Co USD	Group USD	A Co USD	B Co USD	Group USD
Fair value gain/(loss) on swap	40 million	-	40 million	(40 million)	-	(40 million)
Taxable EBITDA	100 million	100 million	200 million	100 million	100 million	200 million
Remove fair value movements on swap	(40 million)		(40 million)	40 million		40 million
EBITDA	100 million	100 million	200 million	100 million	100 million	200 million
Interest expense on loans	(15 million)	(25 million)	(40 million)	(35 million)	(25 million)	(60 million)
Notional interest on swap	(10 million)	-	(10 million)	10 million	-	10 million
Net third party interest expense	(25 million)	(25 million)	(50 million)	(25 million)	(25 million)	(50 million)
Group net third party interest expense/EBITDA ratio	-	-	25%	-	-	25%
Taxable entity-EBITDA	100 million	100 million	-	100 million	100 million	-
Interest capacity	25 million	25 million	-	25 million	25 million	-
Deductible interest expense	(25 million)	(25 million)	-	(25 million)	(25 million)	-
Disallowed interest expense	-	-	-	-	-	-
Unused interest capacity	-	-	-	-	-	-

112. The table above is based on the same facts as before, but in this case Country A and Country B exclude the fair value gains and losses on the swap from group-EBITDA. The impact of this is that the group has a net third party interest expense/EBITDA ratio of 25% in both period 1 and period 2. Therefore, A Co and B Co are able to deduct all of their net interest expense with no disallowance and no unused interest capacity.

Example 8 – Including dividend income in group-EBITDA (taxable dividends)

	A Co USD	B Co USD	Group USD
Dividend income	50 million	-	50 million
Other taxable EBITDA	50 million	100 million	150 million
EBITDA	100 million	100 million	200 million
Net interest expense	(25 million)	(25 million)	(50 million)
Group net third party interest expense/EBITDA ratio			25%
Taxable entity-EBITDA	100 million	100 million	
Interest capacity	25 million	25 million	-
Deductible interest expense	(25 million)	(25 million)	-
Disallowed interest expense	-	-	-
Unused interest capacity	-	-	-

113. In the table above, a group consists of two entities: A Co (resident in Country A) and B Co (resident in Country B). A Co receives dividend income of USD 50 million from entities outside the group. This dividend income does not qualify for the participation exemption in Country A and is subject to tax. The A Co also has other EBITDA of USD 50 million, all of which is subject to tax. B Co has EBITDA of USD 100 million which is fully taxable. Both A Co and B Co have net third party interest expense of USD 25 million. Country A and Country B both include dividend income within Group-EBITDA. Therefore the group has net third party interest expense of USD 50 million and group-EBITDA of USD 200 million, giving a group net third party interest expense/EBITDA ratio of 25%.

114. Under the group ratio rule, A Co and B Co would both apply the group's net third party interest expense/EBITDA ratio of 25% to their taxable EBITDA of USD 100 million. This would give both A Co and B Co interest capacity of USD 25 million. The two entities are able to deduct all of their net interest expense with no disallowance and no unused interest capacity.

Example 9 – Including dividend income in group-EBITDA (tax-exempt dividends)

	A Co USD	B Co USD	Group USD
Dividend income	50 million	-	50 million
Taxable EBITDA	50 million	100 million	150 million
EBITDA	100 million	100 million	200 million
Net interest expense	(25 million)	(25 million)	(50 million)
Group net third party interest expense/EBITDA ratio			25%
Taxable entity-EBITDA	50 million	100 million	
Interest capacity	12.5 million	25 million	-
Deductible interest expense	(12.5 million)	(25 million)	-
Disallowed interest expense	(12.5 million)	-	-
Unused interest capacity	-	-	-

115. In the table above, a group consists of two entities: A Co (resident in Country A) and B Co (resident in Country B). A Co receives dividend income of USD 50 million from entities outside the group. This dividend income qualifies for the participation exemption in Country A and is exempt from tax. A Co also has other EBITDA of USD 50 million, all of which is subject to tax. B Co has EBITDA of USD 100 million which is fully taxable. Both A Co and B Co have net third party interest expense of USD 25 million. Country A and Country B both include dividend income within Group-EBITDA. Therefore the group has net third party interest expense of USD 50 million and group-EBITDA of USD 200 million, giving a group net third party interest expense/EBITDA ratio of 25%.

116. Under the group ratio rule, A Co applies the group ratio of 25% to its taxable EBITDA of USD 50 million to give interest capacity of USD 12.5 million. A Co may therefore deduct net interest expense of USD 12.5 million and incurs an interest disallowance of USD 12.5 million. As 50% of A Co’s net income is subject to tax, it is appropriate that 50% of its net interest expense should be deductible. The net interest expense which is disallowed corresponds to the proportion of the expense that in economic terms is funding tax-exempt dividend income.

117. B Co applies the group’s net third party interest expense/EBITDA ratio of 25% to its taxable EBITDA of USD 100 million to give interest capacity of USD 25 million. As in Example 8, B Co is able to deduct all of its net interest expense with no unused interest capacity.

118. Taking the results of Example 8 and Example 9 together, these show that the inclusion of dividend income in group-EBITDA should ensure the correct result in cases where dividend income is taxable and also in cases where dividend income is tax-exempt. In cases where some or all of a group’s dividend income is tax-exempt, an appropriate response is for a proportionate share of the group’s net third party interest expense to be restricted, in line with the goals set out in the BEPS Action Plan.

Example 10 – Removing dividend income from group-EBITDA (tax-exempt dividends)

	A Co USD	B Co USD	Group USD
Dividend income	50 million	-	50 million
Taxable EBITDA	50 million	100 million	150 million
Remove dividends from group-EBITDA	(50 million)		(50 million)
EBITDA	50 million	100 million	150 million
Net interest expense	(25 million)	(25 million)	(50 million)
Group net third party interest expense/EBITDA ratio			33.3%
Taxable entity-EBITDA	50 million	100 million	
Interest capacity	16.7 million	33.3 million	-
Deductible interest expense	(16.7 million)	(25 million)	-
Disallowed interest expense	(8.3 million)	-	-
Unused interest capacity	-	8.3 million	-

119. This example is based on the same facts as in Example 9. However, in this case Country A and Country B both require groups to remove dividends received from outside the group in calculating group-EBITDA. Therefore, for the purposes of applying the group ratio rule, the group now has net third party interest expense of USD 50 million and group-EBITDA of USD 150 million, giving a group net third party interest expense/EBITDA ratio of 33.3%.

120. Under the group ratio rule, A Co applies the group ratio of 33.3% to its taxable EBITDA of USD 50 million to give interest capacity of USD 16.7 million. A Co may deduct net interest expense of USD 16.7 million and incurs a disallowance of USD 8.3 million. This means that, although only 50% of A Co's net income is subject to tax, it can deduct 67% of its net interest expense. Compared with the position in Example 9, USD 4.2 million of A Co's net interest expense, which in economic terms is funding its tax-exempt dividend income, may be used to shelter the tax on its other taxable income.

121. B Co applies the group's net third party interest expense/EBITDA ratio of 33.3% to its taxable EBITDA of USD 100 million to give interest capacity of USD 33.3 million. B Co is able to deduct all of its net interest expense and has unused interest capacity of USD 8.3 million. Compared with the position in Example 9 (in which B Co could deduct all its net interest expense but did not have unused interest capacity), B Co may now be incentivised to increase its level of net interest deductions to utilise this interest capacity and reduce the amount of income subject to tax in Country B.

Example 11 – Removing dividend income from group-EBITDA (taxable dividends)

	A Co USD	B Co USD	Group USD
Dividend income	50 million	-	50 million
Other taxable EBITDA	50 million	100 million	150 million
Remove dividends from group-EBITDA	(50 million)		(50 million)
EBITDA	50 million	100 million	150 million
Net interest expense	(25 million)	(25 million)	(50 million)
Group net third party interest expense/EBITDA ratio			33.3%
Taxable entity-EBITDA	100 million	100 million	
Interest capacity	33.3 million	33.3 million	-
Deductible interest expense	(25 million)	(25 million)	-
Disallowed interest expense	-	-	-
Unused interest capacity	8.3 million	8.3 million	-

122. This example is based on the same facts as in Example 8. However, in this case Country A and Country B both require groups to remove dividends received from outside the group in calculating group-EBITDA. Therefore, for the purposes of applying the group ratio rule, the group now has net third party interest expense of USD 50 million and group-EBITDA of USD 150 million, giving a group net third party interest expense/EBITDA ratio of 33.3%.

123. Under the group ratio rule, A Co and B Co both apply the group's net third party interest expense/EBITDA ratio of 33.3% to their taxable EBITDA of USD 100 million. This would give both entities an interest capacity of USD 33.3 million. Taken together, the companies have total interest capacity of USD 66.6 million, which is higher than the actual net third party interest expense of the group. A Co and B Co are both able to deduct all of their net interest expense, but each now has unused interest capacity of USD 8.3 million.

124. Therefore, where a group has taxable dividend income, excluding dividend income from group-EBITDA could result in group entities being able to claim net interest deductions in excess of the actual net third party interest expense of the entire group.

Example 12 – Including the share of profit of an equity accounted entity within group-EBITDA (taxable dividends)

	A Co USD	B Co USD	Consolidation adjustments	Group USD
Share of profit of JVE	-	-	50 million	50 million
Dividend income	50 million	-	(50 million)	-
Other taxable EBITDA	50 million	100 million	-	150 million
EBITDA	100 million	100 million		200 million
Net interest expense	(25 million)	(25 million)	-	(50 million)
Group net third party interest expense/EBITDA ratio			-	25%
Taxable entity-EBITDA	100 million	100 million	-	
Interest capacity	25 million	25 million	-	-
Deductible interest expense	(25 million)	(25 million)	-	-
Disallowed interest expense	-	-	-	-
Unused interest capacity	-	-	-	-

125. In the table above, a group consists of two entities: A Co (resident in Country A) and B Co (resident in Country B). A Co has a 50% holding in a JVE which distributes all of its net profit as a dividend. Country A does not apply a participation exemption and taxes dividend income with credit for underlying tax. However, as a result of a tax preference in the country where it operates, the JVE does not pay any tax. Therefore A Co is fully taxable on its dividend income. A Co also has other EBITDA of USD 50 million, all of which is subject to tax. B Co has EBITDA of USD 100 million which is fully taxable. Both A Co and B Co have net third party interest expense of USD 25 million.

126. Under equity accounting rules, the group recognises a 50% share of the profits of the joint venture entity in its consolidated income statement, but does not recognise the dividend income received by A Co (as to include both a share of the joint venture entity's profits and dividends received from the entity would be double counting). Country A and Country B both include the group's share of the joint venture entity's profit within Group-EBITDA. Therefore the group has net third party interest expense of USD 50 million and group-EBITDA of USD 200 million, giving a group net third party interest expense/EBITDA ratio of 25%.

127. Under the group ratio rule, A Co and B Co both apply the group's net third party interest expense/EBITDA ratio of 25% to their taxable EBITDA of USD 100 million. This would give both A Co and B Co interest capacity of USD 25 million. They are able to deduct all of their net interest expense with no disallowance and no unused interest capacity.

Example 13 - Including the share of profit of an equity accounted entity within group-EBITDA (deferred dividends)

	A Co USD	B Co USD	Consolidation adjustments	Group USD
Share of profit of JVE	-	-	50 million	50 million
Dividend income	-	-	-	-
Taxable EBITDA	50 million	100 million	-	150 million
EBITDA	50 million	100 million	-	200 million
Net interest expense	(25 million)	(25 million)	-	(50 million)
Group net third party interest expense/EBITDA ratio			-	25%
Taxable entity-EBITDA	50 million	100 million	-	
Interest capacity	12.5 million	25 million	-	-
Deductible interest expense	(12.5 million)	(25 million)	-	-
Disallowed interest expense	(12.5 million)	-	-	-
Unused interest capacity	-	-	-	-

128. The table above is based on the same fact pattern as in Example 12, with the exception that in this case the joint venture has not paid any dividends and so A Co does not receive any taxable dividend income. For the purposes of this example, it is assumed CFC rules do not apply. If A Co is subject to tax on an attribution of profits under CFC rules then the result should be the same as in Example 12.

129. Under the group ratio rule, A Co applies the group ratio of 25% to its taxable EBITDA of USD 50 million to give interest capacity of USD 12.5 million. A Co may therefore deduct net interest expense of USD 12.5 million and incurs an interest disallowance of USD 12.5 million. If Country A allows the carry forward of disallowed interest expense, then this disallowed expense may be deducted in the future when A Co receives dividends from the joint venture entity which are subject to tax.

130. B Co applies the group’s net third party interest expense/EBITDA ratio of 25% to its taxable EBITDA of USD 100 million to give interest capacity of USD 25 million. B Co is able to deduct all of its net interest expense with no unused interest capacity.

Example 14 - Including the share of profit of an equity accounted entity within group-EBITDA (tax-exempt dividends)

	A Co USD	B Co USD	Consolidation adjustments	Group USD
Share of profit of JVE	-	-	50 million	50 million
Dividend income	50 million	-	(50 million)	-
Taxable EBITDA	50 million	100 million	-	150 million
EBITDA	100 million	100 million	-	200 million
Net interest expense	(25 million)	(25 million)	-	(50 million)
Group net third party interest expense/EBITDA ratio			-	25%
Taxable entity-EBITDA	50 million	100 million	-	
Interest capacity	12.5 million	25 million	-	-
Deductible interest expense	(12.5 million)	(25 million)	-	-
Disallowed interest expense	(12.5 million)	-	-	-
Unused interest capacity	-	-	-	-

131. The table above is based on the same fact pattern as in Example 12, with the exception that in this case Country A applies a participation exemption on dividends with no requirement for underlying tax to be paid, and so the dividends received by A Co are tax-exempt.

132. Under the group ratio rule, A Co applies the group's ratio of 25% to its taxable EBITDA of USD 50 million (not including its tax-exempt dividend income) to give interest capacity of USD 12.5 million. A Co may therefore deduct net interest expense of USD 12.5 million and incurs an interest disallowance of USD 12.5 million. This corresponds with the proportion of A Co's EBITDA which is subject to tax.

133. B Co applies the group's net third party interest expense/EBITDA ratio of 25% to its taxable EBITDA of USD 100 million to give interest capacity of USD 25 million. B Co is able to deduct all of its net interest expense with no unused interest capacity.

134. Taking the results of Examples 12, 13 and 14 together, these show that the inclusion of the group's share of the joint venture's profits in group-EBITDA should ensure the correct result in cases where dividend income is taxable and also in cases where dividend income is deferred or tax-exempt. In cases where some or all of a group's dividend income is deferred or tax-exempt, an appropriate response is for a proportionate share of the group's net third party interest expense to be restricted, in line with the goals set out in the BEPS Action Plan.

Example 15 – The impact of third party debt raised directly by an equity accounted entity

	A Co USD	B Co USD	Consolidation adjustments	Group USD
Share of profit of JVE	-	-	37.5 million	37.5 million
Dividend income	37.5 million	-	(37.5 million)	-
Taxable EBITDA	50 million	100 million	-	150 million
EBITDA	87.5 million	100 million	-	187.5 million
Net interest expense	(12.5 million)	(25 million)	-	(37.5 million)
Group net third party interest expense/EBITDA ratio			-	20%
Taxable entity-EBITDA	50 million	100 million	-	
Interest capacity	10 million	20 million	-	-
Deductible interest expense	(10 million)	(20 million)	-	-
Disallowed interest expense	(2.5 million)	(5 million)	-	-
Unused interest capacity	-	-	-	-

135. This example is based on the same facts as in Example 14. However, in this case A Co has repaid part of its third party debt, reducing its net third party interest expense to USD 12.5 million. Instead, the joint venture entity has raised third party debt directly. The group's share of the joint venture entity's profit is therefore reduced by USD 12.5 million, which corresponds to the group's share of the joint venture entity's net third party interest expense. Overall, the group is in the same economic position as before - its share of the joint venture entity's profit is reduced by USD 12.5 million, but the group's net interest expense is also reduced by the same amount. However, the group's net third party interest expense is now USD 37.5 million and group-EBITDA is USD 187.5 million, giving a group net third party interest expense/EBITDA ratio of 20%.

136. Under the group ratio rule, A Co would apply the group ratio of 20% to its taxable EBITDA of USD 50 million to give interest capacity of USD 10 million. Of its total net interest expense of USD 12.5 million, USD 10 million would be deductible and USD 2.5 million would be disallowed. B Co would also apply the group ratio of 20% to its taxable EBITDA of USD 100 million to give interest capacity of USD 20 million. Therefore, out of its total net interest expense of 25 million, USD 20 million would be deductible and USD 5 million would be disallowed.

137. This may be an appropriate result for the group, as it now has a reduced net third party interest expense and so its group ratio has reduced. However, given the economic effect of raising third party debt at the level of A Co and at the level of the joint venture entity are comparable, a country may for policy reasons allow adjustments to be made to reduce this impact, as in Example 16.

Example 16 – Attributing the group's share of the third party debt of an equity accounted entity

	A Co USD	B Co USD	Consolidation adjustments	Group USD
Share of profit of JVE	-	-	37.5 million	37.5 million
Dividend income	37.5 million	-	(37.5 million)	-
Taxable EBITDA	50 million	100 million	-	150 million
EBITDA	87.5 million	100 million	-	187.5 million
EBITDA adjusted for share of net third party interest expense of JV	-	-	-	200 million
Net interest expense	(12.5 million)	(25 million)	-	(37.5 million)
Net interest expense adjusted for share of net third party interest expense of JV			-	(50 million)
Group net third party interest expense/EBITDA ratio			-	25%
Taxable entity-EBITDA	50 million	100 million	-	
Interest capacity	12.5 million	25 million	-	-
Deductible interest expense	(12.5 million)	(25 million)	-	-
Disallowed interest expense	-	-	-	-
Unused interest capacity	-	-	-	-

138. This example is based on the same facts as in Example 15. However, in this case Country A and Country B allow A Co and B Co to attribute part of the joint venture entity's net third party interest expense to the group. Therefore the group is now treated as having net third party interest expense of USD 50 million and group-EBITDA of USD 200 million, giving a net third party interest expense/EBITDA ratio of 25%. In effect this has put the group back in the position it was in under Example 14, where the third party debt funding the joint venture was raised by A Co rather than directly in the joint venture entity.

139. Under the group ratio rule, A Co would apply the group ratio of 25% to its taxable EBITDA of USD 50 million to give interest capacity of USD 12.5 million. A Co would therefore be able to deduct all of its net interest expense with no disallowance. B Co would also apply the group ratio of 25% to its taxable EBITDA of USD 100 million to give interest capacity of USD 25 million. Again, B Co would be able to deduct all of its net interest expense with no disallowance.

140. This is a more complex approach as it would allow a group to attribute to the group third party interest expense arising in an entity outside of the group. However, given the importance of joint venture arrangements in certain countries and sectors, this may be something a country could consider in introducing a group ratio rule.

Example 17 – The impact of losses on the operation of a group ratio rule

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	10 million	(100 million)	10 million
Net interest	(20 million)	(2 million)	10 million	(12 million)
Group net third party interest expense/EBITDA ratio	-	-	-	120%
Interest capacity	120 million	12 million	0	-
Deductible interest expense	(20 million)	(2 million)	0	-
Disallowed interest expense	-	-	-	-
Unused interest capacity	100 million	10 million	-	-

141. In the table above, a group consists of three entities: A Co, B Co and C Co. A Co has EBITDA of USD 100 million and net third party interest expense of USD 20 million. B Co has EBITDA of USD 10 million and net third party interest expense of USD 2 million. C Co has a negative EBITDA (i.e. losses) of USD 100 million and receives net third party interest income of USD 10 million. Therefore, the group has total EBITDA of USD 10 million and a net third party interest expense of USD 12 million. The group's net third party interest expense/EBITDA ratio is 120%.

142. This very high group ratio causes two problems. Firstly, in the current year A Co receives interest capacity of USD 120 million, which is higher than the group's actual net third party interest expense. This means that in principle the company could deduct more net interest than the total net third party interest expense of the group. Secondly, even after deducting their current year net interest expense, A Co and B Co still have a high level of unused interest capacity. If a country allows the carry forward of unused interest capacity, this could be carried into future periods and used to shelter further interest deductions.

143. In a sense, this issue arises because C Co (which has a negative EBITDA of USD 100 million) is not required to recognise negative interest capacity of USD 120 million. If this was the case, then the interest capacity of the group as a whole would equal the group's net third party interest expense of USD 12 million. However, the recognition of negative interest capacity in loss-making entities is not recommended as part of the best practice approach.

Example 18 – Excluding entities with negative EBITDA from the calculation of group EBITDA for a profitable group

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	10 million	(100 million)	110 million
Net interest	(20 million)	(2 million)	10 million	(12 million)
Group net third party interest expense/EBITDA ratio	-	-	-	10.9%
Interest capacity	10.9 million	1.1 million	0	-
Deductible interest expense	(10.9 million)	(1.1 million)	0	-
Disallowed interest expense	(9.1 million)	(0.9 million)	-	-
Unused interest capacity	-	-	-	-

144. This example is based on the same fact pattern as Example 17. In this case, the negative EBITDA in C Co has been disregarded in calculating group-EBITDA. Therefore, the group now has EBITDA of USD 110 million, rather than USD 10 million. This means that the group's net third party interest expense/EBITDA ratio is now reduced to 10.9%.

145. The effect of this is that A Co has interest capacity of USD 10.9 million and B Co has interest capacity of USD 1.1 million. Taken together, the interest capacity of A Co and B Co are USD 12 million, which is equal to the group's net third party interest expense. By disregarding C Co's negative EBITDA, the group ratio rule now operates to ensure that the group is able to deduct an amount equal to its actual net third party interest expense. However, it may be very difficult for the tax authorities in the countries of A Co and B Co to accurately establish the existence and value of the negative EBITDA in C Co. Therefore, it may not be feasible for a country to apply this approach in practice.

Example 19 – Applying an upper limit on interest capacity

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	10 million	(100 million)	10 million
Net interest	(20 million)	(2 million)	10 million	(12 million)
Group net third party interest expense/EBITDA ratio	-	-	-	120%
Interest capacity	12 million	12 million	0	-
Deductible interest expense	(12 million)	(2 million)	0	-
Disallowed interest expense	(8 million)	-	-	-
Unused interest capacity	-	10 million	-	-

146. In the table above, the group is in the same position as in Example 17. However, the interest capacity of A Co is now subject to a limit equal to the group's actual net third party interest expense. Therefore, A Co's interest capacity is limited to USD 12 million (i.e. the group's total net third party interest expense). A Co is able to deduct net interest expense of USD 12 million, and may carry forward disallowed interest expense of USD 8 million into future periods, if this is permitted.

147. As before, B Co receives interest capacity of USD 12 million and is able to deduct its full net interest expense of USD 2 million. It is also able to carry forward unused interest capacity of USD 10 million, if this is permitted. However, given B Co's interest capacity exceeds 100% of its EBITDA, this may be considered excessive.

148. Note that if the group's EBITDA had not been reduced by negative EBITDA in C Co, the group's net third party interest expense/EBITDA ratio would have been approximately 10.9% (i.e. USD 12 million/USD 110 million). In this case, A Co would have been able to deduct approximately USD 10.9 million of net interest expense. Therefore, the upper limit on interest capacity has not restricted net interest deductions in A Co to below the level that would have been permitted had the losses in C Co not arisen.

Example 20 – Applying a cap to the group ratio

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	10 million	(100 million)	10 million
Net interest	(20 million)	(2 million)	10 million	(12 million)
Group net third party interest expense/EBITDA ratio	-	-	-	50% (capped)
Interest capacity	50 million	5 million	0	-
Deductible interest expense	(20 million)	(2 million)	0	-
Disallowed interest expense	-	-	-	-
Unused interest capacity	30 million	3 million	-	-

149. In this example, the group is in the same position as in Example 17. However, the group's net third party interest expense/EBITDA ratio is now subject to a cap of 50%. Therefore, compared with Example 17, B Co's interest capacity is now limited to USD 5 million (i.e. 50% of B Co's entity-EBITDA of USD 10 million). B Co is able to deduct net interest expense of USD 2 million, and may carry forward unused interest capacity of USD 3 million into future periods, if this is permitted.

150. A Co receives interest capacity of USD 50 million. This is less than in Example 17, where the un-capped group ratio of 120% applies. However, it still significantly exceeds the group's net third party interest expense of USD 12 million. A Co is able to deduct its full net interest expense of USD 20 million and is able to carry forward unused interest capacity of USD 30 million, if this is permitted.

Example 21 – Applying a cap to the group ratio and an upper limit on interest capacity

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	10 million	(100 million)	10 million
Net interest	(20 million)	(2 million)	10 million	(12 million)
Group net third party interest expense/EBITDA ratio	-	-	-	50% (capped)
Interest capacity	12 million	5 million	0	-
Deductible interest expense	(12 million)	(2 million)	0	-
Disallowed interest expense	(8 million)	-	-	-
Unused interest capacity	-	3 million	-	-

151. In the table above, the group is in the same position as in Example 17. However, the group ratio is now subject to a cap of 50% and there is an upper limit on interest capacity equal to the group's actual net third party interest expense.

152. Therefore, as in Example 19, A Co's interest capacity is limited to USD 12 million (i.e. the group's total net third party interest expense). A Co is able to deduct net interest expense of USD 12 million, and may carry forward disallowed interest expense of USD 8 million into future periods, if this is permitted. As in Example 20, B Co receives interest capacity of USD 5 million and is able to deduct its full net interest expense of USD 2 million. It is also able to carry forward unused interest capacity of USD 3 million, if this is permitted. Countries may limit the scope of these carry forwards.

Example 22 – Groups with negative group-EBITDA

	A Co USD	B Co USD	C Co USD	Group USD
EBITDA	100 million	10 million	(120 million)	(10 million)
Net interest	(20 million)	(2 million)	10 million	(12 million)
Group net third party interest expense/EBITDA ratio	-	-	-	n/a
Interest capacity	12 million	2 million	0	-
Deductible interest expense	(12 million)	(2 million)	0	-
Disallowed interest expense	(8 million)	-	-	-
Unused interest capacity	-	-	-	-

153. In this example, C Co has negative EBITDA of USD 120 million. The group therefore has an overall negative group-EBITDA of USD 10 million. This means it is not possible to calculate a meaningful group net third party interest expense/EBITDA ratio. However, the countries where A Co and B Co are resident allow these entities to claim interest capacity equal to the lower of their net interest expense, 50% of entity-EBITDA and the group's net third party interest expense.

154. A Co has net interest expense of USD 20 million, which is less than 50% of A Co's EBITDA, but exceeds the group's net third party interest expense of USD 12 million. A Co's interest capacity is therefore limited to USD 12 million. A Co is able to deduct net interest expense of USD 12 million, and may carry forward disallowed interest expense of USD 8 million into future periods, if this is permitted.

155. B Co has net interest expense of USD 2 million, which is less than the group's net third party interest expense of USD 12 million and is also less than 50% of B Co's EBITDA. B Co's interest capacity is therefore limited to USD 2 million. B Co may deduct its entire interest expense of USD 2 million. There is no unused interest capacity.