

Interest Deduction based on Allocation of Worldwide Debt

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INTEREST DEDUCTION BASED ON ALLOCATION OF WORLDWIDE DEBT

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1. Introduction

Most countries make a fundamental distinction between the tax treatment of debt and that of equity. Interest on debt is subject to certain conditions treated as deductible for tax purposes. On the other hand, dividends are generally not tax-deductible. In *Addressing Base Erosion and Profit Shifting*² (“Addressing BEPS”) the OECD explains that these rules create an obvious bias towards debt financing, particularly when this is combined with low-taxation at the level of the recipient: “A typical case involves setting up a finance operation in a low-tax country to fund the activities of the other group companies. The result is that the payments are deducted against the taxable profits of the high-taxed operating companies while taxed favourably or not being taxed at all at the level of the recipient thus allowing for a reduction of the total tax burden. Leveraging high-tax group companies with intra-group debt is a very simple and straightforward way to achieve tax savings at group level.”³ In its *Action Plan on Base Erosion and Profit Shifting*⁴ (“Action Plan on BEPS”) the OECD not only reiterates that the deductibility of interest expense is an issue in inbound scenarios but also expresses its concern about excessive interest deduction in outbound situations: “From an outbound perspective, a company may use debt to finance the production of exempt or deferred income, thereby claiming a current deduction for interest expense while deferring or exempting the related income. Rules regarding the deductibility of interest expense therefore should take into account (...) that the underlying debt may be used to inappropriately reduce the earnings base of the issuer or finance deferred or exempt income.”⁵ The Action Plan therefore calls to develop rules “to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income”.⁶

In this article it is suggested to develop a rule that allocates a multinational’s worldwide third party debt to the group companies by using assets as an allocation factor (“the worldwide debt allocation rule”).^{7 8} Paragraph 2 outlines the considerations on which this worldwide debt allocation rule is based. Paragraph 3 describes the main characteristics of this rule. Paragraph

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² OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264192744-en>.

³ *Addressing BEPS*, p. 43.

⁴ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

<http://dx.doi.org/10.1787/9789264202719-en>.

⁵ OECD (2013), *Action Plan on BEPS*, p. 16/17.

⁶ OECD (2013), *Action Plan on BEPS*, p. 17, Action 4.

⁷ Portions of this article are derived from my PhD thesis on interest deduction restrictions in international tax law, J. Vleggeert, *Aftekbeperkingen van de rente in het internationale belastingrecht*, Fiscale Monografie nr. 132, Deventer Kluwer 2009.

⁸ M.J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, *Bulletin* November 2008, p. 486-493, proposes to allocate worldwide interest expense rather than worldwide debt.

4 discusses the application of the worldwide debt allocation rule. Paragraph 5 will examine whether the rule is suited to prevent base erosion through the use of interest expense.

2. Considerations on which the worldwide debt allocation rule is based

The worldwide debt allocation rule is based on five principles. First it is assumed that base erosion through the use of interest expense mainly occurs within international groups of companies. A multinational company can shift its debts to group companies situated in a country where the deduction of interest can achieve the greatest tax saving. Any rule aimed at combating this type of profit shifting will therefore have to be targeted at companies which are members of an international group.

Second, it is submitted that a state should only allow deductions of interest on loans used to finance business operations through which a taxpayer generates income that is taxable in that state. States that apply the principle of territoriality for corporate taxation, keep income not related to activities in that state outside the tax base. Dividends and capital gains on shares in foreign subsidiaries are tax exempt. Other states, like the USA, have a hybrid tax system in that it has both elements of a residence based tax and elements of a territorial tax.⁹ These states tax dividends distributed by foreign subsidiaries and provide for an indirect credit for corporation tax paid by the foreign subsidiary. The provisions that may introduce territorial features are deferral¹⁰ and cross crediting.¹¹ Interest on loans used to finance foreign subsidiaries should therefore not be deductible from the taxpayer's domestic income.¹²

Third, the worldwide debt allocation rule must be consistent with the EU freedoms, more in particular the freedom of establishment and the free movement of capital.¹³ The EU freedoms preclude a rule providing that interest on loans used to finance shareholdings is not deductible only where foreign subsidiaries are concerned.¹⁴ This implies that no distinction should be made between domestic and cross-border situations. The worldwide debt allocation rule should therefore provide that interest on loans used to finance shareholdings in *foreign and domestic* subsidiaries is not deductible from the taxpayer's domestic income.

Fourth, the worldwide debt allocation rule is based on the OECD views on the capitalisation of a permanent establishment. According to the Commentary on art. 7 of the OECD Model Tax Convention a permanent establishment should be attributed an arm's length amount of free capital. As to how to determine the amount in free capital, the Commentary particularly

⁹ J.G. Gravelle, CRS Report for Congress, Moving to a Territorial Income Tax: Options and Challenges, July 25 2012, p. 2.

¹⁰ Gravelle describes deferral as follows: "Deferral allows a firm to delay taxation of its earnings in foreign subsidiaries until the income is paid as a dividend to the domestic parent company." J.G. Gravelle, CRS (2012), p. 2.

¹¹ Gravelle describes cross crediting as follows: "Cross crediting is a phenomenon that occurs when credits for taxes paid to one country can be used to offset the domestic tax due on income earned in a second country." J.G. Gravelle, CRS (2012), p. 4.

¹² Income from permanent establishments in other countries is also tax exempt or the corporation tax paid in the permanent establishment state is creditable. Under the authorised OECD approach arm's-length amounts of equity and debt should be allocated to a permanent establishment.

¹³ Art 49 and art. 63 of the Treaty on the Functioning of the European Union ("TFEU").

¹⁴ ECJ 18 September 2003, C-168/01 (Bosal).

refers to the capital allocation approach and thin capitalisation approach discussed in Part 1 of the Report on the “Attribution of Profits to Permanent Establishments”.¹⁵ The capital allocation approach uses as its point of reference the financing structure of the enterprise as a whole. The worldwide debt allocation rule entails applying the capital allocation approach by analogy to companies that are members of a group. Under this approach, a multinational’s worldwide third party debt is allocated to the group companies using assets as an allocation factor.

Finally, a prerequisite for restricting the deductibility of interest is that economic double taxation of interest must be avoided as much as possible. Under the worldwide debt allocation rule a disallowance of an interest deduction at the level of a thinly-capitalised group company should therefore be offset by a corresponding extra deduction of interest at the level of an overcapitalised group company.

3. Main characteristics of the worldwide debt allocation rule

Under the worldwide debt allocation rule, worldwide third party debt is allocated to a particular group company according to the assets shown in the group company’s commercial balance sheet in proportion to the assets shown in the multinational’s commercial consolidated balance sheet. To the extent that the group company’s actual debt exceeds the third party debt that is allocated to it, it has excess debt. The interest due on excess debt is not deductible.

Conversely, to the extent that the third party debt so allocated exceeds the group company’s actual debt, the group company has excess equity. In this case a deduction on the excess equity is allowed. Consequently the worldwide debt allocation rule is applied, irrespective of whether a group company is thinly capitalised (because it has excess debt) or overcapitalised (because it has excess equity).

In fact, the portion of worldwide third party debt that is allocated to a group company is the amount of assets shown in the group company’s commercial balance sheet multiplied by a factor. Reflecting the extent to which the multinational group is funded by third party debt, this factor is determined on the basis of the multinational’s commercial consolidated financial statements. That is to say that the factor equals worldwide group debt divided by worldwide group assets.

However in allocating worldwide third party debt to a group company, not all assets in the group company’s balance sheet are taken into account. No debt is allocated to assets in the group company’s commercial balance sheet that are not included in the multinational’s consolidated balance sheet. Consequently shareholdings in other group companies that are on a group company’s balance sheet are not taken into account. Also loans granted to other group companies will be ignored.

Worldwide third party debt is defined as debt that is on the group’s consolidated balance sheet. Accordingly intragroup debt is not considered worldwide third party debt as intragroup debt is not on the consolidated balance sheet. Therefore intragroup debt has no impact on the calculation of allowable interest deductions. The other side of the coin is that interest income on loans to group companies should be exempt in order to avoid economic double taxation of interest.

¹⁵ Par. 46 of the Commentary on art 7 OECD (2008).

Once any excess debt is determined, an amount of interest should be assigned to it. The starting point here is the amount of interest on total debt in the group company's financial statements prepared for tax purposes. The interest on the excess debt is a portion of the interest on the group company's total debt. This portion reflects the group company's excess debt to total debt ratio.

If the group company is overcapitalised, a deduction will be allowed on the excess equity. Again, the starting point is the amount of interest on total debt in the group company's financial statements prepared for tax purposes. The deduction on the excess equity is a portion of the interest on the group company's total debt. This portion reflects the group company's excess *equity* to total debt ratio. If the group company has no debt, the deduction on excess equity cannot be based on the group company's interest expenses. Instead the deduction on excess equity is determined according to the group's consolidated commercial financial statements. In that case the deduction is a portion of the group's interest expenses in the consolidated accounts. This portion reflects the group company's excess equity to the group's total debt ratio.

The worldwide debt allocation rule will only apply to *interest* on a group company's debts and receivables. It will not provide for an allocation of any currency exchange gains or losses on a group's third party debt. The reason for this lies in the rationale behind the worldwide debt allocation rule. It is designed to prevent base erosion through the use of interest expenses. There is no need, therefore, for an allocation of currency exchange gains or losses on a group's debt.

The worldwide debt allocation rule applies only if the taxpayer is a member of a group of companies. Whether that is the case is determined according to international financial reporting standards or domestic generally accepted accounting principles. The rule does not exclude small and medium-sized enterprises. Alternatively it could be considered to introduce a *de minimis* limit for purposes of excluding amounts of debt that are not considered material.^{16 17}

4. Discussion of the application of the world wide debt allocation rule

This article proposes to develop a rule that allocates a multinational's worldwide third party debt to the group companies using assets as an allocation factor. Alternatively, Webber advocates using earnings rather than assets as an allocation factor.¹⁸ He suggests to limit a group company's tax-deductible interest expenses to the worldwide group's ratio of interest expense to earnings. Sullivan also favors using earnings as an allocation factor: "Allocating interest by gross profit will produce largely the same favorable effects as interest allocation by assets, but with two added benefits: (1) a reduction in administrative and compliance costs and (2) a reduction in the incentive to shift profits out of the [residence state of the group company]. This latter effect will reduce revenue losses from shifting due to aggressive

¹⁶ The UK worldwide debt cap legislation provides for a *de minimis* limit. See S. Webber, *Thin Capitalization and Interest Deduction Rules: A Worldwide Survey*, Tax Notes International, Nov. 29, 2010, p. 696 and HMRC, "Worldwide Debt Cap Current Thinking," 2009, p. 1.

¹⁷ If a *de minimis* limit is introduced further research is necessary to check whether it complies with the EU state aid rules.

¹⁸ Webber, p. 705. More specifically he suggests using EBITDA as an allocation factor apparently because Germany, Italy, and the United States currently reference EBITDA to limit tax deductible interest expenses.

transfer pricing. ¹⁹ In addition he submits that measuring assets for purposes of allocating interest can be problematic: “It is generally believed that using the market value of assets is more accurate than using tax basis, but determining market value can be costly and nevertheless still lead to disputes with the [tax authorities].”²⁰

My main criticism to using earnings as an allocation factor is that debt finances assets rather than profits. A fair interest deduction restriction should allow deductions of interest on loans used to finance assets through which a taxpayer generates income that is taxable in the state where these assets are used. My second objection is that the outcome of an interest deduction restriction using earnings as an allocation factor is unpredictable as earnings fluctuate. Third, if deductible interest expenses were to be limited to the worldwide group's ratio of interest expense to a group company's earnings, income from intragroup dealings should be eliminated from the group company's earnings as these earnings are not included in the group's consolidated accounts. Fourth, using commercial earnings as a point of reference disregards differences between the commercial accounts and tax accounts. Finally, I do not share Sullivan's criticism that measuring assets for purposes of allocating interest can be problematic. The value of assets can be determined according to the commercial accounts.

Another issue is whether a rule that allocates a multinational's worldwide third party debt to the group companies is fair. Webber notes that comparing a group company's debt with the worldwide business may be a fairer and more efficient rule than uniform, somewhat arbitrary, limitations: “Some industries and firms choose to incur more debt than others as part of their funding strategy, and “fair” regulations should not penalize such firms.”²¹ But he adds that “[i]n some cases, a subsidiary may be engaged in a fundamentally different line of work than the worldwide enterprise. In those cases, fairness would dictate establishing an interest expense limit consistent with other firms in that industry, (...).”²²

Indeed it is questionable whether the allocation of a multinational worldwide third party debt is fair if a group company is engaged a different business than the rest of the group or operates in market conditions different to those applying to the rest of the group. In my doctoral thesis I therefore suggested that in those circumstances an alternative rule should apply. ²³ This rule defines excess debt as the amount by which the group company's debt exceeds the debt which it would have owed, had it not been a member of the group and had it conducted the same or similar activities in the same or similar conditions. This rule would allow the worldwide debt allocation rule to be adjusted or the group company's debt to be compared to the level of debt owed by similar independent companies (thin capitalisation approach). However, the alternative rule offers considerably more room for debate between the tax administration and the group company than the worldwide debt allocation rule. Moreover it may be defensible to also apply the worldwide debt allocation rule to group companies that are engaged in a different business than the rest of the group assuming that debt is fungible.

Sullivan submits that “it is generally believed that all components of any firm's finances are interdependent (i.e., that money is fungible) and that it is therefore not possible to assign or

¹⁹ M. A. Sullivan *A Proposal for the Tax Treatment of Interest in a Territorial System*, 40 *Pepp. L. Rev.* 5 (2013) Available at: <http://digitalcommons.pepperdine.edu/plr/vol40/iss5/10>, p.1362.

²⁰ Sullivan, p.1357.

²¹ Webber, p. 696.

²² Webber, p. 706.

²³ J. Vleggeert, p. 634.

trace interest costs to a single component of a firm's operations (...).²⁴ According to Gravelle and Marples the concept of fungibility entails that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid: "For example, a U.S. parent company might borrow in the U.S. and use the funds to increase its equity stake in a foreign subsidiary, which uses those borrowed funds to make its own investments. Conversely, a U.S. firm could borrow domestically to finance domestic investment—investment that might otherwise have been financed through repatriated earnings. In this case, domestic borrowing may support both domestic and foreign investment."²⁵ Next they discuss the presumption of fungibility: "First, in favor of fungibility, corporations are legal entities, and not economic ones. As a result corporate boundaries can be easily manipulated for financial gain. Conversely, the existence of crossjurisdictional interest rate differentials suggest that fungibility may not hold between all jurisdictions."²⁶ This area may need further exploration.²⁷

Under the worldwide debt rule the amount of interest on excess debt or excess equity is determined using the amount of interest on debt in the group company's financial statements prepared for *tax* purposes as a starting point. This implies that states using the worldwide debt rule would continue to have their own rules for deciding whether funding is treated as equity or debt for tax purposes. If the worldwide debt allocation rule is adopted, these rules are necessary to counter tax planning strategies where a group company issues instruments which are treated as equity commercially but which for tax purposes are regarded as debt. Alternatively the amount of interest on excess debt or excess equity could be determined on the basis of the amount of interest in the group company's *commercial* financial statements.²⁸ This entails that for purposes of determining what is equity and what is debt international financial reporting standards or general accepted accounting principles would be decisive.

Gravelle and Marple express their concern that under worldwide allocation of debt or interest firms could artificially increase their assets to enhance any interest allocation: "[I]f firms could borrow and redeposit funds, they could increase their debt to gross asset ratios."²⁹ This issue needs further exploration.

5. Does the worldwide debt allocation rule prevent base erosion through the use of interest expense?

Under the worldwide debt allocation rule the location of debt does no longer affect the size of the interest deduction at the level of the various group companies. The size of the interest deduction depends on the worldwide debt of the multinational group and the debt-equity ratio of the group. Once these parameters are known, it is irrelevant whether a domestic or a foreign group company is financed with debt for purposes of determining the amount of the deductible interest.³⁰

²⁴ Sullivan, p. 1346/1347.

²⁵ J.G. Gravelle, D.J. Marples, CRS Report for Congress, The Foreign Tax Credit's Interest Allocation Rules, August 20, 2008, p. 4.

²⁶ J.G. Gravelle, D.J. Marples, CRS (2008), p. 4.

²⁷ J.G. Gravelle, D.J. Marples, CRS (2008), p. 5.

²⁸ This is similar to Graetz' proposal who suggests to allocate worldwide interest expense. Graetz, p. 490.

²⁹ J.G. Gravelle, D.J. Marples, CRS (2008), p. 5.

³⁰ Disregarding debt/equity classification issues and interest rate differentials.

This paragraph discusses whether the worldwide debt allocation rule meets the objectives of the Action Plan to prevent base erosion through the use of interest expenses. First, the Action Plan calls to prevent base erosion through the use of related-party debt. Under the worldwide debt allocation rule related party debt no longer affects the size of the interest deduction as it allocates a third-party debt only as intra-group debts are consolidated. Conversely, interest income on loans to group companies is exempt in order to avoid economic double taxation of interest.

Second, the Action Plan aims to prevent base erosion through the use of debt to finance the production of exempt or deferred income. Under the worldwide debt allocation rule no debt is allocated to shareholdings in other group companies. Therefore interest on debt that finances exempt or deferred income is no longer deductible.

Third, the Action Plan points out that multinationals have been able to use and/or misapply transfer pricing rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This inter alia results from the overcapitalisation of lowly taxed group companies. The OECD therefore calls to develop rules to prevent base erosion by allocating excessive capital to group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has provided capital.³¹ As indicated above, under the worldwide debt allocation rule related party debt no longer affects the size of the interest deduction. Moreover overcapitalisation of lowly taxed group companies is no longer an issue because the location of equity or debt does no longer affect the size of the interest deduction at the level of the various group companies.

Under the worldwide debt allocation rule, a disallowance of an interest deduction at the level of a thinly-capitalised group company is offset by a corresponding extra deduction of interest at the level of an overcapitalised group company. If adopted multilaterally, economic double taxation of interest is therefore avoided. In case the rule is adopted unilaterally, this principle may be violated if a state denies deductions for interest incurred in that state, assuming that other states do not allow deductions for interest on excess equity. Sullivan , however, submits that “[i]f the United States unilaterally adopts [debt] allocation rules, U.S. multinationals can restore much of the economic value of interest limited in the United States by shifting borrowing outside the United States, particularly if borrowing is shifted to another high-tax jurisdiction. In fact, U.S. corporations will seek to locate as much debt and deduct as much interest as possible outside the United States because the relocation of debt will reduce foreign taxes without having any adverse effect on U.S. taxes. (...) It will, however, likely drive other nations to adopt [debt] allocation rules (...)”³² This suggests that the worldwide debt allocation rule has a strong potential for spontaneous proliferation.

³¹ OECD (2013), Action Plan on BEPS, p. 18/19.

³² Sullivan, p. 1361/1362.