

United Nations Workshop on Double Tax Treaties and Base Eroding Payments for Developing Countries

Nairobi, Kenya
21 – 24 March 2017

Introduction

- OECD/G20 project on Base Erosion and Profit Shifting (BEPS)
 - Final Reports issued in late 2015
 - Now in the implementation phase
- UN activities with respect to BEPS:
 - Subcommittee on BEPS
 - Subcommittee on Transfer Pricing – work on transfer pricing aspects of BEPS
 - Capacity Development Unit activities

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Introduction

- UN Handbook on Protecting the Tax Base of Developing Countries (2015)
 - Deals with OECD BEPS issues plus tax incentives, services and capital gains
 - Second edition in progress for 2017
- Practical Portfolios on Services, Interest and Rent and Royalties
- Workshops and technical cooperation

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The Platform for Collaboration on Tax

- Created in April, 2016 as the structure for the UN, OECD, IMF, WBG to assist developing countries in strengthening their tax systems
- Work program:
 - 8 toolkits
 - Emerging international tax issues
- Work will be done separately by each international organization, not by the Platform

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The Platform for Collaboration on Tax

- Platform meets 3 times annually
- Regional organizations, such as ATAF, will be involved
- Major conference to be held every two years
- Will maintain a public website and make reports to governments

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The Platform for Collaboration on Tax

- Platform activities:
 - 8 toolkits to be completed by March 2018
 - Support participation of developing countries in BEPS implementation through OECD Inclusive Framework
 - Capacity development
 - Building comprehensive and effective exchange of information systems
 - Guidance on the informal economy
 - Information sharing and cooperation on tax issues

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The OECD Inclusive Framework

- Created in February 2016 in response to G20 call for timely implementation of BEPS
- Open to all countries that agree to implement the BEPS minimum standards
- Developing countries participate as equals and will receive capacity-building support
- Consists of government officials

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Relationship between the Inclusive Framework and the Platform

- Inclusive Framework is the OECD's institutional arrangement for implementation and monitoring of BEPS action items
- UN, IMF, and WBG are observers
- The Platform is collective effort of UN, OECD, IMF and WBG to provide practical guidance to developing countries on BEPS measures
- Platform's work will be informed by discussions of the Inclusive Framework and Platform will refer issues to the Inclusive Framework

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Introduction

- The Platform has committed to produce 8 toolkits by March 2018
- UN Capacity Development Unit has taken the lead by developing a series of Practical Portfolios dealing with aspects of BEPS
- Toolkits on tax incentives and transfer pricing comparability analysis have been published
- Practical Portfolios dealing with Services and Interest have been completed; Practical Portfolio on Rent and Royalties has been substantially completed

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Introduction

- Purpose of the Practical Portfolios: intended for the use of tax officials from developing countries to
 - Understand the causes of BEPS
 - Identify and assess the risks of BEPS
 - Assess the options available to counter BEPS
- Practical Portfolios focus on BEPS; they do not deal comprehensively with all aspects of the taxation of income from services, interest or royalties

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Introduction

- The Practical Portfolios are intended to be used as diagnostic tools for tax officials to review their domestic tax systems and tax treaties to determine if, and to what extent, they are facilitating BEPS
- The Practical Portfolios do not focus on any particular country
- Approach is practical, with examples, charts, checklists, sample legislation and sample forms

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Overview of Practical Portfolios

- Each Practical Portfolio follows a common format:
- PART 1: Introduction
 - Explains the content of the portfolio and how to use the portfolio
- PART 2: Tax policy assessment manual
 - Analyzes the design and structural features of domestic law and tax treaties with respect to the relevant issue
 - Identifies the risks of base erosion and possible responses

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Overview of Practical Portfolios

- PART 3: Designing and drafting domestic legislation and negotiating tax treaties to prevent base erosion with respect to income from services
 - Includes sample legislation and treaty provisions
- PART 4: Tax administration manual
 - Administration of provisions of domestic law and tax treaties to prevent base erosion

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UNITED NATIONS PRACTICAL PORTFOLIO: PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES WITH RESPECT TO BASE-ERODING PAYMENTS OF INTEREST

TAX POLICY ASSESSMENT MANUAL

PART 2 OF THE PRACTICAL PORTFOLIO ON BASE-ERODING INTEREST PAYMENTS

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Tax Policy Assessment

- Tax policy analysis of provisions of domestic law with respect to the taxation of interest income and the 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

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General Considerations

- All interest deductions erode a country's tax base
- But most interest expenses represent legitimate expenses
- Therefore, it is inappropriate to deny the deduction of all interest expenses

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General Considerations

Deductible interest payments present base erosion concerns if:

- 1) Deductions are excessive
- 2) The country does not tax the nonresident recipient on the interest or taxes it at a reduced rate
- 3) The country does not tax the income earned from the use of the funds or taxes the income at a preferential rate
- 4) Any combination of the above

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General Considerations

- Base erosion may also occur if interest payments are not deductible and not taxable to the recipient
- But this base erosion is less serious and not dealt with in this Portfolio
- Base erosion may also occur where deductible interest payments are made to resident tax-exempt entities
- But the Portfolio deals only with cross-border base erosion

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Domestic Law: Basic Concepts

- 1) The definition of interest
- 2) Hybrid financial instruments
- 3) Methods for allocating interest expenses to income
- 4) Related-party interest
- 5) Back-to-back financing arrangements

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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

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Domestic Law: Hybrid Financial Instruments

- 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 – very complex

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Cross-Border Hybrid Financial Instrument: Example

- PCo is a resident of Country P, which exempts dividends from foreign affiliates of resident companies
- PCo owns all of the shares of SCo, a resident of Country S
- PCo subscribes for a special class of redeemable preferred shares of SCo
- Dividends paid by SCo on its preferred shares are treated as interest by Country S but as dividends by Country P

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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)

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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 | Apportionment |
|-------------------------|---------|-------------------|-------------------|---------------|
| Deductible interest | 0 | 100 | 0 | 60 |
| Non-deductible interest | 150 | 50 | 150 | 90 |

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Domestic Law: Related-Party Interest

- Definition of related parties
 - Individuals related by blood, marriage or adoption
 - Legal entities related by control through share ownership or other means
- Cross-border interest paid to related person may be less or more than arm's length amount
 - Transfer pricing issues with respect to amount of debt and amount of interest

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Domestic Law: Back-to Back Arrangements

- Back-to-back arrangements may be used to avoid or reduce withholding taxes on interest or to avoid restrictions on the deduction of interest, such as thin capitalization or earnings-stripping rules
- Back-to back arrangements involve debt owed to arm's length intermediary, usually a financial institution, and then debt owed to related party

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Back-to-Back Arrangements: Example 1

- SCo, resident in Country S, owes an amount bearing interest to PCo, its parent company resident in Country P
- Interest paid by residents of Country S to residents of Country P are subject to withholding tax under the law of Country S at a rate of 20%
- Under the tax treaty between Country P and Country S, the withholding tax on interest paid to an arm's-length resident of the other country is limited to a maximum rate of 5%

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Back-to-Back Arrangements: Example 1

- To obtain the reduced rate under the tax treaty, PCo deposits an amount equal to the debt owed by SCo with a bank resident in Country P
- SCo then transfers the debt owed to PCo to the bank
- SCo pays interest to the bank and the bank pays interest to PCo
- The bank claims the reduced rate of withholding tax on the interest received from SCo

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Back-to-Back Arrangements: Example 2

- ACo, resident in Country A, owes amount to its parent company, BCo, resident in Country B
- Under the tax treaty between Country A and Country B, interest paid by a resident of Country A to a resident of Country B is subject to maximum withholding tax of 15%
- Under the tax treaty between Country A and Country C, interest paid by a resident of Country A to a resident of Country C is exempt from withholding tax

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Back-to-Back Arrangements: Example 2

- BCo establishes a subsidiary in Country C
- BCo transfers debt owing by ACo to the subsidiary in Country C in consideration for debt
- ACo pays interest to the subsidiary in Country C, which in turn pays interest to BCo
- Example of treaty shopping

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EXCESSIVE INTEREST DEDUCTIONS

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 shareholder doesn't care whether it receives interest or dividends
- Tax saving from interest deduction may exceed withholding tax on interest

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Nonresidents Financing Resident Entities with Debt

- Excessive payments of interest to related nonresidents result in serious base erosion
- Possible solutions for excessive interest deductions:
 - transfer pricing rules
 - 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

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Thin Capitalization Rules

- Problem of thin capitalization may be seen as transfer pricing issue or as a disguised equity issue
- If transfer pricing, rules apply only to controlled resident companies
- If disguised equity, rules apply to substantial shareholders in resident companies
- Rules should also apply to partnerships, trusts and PEs

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Thin Capitalization Rules: Ratio

- Interest on debt in excess of debt:equity ratio is not deductible
- Typical ratios are 1.5:1 to 3:1
 - How to establish the ratio?
 - Higher ratio for financial institutions
 - Ratio can apply on an entity-by-entity or consolidated basis
 - Issues with both approaches

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Thin Capitalization Rules: Ratio

- Debt:equity ratio can be applied to each substantial nonresident shareholder separately, to all nonresident shareholders, or to the company as a whole
- Debt:equity ratio ignores the interest rate on debt (i.e., if interest rates are low, companies can carry more debt)

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Thin Capitalization Rules: Debt

- Rules may apply to all debt, debt owed to nonresidents, or only to debt owed to controlling or substantial nonresident shareholders
- What debt should be taken into account?
 - Financial instruments treated as debt under domestic law
 - Non-interest bearing debt?
 - Debt owed to arm's length nonresidents?
 - Guaranteed debt?
 - Rules are necessary to deal with back-to-back debt arrangements

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Thin Capitalization Rules: Equity

- All investments, other than debt, or equity as defined under company law or tax law
- Contributed surplus and retained earnings should also be treated as equity because they are available to support the company's debt
 - Unrealized appreciation should not be included

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Thin Capitalization Rules

- When should debt and equity be calculated?
 - Both should be determined at the same time, except retained earnings should be determined at the beginning of each year
 - At beginning or end of year – subject to manipulation by taxpayers
 - Average amount of debt and equity calculated monthly or quarterly – reduces avoidance opportunities but increases compliance costs

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Thin Capitalization Rules: Consequences

- Debt taken into account for ratio and interest deduction disallowed are different issues
- Amount of interest deduction disallowed may be all interest on debt in excess of ratio or only interest on certain debt (for example, debt owed to nonresidents, nonresident shareholders, controlling or substantial shareholders)
- Many countries do not disallow deduction of interest on arm's length debt owed to nonresidents

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Thin Capitalization Rules: Consequences

- Article 24 (nondiscrimination) may prevent the application of thin capitalization rules
- Excess interest may be characterized as interest or as a dividend
 - Note the implications for withholding tax
- Is carryforward for nondeductible excess interest available?
 - Adds some flexibility, but also complexity

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Earnings-Stripping Rules

- Problem of excessive interest deductions viewed as preference for debt compared to equity financing
- Therefore, earnings-stripping rules are not necessarily limited to interest paid to nonresidents
- Rules can apply to all resident entities, resident entities controlled by nonresidents, or resident entities with substantial nonresident shareholders

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Earnings-Stripping Rules

- Deductible interest is limited to percentage of earnings
- Theoretically, rules could apply by reference to interest expenses relative to earnings of the worldwide group, but very complex
- If limited to third-party interest expenses, intergroup debt could not be used to increase interest deductions

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Earnings-Stripping Rules

- How to measure earnings?
 - EBITDA (earnings before interest, taxes, depreciation and amortization)
 - EBIT
 - Can be based on tax or financial accounting information
- Benefit of earnings approach is that if profits are shifted to low-tax country, interest deductions against high-tax country's tax base will be reduced

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Earnings-Stripping Rules

- What percentage of earnings? Most countries use 30% (BEPS Action 4 recommends 10% – 30%)
- Goal is to allow deduction of legitimate interest expenses, but disallow deduction of excessive interest expenses
- Choice of percentage is essentially arbitrary
- Arbitrariness can be mitigated by carryover and exceptions

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Earnings-Stripping Rules

- Factors to be taken into account in setting percentage:
 - Ratios of resident companies and comparison with ratios of companies controlled by nonresidents
 - Is carryover allowed?
 - Higher ratio may be appropriate if country has high interest rates
 - Need to attract foreign investment
 - Others

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Earnings-Stripping Rules

- Rules can be applied on an entity-by-entity or a domestic group basis
- If entity has losses, no interest is deductible
- Penalizes risky businesses
- Carryover of disallowed interest provides some relief, but adds complexity
- Should a carryover for unused interest deductibility room be allowed?

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Earnings-Stripping Rules

- Rules can apply to the gross interest expenses or the net interest expenses of a resident entity
- Gross interest approach is simpler
- Net interest approach avoids duplication of interest from intergroup loans
- Net interest expense is amount of interest expenses in excess of interest income

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Earnings-Stripping Rules

- Net interest approach 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

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Earnings-Stripping Rules: Exceptions

- Exception for resident entities with interest expenses below a threshold
 - Purpose is to reduce compliance burden
 - Requires anti-fragmentation rules
- Higher interest deductions allowed if ratio of worldwide group is higher
- Exception for financing of public interest projects

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OECD/G20 BEPS Action 4: Interest Deductions

- BEPS Action 4 Final Report (October 2015) *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* provides best practices in designing rules to prevent base erosion through interest deductions
- Unilateral action has failed; therefore, consistent international best practices are essential

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Recommended Best Practices

- Deduction of interest limited based on percentage (10% – 30%) of an entity's net interest expense of its 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

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Thin Capitalization Rules

- Fixed debt:equity rule is not acceptable as a best practice
 - Earnings is a better measure of economic activity than assets
 - Allows entities to increase interest deductions 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 (earnings-stripping) rule

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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%

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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)

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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

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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
- Rules should also apply to PEs and non-corporate entities

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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

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Net Income: Example

- ACo owns all the shares of BCo
- ACo has interest expense of 90 with respect to an arm's length loan
- ACo lends some of the funds to BCo
- BCo pays interest of 50 to ACo
- Under the earnings-stripping rules, interest deductions are limited to 20% of earnings

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Net Income: Example

| | ACo | BCo | Group |
|----------------------------|----------------|-----------------|-------|
| Earnings | 200 | 800 | 1,000 |
| Gross interest | (90) | (160) | (250) |
| Maximum interest deduction | 20% x 200 = 40 | 20% x 800 = 160 | (200) |
| Non-deductible interest | 50 | 0 | 50 |

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Net Income: Example

- All interest should be deductible because arm's length interest does not exceed 20% of earnings
- If interest expenses of ACo are not netted against interest received from BCo, intra-group interest is double counted and the deduction of some interest will be disallowed
- Group could restructure intra-group loan to avoid this result

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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?

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WITHHOLDING TAX

Withholding Tax 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

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Withholding Tax on Interest

- Arm's length lenders will pass on withholding tax to borrower – interest payments grossed up
- In effect, withholding tax is paid by resident borrowers and cost of borrowing for residents is increased

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Withholding Tax on Interest

- Loan by bank to XCo with interest of 1,000 annually without any withholding tax
- If XCo's country of residence imposes 10% tax:

| | |
|---------------------------------|-------|
| – Bank will require interest of | 1,111 |
| – Withholding tax at 10% = | 111 |
| – Bank receives net amount of | 1,000 |

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Back-to-Back Arrangements

- Back-to-back financing arrangements can be used to avoid withholding tax if certain payments of interest are exempt or subject to reduced rates of withholding tax (e.g., under tax treaties)
- For example, if payments to arm's length parties are exempt, related parties may enter into back-to-back arrangement with unrelated financial institution
- Can be dealt with by specific rules or general anti-avoidance rules

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INTEREST DEDUCTIONS BY NONRESIDENTS

Domestic Law: Nonresidents Earning Domestic Source Income

- If nonresidents are not taxable on income derived from a country, no interest should be deductible
- If nonresidents are taxable on income derived on a gross basis, no interest should be deductible
- If nonresidents are taxable on income derived on a net basis, interest expenses should be deductible

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Domestic Law: Nonresidents Earning Domestic Source Income

- Nonresidents are ordinarily taxable on a net basis only if they are carrying on business in a country or if they are carrying on business through a PE or fixed base in the country
- Interest expenses incurred to earn the income are ordinarily deductible
- Any restrictions on the deduction of interest expenses may violate Art. 24(3) of tax treaties

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Domestic Law: Nonresidents Earning Domestic Source Income

- Possible restrictions on the deduction of interest:
 - Only deductible if payer withholds (prohibited by Art. 24(3))
 - Only deductible if incurred in the country (prohibited by Art. 7(3))
 - Only deductible if wholly and exclusively for the domestic business (prohibited by Art. 7(3))
 - Excessive interest deductions

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Domestic Law:
Nonresidents Earning Domestic Source Income

- Base erosion occurs if nonresidents deduct excessive interest payments to nonresidents
- Interest payments to related nonresidents may be excessive because the rate is excessive or the amount of debt is excessive
- Countries should apply thin capitalization or earnings-stripping rules
- If restrictions on interest deductions apply only to resident companies, nonresidents may structure their investments as PEs to avoid restrictions

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Domestic Law:
Nonresidents Earning Domestic Source Income

- Payments of interest to nonresidents taxable on a gross basis
 - no interest is deductible
 - the interest is usually subject to withholding tax under domestic law

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Domestic Law:
Nonresidents Earning Domestic Source Income

- Territorial system: interest incurred to earn foreign source income should not be deductible
- Worldwide system: interest incurred to earn taxable foreign source income should be deductible
 - appropriate amount of interest should be allocated to foreign source income for purpose of the limitation on the foreign tax credit

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Residents Earning Foreign Branch Income:
Credit Method

| | | |
|-----------------------|------------|---------------|
| Foreign branch income | \$500 | |
| Foreign tax | 200 | |
| Worldwide income | 2,100 | |
| Interest deduction | 100 | |
| Income | 2,000 | |
| Tax at 40% | 800 | |
| Foreign tax credit | <u>160</u> | or <u>200</u> |
| Tax payable | 640 | 600 |

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Limitation on Foreign Tax Credit

Lesser of:

1) Foreign tax paid = 200

and

2) Domestic tax paid x $\frac{\text{foreign income}}{\text{total income}}$

$$= 800 \times \frac{400}{2,000} = 160$$

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Residents Earning Foreign Branch Income: Exemption Method

| | |
|----------------------|-------|
| Foreign income | \$500 |
| Foreign tax paid | 200 |
| Worldwide income | 2,100 |
| Interest deduction | nil |
| Taxable income | 1,600 |
| Tax at 40% | 840 |
| Domestic tax payable | 640 |

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Domestic Law: Residents Earning Foreign Source Income

- Residents incurring interest expenses to acquire shares of foreign corporations
 - If dividends from foreign corporations are exempt, interest should not be deductible
 - If dividends are taxable and country allows indirect foreign tax credit, interest should be deductible but allocated to foreign income for limitation on the indirect credit
 - Are gains on sale of shares taxable?

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Resident Companies Earning Dividends from Foreign Companies

- Resco borrows to acquire common shares of FA in treaty country

| | |
|-----------------------|--------------|
| FA | |
| Income | 500 |
| After-tax income | 300 |
| Resco | |
| Dividend from FA | 300 |
| Other Income | <u>1,600</u> |
| | 1900 |
| Interest Expense | <u>100</u> |
| Income | 1,800 |
| Less: exempt dividend | 300 |
| Taxable Income | 1,500 |
| Tax payable 40% | 600 |

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Residents Earning Foreign Dividends: Example

- In branch example, proper result is domestic tax payable of 640
- In foreign dividend example, result is domestic tax payable of 600 (unless interest is not deductible)
- Why? Because foreign company is a separate taxable entity
- Result seems improper theoretically

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Debt Push-Down Arrangements

- Nonresidents who own or acquire a subsidiary resident in another country may arrange for the subsidiary to incur additional debt so that the deduction of the interest reduces the country's tax base
- Property acquired by the subsidiary is unlikely to result in any income subject to tax by the country
- Thin capitalization rules may limit amount of debt pushed down to subsidiary

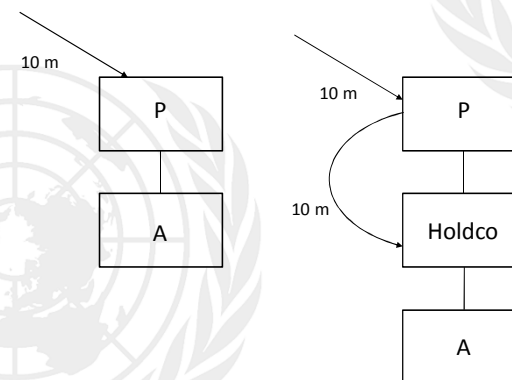
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Debt-Push Down Arrangements

- PCo, resident in Country P, borrows 10 million to acquire all the shares of ACo, resident in Country A
- Interest is deductible by PCo
- Alternatively, PCo may loan 10 million to Holdco, resident in Country A, to acquire the shares of ACo
- Holdco deducts interest against the tax base of Country A
- In effect, the interest deductions have been shifted from Country P to Country A

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Debt Push-Down Example



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INTEREST AND TAX TREATIES

Tax Treaties

- How many tax treaties does your country have? With what countries?
- Are your treaties based on the OECD or UN Model? What variations from these Models do your treaties contain?
- Do your tax treaties contain any special provisions dealing with interest income or deductions of interest?

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Tax Treaties: Limitations on Taxation of Nonresidents

- Several limitations on the taxation of nonresidents with respect to interest income and deductions under the provisions of the UN and OECD Models
- If a country does not tax interest income of nonresidents under its domestic law, or allows the deduction of interest by nonresidents under its domestic law, tax treaties are irrelevant
- Otherwise, limitations in tax treaties can be used to erode a country's tax base

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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

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Tax Treaties: Effect on Nonresidents

Example:

- ACo, resident in 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 the treaty between Country A and Country B, Country B can impose withholding tax on the interest

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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

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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 under the “authorized OECD approach”

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Deduction of Interest in Computing Profits of PE

- No rules in UN Model or Commentary for allocating interest expenses to PE
- Commentary on Art. 7 suggests “practical solution” recognizing that a separate entity would have adequate funding
- Any reasonable allocation should be acceptable

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Deduction of Interest in Computing Profits of PE

- Guidance in Commentary on Art. 7 of the OECD Model
 - Functional and factual analysis of the PE to determine amount of free capital (equity)
 - PE should have sufficient free capital to support its functions, assets and risks

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Deduction of Interest in Computing Profits of PE

- Various methods for allocating free capital to a PE:
 - 1) Capital allocation method – assets and risks of PE as percentage of assets and risks of entire enterprise
 - 2) Thin capitalization method – free capital equal to free capital of independent enterprise carrying on same activities under same conditions by comparing debt:equity ratios
 - 3) Other methods for banking and insurance enterprises
- Creditworthiness of PE same as whole enterprise

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Tax Treaties: Effect on Taxation of Nonresidents

- Art. 24(3): tax on PE cannot be less favourable 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)
 - Branch-level interest tax is OK
- Art. 24(3) does not extend to connected requirements

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Tax Treaties: Effect on Taxation of Nonresidents

- Tax treaties do not generally restrict the taxation of a country's own residents
 - Except for Art. 8, 18, 19, 23 and 24 (see below)
 - Note the new saving clause to be added to the UN and OECD Models
- Art. 23 – relief of double taxation – does not provide detailed rules; therefore, necessary to use domestic law

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Tax Treaties: Effect on Taxation of Nonresidents

- 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

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Tax Treaties: Effect on Taxation of Nonresidents

- 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

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INFORMATION GATHERING

Information Gathering

- Information that is necessary or useful for countries in deciding what rules to adopt for the tax treatment of interest income and deductions
- Information can be obtained from taxpayers and from third parties
- Compliance burden should be balanced against need for information

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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

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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

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Information with respect to Interest Deductions

- Wide variety of information would be useful, including:
 - Total interest (and economic equivalents) deductions claimed by various types of taxpayers
 - Total interest deductions claimed by nonresidents
 - Total interest deductions claimed by resident entities controlled by nonresidents
 - Amount of debt of resident entities with foreign subsidiaries compared to other resident entities

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RISKS OF BASE EROSION

Risks of Base Erosion: Overview

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

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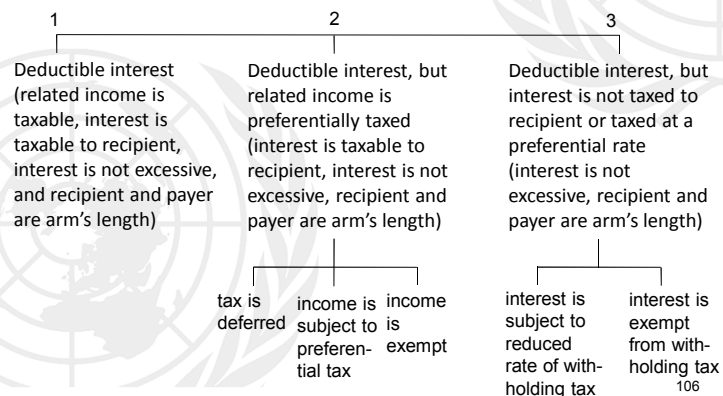
Risks of Base Erosion: Overview

- Risks are greater with respect to related-party interest payments
- Risks must be assessed from the perspective of each country's tax system

105

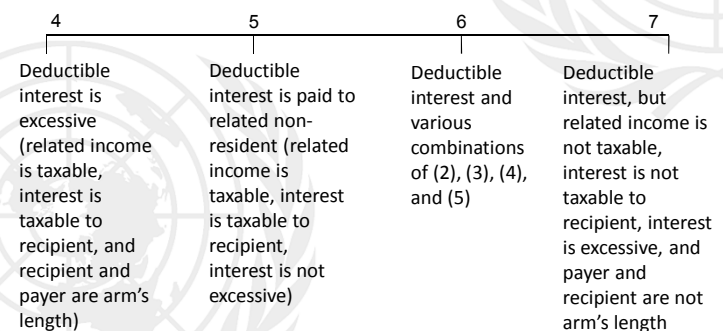
Risks of Base Erosion: Continuum

Least serious risk of base erosion



Risks of Base Erosion: Continuum

Most serious risk of base erosion



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Excessive Interest Deductions Claimed by Residents

- **Risk:** interest rate or amount of debt is excessive compared to arm's length standard
- **Possible Response:**
 - 1) Adopt and apply transfer pricing rules;
 - 2) Specific thin capitalization or earnings-stripping rules

108

Excessive Interest Deductions Claimed by Residents

- **Risk:** interest on debt owed to substantial nonresident shareholder is disguised equity
- **Possible Response:**
 - 1) Rules to characterize shareholder debt as equity in certain circumstances;
 - 2) Adopt thin capitalization rules;
 - 3) Apply transfer pricing rules (treaties will limit application to controlled enterprises).

109

Excessive Interest Deductions Claimed by Residents

- **Risk:** resident entity has disproportionate amount of debt relative to equity
- **Possible Response:** adopt thin capitalization rules
- **Risk:** resident entity has disproportionate interest expenses relative to its earnings
- **Possible Response:** adopt earnings-stripping rules

110

Excessive Interest Deductions Claimed by Residents

- **Risk:** tax treaties may prevent country from applying thin capitalization or earnings-stripping rules
- **Possible Response:**
 - 1) Don't enter into treaties
 - 2) Don't include Art. 24(4) or (5) in treaties
 - 3) Apply rules to residents and nonresidents
 - 4) Exemption if arm's length standard met
 - 5) Exclude rules from Art. 24(4) and (5)
 - 6) Limit Art. 24(4) and (5) to MFN situations
 - 7) Adopt saving clause

111

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

112

Thin Capitalization Rules

- **Risk:** scope of the rules is too narrow
- **Possible Response:** ensure rules apply to all deductible interest paid to nonresidents by all residents and nonresidents
- **Risk:** rules do not apply to payments that are economic equivalents of interest
- **Possible Response:** extend rules to all economic equivalents of interest

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Thin Capitalization Rules

- **Risk:** the debt:equity ratio is too generous
- **Possible Response:** adjust the ratio periodically
- **Risk:** not all types of debt are taken into account
- **Possible Response:** expand rules to cover all types of debt, such as guaranteed debt

114

Thin Capitalization Rules

- **Risk:** rules can be avoided through temporary infusion of equity or temporary repayment of debt
- **Possible Response:**
 - 1) calculate debt and equity on monthly or quarterly basis
 - 2) adopt specific anti-avoidance rules

115

Earnings-Stripping Rules

- **Risk:** scope of the rules is too narrow
- **Possible Response:** ensure that rules apply to all deductible interest paid to nonresidents by all residents and nonresidents
- **Risk:** rules do not apply to payments that are economic equivalents of interest
- **Possible Response:** extend rules to all economic equivalents of interest

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Earnings-Stripping Rules

- **Risk:** the ratio of interest expenses to earnings is too generous
- **Possible Response:** adjust ratio periodically
- **Risk:** the rules can be avoided in various ways
- **Possible Response:** adopt specific anti-avoidance rules or apply general anti-abuse rule

117

Excessive Interest Deductions Claimed by Nonresidents

- **Risk:** nonresidents subject to net-basis tax may claim excessive interest deductions
- **Possible Response:** apply thin capitalization or earnings-stripping rules (or other restrictions on interest deductions) to nonresidents

118

Excessive Interest Deductions Claimed by Nonresidents

- **Risk:** treaties may prevent application of restrictions on interest deductions applying only to nonresidents
- **Possible Response:**
 - 1) Don't enter into treaties
 - 2) Don't include Art. 24(4) or (5) in treaties
 - 3) Apply rules to residents and nonresidents
 - 4) Exemption if arm's length standard met
 - 5) Exclude rules from Art. 24(4) and (5)
 - 6) Limit Art. 24(4) and (5) to MFN situations

119

Excessive Interest Deductions Claimed by Nonresidents

- **Risk:** Art. 24(3) may prevent the application of restrictions on interest deductions to nonresidents
- **Possible Response:**
 - 1) Don't enter into treaties
 - 2) Don't include Art. 24(3) in treaties
 - 3) Exclude rules from Art. 24(3)
 - 4) Limit Art. 24(3) to MFN situations

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Withholding Tax

- **Risk:** deductible interest payments reduce tax base but no tax is imposed on payments
- **Possible Response:** impose withholding tax on all interest payments to nonresidents
 - setting the rate of withholding tax is difficult
 - high rates have disadvantages
 - exemption for some interest payments such as payments to arm's length lenders
 - alternatively, use thin capitalization or earnings stripping rules to protect the tax base

121

Withholding Tax

- **Risk:** treaties may prevent imposition of withholding tax or limit rate of tax
- **Possible Response:**
 - 1) Don't agree to reduced rate of withholding on interest
 - 2) Maintain reasonable rate of withholding on all interest payments
 - 3) Ensure that all exemptions are justified

122

Withholding Tax

- **Risk:** deductible interest payments by nonresidents to nonresidents may not be subject to withholding tax
- **Possible Response:** deductible interest payments by nonresidents subject to tax on a net basis should be subject to withholding tax

123

Residents Earning Foreign Source Income

- Residents earning income through a foreign branch or PE
 - Foreign income is exempt
 - Foreign income is taxable with foreign tax credit
- Residents earning foreign source income (dividends) through a foreign corporation
 - Dividends are exempt
 - Dividends are taxable with indirect credit

124

Residents Earning Foreign Branch Income

- Interest expenses incurred by resident to earn foreign source income
- **Risk:** if foreign source income is exempt, any deductible interest incurred to earn that income erodes the tax base
- **Possible Response:** deny deduction of such interest
 - Rules for linking interest expenses to foreign source income are critical for this purpose

125

Residents Earning Foreign Branch Income

- **Risk:** if foreign source income is taxable, interest is deductible, but if not allocated to foreign income for purposes of foreign tax credit tax base will be eroded
- **Possible Response:** foreign tax credit should be limited to domestic tax on the foreign source income
 - Rules for linking interest expenses to foreign source income are critical for this purpose

126

Residents Earning Dividends from Foreign Companies

- **Risk:** If dividends are exempt (participation exemption), interest deductions will erode tax base
- **Possible Response:** disallow or limit the deduction of interest on funds used to acquire shares of foreign companies
 - Robust rules to allocate interest expenses to shares of foreign companies are necessary

127

Residents Earning Dividends from Foreign Companies

- **Risk:** If dividends are taxable and interest is deductible currently, but dividends are taxable only when received, interest will erode tax base
- **Possible Response:**
 - 1) Interest deductible only when dividends are paid
 - 2) Interest should be allocated to foreign source income for purposes of underlying foreign tax credit

128

Debt Push-Down Arrangements

- **Risk:** interest on funds used to acquire shares of resident company may be shifted from nonresident acquiror to acquired company
- **Possible Response:**
 - 1) Thin capitalization or earnings-stripping rules may limit, but not disallow completely, interest deductions
 - 2) Adopt specific anti-avoidance rules
 - 3) Apply general anti-abuse rule

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DESIGNING AND DRAFTING DOMESTIC LEGISLATION AND NEGOTIATING TAX TREATIES TO PREVENT BASE EROSION

Purpose of Part 3 of the Practical Portfolio

- Identification of the major structural features of domestic law to prevent base erosion
- Sample legislation with explanatory notes
- Negotiation of tax treaties to prevent base erosion
- Sample provisions are suggestions or models only – not recommendations
- May be used as guides to develop your own provisions or as a basis for assessing your provisions

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Domestic Legislation to Prevent Base Erosion

- Three major issues of base erosion:
 - 1) Excessive interest deductions claimed for payments to nonresidents
 - 2) Interest paid to nonresidents is exempt from tax or subject to reduced tax
 - 3) Interest deductions claimed by residents to earn exempt or favourably taxed income
- Domestic legislation must balance effectiveness and complexity

132

Excessive Interest Deductions

- Domestic transfer pricing legislation should be updated periodically to reflect recent UN and OECD developments
- Thin capitalization rules applicable to interest paid to nonresidents
- Earnings stripping rules applicable to interest paid to nonresidents
- Earnings stripping rules based on BEPS Action 4 best practices

133

Taxation of Nonresidents on a Net Basis

- Typically, countries tax nonresidents on a net basis only if carrying on business in the country [through a PE or fixed base]
- Enforcement issues are usually dealt with by provisional withholding and/or a requirement to pay tax in periodic installments
- Usually nonresidents are subject to net basis taxation only on income derived in the country [through a PE or a fixed base]
 - Requires source rules that are not subject to manipulation

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Taxation of Nonresidents on a Net Basis

- Risks of base erosion:
 - 1) Excessive interest deductions claimed
 - Apply transfer pricing rules
 - Apply any restrictions on excessive interest deductions to nonresidents
 - 2) No withholding tax on interest paid to nonresidents
 - Apply withholding tax

135

Gross-Based Taxation of Nonresidents

- Withholding tax offsets effect of interest deduction
 - Withholding can be made a condition for the deduction of the interest payments
- Withholding tax may be excessive and result in unrelieved double taxation
- Withholding taxes may be passed on to residents of your country in some circumstances

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Gross-Based Taxation of Nonresidents

- Major factors in designing withholding taxes on interest payments:
 - What payments should be subject to tax? Or, what payments should be exempt?
 - What rate of tax should be applied?
 - What persons should be required to withhold?
 - Should the withholding tax be final or provisional?

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Gross-Based Taxation of Nonresidents

- What payments should be subject to tax?
- Simplest system is imposition of tax on all interest (and similar) payments irrespective of whether the payments are made to residents or nonresidents
- No need for withholding agent to determine:
 1. Where nonresident is resident
 2. Whether nonresident has a PE or fixed base
 3. Whether the payer and recipient are related

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Gross-Based Taxation of Nonresidents

- Withholding tax typically imposed on payments
- In certain circumstances, imposed on deemed payments:
 - Adjustments in price pursuant to transfer pricing rules
 - Deductions claimed for interest on an accrual basis (or deduction conditional on withholding)

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Gross-Based Taxation of Nonresidents

- What rate of withholding should be applied?
- Very difficult issue
- In theory, withholding tax is a proxy for a tax on net income
- Excessive tax may not be creditable by nonresident

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Gross-Based Taxation of Nonresidents

- What persons are required to withhold?
- Typically imposed on residents and nonresidents with a PE or fixed base in the country
- Difficult to collect tax from individuals for whom interest payments are nondeductible
- Therefore, limit to deductible payments
- Withholding agent is usually jointly liable for the tax

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Gross-Based Taxation of Nonresidents

- Interim or final withholding tax?
- Under interim withholding, nonresident must file a tax return and pay tax on a net basis (i.e., claim actual expenses, pay additional tax or claim a refund)
- Imposes serious compliance and administrative costs
- Possible for tax authorities to issue waivers where nonresident is probably exempt from tax

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Taxation of Residents

- If foreign income is exempt, risks of base erosion are:
 - Incentive to earn foreign income in low-tax countries
 - Interest deductions reduce taxable income
- Solutions: tax foreign source income or restrict interest deductions

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Taxation of Residents

- Your country should have clear source-of-income rules that are not easily manipulated
- Interest expenses incurred by residents to earn exempt foreign income should not be deductible against your country's tax base
 - Fundamental principle that is contained in a general provision of domestic law
 - Such provision must be enforced effectively

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Taxation of Residents

- If foreign income is taxable, the risks of base erosion are related to the allocation of deductible interest expenses to the foreign income for purposes of the limitation on the foreign tax credit
- Important to consider the type of limitation on the foreign tax credit – overall, per-country or item-by-item

145

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 favourably taxed, only a corresponding portion of interest should be deductible
 - complex

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Interest to Earn Favourably Taxed Income: Design Issues

- Method used to allocate interest expenses to foreign source income is very important
 - tracing is subject to manipulation
 - apportionment is complex
- De minimis rule may be appropriate to exclude cases where deductible interest is relatively small
- Exception for interest linked to particular investments may be appropriate
 - e.g., mortgages on immovable property or financing of public projects

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SAMPLE LEGISLATION

Sample Legislation: Thin Capitalization

- (1) Where a resident company, other than a financial institution, makes a payment of interest in a taxation year to a [related] [non-arm's length] non-resident, the interest shall not be deductible in that year to the extent of the portion of the company's total interest payments made during the year [to non-residents] [to non-residents with whom the company does not deal at arm's length] that the company's average debt for the year exceeds [1.5, 2, or 3 times] the company's average equity for the year.

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Sample Legislation: Thin Capitalization

- "interest" means [includes] . . .;
- "debt" includes any loan or indebtedness and any other amount that is treated as debt for tax purposes, but does not include any debt on which no interest is charged;
- "equity" means the share capital of a company and any contributions to the capital of a company by a shareholder of the company;

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Sample Legislation: Thin Capitalization

- "average debt" means the aggregate of the amount of debt of a company [greatest amount of debt of a company] that is outstanding on March 31, June 30, September 30 and December 31 [during each quarter] of a taxation year; and
- "average equity" means the aggregate of the amount of the equity of a company on March 31, June 30, September 30 and December 31 of a taxation year plus the company's retained earnings at the beginning of the year;

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Sample Legislation: Thin Capitalization

- Provisions for:
 - More generous ratio for financial institutions
 - Carryforward of excess interest
 - Excess interest deemed to be dividend
 - Rules extended to partnerships and trusts
 - Rules extended to nonresidents
 - Exception for interest that meets the arm's length standard

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Sample Legislation: Earnings Stripping

- (1) Where a resident company [other than a financial institution] makes a payment of interest in a taxation year to a [related] [non-arm's length] non-resident, the interest shall not be deductible in that year to the extent that the total of the payments of interest for the year by the company [in excess of any interest income received by the company in the year] exceeds [] percent of the company's adjusted earnings for the year.

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Sample Legislation: Earnings Stripping

- (2) "adjusted earnings" means the income or profits of a company for a taxation year [average income or profits for the year and the previous 2 years] computed in accordance with the provisions of this Act [the country's domestic income tax legislation] except that no deductions, allowances or reliefs for interest, taxes, depreciation or amortization shall be taken into account.

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Sample Legislation: Earnings Stripping

- Provisions for:
 - Exemption for resident company that pays de minimis amount of interest
 - Exemption for public benefit projects
 - Exemption for interest that meets the arm's length standard
 - Carryforward of excess interest
 - Excess interest deemed to be a dividend
 - Rules extended to partnerships and trusts
 - Rules extended to nonresidents

155

Sample Legislation: Withholding Tax

(1) Any person not resident in Country X shall pay tax of __ percent of the following amounts that a person resident in Country X pays or credits, or is deemed by the provisions of this Act to pay or credit, to the non-resident person as, on account of, or in lieu of:

(a) interest;

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Sample Legislation: Withholding Tax

- (b) original issue discount;
- (c) a payment on a debt instrument that is dependent on . . .
- (d) a guarantee fee;
- (e) any other payment that is a cost of borrowing money or raising debt financing and is economically equivalent to interest; and
- (f) . . .

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Sample Legislation: Withholding Tax

(2) A person resident in Country X that pays any amount described in section (1) to a non-resident person shall withhold tax on behalf of such non-resident person at the rate of __ percent of the gross amount paid and remit that amount to _____.

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Sample Legislation: Withholding Tax

(3) If a person resident in Country X fails to withhold tax as required by section (2) on an amount paid to a non-resident person, that person shall be liable, together with that non-resident person, for the tax payable by the non-resident person under section (1).

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Sample Legislation: Withholding Tax

- (4) If a person resident in Country X fails to withhold tax as required by section (2), that person shall not be entitled to deduct the amount paid to the non-resident person in computing the person's income subject to tax under this Act.

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Sample Legislation: Withholding Tax

- (5) For the purposes of section (1), if a person who is not resident in Country X (referred to in this section as the "first person") pays or credits an amount to another person who is not resident in Country X, the first person is deemed to be a person resident in Country X to the extent that the amount paid or credited is deductible in computing the first person's income subject to tax under this Act.

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Sample Legislation: Withholding Tax

- (6) For the purposes of section (1), if a partnership in which a person resident in Country X is a partner pays or credits an amount to a person who is not resident in Country X, the partnership shall be deemed to be a person resident in Country X.
- (7) For purposes of section (1), if a partnership in which a non-resident person is a partner receives an amount described in section (1) that is paid or credited by a person resident in Country X, the partnership shall be deemed to be a person who is not resident in Country X.

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NEGOTIATING TREATIES

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
- The provisions of your tax treaties should be reasonably consistent
- Important for your negotiating position to be well thought out

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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

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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

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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

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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 (unless residents cannot deduct interest also)
- Deductibility is an issue for domestic law
- Therefore, your country can limit deductions subject to Art. 24(3)

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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

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Possible 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)

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Other Concerns

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

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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 withholding tax under Art. 11
- Choice of rate requires balancing of several factors

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Treaty Provisions Relating to Nonresidents: Withholding Taxes

- 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 on interest subject to domestic limits
- Relief only for interest arising in the other state

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UNITED NATIONS PRACTICAL PORTFOLIO:
PROTECTING THE TAX BASE OF
DEVELOPING COUNTRIES AGAINST BASE
EROSION WITH RESPECT TO THE
TAXATION OF INCOME FROM SERVICES

TAX POLICY ASSESSMENT MANUAL

PART 2 OF THE PRACTICAL PORTFOLIO
ON SERVICES

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Tax Policy Assessment

- Analysis of provisions of domestic law with respect to the taxation of income from services from the perspective of base erosion
- Analysis of provisions of tax treaties dealing with income from services from the perspective of base erosion
- Information gathering
- Identification of the risks of BEPS with respect to income from services and possible responses

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Domestic Law

- Identification of basic patterns of taxing income from services:
 1. Income derived by residents from services performed outside your country
 2. Income derived by nonresidents from services performed or used in your country
- Your tax base may be eroded if your country does not tax income from services or if it allows the deduction of payments for services

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Domestic Law

- Most countries do not define “services”
- However, if income from services or from certain types of services is taxed differently from other income or other types of services, domestic law must distinguish between the various types of services
- Meaning of services is generally broad

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Domestic Law

- Distinguishing between payments for services and other payments, such as royalties, is often difficult
- Mixed contracts are especially difficult
- Some countries consider that services must involve activities performed by individuals; therefore, automated activities are not services

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Residents Earning Foreign Source Income from Services

- Does your country tax on a worldwide or territorial basis?
 - Worldwide taxation: all income from services subject to tax whether the services are performed inside or outside your country
 - Territorial taxation: only income from services performed or consumed in your country is subject to tax
- Risks of BEPS are less under worldwide taxation

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Residents Earning Foreign Source Income from Services

- If your country exempts all income from services performed outside your country, in effect, it is taxing on a territorial basis
- If your country exempts some income from services to eliminate double taxation, residents will have an incentive to earn low-taxed foreign income from services
- The source of income is critical for this purpose

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Residents Earning Foreign Source Income from Services

- If your country uses a foreign tax credit (FTC) to eliminate double taxation, the credit should be limited to your country's tax on the foreign income
- For purposes of the limitation on the FTC, source of income is critical and expenses must be properly allocated to the foreign income
- Does your country use a worldwide, per country or item-by-item limitation?

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Residents Earning Foreign Source Income from Services

- Source of income from services is generally the place where the service provider is present and performing the services
- Some countries consider income from services to be sourced in their country if the services are consumed or used there (i.e., if the payer is resident or carries on business there)

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Residents Earning Foreign Source Income from Services

- Even if your country taxes residents on their income from services on a worldwide basis, residents can establish controlled foreign companies (CFCs) to earn income
- Such CFCs are generally not taxable by your country unless they earn domestic source income because
 - CFCs are separate taxable entities
 - CFCs are not resident in your country

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Nonresidents Earning Domestic Income from Services

- Almost all countries tax nonresidents earning income from services in their country
- Critical issue is determining the source of the income
- Some countries also tax payments to nonresidents for services performed outside the country
 - The only effective ways to enforce this tax are withholding or denying a deduction for the payments

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Nonresidents Earning Domestic Income from Services

Base erosion example:

- R, resident, pays 1,000 to NR for services
- If tax rate in residence country is 40%, tax base is reduced by 400
- If payment is subject to withholding tax of 15%, tax is 150
- Residence country tax base is reduced by 250

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Nonresidents Earning Domestic Income from Services

- Basic patterns for taxing income from services performed in a country:
 - Tax all income from services on a net basis or by way of a withholding tax
 - Tax only if a threshold is met (e.g., PE or fixed base)
 - Tax only if nonresident is present or performs services in the country for a minimum time

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Nonresidents Earning Domestic Income from Services

- Basic patterns for taxing services consumed or used in a country:
 - All payments to nonresidents for services (or only technical services) subject to withholding tax
 - All deductible payments to nonresidents are subject to withholding tax
 - All deductible payments by nonresidents carrying on business through a PE or fixed base to nonresidents are subject to withholding tax

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The Provisions of Tax Treaties Dealing with Income from Services

- How many tax treaties does your country have? With what countries?
- Are your countries' tax treaties based on the UN or OECD Model? What variations from those Models do your country's tax treaties contain?
- Do your country's tax treaties contain special provisions dealing with fees for technical services?

189

UN and OECD Models

- UN and OECD Models do not generally restrict the ability of countries to tax their residents, except for
 - Under Art. 8, only country in which place of effective management is located is entitled to tax
 - Under UN Model Art. 18, residence country cannot tax social security pensions
 - Under Art. 19 of both Models, payments to employees by a government are taxable only by that country unless employee is a resident and national of that country and services are performed there

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UN and OECD Models

- Several limitations imposed by Models on a country's ability to tax nonresidents on income from services
- If country does not tax income from services under its domestic law, limitations in tax treaties are irrelevant
- Limitations can be used to erode country's tax base

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Limitations on the Taxation of Nonresidents: Article 15

- General rule – no taxation unless:
 - Employment is exercised in the country and
 - Employee is employed by a resident of the country or by a nonresident with a PE or fixed base in the country and salary or wages borne by the PE or fixed base, or
 - Employee is present in the country for more than 183 days in any 12-month period

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Limitations on the Taxation of Nonresidents: Article 15

- Exceptions:
 - Art. 16: remuneration of nonresident directors and top-level managerial officials of a resident company (UN Model only) taxable irrespective of where services are performed
 - Art. 19: payments for government service taxable by payer country unless the employee is a resident and national of the other country and the services are performed in that country

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Limitations on the Taxation of Nonresidents: Article 15

- Exceptions:
 - Art. 17: income from entertainment or sports activities taxable if activities take place in the country
 - Art. 18: UN Model only, social security pensions taxable by payer country; also (Art. 18 (alternative B)) other pensions taxable if payer is a resident of the country or a nonresident with a PE in the country

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Limitations on the Taxation of Nonresidents: Article 17

- Entertainment and sports activities must be performed in the country
- But there is no threshold for source country taxation
- Art. 17(2) is an anti-avoidance rule if income is assigned by an entertainer or athlete to another person

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Limitations on the Taxation of Nonresidents: Article 14

- Income from professional and other independent personal services is not taxable unless the nonresident has a fixed base regularly available in the country or is present in the source country for 183 days or more
- Only income attributable to the fixed base or from services performed in the country is taxable

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Limitations on the Taxation of Nonresidents: Article 7

- General rule: income from business services is taxable only if the nonresident has a PE in the country and the profits are attributable to the PE
- PE is defined to be a fixed place of business
- Under UN Model, Art. 5(3)(b) deems PE to include furnishing services in the country for 183 days or more with respect to the same or a connected project
 - Same or connected project condition to be deleted in 2017 Update

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Limitations on the Taxation of Nonresidents: Article 7

- Construction project or site is a PE only if it lasts for 6 months (UN Model) or 12 months (OECD Model)
 - Construction project or site must also be a fixed place of business under Art. 5(1)
- Insurance: deemed PE if nonresident collects premiums or insures risks in the country other than through an independent agent

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Limitations on the Taxation of Nonresidents: New Article 12

- New Article 12A (Fees for Technical Services) to be added to UN Model in 2017
- Article 12A allows country in which fees for technical services arise to impose gross-based withholding tax on fees, but at limited rate if recipient is the beneficial owner and a resident of the other contracting state
- No threshold for source country tax
- No requirement for services to be performed in the source country

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Limitations on the Taxation of Nonresidents: New Article 12

- Fees for technical services arise in a country if the payer is a resident or a nonresident with a PE or fixed base that bears the fees
- Fees for technical services are deemed not to arise in a country if they are borne by a PE or fixed base in another country

200

Limitations on the Taxation of Nonresidents: New Article 12

- Fees for technical services defined to mean payments for management, technical or consultancy services except payments:
 - to employees by employers
 - for teaching in or by educational institutions
 - by individuals for personal use
- Definition is intended to cover services that require specialized knowledge, skill or expertise, not routine services

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Information Necessary for Tax Policy Analysis

- Income derived by residents from foreign services:
 - Total gross revenue from foreign services
 - Total net income from foreign services
 - Income from services provided to related nonresidents

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Information Necessary for Tax Policy Analysis

- Income derived by nonresidents from services:
 - Types of services
 - Total amounts paid to nonresidents for services
 - Total net income from services performed by nonresidents and tax collected
 - Total withholding tax collected on payments to nonresidents for services
 - Residence of nonresident service providers
 - Transactions with related nonresidents

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RISKS OF BASE EROSION

Risks of Base Erosion: Overview

- Risks with respect to
 - 1) residents earning income from foreign services
 - 2) nonresidents earning income from services
- Risks vary depending on the type of services
- Risks are greater with respect to related-party transactions
- **Risks must be assessed from the perspective of each country's tax system**

205

Risks of Base Erosion: Overview

- Major factors in identifying and assessing the risks of base erosion with respect to services:
 - What income from services does your country **not** tax? Or tax at a low rate?
 - What payments for services are deductible?
 - How does the country in which the nonresident service provider is resident tax the payments?
 - What limitations do your country's tax treaties impose on taxation of income from services?
 - Related-party service transactions

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Risks of Base Erosion: Employment

- Residents earning income from foreign employment services
- Major risk is that such income is not taxable under a territorial system
- Solution: impose tax on worldwide employment income, or at least ensure that expenses are not deductible
- Also ensure that limitation on foreign tax credit works properly

207

Risks of Base Erosion: Employment

- Major risks of base erosion with respect to nonresidents earning income from employment:
- 1) Tax under domestic law if nonresident employee is employed by a nonresident with a PE or fixed base in your country?
 - Salary will be deductible
 - Impose obligation to withhold tax on nonresident employer

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Risks of Base Erosion: Employment

- 2) Tax under domestic law if nonresident employee is employed by a nonresident carrying on business in your country?
 - If not, nonresidents may try to avoid PE or fixed base through commissionaire arrangements, moving activities to different locations, having activities performed by related entities

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Risks of Base Erosion: Employment

- 3) Art. 15(2) will prevent your country from taxing nonresident employees where nonresident employer avoids having PE or fixed base in your country
 - Employer can avoid having a PE or fixed base through various artificial means
 - Solution: anti-avoidance rules in domestic law and treaties (see OECD BEPS Action 7 proposals)

210

Risks of Base Erosion: Employment

- 4) Legal relationship of employment altered to independent contractor
 - Threshold for taxation of independent contractors (PE or fixed base) is much higher than for employees
 - Solution: employment relationship for domestic law and treaty should be determined on the basis of its substance (see UN Commentary on Art. 15, quoting paras. 8.1-8.28 of the OECD Commentary)

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Risks of Base Erosion: Employment

- 5) Nonresident entity hires out employees to residents of your country; therefore, employer is nonresident instead of resident
- Your country may not be able to tax under domestic law or treaty if nonresident employer does not have PE or fixed base in your country
 - Solution: domestic anti-avoidance rules that apply for purposes of your tax treaties or treaty anti-abuse rule

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Risks of Base Erosion: Employment

- 6) Fees paid to nonresident directors and remuneration of nonresident managers of resident companies
- Amounts will be deductible against your country's tax base
 - Solution: amounts should be subject to withholding tax
 - Also, treaties should contain Art. 16 of UN Model (Art. 16 of OECD Model applies only to directors)

213

Risks of Base Erosion: Employment

- 7) Amounts paid by your government to nonresident employees
- Amounts paid reduce government revenues
 - Solution: amounts paid should be subject to withholding tax irrespective of where the services are performed
 - Also, treaties should contain Art. 19 (note that Art. 19 does not apply to independent contractors)

214

Risks of Base Erosion: Employment

- 8) Pensions paid to nonresident former employees
- Amounts paid or prior contributions may be deductible against your country's tax base
 - Solution: pension payments should be subject to withholding tax
 - Also, treaties should contain Art. 18 (alternative B) of UN Model

215

Risks of Base Erosion: Entertainers and Athletes

- Some entertainers and athletes can make substantial amounts in a short time
- Solution: your country should tax all income (or income above a threshold) from entertainment and sports activities performed in your country
- Also, treaties should contain Art. 17

216

Risks of Base Erosion: Entertainers and Athletes

- Nonresident entertainers and athletes may attempt to avoid tax by assigning income to another person (e.g., controlled company)
- Solution: domestic law should impose tax on income irrespective of who receives it
- Also, treaties should contain Art. 17(2)

217

Risks of Base Erosion: Independent Personal Services

- Nonresident service providers may not be subject to tax under your domestic law unless they have a PE or fixed base or spend a minimum amount of time in your country
 - Amounts paid may be deductible
- Solution: impose withholding tax on all payments for services (or services performed in your country) by nonresidents, or deny deduction of such payments

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Risks of Base Erosion: Independent Personal Services

- Also, any treaties with Art. 7 or 14 will limit your country's tax on payments to nonresident service providers
- Solution: do not enter into treaties or negotiate treaties with a shorter time threshold in Art. 14 (e.g., 90 or 120 days)

219

Risks of Base Erosion: Independent Personal Services

- Amounts paid by residents and nonresidents with PE or fixed base in your country to nonresident service provider for services performed outside your country will be deductible
- Solution: impose withholding tax or deny deduction (e.g., tax on fees for technical services)
- Also, treaties must have special provisions to allow such withholding tax
- Note proposed new Article 12A in UN Model on fees for technical services

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Risks of Base Erosion: Other Business Services

- Nonresident service providers may not be subject to tax under your domestic law unless they have a PE
 - Amounts paid may be deductible
- Solution: impose withholding tax on all payments for services (or services performed in your country) by nonresidents, or deny deduction of such payments

221

Risks of Base Erosion: Other Business Services

- Also, any treaties with Art. 7 will limit your country's tax on payments to nonresident service providers
- Solution: do not enter into treaties or negotiate treaties with a shorter time threshold in Art. 5(3)(b) (e.g., 90 or 120 days)
 - Eliminate same or connected project requirement
 - Note: same or connected project requirement has been eliminated from UN Model in 2017

222

Risks of Base Erosion: Other Business Services

- If nonresident service providers are subject to tax only if they have a PE in your country, they may avoid having a PE in various ways
- Solution: ensure that your domestic law and treaties contain anti-avoidance rules to prevent this type of tax avoidance
- Note BEPS Action 7 proposals

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BEPS Action 7 Measures

- Article 5(4) limited to activities that are preparatory or auxiliary considered separately or together
- New Article 5(4.1) anti-fragmentation rule:
Exception in Article 5(4) does not apply if enterprise or closely related enterprise has a fixed place of business PE in the country or if overall activity is not preparatory or auxiliary as long as business activities are complementary functions of a cohesive business operation

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BEPS Action 7 Measures

- Revised Article 5(5) with respect to dependent agents:
 - Includes agent who habitually concludes contracts or plays principal role leading to conclusion of contracts for services without material modification by the principal
- Article 5(5) does not apply to independent agents as defined in Article 5(6)
- Article 5(6) is revised to exclude an agent who acts exclusively or almost exclusively for a closely related person

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BEPS Action 6 Measures

- The general anti-abuse rule to be added to the UN Model may also be effective in preventing avoidance of PE status
 - For example, new PPT (one of the principal purposes test) should prevent contract-splitting arrangements to avoid construction site PE rule
 - Commentary will provide a specific anti-avoidance for countries that prefer a specific rule

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Risks of Base Erosion: Other Business Services

- Amounts paid by residents and nonresidents with PE in your country to nonresident service provider for services performed outside your country will be deductible
- Solution: impose withholding tax or deny deduction (e.g., tax on fees for technical services)
- Also, treaties must have special provisions to allow such withholding tax
- Note proposed new Article 12A in UN Model on fees for technical services

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Risks of Base Erosion: Other Business Services

- If services are provided by a nonresident related to the payer, the payments may be deductible against your country's tax base
- Also, there is a risk that the amounts paid may be more or less than the arm's length price of the services
- Solution: your domestic law should contain robust transfer pricing rules that are enforced rigorously

228

Risks of Base Erosion: Insurance

- If your domestic law imposes tax on insurance companies only if they do business through a PE in your country, they may be able to avoid having a PE
- Solution: impose tax if nonresident company collects premiums or insures risks in your country
- Also, treaties should contain Art. 5(6) of UN Model

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Risks of Base Erosion: Construction

- If your domestic law imposes tax on nonresidents engaged in construction activities in your country only if they have a PE in your country or spend a minimum time there, they may be able to avoid tax
 - Amounts paid for construction will be deductible
- Solution: impose tax on all income derived by nonresidents from construction activities in your country

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Risks of Base Erosion: Construction

- Treaties containing Art. 5(3)(a) of the UN Model will prevent your country from taxing unless construction lasts for at least 6 months and Article 5(1) is satisfied
- Solution: do not enter into treaties or negotiate a shorter time threshold (e.g., 3 months) and allow construction activities at different locations in your country to be aggregated

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Key Risks of Base Erosion

1) Employment

- Nonresidents working for a PE or fixed base of a nonresident employer
- Nonresidents who are legally employed by nonresident but in substance by resident
- Nonresidents who are legally independent contractors but in substance employees

2) Entertainers and athletes who earn substantial amounts from activities in your country

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Key Risks of Base Erosion

3) Independent personal services

- performed in your country by nonresidents without having a PE or fixed base, especially if PE or fixed base is artificially avoided
- Deductible payments to nonresidents for services performed outside your country
- Cross-border related party services

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Key Risks of Base Erosion

4) Other business services

- Performed in your country by nonresidents without having a PE, especially if PE is artificially avoided
- Deductible payments to nonresidents for services performed outside your country
- Cross-border related-party services

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**DESIGNING AND DRAFTING
DOMESTIC LEGISLATION AND
NEGOTIATING TAX TREATIES TO
PREVENT BASE EROSION**

Purpose of Part 3 of the Practical Portfolio

- Identification of the major structural features of domestic law to prevent base erosion
- Sample legislation with explanatory notes
- Negotiation of tax treaties to prevent base erosion
- Sample provisions are suggestions or models only; not recommendations
- May be used as guides to develop your own provisions or as a basis for assessing your provisions

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Major Structural Features of Domestic Legislation

- 1) Residents earning income from foreign services
 - 2) Nonresidents earning income from services taxable on a net basis
 - 3) Nonresidents earning income from services taxable on a gross withholding tax basis
- Distinction between residents and nonresidents is important, but not dealt with here

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Taxation of Residents

- If income from foreign services is exempt, risks of base erosion are:
 - Incentive to earn foreign income in low-tax countries
 - Expenses in earning foreign income deductible against taxable income
- Solutions: move to credit system or limit scope of exemption for income from foreign services

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Taxation of Residents

- Possible limitations on the exemption:
 - Limited to income subject to foreign tax at a minimum rate
 - Limited to income earned in listed countries that tax at a minimum rate
 - Limited to income earned through a foreign PE or fixed base or where resident spends a minimum amount of time in the foreign country

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Taxation of Residents

- Your country should have clear source-of-income rules that are not easily manipulated
- Expenses incurred by residents to earn exempt income from foreign services should not be deductible against your country's tax base
 - Fundamental principle that is contained in a general provision of domestic law
 - Such provision must be enforced effectively

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Taxation of Residents

- If income from foreign services is taxable, the risks of base erosion are related to the limitation on the foreign tax credit
 - 1) Overall and per-country limitations on the credit allow high and low foreign taxes to be averaged
 - Important to consider whether this is appropriate
 - 2) Expenses incurred to earn foreign income should be allocated to that income for purposes of the limitation on the credit

241

Taxation of Nonresidents on a Net Basis

- Generally, nonresidents are subject to tax on a net basis if:
 - They have a substantial presence in your country
 - They incur significant expenses in earning income
 - Your country has the information necessary to compute income accurately
 - Your country can enforce payment of the tax effectively

242

Taxation of Nonresidents on a Net Basis

- Typically, countries tax income from business services on a net basis (if PE or fixed base)
- Enforcement issues are usually dealt with by provisional withholding and/or a requirement to pay tax in periodic installments
- Usually nonresidents are subject to net basis taxation only on income from services performed in the country through a PE
 - Requires source rules that are not subject to manipulation

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Taxation of Nonresidents on a Net Basis

- Risks of base erosion:
 - 1) Avoidance of threshold requirement
 - Eliminate or reduce threshold; adopt robust anti-avoidance rules
 - 2) Insurance
 - Tax based on activities in country
 - 3) International shipping and air transportation
 - Difficult to tax; therefore, not usually subject to net basis tax

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Gross-Based Taxation of Nonresidents

- Often difficult to tax nonresident service providers on a net basis
- Collection of tax through withholding is generally effective but puts compliance burden on payers
- Payments to nonresident service providers are usually deductible and erode the tax base
- Denying deduction may be unacceptable because expenses are legitimate

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Gross-Based Taxation of Nonresidents

- Withholding tax offsets effect of deduction
 - Withholding can be made a condition for the deduction of the payments for services
- Withholding tax may be excessive and result in unrelieved double taxation
- Withholding tax may be passed on to residents of your country in some circumstances

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Gross-Based Taxation of Nonresidents

- Major factors in designing withholding taxes on payments for services:
 - What payments should be subject to tax?
 - What rate of tax should be applied?
 - What persons should be required to withhold?
 - Should the withholding tax be final or provisional?

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Gross-Based Taxation of Nonresidents

- What payments should be subject to tax?
- Simplest system is imposition of tax on all payments for services irrespective of whether the payments are made to residents or nonresidents
- No need for withholding agent to determine:
 1. Where nonresident is resident
 2. Whether nonresident is an employee or independent contractor
 3. The nature of the services

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Gross-Based Taxation of Nonresidents

- Withholding tax typically imposed on payments
- In certain circumstances, imposed on deemed payments:
 - Adjustments in price pursuant to transfer pricing rules
 - Deductions claimed for services on an accrual basis (or deduction conditional on withholding)

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Gross-Based Taxation of Nonresidents

- Payments to nonresidents without any PE or fixed base in the country
 - Provisional withholding may be required here
- Payments to nonresidents if services are provided in the country
- Payments to nonresidents if services are provided outside the country
 - Only if payments are deductible
 - Only payments to related parties
 - Only fees for technical services

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Gross-Based Taxation of Nonresidents

- Base erosion with respect to payments for services provided outside a country can be prevented by withholding tax on payments or denying a deduction to the payer
 - Consider Art. 24(4) of UN Model
 - Consider whether withholding tax would be a violation of the GATS

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Gross-Based Taxation of Nonresidents

- What rate of withholding should be applied?
- Very difficult issue
- In theory, withholding tax is a proxy for a tax on net income
- Excessive tax may not be creditable by nonresident
- Different rates for different services?
 - Increases compliance burden for withholding agent

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Gross-Based Taxation of Nonresidents

- What persons are required to withhold?
- Typically imposed on residents and nonresidents with a PE or fixed base in the country
- Difficult to impose on individuals for whom the payments are personal expenses
- Therefore, limit to deductible payments
- Withholding agent is usually jointly liable for the tax

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Gross-Based Taxation of Nonresidents

- Interim or final withholding tax?
- Under interim withholding, nonresident must file a tax return and pay tax on a net basis (i.e., claim actual expenses, pay additional tax or claim a refund)
- Imposes serious compliance and administrative costs
- Possible for tax authorities to issue waivers where nonresident is probably exempt from tax

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Gross-Based Taxation of Nonresidents

- Types of payments subject to withholding?
 1. Employment income
 2. Directors' fees and remuneration of top-level managerial officials of resident companies
 3. Payments by your government to nonresident employees
 4. Pensions paid to nonresidents by your government, resident employers or nonresident employers (especially if payments are deductible or contributions were deductible)

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Gross-Based Taxation of Nonresidents

5. Payments to nonresident entertainers and athletes
6. Payments to nonresident shipping or air transportation enterprises for goods or persons taken on board in your country
7. Payments to nonresidents for managerial, technical or consulting services

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SAMPLE LEGISLATION

Sample Withholding Tax Provision

- (1) Any person not resident in (your country) shall pay tax of ___ percent of the following amounts that a person resident in (your country) pays or credits, or is deemed by the provisions of this Act to pay or credit, to the non-resident person as, on account of, or in lieu of:

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Sample Withholding Tax Provision

- (a) services performed by the non-resident person;
[Alternative 1. (a) consulting, technical or management services performed by the non-resident person;]
[Alternative 2. (a) for services performed by the non-resident person if the payments are deductible in computing the income of the resident payer;]
- (b) fees for activities of an entertainment or athletic nature performed in (your country);
- (c) fees for shipping or air transportation services that involve the carriage of goods or persons that are taken on board in (your country);

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Sample Withholding Tax Provision

(d) salary, wages or other remuneration in respect of employment exercised in your country except directors' fees and remuneration of managerial officials paid by a company resident in (your country) as described in section ____;

(e) pensions except to the extent that the payment is attributable to employment services rendered by the non-resident person outside (your country) in a taxation year during which the non-resident person was not resident in (your country) at any time;

(f) . . .

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Sample Withholding Tax Provision

(2) A person resident in (your country) that pays any amount described in section (1) to a non-resident person shall withhold tax on behalf of such non-resident person at the rate of ____ percent of the gross amount paid and remit that amount to ____ within ____ days.

(3) If a person resident in (your country) fails to withhold tax as required by section (2) on an amount paid to a non-resident person, that person shall be liable, together with that non-resident person, for the tax payable by the non-resident person under section (1).

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Sample Withholding Tax Provision

(4) If a person resident in (your country) fails to withhold tax as required by section (2), that person shall not be entitled to deduct the amount paid to the non-resident person in computing the person's income subject to tax under this Act.

(5) For the purposes of section (1), if a person not resident in (your country) (referred to in this section as the "first person") pays or credits an amount to another person not resident in your country, the first person is deemed to be a person resident in (your country) to the extent that the amount paid or credited is deductible in computing the first person's income subject to tax in (your country) under this Act.

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Sample Withholding Tax Provision

(6) For the purposes of section (1), if a partnership in which a person resident in your country is a partner pays or credits an amount to a person not resident in (your country), the partnership shall be deemed to be a person resident in (your country).

(7) For purposes of section (1), if a partnership in which a non-resident person is a partner receives an amount described in section (1) that is paid or credited by a person resident in (your country), the partnership shall be deemed to be a person not resident in (your country).

(8) For purposes of section (1)(a), consulting, technical and management fees means (or includes) . . .

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Sample Employment Status Provision

- (1) For purposes of determining whether a non-resident person is an employee of another person, the existence of a legal contract of employment between the non-resident person and the other person shall not be considered conclusive; instead, the relationship between a non-resident person and the person to whom the non-resident provides services shall be determined by reference of all the relevant facts and circumstances, including especially:

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Sample Employment Status Provision

- (a) who has the responsibility or risk for the non-resident person's work;
- (b) who controls the manner in which the work is carried out by the non-resident person;
- (c) who controls the place and the time that the work is carried out by the non-resident person;
- (d) who has the right to discipline the non-resident person with respect to the work and to terminate the contractual relationship with the non-resident person; and
- (e) who bears the non-resident person's remuneration.

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Sample Provision for Directors' Fees and Remuneration of Top-Level Managers

- (1) Where a person who is not resident in (your country) is a director or a top-level managerial official of a company resident in (your country), the non-resident person shall pay tax at a rate of ___ percent of the amount of the fees or remuneration paid by the company to the person.
- (2) A company resident in (your country) that pays fees or remuneration as described in section (1) to a non-resident person who is a director or managerial official of the company shall withhold tax on behalf of such non-resident director or managerial official at the rate of _____ percent of the gross amount of such fees or remuneration and remit that amount to _____ within ___ days.

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Sample Provision for Directors' Fees and Remuneration of Top-Level Managers

- (3) If a company resident in (your country) fails to withhold tax as required by section (2), the company shall be liable, together with that non-resident person, for the tax payable by the non-resident person under section (1).
- (4) If a company resident in (your country) fails to withhold tax as required by section (2), the company shall not be entitled to deduct the amount of the fees or remuneration paid to the non-resident person.

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Sample General Anti-Base Erosion Rule

- (1) Where one of the principal purposes of a transaction or arrangement is to obtain benefits under this Act or under the provisions of an agreement between (your country) and another country for the elimination of double taxation, those benefits shall be denied unless granting those benefits in the circumstances is in accordance with the object and purpose of the provisions of this Act or the agreement, as the case might be.
- (2) Section (1) shall apply notwithstanding any provisions of an agreement for the elimination of double taxation and fiscal evasion entered into between (your country) and another country. [This provision may not be possible under the laws of some countries because of constitutional considerations.]

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NEGOTIATING TAX TREATIES TO PREVENT BASE EROSION

Negotiation of Tax Treaties to Prevent Base Erosion

- Tax treaties result from bilateral negotiations that reflect the bargaining power of the two countries and international consensus
- Deviations from the UN and OECD Models may be resisted; therefore, countries should try to adhere as closely as possible to the Models and the alternative provisions in the Commentary
- Tax treaties limit a country's domestic taxes; therefore, countries should include provisions in their treaties to allow them to apply domestic anti-base erosion rules

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Treaty and Domestic Provisions to Prevent Base Erosion

- Employment income:
 - Adopt provisions in domestic law to ensure that employment status is determined based on substance and not legal form (See Commentary on Art. 15)
 - Deny the benefits of Art. 15 in abusive cases (See Commentary on Art. 1, para. 8)
 - Include alternative provision in Commentary on Art. 15 dealing with international hiring-out of labour

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Treaty and Domestic Provisions to Prevent Base Erosion

- Directors' fees and remuneration of top-level managers
 - Ensure that your tax treaties contain Art. 16 of the UN Model
- Government Service
 - Ensure that your tax treaties contain Art. 19 of the UN Model
- Pensions
 - Ensure that your tax treaties contain Art. 18 (alternative B) of the UN Model

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Treaty and Domestic Provisions to Prevent Base Erosion

- International Shipping and Air Transportation
 - Exclude Art. 8 from your treaties or ensure that your tax treaties contain Art. 8 (alternative B) of the UN Model (but note that it is restricted to international shipping)
- Entertainment and sports activities
 - Ensure that your treaties include Art. 17(1) and (2) of the UN Model

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Treaty and Domestic Provisions to Prevent Base Erosion

- Business and independent services
 - Ensure that your treaties or your domestic law contain rules to prevent the artificial avoidance of a PE or fixed base through fragmentation of activities or the use of related entities
 - If your country wants to tax payments for services performed outside your country, your treaties must contain a provision similar to new Article 12A of the UN Model dealing with fees for technical services
 - Negotiate for lower time thresholds for services and construction in Art. 5(3)

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Treaty and Domestic Provisions to Prevent Base Erosion

- Preparatory and auxiliary activities
 - Adopt revised version of Art. 5(4)
 - Adopt new Art. 5(4.1) to prevent the fragmentations of contracts
 - Be sure to consider the impact on the attribution of profits under Art. 7
- Commissionaire and other arrangements
 - Adopt revised versions of Art. 5(5) and (6)

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Treaty and Domestic Provisions to Prevent Base Erosion

- Insurance
 - Ensure your treaties contain Art. 5(6) of the UN Model
- Construction
 - Include anti-contract splitting rule or apply general anti-abuse rules
- Fees for managerial, technical and consulting services
 - Include new Art. 12A (or an alternative in the Commentary on Art. 12A) to allow the imposition of withholding tax on such fees

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PART 4: Tax Administration Manual

- Tax administration issues in Part 4 of the Practical Portfolio on Interest and Part 4 of the Practical Portfolio on Services discussed together

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Overview

- Administration of provisions of domestic law with respect to services and interest to prevent base erosion
- Disclosure and information reporting requirements
- Audit and verification activities to prevent base erosion
- Administration of provisions of tax treaties with respect to services and interest to prevent base erosion

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Overview

- Each country's situation is unique and depends on its domestic law, tax treaties and its tax administration
- Manual is general and must be adapted to each country's needs
- Manual focuses on nonresidents because risks of base erosion are greater
- Tax administration issues are greater for net basis taxation of nonresidents than gross basis

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Disclosure and Information Reporting: Residents

- Three main sources:
 - The resident taxpayer
 - The tax authorities of other countries with which your country has tax treaties or TIEAs
 - Public information
- Information about foreign revenue and expenses, the amount of foreign tax paid
- Information about related-party interest and services
 - Can be provided in tax return or separate information return

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Disclosure and Information Reporting: Residents

- Five main sources:
 - The nonresident service provider or recipient of interest
 - A local representative or agent of the nonresident
 - Persons making payments to the nonresident
 - The tax authorities of other countries with which your country has tax treaties or TIEAs, including country-by-country reports
 - Public information
- Country must have authority under domestic law to obtain information

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Disclosure and Information Reporting: Nonresidents

- Identification of nonresident service providers from:
 - Tax returns
 - Visa requirements
 - Business registration requirements
 - Applications for taxpayer identification numbers
 - Payers
 - Public information (e.g., entertainers)
- Sometimes difficult or impossible to identify nonresident service providers; therefore, necessary to impose withholding obligation on resident payers

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Disclosure and Information Reporting: Nonresidents

- Identification of nonresidents receiving interest:
 - If taxable on a net basis, tax returns, etc.
 - If taxable on a gross basis, onus on withholding agents to identify nonresident recipients
- Often difficult or impossible to identify nonresident recipients; therefore, necessary to impose withholding or reporting obligation on payers

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Disclosure and Information Reporting: Nonresidents

- Amount of income derived
- Nonresidents should be required to provide information in tax return and to maintain financial books and records
- Payers should be required to provide information about payments to nonresidents
 - Use of prescribed forms for this purpose
- Information from foreign tax authorities

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Disclosure and Information Reporting: Nonresidents

- Related-party services and interest payments
- Necessary for the application of your country's transfer pricing rules
- Require residents or nonresidents with PE or fixed base to provide information about interest payments and payments for services to related nonresidents
 - Use prescribed form
 - If information is provided for transfer pricing purposes, ensure information is available to tax officials dealing with withholding tax

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Disclosure and Information Reporting: Nonresidents

- Related-party interest and payments for services
- Could be limited to deductible payments
- Should also apply to payments to related individual and non-corporate entities
 - Necessary for new Article 12A(7) on fees for technical services (provision similar to Arts. 11(6) and 12(6))

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Disclosure and Information Reporting: Nonresidents

- Related-party payments for services
- Information required:
 - Name and address of nonresident
 - Legal relationship between nonresident and payer
 - Date and amount of payment
 - Type of services
 - Location where services performed
 - Whether nonresident has a PE or fixed base in your country
 - Number of days nonresident or its employees spend in your country

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Disclosure and Information Reporting: Nonresidents

- Related-party interest payments
- Information required:
 - Name and address of nonresident
 - Legal relationship between nonresident and payer
 - Date and amount of payment
 - Amount and nature of debt on which interest is paid
 - Interest rate
 - Whether nonresident has a PE or fixed base in your country

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Disclosure and Information Reporting: Nonresidents

- Prescribed forms for payments of interest to nonresidents and payments for services by nonresidents
- Requirement to file a form for each payment or for payments made on a monthly, quarterly or annual basis
- Penalties for failure to file

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BEPS Transfer Documentation Requirements

- New Chapter V of OECD Transfer Pricing Guidelines
- Large multinationals required to provide “master file” with information of their global business operations and transfer pricing policies
 - Master file intended to be available to all relevant tax administrations
- “Local file” with detailed transfer pricing information available to each country

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Country-by-Country Reporting

- Large multinationals (consolidated group revenue of 750 million Euros) must file an annual report in the country of parent’s residence containing information about each jurisdiction in which the multinational group does business
- Required information includes:
 - Revenue
 - Profit before tax
 - Tax paid and accrued

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Country-by-Country Reporting

- Required information includes (*continued*):
 - Number of employees
 - Stated capital
 - Retained earnings
 - Tangible assets
 - Group entities doing business in country and nature of business
- Requires domestic legislation – Action 13 contains an implementation package with draft legislation

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Country-by-Country Reporting

- Intended to be implemented for fiscal years beginning on or after 1 January 2016
- C-by-C reports to be exchanged automatically pursuant to exchange of information provisions in bilateral treaties, the Multilateral Agreement on Mutual Assistance or TIEAs
- Information concerning related party base eroding payments of interest, royalties and services is not required
- Information on an entity by entity basis is not required

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Mandatory Disclosure Rules

- BEPS Action 12 recommends adoption of mandatory disclosure rules for aggressive tax transactions
- Intended to give tax administrations and tax policy makers to respond quickly to abusive transactions through risk assessment, audit and legislative changes
- BEPS Action 12 Final Report provides principles for designing domestic legislation for mandatory disclosure rules

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Common Reporting Standard for Exchange of Information

- See OECD, *Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard* for detailed information on CRS and a Model Competent Authority Agreement
- CRS represents a minimum standard for automatic exchanges
- Intended to promote tax transparency and allow residence countries to combat tax evasion
- Compliance monitored by Global Forum

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Common Reporting Standard for Exchange of Information

- Common standard for reporting information about investment income
- Applies to individuals and entities
- Exchanges take place through tax treaties, including Multilateral Convention on Mutual Assistance
- Confidentiality of exchanged information must be protected

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Common Reporting Standard for Exchange of Information

- Implementation of CSR requires:
 - Applicable treaty to allow exchange
 - Domestic law authorizing exchange
 - Competent authority agreement to operationalize exchanges
- OECD provides a Model Competent Authority Agreement for countries to use

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Audit and Verification

- Assumes that country taxes all income from services and interest derived by nonresidents (if country doesn't tax, audit is less necessary)
- Same audit and verification techniques that apply generally
- Requires assessment of risks of noncompliance and allocation of enforcement resources to greatest risks
- Costs of audit depend on complexity of provisions of domestic law with respect to services and interest

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Audit and Verification: Residents

- Audit and verification of residents earning income from foreign services or foreign interest is the same as for residents earning foreign source income generally
- Audit and verification of residents incurring interest expense to earn foreign source income (foreign business income or dividends) is special audit issue

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Audit and Verification: Nonresidents

- Audit and verification of nonresidents taxed on a net basis
- Usually activities can focus on books and records for the nonresident's PE or fixed base
- If nonresident is subject to interim withholding, information provided by withholding agents can be used and cross-checked against information provided in tax return
 - Withholding agents also need to be audited

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Audit and Verification: Nonresidents

- Audit and verification of nonresidents taxed on a gross final withholding basis
- Only issue is whether the correct amount was withheld
- Information filed by withholding agent can be checked against agent's books and records, tax returns, etc.
- Penalties imposed on withholding agents will usually ensure their compliance
- Special attention to related party transactions

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Audit and Verification: Nonresidents

- Compliance burden on withholding agents needs to be balanced against your country's need to enforce the tax on nonresidents effectively
- If waivers from the obligation to withhold are permitted, it will be necessary to audit the waiver program to ensure it is operating properly

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Administration of Tax Treaties to Prevent Base Erosion

- For information on the administration of tax treaties generally, see UN *Handbook on the Administration of Tax Treaties* (2013)
- Few rules in tax treaties concerning administrative issues; therefore, rules must be found in domestic law
- Developing countries should consider adoption of uniform rules, including procedural rules, for the application of tax treaties

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Administration of Tax Treaties to Prevent Base Erosion

- Determination of treaty residence
- Is nonresident service provider or recipient of interest a resident of a country with which your country has a tax treaty? Which country?
- Residence is determined under Art. 4 of the relevant treaty by reference to the law of the other country
- Certificate of residence from tax authorities of the other country

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Administration of Tax Treaties to Prevent Base Erosion

- Certificates may also be required or used for “beneficial owner” requirement in Arts. 11 and 12A
- Certificates can be formalized through mutual agreements and use of forms
- Compliance costs if certificate is required for every payment to nonresident

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Administration of Tax Treaties to Prevent Base Erosion

- Can withholding agents rely on nonresident’s address or do they have to obtain residence certificate?
 - More efficient to rely on address
 - But susceptible to abuse
 - Withholding agents are likely to withhold higher amount required by domestic law if residence certificate is necessary
- Note: some treaties may have limitation-on-benefits (anti-treaty shopping) provisions

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Administration of Tax Treaties to Prevent Base Erosion

- Dual residence situations
- Art. 4 provides tie-breaker rules to assign residence to one country
 - Note new tie-breaker rule in Art. 4(3)
- Some treaties may resolve dual residence through the mutual agreement procedure
- Dual-resident entities often used for tax avoidance purposes

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Administration of Tax Treaties to Prevent Base Erosion

- Determining the applicable provision of the treaty
- Several provisions applicable to services; therefore, necessary to determine:
 1. Whether the income is from services
 2. What type of services?
 3. In what legal capacity are the services provided? (employee or independent contractor)
- Easier for interest (usually Art. 11)

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Administration of Tax Treaties to Prevent Base Erosion

- Qualification for treaty benefits
- Are the conditions for the application of the relevant treaty provision met?
 - Is the nonresident a person?
 - Is the nonresident a resident of the country?
 - Is the nonresident the beneficial owner of the owner?
 - Does the nonresident have a PE or fixed base in the country?

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Administration of Tax Treaties to Prevent Base Erosion

- Are the conditions for the application of the relevant treaty provision met?
 - Is nonresident present in your country for minimum time?
 - Are the services performed in your country?
 - Does the interest arise in your country?
 - Does any LOB provision apply?
- Your tax authorities must determine if these requirements are satisfied

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Administration of Tax Treaties to Prevent Base Erosion

- Where nonresident is taxable under Art. 7 or 14, necessary to determine nonresident's income attributable to PE or fixed base
- Income determined on the basis of tax return and supporting books and records
- If no tax return filed, difficult to determine net income, but nonresident will likely file to get treaty benefits

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Administration of Tax Treaties to Prevent Base Erosion

- Rules for computing income are found in domestic law, subject to rules in Art. 7
- Deductions cannot be denied on basis that expenses were incurred outside country
- No deductions for amounts charged by head office to PE or by PE to head office
- If customary, determination of profits by apportionment is acceptable
- Profits must be determined consistently

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Administration of Tax Treaties to Prevent Base Erosion

- Art. 9 and transfer pricing guidelines apply to related-party transactions
- Application of transfer pricing rules is very difficult
- Countries should have robust domestic transfer pricing rules and a specialized transfer pricing unit in the tax administration

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Administration of Tax Treaties to Prevent Base Erosion

- Collection of tax
- For nonresidents taxed on a net basis
 - Interim withholding
 - Payment of tax by installments
 - Assistance in collection from other country under Art. 27

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Administration of Tax Treaties to Prevent Base Erosion

- Collection of tax
- For nonresidents taxed by final withholding tax
 - Treaties don't specify how withholding taxes should be applied
 - Limit on rate of withholding for interest
 - No limit on source country taxation of services, except fees for technical services under Art. 12A
 - Imposed on residents and nonresidents with a PE or fixed base so withholding can be enforced

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Administration of Tax Treaties to Prevent Base Erosion

- Penalties imposed on withholding agents for failure to withhold and remit
 - Interest and financial penalties
 - Joint liability for amount of tax
 - Denial of deduction if no withholding
- Some countries require withholding only for deductible payments

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Administration of Tax Treaties to Prevent Base Erosion

- Method of withholding is a matter of domestic law
 - Interim or final
 - If interim, nonresident must be allowed to file return and claim a refund
 - If final, no return and no refund
- If domestic rate is higher than treaty rate, in order to meet treaty obligations, your country must have a procedure for nonresidents to claim refund

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Administration of Tax Treaties to Prevent Base Erosion

- Withholding agents may be unwilling to risk withholding at treaty rate unless special provisions are in place
 - Possible to allow agents to apply for waiver of obligation to withhold or for permission to withhold at treaty rate
 - Some countries have statutory provision allowing withholding at treaty rate
 - Tax authorities must administer such provisions

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Administration of Tax Treaties to Prevent Base Erosion

- Balancing between the need to deliver treaty benefits efficiently and ensuring that benefits are justified
- Problems of administration are exacerbated as treaty network grows and rates of withholding tax vary
- Assistance in collection of withholding taxes under Art. 27 – however, included in few treaties

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