Introduction and Background

The discussion draft issued by the Organisation for Economic Co-operation and Development (OECD) on the Base Erosion Profit Shifting (BEPS) Action Plan 4 (AP 4) states that 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 risks identified in this area are (a) use of related-party and third-party debt to achieve excessive interest deductions (b) to finance the production of exempt or deferred income (c) obtain relief for interest deductions greater than the actual net interest expense of the group.

The report on AP 4\(^1\) seeks to develop recommendations in designing of rules limiting the deductibility of interest and other economically equivalent payments made to third parties and related parties.

The AP 4 report includes a common approach to tackle 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.

The AP 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 AP 4 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 AP 4 report contains 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, and
- to address the impact of losses on the operation of the rule.

Furthermore, the OECD supplements the best practice approach with additional optional elements and targeted rules. The final report on AP 4 also indicated that the OECD will continue to conduct detailed work on the design and operation of the group ratio rule, to be completed in 2016.

The OECD has now released a discussion draft on elements of the design and operation of the group ratio rule. The discussion draft also includes a number of specific questions related to particular aspects of these topics and examples provided to illustrate the situations encountered while addressing the issues under AP 4. Interested parties may offer additional comments on any of the issues raised in the document along with other responses to be sent on or before 16 August 2016.

Key aspects of the discussion draft on the elements of the design and the operation of the rules are discussed below

Calculation of net third party interest expense

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 AP 4 Report.

The AP 4 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 AP 4 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 AP 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 AP 4 report, and measuring these items based on how they are treated in the consolidated financial statements of the group (approach 3).

Comparison of three approaches

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.

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 AP 4 report. Therefore, it is suggested that both of these approaches should be preferred over approach 1.

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.

The discussion draft includes the following questions:

- 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?
- 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

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 help 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. 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 reduce the likelihood that 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 per cent. A country may also choose to allow entities to apply a smaller uplift or no uplift, where an uplift could enable entities in the group to claim net interest deductions in excess of the group’s net third party interest expense.

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 decides 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, 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.

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 Joint Venture Entity (JVE). 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.

The discussion draft includes the following questions:

- It is important that a country’s tax policy goals can be taken into account while 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?
- 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?
- 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**

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.

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 which are as follows:

- 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**

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.

The approach set out 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. First, 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 AP 4 report. Second, 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.

The discussion draft includes the following question:

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**

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 and should therefore be included within the adjustment for depreciation and amortisation and removed from group-EBITDA.

The discussion draft includes the following question:

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**

In light of the statement in the AP 4 that recommendations should address BERS 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.

Countries should 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).

The discussion draft includes the following questions:

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

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**

A simple approach which can be applied easily and consistently in all countries is that the non-recurring items, with the exception of those which are included within the adjustments for interest income and expense or depreciation and amortisation, should in general be included in group-EBITDA without adjustment.

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.

The discussion draft includes the following question:

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**

As set out in the AP 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

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.

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.

The discussion draft includes the following questions:

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?

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

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.

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.

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.

The discussion draft includes the following questions:

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?

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

Our comments

The discussion draft results into the follow up work on the issue relating to the design and operation of the group ratio rule. It deals with questions relating to various aspects discussed above. It also provides detailed illustrations to exemplify the issues discussed.

The discussion draft attempts to address the issues that arise while countries apply the group ratio rule and it represents an approach that would be suitable for most countries. While it is also stated that the countries may apply a group ratio rule based on any other financial ratio for e.g. equity/total assets ratio, the countries should ensure that the rules applied provide an effective protection against BEPS involving interest.

The report on AP 4 stated that further technical work would be conducted on specific areas of the recommended approach, to address risks posed by banking and insurance groups. This discussion draft does not deal with those issues and one may expect further discussion on the same to follow. The amount of intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules. Further work on the transfer pricing aspects of financial transactions was also to be undertaken during 2016 and 2017. Even this aspect though not touched upon in this discussion draft is expected to be dealt in detail to ensure a more holistic resolve while evaluating intragroup financial payments.

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As part of the BEPS measures, with many countries across the world either introducing or strengthening the thin capitalisation rules in the domestic laws, this discussion draft could pave the way to a co-ordinated implementation of the recommendations made and will successfully impact on the ability of multinational groups to use debt to achieve BEPS outcomes. One may expect more development revolving around AP 4 if the initial review to be conducted by countries involved in the BEPS project by 2020 is to be adhered to.