**WORK IN RELATION TO INTEREST DEDUCTIONS
AND OTHER FINANCIAL PAYMENTS**

In July 2013, the *Action Plan on Base Erosion and Profit Shifting*[1] directed the OECD to commence work on 15 actions designed to ensure the coherence of corporate income taxation at the international level.

Action 4 of this plan stresses the need to address base erosion and profit shifting using deductible payments such as interest that can give rise to double non-taxation in both inbound and outbound investment scenarios. From an inbound perspective, concerns focus on excess interest deductions reducing taxable profits in operating companies even in cases where the group as a whole has little or no external debt. From an outbound perspective a company may use debt finance to produce tax exempt or deferred income, thereby claiming a deduction for interest expense while the related income is brought into tax later or not at all. Similar concerns are raised by payments under financial instruments such as guarantees and derivatives.

Working Party No. 11 of the Committee on Fiscal Affairs (CFA) has examined existing approaches to tackling these issues in order to identify best practices in the design of rules to prevent base erosion and profit shifting using interest and financial payments which are economically equivalent to interest. This consultation document sets out different options for approaches that may be included in a best practice recommendation, and in particular considers issues including:

- What is interest and what are payments economically equivalent to interest.
- Who a rule should apply to.
- Whether a rule should apply to the level of debt or interest expense, and to a gross or net position.
- Whether a small entity exception or threshold should apply.
- Whether interest deductions should be limited with reference to the position of an entity's group.
- Whether interest deductions should be limited with reference to a fixed ratio.
- Whether a combined approach could be applied.
- The role of targeted rules.
- The treatment of non-deductible interest expense and double taxation.
- Considerations for groups in specific sectors.
- Interaction with other areas of the BEPS Action Plan.

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1 OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, available at http://www.oecd.org/ctp/BEPSActionPlan.pdf

- imputed interest on instruments such as convertible bonds and zero coupon bonds;
- amounts under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- amounts re-characterised as interest under transfer pricing rules, where applicable;
- amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity's borrowings;
- foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees with respect to financing arrangements; and
- arrangement fees and similar costs related to the borrowing of funds.

36. An illustration of how this definition could be applied in practice is included in example 1 in Annex 3. This definition is intended to ensure that countries take a consistent approach in terms of the payments covered by a best practice approach to tackling base erosion and profit shifting.

Questions for consultation

1. Do any particular difficulties arise from applying a best practice rule to the items set out in this chapter, such as the inclusion of amounts incurred with respect to Islamic finance? If so, what are these difficulties and how do they arise?
2. Are there any specific items which should be covered by a best practice rule which would not be covered by the approach set out in this chapter? What are these and how could they be included within a definition of interest and other financial payments that are economically equivalent to interest?

V. WHO SHOULD A RULE APPLY TO?

37. Base erosion and profit shifting can arise in a range of situations, including within a corporate group, with connected parties outside a group and through the use of structured arrangements with third parties. A robust response to tackling base erosion and profit shifting should apply to all incorporated and unincorporated entities and arrangements, including permanent establishments, which may be used to increase the level of interest deductions claimed in a country.

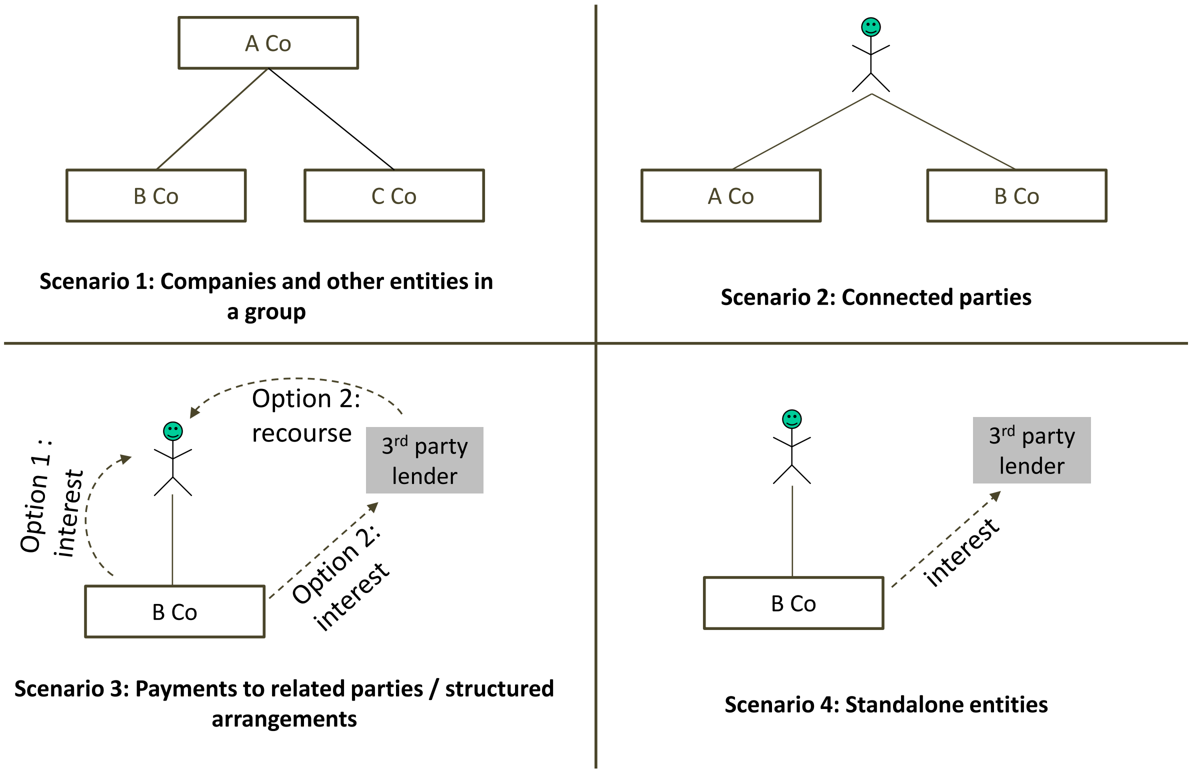
38. The countries involved in this work looked at four scenarios, set out below, and considered the extent to which they present base erosion and profit shifting risks and whether they should be covered by an interest limitation rule or rules.

- *Scenario 1*: Companies and other entities in a group, including permanent establishments. For these purposes entities are in a group where either (a) one entity has direct or indirect ownership or control over another entity, or (b) both entities are under the direct or indirect ownership or control of a third entity.

- *Scenario 2*: Connected parties. For these purposes entities are connected parties where they are under common ownership or control, but are not part of a group. This may arise, for example, where (a) an individual, fund or trust exercises control over the entities, or (b) a shareholder agreement exists which has the effect of bringing the entities under common control. The proposition is that collective investment vehicles under the control of the same investment manager should not be treated as connected parties if there is no other connection between them.

- *Scenario 3*: Payments made to related parties. For these purposes related parties include (a) significant shareholders and investors (and members of their family), (b) entities where there is a significant relationship but which is not sufficient to establish control, and (c) third parties where the payment is made under a structured arrangement. A significant shareholding or a significant relationship exists if one of the two parties concerned directly or indirectly holds a 25 per cent or greater investment in the other party. This is similar to the definition of related parties for the purposes of anti-hybrid rules recommended under Action 2.

- *Scenario 4*: Standalone entities. This would include all entities not falling into any of scenarios 1 to 3.



39. It is proposed that an approach to tackling base erosion and profit shifting using interest should apply to all companies and entities which fall within any of scenarios 1, 2 or 3, including partnerships taxed as separate entities and permanent establishments. Entities which are treated as transparent for tax purposes, including partnerships in many jurisdictions, should be taken into account to the extent they are owned or controlled by companies or other entities. However, it is recognised that companies and entities in each of these scenarios pose different risks and so different interest limitation rules may be applied. For example, risks posed by international groups may be addressed through rules which link interest deductions in each group entity to the position of the worldwide group, while risks posed by connected and related parties may be addressed through targeted rules which apply to specific arrangements. Applying a different set of rules should not, however, provide a competitive advantage to certain entities and the way they are held, for example in the context of private equity. Different types of rules are considered in Chapters VIII, IX and XI of this consultation document.

40. Although it is proposed that rules to limit interest deductions should be applied to entities in scenarios 1, 2 and 3, this would not prevent countries from applying an approach more widely if base erosion and profit shifting risks in their jurisdiction arose in a wider variety of situations. In particular, because of the difficulty tax administrations may have in identifying companies and entities that fall within scenario 3, some countries may wish to apply interest limitation rules to all companies and entities operating in their jurisdiction (ie. including those in scenario 4). This would reduce the risk of a rule missing possible base erosion and profit shifting, but could result in some companies and entities incurring an interest disallowance when in fact they pose little real risk.

Questions for consultation

3. Are there any other scenarios you see that pose base erosion or profit shifting risk? If so, please give a description of these scenarios along with examples of how they might arise.

4. Where do you see issues in applying a 25 per cent control test to determine whether entities are related?

VI. WHAT SHOULD A RULE APPLY TO?
(A) THE LEVEL OF DEBT OR INTEREST EXPENSE AND (B) AN ENTITY'S GROSS OR NET POSITION

41. There are two key questions that need to be answered with respect to the subject of an approach to tackling base erosion and profit shifting using interest expense. First, whether a rule should operate by reference to the level of interest expense in an entity or the level of debt. Second, whether a rule should focus on an entity's gross position (ie. only its interest expense or debt liabilities) or its net position (ie. also taking into account interest income or debt assets).

A. Application by reference to the level of interest expense or the level of debt

42. Rules to address base erosion and profit shifting using interest may operate directly, by restricting the amount of interest an entity may deduct for tax purposes, or indirectly, by restricting the amount of debt with respect to which an entity may claim deductions for interest.

43. To an extent, the answer to this question may depend upon the design of an interest limitation rule. For example, countries which currently limit interest deductions using an income statement test (for example, by reference to an entity's EBITDA) apply the rule directly to the level of interest expense. On the other hand, most countries that use a balance sheet test (which considers an entity's assets or equity) apply the rule to the level of debt. Countries which have more than one rule may take both approaches.

44. In considering whether a rule should operate by reference to the level of interest expense or debt, a number of factors have been taken into account. These include the following.

Factors in favour of referring to the level of interest expense:

- Action 4 requires that an approach should apply to interest expense and other financial payments which are economically equivalent to interest. For some of these payments there may be no existing requirement for an entity to separately identify a financial liability linked to the payment. This would make it difficult to apply a rule which adequately addresses risks posed by these instruments. Even where a specific financial liability can be identified, issues may arise surrounding the valuation of the liability. Payments for which tax relief is being claimed should be easier for entities and tax authorities to identify and value.

- The level of debt in an entity may vary throughout a period, which means that the amount of debt on a particular date, or an average for the period, may not be representative of an entity's true position. On the other hand, the level of interest expense in an entity will reflect all changes in borrowings throughout the period. This is therefore likely to give a more accurate picture of the entity's actual position over a period of time.

- Base erosion and profit shifting using interest is driven by the level of tax deductible interest expense incurred by an entity. Therefore a rule which refers to the level of deductible interest will directly address this key risk factor.

- A rule to limit interest deductions by reference to the value of the debt would still need some way to determine the level of interest expense which is to be disallowed if a limit is exceeded. In addition such a rule may fail to deal with cases where the nominal level of debt in an entity is not excessive, but this debt carries high levels of interest.

Factors in favour of referring to the level of debt:

- A rule based on the level of debt may allow an entity subject to a high interest rate on its borrowings to deduct more interest expense than an entity with the same level of debt which is subject to a lower interest rate. An entity could be subject to a higher interest rate because, for example, it operates in a high interest rate environment or it poses a greater credit risk.

- The level of debt in an entity is under the control of the entity's management and may be stable and easier to predict. The amount of interest expense, however, may vary reflecting market interest rate fluctuations. Where an entity has its debt based on floating interest rates it may be difficult to plan its financing structure to ensure it stays within any limits set by a rule that refers to the level of interest expense.

45. Taking into account the factors set out above, it is proposed that rules to tackle base erosion and profit shifting should operate directly by reference to the level of interest expense in an entity and not the level of debt.

B. Application to an entity's gross position or net position

46. Another key question in the design of an interest limitation rule is whether it should apply to the interest an entity incurs on its borrowings without any offset for interest income (gross interest expense) or after offsetting the interest income it earns on any loans and deposits (net interest expense). In this consultation document, 'interest income' includes receipts corresponding to the payments treated as interest or economically equivalent to interest in Chapter IV.

47. A gross interest rule may have the benefit of simplicity and is also likely to be more difficult for groups to avoid through planning. However, a gross interest rule could lead to double taxation where interest is paid on intragroup loans, and each entity is subject to tax on its full gross interest income, but part of its gross interest expense is disallowed. Therefore even where an interest limitation rule applies to gross interest, countries may look to introduce some form of tax relief for interest income in certain situations. Alternatively, countries may consider allowing an entity to carry forward disallowed interest expense into future periods or leave it to groups to restructure their internal funding arrangements to avoid double taxation.

48. A net interest rule will reduce the risk of double taxation, as interest income will already be taken into account before the interest limitation is applied. However, the fact that an entity has a relatively low net interest expense does not mean that base erosion and profit shifting are not taking place, if for example the entity would be in a net interest income position were it not for excessive levels of debt. Also, a rule which applies to net interest expense could be ineffective if groups can avoid the rule by converting other forms of taxable income into interest income, reducing the level of net interest to which the rule can apply. In addition, applying a rule to net interest expense would mean it has no impact on entities, such as banks, which are recipients of net interest income (see Chapter XIII).

49. However, based on the above considerations, it is proposed that a general interest limitation rule, which limits the overall level of interest deductions in an entity, should apply to the entity's net interest expense after offsetting interest income. Such a rule could be supplemented by targeted interest limitation rules to prevent groups avoiding the effect of a rule or which disallow gross interest expense on specific transactions identified as posing base erosion and profit shifting risks.

Question for consultation

5. What are the problems that may arise if a rule applies to net interest expense? Are there any situations in which gross interest expense or the level of debt would be more appropriate?

VII. SHOULD A SMALL ENTITY EXCEPTION OR THRESHOLD APPLY?

50. All general interest limitation rules involve some level of compliance burden on entities and administrative burden on tax authorities. While the main policy goal of the work set out in this consultation document is the design of rules to address base erosion and profit shifting using interest, it is recognised that certain entities may pose a sufficiently low risk that excluding them from a rule would be appropriate. Reducing the number of entities covered would also reduce the costs of administering a rule. This paper considers two ways to set a threshold below which entities would not be expected to apply a rule: an entity's size (a size threshold); or its level of net interest expense (a monetary threshold).

51. A size threshold would typically be based on a combination of factors such as the number of employees, turnover and total assets. This type of test is currently used by countries for a range of tax purposes, a number of which are discussed in a 2009 OECD Tax Policy Study on the taxation of small and medium-sized enterprises[17]. However, although in the broadest terms it may be correct to say that larger businesses typically pose a greater risk of base erosion and profit shifting, size thresholds ignore the fact that a highly leveraged small or medium sized entity may also have a high level of interest expense.

52. Alternatively, given that the proposal is that a general interest limitation rule will apply to limit deductions for interest expense, a more appropriate test for determining whether an entity should fall within the ambit of a rule could be the level of net interest expense in the entity. A monetary threshold would also be relatively simple to apply. This would ensure that small and medium sized entities which are highly leveraged are required to apply a general interest limitation rule to determine how much interest they may deduct, while larger entities with low levels of debt and interest expense are exempted from a rule.

53. The purpose of a monetary threshold would be to exclude entities with low levels of net interest expense, and which therefore pose a low risk of base erosion and profit shifting, from a general interest limitation rule. However, where the level of net interest expense in an entity exceeds the monetary threshold, it seems appropriate that a rule should apply to all the net interest expense in the entity. That is, it is not intended that a threshold will provide all entities with an amount of interest expense which is exempt from limitation.

54. A country should set the level of a monetary threshold to reflect its economic and interest rate environment and this may be reviewed periodically and updated to reflect changes in this environment. However, as the intention is to exclude only those entities which pose the lowest threat of base erosion and profit shifting, the threshold should be kept at a level which is appropriate to achieve this aim. Where a group has more than one entity in a country, it is preferable that the net interest expense of these entities should be considered together when determining whether a monetary threshold is reached. This ensures that local groups with the same amount of net interest expense are treated consistently, and that a group cannot avoid application of an interest limitation rule by atomising its operations into a large number of entities each applying a separate monetary threshold. For these purposes, countries which tax on a separate entity basis would apply the threshold to the aggregate net interest expense of all group entities in the

17. OECD 2009, *Taxation of SMEs – Key Issues and Policy Considerations,* OECD Publishing

country. Where a country operates a group taxation regime, the interaction of a threshold with this regime would need to be considered.

55. Box 2 below provides an overview of the monetary thresholds applied in selected countries.

Box 2. Overview of monetary thresholds in selected countries

Australia:	Thin capitalisation rule only applies if total debt deductions exceed AUD 2 million (***EUR 1 300 000***).
Denmark:	Limitation of deduction of net financing expenses (paid on related and unrelated party debt) exceeding DKK 21.3 million (***EUR 2.85 million***).
Finland:	Limitation of deduction of net interest expenses (paid on related and unrelated party debt) exceeding ***EUR 500 000***.
France:	Cap on interest deductions applies to net interest expenses exceeding ***EUR 3 million***.
Germany:	Limitation of deduction of net interest expenses (paid on related and unrelated party debt) exceeding ***EUR 3 million***.
Portugal:	Limitation of deduction of net interest expenses (paid on related and unrelated party debt) exceeding ***EUR 1 million***.
Spain:	Limitation of deduction of net financial expenses exceeding ***EUR 1 million***.

56. Countries considering the introduction of a threshold should be aware of possible impacts on commercial decisions by entities on their level of debt funding, particularly by entities which are close to a threshold. For example, an entity may reduce its net interest expense to fall within a threshold and avoid an interest disallowance. An entity may also increase its borrowings and net interest expense to breach a threshold and force an interest limitation rule to apply. This is most likely to be a consideration where a country has introduced provisions to allow the carry forward or carry back of disallowed interest expense or unused capacity to deduct interest expense. For example, where the result of a rule applying would be the creation of unused capacity to deduct interest expense, which could be carried forward or carried back and utilised in other periods. Carry forwards and carry backs of disallowed interest and the capacity to deduct interest are considered in Chapter XII.

57. It is not proposed that a threshold will be required as part of a best practice recommendation. However, countries involved in this work agree that if a country does wish to introduce a threshold, it should be designed to exclude only those entities which pose the lowest risk of base erosion and profit shifting using interest. This is likely to be best achieved using a monetary threshold linked to net interest expense. Also, where a threshold is introduced, it should be set at an appropriate level, taking into account the economic and interest rate environment in the country. In addition, it is preferable that the threshold should apply to the total level of net interest expense in the local group to avoid groups fragmenting into multiple entities each applying a separate threshold.

Question for consultation

6. Are there any other approaches that could be used to exclude low risk entities? What are these and what advantages would they have?

VIII. WHETHER INTEREST DEDUCTIONS SHOULD BE LIMITED WITH REFERENCE TO THE POSITION OF AN ENTITY'S GROUP

A. Group-wide tests as an approach to addressing base erosion and profit shifting

58. Rules to tackle base erosion and profit shifting by limiting interest deductions balance two objectives: allowing entities to claim tax relief for the real cost of their funds, while at the same time protecting a country from excessive interest deductions. As described in Chapter II, this may be best achieved through an approach which encourages groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group. This document considers a number of approaches which may be adopted by countries to achieve this aim, each of which has different advantages and disadvantages. This chapter considers general interest limitation rules which link overall interest deductibility in an entity to the position of its group. Later chapters look at rules which apply fixed ratios to limit interest deductions and targeted rules to tackle specific risks.

59. Group-wide rules limit an entity's deductible interest expense with reference to the actual position of its worldwide group. This chapter focuses on two types of group-wide rule which work on two basic premises. Firstly, that the best measure for total net interest deductions within a group is the group's actual net third party interest expense (ie. total interest paid to third parties less total interest income received from third parties). Secondly, that within a group interest expense should be matched with economic activity. Where net interest expense is matched with economic activity, groups will obtain tax relief for an amount equivalent to their actual third party interest cost. A key benefit of group-wide tests is that they enable a group to centralise its third party borrowings in the country and entity (including a group treasury company) which is the most efficient, taking into account non-tax factors such as credit rating, currency and access to capital markets, and then lend these borrowings within the group. As set out in section VIII.B below, a number of countries currently include other forms of group-wide rule within their existing approaches to tackle excess interest deductions.

60. Group-wide tests in theory have the greatest potential to tackle base erosion and profit shifting using interest. By limiting interest deductions to a part of the group's actual net third party interest expense, a group-wide test directly addresses issues of base erosion where a group claims relief for interest expense in excess of its actual interest costs. A group-wide test also reduces the risk of profit shifting, where taxable income is separated from economic activity, by directly linking the level of interest deductions available to earnings or asset values. Group-wide tests are suitable for dealing with issues arising from inbound and outbound investment and, if they are applied consistently by countries, they have the potential to reduce complexity for international groups which would otherwise need to comply with different, sometimes overlapping, rules in countries where they operate.

61. Because these rules take into account a group's real net third party interest expense, the total amount of interest which can be deducted by each entity increases or decreases to reflect changes in the group's actual interest cost. This approach is therefore flexible to the funding position of different groups, taking into account decisions of management, market conditions and sector specific issues. This means that group-wide tests should be suitable for groups operating in most sectors, and remain suitable as a group's funding needs change throughout its economic cycle. However, while a group-wide test ensures that an entity's net interest deductions reflect the position of its group, it does not impose any limit on how high the net interest expense of the group can be and hence the amount of interest deductions that can be claimed across the group. Where the funding needs and financial position of entities in a group are comparable, a group-wide test applied consistently in the countries where the group operates should ensure

that a group can deduct all of its net third party interest expense. This means, however, that a group-wide rule may need to be supplemented by targeted rules to address base erosion and profit shifting caused by excessive interest deductions on third party debt, as required under Action 4 of the BEPS Action Plan.

62. Some groups are engaged in a range of different activities and, if the positions of entities in a group are not comparable, an entity whose interest expense, earnings or assets are not in line with the rest of its group may find either that it cannot deduct its full net interest expense or that it is not fully utilising its capacity to absorb interest deductions. To an extent these issues may be addressed through provisions for the carry forward of disallowed interest expense, or unused capacity to deduct interest, into future periods. Also, where a group does not have any net third party interest expense (ie. its interest income received from third parties exceeds its interest expense paid to third parties), entities within the group would be restricted from deducting any net interest expense, although they should be able to deduct interest expense to the extent they also have interest income.

63. Another concern with group-wide tests is that volatility in earnings or asset values in one part of a worldwide group could impact the ability of all group entities to deduct their net interest expense. For example, under a group-wide rule which links the ability to deduct interest expense to asset values, a revaluation of intellectual property in one entity could result in an increase in the capacity of that entity to absorb interest deductions. Assuming the group's overall net interest expense remains unchanged, other entities in the group would find themselves able to deduct correspondingly less interest expense, even though their own financial position has not altered. Again, a rule could smooth the effect of this volatility by allowing an entity to carry forward disallowed interest expense or unused capacity to deduct interest into future periods.

64. The compliance cost to groups of complying with a group-wide rule will be largely driven by the availability of group data and the similarity of a rule with that applicable in other countries where the group operates. To the extent information can be obtained from consolidated financial statements, compliance costs may be relatively low. In practice however, it is likely that some additional information will be required. Reliance on group information which cannot be verified by reference to the consolidated financial statements will also increase administrative costs to tax authorities, which may need to exchange information with tax authorities in other countries for tax audit purposes. Where countries introduce consistent rules with the same information requirements, the overall compliance cost to a group should be substantially reduced, but it is likely that compliance costs to groups and administrative costs to tax administrations will be higher under a group-wide rule than under a fixed ratio rule based entirely on local entity numbers.

65. Countries where the tax treatment of interest follows the accounting treatment should be able to compare the amount of interest expense allowable under a group-wide test with the interest expense claimed by an entity without significant adjustment. However, where accounting and tax rules for recognising interest expense are different, a country will need to consider how a limit based on accounting principles can be applied to an entity's actual tax position, or if any special provisions are required to compensate for any mismatches.

66. Under a group-wide test, an entity can still claim a deduction for interest paid on intragroup debt. However, the overall level of interest expense that the entity can deduct is limited by reference to the group's third party interest expense. This means that in practice countries introducing a group-wide rule may no longer be concerned about the pricing of individual intragroup instruments, which could reduce the need for transfer pricing rules in this area. Similarly, where a group-wide rule applies a country may decide that there is less need for certain targeted rules, such as rules to address artificial debt (where there is no additional funding raised by the borrower) though this would be a question for each country to consider. A group-wide rule establishes a limit on the amount of net interest expense that an entity can deduct, but it

does not change the treatment of interest payments for other tax purposes (unless a country decides to make such changes). Therefore, even where a restriction is applied, interest paid by an entity may remain subject to withholding tax in accordance with a country's law. Other practical considerations with respect to group-wide rules are set out in the following sections of this chapter. These, together with any constitutional issues for countries which may arise, will need to be considered as this work progresses.

B. Options for group-wide rules: interest allocation rules and group ratio rules

67. This chapter considers two variations of group-wide tests:

- a group-wide interest allocation rule which operates by allocating a worldwide group's net third party interest expense between group entities in accordance with a measure of economic activity (such as earnings or asset values); and

- a group ratio rule which compares a relevant financial ratio of an entity (such as net interest to earnings or net interest to asset values), with the equivalent financial ratio of the entity's worldwide group.

68. In principle, these two approaches are very similar and could be used by countries to give the same result. However, when considering the design of a group-wide rule within a best practice approach to tackle base erosion and profit shifting, a key factor is the degree of consistency between the rules applied in different countries. Therefore, for the purposes of this consultation document, it is anticipated that an interest allocation rule would be applied consistently, with all countries applying the rule reaching agreement on the main elements (such as the definition of a group, the calculation of the group's net third party interest expense, and the allocation of interest expense between group entities). On the other hand, a group ratio rule would be applied more flexibly, with greater scope for a country to use its own approaches for determining each of these elements, for example to reflect existing domestic tax principles. This could give rise to a spectrum of rules, with some countries adopting a consistent approach while others incorporate narrow differences (such as excluding from a group's net third party expense certain items which would not be deductible under domestic tax law) or broad differences (such as using a domestic law definition of a group or calculating group earnings or asset values on domestic law principles).

i) Group-wide interest allocation rules

69. An interest allocation rule could operate in one of two ways.

- Firstly, by providing each entity with a deemed interest expense, equal to an allocation of part of the group's net third party interest expense. This allocation would be made in accordance with either earnings or asset values. The deemed interest expense allocated to each entity would be tax deductible. All interest actually paid or received by group companies would be disregarded. This is referred to as *a deemed interest rule*.

- Secondly, by providing each entity with an interest cap, equal to allocation of part of the group's net third party interest expense. This allocation would be made in accordance with either earnings or asset values. An entity's net interest expense on intragroup and third party debt up to this cap would be tax deductible. Any net interest income received by the entity would remain subject to tax. This is referred to as *an interest cap rule*.

70. The question of whether an interest allocation rule should allocate a deemed interest expense to group companies or an amount which acts as a cap on the amount of interest expense an entity may deduct is fundamental to the operation of a rule.

71. A deemed interest rule could be applied through the following steps.

a) A Co calculates the total net third party interest expense for its group.

b) A Co identifies its group's total earnings or assets.

c) A Co calculates its allocation of part of the group's net third party interest expense, determined based on the ratio of its earnings or assets to the group's total earnings or assets.

d) A Co's interest allocation is deductible for tax purposes. All interest expense paid or received by A Co is disregarded for the purposes of calculating its taxable profit (other than for the purposes of completing the above calculation). Interest expense paid or received by A Co may not however be disregarded for other tax purposes, such as for withholding taxes.

72. An illustration of how these steps would operate in practice is included as example 2 in Annex 3 to this paper.

73. An interest cap rule would be applied in two stages: firstly to calculate the entity's interest cap; and secondly to apply the interest cap to the entity's actual interest position.

Stage 1: Determination of an interest cap

a) A Co calculates the total net third party interest expense for its group.

b) A Co identifies its group's total earnings or assets.

c) A Co calculates its interest cap, which is an allocation of part of the group's net third party interest expense, determined based on the ratio of A Co's earnings or assets to the group's total earnings or assets.

Stage 2: Application of the interest cap

d) A Co calculates its taxable net interest income or expense under domestic tax rules. This should include financial payments economically equivalent to interest.

e) If A Co has taxable net interest income, this income remains subject to tax under normal domestic rules.

f) If A Co has taxable net interest expense, this is compared against its interest cap. Net interest expense up to the interest cap should be deductible for tax purposes. Net interest expense in excess of the interest cap is disallowed.

74. An illustration of how these steps would operate in practice is included as example 3 in Annex 3.

75. A deemed interest rule could be slightly simpler for countries to administer and groups to apply. It also has the advantage that, to the extent that all countries introduce a rule, this approach should ensure that all net third party interest expense is deductible within a group. However, countries have expressed serious policy concerns about introducing new rules which deem deductions for amounts which are not paid or accrued by an entity. There are also concerns this could give rise to unanticipated complications or opportunities for abuse. For example, a deemed interest rule could operate as an incentive for groups to raise third party borrowings in countries which do not apply the rule and have the fewest protections against base erosion and profit shifting. A group could then benefit from a deduction for its actual interest

cost which accrues in the entity which enters into the borrowing, and a second deemed deduction in group entities which are subject to an interest allocation rule. This risk is illustrated in example 4 in the Annex 3. In contrast, under an interest cap rule there is greater correlation between economic reality and the ability of companies to deduct interest expense. This approach is therefore likely to have fewer unintended consequences and is the approach favoured by countries.

76. Under an interest cap rule, an entity would be able to deduct net interest expense up to the level of its interest cap. Depending on its funding structure, a group should in principle be able to claim total deductions for an amount equal to its actual third party interest cost. However, in practice it is likely that many groups will not currently be in a position to do so. This is because some group entities may have interest expense in excess of the interest cap allocated to them, while others have an interest expense lower than their interest cap. To resolve this issue some groups may seek to re-organise their intragroup financing so that the net interest expense in each entity reflects the interest cap allocated to it. However, it is recognised that there may be tax and non-tax considerations (such as increased withholding taxes or exchange controls) that restrict a group's ability to re-organise its intragroup loans or impose a cost on it doing so.

77. Based on the issues outlined above, countries engaged in Action 4 agreed that if an interest allocation rule is included in a best practice approach to tackling base erosion and profit shifting, it should be structured as an interest cap rule. For the remainder of this consultation document, references to an interest allocation rule should be taken to mean an interest cap rule.

ii) Group ratio rules

78. A group ratio rule compares a relevant financial ratio of an individual entity (such as net interest to earnings or net interest to asset values) with that of its worldwide group. Where an entity's ratio is equal to or below that of the group, all of its third party and intragroup interest expense is deductible. Any interest expense which takes the entity's ratio above that of the group is disallowed.

79. A group ratio rule would typically be applied in two stages:

- Firstly, an entity calculates its group's ratio specified under the rule. For the purposes of determining this ratio, the interest amount would be the group's net third party interest expense (including financial payments which are economically equivalent to interest) after offsetting interest income (including financial receipts which are economically equivalent to interest).
- Secondly, an entity compares this ratio against its own position to establish the maximum amount of net interest expense which it may deduct for tax purposes. Net interest expense above this maximum amount is disallowed.

80. An illustration of the application of a group ratio rule is included as example 5 in Annex 3. As under an interest cap rule, some group entities may currently have interest expense that takes their financial ratio above that of their group (which would be disallowed), while others have interest expense below that which would be allowed. Groups may therefore seek to re-organise their intragroup financing to bring each entity's ratio more in-line with that of the group, subject to any barriers preventing them from doing so.

81. A number of countries have introduced group ratio rules as part of their overall strategy to address excess interest deductions.[18] However, in these countries the group ratio rule generally does not

18 . For example: Australia, Finland, France, Germany and New Zealand.

operate to limit interest deductions, but instead operates as a 'carve-out' which allows companies to escape application of a main fixed ratio rule. These carve-outs typically apply where the gearing of an entity (for example measured using a debt to equity ratio or equity to total assets ratio) does not exceed that of its group. The advantages and disadvantages of this approach are considered in Chapter X.

iii) Comparison of the two approaches

82. Group-wide interest allocation rules and group ratio rules share the same overall aim of ensuring that net interest expense within a group is matched with economic activity and that in total it should not exceed the value of the group's actual net third party interest expense. These rules may therefore limit the ability of certain entities to deduct their net interest expense, but they do not change the nature of the payments made by an entity for other tax purposes, such as for withholding taxes.

83. In designing a best practice rule under either approach, consideration needs to be given to the same key questions.

- Which entities should be included in an interest limitation group?
- How should a group's net third party interest expense be determined?
- How should economic activity be measured? (This will determine how an interest cap should be allocated or which group ratio should be used)
- How should mismatches between accounting and tax rules be addressed?
- How should cash pooling arrangements be treated?
- How should risks posed by connected parties and related parties be dealt with?

84. To the extent the same answers are reached with respect to these questions, an interest allocation rule and a group ratio rule should give the same result. However, in considering how the rules might be incorporated into a possible best practice, the degree of consistency in how countries design their rules could be different under the two approaches.

85. It is anticipated that an interest allocation rule would be implemented in substantially the same way by all countries. This would mean that countries would agree an approach to defining which entities are covered by a rule, how net third party interest expense of a group would be calculated and how an interest cap would be allocated between entities. Countries may still have some flexibility in terms of how an interest cap would be applied to an entity's net interest expense for tax purposes, taking into account their domestic tax system (for example whether they tax local entities separately or on a consolidated basis). This high level of consistency between countries means that an interest allocation rule should provide a coherent and effective solution to the issue of base erosion and profit shifting by international groups. However, because the method for calculating an interest cap needs to be agreed by all countries, mismatches are likely to arise when an entity's interest cap calculated in accordance with an internationally agreed approach is compared against the entity's taxable net interest expense calculated under domestic tax law. These mismatches will need to be addressed within the design of a rule.

86. On the other hand, it is expected that countries would have greater flexibility in the design of a group ratio rule. This could give rise to a spectrum of approaches: some countries could adopt consistent rules based on an agreed standard; some countries could incorporate narrow differences (such as excluding from a group's net third party interest expense certain items which would not be deductible under domestic

tax law); while other countries could include broader differences (such as using a domestic law definition of a group, or calculating group earnings or asset values based on domestic tax principles). Because a group ratio rule can be designed with a country's tax law in mind, mismatches between a group's ratio and an entity's ratio may be reduced. However, to the extent this means groups must comply with different rules in each country, this could significantly increase compliance costs. There is also a risk that differences between group ratio rules in different countries could create opportunities for base erosion and profit shifting (where total net deductions available exceed the group's actual net third party interest expense) or problems of double taxation (where total net deductions available are lower than the group's actual third party interest expense), and it may be impossible for a group to adjust its intragroup financing to comply with a different rule in every country. A simple illustration of this is included as example 6 in Annex 3. These potential problems under a group ratio rule are likely to be greater if countries introduce more differences between their rules.

87. Group ratios can also be applied directly to the earnings or asset value of an entity in its functional currency, whereas an interest cap is more likely to be calculated in the reporting currency of the group and would require translation into an entity's functional currency. This means that a group ratio rule may have advantages for countries with relatively volatile currencies.

88. As mentioned above in section VIII.A, where a group does not have any net third party interest expense, entities within the group would only be able to deduct interest expense to the extent they also have interest income. Example 7 in Annex 3 includes an illustration of this, under both an interest cap and a group ratio rule.

Questions for consultation

7. Are there any practical issues with respect to the operation of (a) interest allocation rules or (b) group ratio rules, in addition to those set out in the consultation document?

8. Where group-wide rules are already applied by countries, what practical difficulties do they give rise to and how could these be overcome?

C. What entities should be included in an interest limitation group?

89. The first key question in the design of a group-wide rule is the definition of the group among which the rule will be applied (the 'interest limitation group'). This will determine the types of base erosion and profit shifting transaction that a rule will address and also the information that an entity will need to obtain to apply a rule. The composition of an interest limitation group should be easily verifiable by entities and tax authorities and should ideally facilitate the collection of financial information for use in applying the rule, including details of the group's net third party interest expense and the level of earnings or asset values.

90. In many countries groups are required to prepare and file audited group financial statements. For public companies, this information is typically published. This means that group financial statements, and the underlying records used to produce those statements, should be readily available to a group's finance function and would be an extremely useful source of information on the financial position of the group overall. This information could then be provided to entities making up the financial reporting group. An implication of using financial statements as a source of information is that the operation of a group-wide rule will be influenced by future changes in accounting standards.

91. Designing a group-wide rule which applies to entities in a financial reporting group should therefore make it significantly easier for an entity to obtain information about its group. Generally, a financial reporting group will include a parent and all entities over which it has control. Control will typically be assumed where the parent has power over more than 50 per cent of the voting rights but may also exist under other circumstances. However, there are differences in the definition of control used in different accounting standards. It is recognised that in some cases this may mean that the composition of a financial reporting group may vary depending upon the accounting standards applied in preparing consolidated financial statements. Consideration needs to be given as to whether this variation is acceptable in order to make a rule easier to apply and administer.

92. Where a group is required to prepare consolidated financial statements at different levels of the group (for example, where a holding company is required to file consolidated financial statements including its subsidiaries, but the holding company is also included in the consolidated financial statements of its parent group), membership of the interest limitation group should be based on the highest level of consolidated financial statements prepared by the parent of the overall group. Where an entity is part of a group (in that it directly or indirectly controls or is controlled by another entity) which does not prepare consolidated financial statements, the entity would need to obtain financial information on the group in order for a rule to be applied. A rule could specify that these group numbers should be based on International Financial Reporting Standards (‘IFRS’) or other generally accepted accounting principles (‘GAAP’), such as that applicable in the country of the group’s parent entity.

93. Alternatively, in applying a group-wide rule, the actual composition of an entity’s financial reporting group could be disregarded. Instead, a single standard definition of an interest limitation group could be applied to all entities. This could be based upon an existing definition (for example, the existing definition under IFRS) or a new definition could be developed based on an ownership and control test agreed by countries. This approach would have the benefit of ensuring that the same definition of an interest limitation group is used by all entities wherever their group is located. However it would mean that, to the extent the composition of an entity’s interest limitation group differed from its financial reporting group, the entity would be required to prepare new group numbers for use in applying the rule.

94. Because of these practical difficulties, and because a rule needs to be workable for groups and tax administrations, it is proposed that any group-wide rule included in a best practice recommendation should apply to entities in a financial reporting group required to prepare consolidated financial statements. Where an entity is in a group which is not required to prepare consolidated financial statements, the composition of the interest limitation group should contain the entities that would be included in consolidated financial statements under IFRS or other specified GAAP. To limit the opportunity for arbitrage (for example where a group chooses to apply the accounting standard which gives it a beneficial outcome) the choice of accounting standard could be limited, for example to IFRS or the GAAP applicable in the country of the group’s parent entity.

95. Under this approach, a group-wide rule should apply to entities which are under the common control of an ultimate parent company. It will not apply to entities which are under the ultimate control of the same individual, trust or fund (which are described as ‘connected parties’ in Chapter V). However, in this case the rule may apply to a sub-group which is headed by a company held by the individual, trust or fund. Section VIII.H below considers how risks posed by connected parties can be addressed within a best practice approach that includes a group-wide rule.

D. How should a group’s net third party interest expense be determined?

96. Action 4 requires that best practice rules are developed to address base erosion and profit shifting using interest expense and also other financial payments economically equivalent to interest. It will

therefore be necessary for an entity applying a group-wide rule to obtain information on the total net third party interest expense, including amounts economically equivalent to interest, for its interest limitation group.

97. As an interest limitation group corresponds with an entity's financial reporting group, the consolidated financial statements should be a good starting point for obtaining information on the group's net interest position. A group's net third party interest expense, including amounts economically equivalent to interest, may be able to be determined on the basis of information contained in notes to the consolidated financial statements (for example, amounts included within investment income and finance costs in financial statements prepared under IFRS). This should provide an accurate reflection of the group's actual net interest expense position taking into account group borrowings and deposits with third parties. However, two adjustments may be required:

- to include any income or expense of the group which is economically equivalent to interest and is not included in these financial reporting figures; and

- to exclude any income or expense of the group which is treated as interest in the group's consolidated financial statements, but where the nature of the payment is such that it would not generally be taken into account for tax purposes.

98. Because it is anticipated that an interest allocation rule should be applied consistently by countries, under this type of rule the items excluded in the second bullet point above would need to be agreed by all countries applying a rule. Therefore, these are likely to be only those items which are not deductible in any country or in a significant majority of countries. Under a group ratio rule, a country would have greater flexibility to include amounts which would not be deductible under its own tax law.

Questions for consultation

9. Do any difficulties arise from basing a group-wide rule on numbers contained in a group's consolidated financial statements and, if so, what are they?

10. In what ways could the level of net third party interest expense in a group's consolidated financial statements be manipulated, and how could a rule address these risks?

E. How should economic activity be measured?

99. Under a group-wide rule, the net interest expense of an entity is linked to the net third party interest expense of its group in accordance with a measure of economic activity. Earnings and asset values are two measures of economic activity which are also measures of an entity's borrowing capacity. A group-wide rule could therefore compare a measure of earnings or asset values of an individual entity against the corresponding measure for the entire allocation group.

i) Measuring economic activity using accounting or tax figures

100. A comparison of economic activity between an entity and its group could in principle be based on either accounting or tax figures.

101. Accounting figures for the earnings or asset values of a group could be determined using the consolidated financial statements. This has an additional benefit that the published figures and underlying records will generally have been subject to independent audit. Where an interest limitation group does not prepare consolidated financial accounts, a rule may require an entity to provide group numbers prepared in

accordance with IFRS or other specified GAAP, which would impose a cost on groups if these numbers are not already prepared for any other reason.

102. In theory, earnings or asset values could also be determined using tax principles. This would allow the economic activity of an entity to be based on taxable profits or the tax value of its assets. However, in practice it is hard to see how tax principles could be used to measure the level of economic activity for a worldwide group without imposing a significant compliance burden on groups and an administrative burden on tax authorities.

103. It is therefore proposed that a comparison of economic activity should be based on an accounting measure of earnings or asset values. However, there may be some areas where these accounting figures can be adjusted to take into account key differences between accounting and tax rules (for example, by excluding categories of tax exempt income from a measure of earnings).

ii) Measuring economic activity using earnings or asset values

104. The key issues arising from the use of earnings or asset values as a basis for measuring economic activity are set out below.

a) Earnings-based approaches

Linking interest expense to value creation and the ability of an entity to raise borrowings

105. The level of earnings in different entities is usually the clearest indicator of value creation across a group, though there may be exceptions to this (for example, where an entity incurs losses while entering a valuable new market). Therefore a measure based on earnings could be the most effective way to ensure that net interest expense is matched with economic activity. An approach based on earnings may also give a fairer result for mixed groups which include entities engaged in activities requiring different levels of investment in assets.

106. In addition to reflecting value creation, the level of earnings is a direct measure of an entity's ability to meet its obligations to pay interest, and is a key factor in determining the amount of debt an entity is able to borrow.

Correlation between earnings and tackling base erosion and profit shifting

107. Where interest expense in an entity is linked to the level of earnings, a group can only increase net interest deductions in a particular country by increasing earnings in that country. Similarly, any restructuring to move profits out of a country will also reduce net interest deductions in the country. On the assumption that an increase in earnings will also give rise to an increase in taxable income, it is unlikely that the level of earnings will be manipulated in order to increase the interest deductions in a country.

108. Action 4 also specifically refers to addressing base erosion and profit shifting using interest expense to fund tax exempt or tax deferred income. In part, this may be addressed through a group-wide rule by using a measure of earnings that excludes dividend income (except possibly portfolio dividend income which is taxed on the same basis as ordinary income). This would ensure that a high interest cap was not allocated to an entity because of a high level of dividend income, which is often taxed on a preferential basis.

The measure of earnings

109. In principle, a group-wide rule could be designed using any measure of earnings, but the choice will directly influence how a rule will impact entities operating in different sectors. The most common measure of earnings currently used by countries with earnings-based fixed ratio tests is earnings before interest, taxes, depreciation and amortisation (EBITDA), although another possible measure that could be used is earnings before interest and taxes (EBIT). By excluding interest expense and also the two major non-cash costs in a typical income statement (depreciation of fixed assets and amortisation of intangible assets), EBITDA is a guide to the ability of an entity to meet its obligations to pay interest, which is an important consideration in determining how much interest expense an entity can reasonably afford to bear. On the other hand, this approach potentially favours entities operating in capital intensive sectors with high levels of fixed asset investment. This is because EBITDA does not include the write down of capitalised costs such as investment in plant and machinery, whereas it does take into account revenue costs which are the majority of the cost base for entities in other sectors. This could mean that if two entities have identical profits before tax, the entity in a more capital intensive sector could have a higher EBITDA and thus be allocated a higher interest cap under a rule which uses this as a measure of earnings, which may be appropriate to the extent it reflects the ability of entities to borrow against these assets.

110. Another possible measure of earnings would be revenue less cost of sales (gross profit). This has the advantage that gross profit is calculated on a broadly comparable basis across most accounting standards, with greater differences introduced as an entity works down its income statement. However, the use of gross profit could lead to problems where one entity in a group provides for example marketing or distribution services to other group entities. This is because the entity providing the service will include its income within its own gross profit whereas the entity paying for services will deduct the corresponding expense further down its income statement, making the comparison of entities difficult. This mismatch should not arise under an EBITDA measure.

111. As mentioned above, in order to address base erosion and profit shifting using interest to fund tax exempt or deferred income, any measure of earnings used may exclude dividend income.

Impact of consolidation adjustments

112. Intercompany transactions within a group mean that there may be cases where an individual entity recognises earnings that are not included in the consolidated earnings of the overall group. This may arise for example where an entity (A Co) sells components to another entity (B Co) in its group, which B Co will use to manufacture products for sale to customers. At an entity level A Co will recognise revenue from these intragroup sales, but on a consolidated level this should not be recognised until a sale takes place outside the group. Other consolidation adjustments may be required to strip out payments between entities for intragroup services.

113. An earnings-based approach may deal with this type of consolidation adjustments in three ways.

- Firstly, group and entity earnings could be compared without adjustment. So long as the measure of earnings used takes into account both sides of an intragroup transaction (ie. income in A Co is offset by expense in B Co), this should reflect the location of earnings across a group. However, where the measure of earnings used does not take into account both sides of an intragroup transaction (for example, where earnings is measured using gross profit, which does not include payments for marketing and distribution services), this approach could lead to an over-allocation of capacity to deduct interest expense among group entities. This is because the aggregated earnings of the group's entities would exceed the earnings in the group's consolidated financial statements. In principle, this approach could also lead to intragroup transactions being used to manipulate the outcome of a rule (for example, where intragroup payments are made to increase the level of earnings in one entity and reduce the level of earnings in another entity), although in practice this may be unlikely to happen as it should also give rise to more taxable income in the entity to which earnings are being shifted.

- Secondly, the total earnings of the group could be calculated using non-consolidated figures (ie. before intragroup transactions are stripped out). The main advantage of this approach is that it would reduce the risk of an over-allocation of capacity to deduct interest expense, as described in the bullet above.

- Thirdly, group earnings could be based on consolidated figures, but individual entities could adjust their earnings to strip out the effect of intragroup transactions. This would prevent manipulation using intragroup transactions. However, these adjusted figures would not typically be produced by entities, which could find such an approach difficult to apply. This would also mean that entities which transact entirely within their group would not recognise any earnings and would not be able to deduct any net interest expense.

114. Other consolidation adjustments, such as those required under purchase accounting and impairment accounting rules, will also need to be taken into account in the design of a possible best practice rule. The extent to which these adjustments will impact on the application of a group-wide rule will depend in part upon the measure of earnings used. For example, consolidation adjustments which result in a higher level of depreciation in a group's consolidated financial statements will impact a group's earnings measured by EBIT, but should not affect earnings measured by EBITDA.

Earnings volatility and losses

115. Entity earnings may be relatively volatile compared with asset values and there is a limit to the extent this can be controlled by a group. This means that under an earnings-based rule it may be difficult for a group to anticipate the level of net interest expense that will be permitted in a particular entity from year to year. A rule could be designed to include features to reduce the impact of this volatility. For example, a rule could be based on average earnings (over a period of say three years), or an entity could be allowed to carry-forward disallowed interest expense or unused capacity to deduct interest expense into future periods. Features of a possible carry-forward provision are considered in Chapter XII.

116. A particular aspect of earnings volatility is the possibility that individual entities or an entire group may be in a negative earnings (ie. loss-making) position. Three issues arise as a result of a group including loss-making entities.

- Firstly, under an earnings-based approach, loss-making entities will not be able to deduct any net interest expense, though a rule may allow disallowed interest to be carried into future periods.

- Secondly, the aggregated earnings of profitable entities in the group will exceed the group's actual total earnings. Therefore a group-wide rule could allow these entities to deduct an amount of net interest expense that exceeds the group's total net third party interest expense.

- Thirdly, unless a rule takes account of the impact of losses, a group-wide rule based on earnings would become impossible to apply where a group is in a loss-making position overall.

117. There appear to be two ways in which this situation could be dealt with, which are illustrated in examples 8 and 9 in Annex 3.

- A group's total earnings could be determined using only the results from entities which make a positive contribution to the group position. Entities with losses would be excluded from a calculation. This would remove the risk that entities would be able to deduct an amount of interest expense in excess of the group's actual net third party interest expense. However, this would require groups to be able to separately identify profitable and loss-making entities.

- Alternatively, a rule could accept that, to the extent an interest limitation group includes loss-making entities, the protection offered by a group-wide rule is reduced (and is removed completely where a group is in a loss-making position overall). For example, a group could use this situation to shift net interest expense to entities in higher tax jurisdictions (illustrated in examples 8 and 9 in Annex 3). However, it is not clear that in practice a group would include loss making entities in its consolidated financial statements in order to achieve limited flexibility in allocating its net interest expense.

Calculation of entity earnings

118. Under a group-wide rule, entity earnings should ideally be determined using the same accounting standards as are applied in preparing the group's consolidated financial statements. This would ensure a consistent approach across the group. However, the work on County-by-Country reporting under Action 13 identified the difficulties in producing consistent entity information across an international group. Therefore, where local GAAP is substantially similar to the accounting standards used in preparing the group's consolidated financial statements, a rule could provide for an entity's earnings to be calculated under local GAAP. For example, in a number of countries local GAAP has been largely aligned with IFRS and these countries may decide to accept the use of entity numbers based on local GAAP. This would reduce the compliance cost to groups and make auditing an allocation easier for authorities.

119. Many entities will operate and maintain accounting records in a currency which is different to the presentation currency in the group's consolidated financial statements. In these cases, an entity's earnings should be translated into the group's presentation currency using the exchange rate applied in preparing the group's financial statements. Where group financial statements are not prepared, a rule could provide for translation using the exchange rate for the dates of transactions or may allow the use of an average rate where this is not materially different.

b) Assets-based approaches

Linking interest expense to asset values

120. An important purpose of raising third party debt is to directly or indirectly fund the group's assets, which are used to generate revenue and earnings. The value of an entity's assets is also a key factor in determining the amount of debt it is able to borrow. Therefore an approach which uses asset value as a measure of economic activity within a group also has a good economic rationale. However, while there is a clear link between the level of earnings and the level of taxable income in an entity (depending on the measure of earnings used), the link between the level of assets and the level of taxable income in an entity may be less strong. Therefore an approach based on assets may not directly address base erosion and profit shifting risk to the same extent as an earnings-based approach.

Categories of assets to include in a calculation

121. An assets-based approach should take into account the value of a broad range of balance sheet assets, in order to accurately reflect a group's activities. However, this should not include financial assets which give rise to interest income. This is to ensure that the ability to deduct interest expense is allocated

to entities with economic activity and not by reference to the location of debt instruments. Also, in order to tackle base erosion and profit shifting from the use of interest to fund tax exempt and tax deferred income, equity investments which give rise to dividend income may be excluded (except possibly portfolio investments giving rise to dividend income which is taxed on the same basis as ordinary income).

122. Therefore, an assets-based approach could take into account the value of assets such as land and buildings, plant and equipment, goodwill and other intangible assets, inventory or stock, trade receivables, and financial assets which do not give rise to amounts treated as interest. But assets such as equity investments, cash and deposits, intragroup and third party loans, other intragroup balances, finance lease assets and other financial assets giving rise to amounts treated as interest could be excluded.

Stability in asset values

123. Compared with earnings, asset values are typically more stable (except in the case of revaluations and write-downs, and assets which are marked to market under accounting rules). This means that using asset values as a basis for measuring economic activity within a group should give rise to a relatively steady and predictable limit on the level of relief that can be claimed. This would improve certainty for groups and could also reduce compliance costs. In addition, an approach based on asset values would mean that entities with losses would still be able to deduct an amount of net interest expense, which would not be possible under an earnings-based approach.

Valuation of assets

124. The key issue surrounding an assets-based approach is achieving a consistent and acceptable model for valuing assets across an international group. A requirement to use market values of assets would appear to be impractical and impose an excessive compliance burden on groups. However, historic cost can give rise to inconsistencies across a group depending upon the age of assets and is subject to influence by decisions of management, for instance on depreciation and amortisation periods and the timing of revaluations and write downs. Differences between accounting standards also mean that under an assets-based model, it may be more difficult for countries to accept results which compare numbers based on different accounting standards.

Internally generated assets and intangibles

125. Intangible assets, including trademarks, patents and trade secrets, can be among a group's most valuable assets. This is particularly the case for major brands and for hi-tech groups. However, accounting standards typically impose stringent requirements on groups before they are able to recognise an intangible asset on their balance sheet, particularly where the asset has been internally created. Even where an intangible asset can be recognised, its carrying value is usually at historic cost, which may be only a fraction of its actual fair market value. Revaluations of intangible assets are generally only possible by reference to a fair value on an active market, and as such will rarely be permitted for most types of intangible.

126. The impact of this is that for a number of large groups, an approach to limiting interest deductions based on asset values for accounting purposes will ignore the group's most valuable assets.

Netting of derivative positions

127. A specific area of difference in the treatment of assets under accounting standards is in the recognition of derivative balances under IFRS and US GAAP, and in particular the ability of groups to report positions on a gross or net basis. This issue arises primarily in financial services groups, groups which have financial operations, and other groups which use derivatives to manage positions for example

in commodity markets. Where a group has offsetting asset and liability positions under derivatives with the same counterparty, these positions will generally be reported separately (ie. on a gross basis) by groups accounting under IFRS, except where an entity has a legally enforceable right of set-off and intends either to settle on a net basis or to realise the financial asset and settle the financial liability simultaneously. Where these conditions are met, IFRS requires the two positions to be reported as a single net asset or liability figure.

128. On the other hand, US GAAP allows groups to offset derivative assets and liabilities carried at fair value wherever two parties owe each other determinable amounts and there is a right of offset enforceable by law. This right of offset is typically found in master agreements which are in place between groups to provide protection in the event of insolvency.

Questions for consultation

11. What approach to measuring earnings or asset values would give the most accurate picture of economic activity across a group? Do any particular difficulties arise from this approach and how could these be addressed?

12. Are there any other difficulties in applying (a) an earnings-based or (b) an asset value-based approach? If so, what are they and how could these difficulties be dealt with?

13. What categories of tax exempt or deferred income should be excluded from the definition of earnings? How could these be identified by entities?

14. Do any particular difficulties arise from asking groups to identify entities with positive and negative earnings balances? What other approaches could be taken to address issues raised by groups with loss making entities under an earnings-based approach?

15. Where an entity's earnings or asset values need to be converted into the currency used in the group's consolidated financial statements, what exchange rate should be used for this conversion?

16. What specific issues or problems would be faced in applying a group-wide rule to a group engaged in several different sectors? Would an assets or earnings-based approach be more suitable for this kind of group?

17. What barriers exist which could prevent a group from arranging its intragroup loans so that net interest expense is matched with economic activity, as measured using earnings or asset values? How could this issue be addressed?

18. Do any particular difficulties arise from the application of a group-wide allocation rule to groups with centralised treasury functions? If so, what are these difficulties and do they vary depending upon how the treasury function is structured and operates?

19. If practical difficulties arise under an earnings or assets-based approach, would these difficulties be reduced if a rule used a combination of earnings and asset values (and possibly other measures of economic activity)? If so, what could this combined approach look like? What further practical difficulties could arise from such an approach?

F. How should mismatches between accounting and tax rules be addressed?

129. A number of mismatches between the accounting and tax treatment of specific items have been considered above, when looking at the calculation of net third party interest expense and the measurement of economic activity. This section focuses on issues that arise when an entity compares its interest cap or the amount of interest expense deductible under a group ratio rule, against its actual net interest expense for tax purposes.

i) Currency

130. In most cases an entity's interest cap under an interest allocation rule will have been calculated in the currency of the group's consolidated financial statements. However, an entity's taxable income will generally be calculated in its functional currency. Therefore, under an interest allocation rule, the interest cap will need to be translated into the entity's functional currency before it can be applied. This translation may be performed at the average exchange rate for the period, although a rule could allow a different exchange rate to be used if this would give a more reasonable result.

131. Under a group ratio rule, a ratio calculated using group numbers in one currency may be applied directly to an entity's earnings or asset value in a second currency without the need for translation.

ii) Permanent and timing mismatches

132. Under either type of group-wide rule, an entity should compare the amount of net interest expense allowable under the rule against its actual taxable net interest expense. An entity's taxable net interest expense includes financial payments economically equivalent to interest (as described in Chapter IV) and, where applicable, other payments which are re-characterised and treated as interest under transfer pricing rules. Where an entity's taxable net interest expense is lower than or equal to the amount permitted under a group-wide rule, the full net interest expense is deductible. Where an entity's taxable net interest expense exceeds the amount permitted under a group-wide rule, the excess is disallowed. The treatment of this disallowed interest expense is considered in Chapter XII.

133. Some differences between the amount of net interest expense allowable under a group-wide rule and an entity's taxable net interest expense will be the result of mismatches in how interest is recognised for accounting and tax purposes. These will include timing mismatches and permanent mismatches. Timing mismatches arise because the interest expense is recognised in different periods for accounting and tax purposes, and in most cases these should correct over the life of a debt. Permanent mismatches arise where the payments treated as interest or economically equivalent to interest in the group consolidated financial statements are different to those treated as such for tax purposes. For example, where an instrument is treated as debt for accounting purposes but equity for tax purposes, payments on that instrument are likely to give rise to permanent mismatches. As discussed in section VIII.D above, this is more likely to arise under an interest allocation rule, where all countries must agree which amounts in the group's consolidated financial statements will be taken into account in calculating net third party interest expense. Under a group ratio rule, a country can more closely link the definition of net third party interest expense to the amounts that will be included in the taxable interest expense of a local entity. This could reduce the number of permanent mismatches, though some they may still arise, for example where interest expense is valued differently for accounting and tax purposes. It is not possible to identify every mismatch which could arise between different accounting and tax rules in all countries, but as part of this consultation comments are invited on where significant mismatches are likely to arise.

134. Timing and permanent mismatches between tax and accounting rules can be addressed in several different ways. For example, timing mismatches could be addressed through provisions for the carry

forward of disallowed interest expense or unused capacity to deduct interest into future periods. The use of carry forwards is discussed in Chapter XII. On the other hand, permanent mismatches could for instance be taken into account by allowing a small uplift in amount of net interest expense deductible under a group-wide rule (so for example an entity would be permitted to deduct net interest expense up to say 105 per cent of its interest).

135. Under an interest allocation rule, where there are significant mismatches between the calculation of interest for accounting and tax purposes, these could be addressed by comparing the interest cap with the entity's net interest expense for accounting purposes and calculating the percentage of the accounting net interest expense which falls within the interest cap. This percentage may then be applied to the entity's net interest expense for tax purposes to determine how much should be allowable (up to 100 per cent). This option would avoid the need for a direct comparison of an interest cap calculated using accounting rules with an interest expense figure calculated using tax rules. A simple example of this approach is included as example 10 in Annex 3. A similar approach could be taken under a group ratio rule, though whether this would be required would depend upon the design of the rule.

iii) Deadlines for filing financial statements

136. Requirements to file entity and group financial statements will be determined under the law in the relevant jurisdiction. In some cases, an entity may be required to file its tax return and pay tax before these financial statements are audited and published. Countries should take into account the timing of the availability of financial information in the design of a group-wide rule, but in many cases groups will prepare and publish their consolidated financial statements significantly earlier than the date required under company law. In some countries entities are already used to using accounting information in the calculation of their tax liability before the publication of financial statements, and it is not anticipated that this should cause significant problems for groups.

Questions for consultation

20. In what situations could significant permanent or timing mismatches arise if an entity's interest cap or group ratio is calculated using accounting rules while its taxable net interest expense is calculated using tax rules?

21. Could all types of timing mismatch be addressed through carry forward provisions (covering disallowed interest expense and/or unused capacity to deduct interest expense)? What other approaches could be taken to address timing mismatches?

G. How should cash pooling arrangements be treated?

137. Cash pooling arrangements are a common part of treasury management in an international group. They allow a group to reduce its net third party interest expense by setting surplus cash balances in certain entities against borrowing needs in other entities, so essentially the group only pays interest on the net position. Interest income or expense is then allocated to individual entities in accordance with transfer pricing principles. Cash pooling can be structured in different ways, including notional arrangements (whereby each entity holds its own position and these are offset by the bank) and zero-balancing or cash-concentration arrangements (whereby each entity's position is swept into a single centralised bank account on a daily basis). International groups may also operate a separate cash pool for each currency in which they have significant operations.