IFA Cahiers – The Key Takeaways

- **Interest deductibility: the implementation of BEPS Action 4**

The 750+ pages Cahiers contains General Report, EU report and branch reports from 44 countries on the topic of "Interest deductibility: the implementation of BEPS Action 4". The General Report authored by James Gadwood (United States) Paul Morton (United Kingdom) finds that BEPS Action 4 aroused great deal of concern among MNEs as it departs from the arm's length standard and adopts mechanical approaches to limiting interest. The authors analyze branch reports from 44 countries in order to understand how countries have implemented BEPS Action 4 and whether countries are moving towards convergence to the agreed common approach.

The General Report is divided into 4 parts viz. (i) introduction, (ii) overview of BEPS Action 4, (iii) discussion and analysis and (iv) conclusions. Referring to interest deductibility rules prevailing in different countries, the Report finds a vast variance in approach of different countries while noting the complexity and uncertainty to be the main problems. The Report further notes various objectives of policy makers while framing interest deductibility rule such as to provide reasonable deduction against income, to use it as a tool to enhance jurisdiction's competitiveness, to stimulate economic development, to favour equity over debt, to counter artificial tax avoidance, etc. The Report then notes wide variation in definition of 'interest' in various jurisdictions. The Report also discusses various facets of interest deductibility like deductibility of interest on funds used for generating tax exempt income, denial of deduction citing abuse of law, interest for trading v non-trading, 'wholly and exclusively' test, notional interest deduction, carry forward, carry back and side way offset and so on.

With regards to implementation of BEPS Action 4, the Report notes that out of 20 EU countries for which branch reports were received, 17 have already implemented an earnings-based fixed-ratio rule in line with the Action 4 report (or more specifically ATAD). Remaining 3 countries viz. Austria, Ireland, and Slovenia have asserted that they qualify for delayed implementation of the ATAD. The Report notes ATAD provides that a member state with national targeted rules for preventing base erosion and profit shifting that are equally effective to the ATAD's interest limitation rule may continue to apply such national rules until the earlier of (1) the date OECD members publish an agreement on a minimum standard regarding BEPS Action 4 or (2) 1 January 2024. The Report further notes that as per European Commission Notice, the European Commission concluded that five EU countries had national rules that satisfy this "equally effective" standard which covered Slovenia, but not Austria and Ireland. The Report comments, "At the time of drafting this general report, it was unclear how this apparent disagreement between the European Commission and each of Austria and Ireland will be resolved."

With respect to 24 branch reports from non-EU countries, the Report notes that only 8 (including India) have earnings-based fixed-ratio rule in line with BEPS Action 4 while 16 do not.

Further, regarding the fixed ration rule adopted by 25 countries, the General Report observes that *"countries with a fixed-ratio rule have consistently chosen to measure economic activity by reference to earnings rather than asset values. Moreover, these countries have overwhelmingly chosen to define earnings by reference to EBITDA rather than EBIT. Countries sometimes style this as "adjusted taxable income" rather than EBITDA, but the result generally appears to be the same."* The Report highlights that 2 countries have adopted EBIT instead of EBITD based ratio viz. USA and Republic of Srpska.

The Report further perceives potentially meaningful differences in how jurisdictions calculate EBITDA for purposes of their fixed-ratio rules. The Report notes that the majority of countries have adopted 30% benchmark though the BEPS report has provided a 'corridor' of 10% to 30%. The Report observes that 8 EU countries have adopted 'group ratio rule' in addition to 'fixed ratio rule', while another 12 EU countries do not have 'group ratio rule'. With respect to non-EU countries, only 2 countries have adopted 'group ratio rule'. Regarding carry over options, the Report observes that *"EU member states were more likely to provide for a carry forward of both disallowed interest expense and unused interest capacity than to provide only for a carry forward of disallowed interest expense. In contrast, the opposite was true for countries outside the European Union."*
The Report also compares *de minimis threshold* adopted by various countries for applying interest deduction limitation rule. The Report states that the countries have adopted an overall conservative approach, but there are major variation in the threshold amount.

The General Report further discusses other approaches to limit interest deduction such as re-characterization of interest as non-deductible distribution, disallowance without re-characterization, Limitation by reference to borrower (e.g. using debt equity ratio of borrower), limitation by reference to lender (e.g. limitation to apply for payment to foreign lender), re-characterizing upstream loan by subsidiary as distribution, etc. The Report also discusses mechanism used in different countries to address double taxation when interest limitation applies to cross border interest payment.

In concluding remarks, the General Report reproduces OECD expectation that by following the Action 4 report, the domestic rules regarding interest limitations will 'converge through the implementation of the agreed common approaches." The authors observe that *"With respect to the European Union, the convergence toward an earnings-based fixed-ratio interest limitation has been remarkable. From a more global perspective, however, convergence has been far less pronounced. The difference, of course, is that EU countries have had to comply with the ATAD* *while non-EU countries have not."* The Report further remark *that "in general the rules in EU countries appear more taxpayer favourable than the rules in non-EU countries."* The authors expect that many more countries will adopt an earnings-based fixed-ratio rule over time.

- **Investment Funds**

The 980+ pages Cahiers contains General Report and Branch Reports from 42 countries on the topic of "Investment Funds". The General Report (the Report) is authored by Sung H. Hwang (USA) and Oktavia M. Weidmann (Switzerland). The Report surveys the current state of taxation of investment funds around the world and examines assumptions and challenges associated with prevailing policies and theories that have driven the evolution of the domestic and international taxation of investment funds, their investors and managers. Based on their salient characteristics, the general report finds three major groupings of funds for tax purposes - (i) funds that qualify as investment funds based on regulatory and sometimes securities law requirements; (ii) funds that are defined as investment funds based on specific tax definitions and (iii) some countries define the subtypes of funds only and tax them according to their legal forms (e.g., company, partnership, trust or contractual arrangement). The General Report attempts to investigate the nature of investment funds and the consequence of this nature for tax purposes, which is closely interlinked with the notion of 'tax neutrality', an often-cited policy objective for investment fund taxation.

With respect to taxation of investment funds, the Report examines how different countries define the investment fund for regulatory purpose. The Report notes that depending on its complexity, a fund generally consists of an outer and an inner layer. The outer shell or the first layer of an investment fund is always the legal shell in which the investments in the fund are wrapped while the inner content or the second layer consists of the investments in which the fund is investing.

The authors of the General Report believe that the term 'tax neutrality' has different dimensions, depending on the comparators used and also different meaning, depending on the countries and commentators. The Report notes that the term is used in situations where the use of an investment fund as part of the legal ownership of an investment does not increase or decrease the effective tax rate or tax cost of such investment activity to its owners vis-à-vis a direct ownership by such owners of the underlying investment. Thus, the Report considers 'horizontal tax neutrality' i.e. neutrality between investments via investment funds and direct investments in the same underlying assets and 'vertical tax neutrality' to avoid economic double taxation. Vertical neutrality can be achieved in following ways – (i) fund can be tax transparent or tax exempt (ii) taxation may happen only at fund level and not at investor level (iii) the taxation can also occur partly at the fund level and partly at the investor level and (iv) a deduction might be granted either at the fund level or at the investor level if the fund distributes the profits at year end, or otherwise. The Report then examines the approaches adopted by different countries to achieve tax neutrality.

The Report also examines tax treaty access of investment funds considering OECD Model Tax Convention and US Model Tax Convention. The Report notes that in order for an investment fund to be so entitled, it needs to be (i) a 'person' (ii) that is resident of a 'contracting state' and (iii) that is the 'beneficial owner' of the relevant income. The Report notes the different approaches in defining residency by different countries under their own domestic laws. The Report remarks that "Some countries, like the US and Peru apply the incorporation test to both normal companies and investment funds, indiscriminately". The Report also note the other criterion used is the effective management test. The Report further observes that substance criterion used for tax residency can differ for investment funds as compared to normal companies, holding companies or conduit companies. Further, the Report remarks that *"Often even high tax countries accept that an investment fund is tax resident in an offshore location and normally refrain from bringing the offshore fund 'onshore', whereas the same criteria for accepting tax residency may not be acceptable for the country's tax authorities in respect to holding companies, finance companies or other conduits.*"

Referring to increased substance requirement in view of BEPS recommendations, the authors believe that *"the tax residency of a fund has different connotations from the tax residency of a normal company or holding company and consequently countries sometimes require fewer substance requirements for accepting the residency of a fund in the particular country compared to holding companies or conduits."*

The Report discusses taxation of various types of investment funds like mutual funds, hedge funds/alternative investment funds, private equity funds, real estate funds including REITs referring to the practices in different jurisdictions.

The Report then proceeds to discuss taxation of investors investing in investment funds covering investors residing in country of investment funds as well as investors where domicile of fund is different from investor's country of residence. With respect to taxation of investors in foreign mutual funds, the authors note that *"many countries apply anti-avoidance rules if they tax domestic investors that invest in foreign funds, in particular in those funds that are domiciled in low tax jurisdictions. These rules can either lead to an annual taxation of distributed or accumulated gains in the foreign fund, irrespectively of an actual distribution; or, anti-avoidance rules apply in order to prevent a deferral of taxation due to a re- characterization of ordinary income into capital gains at the fund level. As a result, these anti-avoidance rules often lead to an application of the potentially less favourable income taxation rules."*

With respect to investors in hedge funds, the Report observes that, many countries apply the same taxation rules to domestic investors investing in domestic mutual funds and domestic hedge funds. However, the Report finds the landscape to be diverse in respect of domestic investors investing in foreign hedge funds. The Report finds that *"… some but not the majority of countries confer a less favourable tax treatment on investors investing in offshore funds located in low tax jurisdictions compared to similar domestic funds. Consequently, the difference in taxation is not* *caused by the type of fund or by the investment strategy but rather the tax residency of the fund in a low tax jurisdiction."*

The Report perceives it to be desirable that the tax residency of the fund in an offshore location alone not be the cause of the application of a less favourable domestic tax regime but rather that such adverse treatment be driven by more complex tax policy considerations; for example by taking into account the investment strategies the fund has entered into (liquid and tradable securities or private equity investments), the applicable domestic taxation of the domestic investor investing in the offshore hedge fund, the effective tax rate applicable to funds in comparable fund jurisdictions and its notion of tax neutrality.

With respect to taxation of real estate funds/ REITs, the Report observes that *"REIT regimes are usually established to attract investment from both domestic and foreign sources in the establishing jurisdictions, and to create and regulate public vehicles to allow domestic retail investors to invest in real estate… REIT regimes are purposefully created to offer tax preferences, compared with the direct investment in the underlying real estate, both at the investment fund and the investor levels. This is the key aspect that sets REITs apart from the rest of investment funds including non-REIT real estate funds."*

The Report also discusses taxation of investment manager with respect to management fees, incentives. With respect to MF managers, the Report states that in majority countries, the tax treatment is similar to ordinary business operations. With respect to hedge fund managers, the Report remarks, "In summary, except for the incentive allocations by hedge funds organised as partnerships, most countries apply the same taxation rules to ordinary business entities and to fund management entities and normally, no distinction is made between the management of mutual funds and hedge funds"

The Reports arrives at the following key conclusions:

- Uniformity in approaches in applying domestic tax benefits and tax treaty benefits has gained momentum and should continue to be the key priority for policy makers, in particular, regarding multi-jurisdictional constellations.
- Tax residency of investment funds has different connotations from the tax residency of a normal company or holding company, and consequently countries sometimes require fewer substance requirements for accepting tax residency of a fund in the particular country compared to holding companies or conduits.
- Tax treaty access of investment funds organised as companies, and in principle entitled to tax treaty benefits, may be solved appropriately in the context of LOB clauses included in tax treaties to limit tax treaty access via investment funds for non-treaty investors.

- The taxation of domestic investors investing in foreign funds lacks sufficient tax neutrality in some jurisdictions although the taxation of resident and non-resident investors of domestic investment funds has been sufficiently streamlined by many countries.
- Tax authorities in some countries do not abstain from regarding either a domestic investment manager or a fund advisory entity as a permanent establishment of an offshore investment fund or an offshore investment management company.
- Unlike ‘conduits’, and trust and holding company arrangements for related parties in offshore locations, the vast majority of investment funds are set up for genuine investment reasons among others to address diverse conditions of unrelated investors in many countries in relation to equally diverse underlying investments they make collectively. The fact that a fund has been set up in a low tax or traditional offshore jurisdiction does not indicate that the fund strives for tax avoidance or tax arbitrage but only that the fund seeks tax neutrality or sometimes preferential tax treatment within generally acceptable legal and tax boundaries.