Monday, September 9

Plenary Session Subject 1: Interest deductibility: the implementation of BEPS Action 4

General Reporters: Jim Gadwood (USA) and Paul Morton (UK)

Chair: Yash Rupal (UK)

Panel Speakers: Bernd-Peter Bier (Germany), Pierre-Henri Durand (France), Karishma Phatarphekar (India), Adam Zalasinski (EU)

Secretary: Sandra Martinho Fernandes (Luxembourg)

It is BEPS that has dominated the tax discourse over the last 5 years... and among the 15 BEPS Action Plans, some have received more attention than the others. Among the Action Plans that have been a "sleeper", which is now gaining some traction in various discussions, is Action Plan 4 on ' Limitation on Interest Deductions.' And it was the Plenary Topic on Monday as the technical deliberations got underway at the London Congress!

The General Reporters and panelists **Mr. Paul Morton** and **Mr. Jim Gadwood** presented the key takeaways from their 750 pages Report, to which 44 IFA Branches contributed Branch reports containing valuable insights on this subject. Mr. Morton termed the subject as "too hard" and admitted that the countries have diverged to the greatest extent possible, when it comes to tackling this Action Plan and their responses. He posed a prescient question for the delegates to ponder - *"Do we apply the business test or mechanical or formula test or Transfer Pricing test or do we adopt multiple approaches...?"* In the same breath he acknowledged that there are different approaches to taxing interest expense, including using it as a tool to increase the economic competitiveness of a jurisdiction. He then opined that the root of the problem is the unbalanced taxation of interest and dividends, and stated that despite criticism, the debt-equity distortion has remained largely accepted and unchanged in the world's income tax systems for almost a century.

Mr. Jim Gadwood then shared interesting statistics culled out by them from the 44 Branch reports submitted. Of the 20 EU countries who contributed to the IFA Branch report on this topic, 17 countries reported having an "Earnings based fixed ratio rule" while among the 24 non-EU nations, only 8 have adopted this rule to limit interest deduction. Most EU countries have unanimously adopted the 30% benchmark, informed the panelist... Mr. Morton quipped that there is a glimmer of hope of the rules becoming simple one day...

Ms. Sandra then took the delegates through the conceptual shift that is happening in interest restriction rules, from the existing measures like Arm's Length Principle (thin capitalisation/transfer pricing), SAARs & TAARs to the solution recommended by the BEPS Action Plan 4, i.e. a comprehensive and far-reaching mechanical restriction on deductibility of interest, which operates alongside the existing measures. She then elaborated on the approaches recommended by BEPS Action Plan 4 and EU's Anti-Tax Avoidance Directive (ATAD) Article 4, namely:

1. Earnings cap/asset ratio

2. Worldwide debt ratio of group

3. Mechanical base protection rule or a general cap on interest deductibility

She added that while the historical rules focused on related party debt, BEPS Action Plan 4 & ATAD Article 4 have their eyes on both related as well as unrelated party debt. Ms. Sandra outlined the purpose and goals of the new interest restriction envisaged by BEPS Action Plan 4 & ATAD as follows:

a) Interest allocation rule: aligning interest deductions with taxable economic activity.

b) Revenue-raising measure/safeguard: to ensure that an appropriate level of tax is collected from investments in the source country.

c) Measure to counteract so-called "low tax loans" and discourage artificial debt arrangements designed to minimise taxes.

Ms. Sandra however wondered if these above goals can be achieved with an earnings cap and whether an earnings cap is a clear, objective measure or is it a 'blunt' tool?

The panel then identified the key issue as being one of potential 'economic double taxation of interest ' but in the same breath, also debated if the outcome achieved by BEPS Action Plan 4 & ATAD Article 4 , to the extent of non-deductible interest payment/excess interest payment, be referred to as "over-taxation" rather than "double taxation"?

EU representative on the panel **Mr. Adam Zalasinki** and M&A specialist **Mr. Pierre-Henri Durand** then highlighted the key aspects of BEPS Action Plan 4 & ATAD, including their coverage, the definition of interest, interest cap and thresholds, ATAD meaning of 'EBITDA', the optional safe harbours offered by Action Plan 4 and the exception to the rules, which they wryly termed the "good news."

Under BEPS Action Plan 4, all part of a multinational group are covered and the countries may apply interest limitations more broadly, while under ATAD Articles 1 & 4, all EU Corporate Income Tax payers, including PEs of entities resident in a third country, are covered. Under ATAD Articles, the Member States may exclude standalone entities, also consolidated groups for tax purposes, can be treated as a single taxpayer. As for definition of 'interest', BEPS Action Plan 4 covers interest on all forms of debt, includes payments economically equivalent to interest and includes expenses incurred in connection with raising finance. ATAD Article meanwhile has the same definition as BEPS Action Plan 4 but with explicit reference to domestic laws of Member States. It also contains a non-exhaustive list of financial expenses (eg. - payments under profit participating loans, imputed interest on zero coupon bonds and guarantee fees). The interest cap and thresholds prescribed make for an interesting reading... while BEPS Action Plan 4 prescribes a 10 to 30% EBITDA limitation, ATAD Article 4 recommends an upto 30% of " tax EBITDA" limitation (i.e. tax adjusted EBITDA, not the accounting concept). The panelists deliberated extensively BEPS Action 4's 'Worldwide Group Ratio Rule', an optional safe harbour that is based on group level interest limitation rather than standalone entity level. Mr. Durand remarked that while the group ratio rules are complex, they can also be advantageous for MNE groups. With regard to the exceptions, BEPS Action Plan 4 gives the option to exclude certain public benefit projects and more importantly, the option to exclude entities in banking and insurance sectors, especially if there is no perceptible risk. Except China, most APAC nations have excluded Banking & Insurance companies from the ambit of these rules. But the bad news, said the panel, is the BEPS Action 4 suggestion to introduce a GAAR as also the recommendation to introduce TAARs such as thin capitalisation rules.

Ms. Karishma Phatarphekar pointed out the overlap between Action Plan 4 and Transfer Pricing as both are SAARs (Special Anti Avoidance Regulations). She opined that the two layers of disallowance, one under Transfer Pricing and another under BEPS Action Plan 4, are a "double whammy" and said in jest that juggling both Transfer Pricing and BEPS Action 4 is nothing less than getting the steps of a Bollywood dance right!

The biggest applause of the day however was reserved for industry representative on the panel **Mr. Bernd-Peter Bier**, representing a big MNE group, who minced no words when he said that if everyone applies interest bearing rule, then the consequences will be less investments and contraction of economic activity.

The panel chair **Mr. Yash Rupal (Linklaters UK)** made several incisive observations during the course of the discussions. He commented that there is plenty of scope still manipulate the rules and felt that the objectives for which Action Plan 4 has been introduced, namely to address BEPS concerns of groups placing higher levels of third party debt in high tax jurisdictions, and using intra-group loans to generate deductions in excess of actual third part interest expense, are not being met. He further opined that the degree of optionality in the Rules is mind-boggling, especially the wide threshold range of anywhere between 10% to 30% to cap interest deductions. In light of all this, he expressed skepticism on how the objective of increased harmonisation in rules among different jurisdictions, is being achieved? Mr. Rupal then offered his solution to tackle the interest deduction connundrum, quipping that *" The purist way to deal with interest deductions is the 'Arm's Length Test.' But tax administrators do not trust the Courts..."* Ms. Karishma Phatarphekar concurred, opining that there is nothing better than the Arm's Length test to deal with financing transactions, especially there being no dearth of information with regards to comparables etc... Mr. Pier referred to Mr. Morton's opening remarks that identified unbalanced taxation of dividends and interests as the root cause of the problem and then urged *"There must be allowance for corporate relief..."*

The panel chair Mr. Yash Rupal wrapped up the deliberations with his concluding thoughts, that there will be scope for tax planning and did some crystal ball gazing, boldly predicting that a decade hence, we will be re-visiting Action Plan 4 and discussing how the mechanical approach didn't work!

D T S & Associates
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DTS & Associates Take:

BEPS Action 4 has proposed the deductibility of interest subject to so many conditions based on EBIDTA etc. 25 developed countries and 15 remaining countries have accepted it. But there are a lot of issues that developing countries are going to face; therefore, one rule one size cannot fit all. OECD does not understand that in the developing countries if you really put such restrictions, the investments will be wiped out, which is a concern. Further, if these restrictions are put by all the countries, global economic activities would go down. De-globalization has already begun and as a result, the countries will suffer. So in the interest of countries, possibly in a few years, they will realize that this is not a correct action and they may think that we should do something else.