United Nations Practical Portfolio: Protecting the Tax Base of Developing Countries with respect to Base Eroding Payments of Interest

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Overview of Practical Portfolio

- Introduction
- Tax policy assessment manual
- Designing and drafting domestic legislation and negotiating tax treaties legislation to prevent base erosion with respect to interest payments
- Tax administration manual

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Tax Policy Assessment Manual

Part 2 of the Practical Portfolio on Base Eroding Interest Payments

Tax Policy Assessment

- Tax policy analysis of provisions of domestic law with respect to the taxation of interest and deduction of interest expenses
- Tax policy analysis of provisions of tax treaties dealing with the taxation of interest and deduction of interest
- Information gathering
- Identification of the risks of BEPS and possible responses

Domestic Law: Definition of Interest

- Compensation for the use of money
- Payments on debt obligations; no ownership interest in payer
- Classic debt: right to interest and repayment of capital; no right to profits; ranks ahead of equity
- Interest is typically deductible; dividends are not deductible

Domestic Law: Hybrids

- Securities with both debt and equity characteristics
- Examples: preferred shares, convertible debt, derivatives
- Hybrids may be treated differently by two or more countries
- see OECD BEPS Action 2: Hybrid Mismatch Arrangements

Domestic Law: Allocation of Interest

- **Only interest expenses incurred to earn taxable income should be deductible**
- **Methods for determining this issue:**
  - Tracing (factual)
  - Ordering (assumed use)
  - Apportionment (assumption that money is fungible)

Domestic Law: Allocation of Interest

Example

- X owns income-earning asset – cost 1,000
- X borrows 1,500 at 10% and uses it for personal purposes

	Tracing	Positive Ordering	Negative Ordering	Apportion -ment
Deductible interest	0	100	0	60
Non-deductible interest	150	50	150	90

Domestic Law: Residents Earning Foreign Source Income

- **Territorial system: is interest incurred to earn foreign source income deductible?**
- **Worldwide system: is interest deductible?**
  - If item of income is exempt?
  - If item of income is taxable? key is limit on foreign tax credit
  - Appropriate amount of interest should be allocated to foreign source income

Domestic Law: Residents Earning Foreign Source Income

- **Residents incurring interest expenses to acquires shares of foreign corporations**
  - Are dividends from foreign corporations exempt or taxable?
  - Are gains on sale of shares taxable?
  - Is interest deductible?

Domestic Law: Nonresidents Earning Domestic Source Income

- **Nonresidents carrying on business in your country**
  - Is the business income taxable?
  - Is interest deductible?
  - How much?
- **Payments of interest to nonresidents**
  - Is the interest deductible?
  - Is the interest subject to withholding tax?

Nonresidents Financing Resident Entities with Debt

- **Nonresident parent financing resident subsidiary with debt or equity**
- **Nonresident has preference for financing with debt because interest is deductible but dividends are not**
- **Often nonresident doesn't care whether it receives interest or dividends**
- **Tax saving from interest deduction may exceed withholding tax on interest**

Nonresidents Financing Resident Entities with Debt

- **Possible solutions for excessive interest deductions:**
  - Deny interest deductions
  - Thin capitalization rules: deny deduction for interest on excessive debt
  - Earnings-stripping rules: deny deduction for interest in excess of percentage of earnings

Thin Capitalization Rules

- **Interest on debt in excess of debt:equity ratio not deductible**
- **Typical ratios 1.5:1 to 3:1**
- **Applicable to controlled corporations or to substantial shareholders?**
- **How is debt calculated? All debt or only related party debt?**
  - Guaranteed debt?
  - Back-to-back debt arrangements

Thin Capitalization Rules

- How is equity calculated?
- How frequently should debt and equity be calculated?
- How is excess interest characterized?
- Is carryforward for nondeductible excess interest available?

Earnings-Stripping Rules

- Deductible interest limited to percentage of earnings
- How to measure earnings?
  - EBITDA (earnings before interest, taxes, depreciation and amortization)
  - EBIT
  - Other
  - Based on tax or financial accounting information?

Earnings-Stripping Rules

- What percentage of earnings?
  - Most countries use 30%
- Applied on an entity-by-entity or group basis
- Carryforward of excess interest?
- Effect of losses?

Withholding Taxes on Interest

- Tax imposed on nonresident recipient on gross amount of interest payment
- Payer required to withhold from payment
- Only resident payers or nonresidents carrying on business in country required to withhold
- What rate?
  - proxy for corporate tax
  - avoid excessive rate
- Definition of payments subject to withholding tax – interest and economic equivalents

Withholding Taxes on Interest

- Possibility that lender will pass on withholding tax to borrower – interest payments grossed up
- Increases cost of borrowing for residents

Tax Treaties

- How many tax treaties does your country have?
- Are your treaties based on the OECD or UN Model?

Tax Treaties: Effect on Taxation of Residents

- **Art. 23 – relief of double taxation – does not provide detailed rules; therefore, necessary to use domestic law**
- **Art. 24(4) – interest payments to nonresidents must be deductible on nondiscriminatory basis**
  - Prevents application of thin capitalization or earnings-stripping rules unless compatible with Art. 9
  - Does not prevent withholding taxes on interest
  - Does not prevent additional information reporting requirements

Tax Treaties: Effect on Taxation of Residents

- **Art. 24(5) – no discrimination against resident enterprises owned or controlled by nonresidents**
  - Prevents application of thin capitalization or earnings-stripping rules unless compatible with Art. 9
  - Does not prevent withholding taxes on interest
  - Does not prevent additional information reporting requirements

Tax Treaties: Effect on Nonresidents

- **Art. 11(2): interest arising in state paid to resident of other state who is beneficial owner is taxable at agreed rate**
  - OECD rate is 10 percent
- **Art. 11(5): interest arises in state if payer is resident or has PE or fixed base in that state and interest is deductible in computing profits attributable to PE or fixed base**

Tax Treaties: Effect on Nonresidents

Example:

- **ACo, resident of Country A, has PE in Country B**
- **ACo pays interest to CCo, resident in Country C**
- **Interest is deductible in computing profits attributable to PE in Country B**
- **Under treaty between Country A and Country B, Country B can impose withholding tax on the interest**

Tax Treaties: Effect on Nonresidents

- **Where interest is taxable on a gross basis, no deduction for expenses (e.g. interest) is required**
- **Where interest is taxable on a net basis under Art. 7 or 14, Art. 7(3) of UN Model provides deductions for expenses incurred for purposes of PE or fixed base**
  - Whether interest expense is incurred for purposes of PE is up to domestic law
- **Deductibility of expenses is matter for domestic law**
- **Notional interest is not deductible, except for financial institutions**

Tax Treaties: Effect on Nonresidents

- **No rules similar to Art. 7(3) for Art. 14**
  - Commentary indicates same approach should apply
- **Art. 7 of OECD Model revised in 2010**
  - Art. 7(3) deleted
  - Notional expenses allowed

Tax Treaties: Effect on Nonresidents

- **Art. 24(3): tax on PE cannot be less favorable than tax on resident enterprises carrying on similar activities**
- **Interest paid to nonresident with PE in state is taxable under Art. 7**
  - Withholding tax on such interest would violate Art. 24(3)
- **Art. 24(3) does not extend to connected requirements**

Information Gathering

- **Interest paid to nonresidents**
  - Total interest paid to nonresidents
  - Total interest subject to withholding tax
  - Total withholding tax collected
  - Interest exempt from withholding tax
  - Interest paid to nonresidents on country-by-country basis, and type of recipient and payer

Interest Paid to Related Nonresidents

- Important for transfer pricing, thin capitalization and earnings-stripping rules and withholding taxes
- New country-by-country reporting (OECD BEPS Action 13)
  - Available only through treaties
- Deductions claimed for interest paid to related nonresidents

Risks of Base Erosion

- All interest deductions erode a country's tax base
- 2 serious base erosion problems:
  1) Interest deductible by residents but related income is not taxable, or is subject to preferential tax
     - Worse if paid to nonresidents
  2) Deductible interest paid to nonresidents but not taxable, or taxable at reduced rate

Interest Payments by Residents

- Interest expenses incurred by resident to earn foreign source income
  1) If income is exempt, interest should not be deductible
  2) If income is taxable, interest should be deductible, but allocated to foreign income for purposes of foreign tax credits

Interest Expense to Acquire Shares in Foreign Corporations

Exemption method

- If dividends are exempt (participation exemption) interest should not be deductible

<u>Example:</u>

- ACo, resident in Country A borrows 1 million with interest at 10% and buys shares of subsidiary in Country B
- Aco receives exempt dividends of 30,000
- Is interest deductible?

Interest Expense to Acquire Shares in Foreign Corporations

Credit method

- If dividends are taxable, interest should not be deductible until dividends are paid and should be allocated to foreign source income for purposes of underlying foreign tax credit

Example:

- ACo, resident in Country A borrows 1 million with interest at 10% and buys shares of subsidiary in Country B

Example – Credit Method

- Aco does not receive any dividends in the year
- Is the interest deductible?
- Aco receives dividends of 30,000 in year 6
- Is the interest deductible in year 1-5? Year 6?
- How is limitation on the foreign tax credit calculated?
  - Interest should be allocated to the foreign source income for purposes of calculating the limitation

OECD/G20 BEPS Action 4: Interest Deductions

- BEPS Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments called for recommendations for best practices in designing rules to prevent base erosion through interest deductions
- Discussion Draft, December 18, 2014 provided options
- Final Report issued in early October, 2015 provides recommendations for best practices

Existing Rules

- Limitation of interest deductions based on fixed ratios – e.g., EBITDA or debt:equity
- Limitation of interest deductions based on worldwide group debt
- Targeted anti-avoidance rules
- 3 other approaches mentioned but rejected
- Fixed debt:equity ratio also rejected

Existing Rules

- **Unilateral action has failed because of**
  - Fungibility of money and financial instruments
  - Fear of economic effects of robust domestic rules (discourage foreign investment and reduce international competitiveness of resident MNEs)
- **Therefore, consistent international best practices are essential**

Discussion Draft

- **Recommended limitation on interest deductions by an entity based on an allocation of the net interest expense of the worldwide group relative to its earnings**
- **Recognized the possibility of a combined approach: a worldwide limitation supplemented by an entity fixed ratio rule or an entity fixed ratio rule supplemented by a worldwide limitation**

Recommended Best Practices

- **Deduction of interest limited based on percentage (10 – 30%) of an entity's fixed financial ratio (EBITDA or EBIT)**
- **Optional higher deduction allowed if group's net interest to worldwide financial ratio (EBITDA or debt:equity) plus 10% is higher**
- **Optional carryover for disallowed interest**
- **General limitations supplemented by targeted anti-avoidance rules**

Thin Capitalization Rules

- **Fixed debt:equity rule is not acceptable as a best practice**
  – Allows entities to increase interest deduction by increasing equity
  – Doesn't deal with the rate of interest
- **But fixed debt:equity rule (thin capitalization) can be used to supplement recommended best practice rule**

Asset-Based Ratios

- Report concludes that earnings is a better measure of economic activity than assets
- Asset-based ratio can be used by countries where groups are heavily capitalized
- Assets producing exempt income should be excluded
- Assets can be valued using accounting or tax values

Fixed Ratio Rule

- Should apply to groups in all sectors other than banking and insurance
- Possible exception where there are economic rents
- EBITDA should be determined using tax rules
- Can be average EBITDA
- If entity's net interest expense exceeds the fixed ratio, the excess is disallowed

Setting the Ratio

- Should be set low enough to address BEPS
- In principle, should allow groups to deduct all of their worldwide net third-party interest expenses, but no more than that amount
- According to empirical data in Report, with ratio of 30% (10%) (5%) of EBITDA, 87% (62%) (50%) of groups would be able to deduct all net third-party interest
- Recommended range 10% - 30%

Setting the Ratio

- Report provides list of factors to be considered in setting the ratio in the range from 10% to 30%
- Higher ratio justified if country has:
  - No group rule
  - No carryforward of unused room or carryback of disallowed interest
  - Targeted rules
  - High interest rates

Optional Group Rule

- Entity allowed to deduct interest up to net interest expense of worldwide group relative to EBITDA if higher than basic limitation
- Optional to allow additional 10%
- No country currently uses such a rule
- Other group limitations are acceptable (e.g., assets-based ratio like Germany's equity escape rule)

Optional Group Rule

- Group rule should be applied on the basis of audited consolidated financial statements prepared in accordance with GAAP
- Definition of a group should be based on the concept of a consolidated group for financial reporting purposes
- Problems may arise if tax and financial reporting definitions of group differ (e.g., if rules are applied to domestic group)

Optional Group Rule

- Interest paid to related parties outside the group can be excluded from the group’s net interest expense or be dealt with by a targeted rule
- An entity’s EBITDA may be calculated on the basis of tax or accounting information
- Necessary to deal with losses:
  - Entity with loss, but group with profits
  - Group with loss, entity with profits

Payments Covered

- Interest should include
  1. Interest on all forms of debt
  2. Payments economically equivalent to interest
  3. Expenses related to financing
- Up to each country
- Should be based on economic substance
- Doesn’t apply to deductible payments on deemed equity

Entities Covered

- At a minimum, rules should apply to all entities that are part of a multinational group
- Optionally, rules can apply to members of a domestic group and/or standalone entities
- Application of rules to PEs and non-corporate entities?

Entities Covered

- Entity is part of a multinational group if it is controlled directly or indirectly by another company or if it controls another company directly or indirectly
- For worldwide group rule, entity is part of group if it is part of consolidated group for financial reporting purposes
- Same approach can be used for basic fixed ratio limitation

Net Interest Expense

- Recommended best practice applies to an entity's net interest (interest expense in excess of interest income)
- Allows multinational group to borrow in one group entity and on-lend to others
- Preferable to rule based on debt, which doesn't deal with rate of interest and varies throughout year

Thresholds

- Discussion Draft proposed that rules should not have minimum threshold
- Final Report allows de minimis threshold for entities with low net interest
  - Should be based on all domestic group entities

Exclusions

- Final Report allows exclusion for the deduction of interest expense to finance "public-benefit projects"
- Tightly restricted to avoid abuse:
  - Only long-term projects
  - Only non-recourse debt
  - Income from project must be subject to tax
  - Funds cannot be on-lent

Carryforwards

- Final Report allows carryover to past and future years of disallowed interest deductions
  - Important for entities with losses in a particular year or years
- Also allows carryforward for unused deductibility room to future years

Targeted Rules

- Several types of targeted rules to supplement general limitation:
  - To prevent avoidance of general rule
  - Rules to address other BEPS risks:
    - Payments on artificial loans
    - Back-to-back arrangements
    - Payments to related parties to earn exempt income
    - Payments to related parties where no or low tax

OECD's General Comments

- According to Final Report, recommended approach is "straightforward" and effective
- Ensures interest deductions are linked to taxable income
- Further work on the operation of the worldwide group rule and the rules for banking and insurance will be done in 2016

Transfer Pricing Aspects

- **Interest payable to a group company lacking substance will be limited to a risk-free return**
- **Group synergies must be taken into account to evaluate group financial payments**
- **Further work in 2016-17**

Implementation

- **Casual reference to "coordinated implementation," but no details**
- **Review of country experiences with best practices by end of 2020**
- **Transitional rules are optional**
- **Rules can be applied to each entity, a domestic tax group or a domestic financial reporting group**

Issues

- **Will the recommended best practices be adopted by many countries?**
- **Even so, will the best practices adopted represent a common approach?**
  – Seems unlikely
- **Best practices are complex both from a legislative and administrative viewpoint**
  – Not feasible for developing countries

Domestic Legislation to Prevent Base Erosion

Two major issues of base erosion:

1) Interest deductions claimed by residents to earn exempt or favourably taxed income, and
2) Excessive interest deductions claimed by residents for payments to nonresidents

Domestic legislation must balance effectiveness and complexity

Interest to Earn Favourably Taxed Income: Design Issues

- **What method is used to allocate interest expenses to income?**
  - Tracing is subject to manipulation
  - Apportionment is complex
- **Should there be a de minimis rule?**
  - Interest up to a certain amount is deductible without any limit
- **Should there be an exception for interest linked to particular investments?**
  - e.g., mortgages on immovable property or financing of public projects

Interest to Earn Favourably Taxed Income: Design Issues

- **For income that is exempt, deduction of interest should be disallowed (added to cost)**
- **For income that is deferred, interest deduction should be deferred**
- **For income that is favorably taxed, only a corresponding portion of interest should be deductible**
  - Complex

Excessive Interest: Design Issues

- **How to determine to what extent interest is excessive?**
  - Debt:equity ratio or interest:earnings ratio?
- **Should rules be based on gross or net interest expenses?**
  - Gross expense is simpler but causes risk of double tax with respect to entities that borrow and on-lend
- **Should there be a de minimis rule?**
- **Relationship with transfer pricing rules**

Excessive Interest: Design Issues

Debt:equity ratio

- **To what resident entities do rules apply?**
- **What ratio?**
  - Many countries 3:1
  - Some countries 2:1 or 1.5:1
- **Higher ratio for financial institutions**

Excessive Interest: Design Issues

- **Computation of debt:**
  - What amounts are included?
  - All debt or just related-party debt?
  - Should rules apply to resident lenders?
  - Timing?
- **Computation of equity:**
  - What amounts are included?
  - Timing?

Excessive Interest: Design Issues

Debt:Equity Ratio

- **Consequences if corporation's debt:equity ratio exceeds specified ratio?**
  - Excess not deductible
  - Only deduction of excess interest on related-party debt disallowed?
  - How is excess characterized? Dividend?
- **Carryover of excess to past or future years?**
- **If corporation's ratio is less than specified ratio, can excess be carried over?**
- **What if group debt:equity ratio is higher?**

Earnings-Stripping Rules

- **To what resident entities should rules apply?**
- **Should rules apply to resident lenders?**
- **What ratio?**
  - Many countries 30%
  - OECD recommends 10 – 30%

Earnings-Stripping Rules

- **How should earnings be measured?**
  - Taxable income
  - EBITDA (earnings before interest, taxes, depreciation and amortization) or EBIT
  - Based on tax data or financial reporting data
  - Earnings of each year or based on average
  - Effect of losses

Earnings-Stripping Rules

- Consequences if ratio exceeded?
- Carryover of excess interest or excess limit to other years?
- What if worldwide group ratio is higher?

Earnings-Stripping Rules

- Note that Art. 24(4) and (5) of the UN or OECD Models may prevent the application of thin capitalization or earnings-stripping rules that are applied only to nonresidents

Negotiating Tax Treaties with Respect to Base-Eroding Interest Payments

- **Tax treaties are bilateral agreements**
  - You can't always get what you want
- **Treaties limit your domestic law**
  - Treaties may prevent your country from applying limitations on the deduction of interest or from taxing interest
- **Should the provisions of your tax treaties be reasonably consistent?**
- **Important for your negotiating position to be well thought out**

Negotiating Tax Treaties with Respect to Base-Eroding Interest Payments

- **Protecting against base-eroding interest involves:**
  1) taxation of interest income and/or
  2) denial of deduction of interest
- **If your domestic law does not tax interest income of nonresidents or does not deny deduction of interest, the provisions of your tax treaties are irrelevant**

Treaty Provisions Relating to Residents: Relief from Double Tax

- **Art. 23A: exemption for interest earned by resident other than interest taxable by the other country under Art. 11(2) (credit for this interest)**
- **Art. 23B: credit for foreign tax subject to domestic limits**
- **Only interest arising in the other state**

Treaty Provisions Relating to Nonresidents: Nondiscrimination

- **Art. 24(4) and (5) prevent denial of deduction of interest paid to nonresidents or paid by resident enterprise owned or controlled by nonresidents in a discriminatory manner**
  - Exception for the application of transfer pricing rules and Art. 11(6)
  - Risk that Art. 24(4) and (5) prevent the application of thin capitalization and earnings-stripping rules

Possible Solutions

- Make domestic rules not applicable if interest expenses conform to Art. 9
- Expressly exclude thin capitalization or earnings-stripping rules for Art. 24(4) and (5)
- Agree only to most-favoured-nation treatment in Art. 24(4) and (5)
- Include a saving clause in your tax treaties

Saving Clause

"This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28."

- Omit reference to Art. 24

Treaty Provisions Relating to Nonresidents: Deduction of Interest

- Art. 7 or 14: your country can tax profits
- Art. 7(3): your country must allow deduction of interest attributable to PE or fixed base
- Deductibility is an issue for domestic law
- Therefore, your country can limit deductions subject to Art. 24(3)

Treaty Provisions Relating to Nonresidents: Deduction of Interest

- Art. 24(3): prohibits less favourable taxation of PE (not fixed base)
- Therefore, no restrictions on interest deductions in computing profits of PE unless also applied to residents

Solutions

- Don’t agree to Art. 24(3)
- Agree only to most-favoured-nation treatment in Art. 24(3)
- Exclude restrictions on interest deductions from Art. 24(3)

Other Concerns

- Ensure that excess interest is not allocated to PE
- Don’t allow deduction of notional expenses (i.e., OECD Art. 7)
- Impose withholding tax on interest deductible in computing PE profits
  - Be sure to include Art. 11(5)

Treaty Provisions Relating to Nonresidents: Withholding Taxes

- Under Art. 11(2), your country is entitled to tax interest paid to residents of the other state at agreed rate
- Two issues:
  - Definition of interest
  - Limit on tax rate
- Compare withholding tax on interest under domestic law with Art. 11(3) definition
- Choice of rate requires balancing of several factors

Part 4: Tax Administration Manual

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Disclosure and Information Reporting

- **For residents:**
  - Foreign source income and interest expenses related to that income (thin capitalization and earnings stripping)
  - Interest paid to related nonresidents
- **For nonresidents:**
  - Interest expenses deductible in computing profits of PE or fixed base
  - Interest received from residents

Disclosure and Information Reporting: Nonresidents

- **Need information to identify nonresidents carrying on business in your country or receiving interest from your country**
  - From nonresident in tax return, registration requirements, etc.
  - From withholding agents
- **Obligation to withhold unless nonresident has PE or fixed base in your country**

Disclosure and Information Reporting: Nonresidents

- **Information to determine amount of income attributable to PE or fixed base, including interest expense**
- **Requirement to keep books and records**
- **Related-party payments – Art. 9 and 11(6)**

Disclosure and Information Reporting: Nonresidents

- **Forms with prescribed information for payments of interest to nonresidents**
- **For each payment and/or for quarterly or annual payments**
- **Penalties for failure to file**

Auditing and Verifying Interest Deductions and Interest Income

- **Nonresident's tax return and books and records with respect to business income**
- **Audit withholding agents with respect to withholding tax**
  - Link to deduction of payments
- **Special attention to related-party interest**

Administration of Tax Treaties

- **Consult UN *Handbook on the Administration of Tax Treaties* (2013)**

Thank you

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