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BEPS Action 4: Interest Deductions and Other Financial Payments

On 18 December 2014, the OECD, as part of its work on the Action Plan to address Base Erosion and Profit Shifting (BEPS), released a Public Discussion Draft on Action 4 in relation to the deductibility of interest expense and economically equivalent financing payments. The Discussion Draft outlines three main alternatives to address non-taxation through the use of interest deductions:

- Deduction limitations based on group attributes
- Deduction limitations based on fixed economic ratios and
- Targeted anti-avoidance measures.

It also summarises a number of areas where further work is needed, and sets out how Action 4 may interact with other BEPS measures, such as the hybrid mismatch proposals in Action 2 and the CFC proposals in Action 3. Notably, it does not cover the transfer pricing aspects of interest deductibility, which will be covered in a separate consultation document.

As with other Discussion Drafts, the proposals do not represent a consensus view from the G20/OECD governments, but are designed to provide preliminary but substantive proposals for public analysis and comment.

Deloitte comments and next steps

The proposals in the Discussion Draft are far-reaching and, if agreed by the G20/OECD, would bring about a major change to multinational financing. The proposals suggest that total interest deductions should be limited to a multinational group’s third-party financing costs, which would be achieved through some form of allocation.

As set out in the Discussion Draft, published data indicates that for the largest non-financial sector groups, the great majority have a net interest to EBITDA ratio of below 10 per cent and many do not have any net interest expense. It is clear, therefore, that the introduction of a group-wide limitation such as that mentioned could significantly increase the level of disallowed interest within a group.

Situations likely to be adversely affected include:

- Cash-rich or minimally leveraged groups that nevertheless create intragroup debt to fund subsidiaries' activities
- Groups with subsidiaries in territories where it is not possible, or where it presents difficulty, to push down interest (e.g. as a result of foreign exchange control, future repatriation restrictions, commercial constraints, etc.)
- Groups with significant head office interest deductions, but relatively small economic activity at head-office level, where the proposed allocation will result in only a small head-office interest allocation
- Groups with subsidiaries in regulated industries, where the regulatory model calls for a certain level of debt financing which may not be the same as in the remainder of the group
- Groups that have historically made or are expected to make significant acquisitions. For example, if a parent company chooses to acquire a target financed through bank debt, then in order to obtain a full deduction for the interest expense it would be obliged to push the debt down to each of its subsidiaries on a proportionate basis. Each of those subsidiaries would need to have ability to absorb the interest deduction. In practice, a number of countries have in place rules which limit interest deductions on debt raised to fund an acquisition.

Group-wide limitations would also make forecasting and preliminary tax payments more problematic, as entities would not necessarily know the extent of their available interest deductions until the worldwide financial statements are available.

The Discussion Draft seeks comment, suggestions and responses to specific questions to help the working group to reach its final position, which is to be delivered in September 2015. The Discussion Draft poses, amongst several others, the specific question of whether difficulties are anticipated to arise from the application of a group-wide allocation rule to groups with centralised treasury functions and, if so, what are they? A number of multinationals have their corporate treasury functions centralised in Ireland and it is of vital importance that business provides sufficiently detailed input to the OECD so that practical issues and difficulties as well as the economic effects of interest disallowance can be clearly observed and hopefully lead to a better final proposal.

Timetable

Comments are invited by 6 February 2015. A public consultation meeting will be held on the Discussion Draft at the OECD in Paris on 17 February 2015 and registration details are available on the OECD's website. The second consultation document covering the transfer pricing aspects of debt will be published during 2015, but no date has yet been set (and that part of the Action is due for completion in December 2015).

Further detailed commentary on the BEPS Action 4 Discussion Draft and other BEPS-related items is available on the Deloitte Ireland website at www2.deloitte.com/ie and www2.deloitte.com/global.

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