Base Erosion and Profit Shifting: Limiting Tax Deductions for Interest Costs

Earlier this week the heads of state of the 20 largest global economies have agreed to adopt the 15 BEPS action points in their respective countries. Ample reason to take a closer look at the details and implications of one of the most far-reaching upcoming tax adjustments.

Action 4 of the OECD's BEPS initiative focuses on the use of interest costs by multinationals and the potential to inappropriately shift profits between tax jurisdictions. The suggested solution is for countries to limit the deductibility of interest and other financing costs in order to limit abuse.

In this article, we contrast and compare the approach adopted by two G20 countries – Germany, which already operates a fixed limit linked to EBITDA, and the UK, which is now consulting on introducing such a limit.

The OECD's core recommendations under Action 4 are:

- a cap on deductibility set between 10% and 30% of EBITDA
- an optional override where external group financing exceeds this ratio
- an optional *de minimis* monetary threshold to exclude low risk entities
- optional carry forward/back of disallowed interest and unused capacity
- targeted anti-avoidance rules
- specific rules to address issues raised by the banking and insurance sectors

Although primarily aimed at multinational groups of companies, the OECD favors including purely domestic groups within the rules, as well as single entities, noting that these situations can also create opportunities for profit shifting.

The German Experience

Germany introduced earning-linked interest limits in 2008, very similar to OECD's Action 4. The following sets out the main features, their implications and some resulting trends in the German business community.

The definition of interest is very broad. In contrast to the traditional thin capitalization rules, the German regime captures any and all interest expenses, regardless of whether the interest results from shareholder or third-party loans or whether it involves domestic or cross-border funding.

Germany's EBITDA percentage is set at 30% and, thus, at the top end of the OECD's recommendations. Earnings-linked interest deductions make medium- and long-term tax projections for planning purposes much more difficult since interest deductibility becomes as volatile as earnings. In this context, it is also interesting to note that the basis is taxable EBITDA and not statutory EBITDA for accounting purposes. Thus, exempt income reduces EBITDA basis accordingly.

There are specific and different rules for companies that belong to a group and for companies that do not. As for the latter, the interest limit regime principally does not apply to stand alone entities. As for the former, the rules provide relief if the challenged entity exceeds the equity ratio of its group.

The German threshold is set at €3 million per annum and entity. At current interest levels in the Euro-Zone, about 2%, such threshold would provide relief up to a leverage amount of €150 million. Consequently, the interest limits should not be relevant for most small- and medium-sized companies even if they are part of a group. If the interest limits are expected to become relevant, thought should be given to establishing separate entities for separate business lines, products or geographic areas.

It is important to note that the €3 million is a threshold and not a deductible allowance. Thus, if the interest exceeds the prescribed threshold by only €1, the aforementioned general regime is applicable and the EBITDA rule applies to the entire interest amount. Consequently, an entity making a loss of €2.1 million after interest deductions of €3.1 million may be paying tax on deemed profits of €1 million. This "all or nothing" consequence has caused Germany's Federal Tax Court to grant temporary injunction relief in a specific case in late 2013 on the grounds of a violation of constitutional principles. The matter is pending and, thus, a final decision is still outstanding.

Disallowed interest may be carried forward indefinitely and used to offset future income. In contrast, unused interest deduction capacity may only be carried forward for five years. No carry backs are prescribed. In this context, it is also interesting to note that these carry forwards could be discontinued after change of control, corporate restructuring, mergers, share for share transactions and the like.

Several trends have emerged in Germany since introduction of the new regime some seven years ago. First, as mentioned, the current Euro interest levels are at a historically all-time low, which provides relief for leveraging most small- and medium-sized entities. Consequently, the new regime has not had significant effects and has not led to a lot of response from the business community as a whole. That said, one easy planning technique would be to utilize separate entities and special purpose entities in order to have the threshold per entity rule apply.

Beyond that, there seem to be two principle avenues to mitigate the effects of the provisions – increase EBITDA or lower interest expenses. As the former cannot be completely controlled by the taxpayer, the more obvious focus is on lowering or substituting interest expenses. One of the general trends is to rent or lease assets instead of borrowing money to buy assets, since rent and leasing payments are not interest. In addition and depending on the respective tax effects, sale and leaseback of assets might also be an option. Finally, another trend may be to securitize property instead of using it as collateral for debt funding. Therefore, asset-backed security transactions and receivable finance in their true sale forms may also come into consideration.

The UK Approach

On October 22, 2015, the UK Treasury issued a consultation document asking for views on how a limit consistent with the OECD's recommendations might be introduced in the UK. This approach follows recent UK practice where tax reforms are first consulted on before legislation is introduced.

Unusually, the document does not set out the government's preferred options. It simply summarizes the key aspects of the OECD report and, in its own words, "sets out some specific questions to frame a discussion for a UK domestic policy context." Interested parties have until mid-January 2016 to respond, and the document notes that new rules are unlikely to be introduced before April 2017.

Given the enthusiasm of the UK government to take action against BEPS, one might have expected a more robust approach. Compare the introduction of diverted profits tax in April 2015 – a new tax that pre-empted aspects of the OECD's work on permanent establishments and transfer pricing. Thus, it is surprising to see the UK exercising caution when it comes to the issue of interest deductions, particularly as the UK could point to the experience of Germany and other countries that already operate fixed limits.

A number of factors are at play here. First, the OECD report acknowledges that there is further work to do during 2016 to refine the recommendations, particularly in relation to the way any limit should work in the context of a group of companies and also whether special rules are needed for the banking and insurance sectors. With financial services remaining a key part of the UK economy, rushing to introduce reforms could leave the UK out of line with other countries.

Second, as a member of the European Union, the UK would find it very difficult to introduce rules that only targeted multinationals. This is an issue faced by all EU member states, which need to ensure that national tax rules are compliant with EU law, including the fundamental freedoms of establishment and movement of capital. The EU Commission and taxpayers can (and sometimes successfully do) challenge the validity of national laws that are seen to discriminate against inward investors by favoring domestic taxpayers. So, a rule that limited tax deductions for a subsidiary of a non-UK based parent company, but did not apply to a company with no overseas connection, is unlikely to be safe from challenge. The State aid rules that have been used to investigate tax rulings that favor particular taxpayers or classes of taxpayers will also be relevant. The OECD reports expressly acknowledge that EU member states have to tread carefully to remain compliant with their EU law obligations.

So let's assume that a new rule limiting tax deductibility of interest costs would have to apply across the board. This raises numerous issues as to how such a limit would operate within the context of existing rules on the treatment of interest costs for tax purposes. For example, some interest costs are already treated under UK tax law as nondeductible expenses – this can result from transfer pricing reviews or from the recharacterization of interest as a dividend (for example, on some convertible debt instruments). In addition, the UK operates a worldwide debt cap. This seeks to limit UK deductions for interest within multinational groups by reference to the group's global external funding costs. The broad aim is to restrict the ability to use intragroup funding to generate excessive UK tax deductions.

The UK consultation document invites stakeholders to consider how any EBITDA-linked cap might interact with these existing rules. For example, would the debt cap rules be adapted to fit the new OECD model or be retained to work in parallel with a new set of group restrictions? Adding complexity would run counter to the UK government's stated objective of "delivering the most competitive corporate tax system in the G20." This suggests a third reason for the UK's cautious approach: introducing a rule limiting tax deductions is less straightforward than first appears and involves a wider review of the tax system.

A fourth reason would be the wider economic impact. Leveraging levels in some sectors of the UK economy have traditionally been high, and future funding of business growth could be adversely affected by a fixed limit. For example, private equity transactions often involve substantial levels of debt finance, with a mix of external bank debt and investor finance. The UK already uses transfer pricing to regulate the deductibility of interest costs, but a fixed limit could go further, potentially making it difficult to fund typical transactions. Debt levels can also be relatively high in the real estate sector where lenders provide finance against rents and investors may focus on capital growth, rather than receiving regular income.

There is an ongoing academic debate about the relative merits of equity and debt finance, including whether the choice should be tax neutral. This was not, of course, part of the OECD's BEPS agenda, but it is to be hoped that the wider picture is now taken into account.

Conclusion

The OECD has set a challenge: Can nations identify a way to prevent companies using interest costs as a way to inappropriately shift profits to low tax jurisdictions without adversely affecting business growth in their economies? The tax deductibility of interest remains a core part of most tax systems. As we have seen, some countries, such as Germany, already operate limits that are broadly compliant with the OECD's recommendations, but their impact may be tempered by a history of lower leveraging within German businesses, which typically have greater use of equity funding. Countries that have instead made greater use of debt finance may choose to look very carefully at how a limit on deductions could have a much wider economic impact than the tax savings it appears to offer. We will be following the UK consultation process closely, as well as the response to the OECD report in other countries.

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