A LEVEL PLAYING FIELD

BEPS, THE INTERNATIONAL INITIATIVE TO DETER PROFIT SHIFTING, HAS WIDE IMPLICATIONS FOR TREASURERS AROUND INTEREST RATE DEDUCTIBILITY AND WITHHOLDING TAX ARRANGEMENTS

Since the financial crisis, the tax practices of large international corporations have come under the spotlight. Public sentiment and media pressure have been focused on some of the world's largest companies, prompting high-level scrutiny over the way some companies are able to structure their businesses so as to minimise the taxes they pay.

Sometimes argued to be tax avoidance, these perfectly lawful ways of operating have been perceived as depriving certain territories of tax revenues. They have been seen as artificial, in that they direct tax revenues away from countries in which companies operate, and anti-competitive, giving advantage to those businesses that operate across borders.

The global initiative designed to address the problem – Base Erosion and Profit Shifting (BEPS), spearheaded by the Organisation for Economic Co-operation and Development and the G20, has been designed to counter perceived tax avoidance by multinational companies.

BEPS describes tax-planning strategies that rely

on mismatches and gaps that exist between the tax rules of different jurisdictions, to minimise the corporate tax that's payable overall by, for instance, shifting profits to low-tax operations. The initiative encompasses 15 specific measures to be introduced by all G20 and EU countries over the next few years.

The measures cover a number of issues around:

- Shifting profits to low tax locations;
- Transparency and disclosure; and
- Dispute resolution.

Multinationals are having to reorganise aspects of:

- Their intercompany holding and funding structure;
- The location of key functions, including group treasury; and
- In some cases, their external capital structure.

When it comes to corporate treasury specifically, there are three key areas to consider; these are: interest deductibility, withholding taxes (WHT) and the taxable location of profits for treasury functions.

Interest deductibility

An issue identified in the BEPS reports was that multinationals reduce the tax base of high tax territories by debt finance. Two recommendations followed on from this. Firstly, that there should be a limitation on the deductibility of interest to (in general) a cap set between 10% and 30% of EBITDA. (There may be higher or lower deductions allowed where a group's commercial gearing is higher or lower than the cap set as a percentage of EBITDA.)

Secondly, there should be a limitation on deductible expenses paid within a group of companies, where the receipt is not taxable (and/or the deduction is taken twice) because of 'hybrid' arrangements, broadly defined as arbitrages between tax regimes.

For example, in the UK, interest and similar expenses (for example, the finance element of an interest rate swap) are only deductible (net) up to 30% of taxable EBITDA. In the US, there is a similar limit of 30% of taxable EBITDA, effective in periods after 1 January 2018. It will change to 30% of taxable EBIT in 2022 and the definition of interest is different from the UK definition.

Practical implications for treasurers include:

- The need to assess whether interest costs are still deductible;
- The fact that this applies to external as well as internal interest cost – ie, it makes no difference whether the interest is payable to third parties such as a bank or bondholders;
- Even if the tests are met this year, it will be important to model whether there is a risk of failing the tests in future. So, for instance, treasurers will need to ask: 'What if operating profits halve?' and 'What if interest rates or FX rates move?'; and
- Many multinational corporations are finding there is likely to be an interest disallowance. This is effectively an increase in the cost of debt.

In terms of practical ways of managing the position, groups that previously had all their debt in one or two high tax-borrowing territories are looking at whether the cost of debt can be spread more evenly in the territories in which earnings arise. This might mean changes to external funding, internal funding, cash management and so on. There may also be knock-on effects on hedging requirements, bank relationship and so on.

Withholding taxes

In terms of issues for treasurers, the BEPS reports suggested that multinationals were in some cases getting 'inappropriate' benefits of tax treaties. In general, where a cross-border payment (interest, royalty or dividend) is subject to WHT, a treaty between the territories reduces the WHT. The concern is that multinationals based in territories with limited tax treaties (and therefore experiencing high rates of WHT on receipts) have set up subsidiaries in territories with good treaty networks to benefit from those treaties and receive payments with low or nil WHT. For example, they may use Dutch or Luxembourg holding or financing companies. The BEPS proposal is that treaty rates of WHT should be denied by one or both of the following measures:

- The principal purpose test – where the main purpose of the recipient of a payment being in the territory is to obtain the benefits of the treaty; and/or
- The limitation of benefits test – where the WHT rate obtained by the recipient is lower than the rate that would arise if the payment were to the ultimate parent.

These changes are being brought in by a Multilateral Instrument – a single treaty signed by all interested territories. Treasurers will need to be aware that the application of these rules may increase the WHT rate applied to intercompany interest or royalties.

Transfer pricing

The third area for treasurers to be aware of is the taxable location of profits. Transfer pricing, ie the method by which profits are allocated to different territories for tax purposes, is also affected by BEPS. In particular, there are measures designed to ensure that tax location of profits matches up with economic substance (people, assets, risks being managed) rather than legal form and/or capital.

Many multinationals are evaluating how this might change the tax profile of treasury functions, where the location of the employees is different from the tax jurisdiction of the companies. To mitigate this risk (and in some cases the WHT risk discussed earlier), some multinationals are consolidating, simplifying their treasury functions into one or a small number of locations where it can be clearly demonstrated that there are people and functions.

In this important area, treasurers will need to keep on top of their analysis of those areas of activity affected by the BEPS initiative.

This article is based on a podcast featuring: Graham Robinson, tax partner at PwC, and Alan Dick, vice president of treasury at Delphi Technologies.

ACT members can access the full CPD podcast on which this article is based at www.treasurers.org/cpd/podcast

IKON IMAGES