

BEPS Action 4: When Theory Meets Practice

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FEATURED PERSPECTIVE

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The OECD in December 2014 released a discussion draft on action 4 of the base erosion and profit-shifting action plan relating to interest deductions and other financial payments for public consultation. More than 1,000 pages of public comments have been provided by multinationals, business associations, and other interested parties on the discussion draft that considers approaches to limit the deductibility of interest. The authors offer a critical overview of the proposals in the discussion draft, consider the interactions with other BEPS action items, and analyze whether the proposals are compatible with EU law.

On December 18, 2014, the OECD released a discussion draft on action 4 of the base erosion and profit-shifting action plan relating to interest deductions and other financial payments for public consultation. This article provides a critical overview of the proposals in the discussion draft and analyzes the potential impact on cross-border business activities and investment.

I. Introduction

The corporate income tax treatment of debt and equity is fundamentally different. In most countries, interest is taxable, or tax deductible (if certain conditions are met), when received or paid, respectively. In contrast, dividends are paid out of taxed profits and do not reduce a company's taxable income. At the level of the shareholder, dividends may be subject to a (partial) tax exemption or a tax credit. When loans are granted between different members of a multinational group, the interest payments will reduce the taxable income of the borrowing entity and increase the taxable income of the lending entity. Thus, in a cross-border context, the income will be taxable in the state of residence of the lender and not in that of the borrower. In order to limit the amount of tax-deductible expenses, virtually all high-tax countries introduced different kinds of rules that set limits to the amount of allowable interest expenses (for example, thin capitalization rules, earnings stripping rules, and arm's-length interest rates).

The discussion draft starts with the assumption that "the use of interest (and, in particular, related-party interest) is perhaps one of the most simple of the profit-shifting techniques available in international tax planning," giving the impression that interest payments necessarily involve some kind of BEPS element. Throughout the discussion draft, the OECD gives the impression that all multinational enterprises arrange their financing with a view to reduce tax costs and that it is equally easy for a group to finance a subsidiary with debt or equity. However, this ignores the fact that there are many legitimate nontax reasons affecting the decision on how a company is financed (legal requirements, regulatory constraints, foreign currency implications, business considerations, and so forth).

This article analyzes the key commercial reasons for debt funding (Section II) and the proposals in the discussion draft (Section III). It further considers the interactions of BEPS action 4 with other actions of the BEPS plan (Section IV) and analyzes restrictions from an EU law perspective (Section V).

II. Key Reasons for Debt Funding

How a business finances its operations is an important business decision that depends on a range of factors. While the deductibility of interest expenses is one factor to be considered, the decision of whether a company should be financed by equity or debt is generally not tax-driven; there are a number of good commercial reasons why intragroup loans can be preferable to a contribution of equity. Evidently, a loan receivable is very different from a participation in a company.

On the one hand, debt is easier to create and provides more flexibility in terms of cash repatriation (that is, repayment of principal amount and payment of interest) than equity does. The cost of capital of debt is generally lower than that of equity. On the other hand, equity tends to be more formal and bureaucratic to issue and repay resulting in higher administrative costs for financing. Furthermore, dividend distributions are subject to limitations in terms of amount and timing, and the repayment of capital is not a straightforward exercise and may trigger additional tax costs.

In many circumstances, the split between equity and debt funding will be dictated by external aspects. While debt generally ranks *pari passu* with other creditors, equity always ranks below debt. Hence, the choice of equity or debt funding has a significant impact on the ranking between intragroup funding and external debt funding. In some countries, the decision regarding the mix of debt and equity will be dictated by foreign exchange controls¹ or other local regulatory constraints and, in the absence of economic and political stability, there may be a strong preference for debt funding (to ease future cash repatriation). Moreover, debt funding may be preferred when minority shareholders co-invest in a company in order to not change the dynamics of an investment; additional equity funding may further be subject to shareholder approval.

A key consideration that is absent in the discussion draft is that a group will seek external finance in the country where the capital market offers the best conditions. This is, however, not necessarily the country of investment, and parent companies will often be able to raise external funding at lower rates than their subsidiaries. It is acknowledged in the discussion draft that there are significant commercial benefits from a cen-

¹For example, some jurisdictions, such as China, obstruct the repatriation of equity from companies located in their territory in order to keep cash from inbound investments within their country's borders.

tralized treasury function managing a group's financing. Accordingly, it is legitimate — and not BEPS-motivated — to implement a central treasury function or finance companies. When access cash is moved around a group between entities without a direct shareholding relationship, there is reasonably no way to grant additional funding in the form of equity.

III. Proposals in the Discussion Draft

A. Opening Comments

The discussion draft describes six approaches that are currently used by countries to limit the deductibility of interest expenses. Three of these approaches are assumed not to be suitable options for a best practice rule, including:

- the application of withholding taxes;
- arm's-length tests; and
- rules that disallow a percentage of the interest expenses of an entity.

The three remaining approaches that may be recommended by the OECD as best practice would be either:

- a groupwide rule that would limit the group's total interest deductions to its actual net third-party interest expense;
- a fixed ratio rule that would limit the interest expense deduction of an entity by reference to an entity's earnings, assets, or equity; or
- a combination of both approaches in which one approach would take the form of a general rule, and the other approach would provide an exception to the general rule.

The discussion draft suggests that depending on the final design of any rule included in a best practice recommendation, some targeted rules may also be required.

B. Groupwide Rules

1. Opening Comments

The discussion draft suggests a groupwide rule that would limit the availability of interest deductions, within the group as a whole, to the overall third-party interest expense incurred by the group. Here, different methods are proposed on how the deductible interest expense would be split among group members.

Under the interest allocation approach, each entity would be provided with a deemed interest expense that is equal to an allocation of part of the group's net third-party interest expense. This allocation would be made in accordance with either earnings or asset values. However, according to the discussion draft, this approach was strongly objected to by countries engaged in BEPS action 4.

Under the group ratio rule, the deductible expenses of each group member would be determined by comparing a financial ratio of the individual entity with that of its worldwide group (for example, net interest

to earnings or net interest to asset values). When an entity's ratio is equal to or below that of the group, all of its third-party and intragroup interest expense would be deductible. Any interest expense that takes the entity's ratio above that of the group would be disallowed.

The underlying assumption of a groupwide rule is that the indebtedness of all members of a multinational group should be at a constant rate. However, in practice the level of debt funding varies depending on a number of facts such as line of business, business cycle, level of risk, jurisdiction, and other factors that do not give rise to BEPS concerns.

2. Double Taxation Issues

The introduction of groupwide rules would inevitably result in double taxation since nondeductible interest payments will be taxed at the level of the lender. In this regard, the discussion draft offers two remedies:

- a mechanism that would allow companies to carry forward their interest expense and possibly their interest limitation; and
- the possibility to restructure.

The first proposed solution may help smooth business cycles but would fail in case of more structural concerns such as a long-term shift in the profitability. This is because a carryforward mechanism may only provide relief when a company's earnings or assets improve relative to the rest of the group. However, this ignores that some companies may consistently underperform compared with other members of the group for legitimate commercial reasons (different geographical markets, business lines, and so forth). A permanent disallowance of interest deductions may further occur if the carryforward is limited in time or denied upon a change of ownership.

As an alternative, the discussion draft considers that MNEs may perform financial reorganizations in order to bring a company's financial ratio in line with the group ratio. However, in a group operating in many countries with hundreds of companies and many tiers of ownership, it would be extremely difficult (if it is legally possible at all) and somehow artificial for an MNE, in the absence of a business rationale, to match third-party net interest expenses in exactly the way that is needed for maximum deductibility at the level of each entity. Also, the reorganization of the financing of group companies will often not be possible or will trigger significant tax and restructuring costs.²

In some countries, currency flows are heavily regulated (foreign exchange controls), and it will simply not be possible to align the financing to the rest of the group. In other cases, group companies may be constrained by regulatory restrictions, or debt funding may

be prohibitively expensive in view of significant foreign exchange volatility. The latter would increase the cost of capital in those countries and, therefore, make investment less attractive. Minority investors may further limit the flexibility of MNEs to reorganize the financing of group companies.

In many cases, interest paid following an internal debt restructuring will not be deductible under domestic tax law or challenged by local tax authorities, particularly when there is no commercial need for additional capital in an entity.³ Note that tax-driven restructurings designed to maximize the deductibility of interest expense for tax purposes may itself give rise to BEPS concerns and fall within the ambit of domestic antiabuse provisions. The latter may prevent a group from arranging its intragroup loans with a view to achieve the maximum deduction allowed at a group's level.

Even if this process could be overcome without significant transaction costs, it would also be very difficult to introduce the correct level of debt into each company. In particular, the amount of maximum deductibility may vary from one year to another because of reasons that are not under the control of the MNE (for example, because of the volatility in earnings and asset balances).⁴ This would make it impossible to forecast the interest cap per entity before the end of a fiscal year.

Finally, the inconsistent implementation of a groupwide rule would be another source for double taxation. The discussion draft provides a series of options for best practices that include a wide range of possibilities. While some countries may implement different versions of a groupwide rule, it seems clear from public statements of various OECD members that some countries believe that their current interest deductibility rules are fit for its purpose.

In light of the above, the recommendation of a groupwide rule will often result in a loss of deductibility of third-party interest overall. Apart from the practical challenges, the groupwide rule would result in significant uncertainty, as the amount of deductible interest expense may only be determined once all information at the group level is available (this may be months after the end of the fiscal year).

³For example, when intragroup loans are introduced in order to repay part of the equity, interest expenses will not be deductible in many countries.

⁴Also, the impact of annual movements in debt levels, interest rates, group and entity profits, acquisitions, or disposals that drive the allocation of interest across a group will create uncertainty and volatility regarding the level of annual deductible interest in each territory under both the groupwide test and the fixed ratio test.

²Those transactions typically require various conditions to be satisfied (distributable reserves, solvency tests, third-party creditor protection, and so forth) at each level to repatriate the money.

3. *Departure From the Arm's-Length Principle*

As a matter of principle, a groupwide interest limitation would be a departure from the arm's-length principle and a significant move toward formulary apportionment. An arm's-length test was not included as an option for a best practice recommendation, because it would be too burdensome to apply and enforce.

While the application of the arm's-length principle has some disadvantages, such as being resource-intensive and time-consuming, the avoidance of these disadvantages cannot justify the adoption of rules that ignore the arm's-length principle. Also, the application of the arm's-length principle would be no more burdensome than the proposed groupwide tests, and taxpayers are familiar with the arm's-length standard as they are currently required to ensure that virtually all intragroup arrangements comply with that standard.

Moreover, the arm's-length principle has some advantages over the current proposals in the discussion draft. In particular, it recognizes that leverage and interest ratios vary between entities depending on, among other things, the nature of their business, their stage in the business cycle, their business strategies, their size, and the markets in which they operate. Thus, the arm's-length standard provides more flexibility and maintains a level playing field between domestic and foreign-owned companies. In contrast, the underlying assumption of the groupwide rule seems to be that all companies of a group will have a similar need for debt.

4. *Practical Issues and Compliance Costs*

The application of a groupwide rule would be an extremely complex exercise and entail many difficult measurement issues given the significant differences in tax and accounting principles applicable in different countries. Even the mere definition of interest may vary from one country to another. This would mean that MNEs will have to determine relevant figures for each group company and make adjustments to account for differences in the accounting and tax treatment.

Another issue of the groupwide rule is linked to foreign exchange variations. The discussion draft states that foreign exchange gains and losses on borrowings are included within the scope of interest expense. Hence, the amount of interest will vary depending on the taxpayer's reporting currency, making unified measurement difficult. In this regard, it would be necessary to specify in which currency measurement should be made and which exchange rate should be used.

The discussion draft concludes that there should be a degree of coordination between the tax authorities of different countries (for example, the review of consolidated financial statements would necessitate coordinated tax audits). While this seems to be difficult to achieve in practice, international coordination of tax audits would be a minimum requirement for an effective audit of all entities.

Furthermore, the groupwide rule would not be implemented consistently as countries will have some leeway. All this would elevate the compliance burden and related costs to an unprecedented level. Furthermore, current year tax payment would become more problematic and unpredictable due to groups not knowing their interest deductions until a considerable time after reporting their annual results to the market when their worldwide financial statements become available. However, the groupwide rule does not only present an enormous administrative burden to taxpayers. Rather, taxpayers and tax authorities alike will have to bind substantial resources to administer such an intricate rule.

5. *Impact on Business Decisions and International Trade*

The proposal would have a significant impact on business decisions as it would increase the effective cost of capital for businesses. This may force multinationals to raise the level of target return required on investments with the consequence that investments may be rejected that otherwise would have been approved. Apart from the negative impact on global growth and employment opportunities, the ultimate long-term effect of the proposal could be increased costs being passed onto consumers and reduced earnings realized by the shareholders.

A groupwide rule presents a particular issue to MNEs engaged in completely different sectors with different debt requirements. Here, multinational groups may be constrained to structure their financing in a way that is most favorable from a tax perspective but that might be completely opposite to how the financing would be structured from a commercial perspective. However, even within the same corporate group, individual companies may be financed in different ways. The mechanical application of a groupwide rule would significantly restrict the freedom of business to structure their financing, which would also affect sound business activities and financial market transactions.

The discussion draft states that MNEs may restructure the financing of their group companies in order to more closely align net interest expense with economic activity and to maximize deductions for interest paid across the group. While this seems not to be a viable option for groups with hundreds of entities, it would mean that intragroup debt would have to be implemented when there is no commercial requirement for additional funding.

Moreover, it is questionable whether reported earnings or asset value alone are a reliable indicator for an entity's economic activity. A company that temporarily realizes losses may nonetheless be very active and generally profitable. An earnings-based ratio would not be appropriate in these circumstances as it would deny the deductibility of interest expense and increase a company's tax base regardless of the economic loss position. Thus, it would exacerbate the situation of the company and may even lead to default when tax is due regardless of the profitability. Likewise, an asset-based

figure would not be appropriate to reflect economic activity although it would mirror the financial requirements relating to investments into long-term and current assets. This does not, however, reflect an entity's profitability and ability to bear tax. Notably, earnings and asset-based figures would have a completely different economic effect and viewpoint.

In a group of companies, there may be capital-intensive businesses with a high level of leverage (because debt funding represents the lowest cost of capital) and businesses that are not (for example, service companies). In these circumstances, a groupwide rule would disallow the deductibility of interest expense of the capital-intensive business, whereas other companies would not be able to use their allowable interest deductions. Likewise, for institutional funds investing in a range of alternative investment classes such as real estate, private equity, and infrastructure with different debt, asset, and earnings profiles, a "blended rate" is unlikely to be representative.

The groupwide rule would further create a competitive disadvantage for pension funds and sovereign wealth funds that usually have no third-party debt compared with other types of investors with significant debt funding. This could act as a barrier to investment in the real estate and infrastructure sector in which significant investments are needed.

A disturbing feature of a groupwide rule is that it would be an incentive to increase external debt funding for tax purposes, contrary to the lessons learned from the financial crisis. This is because highly leveraged groups are treated more favorably if a groupwide rule is applied since group companies would be allowed to deduct higher amounts of interest expenses. If the groupwide rule only applies to cross-border financing transactions, it may further create an uneven playing field between multinational and purely domestic groups (in favor of domestic businesses).

C. Fixed Ratio Rules

Another rule suggested in the discussion draft is a fixed ratio test that would restrict an entity's interest expense to a specified portion of earnings, assets, or equity of an individual company regardless of the leverage of the group as a whole. As such, a fixed ratio rule would be less complex to apply for taxpayers and the tax authorities, provide for legal certainty, and limit the compliance burden and costs. A fixed ratio test also has the advantage that the rule does not need to be designed identically in all countries.

The key weakness of the fixed ratio rule is that it proposes a one-size-fits-all approach that does not take into account the significant differences among businesses in different sectors with different profit margins and different debt ratios; some businesses require more debt funding than others. As such, the deductibility of interest expenses may be restricted merely because a company is not profitable during some periods or a recession.

When interest expenses are not deductible, double taxation will likely arise because the lender should be taxable on the corresponding income. To deal with this obstacle, a carryforward mechanism should be implemented in regard to both the nondeductible interest and unused capacity so as to mitigate the effect arising from the volatility in a company's earnings over time. Nonetheless, even such carryforward would not eliminate the problem of double taxation as companies may never be in a position to use the amounts carried forward (for example, banks, real estate property companies, or finance companies).

While the discussion draft does not propose a specific percentage, it is stated that 30 percent of the earnings before interest, taxes, depreciation, and amortization as currently applied by several countries seems to be too generous. This assumption is based on a study that examined the net interest expenses of 79 of the global top 100 multinationals by market capitalization. However, this sample seems to be wholly inappropriate to determine a benchmark ratio given that these are mature businesses, and the debt levels of these companies would not be representative of the whole range of multinationals that would potentially be affected by the interest limitation recommendations.

Therefore, in order to reduce the negative impact on the financing of investments (for example, investments in capital-intensive industries and real estate or infrastructure projects), a recommendation regarding the fixed ratio must not be set too low. It is also important to remember that the current interest rates are at historic lows. Hence, data on interest expense levels in the current environment are not at all representative and cannot be the basis for benchmarking an appropriate fixed ratio.

Fixed ratio rules could lead to significant disallowance of interest expenses in case of alternative investments (for example, real estate, private equity, and infrastructure). These investments usually have relatively high levels of third-party debt. Nevertheless, interest paid to third parties does not give rise to base erosion.

D. Combined Approach

The discussion draft further considers a combination of the above approaches to address BEPS. Approach 1 is centered on groupwide interest allocation rules and provides a fixed ratio test with a low threshold as a carveout. This approach is not desirable as it entails all the problems mentioned above (see Section III.B of this article).

In contrast, Approach 2 adopts the fixed ratio rule as the general rule and applies a groupwide rule as a carveout from the general rule. By adding a carveout to the fixed ratio rule, the specific circumstances of capital-intensive industries and investments relying heavily on external funding (for example, real estate and infrastructure investments) could be considered. However, it would be important that the combined approach offers an effective carryforward mechanism,

allowing the companies to carry forward both non-deductible interest and unused capacity.

This approach would allow entities with lower levels of interest expenses to apply a simple fixed ratio test, while more highly leveraged groups would apply a more complex groupwide test. This would also reduce the distortions regarding the competitiveness of capital-rich groups (as opposed to highly leveraged groups) that could otherwise deduct less interest expense than groups that rely more on external funding. It is, however, crucial that the fixed ratio would not be set too low. Otherwise, the complex and costly groupwide rule would — by default — become a main rule.

IV. Interactions With Other BEPS Actions

Apart from BEPS action 4, action 2 (hybrid mismatch arrangements) and action 3 (strengthen CFC rules) directly address the deductibility of interest. Also, there are overlaps with action 6 (prevent treaty abuse), action 9 (risks and capital), action 11 (establish methods to collect and analyze data on BEPS and the actions to address it), action 13 (transfer pricing documentation and country-by-country reporting), and action 14 (make dispute resolution mechanisms more effective).

In contrast to the previous work on the BEPS project that was largely focused on discontinuities in the international tax system (creating opportunities for double nontaxation), action 4 appears to exclusively focus on the availability of interest deductions regardless of the corresponding treatment of the income at the level of the lender. Although it is acknowledged in a number of BEPS actions that the differences in the tax treatment of debt and equity create a tax-induced bias in favor of debt financing, there does not seem to be a coherent approach in the BEPS action plan to address this difference in treatment.

Actions 8 to 10 (ensure that transfer pricing outcomes are in line with value creation) appear to reflect concern with overcapitalization, and the related discussion draft considers notional deductions on equity (and a related inclusion of income by the provider of equity financing) if a company is heavily equity financed.

Likewise, action 3 (strengthen CFC rules) will likely address interest income of controlled companies that are resident in or otherwise subject to tax in a low-tax jurisdiction. The proposed rules in action 3 would need to be coordinated with the proposed rules in action 4 and should include a mechanism to reduce the inclusion to the CFC owner to the extent there is a corresponding denial of interest expense deductions in accordance with the recommendations of action 4.

Broadly, action 3 and actions 8 to 10 appear to reflect a view that taxing rights should be allocated primarily to the jurisdiction in which the provider of capital is resident, not to the jurisdiction in which the user of the funds is resident. This approach is consistent with existing tax treaty rules, which assume that

the jurisdiction in which the lender is resident has a stronger taxing right (tax treaties generally allocate only a limited primary taxing right to the state of source). Conversely, action 2 and action 4 seem to reflect a view that taxing rights should be allocated primarily to the jurisdiction in which the user of capital is resident. These differences in approaches raise questions about the overall policy objectives, and it is unclear how the approaches in the discussion draft would be coordinated with the other proposed rule changes.

Given the large interdependencies between the different actions addressing the deductibility of interest, it would be crucial to better align the work of the OECD on these action items, in particular in order to ensure a consistent and holistic approach. In light of the above, more targeted rules such as the anti-hybrid rules proposed under BEPS action 2 should be used to address the perceived abuses relating to interest expense.

V. Considerations Regarding EU Law

A. Opening Comments

The discussion draft acknowledges that an international approach to the deductibility of interest is unlikely to be effective unless it can be fully implemented in the EU and that further considerations must be given to design rules that are consistent with EU treaty freedoms, directives, and state aid rules. Indeed, the majority of OECD countries (that is, 21 of 34 countries) are member states of the EU that must respect EU law as interpreted by the Court of Justice of the European Union.

Therefore, the question of whether the proposed approaches for limiting interest deductions within MNEs are compatible with EU law is of utmost importance. Recommendations that violate the principles of EU law (for example, the freedom of establishment or free movement of capital) may not be followed by EU member states. The discussion draft contains a rather cursory examination of the EU law point in Annex 2, without reaching any conclusion.

B. EU Fundamental Freedoms

In general, the proposed interest limitation rules must apply to both cross-border loans between EU affiliates and loans between affiliates in the same member state in order to not constitute an obstacle to the freedom of establishment. This would evidently impose a substantial additional compliance burden on mere domestic groups (not only on MNEs), although no BEPS concern is present in these circumstances. However, even if the interest limitation rules would also apply to mere domestic cases, in practice there may still be a restriction of the freedom of establishment. An undue discrimination of MNEs may, for example, still exist if it is possible for domestic groups to escape from the additional compliance burden (for example,

through a tax consolidation), whereas MNEs would suffer from a (significantly) greater compliance burden.⁵

If the interest limitation rule would be designed in a way that it only applies to cross-border intragroup loans, this restriction on the freedom of establishment is only permissible if it is proportionate and justifiable to combat tax avoidance through the use of a wholly artificial arrangement. Considering that the interest limitation rules would target common business transactions and not allow EU companies to demonstrate that in a specific case, a higher level of indebtedness was commercially justifiable, it is unlikely that the proposed interest limitation rules (applied exclusively in a cross-border context) would be compatible with EU law. Even in the case of wholly artificial arrangements (with no or limited commercial reasons), interest deductions should only be disallowed under a justified restrictive domestic rule regarding excessive interest charges determined on the basis of the arm's-length principle.⁶

An interest limitation rule that applies only in a cross-border context can only be justified by the need to (i) preserve a balanced allocation between EU member states of power to impose taxes and (ii) prevent tax avoidance and combat artificial arrangements.⁷ While the CJEU requires that both items must be fulfilled, the discussion draft states that a restriction of the freedom of establishment may be based merely on the basis of the "balanced allocation" justification. We believe any interest limitation rule should not go beyond what is necessary and appropriate to prevent "abusive arrangements."⁸

Last, the proposed groupwide rule and fixed ratio rule may pose concerns regarding the free movement of capital (that is, when non-EU third parties grant loans to EU borrowers). The CJEU recently held that member states may not deny interest relief in the absence of a shareholding relationship when the interest limitation rule presumes that the borrower's overall indebtedness forms part of a tax avoidance arrangement without allowing taxpayers to justify the arm's-length nature of the arrangements.⁹

C. EU State Aid

The proposed rules may further pose concerns regarding EU state aid rules if any general (or targeted)

interest limitation rules are designed in a way that provide selective advantages to specific taxpayers. Therefore, potential carveouts must be carefully drafted in order to avoid any EU state aid issues. Ideally, carveout rules should be designed in consultation with the European Commission so as to preclude potential future state aid infringement proceedings.

VI. Conclusion and Outlook

The discussion draft addresses BEPS issues around the deduction of interest and other financial payments, but it fails to define excessive interest deductions, which is the perceived BEPS concern. It is evident that the proposals set out in the discussion draft go far beyond action to counter BEPS and would deny the deductibility of interest expenses even in genuine commercial transactions with legitimate business purposes. Considering that this topic is already in the scope of other BEPS actions, it appears to be appropriate to recommend a more targeted rule, rather than impose substantial restrictions on every company regardless of size, level of tax risk, and presence of any tax motive. Moreover, the work on BEPS action 4 should be more closely aligned to other action items that also concern the deductibility of interest payments in order to result in a consistent and holistic approach.

The preferred option in the discussion draft seems to be the groupwide rule, which is designed to limit the availability of interest deductions within a group to the overall third-party interest expense incurred by the group. However, why would the level of internal debt funding in excess of third-party debt evidence BEPS to another jurisdiction? This rule would cause double taxation and distortions in the competitiveness between multinational groups (that is, capital-rich vs. highly leveraged) as well as distortions in the competitiveness between multinational and purely domestic groups. It is further concerning that the proposed rules would create a tax-driven incentive for groups to increase third-party debt funding. Given that there is currently no major OECD country that applies a groupwide test as a main rule, it is hard to imagine that such a rule would be supported by countries around the globe. How could an approach that has never been used in practice be recommended as a best practice?

While the fixed ratio rule would be simple to operate given its mechanistic nature, its one-size-fits-all approach is not appropriate given the significant differences in the need for debt funding in different sectors. A combined approach with a fixed ratio rule as the general rule (and a reasonable high ratio) and the groupwide rule as a carveout is the most sensible approach since it would allow MNEs to avoid the application of the groupwide rule, whereas businesses with a higher external leverage would have the option to apply the alternative rule (for example, real estate and

⁵For example, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (C-234/00), Dec. 12, 2002.

⁶For example, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* (C-524/04), Mar. 13, 2007.

⁷For example, *Société de Gestion Industrielle SA (SGI) v. Belgium* (C-311/08), Jan. 21, 2010.

⁸For example, *NV Lammers & Van Cleeff v. Belgische Staat* (C-105/07), Jan. 17, 2008.

⁹*Itelcar — Automóveis de Aluguer Lda v. Fazenda Pública* (C-282/12), Oct. 3, 2013.

private equity funds). Nevertheless, none of the proposed rules are consistent with the arm's-length principle — yet another step within the BEPS project in the direction of formulary apportionment.

The proposals in the discussion draft pose significant compatibility issues with EU law. Therefore, EU member states should not be able to adopt the proposals in the discussion draft. Moreover, these proposals raise concerns from a constitutional law perspective in many countries as they put limits to the net income principle (allowing taxpayers the deduction of expenses in relation to their income-generating activities). The discussion draft is not, however, a consensus document, and the work on BEPS action 4 will only result in best practice recommendations. Thus, countries will be free to keep their existing rules or to adopt the OECD recommendations in their domestic tax law.

We believe a best practice recommendation should be well-targeted, designed to have minimal impact on investments and competition, and avoid double taxation and high compliance costs. Ultimately, countries must strike a balance between limiting interest deductibility to a reasonable level and remaining attractive for foreign investments. ♦

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