

Public Discussion Draft

# **BEPS ACTION 4 APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS**

28 July 2016



**BEPS ACTION 4 – DISCUSSION DRAFT ON APPROACHES TO ADDRESS BEPS  
INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS**

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#### **BEPS ACTION 4 - DISCUSSION DRAFT ON APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS**

The report on Action 4, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, establishes a common approach to tackling BEPS involving interest, but highlights a number of factors which suggest that a difference approach may be needed to address risks posed by entities in the banking and insurance sectors. These include the fact that banks and insurance companies typically have net interest income rather than net interest expense, the different role that interest plays in banking and insurance compared with other sectors, and the fact that banking and insurance groups are subject to regulatory capital requirements that restrict the ability of groups to place debt in certain entities. The Report therefore provides at paragraphs 188 to 190 that countries may exclude entities in banking and insurance groups, and regulated banks and insurance companies in non-financial groups, from the scope of the fixed ratio rule and group ratio rule, with work to be conducted in 2016 to identify approaches suitable for addressing the BEPS risks posed by these sectors, taking into account their particular characteristics. This discussion draft has been produced as part of the follow-up work on this issue, which focuses on -

- the risks posed by banking and insurance groups to be addressed under Action 4,
- approaches to address risks posed by banks and insurance companies, and
- approaches to address risks posed by entities in a group with a bank or insurance company.

The discussion draft includes a number of specific questions (which appear in boxes) related to particular aspects of these topics. The CFA invites interested parties to send written responses to these questions, in order to facilitate the analysis of the issues covered by the discussion draft. As indicated in the final question, interested parties may also offer additional comments on any of the issues raised in the document. Responses should be sent by email to [interestdeductions@oecd.org](mailto:interestdeductions@oecd.org) in Word format, by no later than **8 September 2016**. They should be addressed to the International Co-operation and Tax Administration Division, OECD/CTPA.

Please note that all responses to this discussion draft will be made publicly available. Responses submitted in the name of a collective “grouping” or “coalition”, or by any person submitting responses on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

*The views and proposals included in this discussion draft do not represent consensus views of the Committee on Fiscal Affairs or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment. It is considered that stakeholder comments are essential to advancing this work.*

## **BEPS ACTION 4 – DISCUSSION DRAFT ON APPROACHES TO ADDRESS BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS**

### **Introduction and background**

1. International tax issues have never been higher on the political agenda. The integration of national economies and markets has increased substantially in recent years, putting a strain on international tax rules which were designed more than a century ago. Weaknesses in existing rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created. Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS by multinational groups. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty. Against this background, the BEPS package of measures for a comprehensive, coherent and co-ordinated response by countries was adopted by the OECD Council on 1 October 2015, endorsed by G20 Finance Ministers at their meeting on 8 October 2015 in Lima, Peru and endorsed by G20 Leaders at their summit on 15-16 November in Antalya, Turkey.

### ***The Action 4 Report and the common approach to tackling BEPS involving interest***

2. The use of interest is one of the simplest profit-shifting techniques available in international tax planning. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in an entity. The BEPS report *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (the Action 4 Report or the Report) includes a common approach to tackling BEPS involving interest and payments economically equivalent to interest. At the heart of the common approach is a fixed ratio rule which restricts an entity's net interest deductions to a fixed percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA) calculated using tax principles.

3. The Report also recommends that countries consider introducing a group ratio rule which allows an entity in a highly leveraged group to deduct net interest expense in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of its worldwide group. The Report contains a description of such a group ratio rule which permits an entity to deduct net interest expense up to the net third party interest expense/EBITDA ratio of its group and this represents an approach that should be suitable for most countries. However, flexibility is provided for a country to apply a different group ratio rule based on a relevant financial ratio of an entity's worldwide group, such as a different net interest/earnings ratio or an equity/total assets ratio similar to that currently applied in Finland and Germany, or to apply no group ratio rule.

4. The fixed ratio rule and group ratio rule are general interest limitation rules, which impose an overall limit on an entity's net interest deductions. In addition to these, the Action 4 Report recommends that countries should consider introducing targeted rules to deal with specific arrangements that pose a BEPS risk.

### ***The need to consider a different approach for entities in the banking and insurance sectors***

5. The common approach contained in the Action 4 Report is suitable for addressing BEPS involving interest in the majority of sectors. However, there are a number of factors identified in the Report which mean that a different approach may be appropriate when dealing with entities in the banking and insurance sectors.

- Banks and insurance companies are key providers of debt finance to groups in other sectors, either as lenders or as investors in corporate bonds. As such, entities engaged in banking or insurance business will typically have net interest income rather than net interest expense. The fixed ratio rule and group ratio rule apply a limit to the net interest deductions that an entity may claim, but have no impact on the ability of an entity with net interest income to deduct all of its interest expense, even if part of this is related to BEPS.
- Although banks and insurance companies are engaged in very different businesses, in both cases third party interest income is vitally important to ensure a group's profitability and liquidity. For most banks, interest income and expense are largely operating items and play a role which is broadly comparable with revenue and cost of sales for entities in non-financial sectors. For insurance companies, interest income is a major form of investment income used to meet insurance liabilities as they fall due. In both cases, the nature of interest is fundamentally different to that for most other businesses, where interest income is linked to the treasury function of managing a group's net debt.
- Banks and insurance companies are subject to regulatory capital rules and commercial constraints (e.g. from credit rating agencies) which require them to hold minimum amounts of equity and restrict their ability to place an excessive level of debt in particular entities or to use debt to fund equity investments in subsidiaries. It is essential that the nature, extent and impact of these requirements are understood in order to assess if and how they reduce the opportunities for certain entities to engage in particular types of BEPS activity.

6. In light of these considerations, the Action 4 Report concluded that, while countries should have an approach to deal with BEPS involving interest where it arises, a country could exclude entities in banking and insurance groups, and regulated banks and insurance companies in non-financial groups, from the scope of the fixed ratio rule and group ratio rule. Further work would be conducted in 2016 to identify appropriate approaches to address BEPS risks in these entities, taking into account the risks posed, the role interest plays in banking and insurance businesses, and restrictions already imposed by capital regulation. In particular it was noted that any approaches adopted should not conflict with or reduce the effectiveness of regulatory capital rules intended to reduce the risk of a future financial crisis.

7. The concerns listed above are relevant to entities in both banking and insurance sectors. However, there are significant differences between banking and insurance groups in terms of their business models, their structure, how they are financed and how they are regulated, and these also vary for groups in different countries. This means that the BEPS risks groups pose, and the approaches that may be appropriate to deal with these risks, may also differ. Therefore there is no requirement or expectation for a country to apply the same rules to both banks and insurance companies, or to both entities in a group with a bank and entities in a group with an insurance company. Entities such as captive insurers and group treasury companies which are not subject to capital regulation are not the subject of this discussion draft, and remain subject to the general approach set out in the Action 4 Report.

### **The risks to be addressed through interest limitation rules**

8. The fixed ratio rule and group ratio rule contained in the common approach under Action 4 provide countries with protection against the main broad risks of BEPS involving interest posed by multinational groups. These include cases where -

- excessive third party or intragroup interest expense is placed in a particular entity
- group entities use intragroup interest expense to claim net interest deductions in excess of the group's actual net interest expense

- an entity uses third party or intragroup interest to fund non-taxable income.

9. In the course of work on this discussion draft, countries have identified financing structures used by banking and insurance groups which pose the types of BEPS risk intended to be addressed under Action 4. The main BEPS risks involving interest that have been identified include -

- banks or insurance companies, and entities in a group with a bank or insurance company, using third party or intragroup interest to fund equity investments giving rise to income which is non-taxable or is taxed in a preferential manner;
- entities in a group with a bank or insurance company incurring excessive third party or intragroup interest expense, which may be set against taxable interest income in the bank or insurance company.

10. These fall into the categories of risk addressed in other sectors by the common approach in the Action 4 Report. It is therefore appropriate that work to identify approaches to address BEPS involving interest in the banking and insurance sectors should focus on these issues. This ensures that the risks to be dealt with in different sectors are comparable, and work on approaches to be applied in the banking and insurance sectors is based on the types of arrangement that countries see in practice rather than on hypothetical risks.

11. In identifying financing structures which pose a potential BEPS risk, countries distinguished between -

- risks posed by entities engaged in banking or insurance business and subject to capital regulation at a solo level (i.e. at entity level), referred to as banks and insurance companies in this discussion draft
- risks posed by other entities in a group with a bank or insurance company, including holding companies.

12. In considering approaches to deal with BEPS involving interest, these two broad categories of entity are looked at separately.

### **Question for consultation**

1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

### **Banks and insurance companies**

13. Banks and insurance companies are at the heart of the modern financial system. The two types of business are fundamentally different and these differences need to be recognised. However, in terms of identifying approaches to tackle BEPS involving interest, banks and insurance companies have three key features in common. First, for both banks and insurance companies the generation of interest income, either as operating income or investment income, is fundamental to their business and profitability. Second, banks and insurance companies are subject to prudential regulation which in most countries includes specific requirements on the amount and nature of capital they must hold. This may reduce the risk of banks and insurance companies being over-leveraged or engaging in certain transactions which pose a

BEPS risk. Third, in the significant majority of cases, banks and insurance companies will be in a net interest income position, rather than a net interest expense position which is common for most operating companies in other sectors. Therefore, to the extent there is a risk of BEPS involving interest after taking into account the impact of capital regulation, the fixed ratio rule which is at the heart of the common approach established in the Action 4 Report will not be effective in addressing this risk.

### ***The role of interest in banking and insurance***

14. Modern banks are engaged in providing a broad range of financial services to individuals and businesses. However, for most banks the use of deposits and short term debt to make loans remains a core activity. In undertaking this activity a bank generates profit by charging more interest on the loans it makes than it pays on its deposits and its debt, and managing its exposure to default and other risks. Interest is therefore a key source of a bank's profitability, which may be compared with revenue and cost of sales for entities in other sectors. This means that a bank will typically be very highly leveraged and interest expense is usually the biggest single expense item on a bank's income statement. However, once a bank's interest income is taken into account, in the significant majority of cases a bank will have net interest income overall. A possible exception may apply in the case of groups with significant investment banking activities, including securities trading (on behalf of the bank and/or its clients), deal arrangement, underwriting security issuances and the provision of advisory services and research. These activities may be funded using debt but give rise to non-interest income, which in some cases could result in a bank having net interest expense. Whether there is net interest income or net interest expense at the level of a group will depend upon the mix of investment banking and other banking activities. However, in the significant majority of cases it would be expected that a banking group will have net interest income.

15. Insurance business follows a very different model to banking, and concerns the taking of insurance premiums to underwrite risk, and paying out claims and other benefits to customers. Insurance companies invest premiums in stable income producing assets, often long-term debt instruments, in order to generate income and ensure sufficient liquidity to pay claims as they fall due. To the extent that premiums and investment income exceed claims and expenses, an insurance company will earn a profit. The generation of interest income is therefore a key part of an insurance company's business and overall profitability. Most of an insurance company's investments are funded using premiums rather than debt, and so insurance companies and groups typically have very low levels of leverage compared with banks. However, taking into account the income from investments, they are generally net interest income recipients by a significant margin.

### **Question for consultation**

2. Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?

### ***Excessive leverage in a bank or insurance company***

16. BEPS involving excessive interest deductions is in general viewed as a risk posed by entities in a group with a bank or insurance company, rather than by banks or insurance companies themselves. This is likely to be at least in part due to regulatory capital rules which require minimum amounts of equity to be held and limit the amount of leverage in a solo-regulated entity. A high level overview of the impact of regulatory capital rules on the level of equity in a bank or insurance company is included in Annex 2.

17. Regulatory capital rules are intended to ensure that the leverage of a bank or insurance company does not leave it with insufficient capital to deal with financial or economic shocks. Countries may wish to consider whether this also produces an appropriate outcome from a tax perspective. Circumstances where

regulatory rules may not produce an appropriate result for tax purposes are explored further below. This includes consideration of the position of permanent establishments of banks and insurance companies, which are generally not separately capitalised for regulatory purposes.

*The impact of regulatory capital rules on leverage in a bank or insurance company for tax purposes*

18. Banks and insurance companies are subject to regulatory capital requirements which require minimum levels of equity to be held to ensure they have sufficient loss-absorbing capital to adequately support the risks they face. In principle, by ensuring that a bank or insurance company is capitalised with an appropriate level of equity, these rules may also to some extent provide protection against excessive leverage for tax purposes and in many countries this will be the case. However, there are a number of factors that mean this may not always happen.

19. First, and most simply, regulatory capital rules differ between countries and the type of regulated activity undertaken. This is in particular the case for insurance companies where there is no accepted international standard for capital regulation. However, there are also differences in the way that the Basel III framework on the regulation of banks is introduced in different countries. Therefore, it is not possible to reach a conclusion that regulatory capital rules provide the same level of protection against excessive leverage for tax purposes in all countries and in all cases.

20. Second, differences exist in how regulators and tax authorities may view the issue of excessive leverage. Regulators are concerned with ensuring that banks and insurance companies are able to survive financial shocks long enough either for them to recover, or for an orderly resolution to take place. On the other hand, tax authorities are concerned with ensuring that an excessive level of interest-bearing debt is not pushed into an entity, reducing the level of profits subject to tax. This may lead to differences in how regulators and tax authorities view the leverage of a particular regulated entity. For example, although banking and insurance regulation typically requires a minimum amount of capital to be in the form of ordinary shares and retained earnings, some countries also allow interest-bearing instruments to be treated as regulatory capital for certain purposes and subject to prescribed limits. This may be because, although the instruments are legally in the form of debt, they include certain characteristics which mean they are able to absorb losses. For example, they may be automatically written-down or converted into equity on certain trigger events, or they may be long-dated and subordinated to other forms of debt. Where the interest on these instruments is tax deductible, a country may take the view that these instruments should be viewed as debt for tax purposes. In this case, a bank or insurance company's leverage for tax purposes may be higher than its leverage for regulatory purposes.

21. Finally, as described in the Action 4 Report, differences in the economic environment or legal frameworks in place in different countries mean that it is not possible to set a single limit on net interest deductions for tax purposes to be applied in all countries. Therefore, in introducing the fixed ratio rule, countries set a benchmark fixed ratio within a corridor of 10%-30%, taking into account relevant factors. Similarly, countries may take different views on what represents an appropriate level of leverage for a bank or insurance company for tax purposes, so long as this is not based on considerations that are inconsistent with the aims of Action 4. In light of this, even where two countries apply the same regulatory capital rules to a particular type of regulated entity, these countries may take different views as to the amount of interest expense that should be deductible for tax purposes.

### Question for consultation

3. Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country's regime.

#### *Attribution of free capital to permanent establishments of banks and insurance companies*

22. In a small number of countries, the banking or insurance regulator also requires minimum capital ratios to be maintained by a permanent establishment of a foreign bank or insurance company. However, this is not common and in most countries there is no regulatory requirement for capital to be allocated to a permanent establishment. Therefore, while regulatory capital rules may provide protection against a bank or insurance company being over-leveraged as an entity, these rules would not necessarily prevent a permanent establishment of a bank or insurance company claiming an interest deduction for all of its funding costs without limitation.

23. The *2010 Report on the Attribution of Profits to Permanent Establishments* (the 2010 Report) contains an authorised OECD approach for the attribution of profits to permanent establishments of banks and insurance companies, including the determination of the permanent establishment's 'free capital'. Free capital is the part of a permanent establishment's capital base which does not give rise to a funding cost in the nature of interest that is tax deductible in the host country. In broad terms, this can be compared with the equity capital of a separate entity.

24. The 2010 Report includes options to determine the free capital in a permanent establishment, using the level of risk weighted assets attributable to a permanent establishment of a bank or the level of investments assets attributable to a permanent establishment of an insurance company. These may be based on an allocation of the actual free capital of the entity as a whole (taking into account regulatory capital rules in the home country of the entity) or on the level of free capital that would be required by an independent enterprise carrying on the same or similar activities under the same or similar conditions (taking into account regulatory capital rules in the host country of the permanent establishment).

25. Where a country applies one of these options, a permanent establishment should be attributed an arm's length amount of free capital. However, as these approaches take into account either the regulatory capital requirements in the home country or the host country, the concern highlighted above that regulatory capital rules in different countries may not provide the same level of protection against excessive leverage for tax purposes is also relevant when looking at the position of a permanent establishment.

### Question for consultation

4. Are there other any general issues related to the operation of the authorised OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?

#### *Addressing BEPS involving excessive leverage in banks and insurance companies, including permanent establishments*

26. Countries should consider the level of BEPS risk currently posed by excessive leverage in banks and insurance companies in their country, including permanent establishments. In doing this, they should separately consider risks posed by banks and insurance companies, and any subset of these which are

material in that country (e.g. retail banks vs investment banks, life insurance companies vs general insurance companies, insurance companies vs reinsurance companies). In connection with the work on Action 4, excessive leverage in a bank or insurance company has not been identified as a key risk at this point in time and so it is anticipated that, in the majority of cases, this risk will be low. Where a country determines that this is the case, there may be less need for it to introduce tax rules aimed at dealing with a risk that does not exist or is already addressed.

27. If a country does identify a material BEPS risk from excessive leverage in banks and/or insurance companies, it would suggest that existing rules are not adequately addressing this concern. Unless suitable changes are planned, the country should consider introducing tax rules to deal with this. However, it is not expected that this will be an issue for the majority of countries and so there is no need at this time to develop a single common approach to deal with this risk. Instead, the final report on approaches to address BEPS involving interest in the banking and insurance sectors will include a summary of the approaches currently applied by countries. Countries may use this information in order to identify approaches which are suitable to address the specific risks they face.

28. Irrespective of whether or not a country identifies a material BEPS risk, it may still choose to apply general interest limitation rules to banks and insurance companies, for example if it applies such rules to other sectors and for policy or legal reasons it needs to apply similar rules to all entities.

#### **Questions for consultation**

5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?
6. What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.

#### *Applying the fixed ratio rule to a bank or insurance company*

29. The fixed ratio rule in the Action 4 Report sets a limit on an entity's net interest expense based on a percentage of entity-EBITDA calculated under tax principles. It is likely that in the significant majority of cases a bank or insurance company will be in the position of having net interest income rather than net interest expense, and so the fixed ratio rule would have no application. Therefore, the Report concludes that a country may apply the fixed ratio rule to banks and insurance companies, or it may also choose to exclude one or both of these from the scope of the rule.

30. However, there may be particular circumstances where a bank or insurance company has net interest expense. In practice, this may be more likely with respect to a bank rather than an insurance company, as typically insurance companies have a very low leverage, but in principle it could happen to either type of entity. Net interest expense could arise because of economic circumstances, such as where losses on a loan portfolio mean that the expected level of interest income is not received but the entity still incurs interest expense on its debt funding. More commonly, net interest expense may be a result of activities generating non-interest income. For example, banks engaged in investment banking activities may earn non-interest income of different types, including trading profits, dividend income, commissions and fees. Where the interest expense funding these activities exceeds the bank's interest income, it will have net interest expense.

31. Where the fixed ratio rule is applied to banks and insurance companies, the question as to whether or not it could result in a disallowance where an entity has net interest expense depends on a number of factors. The Action 4 Report provides that the fixed ratio rule may be applied entity-by-entity or to the net position of the local group. Where a country applies the fixed ratio rule to the position of the local group, which includes a bank or insurance company with net interest expense and also a bank or insurance company with net interest income, the local group may still have net interest income overall and the rule would have no effect. However, if a country applies the fixed ratio rule to each entity separately, or if a local group has net interest expense overall, then there could be a disallowance to the extent net interest expense exceeds the benchmark fixed ratio. This would be consistent with the treatment of entities in other sectors.

32. Where a country does not apply the fixed ratio rule to banks and insurance companies, there would be no disallowance even if an entity does have net interest expense above the benchmark fixed ratio. On the other hand, there are a number of potential benefits from excluding banks and insurance companies from the scope of the rule.

- This could mean that the fixed ratio rule may be applied more effectively to other entities in a group, without taking into account the net interest income or EBITDA of banks or insurance companies in the group. This is considered in more detail below.
- Because interest income is the main or a main source of operating income for most banks and insurance companies, even a profitable entity is likely to have low or negative EBITDA once all of its interest income and expense is removed. Therefore, in cases where a bank or insurance company finds itself in a net interest expense position as a result of poor market conditions, the fixed ratio rule is likely to result in a disallowance of most or all of this net expense. In particular for banks, as interest expense is typically a bank's largest single operating expense, this disallowance could seriously hinder an entity's ability to survive financial shocks.
- Where a country permits disallowed interest expense to be carried forward and used in later periods, entities in other sectors which incur an interest disallowance as a result of poor market conditions will generally be able to deduct this interest expense once they return to profitability. However, as most banks and insurance companies will always have a low or negative EBITDA even when they are highly profitable in terms of their level of net interest income, any disallowance that is incurred under the fixed ratio rule is likely to be permanent.

33. In deciding whether to exempt banks and/or insurance companies from the scope of the fixed ratio rule, a country should take into account these factors, as well as the likely number of occasions in which the rule could actually be applied to a bank or insurance company with net interest expense. For example, a country which applies the fixed ratio rule to the position of the local group may conclude that the rule would be capable of being applied less often than a country which applies the rule entity-by-entity.

#### **Question for consultation**

7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?

#### ***Interest expense funding non-taxable income in a bank or insurance company***

34. The fixed ratio rule sets a limit on an entity's net interest deductions based on its EBITDA calculated using tax principles. As this does not include non-taxable income, such as dividends or branch profits that benefit from a participation exemption, the rule prevents an entity from using income which is

not brought into tax to support a higher level of net interest deductions. However, as set out in this discussion draft, countries may exempt banks and insurance companies from the scope of the fixed ratio rule and, even where the rule is applied, the fact that banks and insurance companies typically have net interest income means that it is unlikely to have any effect. Therefore, countries should consider introducing alternative rules to address the BEPS risk posed by a bank or insurance company using interest expense to fund non-taxable income.

#### *Interest funding non-taxable income from an equity investment*

35. BEPS risks identified by countries which concern a solo-regulated entity using deductible interest expense to fund non-taxable income typically involve a bank receiving a non-taxable return on an equity investment. This may be because the return benefits from a participation exemption or some other favourable tax treatment, or because the tax on the return is largely or wholly sheltered by tax credits. However, while it is possible for a bank or insurance company to hold equity investments and receive non-taxable income, there are a number of regulatory and commercial considerations which impose costs or other down-sides as a result of it doing so, reducing the attractiveness of such arrangements in most cases.

36. First, where a bank or insurance company holds an equity investment in a subsidiary or in a financial undertaking outside the group, regulatory capital rules often require the value of this investment to be deducted from the bank or insurance company's own equity when assessing whether it meets capital adequacy ratios. This is to prevent 'double leverage' or 'double gearing', where capital which in economic terms is the same equity is taken into account by different entities, to support multiple tranches of risk. In effect, if a bank or insurance company uses borrowings to fund such an equity investment, it would then need to issue more equity in order to maintain its capital ratios. This would increase its cost of capital, as holders of equity typically demand a higher return than holders of debt. It is therefore relatively expensive for a bank or insurance company to over-capitalise a subsidiary. However, there are exceptions to this rule. For example, deductions against capital are typically only required for investments in subsidiaries or financial undertakings, and exceptions may apply where the parent and subsidiary are 'solo consolidated' (e.g. where there are no restrictions on the subsidiary's capital being paid up to support the assets of the parent, and so regulatory capital rules can be applied to the consolidated position of both entities).

37. Second, even where a bank or insurance company is not required to deduct a particular investment from its equity capital, regulators and ratings agencies both encourage groups to avoid using debt to fund equity investments. This is to prevent strain on a parent's cash flows where payments of interest and principal on its debt are in effect subject to the ability of a subsidiary to pay regular dividends. This will be exacerbated if there are restrictions on those dividends, either because the subsidiary may not have sufficient earnings after financing its own debt or because the payment of dividends requires the approval of a local regulator. The approaches used by regulators to monitor this risk vary by country and sector and, while these rules do not prohibit all cases where debt is funding an equity investment, regulators may intervene if the level is excessive or if the debt issued by the parent does not appear to be sustainable.

38. Finally, groups and regulators will typically try to avoid situations where an excessive level of equity capital is 'trapped' in a subsidiary. Equity is less flexible than debt and once injected into a foreign subsidiary it can be difficult to redeem the equity and repatriate the capital to the parent. This is particularly the case where the subsidiary is subject to regulatory capital requirements, and so equity capital can only be redeemed in limited circumstances including at the approval of the local regulator. Because of this lack of flexibility, a group's regulator may require a parent to obtain approval before capitalising a foreign subsidiary using equity, to limit the risk of capital being trapped in scenarios where it is needed by rest of the group.

39. Despite these considerations, a number of countries involved in the work on Action 4 have identified cases where solo-regulated entities claim deductions for interest funding equity investments

which give rise to non-taxable income. These include, for example, cases in which banks incorporate equity funded vehicles in low tax jurisdictions, which are used to invest in portfolio investments. Income in these vehicles is subject to low or no taxation, while the interest expense on the debt funding the investments is set against taxable interest income in the banks. Countries which have identified such a concern should therefore consider introducing measures to deal with this kind of risk. Possible options may include rules to disallow the interest expense used to fund non-taxable income, rules to reduce the amount of income which benefits from a participation exemption or other favourable regime to reflect the value of the interest funding the income, and rules that turn off the participation exemption or beneficial regime in certain circumstances. In considering the need for such measures, and in designing measures where they are judged appropriate, a country may take into account features of a country's regulatory capital regime where these are relevant. For example, where a bank or insurance company has been required by regulatory capital rules to deduct the value of an equity investment from its own equity capital, a rule may treat this investment as funded wholly using equity. In this case, there may be no need to apply a tax rule to address interest funding non-taxable income.

40. As described above, the final report on approaches to address BEPS involving interest in the banking and insurance sectors will include a summary of the rules currently applied by countries which are intended to provide protection against BEPS involving interest in the banking and insurance sectors. This may then be used by countries which have identified cases of interest being used by banks and insurance companies to fund non-taxable income, to develop suitable rules based on the risks they encounter and the structure of their tax system.

#### **Questions for consultation**

8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?
9. What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

#### *Interest funding non-taxable income from an investment in a permanent establishment*

41. Banking and insurance groups often operate through branch structures rather than subsidiaries. A driver of this is the fact that branches typically do not need to be separately capitalised for regulatory capital purposes, and so a branch structure provides greater flexibility in terms of overall capital management. As regulatory capital rules generally do not take into account the capitalisation of branches, they may not provide protection against a bank or insurance company claiming interest deductions on debt which is funding a permanent establishment which is not taxable in the residence jurisdiction (e.g. because a participation exemption applies).

42. However, as described above, the 2010 report contains an authorised approach to attribute profit to permanent establishments, including options for attributing free capital to the permanent establishment of a bank or insurance company. So long as the residence country applies one of these options, this should ensure that a bank or insurance company cannot attribute an excessive amount of free capital to a permanent establishment and claim a deduction for excessive interest expense in the residence country. Therefore, if country applies the authorised approach, there may be no need for the country to apply additional tax rules to deal with a bank or insurance company using interest expense to fund non-taxable income from an investment in a permanent establishment.

### Question for consultation

10. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?

#### *Targeted rules to address specific risks*

43. Alongside the fixed ratio rule and group ratio rule, the Action 4 Report recommends that countries consider introducing targeted rules to address the following specific BEPS risks.

- An entity which would otherwise have net interest income enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party to reduce the level of interest income subject to tax in the country
- An entity makes a payment of interest on an “artificial loan”, where no new funding is raised by the entity or its group.
- An entity makes a payment of interest to a third party under a structured arrangement, for instance under a back-to-back arrangement.
- An entity makes a payment of interest to a related party which is excessive or is used to finance the production of tax exempt income
- An entity makes a payment of interest to a related party, which is subject to no or low taxation on the corresponding interest income.

44. Although regulatory capital requirements reduce the risk of a bank or insurance company being over-leveraged in general terms, they are unlikely to prevent an entity in all cases from entering into a scheme that gives rise to particular BEPS outcomes. Therefore, where targeted rules are introduced to address these specific risks, they may be applied to banks or insurance companies in the same way as to other entities. However, depending upon how a rule operates, in some cases a particular targeted rule may have an unintended or excessive impact if applied to a bank or insurance company without modification. In this case, a country should consider applying a modified version of the rule to banks and/or insurance companies, taking into account their particular characteristics, to ensure a comparable level of protection against BEPS involving interest by entities in different sectors.

### Question for consultation

11. Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

#### **Entities in a group with a bank or insurance company**

45. A bank or insurance company will typically be part of a group with other entities. These may include holding companies, entities which support the activities of the bank or insurance company, entities engaged in financial activities which are not subject to regulatory capital requirements, and entities engaged in non-financial activities. This final category will be particularly relevant where a bank or

insurance company is part of a non-financial sector group (such as a manufacturing or retail group) but may also arise in some financial sector groups.

46. The section above considered the position of banks and insurance companies that are subject to regulatory capital requirements at an entity or solo level. Regulators may also require capital ratios to be met at the level of a worldwide group, a regional group (e.g. in the European Union) and/or a local group (e.g. including all group entities in the same country). In these cases, debt issued by a group entity which is not a bank or insurance company may be taken into account in testing whether the group meets relevant capital ratios, and this can operate as a limit on the capital structure of all entities in the group. However, where a group includes entities in more than one country, or includes entities which are taxed differently, there may still be scope for these entities to engage in BEPS without preventing the group as a whole from meeting its regulatory capital requirements. In addition, there may also be cases where an entity is resident in a country for tax purposes, but because of how it is held it is not part of the local group for regulatory purposes. Debt issued by these entities will not be taken into account in testing the capital ratios of the local group, although they would be taken into account in assessing the capital adequacy of the worldwide group. Therefore, entities in a group with a bank or insurance company may pose BEPS risks which are similar in nature to those posed by entities in other sectors, although the extent of these risks may be limited by group regulation.

47. The fixed ratio rule and group ratio rule provide countries with protection against entities in other sectors being over-leveraged using third party or intragroup debt, and from using deductible interest expense to fund non-taxable income. In principle, these rules could be used by countries to provide protection against BEPS involving interest by entities in a group with a bank or insurance company. However, depending upon how a rule is implemented by a country, the rules may be modified to ensure that the presence of a bank or insurance company in a group does not reduce their effectiveness when applied to other group entities.

### Questions for consultation

12. Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?

#### *The fixed ratio rule*

48. In applying the fixed ratio rule to an entity in a group with a bank or insurance company, a country should consider two particular issues -

- the application of the rule to the net position of a local group
- the treatment of interest expense on debt supporting banking or insurance activities.

#### *Application of the fixed ratio rule to the net position of a local group*

49. The Action 4 Report provides that the fixed ratio rule may be applied separately to each entity in a group or it can be applied to the net position of the local group taking into account the net interest expense and EBITDA of all group entities in the country. Where a country applies the fixed ratio rule on an entity-by-entity basis, and there is no ability for the surrender of unused interest capacity or disallowed interest expense between group entities, then the rule can be applied to entities in a group with a bank or insurance company in the same way as to entities in other types of group.

50. The flexibility to apply the fixed ratio rule to the net position of the local group (or to allow the surrender of unused interest capacity or disallowed interest expense within a group) is intended to avoid a situation where an entity incurs an interest disallowance if this could be sheltered by unused interest capacity in an entity in the same group in the same country. Where a country applies such an approach, there may be cases in any sector where certain entities in a group generate net interest income, which offsets or reduces the level of net interest expense in other group entities subject to the rule. This may be appropriate for groups in the majority of sectors, where all or most of the group's interest income and expense arises as a result of managing the group's overall net debt and hedging, which is secondary to the group's main activities. However, there are two factors that suggest this approach may not be appropriate for entities in a group with a bank or insurance company.

- The generation of net third party interest income is a key part of the main business of a bank or insurance company. This means that the nature of interest in a bank or insurance company is different to that in other types of entity. In applying the fixed ratio rule, it may therefore not be appropriate for the net interest income of a bank or insurance company to be offset against the net interest expense of other group entities, which has a nature closer to that in other sectors (although see comments below with respect to interest expense on debt supporting banking or insurance activities).
- In the majority of cases, the net interest income of a bank or insurance company will exceed the net interest expense of all other entities in the local group. This means that the fixed ratio rule would not provide any protection against BEPS involving interest by group entities engaged in other activities. Even where the net interest income of a bank or insurance company does not entirely offset net interest expense of other entities in a group, it will typically still significantly reduce the level of protection provided by the rule.

51. It is not suggested that the nature or level of interest income in a bank or insurance company increases the BEPS risk posed by a group. However, to ensure that the fixed ratio rule provides protection against the BEPS risks posed by other entities in a group, where a country applies the fixed ratio rule to the net position of a local group it should consider applying the rule to the local group excluding banks and insurance companies. The impact of this is illustrated by Examples 1 and 2 in Annex 3. To the extent that a country intends to apply the fixed ratio rule to banks and insurance companies, these could be included in a second local group containing only solo-regulated entities, to which the fixed ratio rule would be applied separately.

52. Where a country adopts this approach, interest expense in banks and insurance companies would typically be fully deductible. Where a particular bank or insurance company has net interest expense, in most cases this would be offset by net interest income in other banks or insurance companies in the local group. Net interest expense in other group entities would also be deductible, up to the benchmark fixed ratio. It is expected that excluding banks and insurance companies from a local group should in most cases remove the main operating entities which earn interest income as a primary activity. The impact of the rule on an entity in a group with a bank or insurance company should thus be closer to that on entities in other groups. However, the local group may still include some entities with net interest income, such as those engaged in providing finance leases to customers. A country may therefore also consider ways in which the fixed ratio rule could be modified to reduce the impact of these other entities with net interest income.

53. Where a country taxes groups on a consolidated or similar basis, the fixed ratio rule could be applied without taking into account the EBITDA or net interest position of banks and insurance companies within the consolidated tax group. However, it is recognised that this could be more difficult to apply compared with the situation in a country where entities are taxed separately, and this may be taken into account by a country in deciding whether to adopt this approach.

*The treatment of interest expense on debt supporting banking or insurance activities*

54. Where a country applies the fixed ratio rule to the position of a local group excluding banks and insurance companies, this ensures that net interest expense funding the activities of other entities is deductible up to the benchmark fixed ratio. However, in some cases these entities may incur interest expense on third party loans used to support regulated activities in a bank or insurance company within the group.

55. This is most likely to happen where a holding company (or other entity which is not a bank or insurance company) issues interest-bearing instruments to third party investors which count as regulatory capital for the purposes of the group's capital adequacy ratios. Depending upon the terms of the instrument these may be treated as different levels of capital for regulatory purposes (e.g. as Additional Tier 1 or Tier 2 capital under Basel III or as Tier 1, Tier 2 or Tier 3 capital under Solvency II). These instruments may be issued by a particular entity due to a requirement or a preference on the part of regulators for a group to issue regulatory capital from a 'single point of entry' which is usually, although not always, at the top of the group. There are also important practical benefits for a group from issuing regulatory capital instruments out of a single entity, which enables the group to maximise the flexibility and efficiency of its capital. Following the issue of such instruments, three things may occur.

- The capital may be retained by the issuing entity. A group may hold capital in addition to the amount required by particular entities. This capital is retained at the top of the group in order to ensure flexibility in the event that additional capital is required by a particular part of the group.
- The capital may be on-lent within the group as interest-bearing regulatory capital. This may be on the same terms as the third party instrument, or it may be on different terms in which case the interest rate on the third party and intragroup instruments could differ.
- The capital may be injected into a group entity in the form of equity. There are regulatory and commercial constraints which limit the extent to which a group can use interest-bearing instruments to fund equity investments, but there are cases where this does arise. For example, a local regulator may require additional equity to be provided to a solo-regulated entity, but the group may have capacity to fund this out of capital it already has available, some of which is in the form of interest-bearing instruments.

56. In each of these cases, the entity issuing regulatory capital may incur a net interest expense, either because it has no interest income or its interest income is lower than its interest expense, and this could be subject to limitation under the fixed ratio rule. However, this outcome may not be appropriate if these instruments are issued to support regulated banking or insurance activities, but the net interest income derived from those activities is not taken into account because banks and insurance companies are not included in the local group. Therefore, where a country applies the fixed ratio rule to a local group excluding banks and insurance companies, it should consider excluding some or all of the third party interest expense on regulatory capital from the net interest expense subject to the rule. The impact of this approach is illustrated by Examples 3 and 4 in Annex 3.

57. This should give the correct outcome from the perspective of the country and from the perspective of the group. In the majority of cases the interest expense on regulatory capital instruments will be lower than the net interest income derived from regulated banking or insurance activities and so, had the instruments been issued directly by a bank or insurance company, none of the interest expense would be disallowed. A country may take the view that this outcome should not be altered where instruments are issued out of a different entity in order to meet the requirements of regulators. For consistency, if a country adopts this approach then in applying the fixed ratio rule it should also exclude from net interest expense any interest income received by the local group on regulatory capital issued to it either by a bank or insurance company, or by another group entity in a different country.

58. Some regulators require foreign headed groups to establish a local holding company, which must issue regulatory capital instruments to support the activities of banks and insurance companies in that country. These instruments will typically be issued intragroup, for example to a top-level holding company which issues regulatory capital instruments to third party investors. In this situation, a country may adopt a similar approach to that set out above. Where the fixed ratio rule is applied to the local group excluding banks and insurance companies, the net interest expense subject to limitation would exclude interest expense on regulatory capital issued by the local group and interest income on regulatory capital issued to the local group. Where intragroup interest is paid on an instrument which has the appearance of regulatory capital, but which is not in fact treated as regulatory capital by the local group, this exclusion should not apply. This is to prevent entities taking advantage of the exclusion by issuing an excessive amount of intragroup instruments which are not actually treated as capital for regulatory purposes.

59. Where a country applies the fixed ratio rule on an entity-by-entity basis, a similar issue may arise. An entity other than a bank or insurance company may incur a disallowance of interest on regulatory capital it has issued, as the fixed ratio rule will take into account the entity's net interest expense but not the interest income generated by regulated activities in a bank or insurance company in the group. In this case, the country may exclude interest expense on regulatory capital issued by the entity, and interest income on regulatory capital issued to the entity, from the net interest expense subject to the rule. However, in these circumstances a country may also take the view that the argument to exclude certain categories of interest income and expense is weaker. This is because, where the rule is applied entity-by-entity, any entity which incurs net interest expense on instruments which fund interest income or EBITDA in another entity may incur a disallowance. Therefore, an entity which does so in a group which includes a bank or insurance company is not necessarily in a worse position than an entity in a group in a different sector.

60. There may also be circumstances where third party debt which does not qualify as regulatory capital is raised by another entity in a group to fund activities in a bank or insurance company. In many cases, it is expected that this debt will be on-lent to the bank or insurance company on similar terms, and so it does not pose an issue for the operation of the fixed ratio rule (i.e. interest income will offset interest expense, perhaps leaving an interest margin). However, there may be some cases where this debt is used to fund an equity investment, for example as acquisition finance to fund part of the purchase price of a bank or insurance company, and in this case the entity raising the debt will have a net interest expense. Where the entity with the net interest expense and the bank or insurance company are in the same country, the country should consider permitting an adjustment to exclude the net interest expense from the scope of the fixed ratio rule. This is on the basis that the net interest expense is funding activity which is taxable in the same country and so does not pose a BEPS risk. Where an entity has non-regulatory capital debt funding equity investments in a number of banks or insurance companies, this may involve an allocation of net interest expense between equity investments in banks or insurance companies in the same country and those in other countries.

#### *Other issues*

61. In addition to those described above, other issues which countries may take into account in applying the fixed ratio rule to entities in a group with a bank or insurance company include the following.

- The fixed ratio rule in the Action 4 Report limits net interest deductions by reference to an entity's EBITDA, which excludes interest income and expense. Because interest is a key source of income for banking and insurance groups, in some cases the EBITDA of entities in such a group may be low even if the results of banks and insurance companies are excluded. In these cases, this could result in the fixed ratio rule having a greater impact on entities in a banking or insurance group, compared with that on entities in other sectors.
- The Action 4 Report states that rules to address BEPS involving interest should be robust against attempts to avoid or reduce their effect. For example, the Report at paragraph 171 provides that

the fixed ratio rule should be supported by targeted rules to counteract planning by groups, including where an entity with net interest expense enters into arrangements to reduce the net interest expense subject to the rule. These targeted rules should therefore cover arrangements which artificially shift interest income from a bank or insurance company to another group entity, to reduce the level of net interest expense subject to limitation in that entity

### Questions for consultation

13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company -
  - a. application of the fixed ratio rule to the local group excluding banks and insurance companies
  - b. the treatment of interest expense on debt supporting banking or insurance activities
  - c. other issues?
14. Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?

### *The group ratio rule*

62. The group ratio rule described in the Action 4 Report enables an entity with net interest expense in excess of that permitted under the fixed ratio rule to deduct more interest expense, to the extent this is in line with the net third party interest expense/EBITDA ratio of the entity's group. The Report also provides flexibility for a country to apply a different group ratio rule based on a relevant financial ratio of an entity's worldwide group, such as a different net interest/earnings ratio or an equity/total assets ratio, or to apply no group ratio rule.

63. The majority of groups which include a bank or insurance company are likely to have net third party interest income, once the interest income of the bank or insurance company is taken into account. Where a bank or insurance company is part of a non-financial group, its interest income may not be sufficient to put the group into a net interest income position overall, but it is likely that it will still significantly reduce the group's net third party interest expense. Where the fixed ratio is applied on an entity-by-entity basis, or to the position of the local group excluding banks and insurance companies, this means an entity in a group with a bank or insurance company could incur a disallowance of net interest expense under the fixed ratio rule, but the group ratio rule may not provide any relief.

64. Where a country applies the fixed ratio rule on an entity-by-entity basis, an entity which is in a group with a bank or insurance company will be in the same position as any other entity which is part of a group with net third party interest expense. Therefore, although the entity might not be able to use the group ratio rule to claim more interest deductions, this is consistent with the treatment of other groups in a comparable position.

65. Where a country applies the fixed ratio rule to the position of a local group, an entity with net interest expense would typically be able to offset this against the net interest income of other group entities in the same country. If the local group has net interest income overall, there would be no disallowance under the fixed ratio rule and so no need for the entity to apply the group ratio rule. However, an entity in a group with a bank or insurance company will be restricted in its ability to offset its net interest expense against net interest income in other group entities, if banks and insurance companies are excluded from the local group. Therefore, where the fixed ratio rule is applied to a local group excluding banks and insurance

companies, an entity in a group with a bank or insurance company may have a greater need to apply the group ratio rule than an entity in a different sector. Countries may respond to this in different ways, including the following.

- The group ratio rule could be applied in the same way as it applies to entities in other sectors. This would mean that an entity in a group with a bank or insurance company would be able to deduct net interest expense up to the benchmark fixed ratio, but may be unable to rely on the group ratio rule to deduct net interest expense in excess of this amount.
- In applying the group ratio rule, the calculation of a group's net third party interest/EBITDA ratio could exclude items related to the funding and results of banks and insurance companies in the group. Net third party interest expense would exclude the net third party interest income or expense of banks and insurance companies, and the interest expense on debt issued by other group entities to support banking or insurance activities. Group-EBITDA would exclude the EBITDA of banks and insurance companies. The impact of this approach is illustrated by Example 5 in Annex 3.
- The Action 4 Report provides that a country may apply a higher benchmark fixed ratio if it operates a fixed ratio rule in isolation rather than in combination with a group ratio rule. It would be consistent with this approach for a country to apply a lower benchmark fixed ratio in combination with a group ratio rule to entities in most sectors. However, for entities in a group with a bank or insurance company the fixed ratio rule could apply in isolation, but with a higher benchmark fixed ratio within the corridor of 10%-30%. The group ratio rule would not be available to entities in these groups. The scope for a country to do this will vary depending upon the level of the benchmark fixed ratio applied to entities in other sectors.
- The fixed ratio rule could be applied in isolation to all entities. The group ratio rule would not be available to entities in any group. In this case, as set out in the Action 4 Report, the fixed ratio rule should be applied consistently to entities in multinational groups and domestic groups without improper discrimination.

66. In practice, excluding items related to the funding and results of banks and insurance companies from the calculation of a group's net third party interest expense/EBITDA ratio may be more easily applied to entities in non-financial groups which include a bank or insurance company, and could be the most appropriate option in this situation. In these cases, even after excluding banks and insurance companies, the remaining entities should constitute a coherent group to which the group ratio rule can be applied in a meaningful manner. However, depending on the scale of banking or insurance activities in relation to the rest of the group, an entity in a non-financial group which includes a bank or insurance company may still prefer to apply the group ratio rule without adjustment if this is simpler and would allow the entity to deduct all of its net interest expense. Therefore if a country does allow the group ratio rule to be applied excluding items relating to the funding and results of banks and insurance companies, it is suggested that these adjustments should be optional.

67. Where a group's main business activities are banking or insurance, excluding items related to the funding and results of banks and insurance companies from the calculation of a group's ratio raises a number of practical issues. In particular, the group ratio rule relies on an assumption that equity and debt capital are fungible within a worldwide group. However, this assumption begins to break down if key operating entities are excluded from the group, leaving entities which are mainly holding companies and those engaged in providing group services or activities which are secondary to the group's main business, may not have a significant level of EBITDA and which often have no direct relationship to each other. There may also be regulatory capital restrictions which operate as barriers to a group shifting equity or debt between countries. In addition, while it may be possible to identify specific amounts relevant to a bank or insurance company within a non-financial group from the group's consolidated financial statements, this is

likely to be more difficult for groups which are primarily engaged in banking and insurance. Therefore, for these groups calculation of the group ratio would need to be more heavily based on information extracted from the group's underlying accounting records. Finally, as set out in the Action 4 Report, a country may exclude interest paid to related parties from net third party interest expense, in order to avoid related party debt being used to inflate a group's ratio. However, this may be inappropriate if this interest is paid to a related bank or insurance company, for example where the interest is paid on a loan made by a bank in the ordinary course of its business. Despite these limitations, a country could still apply the group ratio rule excluding the funding and results of banks and insurance companies, and there are benefits from applying a consistent approach to all entities which are in a group with a bank or insurance company, without the need to distinguish between those where banking or insurance is the group's main business or is secondary to another business such as retail or manufacturing. These factors should all be taken into account by a country is deciding which approach to apply.

#### **Questions for consultation**

15. Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?
16. Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?
17. Do you have any other comments on any of the issues raised by this discussion draft?

## ANNEX 1: SUMMARY OF QUESTIONS FOR CONSULTATION

### **The risks to be addressed through interest limitation rules**

1. Are there any categories of BEPS risk involving interest posed by banks or insurance companies, or entities in a group with a bank or insurance company, not identified in the discussion draft which should be focused on as part of this work? If so, what are these risks and how could they be addressed (either through the approaches set out in this discussion draft or otherwise)?

### **Banks and insurance companies**

2. Are there any other considerations with respect to the role of interest in banking and insurance which should be taken into account?
3. Are there other any general issues related to the impact of regulatory capital rules on the level of leverage in a bank or insurance company that should be taken into account? It should be clearly identified where these are issues relevant to all or a large number of countries or where they concern a particular country's regime.
4. Are there other any general issues related to the operation of the authorised OECD approach and the impact on the level of free capital in a permanent establishment of a bank or insurance company that should be taken into account?
5. Are there any concerns raised by a country not introducing tax rules to deal with excessive interest deductions in banks and/or insurance companies including permanent establishments, if the country has established that no material BEPS risk exists (which may be as a result of the operation of regulatory capital rules)?
6. What approaches currently applied by countries would be effective in reducing BEPS risks posed by over-leverage in banks and/or insurance companies including permanent establishments, if a country identifies that such a risk exists? These may be sector specific rules or rules which apply to all sectors.
7. Are there any other practical considerations related to the application of the fixed ratio rule to banks or insurance companies that should be taken into account?
8. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an equity investment that should be taken into account?
9. What approaches currently applied by countries would be effective in reducing BEPS risks posed by a bank or insurance company using interest to fund non-taxable income on an equity investment? These may be sector specific rules or rules which apply to all sectors.

10. Are there any other considerations with respect to the ability of banks and insurance companies to use interest to fund non-taxable income on an investment in a permanent establishment that should be taken into account?
11. Where a country introduces targeted rules to address the specific risks identified in the Action 4 Report, are there any implications from applying these rules to banks and insurance companies that would be different from the implications for other types of entity?

**Entities in a group with a bank or insurance company**

12. Are there any other general issues related to the level of BEPS risk involving interest posed by entities in a group with a bank or insurance company that should be taken into account?
13. Are there any additional practical issues arising from the modifications to the fixed ratio rule described in the discussion draft, as it applies to an entity in a group with a bank or insurance company -
  - a. application of the fixed ratio rule to the local group excluding banks and insurance companies
  - b. the treatment of interest expense on debt supporting banking or insurance activities
  - c. other issues?
14. Should any other modifications be considered in applying the fixed ratio rule to an entity in a group with a bank or insurance company?
15. Are there any additional practical issues arising from the approaches for applying the group ratio rule to an entity in a group with a bank or insurance company that should be taken into account?
16. Are there any other approaches to applying the group ratio rule to an entity in a group with a bank or insurance company that should be considered?
17. Do you have any other comments on any of the issues raised by this discussion draft?

## ANNEX 2: AN OVERVIEW OF CAPITAL REGULATION IN BANKING AND INSURANCE

68. Regulatory capital rules for banks are aimed at ensuring that banks and banking groups have sufficient high quality capital and liquidity to absorb financial and economic shocks or, if the shock cannot be fully absorbed, to achieve an ordered resolution with minimum impact on the wider financial system and the real economy. Most countries apply rules based on a framework established by the Bank for International Settlements. The previous framework (Basel II) is currently in the process of being extended and strengthened by the latest standard (Basel III) which was introduced as a response to the financial crisis and implementation is being phased in over the period to 2019.

69. One of the main goals of Basel III is to strengthen the capital base of banking groups to protect the solvency of banks, and this has a direct impact on the ability of banks to be over-leveraged. In placing limits on the capital structure of banks, these rules focus on the amount and nature of a bank's capital as a percentage of its risk weighted assets (RWAs). This reflects the fact that banks undertaking different types of lending carry different amounts of risk. Under the framework, most banks must have Common Equity Tier 1 capital (i.e. ordinary share capital and retained earnings) of at least 4.5% of RWAs and total Tier 1 capital of at least 6% of RWAs. Tier 1 capital may be made up of Common Equity Tier 1 capital and also Additional Tier 1 capital such as preferred shares and certain types of hybrid debt which have the capacity to absorb losses either by being written down or converting into common shares upon a trigger event. A bank must also have total capital of at least 8% of RWAs, including Tier 1 capital and Tier 2 capital, which includes some categories of long-term subordinated debt. In order to avoid restrictions on the ability to pay dividends, banks must in addition maintain a capital conservation buffer comprising Common Equity Tier 1 capital equal to a further 2.5% of RWAs. In cases where a country is concerned that there is a build-up of excessive credit and system-wide risk, it may impose an additional countercyclical buffer of up to 2.5% of RWAs.

70. While these ratios apply to most banks, from 2018 Basel III will also require globally systemically important banks (G-SIBs) to hold additional Common Equity Tier 1 capital of between 1% and 3.5% of RWAs. The level of this G-SIB surcharge for a particular bank reflects its systemic importance, taking into account its size, interconnectedness, substitutability, complexity and global reach. Countries may apply similar surcharges to banks which are considered to be systemically important on a national level. In addition, in 2015 the Financial Stability Board announced that G-SIBs will be required to hold total loss-absorbing capital equal to 16% of RWAs by 2019 and equal to 18% of RWAs by 2022. Total loss-absorbing capital includes both Tier 1 capital and Tier 2 capital, but does not include capital held as part of the capital conservation buffer, countercyclical buffer or G-SIB surcharge.

71. Alongside these capital adequacy requirements, Basel III also provides protection against illiquidity. Banks are required to meet liquidity ratios to ensure that they hold sufficient high quality liquid assets to meet their funding needs for the next 30 days, as well as to ensure that stable funding in place to support the business for the following year.

72. Although the overall framework for bank capital regulation is agreed on a global basis, there may still be differences in how the framework is implemented by countries. For example, in some cases countries may 'gold-plate' their regimes by applying stricter rules either to all banks or to those which are seen as systemically important. It is also important to note that these requirements continue to evolve and have not yet been fully implemented by countries.

73. Unlike for banks, there is currently no global standard for the capital regulation of insurance groups and so there is much greater variance in the nature and level of protection provided in different countries. Within the European Union, a new regulatory framework (Solvency II) came into force on 1 January 2016 which aims to increase the level of harmonisation of insurance regulation and introduce requirements that are more sensitive to the level of risk undertaken. The framework aims to ensure that an insurance company's obligations arising from all types of risk are sufficiently covered by loss-absorbing capital to protect against insolvency, and its capital is invested in high quality assets to protect against illiquidity. Solvency II is used here as an example of a regulatory capital regime for insurance companies which is applied in 28 countries.

74. Under Solvency II, an insurance company should hold sufficient capital to cover all of its obligations arising from underwriting risk, market risk, credit risk and operational risk over the next 12 months, with a probability of 99.5% (the Solvency Capital Requirement). This is intended to limit the risk to customers and the wider economy of an insurance company being unable to withstand these risks to a 1 in 200 year event. The Solvency Capital Requirement may take into account risk mitigation techniques that a group can demonstrate it would apply, and can be calculated using a standard formula or a model developed by the group and approved by the regulator.

75. Solvency II also includes a Minimum Capital Requirement, which is based on an insurance company being able to meet its obligations over the next 12 months with a probability of 85%. However, in all cases this should be no lower than 25% and no higher than 45% of the Solvency Capital Requirement. This gives regulators scope to make greater interventions as an insurance company's capital falls below its Solvency Capital Requirement and gets closer to its Minimum Capital Requirement. If capital falls below the Minimum Capital Requirement, an insurance company's liabilities may be transferred to another insurer and its licence withdrawn.

76. In terms of the proportion of an insurance company's capital that must be in the form of equity, 50% of the capital needed to meet the Solvency Capital Requirement and 80% of that needed to meet the Minimum Capital Requirement must be Tier 1 capital. Of this Tier 1 capital, at least 80% must be in the form of ordinary shares and retained earnings. The remaining 20% of Tier 1 capital may be made up of other items which are permanently available and subordinated, including paid-up preference shares and certain long-dated debt instruments with an original term of at least 30 years which meet certain conditions (e.g. they must include clauses for them to be written-down or converted into ordinary shares on a trigger event).

77. The remaining capital needed to meet the Solvency Capital Requirement or the Minimum Capital Requirement may be in the form of either Tier 1 capital or Tier 2 capital. Tier 2 capital includes certain long-dated debt instruments with an original term of at least 10 years, subject to conditions such as terms that provide for the suspension of interest payments and redemption in circumstances such as where the Solvency Capital Requirement is not met. For the Solvency Capital Requirement only, up to 15% of the capital needed may be in the form of Tier 3 capital which includes subordinated debt with a minimum original term of at least 3 years.

78. In addition to these minimum capital requirements, there are two further features of Solvency II which operate to restrict the excessive use of regulatory capital debt by insurance companies.

- First, any Tier 2 or Tier 3 capital which does not count towards the Solvency Capital Requirement or Minimum Capital Requirement is re-categorised as an ordinary liability. A company would incur a high funding cost but obtain no additional regulatory capital benefit to support new business.

- Second, at all times Tier 1 capital must exceed the total amount of debt treated as Tier 2 or Tier 3 capital. This means that in principle an insurance company could meet its Solvency Capital Requirement and Minimum Capital Requirements using 50% Tier 1 capital and 50% Tier 2 capital (or 35% Tier 2 capital and 15% Tier 3 capital). However, if such a company incurred a loss which reduced its retained earnings, its Tier 1 capital would fall. Because Tier 1 capital must at all times be equal to or exceed the total of Tier 2 and Tier 3 capital, the maximum amount of debt that can be treated as Tier 2 or Tier 3 capital would also fall, and some of this capital would be re-characterised as an ordinary liability. In effect the fall in retained earnings would result in a reduction in capital which is double that which would have occurred had all of the insurance company's capital been in the form of Tier 1. This creates an incentive for an insurance company to include more than the minimum amount of Tier 1 as a proportion of its overall capital base. A similar incentive exists for an insurance company to hold more equity as a proportion of its total Tier 1 capital than the minimum of 80% required.

79. Solvency II operates across the European Union, and applies on a solo level to insurance companies and on a consolidated group level (to the worldwide group for EU-headed groups and to the EU-headed sub-group for foreign-headed groups). Some countries outside the European Union apply risk based capital regimes which contain similar elements to Solvency II, but in many cases there are significant differences in the rules applied and the amounts and types of capital which must be held. For example, some countries do not allow any types of debt to be treated as regulatory capital, and so an insurance company will be required to meet all of its capital adequacy ratios using equity. Solvency II also applies equally to insurance companies engaged in different types of business, including life insurance, general insurance (referred to as non-life insurance or property and casualty insurance in some countries) and reinsurance. However, outside the European Union countries may apply different rules depending on the business carried on. There is also currently significant change within insurance regulation across the world, with a number of countries looking to revise or expand their existing standards.

### ANNEX 3: EXAMPLES

*Example 1 – Applying the fixed ratio rule to a local group including banks and insurance companies*

	A Co USD	B Co USD	C Co USD	Local group USD
EBITDA	10 million	70 million	20 million	100 million
Net interest income/(expense)	(3 million)	(21 million)	50 million	26 million
Benchmark fixed ratio	-	-	-	25%
Interest capacity	-	-	-	(25 million)
Net interest income/(expense) of local group	-	-	-	26 million
Total interest disallowance	-	-	-	0
Allocation of disallowance	0	0	0	0
Interest taxable/(deductible)	(3 million)	(21 million)	50 million	-

80. In the table above, a group consists of three entities all of which are located in Country X. A Co is a holding company with two subsidiaries, B Co and C Co. B Co is an operating company carrying on non-financial activities. C Co is a solo-regulated bank or insurance company. A Co has EBITDA of USD 10 million and net interest expense of USD 3 million. B Co has EBITDA of USD 70 million and net interest expense of USD 21 million. C Co has EBITDA of USD 20 million and net interest income of USD 50 million.

81. Country X applies the fixed ratio rule with a benchmark fixed ratio of 25%. The rule is applied to the net position of the local group, including regulated banks and insurance companies. The benchmark fixed ratio of 25% is applied to the total EBITDA of the local group of USD 100 million, giving interest capacity of USD 25 million. As the local group has net interest income of USD 26 million, no net interest expense is disallowed. Therefore at entity level, A Co and B Co are able to deduct all of their net interest expense without restriction. Even though A Co and B Co each have a net interest/EBITDA ratio of 30%, they do not incur any interest disallowance as their net interest expense is offset against net interest income in C Co.

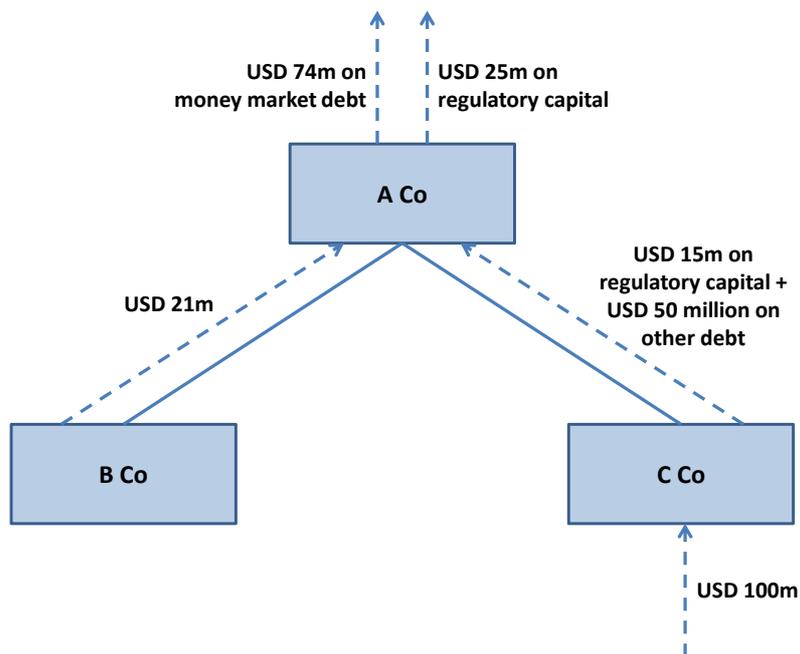
*Example 2 - Applying the fixed ratio rule to a local group excluding banks and insurance companies*

	A Co USD	B Co USD	C Co USD	Local group (excl. C Co) USD
EBITDA	10 million	70 million	20 million	80 million
Net interest income/(expense)	(3 million)	(21 million)	50 million	(24 million)
Benchmark fixed ratio	-	-	-	25%
Interest capacity	-	-	-	(20 million)
Net interest income/(expense) of local group	-	-	-	(24 million)
Total interest disallowance	-	-	-	(4 million)
Allocation of disallowance	(0.5 million)	(3.5 million)	0	(4 million)
Interest taxable/(deductible)	(2.5 million)	(17.5 million)	50 million	-

82. This example is based on the same facts as Example 1. However, in this case Country X applies the fixed ratio rule to the net position of the local group excluding banks and insurance companies. Country X does not apply the fixed ratio rule to banks and insurance companies.

83. The benchmark fixed ratio of 25% is applied to the total EBITDA of the local group of USD 80 million (excluding the EBITDA of C Co), giving interest capacity of USD 20 million. As the local group has net interest expense of USD 24 million, there is a total interest disallowance of USD 4 million. As Country X taxes entities on a separate entity basis, it must have a method for allocating the interest disallowance between entities in the local group. As described in the Action 4 Report, a country is free to determine the method used, which may include allowing a group to determine the allocation. In this example, it is assumed that the interest disallowance is allocated in such a manner as to ensure that each entity in the local group has net interest deductions that do not exceed 25% of EBITDA. Therefore, USD 0.5 million of the disallowance is allocated to A Co and USD 3.5 million is allocated to B Co. A Co can deduct net interest expense of USD 2.5 million and incurs a disallowance of USD 0.5 million, while B Co can deduct net interest expense of USD 17.5 million and incurs a disallowance of USD 3.5 million. This is the same outcome as would have arisen if A Co and B Co had been entities in a different sector and had not been part of the same group as a bank or insurance company.

*Example 3 – Applying the fixed ratio rule to interest on debt funding banking or insurance activities*



84. The diagram above shows the interest flows for a group comprising three entities in Country X. A Co is a holding company with two subsidiaries, B Co and C Co. B Co is an operating company carrying on non-financial activities. C Co is a solo-regulated bank or insurance company. The group raises all of its external debt funding through A Co.

85. A Co raises money market debt upon which it pays interest of USD 74 million. Part of this is on-lent to B Co and C Co. On this debt, B Co pays interest of USD 21 million and C Co pays interest of USD 50 million. In addition, A Co issues an interest-bearing instrument which is treated as Tier 1 capital for regulatory capital purposes. A Co pays USD 25 million of interest on this instrument. A Co uses part of the issue proceeds to subscribe for a regulatory capital instrument issued by C Co upon which C Co pays interest of USD 15 million. C Co also received interest income from third party borrowers of USD 100 million.

	A Co USD	B Co USD	C Co USD	Local group (excl. C Co) USD
EBITDA	10 million	70 million	20 million	80 million
Net interest income/(expense)	(13 million)	(21 million)	35 million	(34 million)
Benchmark fixed ratio	-	-	-	25%
Interest capacity	-	-	-	(20 million)
Net interest income/(expense) of local group	-	-	-	(34 million)
Total interest disallowance	-	-	-	(14 million)
Allocation of disallowance	(10.5 million)	(3.5 million)	0	(14 million)
Interest taxable/(deductible)	(2.5 million)	(17.5 million)	35 million	-

86. The table above shows the impact of the fixed ratio rule if Country X applies the fixed ratio rule with a benchmark fixed ratio of 25% to the net position of the local group excluding banks and insurance companies, with no adjustment for interest on regulatory capital. Country X does not apply the fixed ratio rule to banks and insurance companies.

87. The benchmark fixed ratio of 25% is applied to the total EBITDA of the local group of USD 80 million (excluding the EBITDA of C Co), giving interest capacity of USD 20 million. As the local group has net interest expense of USD 34 million, including the net interest expense on the regulatory capital instrument, there is a total interest disallowance of USD 14 million. As Country X taxes entities on a separate entity basis, it must have a method for allocating the interest disallowance between entities in the local group. As described in the Action 4 Report, a country is free to determine the method used, which may include allowing a group to determine the allocation. In this example, it is assumed that the interest disallowance is allocated in such a manner as to ensure that each entity in the local group has net interest deductions subject to the fixed ratio rule that do not exceed 25% of EBITDA. Therefore, USD 10.5 million of the disallowance is allocated to A Co and USD 3.5 million is allocated to B Co. A Co can deduct net interest expense of USD 2.5 million and incurs a disallowance of USD 10.5 million, while B Co can deduct net interest expense of USD 17.5 million and incurs a disallowance of USD 3.5 million. Compared with the position in Example 2, all of A Co's net interest expense with respect to the regulatory capital instrument has been disallowed. However, the regulatory capital issued by A Co is being used to support assets in C Co that generate additional interest income, but this is not taken into account in applying the fixed ratio rule.

*Example 4 – Applying the fixed ratio rule with an exclusion for interest on debt funding banking or insurance activities*

	A Co USD	B Co USD	C Co USD	Local group (excl. C Co) USD
EBITDA	10 million	70 million	20 million	80 million
Net interest income/(expense)	(13 million)	(21 million)	35 million	(34 million)
Net interest income/(expense) on regulatory capital	(10 million)	0	(15 million)	(10 million)
Net interest income/(expense) subject to fixed ratio rule	(3 million)	(21 million)	-	(24 million)
<b>Benchmark fixed ratio</b>	-	-	-	25%
<b>Interest capacity</b>	-	-	-	(20 million)
Net interest income/(expense) of local group subject to rule	-	-	-	(24 million)
<b>Total interest disallowance</b>	-	-	-	(4 million)
<b>Allocation of disallowance</b>	(0.5 million)	(3.5 million)	0	(4 million)
<b>Interest taxable/(deductible)</b>	(12.5 million)	(17.5 million)	35 million	-

88. The table above is based on the same fact pattern as Example 3, but shows the impact of the fixed ratio rule if Country X applies an adjustment to exclude net interest on regulatory capital instruments from the scope of the fixed ratio rule.

89. The benchmark fixed ratio of 25% is applied to the total EBITDA of the local group of USD 80 million (excluding the EBITDA of C Co), giving interest capacity of USD 20 million. A Co's net interest expense of USD 10 million on regulatory capital is excluded from the net interest expense subject to the rule. Therefore the total interest capacity is compared against the local group's remaining net interest expense of USD 24 million. This gives a total interest disallowance of USD 4 million. As Country X taxes entities on a separate entity basis, it must have a method for allocating the interest disallowance between entities in the local group. As described in the Action 4 Report, a country is free to determine the method used, which may include allowing a group to determine the allocation. In this example, it is assumed that the interest disallowance is allocated in such a manner as to ensure that each entity in the local group has net interest deductions subject to the fixed ratio rule that do not exceed 25% of EBITDA. Therefore, USD 0.5 million of the disallowance is allocated to A Co and USD 3.5 million is allocated to B Co. A Co can deduct net interest expense of USD 12.5 million and incurs a disallowance of USD 0.5 million, while B Co can deduct net interest expense of USD 17.5 million and incurs a disallowance of USD 3.5 million. Compared with the position in Example 3, all of A Co's net interest expense with respect to the regulatory capital instrument is deductible. As this interest expense is supporting additional interest income in C Co, but this income is not taken into account in applying the fixed ratio rule, this would appear to be the correct outcome.

*Example 5 – Application of the group ratio rule including and excluding amounts related to the funding and earnings of banks and insurance companies*

	Country X		Country Y	
	A Co + B Co USD	C Co USD	D Co USD	E Co USD
EBITDA	80 million	20 million	20 million	80 million
Net interest income/(expense)	(34 million)	35 million	35 million	(24 million)
Net interest income/(expense) on regulatory capital	(10 million)	(15 million)	(15 million)	-
Net interest income/(expense) excluding regulatory capital	(24 million)	50 million	50 million	(24 million)
<b>Benchmark fixed ratio</b>				
Benchmark fixed ratio	25%	-	-	25%
<b>Interest capacity under fixed ratio rule</b>				
Interest capacity under fixed ratio rule	20 million	-	-	20 million
<b>Net third party interest income/(expense) of worldwide group excluding regulatory capital</b>				
Net third party interest income/(expense) of worldwide group excluding regulatory capital	52 million	-	-	(48 million)
<b>EBITDA of worldwide group</b>				
EBITDA of worldwide group	200 million	-	-	160 million
<b>Group ratio</b>				
Group ratio	n/a	-	-	30%
<b>Interest capacity under group ratio rule</b>				
Interest capacity under group ratio rule	0	-	-	24 million
<b>Rule applied</b>				
Rule applied	Fixed ratio rule	-	-	Group ratio rule
<b>Interest capacity</b>				
Interest capacity	20 million	-	-	24 million
<b>Interest disallowed</b>				
Interest disallowed	(4 million)	0	0	0

90. In the table above, a group includes five entities. A Co is a holding company with four subsidiaries. B Co and E Co are operating companies carrying on non-financial activities. C Co and D Co are solo regulated banks or insurance companies. A Co, B Co and C Co are resident in Country X. D Co and E Co are resident in Country Y. All of the interest payments in this example are with third parties.

91. Both Country X and Country Y apply the fixed ratio rule with a benchmark fixed ratio of 25% to the net position of the local group excluding banks and insurance companies. They do not apply the fixed ratio rule to banks and insurance companies and net interest expense on regulatory capital is excluded from the scope of the rule. In Country X, the benchmark fixed ratio of 25% is applied to the combined EBITDA of A Co and B Co of USD 80 million to give total interest capacity of USD 20 million. Out of their total net interest expense of USD 24 million (excluding net interest on regulatory capital) A Co and B Co can deduct total net interest expense of USD 20 million and incur a disallowance of USD 4 million. In

Country Y, the benchmark ratio of 25% is applied to the EBITDA of E Co of USD 80 million to give an interest capacity of USD 20 million. Out of its total net interest expense of USD 24 million, E Co can deduct USD 20 million and incurs a disallowance of USD 4 million.

92. Country X applies a group ratio rule alongside the fixed ratio rule, based on the total net third party interest expense and EBITDA of the worldwide group. However, as the worldwide group has net interest income, this rule cannot be applied. Therefore A Co and B Co must rely on the fixed ratio rule and deduct net interest expense of USD 20 million with USD 4 million disallowed. This appears to put A Co and B Co at a disadvantage compared with entities in other groups, as the position of banks and insurance companies in the group is not taken into account in applying the fixed ratio rule but is taken into account in applying the group ratio rule.

93. Country Y also applies a group ratio rule alongside the fixed ratio rule, but in this case it is based on the net third party interest expense and EBITDA of the worldwide group excluding banks and insurance companies and net interest expense on regulatory capital issued by other entities. This gives a group ratio of 30%. Applying the group ratio to E Co's EBITDA of USD 80 million means the entity has interest capacity under the group ratio rule of USD 24 million. Therefore E Co is able to apply the group ratio rule and deduct all of its net interest expense with no disallowance. This puts E Co in a position which is closer to that of an entity in a group which did not include banks or insurance companies.