TAXAND

A DISCUSSION OF LIMITED INTEREST

Your global tax partner

SESSION OVERVIEW

A DISCUSSION OF LIMITED INTEREST

Juan Carlos Ferrucho (USA), Torsten Engers (Germany), Claire Lambert (UK), Nishant Shah (India), Alistair Amstrong (U+I)

BEPS Action 4 called for recommendations on best practices in the design of rules to prevent corporate tax base erosion through the use of interest expense. A number of countries such as the US in the US Tax Cuts Act, as well as Germany, the UK, India and the Netherlands, have moved to adopt these or similar rules. Our panel will provide an overview of these changes, the issues that they raise for multi-national enterprises individually and through their interaction with one another, and then address how they impact structuring of internal and external financing, and how multinational enterprises should be planning and responding, through case study examples.

PANEL INTRODUCTIONS

Panelists

Juan Carlos Ferrucho
Moderator

Alvarez and Marsal, Taxand USA

Claire Lambert
Alvarez and Marsal, Taxand UK

Alistair Armstrong
Head of Tax, U+I Plc

Torsten Engers
FGS, Taxand Germany

Nishant Shah
ELP, Taxand India

SESSION OVERVIEW

1. Introduction
2. Comparative analysis
3. Case studies

   UK | India | Germany | US
4. Key challenges
5. Q&A

TAXAND

TAXAND

INTRODUCTION

POLLING QUESTION 1

If your company already considered the new interest deductibility limitations in the United States, do you have a sense of how these rules will impact your business?

A	Significantly detrimental
B	Moderate negative impact
C	Neutral
D	Positive

INTRODUCTION

- OECD BEPS Action Point 4
- European Union (‘EU’) Anti-Avoidance tax directive (‘ATAD’)
- Sample countries with local legislation:
  - United Kingdom
  - Germany
  - India
  - Austria
  - Italy
- EU ATAD will require EU wide implementation unless local law covers it.

BEPS: INTEREST LIMITATION OBJECTIVES

- Base Erosion and Profit Shifting (BEPS) risks generally arise in three basic scenarios:

1	2	3
Groups placing higher levels of third party debt in high tax countries	Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense	Groups using third party or intragroup financing to fund the generation of tax exempt income

- Action Point 4 (BEPS Action Plan, OECD, 2013) recommends regarding best practices in the design of rules to prevent base erosion through the use of interest expense.

BEPS: INTEREST DEDUCTION LIMITATION

- Action 4: Focus on **limiting deductibility** of ‘excessive interest’
- Proposed limitation on two fronts:
  - Fixed ratio: restricts an entity’s net interest deductions to a fixed percentage (ie **10%** to **30%)** of its earnings before interest, taxes, depreciation and amortization (EBITDA) calculated using tax principles
  - Group ratio: 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. Such a group ratio rule should never operate to impose a stricter limit than the fixed ratio rule
- Possible carry back and forward mechanisms
- Optional de minimis threshold.

EU: ANTI TAX AVOIDANCE DIRECTIVE ‘ATAD’ (1/2)

- **ATAD** – Limit multinational groups from reducing tax base through excessive group financing
- Like BEPS, focus is on **net interest expense** (deductible interest minus taxable interest income)
  - Recommended limit at **30%** of the taxpayer's tax-EBITDA
  - Optional: Group ‘Equity/Asset’ ratio or group ‘Debt/EBITDA’ ratio
- Recommended taxpayer exclusions:
  - Individuals
  - Standalone entities and/or financial/insurance groups

TAXAND

EU: ANTI TAX AVOIDANCE DIRECTIVE 'ATAD' (2/2)

- Recommended exclusions from net interest expense:
  - Grandfathered loans before 22 May 2016
  - Certain loans to fund long-term public infrastructure projects
  - First 3m Euros of interest not subject to limitation
  - Group ratio overrides **30%** fixed ratio
- Related/unrelated loans
- Unlimited carryforward of disallowed interest, and two carryback options (no carryback, three years). Option for carryforward of excess limitation.

COMPARISON: BEPS 4 V. ATAD

Generally more favorable for taxpayers than BEPs proposals:

- Fixed ratio is **30%** of tax-EBITDA versus corridor of **10%** to **30%**
- Unlimited carry-forwards on disallowed interest and potential carryback
- Potential for carry-forward of excess limitation for **five years**
- EUR 3,000,000 of interest expenses excluded
- Standalone entity exception
- Optional ‘equity/assets’ ratio.

COMPARATIVE ANALYSIS

GERMAN/ATAD INTEREST BARRIER RULE (IBR) AT A GLANCE

	Application	Limits	Exemption	Carry forward: Interest	Carry forward: EBITDA
Germany	• Domestic/foreign entities and PEs of foreign entities, ie, partnerships and corporations • Third party loans and/or shareholder loans.	• Interest expense fully deductible up to realized interest income • Remaining interest expense is deductible up to 30% of tax-relevant EBITDA • Calculation of EBITDA on the level of the group/fiscal Unity.	• Interest up to **EUR 3m** threshold fully deductible • Entity is not part of a group (stand-alone clause), or entity is part of a group but its equity ratio is the same or higher than the group's equity ratio (equity ratio clause). However, stand-alone/equity ratio clauses are not applicable if 10% or more of interest is paid to certain affiliated companies. The 10% threshold applies for the equity ratio clause for any subsidiary, even foreign entities which are not relevant for German taxation. Application of stand-alone/equity ratio clauses are very restrictive and difficult to handle • No sector exceptions.	Yes, unlimited	Yes, limited up to five years
ATAD	• Domestic/foreign entities and PEs of foreign entities, ie, partnerships and corporations • Third party loans and/or shareholder loans.	• Remaining interest expense is deductible up to 30% of tax-relevant EBITDA. However, MS may implement an EBITDA rate <30% • Calculation of EBITDA on the level of the group/fiscal unity not mandatory.	• Interest up to **EUR 3m** threshold fully deductible. However, MS may implement a **threshold ≤ EUR 3m** • More straight-forward application of stand-alone/equity ratio clause • MS may exclude banking or insurance companies.	MS may limit duration of interest carry-forward	MS may limit duration of EBITDA carry-forward. However, maximum duration is five years

UK INTEREST LIMITATION RULES

Application	Applies from 1 April 2017 Very closely follows the recommendations in BEPS Action 4 Applies to intercompany and external debt Applies to loan relationships and certain derivative contracts Complex! 166 pages of statute, 577 pages of guidance.
Limits	Fixed ratio rule – net interest deductions limited to 30% of UK group's tax EBITDA Group ratio can apply instead by election – apply worldwide group net interest ratio to UK group tax EBITDA Both of the above are limited by a modified calculation of net group interest to limit the overall deduction.
Threshold	Applies to groups with net UK interest exceeding £2m – the first £2m is always deductible.
Exemptions	Public Benefit Infrastructure Exemption ('PBIE') – also applies to certain real estate investment activity in the UK.
Carry forward	Can carry forward excess interest expense indefinitely Can carry forward spare capacity for five years.

NEW US INTEREST LIMITATION RULES

Application	Applies from 1 January 2018 Framework similar to BEPS Action 4 Applies to intercompany and external debt Applies to business interest only Applies to consolidated groups and partnerships.
Limits	Fixed ratio rule – net interest deductions limited to 30% of US group's adjusted taxable income ('ATI') (ie tax EBITDA) until 2021 and thereafter, tax EBIT ATI does not include carryforward NOLs, Section 199 or tax amortization, depreciation or depletion Owners of passthrough entities may not use the items of income, gain, deductions or losses from partnerships to compute limitation to avoid double counting.
Threshold	Applies to businesses with average annual gross receipts exceeding USD $25m.
Exemptions	Small businesses, real property trade or businesses, certain utilities and floor plan financing.
Carry forward	Can carry forward excess interest expense indefinitely Pass-through entity's owners may use the unused interest limitation of the partnership but only for the current year.

TAXAND

INDIAN INTEREST EXPENSE LIMITATION RULES

Background	Applies from 1 April 2017 Based on Action Plan 4 of BEPS Limits tax break on interest expense or similar nature on debt obtained from or guaranteed by AEs.
Payer	Indian Company or PE of a Foreign Company in India. (Not engaged in the business of Banking or Insurance)
Receiver	NR AEs or Non-AE to whom implicit or explicit guarantee or corresponding or matching amount provided by AE.
Threshold	Interest expense per TY exceeds INR 10m (approx. $150,000).
Tax Break Available	Interest expense to the tune of 30% of EBITDA or actual interest paid for AE, whichever is less Disallowed amount eligible for carry forward for eight succeeding tax years Carry forward of spare capacity not available.

Prior to introduction of interest limitation rules in the Indian tax laws, exchange control regulations prescribed **limits on the borrowings** and rate of interest from NR.

TAXAND

INTEREST EXPENSE LIMITATION: A COMPARATIVE ANALYSIS

Parameter	Germany	UK	US	India
Tax Break Available	• 30% of EBITDA • Very restrictive stand-alone clause and world wide group ratio rule.	• 30% of UK tax EBITDA • Can elect to use worldwide group ratio and apply to UK tax EBITDA • Limited by 'modified' net group interest calculation.	• 30% of EBITDA from 1 January 2018 up to 31 December 2021 • 30% of EBIT 1 January 2022 onwards.	• 30% EBITDA from 1 April 2017 onwards.
Threshold	• Interest payments less than EUR 3m are exempted.	• Net UK Interest exceeding £2m.	• Exempts taxpayers with three years average gross receipts of $25m or less.	• Interest payment to AEs in excess of INR 10m (Approx. $150,000).
Carry-forward of disallowed interest	• Indefinitely.	• Indefinitely.	• Indefinitely.	• Allowed only for eight succeeding years.
Applicability	• Applicable to both related-party and unrelated-party debt.	• Applicable to both related-party and unrelated-party debt.	• Applicable to both related-party and unrelated-party debt.	• Applicable only to debt provided or guaranteed by related party.
Specific Exclusions	• No sector exclusion.	• Specific rules for banking and insurance businesses. Certain public infrastructure activities are exempt (but detailed conditions).	• Excludes certain trades and businesses.	• Excludes banking and insurance businesses.

TAXAND

POLLING QUESTION 2

Do you expect that the interest deductibility limitations around the world will create volatility in the effective tax rate of your business?

- **A** Yes
- **B** No

CASE STUDIES

YOU WILL KNOW US BY THE PLACES WE CREATE


EVERYTHING
IS
CONNECTED


citi
HSBC
BARCLAYS

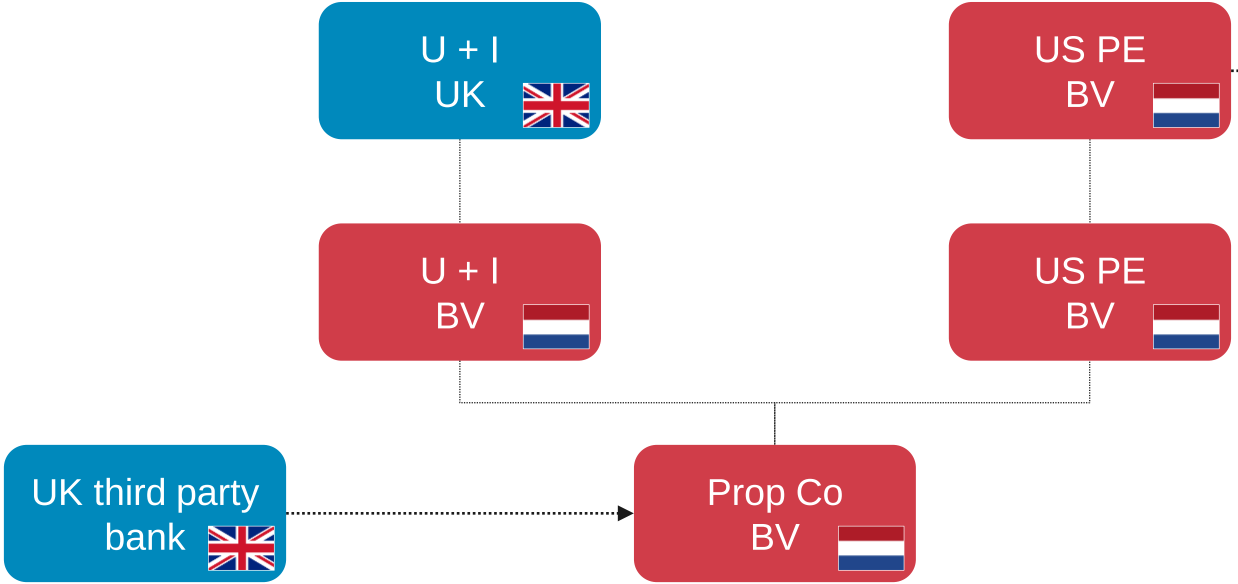
LONDON COMMERCIAL REAL ESTATE MARKET

- $470bn – total value
- $260bn – 55% own by overseas capital

2017

- $23.5bn completed transactions
- 83% – $19.5bn overseas capital
- 3 x greater than New York City
- Greater than Paris, Frankfurt, Berlin and Amsterdam combined.

2015 TRANSACTION STRUCTURE



CHANGES TO UK TAX LEGISLATION

January 2017

Hybrid mismatch rules

April 2017

BEPS Action Point 4

April 2019

Foreign entities subject to UK Capital gains

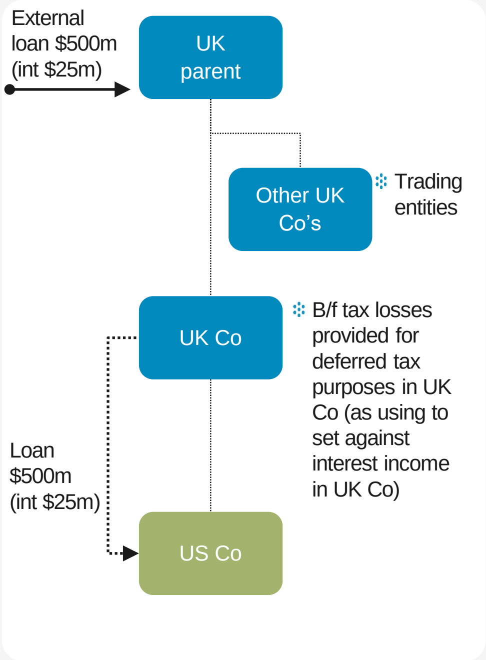
April 2020

Foreign entities subject to UK Corporation tax

DOES ANY OF THIS REALLY MATTER?

Known Knowns	• Hybrid mismatch, BEPS 4, Capital gains, Corporation tax
Known Unknowns	• Will this kill the market?
Unknown Unknowns	• Brexit

UNITED KINGDOM: CASE STUDY

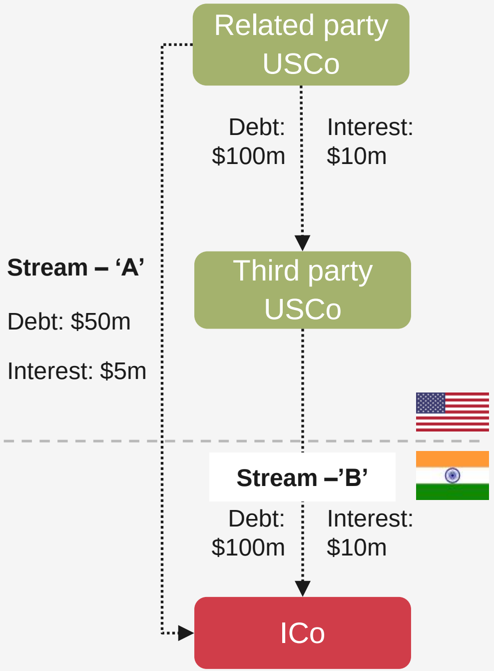


Considerations

- When assessing how to reduce US interest deductions necessary to consider wider impact on other territories
- Reducing/capitalising intergroup loan reduces interest income in UK Co
- Reduced interest income means less income to set b/f losses against
- Therefore may have to reassess recoverability of b/f losses in UK Co and derecognise deferred tax asset on b/f losses
- Depending on how much you deleverage the US, could have a knock on impact on UK interest deductibility as the more the income is reduced the larger the UK net interest – may be subject to UK interest disallowance
- US tax reform also means minimal rate arbitrage
- So ETR impacted by change in rate arbitrage, derecognition of deferred tax asset and restriction on UK interest deductibility (may be other things that help eg reduced tax on US profits but depends on group profile)
- Relevant as more jurisdictions introduce interest limitation rules.

TAXAND

INDIA: CASE STUDY



Particulars	TY 2016 (Prior to introduction of interest limitation rules)		TY 2018 (After introduction of interest limitation rules)	
	Stream 'A'	**Stream 'B'**	**Stream 'A'**	**Stream 'B'**
	Loan to ICo by related party USCO	Loan to ICo by third party USCO	Loan to ICo by related party USCO	Loan to ICo by third party USCO
Debt	$50	$100	$50	$100
Interest paid	$5	$10	$5	$10
EBITDA	$30		$30	
30% of EBITDA	NA		$9	
Total interest expense allowed (subject to interest limitation rules)	$15 [$10 + $5] (Interest limitation rules NA)		$9 (Interest limitation rules applicable on both streams)	
Balance carry forward	NA		$6	

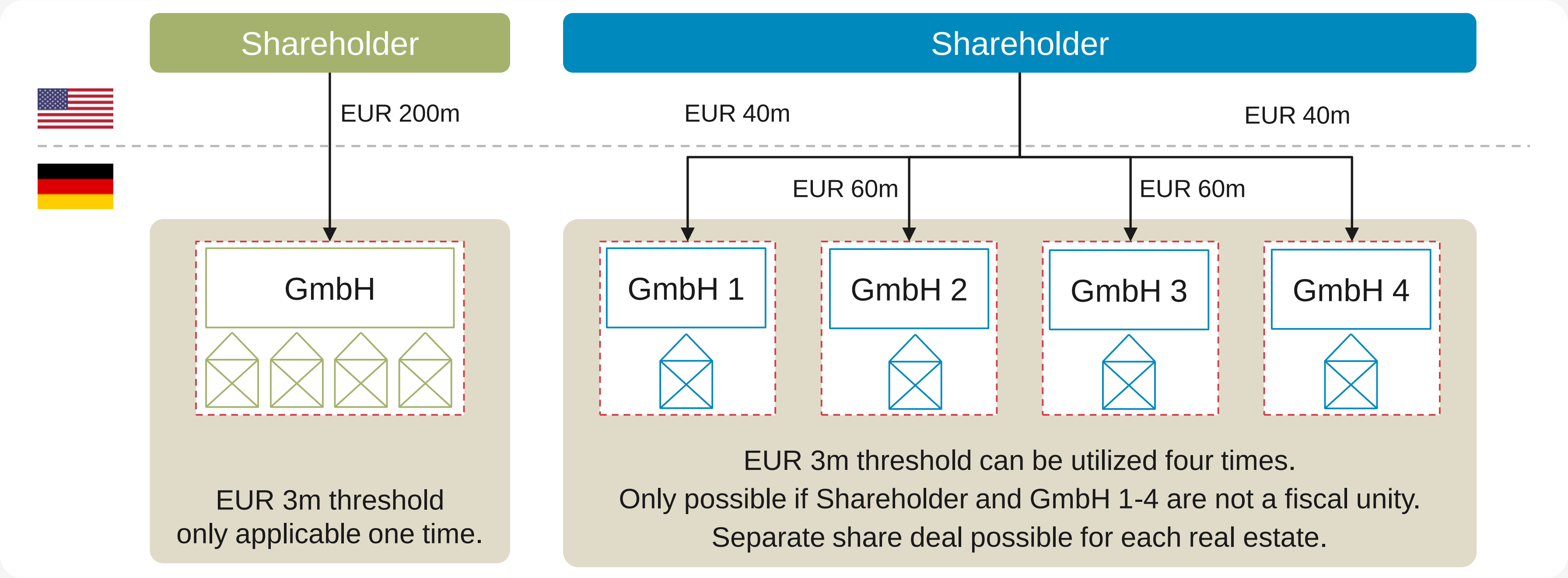
Potential measures to mitigate exposure of Indian interest limitation rules:

- Converting NR AE debt to non-AE debt
- Obtaining debt from resident non-AE where guarantee by AE is necessary
- Changing the form of the Indian entity from Company to LLP

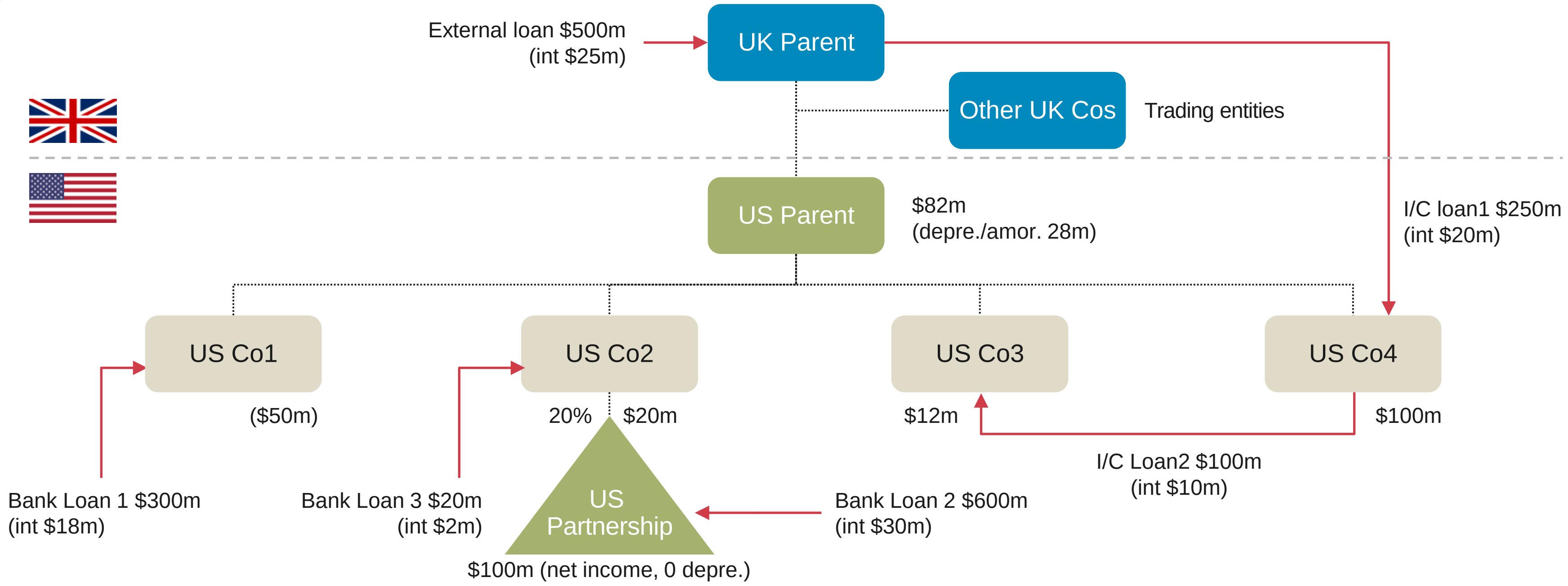
GLOSSARY

Acronym	Abbreviation	Acronym	Abbreviation
AE	Associated Enterprise	INR	Indian Rupee
BEPS	Base Erosion and Profit Shifting	LLP	Limited Liability Partnership
CbCR	Country by Country Reporting	LOB	Limitation of Benefits
CFC	Controlled Foreign Company	MLI	Multilateral Instrument
CTA	Covered Tax Agreements	Mn	Million
DAPE	Dependent Agent PE	NA	Not Applicable
EBIT	Earning Before Interest and Taxes	NR	Non-Resident
EBITDA	Earning Before Interest, Taxes, Depreciation and Amortization	PE	Permanent Establishment
ECB	External Commercial Borrowings	RBI	Reserve Bank of India
GAAR	General Anti-Avoidance Rule	TY	Tax Year

GERMANY: CASE STUDY



UNITED STATES: CASE STUDY (1/3)



TAXAND

US CASE CALCULATIONS

Particulars	US Parent	US CO 2	Partnership
Taxable income	$82	$(2)	$100
Reverse partnership items	$(20)	0	0
Add: Depreciation and amortization expense	$28	0	0
Add: net interest expense	**$40** *	**$2**	**$30**
Adjusted taxable income ('ATI')	$130	0	$130
Excess ATI (partnership)	$6	$6	0
Total ATI	**$136**	**$6**	**$130**
Fixed ratio limitation 30%	$40.8	$1.8	$39
Interest (disallowed)/allowed	$40	$(0.2)	$30
Excess ATI (partnership)	0	0	$30
Excess capacity Lost	$0.8		

Facts	Interest expense	
Bank loan 1	$18	*
Bank loan 2 (Partnership)	$30	
Bank loan 3	$2	*
I/C/loan 1	$20	*
I/C/loan 2	**$10**	
Interest partnership	$30	

	Taxable income
US Co1	$(50)
US Co2	$20
US Co3 (w/out/I/C)	$22
US Co4 (w/out/I/C)	**$90**
US Parent taxable income	**$82**
US Partnership taxable income	**$100**

TAXAND

UNITED STATES: CASE STUDY (2/3)

Considerations

- So what if the interest was disallowed:
  - CFWD
  - BEAT implications
  - Allocations for members leaving the group
  - Impact on withholding taxes/treaty
  - Excess partnership interest
- Computations for US done on a consolidated parent basis, but not because of statute
- No carry forward of US Parent excess capacity
- Exclude US Partnership income, expenses, gain or loss

UNITED STATES: CASE STUDY (3/3)

Considerations (continued)

- US partnership done on a standalone basis
- Adjustments to partnership basis of US Co2
- US Co2 on a standalone basis interest disallowed
- US Co2 as part of Parent Group all interest allowed
- Intra Consolidated Group financing ignored
- US Co1 Interest absorbed by US Co3 and US Co4
- May also apply to compute SubF and GILTI for CFCs
- BEAT may apply on I/C Loan 1 to UK.

POLLING QUESTION 3

With the changes in the US tax rules (ie, lower corporate rate, capex deductions, interest limitations), is your business likely to pursue financing foreign operations over the US?

A	Unlikely
B	Yes, likely
C	I don't know yet

TAXAND

KEY CHALLENGES

10TH ANNIVERSARY OF INTEREST BARRIER RULE IN GERMANY

Consequences of IBR implementation in 2008 (long before BEPS and ATAD) **were not as bad as anticipated.**

Actual **economic significance of IBR** is reduced due to:

- Good economy → high EBITDA
- Low interest-phase + EUR 3m threshold → allow substantial debt financing.

German Federal Tax Court (case no. I R 20/15) has called the German Federal Constitutional Court (case no. I R 20/15, 2 BvL 1/16) **to scrutinize the constitutionality of the German IBR.**

- Limitation of interest deduction requires justification because other business expenses are typically deductible without restrictions (principle of fair taxation).

UK INTEREST LIMITATION RULES: KEY CHALLENGES

Calculating the group ratio

- Many optional elections (eg elections relating to calculation of interest, joint ventures and partnerships)
- Calculations can be complex – eg recalculate actual profit/loss on disposal shown in the accounts and recompute ignoring any depreciation/revaluations – in most cases this will be proceeds less original cost
- Related party debt excluded from group ratio calculations – related party very broadly defined.

Volatility

- Carry forward of capacity/excess interest meant to help smooth volatility but can still have significant differences in capacity each year.

Exemptions

- Conditions for PBIE are complicated and have a broader knock on effect for the wider group calculations.

Assessment of investment decisions

- Investment appraisals often using incorrect assumptions that can impact valuation of businesses.

Administration

- Significant compliance and administration burden for groups, information gathering may be difficult.

US INTEREST EXPENSE LIMITATION RULES: KEY CHALLENGES

Interplay of 163(j) with GILTI

- There is still uncertainty on whether, and how, 163(j) applies for the computation of GILTI.

Section 382 and consolidated group rules?

- Will there be an ordering rule on how Section 382 operates when there is an ownership change and there are both NOLs and disallowed interest attributes in the entity?
- How will the consolidated rules deal with the disallowed interest on incoming or departing group members and using business income from other group members?

Investment interest of partnerships?

- No guidance on the treatment of investment interest paid inside a partnership with corporate partners?

What about Section 385?

- Will Section 385 regulations survive after the enactment of new Section 163(j), are they really necessary?

EBITDA or EBIT and Section 163(n)?

- Will Congress keep EBITDA beyond 2021?
- Will Section 163(n), worldwide group ratio, be reintroduced by Congress in the future?

TAXAND

INDIAN INTEREST EXPENSE LIMITATION RULES: KEY CHALLENGES

EBITDA calculation?

- No specific clarity provided on calculation of EBITDA ie based on tax computation or statutory financial statements
- BEPS Action Plan 4 recommends EBITDA should be based on tax rules.

Deemed AE debt: Implicit guarantee and corresponding and matching amount of funds?

- Implicit guarantee not defined under the Indian Income-tax law – Challenges in identifying existence of an implicit guarantee from AE in an underlying third-party debt
- Challenge in determining the quantum of corresponding or matching amount of funds provided by AE in an underlying third-party debt.

Indian resident AE covered?

- Debate on applicability of interest limitation rules in case implicit guarantee or corresponding funds provided by an Indian resident AE in an underlying NR third-party debt arrangement.

Interest or similar nature?

- Challenge in the basis of determining interest or similar payments for application of interest limitation rules.

SPEAKER PROFILES

SPEAKER PROFILE

Alistair Armstrong

U+I

Alistair is based in London and is Head of Tax at property developers, U+I PLC. Specialising in transactional real estate structuring, Alistair has established joint venture platforms with various US based Private Equity firms, both in the UK and also Ireland, The Netherlands, Luxembourg and The Channel Islands. Alistair has extensive experience in tax litigation and is considered one of the leading In-house authorities on corporate tax residency.

TAXAND

SPEAKER PROFILE

Torsten Engers

Flick Gocke Schaumburg, Taxand Germany

T: +49 69/717 03-0 | E: torsten.engers@fgs.de

Torsten Engers is a tax partner with Flick Gocke Schaumburg, Taxand Germany, in Frankfurt. His practice areas include German and international tax law. He is specialised in structuring of cross-border investments (inbound and outbound) mergers and acquisitions and corporate reorganisations with a strong focus on real estate investments. Torsten is also a lecturer at the University of Frankfurt am Main and a frequent speaker at international conferences.

SPEAKER PROFILE

Juan Carlos Ferrucho

Alvarez & Marsal, Taxand USA

T: +1 305 704 6670 | E: jferrucho@alvarezandmarsal.com

Juan Carlos Ferrucho is a Managing Director with Alvarez & Marsal Taxand, LLC. He has more than 18 years of experience working with both public accounting and law firms, and advises US and foreign businesses on complex business transactions including acquisitions, divestitures, and reorganisations. His work involves a variety of industries, including technology, communications, media, infrastructure, energy, real estate and retail.

TAXAND

SPEAKER PROFILE

Claire Lambert

Alvarez & Marsal, Taxand UK

T: + 44 207 072 3285 | E: clambert@alvarezandmarsal.com

Claire Lambert is a Senior Director with Alvarez & Marsal Taxand UK. Claire has over 18 years of experience in corporate and international tax, working with multinational companies active across the globe but has particular expertise in UK, US and European jurisdictions. Claire's clients have included a wide range of companies from some of the largest listed multinationals right the way through to growing privately held companies.

TAXAND

SPEAKER PROFILE

Nishant Shah

Economic Laws Practice, Taxand India

T: +91 22 6636 7000 | E: NishantShah@elp-in.com

Nishant Shah is a Partner of Economic Laws Practice, Taxand India. He is a qualified Lawyer and Chartered Accountant assisting his clients on various tax laws. Recently, he has been focused on assisting clients and industry association with the transition to GST. His area of expertise prior to the introduction of GST included the multiple indirect taxes applicable in India as well as the various import and export regulations.

TAXAND