United Nations Practical Portfolio

Protecting the Tax Base

of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses

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Contents

Part 1
Introduction 1
1.1 Background 1
1.2 How to use the present Portfolio 5

Part 2
Tax Policy Assessment Manual 7

Chapter 1
Tax policy analysis of the provisions of a country's domestic law dealing with the deduction of interest and other financing expenses . 7
1.1 Introduction 7
1.2 Basic concepts 12
1.3 Excessive interest payments 25
1.4. Withholding taxes on interest 47
1.5 Non-residents incurring deductible interest and other financing expenses to earn domestic source income 48
1.6 Residents incurring interest and other financing expenses to earn foreign source income 52

Chapter 2
Analysis of the provisions of a country's tax treaties and model tax treaties dealing with payments of interest and the deduction of interest 63
2.1 Introduction 63
2.2 Tax treaty network. 64
2.3 The provisions of the United Nations and OECD Model Conventions dealing with payments of interest and the deduction of interest 64

Chapter 3
Information gathering for tax policy analysis 85
3.1 Introduction 85
3.2 Interest paid by residents to non-residents—withholding taxes 85
3.3 Interest and other financial equivalents paid to related non-residents 87
3.4 Deductions of interest and other similar amounts. 89

Chapter 4
Risks of base erosion with respect to interest payments and possible responses **91**

4.1 Introduction 91
4.2 Excessive interest deductions 92
4.3 Withholding taxes on interest 104
4.4 Risks of base erosion with respect to deductible interest payments by residents to earn exempt or preferentially taxed foreign source income 106
4.5. Debt push-down arrangements 111

Part 3
Designing and drafting domestic legislation and negotiation of tax treaties to prevent base erosion with respect to payments of interest . . . 117

Chapter 1
Introduction **117**

Chapter 2
The major design elements in drafting domestic legislation to counter base erosion with respect to payments of interest **119**

2.1 Disallowance of "excessive" interest expense 119
2.2 Withholding taxes on interest 126
2.3 Interest expenses incurred by residents to earn exempt or preferentially taxed income 127

Chapter 3
Sample legislative provisions with explanatory notes **131**

3.1 Introduction 131
3.2 Thin capitalization—sample legislation with explanatory notes . 131
3.3 Earnings-stripping rules—sample legislation with explanatory notes 139
3.4 Sample withholding tax provision with explanatory notes 146

Chapter 4
Negotiation of tax treaties to prevent base erosion with respect to base-eroding payments of interest and other financing expenses 153

4.1 Introduction 153
4.2 The effect of tax treaties on non-residents 155
4.3 Residents 160

Part 4
Tax Administration Manual 169

Chapter 1
Introduction 169

Chapter 2
Disclosure and information reporting requirements 173

2.1 Introduction 173

2.2 Disclosure and information reporting requirements for residents incurring interest expenses to earn income from foreign sources 173

2.3 Disclosure and information reporting requirements with respect to thin capitalization and earnings-stripping rules ... 175

2.4 Disclosure and information reporting requirements for non-residents 179

Chapter 3
Auditing and verifying interest income and interest deductions 185

3.1 Introduction 185

3.2 Auditing the taxation of residents with respect to the deduction of interest 186

3.3 Auditing the taxation of interest income earned by non-residents on a net basis 189

3.4 Provisional or final withholding taxes 189

3.5 Checklist 191

Chapter 4
Administration of tax treaty provisions to counter base-eroding payments of interest 193

4.1 Introduction 193

4.2 Identification of non-residents deriving interest income 195

4.3 Determining the country of residence of the non-resident recipient of interest in order to establish the relevant treaty ... 196

4.4 Determining the applicable provision of the treaty 200

4.5 Qualification for treaty benefits 202

4.6 Computation of income 204

4.7 Collection of tax 206

4.8 Checklist 209

Part 1
Introduction

1.1 Background

In 2012, the Organisation for Economic Co-operation and Development (OECD) began working on the problem of base erosion and profit shifting (BEPS). The work on BEPS was a natural outgrowth of the OECD work on exchange of information as a means of countering international tax avoidance and evasion. In their June 2012 meeting, the G20 finance ministers emphasized "the need to prevent base erosion and profit shifting". In February 2013, in response to the G20, the OECD issued a short report on *Addressing Base Erosion and Profit Shifting*[1] that identified several areas for action and deadlines for the implementation of those actions. On 19 July 2013, the OECD released an *Action Plan on Base Erosion and Profit Shifting*.[2] This action plan set out an ambitious agenda with 15 specific action items, some of which were completed in September 2014 and the rest in October 2015. The Final Report on BEPS was issued in November 2015.

Early in the BEPS project, the OECD recognized the importance of involving developing countries because their tax systems are probably more susceptible to BEPS than those of developed countries. In general, revenue from corporate taxes forms a larger part of the total tax revenues of developing countries than that of developed countries, and the tax authorities of developing countries generally have fewer administrative resources than developed countries to combat international tax avoidance and evasion and to prevent BEPS.

The United Nations has been active in assisting developing countries to protect their tax bases against BEPS. Some of these actions predate the OECD BEPS project. In 2013, the United Nations Committee of Experts on International Cooperation in Tax Matters

[1] Organisation for Economic Co-operation and Development (OECD), *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available from http://www.oecd.org/tax/beps-reports.htm.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available from http://www.oecd.org/ctp/BEPSActionPlan.pdf.

established a Subcommittee on Base Erosion and Profit-Shifting with a mandate to consider the implications of BEPS for developing countries and to recommend changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[3] to deal with BEPS. In addition, the Subcommittee on Transfer Pricing is engaged in work with respect to the effects of the transfer pricing aspects of BEPS on developing countries.

In early 2014, the Capacity Development Unit of the United Nations Financing for Development Office launched a project to assist developing countries in identifying the major risks of BEPS in their domestic tax laws and tax treaties. This project resulted in a book of 10 chapters dealing with six of the OECD/G20 BEPS action items (other than transfer pricing) that are considered by developing countries to be most important—hybrid entities and instruments, the avoidance of permanent establishment (PE) status, interest and other financing expenses, the digital economy, treaty abuse, and disclosure of aggressive international tax planning—and three additional chapters dealing with tax incentives, income from services and capital gains, plus an introductory overview.[4]

Part 2 of the September 2014 Report to the G20 Development Country Working Group (DWG) on the Impact of BEPS on Low Income Countries requested the OECD, the International Monetary Fund (IMF), the United Nations, the World Bank Group (WBG) and regional organizations to assess how practical toolkits can be developed to assist developing countries in implementing rules to deal with base-eroding payments. The DWG Report suggests that such a toolkit could consist of:

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[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[4] See United Nations, Department of Economic and Social Affairs, *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf (hereinafter referred to as "*Handbook on Protecting the Tax Base of Developing Countries*"). A revised version of the *Handbook*, to reflect the OECD/G20 BEPS Final Reports and to add a new chapter dealing with base-eroding payments of rent and royalties, is to be issued in mid-2017.

- An explanatory note to identify the risks of base-eroding payments
- A paper on tax policy considerations related to countermeasures to such base-eroding payments
- An analysis of the advantages and disadvantages of the various options to deal with base-eroding payments
- Model legislation and explanatory notes
- Administrative guidance and practical auditing techniques
- Training materials

In response to the recommendation of the DWG Report, the Capacity Development Unit of the Financing for Development Office of the United Nations embarked on a project to produce a series of practical portfolios to assist developing countries in protecting their domestic tax bases against BEPS. The present *Portfolio*, dealing with the deduction of interest and other financing expenses, is the second in a series of similar portfolios providing practical guidance to developing countries to assist them in combating base erosion in various forms, such as base-eroding payments involving fees for services, rents, royalties, capital gains and tax incentives.

This *Practical Portfolio* is intended for the use of tax officials from developing countries. It is intended to assist these tax officials in identifying the risks of BEPS with respect to base-eroding payments of interest, understanding the causes of such BEPS and assessing the options for countering it. The material in the present *Portfolio* is not aimed at any particular country or group of countries, but is intended for use by a wide range of developing countries with different tax systems and different levels of economic development. Therefore, the guidance provided in this *Portfolio* must be adapted to the particular needs and circumstances of each country.

This *Practical Portfolio* focuses on the tax treatment of interest and other financing expenses under a developing country's domestic law and its tax treaties from the perspective of potential BEPS; it does not provide a comprehensive examination of the tax policy aspects of the deductibility of interest and other financing expenses or the taxation of cross-border interest payments. Therefore, any decisions by a particular country about the adoption of measures to counter BEPS

with respect to cross-border interest payments should take into account many aspects that are not dealt with, or are dealt with only briefly, in this *Portfolio*. For example, some measures may be effective in countering BEPS but may have the effect of discouraging non-residents from providing financing to residents of developing countries. Further, some countermeasures may be difficult for tax officials in developing countries to administer and enforce effectively.

It is worth emphasizing that any country thinking about BEPS should first review the provisions of its domestic tax system to determine whether it is imposing tax and allowing the deduction of interest in all the situations in which the country considers that it is appropriate and feasible to do so effectively. Second, the country must review the operation of the rules of its tax system to determine whether those rules are operating as intended or whether they are allowing or facilitating BEPS. Third, if the existing rules are allowing or facilitating BEPS in certain circumstances, the country should consider what types of action it might take to prevent it.

This *Practical Portfolio* contains four parts, including this introduction. Part 2 is a Tax Policy Assessment Manual consisting of:

- An analysis of the provisions of the domestic law of developing countries dealing with the deductibility of interest and other financing expenses
- An analysis of the provisions of the tax treaties of developing countries dealing with the treatment of cross-border interest payments
- A description of the information that is necessary or desirable for the tax officials of developing countries to gather in order to formulate tax policy with respect to the deductibility of interest and other financing expenses appropriately
- The identification of the risks of BEPS with respect to the deductibility of interest and other financing expenses and the options for countering such risks, and
- A checklist of the tax policy considerations that should be taken into account by tax officials of developing countries in adopting provisions of domestic law and negotiating provisions of tax treaties dealing with interest and other financing expenses

This Tax Policy Assessment Manual does not deal with the domestic laws or tax treaties of particular countries. Instead, it deals with the basic patterns of dealing with the deductibility of interest and the treatment of cross-border interest payments that are commonly found in the domestic laws and tax treaties of many countries. Tax officials from developing countries will find it necessary to adapt the material in the Manual to the particular situation in their countries.

Part 3 of the *Portfolio* provides guidance for tax officials from developing countries in designing and drafting domestic legislation to counter BEPS and in negotiating tax treaties to counter BEPS with respect to base-eroding interest payments. Part 4 is a Tax Administration Manual, which provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with interest.

1.2 How to use the present Portfolio

Tax officials from developing countries can use this *Practical Portfolio* in a variety of ways. First, it can be used to obtain a general understanding of the tax treatment of cross-border interest and other financing expenses under domestic law and tax treaties. If this is the goal, part 2, chapter 2 (Analysis of the provisions of a country's tax treaties and model tax treaties dealing with payments of interest and the deduction of interest) and chapter 3 (Information gathering for tax policy analysis), should be the principal focus. Second, the *Portfolio* can be used as a guide for analysing the provisions of a country's domestic law and tax treaties dealing with cross-border interest and other financing expenses. In this case, chapters 2 and 3 should be read carefully with a view to comparing the rules of a particular country with the general patterns of taxation of cross-border interest that are commonly used worldwide, and comparing the provisions of the country's tax treaties dealing with interest with the equivalent provisions of the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital (OECD Model Convention).[5] Third, the *Portfolio* can be used to investigate the treatment of a particular type

[5] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

of cross-border interest payment. The table of contents will be useful for this purpose in directing readers to the relevant sections of parts 2, 3 and 4 dealing with that type of payment. Fourth, tax officials with a good understanding of a country's rules and tax treaties for dealing with cross-border interest can focus primarily on part 2, chapter 4, dealing with the risks of base erosion.

Part 2

Tax Policy Assessment Manual

Chapter 1

Tax policy analysis of the provisions of a country's domestic law dealing with the deduction of interest and other financing expenses

1.1 Introduction

Base erosion with respect to payments of interest and other financing expenses often focuses on thin capitalization and earnings-stripping rules. These rules target the payment of excessive interest by resident entities; they often focus narrowly on interest paid to non-residents, or even more narrowly on interest paid to related non-residents, the latter posing the most serious risks of base erosion. However, a country's tax base may be eroded by payments of interest and other similar amounts in many other ways. The present *Portfolio* takes a comprehensive approach to the examination of base-eroding payments of interest and other similar amounts. It provides a framework to identify all the circumstances in which interest payments erode a country's tax base; it evaluates the seriousness of the risks of base erosion in those circumstances; and it outlines the possible responses that developing countries might consider adopting in order to prevent base erosion.

Developing countries are usually confronted with the difficult task of balancing two competing objectives: the need to attract investment from non-residents and the need to protect the tax base. Although all interest deductions erode a country's tax base, denying the deduction of all interest payments to non-residents is probably too drastic an approach. Debt financing is commercially necessary and the deduction of interest is appropriate in most circumstances as a legitimate cost of earning income. However, in some circumstances, developing countries may be justified in considering interest deductions to be inappropriate. This *Portfolio* is intended to provide guidance to developing countries in identifying the circumstances in which base

erosion through interest payments is inappropriate and the possible responses to such base erosion.

The framework of analysis used in the *Portfolio* is based on the residence of the payers and recipients of interest payments and the consequences of the tax treatment of those payments. There are four possibilities with respect to the residence of the payers and recipients of interest:

(a) A resident of a country pays deductible interest to another resident of the same country;

(b) A resident of a country pays deductible interest to a non-resident;

(c) A non-resident pays interest that is deductible against a country's tax base to a resident of that country; and

(d) A non-resident pays interest that is deductible against a country's tax base to another non-resident.

In general, interest paid by a non-resident is deductible against another country's tax base only if the non-resident is carrying on business in that country and is subject to tax on a net basis.

With respect to the tax treatment of interest payments, base erosion occurs only where either the payments are deductible or are not taxable, or both. Where interest payments are not deductible against a country's tax base, erosion of that country's tax base occurs only if the interest payments are not subject to tax by that country. For example, if an individual borrows from a non-resident and uses the borrowed funds for personal purposes, the interest is unlikely to be deductible. Therefore, the only issue is whether the non-resident lender is subject to tax on the interest received by the country in which the payer is resident. It may be questionable whether such a situation should be considered to constitute base erosion. Even if it is considered to be base erosion, it is much less serious than the base erosion that results from interest deductions, and therefore it is not discussed further in this *Portfolio*.

Thus, the focus of the present *Portfolio* is on deductible interest payments resulting in base erosion in the following situations where:

(a) The deductions are excessive for some reason;

(b) The interest payments are not taxable or are taxable at a reduced rate (by the country in which the payer is resident or carrying on business)[1] in the hands of the recipient;

(c) Any income earned from the use of the funds on which the interest is paid is not subject to tax or is taxed at a preferential rate (by the country in which the payer is resident or carrying on business); or

(d) Any combination of the preceding three situations.

Although all deductions, including interest deductions, reduce a country's tax base, it should be recognized that most interest payments represent legitimate expenses incurred for the purpose of earning income. Where interest payments are reasonable, are subject to withholding tax, and the income earned by the borrower from the use of the borrowed funds is subject to tax, the deductions claimed for the interest payments should not be considered to give rise to improper base erosion. However, where the interest payments are excessive or are exempt from, or subject to, reduced withholding tax, or the related income is not subject to tax or subject to preferential tax, a country's tax base is improperly eroded and countermeasures to prevent such base erosion may be appropriate. The base erosion is clearly most serious where all three base-eroding effects occur: the interest payments are excessive, the interest payments are not subject to withholding tax and any related income is not subject to tax.

Table 1 below shows the risks of base erosion in the various circumstances involving resident and non-resident payers and resident

[1] From the perspective of the country that allows the deduction of interest, base erosion occurs irrespective of whether or not the interest received is subject to tax by the country in which the recipient of the interest is resident. From a global perspective, however, if interest is deductible in one country but taxable in another country at the same rate, there is no base erosion. The present *Portfolio* does not deal with the treatment of interest in the country in which the recipient of the interest is resident. Hybrid financial instruments present especially difficult issues where two countries allow deductions for the same payment, or one country allows a deduction for a payment but the country in which the recipient of the payment is resident does not impose tax on the payment. See section 1.2.2 for a brief discussion of hybrid financial instruments and hybrid entities.

and non-resident recipients, and provides references to the section of chapter 1 where each particular type of base erosion is discussed.

Table 1
Risks of cross-border base erosion as a result of deductible interest payments

Risks of base erosion	Reference
Deductible interest paid by residents to non-residents	▪ Restrictions on deduction of interest (thin capitalization or earnings-stripping rules)—section 1.3 ▪ Withholding tax—section 1.4
Deductible interest paid by non-residents to non-residents	▪ Restrictions on deduction of interest (thin capitalization or earnings-stripping rules)—section 1.3 ▪ Withholding tax—section 1.4
Deductible interest paid by residents to residents or non-residents to earn foreign source income that is exempt from taxes	▪ Sections 1.6.2 and 1.6.4.2

Some general observations may be made on the basis of table 1:

(a) Where interest is paid by a resident or a non-resident of a country to a resident of that country, base erosion occurs if the related income is not taxed by the country or is subject to preferential tax.

(b) Where interest is paid by a resident or a non-resident of a country to a non-resident, base erosion always occurs, but may be exacerbated if the related income is not taxed by the country or is subject to preferential tax.

(c) Where interest is paid by residents of a country or by non-residents carrying on business in that country to non-residents of the country, an additional base-erosion concern arises related to withholding tax on the interest. The interest paid is usually deductible by the payer against the country's tax base. Withholding tax on the interest serves to offset the effect of the deduction of the interest, but may not offset that effect completely, especially where

the interest is exempt from withholding tax or is subject to a reduced rate of withholding tax pursuant to a tax treaty.

(d) In all cases, there is a risk that excessive amounts of interest (measured by reference to some financial ratio such as debt/equity or interest/earnings) may be deductible against a country's tax base. As mentioned below, this risk is most serious where the payer and recipient are related.

(e) The risks of base erosion are exacerbated where interest is paid by a resident to a related non-resident or by a non-resident to a related resident. Where the payer and recipient of interest are related, the amount of debt or the interest rate charged may be in excess of the amount of debt or the interest rate of parties dealing at arm's length. One obvious response to this type of base erosion is the application of transfer pricing rules. However, transfer pricing rules are not dealt with in detail in this *Portfolio*.

Although this *Portfolio* deals exclusively with cross-border base erosion through interest payments, such base erosion may also occur in an exclusively domestic situation where there is no cross-border element. For example, where a resident entity makes deductible interest payments to a domestic tax-exempt entity, there is no domestic tax on the recipient of the interest to offset the reduction in the country's tax base as a result of the deduction of the interest payments. The effect of the base erosion in this situation is the same as the effect of the base erosion that occurs where a resident entity pays deductible interest to a non-resident that is exempt from residence country withholding tax; however, this type of base erosion is not discussed in this *Portfolio*.

This chapter begins with a discussion of five basic issues concerning the tax treatment of interest payments. These concepts — the definition of interest, hybrid financial instruments, the methods of allocating interest expenses to income, related-party interest and back-to-back financing arrangements — permeate the discussion throughout this *Portfolio* of base erosion caused by interest payments. The chapter then provides an analysis of the tax policy considerations in the three situations involving base-eroding interest payments identified above: excessive interest deductions, withholding taxes on interest payments, and deductible interest used to earn exempt or preferentially taxed income.

1.2 Basic concepts

1.2.1 The definition of interest and other financing expenses

In analysing the potential base-erosion risks that arise in connection with payments of interest, the threshold question, of course, is how to define a payment that qualifies as "interest" for tax purposes. This is not a simple question.

Interest is generally understood to be compensation for the use of money or a payment associated with a debt obligation. (By contrast, dividends—which are generally not tax deductible—are payments associated with equity investments in corporate entities.) Intuitively, taxpayers and tax administrators generally know what is meant by the terms "debt" and "equity":

- A debt instrument, classically a loan (from a bank, for instance) or a bond (issued by a Government or corporate borrower), entitles the holder to receive a fixed, periodic return, typically called interest. The holder does not have an ownership interest in the borrower, so the holder does not share in profits of the borrower. But, for the same reason, the holder ranks ahead of the owners of the borrower in the event of a default or bankruptcy.
- Equity, in whatever form issued, represents an ownership interest in the underlying entity and an entitlement to share in the profits of that entity.

For business taxpayers, interest payments are generally considered to be ordinary expenses of earning income that are deductible in determining net income subject to tax. Interest payments are normally treated as income to the recipient in determining the recipient's income subject to tax.

On the other hand, payments with respect to equity are typically not deductible by the payer, since the payments represent an after-tax return on a capital investment (a distribution of profits after they have been earned). The tax treatment of equity payments (which often take the form of dividends in the case of investments in the shares of corporations) in the hands of the recipient depends on the tax system applicable to the recipient; in some cases, the payment may be fully taxable in the recipient's home country, but in other cases, the payment may

be partially or wholly exempt. The country from which the dividend is paid may levy a withholding tax on the dividend, representing a tax on the shareholder.

In addition to the fundamental difference between debt and equity — interest is deductible; dividends are not deductible — there are usually other differences in the tax treatment of debt and equity. For example, repayments of debt are not usually taxable until the principal amount has been fully recovered, whereas partial dispositions of equity capital are usually taxable on a pro rata basis. Moreover, any repayment of debt is usually treated as a tax-free return of capital, whereas the tax-free return of share capital is often limited to certain specific types of corporate transactions. Tax-deferred rollovers are often allowed with respect to several types of transactions involving shares of a corporation, whereas rollovers for transactions involving debt are generally more limited.

The treatment of a payment as "interest" should depend not on the label assigned to the payment, but rather on the character of the instrument or obligation on which the payment is made. This is most evident in the case of hybrid instruments, discussed in section 1.2.2 below. A useful discussion of the differences between debt and equity is provided in chapter 2 of the OECD/G20 *Action 4: 2015 Final Report: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* (hereinafter referred to as "BEPS Action 4 Final Report").[2]

In a wholly domestic context, where the party providing funding (the lender or creditor) and the recipient of the funding (the borrower or debtor) are in the same country or tax jurisdiction, the decision as to whether an instrument is debt (and therefore gives rise to deductible interest) or equity may be less important than in a cross-border context. Whatever tax characterization is assigned to the instrument applies to both parties to the transaction, and both parties are usually subject to tax in the same jurisdiction. However, where the party providing the funding and the party receiving the funding are in different countries or jurisdictions, the potential for base erosion can — indeed, will — arise if the instrument is characterized differently by the two jurisdictions.

[2] Available from http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm.

Any rules with respect to the taxation of interest or the deduction of interest expenses should in principle apply to both interest and payments that are economically equivalent to interest; otherwise, taxpayers may be able to avoid the rules with respect to interest by using alternative payments. The extension of rules with respect to interest to all payments that are economically equivalent to interest represents an economic-substance approach; this approach may be inconsistent with the reliance on the legal form of instruments and transactions that is typical in many countries. However, even countries that rely on legal form should carefully consider a broader economic-substance approach for dealing with restrictions on the deduction of interest.

According to chapter 2 of the BEPS Action 4 Final Report, payments that are economically equivalent to interest should generally include any payments that are linked to a financing and are determined by reference to a percentage of the actual or notional amount of principal. The BEPS Action 4 Final Report gives the following list of payments that should be treated as interest:

- Original issue discounts
- Islamic finance arrangements
- Payments under financial leases (but not operating leases)
- Payments under participating debt arrangements
- Foreign exchange gains and losses connected with financing, other than those arising from hedging arrangements, and
- Notional amounts under derivative instruments

In addition, arrangement fees and guarantee fees with respect to financing should also be subject to the same restrictions as interest.

For the purposes of this *Portfolio*, any references to "interest" should be read as including payments that are economically equivalent to interest.

1.2.2 Hybrid financial instruments

In simple terms, a hybrid instrument is a legal contract that is treated as a debt instrument in one country (say, the country of the borrower) and as an equity instrument in another country (say, the country of the lender). The following example illustrates the concept of a hybrid instrument.

Example 1

B Corporation, resident in Country B, wants to obtain 1,000 for use in its business. It issues an instrument called a "bond" with the following characteristics:

- The bond has a 100-year term.
- The holder of the bond (the lender advancing the funds) will receive a 4 per cent return on the investment during the life of the bond; at maturity, the amount of the investment will be returned to the holder.
- The holder of the bond has no rights to a vote on the management of B Corporation's business unless the interest is not paid for a period of two years. In the event of non-payment for two years, the holder of the bond acquires voting rights at a pre-established ratio.

It is possible, of course, for this instrument to have many additional characteristics, some of which may be debt-like; and others—which may be equity-like.

B Corporation issues the bond to A Corporation, resident in Country A, in consideration for a payment by A Corporation of 1,000. (A Corporation and B Corporation may be related or unrelated.) Country B considers the instrument to be a bond and the payments to be interest, which is deductible in computing B Corporation's income subject to Country B tax. Country B reaches this conclusion on the grounds that the instrument is called a bond, the annual payments are fixed in amount and do not vary with the profits of B Corporation, and at maturity the holder of the instrument receives only the return of the amount of the original investment. Therefore, the annual interest of 40 paid by B Corporation to A Corporation is tax-deductible in Country B in computing B Corporation's taxable income.

By contrast, Country A considers the instrument to be equity and the payments received by A Corporation from B Corporation to be dividends. Country A concludes that the instrument is equity on the grounds that the bond has a 100-year duration (which makes it a long-term investment) and, in the event of default in the payments, the holder acquires significant voting rights. Because the annual payment of 40 from B Corporation to A Corporation relates to an equity investment, Country A may give A Corporation favourable tax treatment with respect to the dividends in the form of a partial or full exemption.

This transaction can be viewed as base erosion or profit shifting because the payment by B Corporation is tax deductible in Country B, while the

payment receives favourable tax treatment in Country A. Thus, the tax base of Country B is eroded by the deduction of what Country B views as payments of interest, and the profits of B Corporation (to the extent of the interest payments) are effectively shifted from Country B to Country A, where they may be taxed more favourably or not taxed at all.

The challenges of properly characterizing an instrument as debt or equity, and therefore knowing the appropriate tax treatment of payments associated with the instrument, are daunting. Sometimes a hybrid financial instrument may be designed with a combination of debt and equity features primarily for commercial rather than tax reasons. Nonetheless, the many variations of financing instruments give rise to challenging issues of tax administration.

Here is a short list of hybrid financial instruments that are frequently encountered:

- **Preferred shares** are investments that are generally treated for tax and commercial purposes as equity, but which have certain debt-like qualities. For instance, preferred shares may have a fixed dividend and little or no opportunity to benefit from appreciation in the value of the business enterprise (that is, they do not share in the profits of the enterprise beyond the fixed dividend). Voting rights are generally more limited than the voting rights accorded to the holders of common shares. In return, owners of preferred shares have a higher priority in the event of a bankruptcy than the owners of common shares.
- **Convertible debt** instruments are generally treated for tax and commercial purposes as debt, but can be converted to equity by the holder if certain conditions are met. (In some situations, the holder of the debt can be forced to convert the instrument into equity.) Although payments in connection with convertible debt are generally treated as interest, this characterization may be challenged if all the conditions for conversion to equity are met but the holder has elected not to convert.
- **Derivative instruments** are instruments that "derive" their value from the prices and yields of other instruments, which are often publicly traded. They are particularly challenging for tax purposes, because some derivatives are widely available and

have well-established characteristics, while others are "bespoke" and designed for a single holder.

The Organisation for Economic Co-operation and Development (OECD) has recognized the many challenges raised by hybrid financial instruments in connection with its BEPS project. The issues are discussed in the OECD/G20 *BEPS Action 2: Final Report: Neutralising the Effects of Hybrid Mismatch Arrangements*.[3,4] Combating potential base erosion in connection with these instruments can be challenging because of the need for both technical expertise and bilateral and multilateral cooperation to deal with hybrid arrangements effectively. For most countries, it is likely to be sufficient to protect the tax base through more blunt, but administrable, approaches as discussed in the present *Portfolio*. Furthermore, and importantly, the country in which interest expense arises is entitled to apply its laws as described in this *Portfolio* in such a manner as to disallow deductions for interest where those payments erode the country's tax base. For this reason, hybrid financial instruments are not given any special treatment in this *Portfolio*.

1.2.3 Allocating interest expenses (or debt) to income (or assets)

Unless all interest is deductible or no interest is deductible, it is necessary for a country to have rules establishing the conditions for the deduction of interest. These rules may be the same as the rules for the deduction of expenses generally, or they may be special rules for interest. In many countries, expenses, including interest, are deductible if they are incurred for the purpose of earning income that is subject to tax. In general, interest expenses are not deductible if they are incurred to earn income that is exempt from tax or are not incurred for the

[3] Available from http://www.oecd.org/tax/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm.

[4] For a discussion of BEPS Action 2 and hybrids generally, see Peter A. Harris, "Neutralizing effects of hybrid mismatch arrangements", in *Handbook on Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), chapter V, 187–273, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

purpose of earning taxable income (for example, interest expenses incurred for personal reasons). Thus, it is usually necessary to determine when interest expense is incurred to earn taxable income.

There are three basic methods for determining whether interest expenses are incurred to earn taxable income:

- Tracing
- Ordering rules
- Apportionment

The particular method or methods used by a country may be established in the tax legislation, in the administrative practices of the tax authorities, in court cases or in a combination of these methods. In practice, most countries use a combination of these methods.

Under tracing rules, the use of borrowed funds is physically traced or tracked in order to determine whether the funds are used for a qualifying (income-earning) or non-qualifying (non-income earning) purpose. Thus, for example, if borrowed funds are used to acquire a rental property, interest on the funds is deductible assuming that the rent derived from the property is taxable. If the rental property is sold and the proceeds of sale are used to acquire a non-income earning property (for example, a personal residence that the taxpayer occupies), the interest will cease to be deductible because the property is no longer used to earn income. This example illustrates that, under a tracing approach, interest deductibility may change if the use of property acquired with borrowed funds changes.

Under an ordering approach, an assumption is made about the use of borrowed funds (debt) and savings (equity); the actual use (tracing) of the funds is irrelevant. The assumption can be either that any borrowed funds are used first for qualifying income-earning purposes (positive ordering) or that savings are used first for income-earning purposes (negative ordering). The results under a positive ordering approach are equivalent to a tracing approach, under which all taxpayers plan their affairs perfectly to maximize their interest deductions (in other words, taxpayers always use the borrowed funds for income-earning purposes to the maximum extent possible and always use their savings for non-income earning purposes to the maximum extent possible).

Under an apportionment approach, interest expenses or debt is allocated to assets or gross income on the basis of a formula. The assumption underlying an apportionment method is that money is fungible, so that all sources of funds (and, in particular, debt) support or finance all the taxpayer's uses of funds (that is, assets or activities) proportionately. Under an apportionment method, the actual use of debt and savings is irrelevant, just as it is under ordering rules.

The basic operation of tracing, ordering and apportionment rules to determine the use of borrowed funds is illustrated in the following example.

Example 2

X owns an income-producing asset that costs 1,000. X borrows 1,500 at 10 per cent annually and uses it in part to buy a personal-use asset, such as an automobile. X incurs 150 in interest expense each year.

Under a tracing approach, X would not be allowed to deduct any interest expense because the borrowed funds are not used for an income-earning purpose (assuming that the automobile is used exclusively for personal purposes).

Under a positive ordering approach, X would be allowed to deduct interest of 100 because X would be considered to have used the borrowed funds (to the extent of 1,000) to acquire the income-producing asset. The balance of the borrowed funds (500) would be considered to have been used to acquire the personal-use asset (the automobile) and the interest on that amount would not be deductible. The savings of X, represented by the cost of the income-producing asset, would be considered to have been used to the extent of 500 to acquire the automobile and to the extent of 500 to acquire the income-producing asset.

Under a negative ordering approach, X would not be allowed to deduct any interest because X would be considered to have used all the borrowed funds to acquire the personal-use asset. Thus, based on these facts, a negative ordering rule produces the same result as tracing.

Under an apportionment approach, X would be entitled to deduct interest of 60, which is the amount of interest at 10 per cent on debt of 600 that is allocated to the income-earning assets of X. The amount of the total debt of X allocated to income-earning assets is calculated as 1,000/2,500 × 1,500 = 600 (income earning assets/total assets × debt). Of the total debt of 1,500, 900 would be allocated to the non-income earning assets,

calculated as 1,500/2,500 × 1500 = 900. Thus, 90 of interest (10 per cent of 900) would not be deductible.

Summary

Debt with interest at 10 per cent used to acquire a non-income earning asset	1,500
Cost of non-income earning assets	1,500
Cost of income-earning assets	1,000
Cost of total assets	2,500

	Tracing	Positive ordering	Negative ordering	Apportionment
Deductible interest	0	100	0	60
Non-deductible interest	150	50	150	90

As illustrated by the example, the three different methods produce significantly different results. Tracing is probably the method that is most commonly used by countries, perhaps because it is the method that is applicable to the deduction of expenses generally. However, the tracing approach is subject to manipulation by taxpayers. Wealthy individuals and corporations often have significant amounts of savings or equity and can arrange their affairs so that such savings or equity are used to finance non-income earning assets and activities and debt is used to finance income-earning assets and activities.

An important feature of the tracing method is that in certain circumstances, tracing is impossible. In these circumstances, interest may not be deductible because usually the onus is on the taxpayer to prove that the funds have been used for the purpose of earning income. Alternatively, where tracing is impossible, a country's tax rules may require a change from tracing to a different method. For example, if a taxpayer borrows 100 and deposits the funds in a bank account that contains 50 of savings, the borrowed funds are commingled with the savings. As a result, if the taxpayer withdraws 75 from the bank account and uses it for an income-earning purpose, it is impossible to know if, or the extent to which, the funds withdrawn came from the borrowed funds or the savings. Therefore, a country might adopt a rule that disallows the deduction of interest if borrowed funds and other

funds are commingled. Such a rule would place the onus on taxpayers to avoid comingling funds where such commingling would result in the denial of interest deductions. Alternatively, a country might switch from tracing to a positive ordering rule or to an apportionment approach where tracing is impossible. Thus, based on the facts of this example, if apportionment is used, interest on two thirds of the funds withdrawn from the bank account

$$\frac{75 \times 100 \text{ (borrowed funds)}}{150 \text{ (total funds)}} = 50$$

would be deductible and interest on one third of the funds

$$\frac{75 \times 50 \text{ (savings)}}{150 \text{ (total funds)}} = 25$$

would not be deductible. If a positive ordering approach were used, interest on 75 would be deductible, on the assumption that the borrowed funds in the bank account are used first (to the extent of 100) for qualifying income-earning purposes.

It is not necessary for all of a taxpayer's debt and interest expense to be considered the same for the purposes of determining whether the interest is deductible or the deduction of the interest is subject to restrictions. Interest expense arises from many different business needs, such as the need for initial capital to start the business, for debt incurred for a specific purpose, such as a mortgage to purchase real estate or a loan associated with the purchase of capital equipment, or for funds for ongoing operations. It is often said that "money is fungible", which may suggest that all interest expense should be subject to the same rules, but that is not the only possible approach. Countries may conclude that certain kinds of interest expense are less susceptible to abuse and therefore should be subject to fewer restrictions on deductibility; for instance, borrowing for initial capital to form a company may be subject to more scrutiny than borrowing to purchase real property or capital equipment.

1.2.4 Interest paid to related persons

Special problems may arise where a person pays interest to a related non-resident person. Individuals are generally considered to be related

if there is a close personal connection between them — for example, if they are spouses or one is the child or grandchild of the other. In the corporate context, a corporation is generally related to or associated with another corporation where one controls the other or both are controlled by the same person. Domestic laws of countries may vary considerably with respect to the scope of persons who are considered to be related for tax purposes.

Where interest is paid by a resident of one country to a related person resident in another country, the potential for tax avoidance and base erosion is increased. First, transfer pricing is a serious concern if the rate of interest charged is unreasonably high or low, or if the amount of debt on which the interest is paid is unreasonably high or low. For example, consider a company resident in Country A that borrows 1,000 from a related company resident in Country B at an interest rate of 15 per cent. Assume that the company could borrow the same amount on the same terms from an arm's length lender at an interest rate of 10 per cent. In this example, if Country A allows a deduction for the full 15 per cent interest paid, or 150, its corporate tax base will be reduced by that amount. However, if the company had paid an arm's length rate of interest, the tax base of Country A would be reduced by only 100. Assuming that Country A imposes corporate tax at a rate of 30 per cent, the tax of Country A has been reduced inappropriately by 15. This type of arrangement is advantageous to taxpayers only if the tax imposed by Country B on the recipient of the interest is less than the tax saving in Country A and if any withholding tax imposed on the interest payment by Country A is less than the reduction in the corporation tax of Country A as a result of the deduction of the interest. Country B may impose little or no tax on the interest if it is a tax haven or if it treats the interest as an exempt dividend (see the discussion of hybrid instruments in section 1.2.2 above).

With respect to the relationship between a country's income tax and withholding taxes on interest, assume, for example, that Country A imposes withholding tax on interest at a rate of 30 per cent. In this case, the reduction in the corporation tax of Country A as a result of the excessive interest paid (15) would be offset by the additional withholding tax collected on the 50 of excessive interest paid. However, if Country A imposes withholding tax at a lower rate or if its withholding tax is limited by an applicable tax treaty (to 10 per cent, for

example), the tax base of Country A would be eroded by a net amount of 10 (15 less withholding tax of 5).

As the preceding example illustrates, countries need robust transfer pricing or equivalent rules to ensure that the deduction of interest paid by residents to related non-residents is limited to an arm's length amount.

Transfer pricing is also a serious concern if the amount of debt is excessive compared to the amount of debt that a company dealing at arm's length with its lenders would have been able to borrow. Many countries have thin capitalization rules or earnings-stripping rules to deal with the problem of excessive debt (see sections 1.3.2 and 1.3.3 below). In some cases, these rules focus especially on non-arm's length debt, but in other cases they treat related-party debt and arm's length debt similarly. The fundamental problem with related-party debt is that a controlling shareholder of a corporation may be indifferent from a commercial perspective to whether the return on its investment is received in the form of interest or dividends. However, for tax purposes, since interest is deductible but dividends are not deductible, it may be advantageous for controlling shareholders to fund their subsidiaries disproportionately with debt rather than equity.

Example 3

Parentco is resident in Country P and is the parent company of a multinational group of companies operating worldwide. Parentco has established Finco, a wholly owned finance subsidiary in Country S, which provides funding to all the group's operating companies as necessary. Country S is a low-tax country that has a large network of tax treaties, under which withholding taxes on cross-border interest payments have been reduced to 5 per cent or eliminated entirely. Parentco owns all of the shares of Opco, an operating subsidiary resident in Country O. Parentco's initial equity investment in Opco was a nominal amount of 10. Finco provides loans to Opco of 500 at an arm's length interest rate of 10 per cent. Assume that Country O and Country S impose corporate tax at rates of 40 per cent and 10 per cent, respectively.

Opco will claim a deduction for interest paid to Finco of 50, which will result in the reduction of tax payable to Country O of 20. Under the tax treaty between Country O and Country S, the withholding tax levied by Country O on the interest payments to Finco cannot exceed 5. Therefore,

the tax base of Country O is eroded to the extent of a net amount of 15. Although the interest rate charged by Finco on the loans to Opco does not exceed an arm's length rate, Finco has more debt than arm's length lenders would have been willing to lend it. Opco's debt/equity ratio of 50:1 is possible only because the debt is provided by a related entity (Finco), and is motivated by tax avoidance considerations. Therefore, Country O should have measures to protect its tax base from the deduction of interest on related-party debt in excess of an arm's length amount.

1.2.5 Back-to-back financing arrangements

Withholding taxes on interest may be imposed only on payments of interest to certain non-residents—for example, payments to non-residents with whom the payer does not deal at arm's length. Similarly, restrictions on the deduction of interest may be imposed only on interest payments to certain non-residents—for example, controlling or substantial shareholders of a resident company. At the same time, the benefits of reduced withholding tax under a tax treaty typically apply only if the recipient is the beneficial owner of the interest. In all these cases, it is necessary to determine the identity of the recipient of interest payments, and, as a result, taxpayers have opportunities to avoid the rules through back-to-back arrangements.

Example 4

ACo, a resident of Country A, lends 1,000 to its wholly owned subsidiary BCo, a resident of Country B. BCo, in turn, lends 1,000 on the same day to a related corporation, CCo, a resident of Country C. Should the loan to CCo be treated as a loan from BCo (the nominal lender), or as a loan from ACo (the original source of the funds)?

This issue is important under treaties (as discussed in chapter 2, section 2.3.1.2, and chapter 4, section 4.3, below) and may also be important under domestic law. In the case of treaties, identifying the lender is essential for determining whether the lender is the beneficial owner of the interest and entitled to treaty benefits, and possibly a reduced withholding tax. Under domestic law, proper identification of the lender can be important for information reporting purposes as well as for withholding tax and the application of any restrictions

on the deduction of interest, such as thin capitalization rules or earnings-stripping rules.

The difficulty in identifying the correct lender in the case of back-to-back arrangements is even more challenging when the intermediary, such as a financial institution, is not related to the other parties. For instance, assume that, based on the facts of the previous example, ACo makes a deposit of 1,000 in a bank resident in Country B. That same bank then lends 1,000 to CCo. Should the loan to CCo be treated by Country C as a loan by ACo?

This question may be easy to answer based on the simple facts above, especially if, for example, interest paid directly from CCo to ACo were subject to a 25 per cent withholding tax but interest payments to arm's length financial institutions are exempt from withholding tax. However, in other situations the question may be difficult to determine. For example, what if the amounts or terms of the loans or the currency in which the funds are denominated are not the same? In general, the issue depends on factors such as the amounts of the two transactions, how closely related they are in time, and the terms of the two transactions, including the interest rates. If the first transaction is conditional on the ultimate loan or indebtedness, that will likely be a clear indication that the two transactions form a back-to-back arrangement.

Back-to-back arrangements may be structured in a wide variety of ways. Countries should ensure that they have effective anti-avoidance rules to prevent the use of back-to-back financing arrangements to avoid various rules dealing with interest deductions and withholding taxes on interest, or to obtain treaty benefits improperly.

1.3 Excessive interest payments

1.3.1 Introduction

As noted in the introduction to this chapter, the most serious risks of base erosion through interest payments probably involve excessive payments of interest by resident entities to related non-residents. For example, a parent corporation in Country X lends money to a subsidiary corporation resident in Country Y. The subsidiary is a separate legal entity from its parent corporation and shareholder. The issues

that arise in this context are whether the interest rate on the debt is excessive, whether the amount of the debt is excessive, or, more generally, whether the amount of interest expense claimed by the subsidiary against the tax base of Country Y is excessive. The difficult tax policy issue in all these situations is how to measure whether the interest rate, the amount of debt, or the amount of deductible interest is excessive.

Countries use a wide variety of approaches to limit the deduction of excessive interest. Some countries have legislative or judicial rules that may be applied to characterize excessive debt of an entity as equity and to disallow the deduction of any interest on the excessive debt. Many countries apply transfer pricing rules to determine whether related-party interest is excessive. Under this approach, "excessive" means in excess of an arm's length amount of interest or debt.[5] Other countries may use general anti-abuse rules to police excessive interest deductions on a case-by-case basis. However, many countries use thin capitalization rules or earnings-stripping rules to prevent the deduction of excessive interest. The next two sections, 1.3.2 and 1.3.3, provide a tax policy analysis of thin capitalization rules and earnings-stripping rules, respectively. In section 1.3.4, the best practices recommended by the BEPS Action 4 Final Report are described briefly.[6]

It is important to note that tax laws in a country generally do not—indeed, cannot—forbid an enterprise from having an excessive level of debt, regardless of how that limit may be defined. Rather, government agencies may impose (and measure whether an enterprise exceeds) acceptable levels of debt. Tax rules, however, frequently limit the amount of interest that may be deducted by an enterprise in determining its taxable income. These limitations are valuable because they backstop and help enforce non-tax rules that restrict excessive levels of debt. Moreover, these limitations prevent taxpayers from incurring so much debt that the relevant tax base is eroded.

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[5] See generally United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

[6] See also Peter Barnes, "Limiting interest deductions", in *Handbook on Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015) chapter IV, 155–186, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

The problem of excessive interest applies both to interest expenses incurred by resident entities and by non-residents and to interest paid to residents and non-residents. However, the most serious base erosion occurs where resident entities pay excessive interest to non-residents, and this aspect of the problem is often the target of thin capitalization and earnings-stripping rules, discussed in sections 1.3.2 and 1.3.3 below. The deduction of excessive interest expenses by non-residents is also discussed in those sections and in section 1.5.3 below.

"Thin capitalization" is the term usually used to describe the situation in which a taxpayer is determined to have incurred excessive debt and therefore excessive interest expenses. In most cases, tax rules regarding thin capitalization focus on the debt owed and the interest paid by resident entities to non-residents. Since the global financial crisis in 2008, however, non-tax regulators have increasingly focused on thin capitalization without regard to whether the debt is owed to residents or non-residents.

The term "earnings-stripping" is used to indicate that a taxpayer has incurred excessive interest expense relative to the taxpayer's earnings. The two terms—thin capitalization and earnings-stripping—describe the two primary ways in which tax authorities seek to measure whether interest is excessive:

- The debt/equity ratio of the enterprise: If a taxpayer has too much debt relative to its equity, the deduction of the interest on the excessive debt is usually denied.
- Interest paid in excess of a prescribed financial ratio (such as a percentage of pre-tax profit): If the interest paid by an entity exceeds a specified percentage of its earnings, the deduction of the excess interest is usually denied.

Each country must consider which approach to limiting interest expense is reasonable and administrable in its particular circumstances.

1.3.2 Thin capitalization rules

1.3.2.1 Entities covered

One of the first issues to be decided in designing thin capitalization rules is the scope of the rules in terms of the taxpayers to which the

rules apply. In theory, the rules should potentially apply to all entities, resident and non-resident, that are entitled to deduct interest in computing income subject to a particular country's tax. However, no country applies such comprehensive thin capitalization rules.

Most countries view the problem of excessive interest as a transfer pricing issue; as a result, they apply their thin capitalization rules only to resident entities that are controlled by non-residents. Control for this purpose is often defined in the same way as control is defined for purposes of the transfer pricing rules, namely, legal control (generally, the ownership of a sufficient number of voting shares to elect a majority of the board of directors of the company). In other situations, these countries may rely on the absence of control as sufficient to protect against base erosion through excessive interest deductions. However, if control for purposes of a country's thin capitalization rules means legal control, then those rules will not provide any protection against base erosion in situations where a resident entity is controlled factually, but not legally, by non-residents, or is not controlled factually or legally by non-residents but pays interest to non-residents. Note that under most countries' thin capitalization rules, shares owned by related non-residents are aggregated in order to determine whether a resident company is controlled; however, shares owned by unrelated non-residents are not aggregated for this purpose.

Some countries view thin capitalization as a problem of equity disguised as debt. Because interest is deductible but dividends are not, non-resident shareholders of resident companies generally prefer to finance resident companies with debt rather than equity. This is clearly the case with respect to resident companies that are wholly owned by non-residents, but may also be the case with respect to substantial non-resident shareholders of resident companies. For countries that view the problem in this way, thin capitalization rules may be targeted only at the deduction of interest paid on excessive debt owed to substantial non-resident shareholders, whether or not the shareholder controls the company. A substantial shareholder is typically defined as a shareholder that owns shares of the company representing at least a specified percentage (10 per cent to 25 per cent) of the votes and value of all the shares. Shares owned by related non-residents are generally aggregated for purposes of determining whether a non-resident shareholder is a substantial shareholder.

Example 5

The shares of ACo, a resident of Country A, are owned to the extent of 40 per cent by BCo, a resident of Country B, and 25 per cent by CCo, a resident of Country C. Both BCo and CCo are wholly owned by DCo, another non-resident company. The balance of the shares is widely owned by residents of Country A. Assume that Country A has thin capitalization rules that apply to any resident companies controlled by non-residents. If the shares of ACo owned by BCo and CCo must be aggregated for purposes of determining control of ACo, ACo would be considered to be controlled by BCo and CCo and the thin capitalization rules of Country A would apply. If, however, BCo and CCo were not related, the thin capitalization rules of Country A would not apply since ACo would not be controlled by either BCo or CCo. However, if the thin capitalization rules of Country A apply to resident companies with substantial non-resident shareholders, those rules would likely apply to ACo since BCo and CCo each own a substantial percentage of the shares of ACo.

Note that whether a country's thin capitalization rules apply to resident companies and the extent to which the deduction of interest claimed by resident companies to which the rules apply are separate questions. For example, if the thin capitalization rules apply to a resident company, all the excessive interest expenses could be denied; or only the excessive portion of the interest expenses paid to non-residents could be denied; or only the excessive portion of the interest expenses paid to the controlling or substantial non-resident shareholders could be denied. The extent to which the deduction of interest is denied is discussed in section 1.3.2.5 below.

In principle, it is unnecessary to apply thin capitalization rules to interest paid by a resident entity to residents of the same country because the resident recipients of the interest (other than tax-exempt entities) are subject to tax on the interest income they receive. However, some countries apply thin capitalization rules to such interest in order to prevent the rules from being considered discriminatory under Article 24 (4) (Non-discrimination) of an applicable tax treaty. Article 24 is discussed below in sections 2.3.2.3 and 2.3.2.4. Moreover, for countries in the European Union, the European Court of Justice has held that a member country cannot apply thin capitalization rules to deny the deduction of interest paid to residents of other member countries. This explains why some European countries have adopted

earnings-stripping or thin capitalization rules that apply to interest paid to both residents and non-residents.

Although the primary focus of thin capitalization rules is interest paid by resident entities to non-residents, the rules should also apply to non-residents that are allowed to deduct interest in computing income subject to tax by a country. This usually occurs where non-residents are carrying on business in a country and are taxable on a net basis. In these situations, non-residents may claim excessive interest deductions; the application of thin capitalization rules can limit those deductions and thereby prevent base erosion. The deduction of excessive interest by non-residents is discussed in section 1.5.2 below.

If a country treats partnerships as separate taxable entities, such as corporations, the thin capitalization rules should apply to such partnerships without the need for any special rules. If, however, a country treats partnerships as transparent or flow-through entities, the thin capitalization rules should apply to any debt of a partnership in which a resident company is a partner.

Example 6

ACo, a non-resident company, owns all the shares of BCo and CCo, both of which are resident in Country B. BCo and CCo are equal partners in a partnership, which is treated as transparent for purposes of the tax laws of Country B. ACo owns share capital in BCo of 200 and in CCo of 300. Assume that the thin capitalization rules of Country B disallow the deduction of interest paid by a resident company to the extent of the interest on debt in excess of twice the equity of the company. Thus, ACo would be able to lend 400 to BCo and 600 to CCo without the thin capitalization rules of Country B applying to either BCo or CCo. If ACo lends 800 to BCo and 1,200 to CCo, the thin capitalization rules would disallow the deduction of interest on the excessive debt of 400 lent to BCo and the excessive debt of 600 lent to CCo. However, unless the thin capitalization rules of Country B apply to partnerships, ACo could avoid the thin capitalization rules by lending 2,000 to the partnership. Therefore, the thin capitalization rules should deem the portion of any loan by a non-resident to a partnership in which a resident company is a partner to be made directly to the corporate partner and equal to that partner's percentage interest in the partnership. Based on the facts of this example, the 2,000 loan to the partnership should be deemed to be made to each partner to the extent of 1,000.

1.3.2.2 Establishing a debt/equity ratio

One of the most important decisions in developing thin capitalization rules is establishing the debt/equity ratio. Usually, any interest deductions claimed on debt in excess of the ratio are disallowed. Therefore, if the ratio is too generous, excessive interest may continue to be deductible against the country's tax base and the thin capitalization rules will be ineffective in preventing base erosion. On the other hand, if the ratio is too strict, resident companies may be denied the deduction of legitimate interest expenses and their ability to obtain funding from non-residents may be adversely affected.

When thin capitalization rules first started to be adopted in the 1970s and 1980s, it was typical for countries to use a debt/equity ratio of 3:1. However, since 2000, the typical ratio has steadily decreased to 2:1, 1.5:1 or even 1:1. Many factors should be considered in setting a debt/equity ratio for purposes of a country's thin capitalization rules, including the following:

- The average debt/equity ratio of resident companies
- The average debt/equity ratio of resident companies controlled by non-residents (if non-resident-controlled resident companies have a higher debt/equity ratio than other resident companies, this may indicate that non-resident-controlled companies are deducting too much interest)
- The types of businesses carried on by resident companies, since different types of businesses may have different needs for debt financing
- The needs of resident companies to access financing from non-residents, and
- Debt/equity ratios used by other government agencies

It is generally accepted that a higher debt/equity ratio is appropriate for financial institutions because the nature of their business generally requires more debt financing than other businesses.

Whatever debt/equity ratio is adopted, it must be decided whether that ratio should apply on an entity-by-entity basis or on a consolidated basis. If the thin capitalization rules apply on an entity-by-entity basis, the deduction of interest expenses may be disallowed

where a non-resident company lends funds to a related resident company in which it does not own any shares.

Example 7

ACo, a resident of Country A, owns all the shares of BCo, a resident of Country B. The shares of BCo represent capital of 100. ACo has also lent 100 to BCo. BCo owns all the shares of Subco, which is also resident in Country B. The shares of Subco represent an original capital investment by BCo of 200, consisting of 100 that ACo invested in shares of BCo and 100 of debt that ACo lent to BCo. Assume that Country B has thin capitalization rules based on a debt/equity ratio of 2:1, which applies to each resident entity separately.

If ACo loans 100 to Subco, the thin capitalization rules of Country B will disallow the deduction of any interest paid by Subco on that loan because ACo does not own any equity in Subco. However, if ACo lent an additional 100 to BCo, all the interest paid by BCo to ACo on the debt outstanding of 200 would be deductible, since the debt/equity ratio of BCo would not exceed 2:1. Therefore, in principle, where a non-resident company loans funds to a resident company that is a member of the same related group but in which the non-resident company does not own any shares directly, the result should be the same as if the loan were made to a group company in which the non-resident company owns shares. This result can be accomplished by applying the debt/equity ratio on a consolidated basis.

Note, however, that based on the facts of the above example, Subco should be able to deduct interest on only 100 of debt, despite the fact that its share capital is 200. The equity of Subco consists entirely of share capital in BCo, which has already been counted in computing the share capital of BCo, and debt of 100 lent to BCo by ACo, which has been converted into share capital in Subco. Therefore, under a consolidated approach, any equity in a lower-tier company must be reduced to the extent that it results from equity or debt in a higher-tier company. Based on the facts of the example, the consolidated group of BCo and Subco should have equity of 100 and should be allowed to deduct interest on debt of 200. As can be seen from this example, thin capitalization rules will be significantly more complex if they operate on a consolidated basis. Therefore, it may be preferable for the rules to

apply on an entity-by-entity basis and require non-resident companies to arrange their financing accordingly to comply with the rules.

If a country's thin capitalization rules apply to resident companies with substantial non-resident shareholders, it must be decided whether the debt/equity ratio should apply to each non-resident shareholder separately or to the resident company as a whole without regard to its shareholders.

Example 8

The shares of ACo, a resident of Country A, are owned to the extent of 40 per cent by BCo, a resident of Country B, and 25 per cent by CCo, a resident of Country C. BCo and CCo are not related. All the other shares of ACo are owned by residents of Country A. Country A has thin capitalization rules that apply to resident companies with substantial non-resident shareholders (defined as shareholders owning 25 per cent or more of the shares). The rules apply a debt/equity ratio of 2:1. The total debt of ACo is 2 million and its total equity is 1 million. The equity of BCo in ACo is 400,000 and it has lent ACo 1 million. The equity of CCo in ACo is 250,000 and it has lent ACo 300,000.

If the debt/equity ratio in the thin capitalization rules of Country A applies to ACo as a whole, none of the interest deductions of ACo would be denied because its debt does not exceed twice its equity. If, however, the debt/equity ratio applies to each substantial non-resident shareholder separately, the interest of ACo on the loans from BCo would not be deductible to the extent of the interest on 200,000 because the debt/equity ratio of ACo with respect to BCo is 4:1, which exceeds the allowable limit of 2:1. The other interest expenses of ACo, including the interest on the loans from CCo, would be fully deductible.

Assuming that the total debt of ACo was 3 million and its equity was 1 million, that the debt and equity of BCo in ACo are 400,000 and 800,000, respectively, and that the debt and equity of CCo in ACo are 250,000 and 500,000, respectively, the thin capitalization rules of Country A would apply to deny the deduction of interest on 1 million of the ACo debt because it exceeds the allowable ratio of 2:1. This result would apply irrespective of the fact that the debt and equity of ACo non-resident shareholders do not exceed the allowable ratio.

If, however, the thin capitalization rules of Country A apply to each substantial non-resident shareholder of ACo separately, none of the interest deductions of ACo would be denied, since BCo and CCo have debt and equity in ACo that do not exceed the allowable limit.

One obvious deficiency in the use of a fixed debt/equity ratio approach to limiting interest deductions is that it does not take interest rates into account. In a low-interest-rate environment, clearly companies can carry more debt than when interest rates are high. Therefore, whatever debt/equity ratio is adopted, it may require adjustment from time to time to reflect changes in interest rates.

1.3.2.3 Computation of debt

What debt of a resident company should be taken into account for purposes of a debt/equity ratio? Perhaps the easiest approach is to take all debt into account. However, since the primary focus of thin capitalization rules is interest on debt owed to non-residents, a more targeted approach is to limit the debt/equity ratio to debt and equity held by non-residents or, even more narrowly, to debt and equity of substantial or controlling non-resident shareholders. Whatever approach is used, careful consideration should be given to the definition of debt for this purpose. For example, if certain financial instruments, such as preferred shares, are treated as debt for purposes of a country's domestic tax law generally, such instruments should probably be treated as debt for purposes of the thin capitalization rules. Similarly, any debt instruments, such as convertible debt or participating debt, that are treated as equity should probably be treated as equity for purposes of the thin capitalization rules.

Many other subsidiary tax policy issues must be considered in determining the definition of debt for purposes of thin capitalization rules, including:

- Should non-interest-bearing debt be treated as debt or equity, or should such debt simply be ignored?
- Should short-term trade payables arising in the ordinary course of business be taken into account?
- Should debt held by non-residents dealing at arm's length with a resident company be included in computing the amount of

debt for purposes of the debt/equity ratio? Although such arm's length debt itself is not problematic from a base-erosion perspective, the issue is whether it should be taken into account together with non-arm's length debt to determine whether a resident company is excessively funded with debt. Note that the inclusion of arm's length debt in the debt/equity ratio does not necessarily mean that the deduction of interest on such debt must be denied.

- Should arm's length debt of a resident company that is guaranteed by the company's non-resident parent company be included in computing the amount of debt for purposes of the debt/equity ratio? In some circumstances, such guaranteed debt may be used as a substitute for a direct loan from the parent company, in which case guaranteed debt can be viewed as a technique to avoid the thin capitalization rules. However, in other circumstances, a non-resident parent company may guarantee arm's length debt of a subsidiary in order to allow the subsidiary to get more favourable loan terms. In this situation, the guarantee is not intended to avoid the application of the thin capitalization rules and should probably not alter the treatment of the debt as arm's length debt.
- Are special anti-avoidance rules necessary? Special anti-avoidance rules are probably necessary to prevent the use of back-to-back financing arrangements to avoid the thin capitalization rules. For example, instead of borrowing from its non-resident parent company, a resident company might borrow from an arm's length financial institution, which in turn borrows an equivalent amount on similar terms from the parent company. See section 1.2.5 above for a discussion of back-to-back arrangements.
- When should the amount of debt of a company be measured? There are several possibilities in this regard, including a particular point in time, such as the beginning or the end of the tax year, and an average of the amount of debt computed on a monthly or quarterly basis. If the amount of debt is measured at a particular point in time, taxpayers may have the opportunity to arrange their affairs to minimize the amount of debt on that date—for example, by repaying outstanding non-arm's

length debt shortly before the relevant date and re-establishing the debt shortly after that date. Computing the amount of debt as an average of the amount outstanding monthly or quarterly reduces the opportunities for avoidance; however, the costs of compliance and administration increase as the frequency of the calculation increases. The tax avoidance opportunities can be eliminated if the amount of debt is calculated as the greatest amount of debt outstanding at any time during the relevant period. However, this approach may produce unfair results where a company has an amount of debt outstanding for a brief period.

1.3.2.4 Computation of equity

What types of amounts should be recognized as equity for purposes of the debt/equity ratio? In general, equity should include all investments in a company other than debt. Whether an amount is considered to be equity for purposes of the thin capitalization rules may depend on the concept of equity capital under a country's corporate law or tax law. Share capital (the amount for which the shares are issued by the company) should clearly be taken into account, as well as what is sometimes referred to as contributed surplus or capital (the amount contributed by shareholders to the company where they do not receive any shares in exchange). In addition, the retained earnings of the company should be treated as equity, since those earnings are available to support the company's outstanding debt and its ability to borrow. However, unrealized appreciation in the assets of a company should probably not be counted as equity (although it is also available to support the company's debt) because such unrealized appreciation has not been subject to tax.

For purposes of the debt/equity ratio, equity should probably be measured at the same time as debt, except that retained earnings should be determined at the beginning of each year. Therefore, for example, if debt is measured on an average monthly basis, the share capital and contributed surplus components of equity should probably also be measured on an average monthly basis.

The measurement of equity on an annual basis presents avoidance opportunities because shareholders may find it relatively easy to make an equity contribution shortly before the end of a year and then withdraw that contribution (perhaps as tax-free return of capital)

shortly after that date. A specific anti-avoidance rule may be necessary to prevent these types of transactions from increasing the equity of a company artificially in order to avoid the thin capitalization rules. The measurement of the share capital and contributed surplus components of equity on an average basis, either quarterly or monthly, will reduce the risks of artificial temporary infusions of equity.

1.3.2.5 Consequences

Typically, if a country's thin capitalization rules apply, the deduction of certain, but not necessarily all, interest on debt paid to non-residents is disallowed. As noted above, it is not necessary for a country to disallow the deduction of interest on all debt taken into account for purposes of the debt/equity ratio. The determination of the debt included in computing a company's debt/equity ratio and the disallowance of the deduction of interest are separate questions. Therefore, it is possible for a country to disallow the deduction of all interest on debt that exceeds the allowable debt/equity ratio or to disallow only some of that interest—for example, interest paid to non-residents, interest paid to substantial non-resident shareholders, or interest paid to controlling non-resident shareholders. Further, as discussed above, some countries apply their thin capitalization rules separately to each substantial non-resident shareholder of a resident company, in which case the deduction of interest is disallowed only on the excessive debt owed to that particular non-resident shareholder.

Many countries have decided not to disallow the deduction of interest on arm's length debt on the basis that such interest is inherently not excessive and represents a legitimate commercial cost of doing business and earning income. Moreover, to the extent that a country has entered into tax treaties with non-discrimination provisions similar to those in Article 24 (4) and (5) of the United Nations Model Convention,[7] those provisions will prevent the application of the country's thin capitalization rules if a taxpayer can establish that the interest rate and the amount of debt conform to the arm's length standard in Article 9 (Associated enterprises). See the discussion of

[7] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

Article 24 (4) and (5) of the United Nations Model Convention in sections 2.3.2.3 and 2.3.2.4 below.

If a country's thin capitalization rules apply to deny the deduction of interest, two additional tax policy decisions must be made. First, how should the amount of disallowed interest be characterized? For those countries that view thin capitalization rules as being targeted at payments on equity that is disguised as debt, the question is whether the disallowed interest should be treated as a dividend or whether it should retain its legal character as interest. This question may have important consequences for a country's withholding tax if the rates of withholding tax on interest and dividends differ under domestic law or under the country's tax treaties. For example, if a country has entered into tax treaties based on the OECD Model Convention,[8] Article 11 of that Convention (Interest) limits the rate of withholding tax on interest to 15 per cent, but Article 10 (Dividends) limits the rate of withholding tax on dividends paid to a non-resident company that owns at least 25 of the payer's share capital to 5 per cent. Therefore, if the country's thin capitalization rules deem any disallowed interest to be a dividend, the result may be to confer an unintentional benefit on the non-resident shareholder in the form of a reduced withholding tax.

Second, should a resident company be entitled to carry over any disallowed interest to other years and deduct such interest in those years to the extent that the debt/equity ratio of the company for those years is not in excess of the allowable limit? Such a carry-over can provide a measure of flexibility to the thin capitalization rules, in recognition of the inherent arbitrariness of a fixed debt/equity ratio and the commercial needs of businesses for debt financing. However, a carry-over adds complexity to the administration of the rules and requires reopening tax returns for past years (in the case of a carry-back) or keeping track of information from past years (in the case of a carry-forward). Some countries even allow the unused capacity to deduct interest to be carried forward to future years. For example, if a country has a 2:1 debt/equity ratio and a particular company has a 1.5:1 debt/equity ratio in one year, it would be allowed to deduct interest on debt in the following year up to a maximum of 2.5:1.

[8] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

1.3.2.6 Specific anti-avoidance rules

Specific anti-avoidance rules may be useful or necessary to supplement thin capitalization rules. Several types of targeted rules that countries may wish to consider are:

- Rules to deal with back-to-back arrangements (see section 1.2.5 above), and
- Rules to prevent artificial increases in equity

The addition of specific anti-avoidance rules will obviously increase the complexity of the rules.

1.3.3 Earnings-stripping rules

1.3.3.1 Entities covered

The tax policy issues concerning the entities to which earnings-stripping rules should apply are fundamentally the same as those with respect to thin capitalization rules discussed above in section 1.3.2.1. Thus, the rules can be applied to all resident entities, to resident entities controlled by non-residents and to resident entities with substantial non-resident shareholders.

In deciding on the scope of earnings-stripping rules, countries should consider whether they are concerned primarily about cross-border base erosion through interest payments or about such base erosion more generally. If a country is concerned about base erosion through excessive interest payments generally, it might consider applying its earnings-stripping rules to all resident entities irrespective of whether interest is paid to residents or non-residents. On the other hand, if a country is primarily concerned with cross-border base erosion (which is the primary focus of the present *Portfolio*), it may choose to limit its earnings-stripping rules to interest payments by resident entities to non-residents or to interest payments by resident entities controlled by non-residents. If a country's earnings-stripping rules are limited in these ways, any tax treaties concluded by that country with provisions similar to those of Article 24 (4) and (5) of the United Nations Model Convention will prevent the application of those rules. See sections 2.3.2.3 and 2.3.2.4 below for a discussion of Article 24 (4) and (5) of the United Nations Model Convention.

1.3.3.2 Limiting interest deductions based on a percentage of earnings

Under earnings-stripping rules, the deduction of interest by an entity is typically limited to a specified percentage of the entity's earnings. Theoretically, an entity's interest deductions could be limited to the ratio of interest expenses to earnings of the worldwide multinational group to which the entity belongs, focusing only on debt and interest owed to third parties. Under such a worldwide group approach, each group entity would be entitled to deduct the portion of the entity's third-party interest expenses that corresponds to the ratio of the net arm's length interest expenses of the worldwide group to the group's total earnings. Under this approach, a multinational group would be unable to increase its interest deductions through intergroup financing arrangements. However, this type of worldwide group approach involves significant complexity because it requires the tax authorities of a country to obtain detailed information about the interest expenses and earnings of the group as a whole. Consequently, the worldwide group approach is probably not feasible for developing countries or for most developed countries, and it is not discussed further here.

One important advantage of an earnings-stripping rule is that if a multinational group of companies shifts profits from a high-tax country to a low-tax country, the deduction of interest against the high-tax country's tax base will be reduced accordingly.

There are two important tax policy questions with respect to limiting interest deductions based on earnings: how should earnings be measured for this purpose? and how should the allowable percentage of earnings be established?

In general, earnings can be measured either by reference to tax information or financial accounting information. With respect to resident entities, tax information about their earnings should be readily available from their annual tax returns. Thus, the use of tax information should minimize compliance and administrative costs and should be reasonably reliable for the purpose of restricting interest deductions. If financial accounting information is used to calculate profit for a country's domestic tax purposes, it may not matter whether tax or accounting information is used for purposes of earnings-stripping rules. However, if profit for tax purposes differs from profit for accounting purposes, the

use of tax information to compute earnings for purposes of a country's earnings-stripping rules is probably more appropriate.

Some countries with earnings-stripping rules use EBITDA (earnings before interest, taxes, depreciation and amortization), a well-known and well-accepted financial concept, as the relevant measure of earnings. Obviously, it is possible to define earnings in a variety of ways for purposes of a country's earnings-stripping rules, and each country should carefully consider what method of measuring earnings would be most appropriate for it.

One serious problem in restricting interest deductions on the basis of earnings is how to deal with situations in which an entity has a loss for a year. Typically, interest is deductible whether or not taxable income actually results from the use of the borrowed funds. It is generally accepted that it would not be good tax policy to make interest deductions dependent upon the actual production of income because that would discourage taxpayers from engaging in risky ventures. Therefore, to avoid penalizing businesses that are very risky or are cyclical, countries that adopt earnings-stripping rules need to consider how to provide relief for businesses with losses. One possibility in this regard is to provide a carry-over for any disallowed interest so that an entity with a loss in one year can deduct any disallowed interest in a past or future year when it may have positive earnings (see section 1.3.3.5 below). However, it should be noted that any carry-over adds complexity and increases the compliance and administrative burden of applying earnings-stripping rules.

To a certain extent, the selection of a specific percentage of earnings as the allowable limit for interest deductions is arbitrary. The goal is to allow entities to deduct interest expenses that are reasonable costs of doing business but to disallow interest expenses that are excessive and represent an unacceptable erosion of a country's tax base. Thus, the allowable limit should be set so that the country's tax base is protected but the ability of resident entities to finance their business activities is not adversely affected. Factors that should be taken into account in setting the percentage of earnings include:

- The existing interest-to-earnings ratios of resident companies, including a comparison of resident companies controlled by non-residents and other resident companies

- A higher ratio which may be appropriate if a country does not provide a carry-over for disallowed interest
- A higher ratio which may be appropriate if a country applies additional restrictions on the deduction of interest
- A higher ratio which may be appropriate if a country has relatively high interest rates
- A higher ratio which may be appropriate if a country's economic policy is focused on increasing investment in infrastructure projects
- The need to attract foreign investment
- The size of the multinational group to which a resident entity belongs

The arbitrariness of limiting interest deductions to a fixed percentage of earnings can be mitigated by allowing disallowed interest to be carried over and deducted in other years and by providing specific exceptions to the rules, as discussed in sections 1.3.3.5 and 1.3.3.4 below, respectively. The BEPS Action 4 Final Report recommends that countries adopt a fixed percentage of between 10 and 30 per cent of earnings.

1.3.3.3 Net or gross interest expense

Earnings-stripping rules can apply either to the gross interest expenses incurred by a resident entity or the gross interest expenses in excess of the interest income received by the entity (net interest expenses). The gross interest expense approach has the benefit of simplicity. The net interest approach is more complicated, but avoids the duplication of interest expenses as a result of intergroup loans. The effects of this duplication can be seen in example 9.

Example 9

ACo, a resident of Country A, incurs 90 of interest on arm's length debt, part of which is onlent to its wholly owned subsidiary, BCo, a resident of Country B. BCo pays interest of 50 to ACo. Both Country A and Country B have earnings-stripping rules under which interest deductions are disallowed to the extent that an entity's gross interest expenses exceed 20 per

cent of its earnings. ACo and BCo have the following earnings and interest expenses:

	ACo	BCo	Group
Earnings	200	800	1,000
Gross interest expense	(90)	(160)	(250)
Net interest expense	40	(160)	(200)
Maximum deductible interest	20% × 200 = 40	20% × 800 = 160	(200)
Disallowed interest	50	0	50

Based on these facts, ACo and BCo each have arm's length interest expenses not in excess of 20 per cent of earnings, so all the interest should be deductible. However, the intragroup interest income received by ACo is effectively double-counted as interest expense of both ACo and BCo. This result can be avoided if the earnings-stripping rules apply to an entity's net interest expenses (gross interest expenses in excess of interest income). However, it may be noted that taxpayers can avoid double-counting from intragroup loans if the loans are restructured. For example, BCo could borrow directly from a third-party lender rather than from ACo, or ACo could advance the funds to BCo by way of equity or a non-interest-bearing loan. Also, some relief from double taxation can be provided if a carry-forward of any disallowed interest expense is allowed.

1.3.3.4 Exceptions

Countries may consider applying their earnings-stripping rules only to entities that have interest expense in excess of a minimum threshold amount. Such a de minimis threshold can be applied to all domestic entities in a group or to each entity separately. If a de minimis threshold is applied to each entity separately, taxpayers may attempt to take advantage of the threshold exemption by multiplying the number of entities. Anti-fragmentation rules may be necessary to prevent this type of avoidance. Establishing the amount of the threshold requires a delicate balancing between the need to reduce the compliance and administration burden of applying the earnings-stripping rules and the need to prevent base erosion.

Developing countries may also consider other exemptions from the earnings-stripping rules to reflect their particular circumstances. For example, the BEPS Action 4 Final Report suggests that countries may wish to exclude from the rules any interest related to the financing of certain privately owned assets in which there is a general public interest. Any such exemptions should be limited in order to prevent abuse.

The BEPS Action 4 Final Report also suggests that countries should consider allowing an entity to deduct interest in excess of the basic interest-to-earnings ratio if the interest-to-earnings ratio of its group as a whole is greater. In effect, this supplementary worldwide group ratio rule would allow an entity to deduct interest up to the amount of leverage of the group as a whole. No country currently uses this type of worldwide group ratio approach. A worldwide group ratio rule, regardless of how it is structured, is inevitably complex in terms of both legislation and compliance and administration.

1.3.3.5 Consequences

Typically, under earnings-stripping rules, any interest in excess of the specified percentage of earnings is not deductible. Beyond this obvious result, there are several ancillary policy issues that require consideration. For example, how should the disallowed interest expenses be characterized? Should the disallowed interest be eligible to be carried over to past or future years and deducted in those years? If an entity's interest expenses for a year are less than the specified allowable percentage of its earnings, can the unused balance be carried over to another year to allow the deduction of additional interest in that year? These issues are essentially the same as those discussed above in section 1.3.2.5 in connection with thin capitalization rules.

1.3.3.6 Specific anti-avoidance rules

Specific anti-avoidance rules may be useful or necessary to supplement general earnings-stripping rules. Several types of targeted rules are listed in the BEPS Action 4 Final Report as rules that countries may wish to consider in order to prevent:

- Avoidance of the general limitations: for example, by converting interest expense into a different type of deductible expense or decontrol arrangements

- Interest on artificial debt where no additional funds are raised
- Back-to-back arrangements (see section 1.2.5 above)
- Excessive interest paid to a related party, and
- Interest expense incurred to earn exempt income

The necessity for targeted rules reflects the possibility that basic earnings-stripping rules may not be effective in eliminating base erosion from interest deductions. The addition of specific anti-avoidance rules will obviously increase the complexity of the rules.

1.3.4 OECD/G20 BEPS Action 4 Final Report

As part of the BEPS exercise, the OECD and G20 considered domestic legislation that countries could adopt to limit the risk of base erosion through interest payments while allowing deductions for reasonable interest expenses. The BEPS Action 4 Final Report provides a best-practices approach for countries to adopt, plus a discussion of alternative measures that countries have adopted, including the benefits and challenges of some of these alternative measures. These best practices are not mandatory even for OECD member countries; they are simply recommendations that countries may or may not choose to adopt. The BEPS Action 4 Final Report rejects thin capitalization rules in favour of earnings-stripping rules, largely because, according to the Report, earnings provide a better measure of an entity's ability to meet its interest obligations, and also because thin capitalization rules do not take interest rates into account. The OECD/G20 best-practices approach may be too complex for many developing countries — and, indeed, for many developed countries. However, it provides an alternative approach to limiting base erosion through interest payments that countries should consider carefully.

In simple terms, the best practices in BEPS Action 4 involve the following features:

(a) Countries may allow an entity to deduct all its interest expenses, as long as those expenses do not exceed a de minimis monetary threshold. This de minimis threshold is intended to reduce the administrative and compliance burden of the rules without allowing a significant erosion of the country's tax base.

(b) An entity would be permitted to deduct its net interest expense up to a benchmark ratio of its net interest expenses (interest expenses in excess of interest income) to EBITDA (earnings before interest, taxes, depreciation and amortization). An entity's net interest expenses and EBITDA would be calculated on the basis of tax information, not financial accounting information. As a result, all necessary information should be available on the entity's local-country tax return. The allowable benchmark ratio would be set within a range of 10 per cent to 30 per cent of an entity's EBITDA. Interest expense in excess of the allowable amount would not be deductible. The BEPS Action 4 Final Report gives guidance with respect to how a country should determine the benchmark ratio within the 10 to 30 per cent of EBITDA range. Once determined, however, the benchmark ratio would apply to all resident entities in that country. EBITDA could be calculated on the basis of the entity's average earnings over a three-year period.

(c) As an optional relief measure, an entity would be allowed to deduct interest expenses in excess of the allowable percentage of its EBITDA if the net arm's length interest expense-to-EBITDA ratio of the multinational group of which the entity is a part is greater than the entity's ratio. The rationale for this alternative test is that, if a resident entity is leveraged at a ratio approximating the global group's leverage ratio, the base erosion resulting from the interest deductions claimed by the resident entity is acceptable and not excessive. But this optional worldwide group rule presents difficulties. For example, taxpayers and tax administrators must assemble and audit the financial information with respect to the multinational group that is required to apply the rule; it would also be necessary to use financial accounting information rather than tax information for this purpose. The BEPS Action 4 Final Report recognizes that no country currently uses such a rule and that further work is necessary to provide guidance to countries. It seems unlikely that this type of optional relief measure would be appropriate for developing countries.

(d) The BEPS Action 4 best-practices approach suggests that taxpayers should be allowed to carry over disallowed interest expenses to past or future years.

(e) Countries may adopt targeted rules to prevent artificial arrangements and to address the special considerations of financial services and insurance companies.

The BEPS Action 4 best practices provide one approach for dealing with the risk of base erosion through the payment of interest expense that developing countries may wish to consider. However, those best practices involve significant complexity and should be carefully evaluated by developing countries.

1.4. Withholding taxes on interest

Many developing countries impose withholding taxes on payments of interest to non-resident lenders. The withholding tax is sometimes perceived as a tax cost to the non-resident lender, with the benefit of raising tax revenue that partially offsets the tax cost of the deduction of the interest.

The effect of withholding taxes on interest can be difficult to predict. If there are sufficient local funds available to finance all domestic investment in a country, withholding taxes may not increase the borrowing costs of residents of that country. On the other hand, if a country needs investment capital from offshore, withholding taxes on interest will likely increase borrowing costs for residents, because the offshore lender can usually shift the economic burden of the tax onto the borrower. This result can be accomplished by the lender requiring the borrower to gross up the amount of the interest payments so that the lender receives an amount after the withholding tax equal to the interest that would have been charged if no withholding tax had been imposed on the interest. The result of the gross-up of interest payments by residents to non-resident lenders is that the withholding tax is effectively borne by residents and increases the costs of borrowing by residents from non-residents, as shown in the following example.

Example 10

Banco is a bank resident in Country A. It is in negotiations for a large financing with BCo, a corporation resident in Country B. Country B imposes a withholding tax on interest at a rate of 10 per cent. In the absence of the withholding tax, Banco would be willing to lend the funds

to BCo at an annual interest rate of 10 per cent, which would give Banco a profit of 1 per cent since its cost of funds is 9 per cent. A withholding tax of 10 per cent would represent a tax of 100 per cent of Banco's profit from the loan to BCo. Therefore, Banco would be unwilling to lend to BCo on these terms. Instead, it would require BCo to bear the cost of the Country B withholding tax. This would be accomplished by grossing up (increasing) the interest payable by BCo so that Banco receives payments (after Country B withholding tax) equal to 10 per cent of the amount of the loan. For example, interest of 1,000 would be grossed up as follows:

Grossed-up interest	1,111.0
Withholding tax (10 per cent)	111.0
Net amount	1,000.0
Interest rate before tax (percentage)	11.1
Interest rate after tax (percentage)	10.0

In tax treaties, the challenge of establishing a proper withholding tax rate is often addressed by setting a lower rate for loans from financial institutions and a higher rate for other lenders.

While it is attractive to impose a withholding tax on payments of interest to a non-resident lender, both to discourage cross-border debt and to reduce the risk of base erosion by effectively clawing back some of the tax revenue associated with the tax deduction for the interest payments, the decisions to impose a withholding tax, and the rate of the tax, are never simple.

In the BEPS Action 4 Final Report, the decision to impose a withholding tax on interest is viewed as being independent from limits on interest deductions; accordingly, withholding taxes are not a substitute for statutory limits on interest deductibility, such as thin capitalization rules and earnings-stripping rules.

1.5 Non-residents incurring deductible interest and other financing expenses to earn domestic source income

1.5.1 Introduction

Base erosion with respect to interest expenses incurred by non-residents results where those interest expenses are deductible against

the source country's tax base, just as it does with respect to interest expenses incurred by residents. In general, if a country does not impose tax on income earned by non-residents that arises or has its source in the country, that country should not allow the deduction of any expenses, including interest and other financing expenses incurred by those non-residents in earning the income. Similarly, where a country taxes income earned by non-residents, including interest income, on the basis of a withholding tax on the gross amount of payments, no deductions will be allowed for expenses incurred by those non-residents in earning the income. In general, many countries tax investment income, such as dividends, interest and royalties, on a gross basis. These situations do not present serious risks of base erosion except to the extent that any interest received by non-residents is not subject to source country withholding tax, discussed in section 1.4 above, or resident payers are entitled to deduct interest paid to non-residents, discussed in section 1.6 below.

Where non-residents are taxable by the source country on a net basis, they will usually be entitled to deduct any expenses, including interest and other financing expenses, incurred in earning the income. These situations present the risk of base erosion. In general, most countries tax non-residents on a net basis only with respect to income from a business or income from activities that involve significant expenses. The risk of base erosion in these situations is discussed in section 1.5.2.

1.5.2 Non-residents earning income in the source country that is taxable on a net basis

Where a country imposes tax on the net income derived by non-residents, it will usually allow a deduction for any interest and other financing expenses incurred by the non-residents for the purpose of earning the income. Although the deduction of these expenses erodes the country's tax base, it should be recognized that these expenses are often legitimate costs of earning income that should be deductible in computing the net income subject to tax. However, it may be difficult for the tax authorities of the source country to verify that the expenses claimed as deductions are incurred for the purpose of earning income subject to tax by the source country and that the amount of the deductions claimed is reasonable. As a result, some countries may

consider disallowing the deduction of all interest expenses incurred by non-residents, or interest expenses that are incurred outside the source country or that are not incurred wholly and exclusively for purposes of earning the income subject to tax by the source country. These responses are often considered to be Draconian and arbitrary. In addition, they will not be effective to the extent that a country has entered into tax treaties with provisions similar to those of the United Nations and OECD Model Conventions. Article 24 (3) (Non-discrimination) of the United Nations and OECD Model Conventions prevents countries from discriminating against non-residents carrying on business through a permanent establishment (PE) (but not a fixed base). Therefore, a country would not be able to deny the deduction of interest and other financing expenses incurred by non-residents carrying on business through a PE unless the denial of deductions also applied to residents of the country engaged in similar business activities. An alternative approach might be to impose a special burden of proof on a taxpayer to justify its entitlement to such deductions

In addition, some countries may disallow the deduction of amounts, including interest, paid to non-residents unless the payer withholds tax from the payment. This type of condition for the deduction of interest and other financing expenses is prohibited by Article 24 (3) of the United Nations and OECD Model Conventions unless it applies equally to residents claiming similar deductions. In this situation, it might be reasonable to apply this condition to both residents and non-residents paying interest to non-residents. See section 2.3.1.3.4 below for a detailed discussion of Article 24 (3).

Article 7 (3) of the United Nations Model Convention (Business profits) prohibits the denial of deductions in computing the profits of a PE on the basis that the expenses are incurred outside the PE country or are not incurred wholly and exclusively for the purposes of the PE. Similar rules should apply for purposes of computing the profits attributable to a fixed base under Article 14 (Independent personal services). See section 2.3.1.3.2 below for a discussion of Article 7 (3) and Article 14.

The risks of base erosion with respect to deductions of interest and other financing expenses claimed by non-residents apply irrespective of whether the payments are made to residents of the source

country or to non-residents. However, the risks are clearly more serious where the payments are made to non-residents. Where the payments are made by a non-resident to residents of the source country, those resident recipients are likely to be subject to tax on those payments; thus, the source country tax on the resident recipients will offset the reduction in source country tax as a result of the interest deductions. In contrast, where payments are made by a non-resident to other non-residents, those recipients may not be subject to withholding tax on the payments under the domestic law of the source country. Thus, as discussed in chapter 4, section 4.3 below, countries should ensure that they impose withholding tax on payments of interest and other amounts by non-residents to non-residents if the payments are deductible in computing income subject to source country tax. (See part 3, chapter 3, section 3.4 for a sample withholding tax provision that extends to payments by a non-resident to another non-resident.)

1.5.3 Excessive interest payments by non-residents

As discussed above in section 1.3.1, base erosion may occur with respect to excessive payments of interest by non-residents in the same way as it would for excessive payments of interest by residents. For example, non-residents may pay interest to related persons at a rate that exceeds an arm's length rate; they may have excessive levels of debt compared to arm's length parties; and they may pay interest that is excessive by reference to a financial ratio. Therefore, many countries extend the application of their thin capitalization rules or earnings-stripping rules to non-residents earning income that is taxable on a net basis.

Although base erosion through excessive interest payments by non-residents is a less serious aspect of base erosion than excessive payments of interest by residents, nevertheless, the issue is important and should be carefully considered by developing countries concerned about base erosion through interest deductions. In the absence of any rules dealing with excessive interest payments by non-residents, taxpayers may structure their investments in a country as branches or PEs rather than as subsidiaries in order to avoid the application of any restrictions on the deductibility of interest.

Where a tax treaty based on Article 7 of the United Nations Model Convention applies, Article 7 (3) governs the deductibility of

interest and other expenses in computing the profits attributable to the PE that may be taxed by the country in which the PE is located. Article 7 of the United Nations Model Convention is discussed in detail in section 2.3.1.3 below.

1.6 Residents incurring interest and other financing expenses to earn foreign source income

1.6.1 Introduction

There are two basic patterns for taxing income earned by residents of a country:

(a) Worldwide taxation, under which residents are taxable on their income derived from the country in which they are resident and their income from sources outside that country (foreign source income); and

(b) Territorial taxation,[9] under which a country taxes income only if it is earned or derived from the country, so that residents are not taxable on income earned outside the country. In effect, under territorial taxation, foreign source income is exempt from tax.

It is not necessary for a country to tax all income in accordance with one of these basic patterns. For example, a country that generally taxes on a worldwide basis may decide to exempt certain foreign source income, such as business profits earned through a foreign PE and dividends received from foreign corporations in which resident corporations own a substantial interest (generally 10 per cent or more of the shares of the foreign corporation). Similarly, a country that generally taxes on a territorial basis may tax certain types of foreign source income.

[9] The term "territorial taxation" or "territoriality" is used loosely to mean different things. Sometimes it is used to describe an exemption for dividends from foreign corporations in which resident corporations own a minimum percentage of the shares. In the present *Portfolio*, the term is used to mean a tax system under which all or almost all foreign source income earned by residents of the country is exempt from tax.

The deduction of interest and other financing expenses by residents of a country may result in the erosion of that country's tax base irrespective of whether the country taxes or exempts the foreign source income of its residents. However, as explained below, the circumstances under which base erosion occurs differ depending on whether foreign source income is exempt or taxable with a credit for foreign taxes on the income. For many developing countries, the erosion of their tax base through interest deductions claimed by residents to earn foreign source income is not as serious a problem as the problems described above in sections 1.4 and 1.5 with respect to interest payments associated with inbound investment by non-residents. However, for some developing countries the problem of base erosion through interest deductions to earn foreign source income may be a growing concern as foreign investment by their residents increases.

1.6.2 Exemption of foreign source income

If a country exempts some or all foreign source income derived by its residents, the critical issue is whether interest and other financing expenses incurred to earn that exempt foreign source income are deductible. In theory, since the foreign source income is not taxable by the country, any expenses incurred by the taxpayer for the purpose of earning such income should not be deductible. Although this fundamental principle is clear, it is difficult to apply in practice because money is fungible. It is difficult to allocate sources of funds, such as debt and equity, to assets or income in a reasonable manner that cannot be easily avoided by taxpayers or that does not impose serious compliance and administrative problems (see section 1.2.3 above).

If a country allows the deduction of interest expenses to earn exempt foreign source income, the erosion of the country's tax base is clear. The deduction reduces or erodes the country's tax on income earned in the country (domestic source income), but the foreign source income that the expenses were incurred to earn is not taxable by the country. If the country denies the deduction of interest expenses to earn foreign source income, the issue is whether those rules are effective or are easily avoided by taxpayers.

The base erosion from deductible interest expenses to earn exempt foreign source income applies to both passive investment

income and active business income, as illustrated in the following examples.

Example 11

ACo, a resident of Country A, receives interest payments of 500 from a resident of Country B. ACo also has income of 1,600 from Country A. Country A imposes corporate tax at a rate of 30 per cent. Country B imposes a withholding tax of 30 per cent on payments of interest by its residents to non-residents. ACo incurs interest expenses of 100 on borrowed funds that are lent to the resident of Country B. Country A exempts foreign interest income from tax.

If Country A allows ACo to deduct the interest expenses of 100, the income of ACo subject to tax by Country A will be 1,500 and the tax payable to Country A will be 450 (30% × 1,500). In effect, although the interest expenses are attributable to the income earned in Country B, they are deductible against the income earned in Country A and erode its tax base. This result is inappropriate. The interest should not be deductible against the tax base of Country A; the tax payable by ACo to Country A should be 480 (30% × 1,600). In effect, Country A should exempt the foreign interest income only to the extent of the net amount, or 400.

The analysis is the same where a resident taxpayer earns foreign source business income, as shown in the next example.

Example 12

ACo, a resident of Country A, earns income of 500 in Country B and income of 1,600 from Country A. Both Country A and Country B impose tax at a rate of 30 per cent. ACo pays tax to Country B of 150. ACo incurs interest expenses of 100 on borrowed funds that are used to earn the income from Country B. Country A exempts foreign business income from tax.

If Country A allows ACo to deduct the interest expenses of 100, the income of ACo subject to tax by Country A will be 1,500 and the tax payable to Country A will be 450 (30% × 1,500). In effect, although the interest expenses are attributable to the income earned in Country B, they are deductible against the income earned in Country A and erode its tax base. This result is inappropriate. The interest should not be deductible against the tax base of Country A; the tax payable by ACo to Country A should be 480 (30% × 1,600).

From the perspective of Country B, it should allow the deduction of the interest expenses so that the tax payable to Country B should be only 120 (30% × 400). If Country B allows the deduction of the interest and Country A does not, the result is appropriate from a worldwide perspective. ACo would have worldwide income of 2,000 (400 from Country B and 1,600 from Country A) and would pay total tax of 600 (120 to Country B and 480 to Country A).

1.6.3 Taxation of foreign source income with a credit for foreign tax

If a country taxes its residents on their foreign source income, any interest expenses incurred for the purpose of earning foreign source income are likely to be deductible in the same way as other expenses incurred to earn income. Several important consequences flow from the decision to tax residents on their foreign source income.

First, if a country taxes residents on their foreign source income, the income derived by residents of the country will often be subject to double taxation — once by the country in which the income is earned (the source country) and again by the country in which the taxpayers are resident. It is generally accepted that the country of residence has the obligation to eliminate the double taxation, and must do so either by providing a credit against its own tax for the tax paid to the source country or by exempting the income earned in the source country. The effect of the deduction of interest expenses under the exemption method for providing relief from double taxation is discussed in section 1.6.2 above.

Second, if a country uses a foreign tax credit to eliminate double taxation, the credit is usually limited to the amount of the country's tax on the foreign source income. Therefore, for purposes of this limitation on the credit, it is necessary for the country to calculate the amount of the foreign source income, and in particular, to determine which expenses incurred by taxpayers are allocated to foreign source income. If the proper amount of expenses is not allocated to the foreign source income for this purpose, in effect, the expenses will be deductible against the country's domestic source income. This result is inappropriate and can be viewed as a form of base erosion. In addition, depending on the type of limitation used for purposes of the foreign tax credit (overall, per

country or item-by-item), residents of a country may be able to obtain credit for foreign taxes on income from foreign sources that are higher than the country's tax on such income by averaging those foreign taxes with lower foreign taxes on other income. This aspect of a foreign tax credit is beyond the scope of the present *Portfolio*.[10]

The base erosion that occurs where interest expenses are not allocated to foreign source income for purposes of the limitation on the foreign tax credit is illustrated in examples 13 and 14, which use the same basic facts as the previous examples in section 1.6.2 involving the exemption method for relieving international double taxation.

Example 13

ACo, a resident of Country A, receives interest payments of 500 from a resident of Country B. ACo also has income of 1,600 from Country A. Country A imposes corporate tax at a rate of 30 per cent. Country B imposes a withholding tax of 30 per cent on payments of interest by its residents to non-residents. ACo pays withholding tax to Country B on the interest payments of 150. ACo incurs interest expenses of 100 on borrowed funds that are lent to the resident of Country B.

Country A imposes tax on the worldwide income of its residents so that the income of ACo for purposes of Country A is 2,000 (500 from Country B plus 1,600 from Country A, less interest expenses of 100). The tax payable to Country A before taking the foreign tax credit into account is 600 (30% × 2,000). If Country A allows a credit for the full amount of the tax of 150 paid to Country B, the tax of Country A will be reduced to 450. Instead, the credit should be limited to the tax of Country A on the net income derived by ACo from Country B, which is 30% × 400, or 120. This result is obtained only if the interest expenses of 100 are deducted in computing the foreign source income. As a result, Country A tax should be 600 – 120 = 480, which is the same result as in the previous example involving the exemption method.

The analysis is the same where a resident taxpayer earns foreign source business income, as shown in the next example, except that Country B should allow a deduction for the interest in computing ACo income subject to Country B tax.

[10] For a basic description of the types of limitation on the foreign tax credit, see Brian J. Arnold, *International Tax Primer*, 3rd edition, 54 – 59.

Example 14

ACo, a resident of Country A, earns income of 500 from Country B and income of 1,600 from Country A. Both Country A and Country B impose tax at a rate of 30 per cent. ACo pays tax to Country B of 150. ACo incurs interest expenses of 100 on borrowed funds that are used to earn the income from Country B. Country A imposes tax on the world-wide income of its residents, so that the income of ACo for purposes of Country A is 2,000 (500 from Country B plus 1,600 from Country A, less interest expenses of 100). The tax payable to Country A before taking the foreign tax credit into account will be 600 (30% × 2,000).

The credit allowed for the tax paid by ACo to Country B of 150 is usually calculated as the lesser of the tax paid and the amount of Country A tax on the income earned in Country B. If the interest expenses are not allocated to the income earned in Country B, the credit would be limited to:

$$\frac{\text{600 (Country A tax before credit)} \times \text{500 (Country B income)}}{\text{2,000 (total income)}} = 150$$

and the tax payable to Country A would be 450 (600 – 150).

On the other hand, if the interest expenses are allocated to the income earned in Country B, the credit would be limited to:

$$\frac{\text{600 (Country A tax before credit)} \times \text{400 (Country B income)}}{\text{2,000 (total income)}} = 120$$

and the tax payable to Country A would be 480, which is the same result as in the previous example, where Country A exempts foreign source income and does not allow the deduction of the interest expenses.

In effect, if the interest expenses are not allocated to the income earned in Country B, the foreign tax credit is overstated by 30 and the tax of Country A on its domestic source income, which should be 480 (30% × 1,600) is inappropriately reduced by 30.

If a treaty similar to the United Nations Model Convention exists between Country A and Country B and ACo carries on business through a PE or fixed base in Country B, Country B would be required by the provisions of the treaty to allow a deduction for the interest expenses incurred by ACo for the purposes of the PE or fixed base.[a] (See section 2.3.1.3.2.)

[a] Unless Country B also denies the deduction of interest expenses incurred by residents of Country B in the same circumstances.

1.6.4 Foreign source income earned indirectly through foreign corporations—the tax treatment of dividends from foreign corporations

1.6.4.1 Introduction

Sections 1.6.2 and 1.6.3 above deal with interest expenses incurred by residents of a country to earn foreign source income directly. However, residents often earn foreign source income indirectly through foreign corporations in which they own shares, and the acquisition of the shares may be financed by debt on which interest expenses are incurred. This section discusses the treatment of dividends from foreign corporations and the deduction of interest expenses incurred to acquire shares of foreign corporations.

Most countries do not usually tax the foreign source income derived by non-resident corporations that are owned or controlled by residents because non-resident corporations are generally considered to be taxable entities separate from their shareholders, including controlling shareholders. Thus, residents of a country may form non-resident corporations that they control to earn foreign source income. This use of a controlled foreign corporation (CFC) is a relatively simple way for residents of a country to avoid paying tax to their country of residence on their foreign source income. Moreover, such CFCs can sometimes be used to earn income from sources in the residence country.

If residents of a country are entitled to deduct interest expenses incurred in respect of debt used to acquire shares of non-resident corporations, the country's tax base may be eroded in two ways. First, there may be a mismatch in the timing of the deduction of interest and the timing of the recognition of dividends on the shares. Interest is usually deductible annually when it is paid, payable or accrued. Dividends are usually taxable only when received. As a result, interest expenses on debt incurred to acquire shares of non-resident corporations are usually deductible before, and in some cases many years before, dividends on the shares are received. Second, income in respect of shares is usually realized in the form of dividends or capital gains on the disposition of the shares. In many countries, dividends and capital gains are subject to preferential rates of tax. If this is the case,

the deduction of interest results in the reduction of a country's tax at the full rate of tax, but the related income is taxable at a lower rate or exempt from tax completely. The effect of this mismatch is maximized where dividends or capital gains are exempt from tax.

1.6.4.2 Exemption of dividends from foreign corporations

If a country exempts dividends received by its residents from foreign corporations, in principle, any interest expenses incurred to acquire the shares of foreign corporations should not be deductible. However, many countries allow the deduction of interest in these circumstances, perhaps for the purpose of supporting the international competitiveness of resident corporations.

The resulting base erosion is illustrated in the following example, which, as far as possible, uses the same facts as in the previous examples in sections 1.6.2 and 1.6.3 involving foreign income earned directly.

Example 15

ACo, a resident of Country A, owns all the shares of BCo, a company resident in Country B. BCo earns income of 500 in Country B. ACo earns income of 1,600 from Country A (before the deduction of any interest expenses). ACo incurs interest expenses of 100 on borrowed funds that are used to acquire the shares of BCo. Both Country A and Country B impose tax at a rate of 30 per cent. BCo pays tax to Country B of 150 (30% × 500). Country A imposes tax on the worldwide income of its residents, but provides an exemption for dividends from foreign corporations received by corporations resident in Country A that have a 10 per cent or greater interest in those foreign corporations.

If ACo is entitled to deduct its interest expenses of 100, ACo will have net income of 1,500 and will pay tax to Country A of 450. The tax base of Country A will be eroded by the deduction even though Country A will never be entitled to tax any income (dividends) from the ACo investment in the shares of BCo. This result is theoretically inappropriate because expenses incurred to earn exempt income should not be deductible. If Country A denies the deduction of the interest expenses, ACo will pay tax to Country A of 480, which is the same result as in the case where Country A exempts foreign business income earned by ACo directly (see section 1.6.2).

Note that if Country B allowed BCo to deduct interest of 100, BCo would have income of 400 and pay tax to Country B of 120, which is the same as the result in the previous examples if interest expenses are allocated to the foreign income. However, Country B will not allow BCo to deduct the interest expenses because they are incurred by ACo, a different taxable entity.

1.6.4.3 Taxation of dividends from foreign corporations with a credit for foreign taxes

Countries that tax dividends received by residents from foreign corporations will usually allow the deduction of interest expenses incurred to acquire the shares on which the dividends are paid. To provide relief from double taxation, most countries allow a credit for any foreign withholding taxes on the dividends. Some countries provide enhanced relief by allowing a credit for the underlying foreign corporate tax paid by the foreign corporation on the income out of which the dividends were paid. In either case, base erosion will occur to the extent that any interest expenses incurred to acquire the shares of the foreign corporation are not allocated to the dividends for purposes of the limitation on the foreign tax credit.

This result can be illustrated in example 16 below, which, as far as possible, uses the same facts as examples 11-14 in sections 1.6.2 and 1.6.3 involving foreign income earned directly.

Example 16

ACo, a resident of Country A, owns all the shares of BCo, a company resident in Country B. BCo earns income of 500 in Country B. ACo earns income of 1,600 from Country A (before the deduction of any interest expenses). ACo incurs interest expenses of 100 on borrowed funds that are used to acquire the shares of BCo. Both Country A and Country B impose tax at a rate of 30 per cent. BCo pays tax to Country B of 150 (30% × 500). BCo pays a dividend of 350, equal to its entire after-tax income. Country A imposes tax on the worldwide income of its residents, including dividends received from foreign corporations, and it allows a deduction for interest expenses to acquire shares in foreign corporations.

Assumption 1. Assume that Country B imposes a withholding tax of 10 per cent on dividends paid by resident corporations to non-resident

shareholders. As a result, ACo pays tax of 35 to Country B on the dividend of 350. Country A provides a credit only for any foreign withholding taxes imposed on dividends from foreign corporations.

Under this assumption, ACo would have income of 1,600 plus the dividend of 350, less interest expenses of 100 = 1,850. ACo would be subject to tax by Country A of 555 (30% × 1,850) and would qualify for a foreign tax credit of 35 for the withholding tax imposed by Country B on the dividend. Thus, ACo would pay net tax to Country A of 520. The deductible interest expenses reduce the tax base of Country A by 30, but the tax on the dividend even after the foreign tax credit (30% × 350 − 35 = 70) more than compensates. Thus, compared with the example in section 1.6.3 where ACo paid 480 tax to Country A, in this example ACo pays 520, or 40 more, which represents the tax on the dividend (70) less the tax saving from the interest deduction (30).

Base erosion is probably not a serious problem given the facts of this example. However, it should be noted that in many cases, the tax saving from the interest deductions would be realized annually as long as the loan is outstanding, but the tax on the dividend would be payable only when the dividend is paid and received. In many situations where residents control foreign corporations, the distribution of dividends can be deferred for many years and possibly indefinitely. If dividends are deferred, the interest deductions erode the residence country's tax base until dividends are paid.

Assumption 2. Assume that Country B does not impose any withholding tax on the dividends paid by BCo. Also assume that Country A provides an indirect foreign tax credit for the corporate tax paid by BCo on its income out of which the dividends were paid.

In this case, the amount of the dividend included in the income of ACo would be grossed up by the amount of the tax paid by BCo on the income out of which the dividend was paid. Thus, the dividend of 350 would be grossed up by 150 and 500 would be included in the income of ACo. The total ACo income would be 1,600 (income from Country A) plus 500 (grossed up dividend from BCo) less interest expense of 100 = 2,000. The income of ACo would be subject to tax of 600 (30% × 2,000).

The indirect foreign tax credit allowed for the tax paid by BCo on its income out of which the dividend was paid is usually calculated as the lesser of the tax paid and the amount of Country A tax on the dividend (30% × 500 = 150). If the interest expenses are not allocated to the income earned by BCo in Country B, the credit would be limited to:

$$\frac{600 \text{ (Country A tax before credit)} \times 500 \text{ (Country B income)}}{2{,}000 \text{ (total income)}} = 150$$

and the tax payable to Country A would be 450 (600 – 150).

On the other hand, if the interest expenses are allocated to the income earned by BCo in Country B, the credit would be limited to

$$\frac{600 \text{ (Country A tax before credit)} \times 400 \text{ (Country B income)}}{2{,}000 \text{ (total income)}} = 120$$

and the tax payable to Country A would be 480, which is the same result as in the example in section 1.6.2 where Country A exempts foreign source income earned by ACo directly and does not allow the deduction of the interest expenses, and in the example in section 1.6.4.2 where Country A exempts foreign dividends but does not allow the deduction of the interest expenses.

Chapter 2

Analysis of the provisions of a country's tax treaties and model tax treaties dealing with payments of interest and the deduction of interest

2.1 Introduction

In general, tax treaties impose restrictions on the taxes imposed by the contracting States under their domestic laws. Therefore, there are two major questions with respect to the treatment of interest and other financing expenses under tax treaties. First, do tax treaties restrict a country's authority to impose withholding tax on interest payments made to residents of the other contracting State under its domestic law? Second, do tax treaties require countries to allow the deduction of interest in circumstances where no deduction would be allowed under domestic law?

The previous chapter examined how countries tax residents and non-residents in order to provide a foundation for determining the extent to which their tax bases can be eroded through interest payments. Since tax treaties restrict a country's ability to tax under its domestic law, the provisions of a country's tax treaties dealing with interest payments and interest deductions may create risks of base erosion that do not exist under domestic law. This chapter examines the provisions of tax treaties dealing with interest payments and interest deductions in order to provide a foundation for determining the extent to which a country's tax base can be eroded through such payments and deductions as a result of its tax treaties.

First, the chapter poses some basic questions about a country's tax treaty network and the most important provisions of tax treaties dealing with interest payments and interest deductions. Second, the chapter examines the provisions of the United Nations and OECD

Model Conventions[11] dealing with such payments and deductions. These model treaties provide a convenient basis for comparison with a particular country's tax treaties.

2.2 Tax treaty network

It is important to determine how many tax treaties a country has and with which countries. For example, does a country have tax treaties with developed and developing countries; with its major trading partners; with countries that are geographically close; or with low-tax countries or tax havens?

Are a country's tax treaties primarily based on the United Nations Model Convention or the OECD Model Convention? What, if any, variations from the United Nations or OECD Model Conventions do a country's tax treaties usually contain? Do these variations have any impact on the deductibility of interest or the imposition of withholding tax on interest payments?

2.3 The provisions of the United Nations and OECD Model Conventions dealing with payments of interest and the deduction of interest

2.3.1 Restrictions on the taxation of non-residents

2.3.1.1 Introduction

Tax treaties have important consequences, both for the receipt of interest by non-residents and the payment of interest by non-residents. Where interest arises in one contracting State and is paid to a resident of the other contracting State, the first State is entitled under Article 11 of the United Nations and OECD Model Conventions (Interest) to impose tax at a limited rate (10 per cent in the case of the OECD Model

[11] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Convention and a rate to be agreed on by the parties in the case of the United Nations Model Convention) on the gross amount of the interest payments. Where a resident of one contracting State earns income or profits in the other State that are taxable under Article 7 (Business profits) or 14 (Independent personal services)—in the case of the United Nations Model Convention—on a net basis, the United Nations and OECD Model Conventions contain provisions dealing with the deduction of interest and other expenses incurred in earning the income. The provisions of the United Nations and OECD Model Conventions dealing with withholding tax on interest payments and the deduction of interest expenses by non-residents are dealt with below.

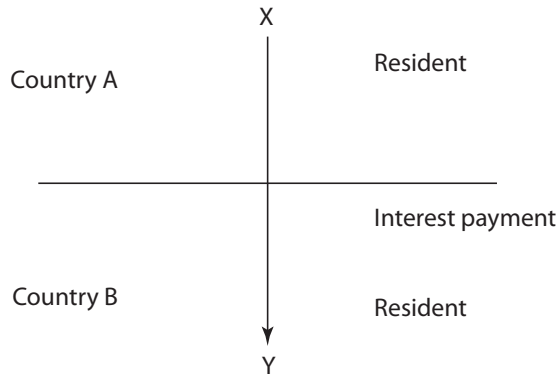
2.3.1.2 Withholding taxes on interest (Article 11)

Under Article 11 (2) of the United Nations Model Convention, where interest arises in a contracting State and is paid to a resident of the other State, the interest may be taxed by the State in which the interest arises. If the recipient is also the beneficial owner of the interest, the rate of tax on the interest is limited to the rate agreed by the contracting States. Under Article 11 (2) of the OECD Model Convention, the rate is limited to 10 per cent of the gross amount of the interest payments. Under both Model Conventions, interest arises in a contracting State if the payer is a resident of that State. However, if the payer has a permanent establishment (PE) (or fixed base in the case of the United Nations Model Convention) in the source country (whether or not the payer is a resident of either of the contracting States); if the debt was incurred in connection with the PE (or fixed base in the case of the United Nations Model Convention); and if the interest expense is deductible in computing the income attributable to the PE (or fixed base in the case of the United Nations Model Convention), under Article 11 (5), the interest is considered to arise in the State in which the PE or fixed base is located. The application of Article 11 (2) is illustrated in the following examples.

Example 17

X, a resident of Country A, pays interest to Y, a resident of Country B. Country A and Country B have concluded a tax treaty that contains a provision identical to Article 11 of the United Nations Model Convention.

Under Article 11 (5), the interest arises in Country A because X, the payer, is a resident of Country A. Since the interest arises in Country A and is paid to a resident of Country B, Country A is entitled to tax the interest payment subject to the maximum rate agreed to in Article 11 (2), assuming that Y is the beneficial owner of the interest.

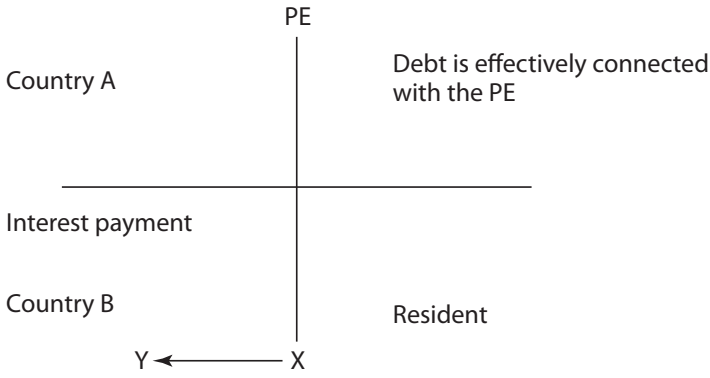


- Interest arises in Country A
- Country A can impose tax subject to limitations in Article 11 (2)

Example 18

X, a resident of Country B, pays interest to Y, who is also a resident of Country B. The debt on which the interest is paid is effectively connected with a PE of X in Country A. Country A and Country B have concluded a tax treaty that contains a provision identical to Article 11 of the United Nations Model Convention.

Under Article 11 (5), the interest is deemed to arise in Country A because the debt on which it is paid is effectively connected to the PE of X in Country A. Since the interest arises in Country A and is paid to a resident of Country B, Country A is entitled to tax the interest payment subject to the maximum rate agreed in Article 11 (2), assuming that Y is the beneficial owner of the interest.

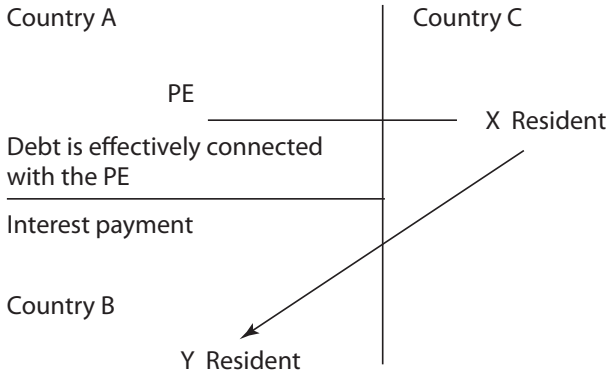


- X pays interest to Y on debt effectively connected to the PE of X in Country A
- Country A can impose withholding tax subject to limitations in Article 11 (2)

Example 19

X, a resident of Country C, pays interest to Y, a resident of Country B. The debt on which the interest is paid is effectively connected with a PE of X in Country A. Country A and Country B have concluded a tax treaty that contains a provision identical to Article 11 of the United Nations Model Convention.

The interest is deemed to arise in Country A under Article 11 (5) of the treaty between Country A and Country B because the debt on which the interest is paid is effectively connected with the PE of X in Country A. It does not matter that the payer, X, is not a resident of either of the contracting States. Therefore, Country A is entitled to tax the interest payment subject to the maximum rate agreed in Article 11 (2), assuming that Y is the beneficial owner of the interest.



- X pays interest to Y on debt effectively connected to the PE of Y in Country A
- Country A can impose withholding tax subject to limitations in Article 11 (2)

If the debt was not effectively connected with the PE of X in Country A (that is, the interest was not deductible in computing the profits attributable to the PE), the interest would be deemed to arise in Country C, where the payer of the interest, X, is resident. In this situation, the treaty between Country A and Country B would not apply to the interest.

2.3.1.3 The deductibility of interest expenses under the provisions of tax treaties

2.3.1.3.1 Introduction

In general, the deduction of interest and other financing expenses is governed by domestic law rather than the provisions of tax treaties. Where tax treaties allow the source country to tax a non-resident on a gross basis (which is the case for all income other than business profits attributable to a PE under Article 7 and income from professional and other independent services taxable under Article 14), the source country is not required to allow any deductions. Despite the provisions of a treaty, a country may allow a non-resident to deduct expenses under its domestic law; if it does so, the deductions are governed completely by its domestic law.

Where tax treaties require income to be taxed by the source country on a net basis, the deductibility of expenses is largely a matter for the domestic law of the source country. However, Article 7 provides some general rules about deductions, and Article 24 (3) (Non-discrimination) precludes a country from discriminating against a resident of the other contracting State carrying on business in the country through a PE (but not through a fixed base).

2.3.1.3.2 Deduction of interest expenses under Articles 7 and 14 of the United Nations Model Convention

Profits or income earned by a resident of one contracting State through a PE or fixed base in the other contracting State are taxable on a net basis under Articles 7 and 14 of the United Nations Model Convention, respectively. Article 7 (3) provides that expenses incurred for the purposes of the business of the PE "shall be allowed as deductions". It also provides that the deduction of these expenses must be allowed irrespective of where the expenses are incurred (that is, in the country where the PE is located or elsewhere). The deduction of notional interest expenses for amounts advanced by a PE to its head office or by the head office to a PE is explicitly prohibited by Article 7 (3), except in the case of financial institutions.[12] Thus, except for financial institutions, only actual interest expenses incurred by an enterprise for the purposes of a PE are deductible for purposes of computing the profits attributable to the PE. However, neither Article 7 of the United Nations Model Convention nor the Commentary indicates how a country should determine whether interest expenses are incurred for the purposes of a PE. This is a matter for domestic law. See the description of the three basic methods for attributing interest expenses to income or assets in section 1.2.3 of chapter 1 above. The Commentary on paragraph 3 of Article 7 does not prescribe any particular method for attributing interest expenses to the profits of a PE. It simply recommends a "practical solution" that recognizes that a separate and independent enterprise would have adequate funding.[13]

[12] See paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 41 of the Commentary on the 2008 OECD Model Convention.

[13] See paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention.

Example 20

ACo is a resident of Country A; in 2015 ACo commences to carry on business in Country B through a PE in Country B. ACo has debt owing to financial institutions of 1 million. In 2015 ACo borrows an additional 100,000 at an interest rate of 6 per cent, which it advances to the PE in Country B along with an additional advance of 250,000. ACo claims a deduction for interest in computing the profits of the PE of 8 per cent on the total 350,000 advanced to the PE. Assume that there is a treaty between Country A and Country B that is similar to the United Nations Model Convention.

Country B is not required to allow ACo a deduction for interest at 8 per cent on the advances to the PE of 350,000. First, with respect to the advance of 100,000 that ACo borrowed from the bank at 6 per cent interest, Country B is not required to allow a deduction for the mark-up of 2 per cent. Second, with respect to the advance of 250,000, Country B is not required to allow the deduction on this entire amount, since that would mean that the PE was funded entirely by debt. Country B should determine on some reasonable basis the extent to which the funding supplied by ACo is debt and equity. Country B is not required by Article 7 of the treaty between Country A and Country B to allow a deduction for notional interest on amounts advanced by ACo to the PE (unless ACo is a financial institution). Thus, Country B might take the position that 250,000 advanced to the PE represents equity of ACo on which no interest deduction is allowed, but it might allow the deduction of interest at 6 per cent on the borrowed funds of 100,000 advanced to the PE. Alternatively, Country B might use an apportionment method and require ACo to allocate interest to the PE in proportion to the assets of the PE as a percentage of the total assets of ACo.

In addition, it is important to understand that Article 7 (3) deals only with the expenses attributable to a PE. As the Commentary provides, "It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular paragraphs 3 and 4 of that Article)."[14]

[14] See paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 30 of the Commentary on Article 7 of the 2008 OECD Model Convention.

Article 14 of the United Nations Model Convention does not contain any provisions dealing with the computation of income attributable to a fixed base or the deduction of interest or other expenses. The Commentary on Article 14 of the United Nations Model Convention provides that the principles in Article 7 should apply for purposes of Article 14, and that expenses incurred for the purposes of the fixed base "should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment".[15] However, as explained above, Articles 7 and 14 deal only with the attribution of expenses to a PE or fixed base; they do not deal with the conditions for the deductibility of expenses, which is a matter for domestic law.

Article 7 of the OECD Model Convention was substantially revised in 2010 and Article 7 (3) dealing with the attribution of expenses to a PE was deleted. The current version of Article 7 of the OECD Model Convention takes the separate-entity principle of Article 7 (2) to its logical conclusion and allows the deduction of notional expenses, including interest, in determining the profits attributable to a PE. However, it maintains that the deductibility of expenses is a matter of domestic law. In addition, Article 14 of the OECD Model Convention was deleted in 2000 and, as a result, income from professional and independent personal services is dealt with under Article 7.

2.3.1.3.3 Determination of the debt capital of a PE

As noted in section 2.3.1.3.2, neither the provisions of Article 7 of the United Nations Model Convention nor the Commentary on Article 7 provides any rules or guidance for determining the amount of debt and equity to be allocated to a PE for purposes of determining the amount of interest expenses to be allowed as deductions in computing the profits of the PE. In the absence of any such rules or guidance, any reasonable allocation may be acceptable.

Some guidance with respect to the allocation of debt and equity to a PE may be found in the OECD *2010 Report on the Attribution*

[15] See paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraph 3 of the Commentary on Article 14 of the 1997 OECD Model Convention.

of Profits to Permanent Establishments.[16] Although this Report relates to the attribution of profits to PEs under the new version of Article 7 (added to the OECD Model in 2010), which has been rejected by the Committee of Experts on International Cooperation in Tax Matters with respect to the United Nations Model Convention, the aspects of the Report dealing with the allocation of capital to a PE may be useful for developing countries in applying Article 7 or 14 of the United Nations Model Convention.

The allocation of profits to a PE is part of the first step under the "authorized OECD approach", which involves a functional and factual analysis of the PE. The second step involves the application of the OECD transfer pricing guidelines, by analogy, to the dealings between the PE and the other parts of the enterprise of which the PE is a part. (This second step is not relevant for the purposes of allocating capital to a PE under the United Nations Model Convention.) The functional and factual analysis of a PE is used to determine the amount of "free capital" of a PE. Free capital is equivalent to equity capital—that is, capital that does not result in a deductible return in the nature of interest. According to the Report, a PE should have sufficient free capital to support its functions, assets and risks. Unlike a separate entity, free capital must follow risks with respect to a PE; capital cannot be segregated in another entity pursuant to a guarantee. The Report recognizes a variety of different approaches for determining the amount of free capital to be attributed to a PE, and emphasizes that these approaches result in a range of acceptable arm's length amounts rather than a single number. The attribution of free capital to a PE does not require any formal allocation of capital to the PE by the enterprise.

Under the "capital allocation approach," a PE is allocated free capital based on the assets and risks of the PE as a percentage of the assets and risks of the enterprise as a whole. This approach may be inappropriate where an enterprise as a whole is thinly capitalized or where the PE is engaged in a business that is significantly different from the business conducted by the rest of the enterprise. Under the "thin capitalization approach", a PE is allocated the same amount of free capital

[16] OECD, *2010 Report on the Attribution of Profits to Permanent Establishments, 22 July 2010,* available from https://www.oecd.org/ctp/transfer-pricing/45689524.pdf.

as an independent enterprise carrying on the same activities under the same conditions by comparing debt/equity ratios of similar independent enterprises. Both of these approaches present substantial difficulties, as discussed in the OECD Report. The Report also discusses other methods that might be more appropriate with respect to banking and insurance companies.

The Report also contains a discussion of the attribution of capital to a PE where the enterprise as a whole is thinly capitalized. For example, if an enterprise has 100 of equity capital and 1 million of debt, even the allocation of all the equity of the enterprise to the PE will not produce an arm's length result and will allow the deduction of too much interest in computing the profits of the PE. In this type of situation, the Report suggests two possible approaches: a thin capitalization approach, under which the capital structure of similar independent enterprises is used to determine an arm's length amount of free capital; and an approach under which the free capital of the enterprise as a whole is adjusted to an arm's length amount, then the free capital is allocated to the PE based on the capital allocation approach discussed above.

For purposes of allocating capital to a PE, the creditworthiness of the PE is assumed to be the same as the creditworthiness of the entire enterprise, so that internal dealings affecting creditworthiness, such as guarantee fees, are not recognized. The Report emphasizes that although there is widespread agreement on the necessity for a PE to have sufficient free capital to support its assets and risks, there is no international agreement on any single method to determine the amount of free capital to be allocated to a PE.

2.3.1.3.4 Non-discrimination (Article 24 (3))

Under Article 24 (3) of both the United Nations and OECD Model Conventions, a contracting State is prohibited from taxing a PE of a resident of the other contracting State less favourably than it taxes its own enterprises carrying on similar activities. Thus, if resident enterprises are taxable on their profits on a net basis, non-residents carrying on business through PEs must be similarly taxable on a net basis and must be allowed to deduct interest expenses in the same manner as resident enterprises. It is important to note in this regard that, although

Article 7 (3) deals with the attribution of expenses to PEs and leaves the deductibility of expenses to domestic law, Article 24 (3) covers the deductibility of expenses in computing the profits of a PE.

Where a country in which interest arises levies a withholding tax on interest paid to a resident of the other contracting State, but that resident has a PE in the first country, the first country is entitled to tax the interest under Article 7 without the limitations imposed by Article 11 (2). However, the imposition of withholding tax on interest in these circumstances would appear to be a violation of Article 24 (3) unless withholding tax is also imposed on interest paid to residents of the country.[17]

If a country levies a branch-level interest tax (that is, a tax on the amount of any interest deducted in computing the profits attributable to a PE),[18] Article 24 (3) does not apply because the tax is not levied on the PE, but on the enterprise to which the interest is considered to be paid.[19]

Since Article 24 (3) refers only to the taxation of a PE and not to connected requirements (unlike Article 24 (5), as discussed in section 2.3.2.4 below), Article 24 (3) does not prevent a country from imposing

[17] See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraphs 62 – 65 of the Commentary on Article 24 of the OECD Model Convention.

[18] A branch-level interest tax is different from a "branch tax", which is an additional tax levied on the profits of a PE to make up for the absence of any withholding tax on the distribution of profits of a PE. A branch tax is intended to make the treatment of PEs similar to the treatment of subsidiaries of non-resident corporations. A country generally imposes tax on the profits of a domestic subsidiary, as well as a withholding tax on any dividends distributed to its non-resident parent corporation. However, in the case of a PE, the non-resident corporation is taxed only on the profits of the PE because a PE does not pay dividends. A branch tax would be a violation of Article 24 (3). See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 60 of the Commentary on Article 24 of the OECD Model Convention.

[19] See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 61 of the Commentary on Article 24 of the OECD Model Convention.

different information reporting requirements, penalties and other administrative rules connected with the taxation of non-residents carrying on business through a PE from those imposed on residents carrying on similar activities. Therefore, for example, a country could allow a deduction for interest expenses in computing the profits attributable to a PE only if the payer withholds tax from the payment, without imposing a similar requirement on residents claiming interest deductions.

2.3.2 Restrictions on the taxation of residents

2.3.2.1 Introduction

The provisions of tax treaties, including both the United Nations and OECD Model Conventions, do not generally limit the ability of the contracting States to tax their own residents.[20] However, there are at least three important exceptions to this general principle. First, Article 23 of both the United Nations and OECD Model Conventions imposes a general obligation on the residence country to provide relief from the double taxation of income earned by residents of the other contracting State where the other State taxes the income in accordance with the provisions of the treaty. The relief of double taxation under the United Nations and OECD Model Conventions and the treatment of interest for the purposes of such relief are discussed in section 2.3.2.2 below. Second, Article 24 (4) and (5) provides protection for residents of a country against certain types of discrimination. Third, Article 9 allows the contracting States to adjust the prices of transactions entered into between associated enterprises if those prices differ from the prices that would have been agreed to if the parties had been dealing with each other at arm's length.[21]

[20] Exceptions to this general principle are found in Articles 8, 18 and 19. Under these provisions, the country in which the taxpayer is resident is precluded from taxing profits from, respectively, the use of ships and aircraft in international traffic, social security pensions, and payments for government service (unless the recipient is a resident and national of the other State and the services are rendered in that State). These provisions have little, if any, impact on payments of interest and the deduction of interest.

[21] The transfer pricing guidelines applicable under Article 9 of the United

2.3.2.2 Relief of double taxation (Article 23)

Article 23 of both the United Nations and OECD Model Conventions requires a contracting State to provide relief from double taxation of its residents where they are subject to tax in the other contracting State in accordance with the treaty. Under Article 23 of both Models, the residence country may provide relief from double taxation by exempting the income from tax (Article 23 A) or granting a credit for the tax paid to the other country against the resident country's tax (Article 23 B). Article 23 A (2) allows a country that generally uses the exemption method to apply the credit method to dividends and interest (and royalties in the case of the United Nations Model Convention) that are taxable by the other State. Conversely, a country that uses the credit method may be required by certain provisions of the treaty to exempt income because that income is taxable exclusively by the source country (for example, Articles 8 (Shipping, inland waterways transport and air transport), 18 (Pensions and social security payments) and 19 (Government service)).

Where the United Nations or OECD Model Conventions authorize the use of the credit method for relieving double taxation (that is, Article 23 A (2) or Article 23 B (1)), both Model Conventions provide explicitly that the credit shall be limited to the amount of residence country tax that is attributable to the income that may be taxed by the other contracting State in accordance with the treaty.[22] Article 23 A (3) and 23 B (2) also provides that any income that is exempt from tax in the residence country may nevertheless be taken into account for purposes of establishing the tax rate on the taxpayer's other income (so-called exemption with progression).

These limitations on the credit recognize that the credit method is intended to eliminate double taxation but is not intended to require a country to provide any further relief. For example, assume that a resident of Country A earns income of 1,000 in Country B that is taxed at a rate of 40 per cent, but Country A taxes the income at a rate of

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Nations Model are beyond the scope of this *Practical Portfolio*. For information on transfer pricing issues, see United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

[22] See the second sentence of both Article 23 A (2) and Article 23 B (1).

only 30 per cent. Under Article 23 B of the United Nations and OECD Model Conventions (assuming that Country B is entitled to tax the income in accordance with the treaty), Country A is obligated to allow a credit for the tax paid to Country B. However, the credit is limited to Country A tax attributable to the income taxable by Country B under the treaty, which is 30. If Country A were required to provide a full credit for the tax paid to Country B without any limitation, it would be necessary for it to provide a refund to the taxpayer of 10, which would represent a reduction of Country A tax, not on the income taxable by Country B, but on other income taxable by Country A.

Although Article 23 A and 23 B of both the United Nations and OECD Model Conventions provide for the general principles of exemption and credit, respectively, they do not provide detailed rules for the limitations on the amount of income to be exempted or the amount of foreign tax to be credited. The Commentary on both Model Conventions recognizes that rules for the limitation of the exemption or credit must be provided by domestic law.[23] Some countries that apply the credit method include an explicit reference in Article 23 to the provisions of the foreign tax credit under their domestic law. If a country does not use the credit method under its domestic law, but agrees to the application of that method pursuant to a treaty, it should establish rules for the application of the credit method and might consider consulting with the competent authority of the other State for that purpose.[24]

2.3.2.3 Non-discrimination (Article 24 (4))

Pursuant to Article 24 (4) of both the United Nations and OECD Model Conventions, a contracting State must allow the deduction of interest,

[23] See paragraphs 39 – 43 of the Commentary on Article 23 A of the OECD Model Convention and paragraphs 60 – 64 of the Commentary on Article 23 B of the OECD Model Convention. See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 39 – 43 of the Commentary on Article 23 A of the OECD Model Convention, and paragraphs 60 – 64 of the Commentary on Article 23 B of the OECD Model Convention.

[24] See paragraph 60 of the Commentary on Article 23 B of the OECD Model and paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 60 of the Commentary on Article 23 B of the OECD Model Convention.

royalties and other disbursements made by an enterprise of that State to a resident of the other contracting State under the same conditions as if the amounts had been paid to a resident of the first State. This provision is subject to the transfer pricing rules in Article 9 (1) and the rules in Articles 11 (6) and 12 (6) with respect to excessive payments of interest and royalties.

Article 24 (4) prevents a country from imposing conditions on the deduction of interest paid to a resident of the other contracting State that are different from the conditions imposed on the deduction of interest paid to residents of the country, or from disallowing the deduction of interest paid to a resident of the other contracting State if interest paid to residents of the country is deductible. Therefore, for example, Article 24 (4) would prevent a country from imposing thin capitalization or earnings-stripping rules on a resident enterprise under which the deduction of interest paid by such an enterprise to non-residents is limited to interest on debt that does not exceed a specified debt/equity ratio or a percentage of the earnings of the enterprise. However, such thin capitalization and earnings-stripping rules can be applied if they are compatible with the transfer pricing rules in Article 9 (1)—in other words, if they comply with the arm's length standard. For this reason, some countries include provisions in their thin capitalization rules to the effect that the restrictions on the deduction of interest do not apply if a taxpayer can establish that the amount of debt and interest are in accordance with the arm's length standard. Thin capitalization and earnings-stripping rules can also be applied without violating Article 24 (4) if they apply to interest paid to residents as well as non-residents, although it is questionable whether it is necessary for the rules to be applied to residents. Alternatively, countries might consider specifically excluding their thin capitalization rules from the scope of Article 24 (4) in order to allow those rules to be applied to the residents of treaty countries, although this approach will usually be too drastic.

Article 24 (4) does not prevent a country from imposing withholding tax on interest paid to residents of the other contracting State. Article 24 (4) prevents discriminatory treatment of interest paid by residents of a country to residents of its treaty partners; it does not prevent taxation of non-residents on a basis that is different from that applied to residents. Nor is there any other provision in Article 24 that would

prevent a country from imposing a withholding tax on interest paid to residents of the other contracting State even if the country does not impose a similar withholding tax on interest paid to its own residents. Similarly, Article 24 (4) does not prevent a country from imposing additional or different information reporting requirements with respect to interest paid to non-residents as compared to interest paid to residents.[25]

2.3.2.4 Non-discrimination (Article 24 (5))

Article 24 (5) prohibits a country from discriminating against its own resident enterprises that are owned or controlled, directly or indirectly, by residents of the other contracting State. Pursuant to Article 24 (5), resident enterprises owned or controlled by residents of the other State must not be subjected to taxation or any connected requirement that is different from or more burdensome than the treatment of similar resident enterprises. The application of Article 24 (5) to any requirement connected with taxation means that a country cannot impose different administrative requirements, such as information reporting obligations or penalties, on resident enterprises owned or controlled by residents of its treaty partners from those imposed on other resident enterprises.

Article 24 (5) protects resident enterprises from discrimination; it does not deal with the taxation of non-residents who own or control resident enterprises or who receive payments from such enterprises. Similarly, Article 24 (5) does not prevent a country from treating payments of interest or other amounts made by resident enterprises to non-residents differently from similar payments to residents unless the different treatment is based on the ownership or control by the non-residents of the resident enterprises.[26] However, if a country has thin capitalization or earnings-stripping rules that deny or limit the deduction of interest only for payments of interest to non-residents that own or control (shareholders) resident corporations, Article 24 (5) of an applicable tax treaty would prohibit the application of those rules

[25] See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 75 of the Commentary on Article 24 of the OECD Model Convention.

[26] See paragraph 4 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 79 of the Commentary on Article 24 of the OECD Model Convention.

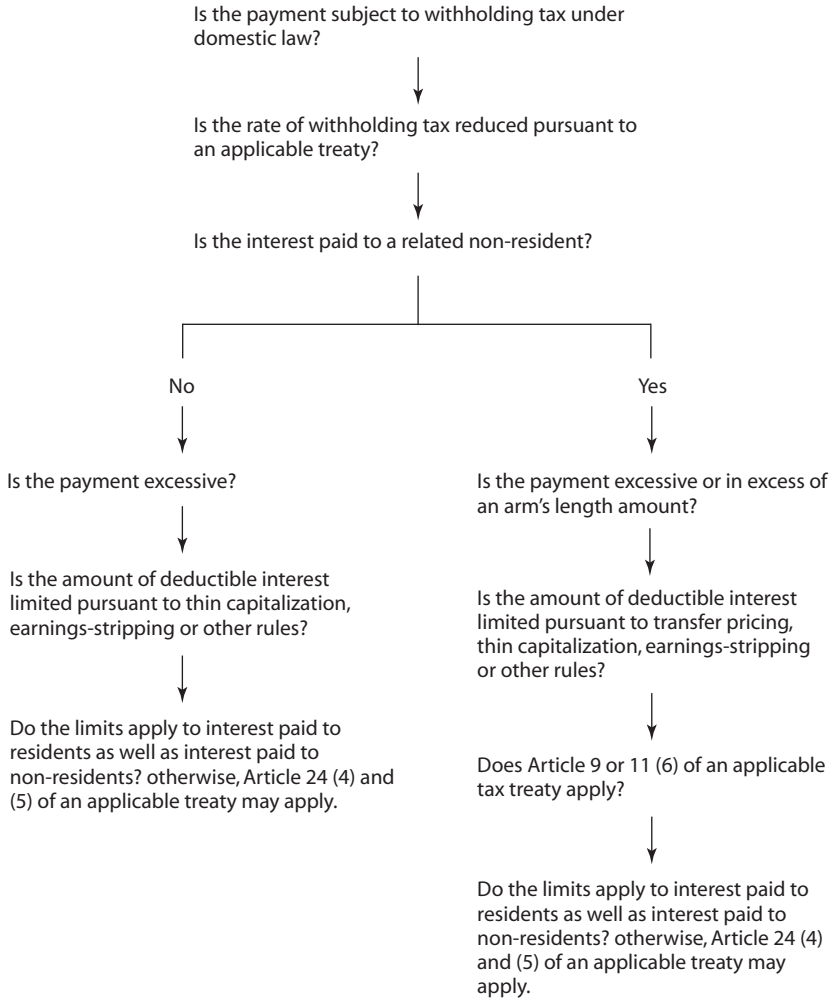
to shareholders resident in the other country. Although Article 24 (5) does not contain the exceptions for Articles 9 (1), 11 (6) and 12 (6) that are contained in Article 24 (4), the Commentary indicates that those exceptions apply equally to Article 24 (5).[27]

2.3.3 Other relevant treaty provisions

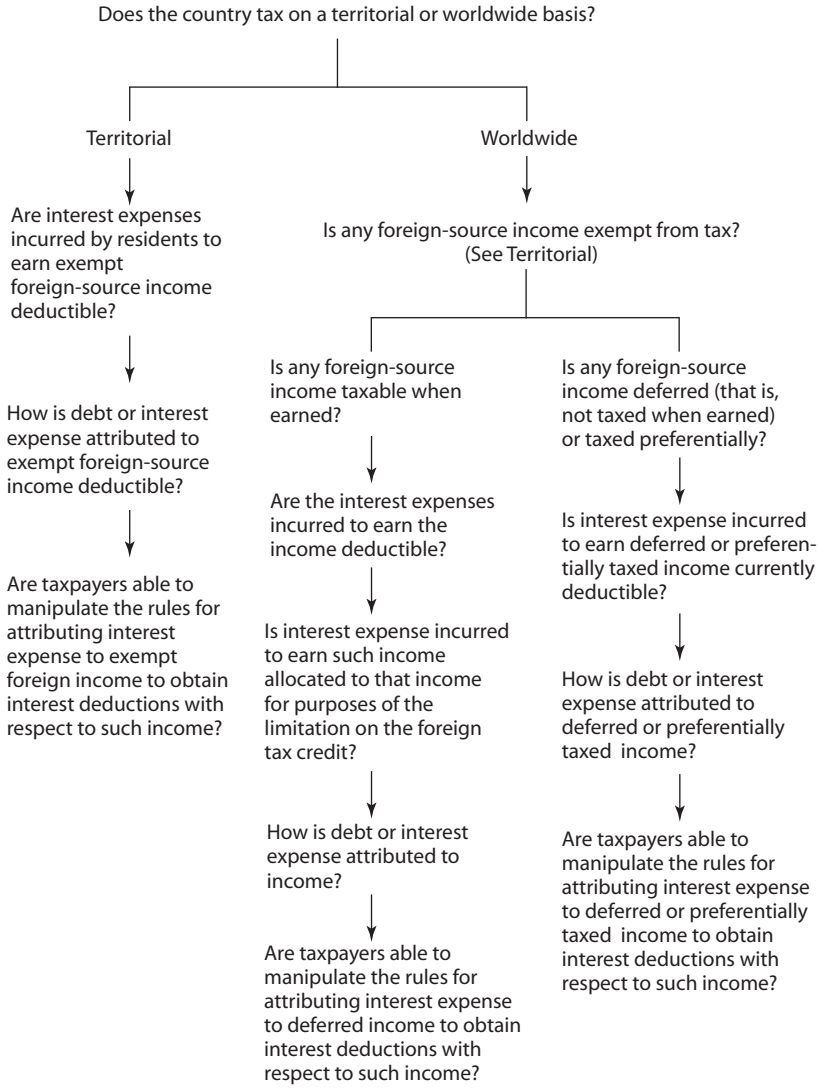
Article 11 of the United Nations and OECD Model Conventions applies only to interest that arises in a contracting State and is paid to a resident of the other contracting State. Where the interest arises in a third State, Article 11 does not apply; instead, Article 21 (Other income) applies to such interest. Under Article 21 (1), such interest would be taxable exclusively by the country in which the taxpayer is resident. However, if the resident carries on business in the other contracting State through a PE or fixed base there and the interest is effectively connected with the PE or fixed base, the interest income is taxable in accordance with Article 7 (Business profits) or 14 (Independent personal services). For example, assume that Company A is a resident of Country A and carries on business through a PE in Country B. Company A receives interest from a person resident in Country C; however, the interest is effectively connected to a receivable held in connection with the PE of Company A in Country B. In this situation, the interest would be taxable by Country B under Article 21 (2), assuming that Country A and Country B have a tax treaty similar to the United Nations Model Convention. This would not appear to raise any serious base-erosion concerns with respect to Article 21 and interest expenses.

[27] Ibid.

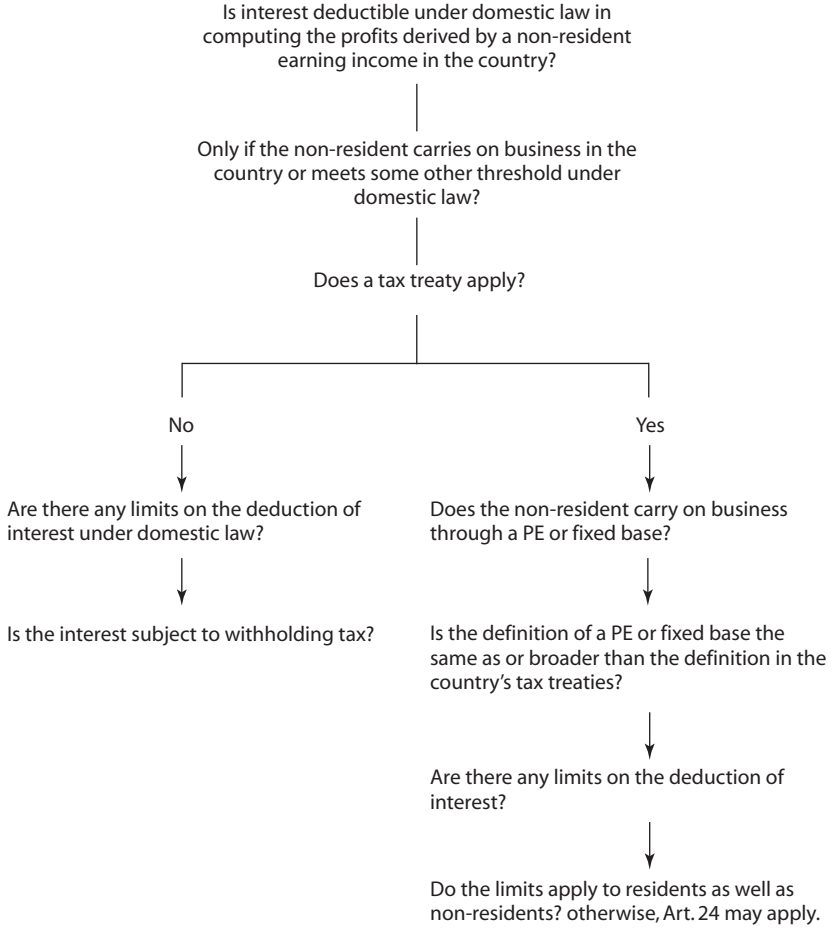
Flow chart 1
Residents paying interest to non-residents



Flow chart 2
Residents incurring interest expenses to earn foreign source income



Flow chart 3
Non-residents incurring interest expenses to earn domestic source income



Chapter 3

Information gathering for tax policy analysis

3.1 Introduction

For purposes of applying tax policy analysis to a country's tax system with respect to payments of interest and other financing expenses to non-residents and the deduction of such payments, the information outlined below would be useful. Ideally, the information should be collected on a country-by-country basis. Most of the information is collected from taxpayers or third persons such as withholding agents and financial institutions. Countries should balance the need for and usefulness of any information against the burden imposed on taxpayers and third parties to provide that information. Also, countries should not require taxpayers and third parties to provide information that the tax authorities do not have the capacity or intention to use.

3.2 Interest paid by residents to non-residents—withholding taxes

3.2.1 Total amount of interest and other financing expenses paid to non-residents

Information on the total amount of interest and other financing expenses paid to non-residents is useful because it will give the country an idea of the total amount potentially subject to withholding tax. The information can be collected from residents that pay interest to non-residents; however, it might be difficult to collect the information from resident individuals. It would be useful if this information were broken down into categories related to the type of payer (for example, individuals, small and medium-sized companies,

and large companies) and recipient (financial institutions, related parties). It would be useful to have information about the different types of payments to non-residents described in section 1.2.1, such as interest, guarantee fees and amounts that are economic equivalents of interest.

3.2.2 Total amount of interest and other financing expenses subject to withholding taxes

Information on the total amount of interest and other financing expenses subject to withholding taxes is useful in order to show the amount of interest and other financial equivalents paid to non-residents that is subject to withholding tax. As discussed above, it would also be useful to have information about the types of debt on which interest is paid, the types of creditors to whom the interest is paid, and the types of resident payers.

3.2.3 Total amount of withholding taxes on interest and other amounts collected

Information on the total amount of withholding taxes on interest and other amounts collected is useful in order to show the amount of tax collected through withholding taxes on interest and other similar amounts paid to non-residents. Such information would be important with respect to proposals to reduce or eliminate the withholding taxes on interest. It would be useful to have this information on a country-by-country basis, especially if interest withholding taxes are reduced or eliminated pursuant to a country's tax treaties.

3.2.4 Interest and other amounts exempt from withholding taxes

It would be useful to know the amounts of interest and other financial equivalents that qualify for any exemptions from withholding tax provided by a country's domestic law or its tax treaties in order to evaluate those exemptions. This information would be more useful if collected on the basis of each exemption rather than on an aggregate basis.

3.2.5 Interest and other financial equivalents paid to non-residents on a country-by-country basis

Information on interest and other financial equivalents paid to non-residents on a country-by-country basis would be useful in order to determine how much interest is being paid to residents of low-tax or no-tax countries, where it is unlikely to be subject to any significant tax. It would also be useful to determine how much interest is being paid to residents of countries with which a country has tax treaties.

3.2.6 Non-resident recipients of interest and other financial equivalents

It might be useful to know the amounts of interest and other financial equivalents paid by residents of a country to different types of non-resident lenders — financial institutions, non-financial corporations, other entities, individuals, etc.

3.2.7 Resident payers

It would be useful to know what types of residents — financial institutions, non-financial corporations, other entities, individuals, etc.— are paying interest and other financial equivalents to non-residents, as well as the type and amount of debt in respect of which the interest is payable and the amounts of interest and other financial equivalents payable.

3.3 Interest and other financial equivalents paid to related non-residents

Information on interest and other financial equivalents paid to related non-residents is important for purposes of a country's transfer pricing rules and its thin capitalization or earnings-stripping rules, as well as for withholding taxes. It is important to ensure that residents are not paying more than an arm's length interest rate on money borrowed from related non-residents and also that residents do not have an excessive amount of debt owed to related non-residents. It would be useful to have sufficient information to compare the amount of leverage of resident corporations that are controlled by non-residents to that of other resident corporations.

In this regard, it should be noted that the OECD/G20 BEPS *Action 13: Final Report: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*[28] proposes that multinational enterprises be required to report certain information to each jurisdiction in which it is operating (so-called country-by-country reporting). Such information would include:

- Revenue earned in the country
- Profits before tax
- Taxes paid and accrued
- Employees
- Capital
- Retained earnings
- Tangible assets

In addition, multinationals would be required to identify all entities in the group doing business in the country and the type of business they carry on. However, the information referred to above would be provided on an aggregate basis for each country and not on an entity-by-entity basis. Some developing countries might prefer also to require multinational enterprises to provide information concerning payments of interest, royalties and services to related parties.

The information available to countries pursuant to this proposed country-by-country reporting is an important source of information for the tax authorities to use in combating base erosion. Such information will likely be available only through the exchange-of-information provisions in bilateral tax treaties, tax information exchange agreements or the Multilateral Agreement on Mutual Assistance in Tax Matters. Developing countries that do not have an extensive network of bilateral tax treaties may wish to consider ratifying the Multilateral Agreement on Mutual Assistance for this reason.[29]

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[28] Available from http://www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm.

[29] See generally Diane Ring, "Transparency and disclosure", in *Handbook on Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), chapter X, 497–568, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

3.4 Deductions of interest and other similar amounts

It would be useful for tax policy analysis to have a wide variety of information about deductions for interest and other similar amounts claimed by both residents of a country and non-residents carrying on business in the country. Such information would include:

- The total amount of interest deductions claimed by residents
- The total amount of deductions of amounts economically similar to interest claimed by residents
- The total amount of interest deductions claimed by non-residents
- The total amount of deductions of amounts economically similar to interest claimed by non-residents
- The amount of deductions of interest and other economically similar amounts claimed by various types of resident and non-resident enterprises—for example, financial institutions
- The amount of deductions of interest and other economically similar amounts claimed by resident enterprises controlled by non-residents
- The amount of debt of resident enterprises controlled by non-residents compared with that of other resident enterprises
- The amount of debt of resident enterprises with foreign subsidiaries or PEs compared with that of other resident enterprises
- Deductions of interest and other economically similar amounts claimed by non-resident enterprises carrying on business in a country through a PE or fixed base in the country
- Information about guaranteed debt and back-to-back debt of resident enterprises controlled by non-residents

Chapter 4

Risks of base erosion with respect to interest payments and possible responses

4.1 Introduction

As explained in section 1.1, the introduction to chapter 2, base erosion through interest payments occurs because the payments are deductible by the payer, and is exacerbated where the payments are not taxable to the recipient and/or the related income is exempt from tax or taxed at a preferential rate. The risks of base erosion through interest payments are also a function of the residence of the payer and the recipient of the interest payments. The risks of base erosion with respect to payments of interest and other financing expenses are clearly greatest where the payments are deductible against a country's tax base and are made to non-residents. Such interest payments ordinarily reduce the payer's income subject to tax and the amount of tax payable; they are not subject to tax, or are subject to a reduced rate of tax in respect of the non-resident recipient. These interest payments are the primary focus of this chapter.

All interest deductions reduce a country's tax base. If, like dividends, interest were not deductible, they would not result in base erosion. However, in most countries, unlike dividends, interest is generally deductible in computing a taxpayer's profits and reduces a country's tax base. Although all interest deductions erode a country's tax base, not all interest deductions should be viewed as problematic from the perspective of base erosion because most interest expenses represent legitimate expenses incurred in earning taxable income that should be deductible.

The risks of base erosion are not serious where interest and other financing expenses are not deductible against a country's tax base. In

such a situation, the only issue is whether the interest payments are subject to withholding tax. As discussed in section 1.4 above, there are good reasons for countries not to impose withholding tax on interest in certain circumstances.

The discussion of the risks of base erosion through deductible interest payments in this chapter follows the framework set out in the introduction to chapter 1. In section 4.2, the risks of base erosion through deductible interest payments by both residents and non-residents of a country that are excessive for some reason, and the possible responses, are discussed. In section 4.3, the risks of base erosion through deductible interest payments by both residents and non-residents of a country where the non-resident recipient of the payments is not subject to tax, or is subject to a reduced rate of tax by that country, and the possible responses, are discussed. In section 4.4, the risks of base erosion through deductible interest payments by both residents and non-residents of a country where the related income is not subject to tax, or is subject to preferential tax by that country, and the possible responses, are discussed.

The risks of base erosion through deductible interest payments can be viewed as a continuum, as shown in table 2 below.

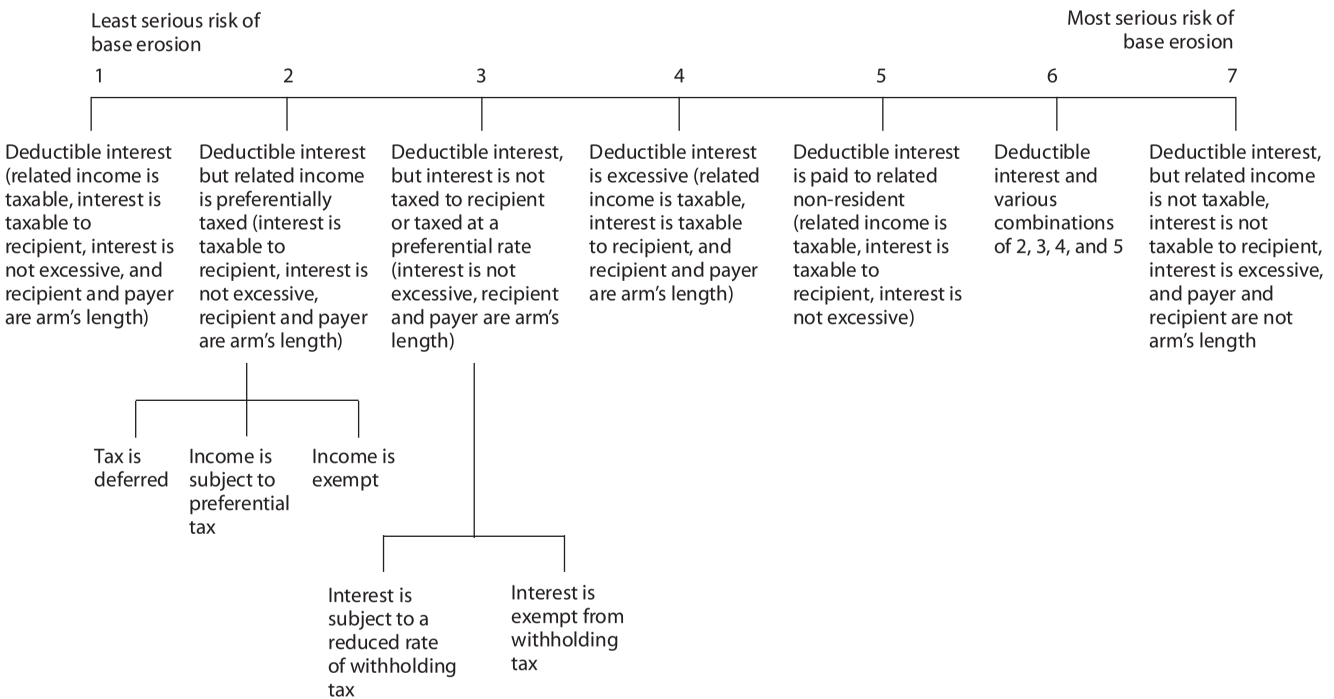
The risks of base erosion through deductible interest payments are greatest where the interest deductions against a country's tax base are excessive, the interest payments are not subject to that country's withholding tax, and the income generated by the financing on which the interest was paid is exempt from that country's tax. Although the risks of base erosion are multiplied where a combination of the relevant base-eroding effects is present, it is convenient to discuss each effect and the possible responses separately.

4.2 Excessive interest deductions

4.2.1 Introduction

As discussed above in section 1.3 of chapter 1, many countries have provisions in their domestic law to prevent taxpayers from deducting interest payments to the extent that such payments are excessive. Interest payments may be considered excessive if the interest rate is

Table 2
Continuum of base erosion from deductible interest payments



higher than the interest rate on similar arm's length debt, if the amount of debt is excessive, or the amount of deductible interest is excessive based on a certain debt/equity ratio or interest/earnings ratio.

The problems of excessive interest rates and excessive amounts of debt are sometimes dealt with through transfer pricing rules or general anti-avoidance rules. Transfer pricing rules apply where a resident enterprise and a non-resident enterprise are related or associated, which is the case where one enterprise controls the other or both enterprises are controlled by a third enterprise. Transfer pricing rules and general anti-avoidance rules are beyond the scope of this *Portfolio*.[30]

Several countries prefer to deal with the problem of excessive interest with specific rules, such as thin capitalization rules or earnings-stripping rules, that may have a broader scope than transfer pricing rules. The risks of base erosion associated with these rules are dealt with in section 4.2.2 below.

The problem of excessive interest deductions applies to both resident and non-resident entities. In general, non-resident entities are entitled to deduct interest expenses only where they are subject to net-basis taxation by the country in which they earn income; this is usually the case where non-residents carry on substantial business activities in that country (often through a PE or fixed base). The risks of base erosion with respect to non-residents are dealt with in section 4.2.2.4 below.

4.2.2 Excessive interest deductions claimed by resident entities

4.2.2.1 Introduction—general risks of base erosion through excessive interest deductions

Risk of base erosion through excessive interest deductions is an aspect of base erosion through interest payments that is difficult to identify precisely. All interest deductions erode a country's tax base, but most

[30] See generally United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

of those deductions represent legitimate costs of doing business and earning income. Therefore, the question is, at what point do interest deductions become excessive enough for a country to consider imposing limits on those deductions?

The risks of cross-border base erosion through excessive interest payments to non-residents, and the possible responses, are identified and discussed briefly below:

1. *Risk*: The interest rate or the amount of debt exceeds what would be an arm's length rate or an arm's length amount of debt.

   This risk is generally considered to arise only with respect to associated or related enterprises that do not deal at arm's length.

   Possible responses: The appropriate response to this risk of base erosion is the application of transfer pricing rules to disallow the deduction of interest in excess of an arm's length amount. Therefore, countries that do not have transfer pricing rules applicable to interest should consider adopting such rules. However, transfer pricing rules are notoriously difficult to apply, and many countries have preferred to enact specific anti-avoidance rules, such as thin capitalization or earnings-stripping rules, to deal with excessive interest payments by resident entities to non-residents.

2. *Risk*: Interest is paid to substantial non-resident shareholders of a resident entity on debt that may be considered to be excessive because the debt is disguised equity.

   This risk is broader than the risk of base erosion with respect to interest payments to associated or related enterprises because substantial shareholders usually include non-resident shareholders who own a significant percentage (10 to 25 per cent or more) of the shares or equity interests of the resident entity.

   Possible responses: A country that is concerned about this type of base erosion could apply its transfer pricing rules; however, any tax treaties entered into by the country would likely prevent it from applying those rules to non-resident shareholders that do not control the resident entity.

Alternatively, a country could enact rules to treat shareholder debt as equity in certain circumstances, or thin capitalization rules to disallow the deduction of interest paid to substantial non-resident shareholders where such shareholders have excessive debt relative to their equity or the equity of the enterprise.

3. *Risk*: Interest is excessive because a resident entity has a disproportionate amount of debt relative to its equity.

   This risk is similar to the previous risks, except that the risk is perceived to be broader because it applies to all interest paid to non-residents, not just substantial or controlling shareholders.

   Possible response: A country that is concerned about this type of base erosion could enact thin capitalization rules to disallow the deduction of interest paid by resident entities to non-residents where the resident entities have excessive debt relative to their equity. The specific risks of base erosion from inadequately designed thin capitalization rules are identified below in section 4.2.2.2.

4. *Risk*: Interest is excessive because a resident entity has interest expenses that are disproportionate to its earnings.

   This risk is similar to the previous risk, except that whether interest paid by a resident entity is deemed excessive is measured by reference to the entity's interest expenses relative to its earnings.

   Possible response: A country that is concerned about this type of base erosion could enact earnings-stripping rules to disallow the deduction of interest paid by resident entities to non-residents where the resident entities have excessive interest expenses relative to their earnings. The specific risks of base erosion from inadequately designed earnings-stripping rules are identified below in section 4.2.2.3.

5. *Risk*: A country's tax treaties may prevent it from applying its thin capitalization or earnings-stripping rules.

   Even if a country adopts thin capitalization or earnings-stripping rules, any tax treaties entered into by the country that contain provisions similar to Article 24 (4)

and (5) on non-discrimination of the United Nations Model Convention[31] may prevent that country from applying those rules.

Possible responses: A country may take a variety of steps to prevent its tax treaties from preventing the application of its thin capitalization or earnings-stripping rules:

- It may decline to enter into tax treaties
- It may refuse to agree to the inclusion of Article 24 (4) and (5) in its tax treaties
- It may enact thin capitalization or earnings-stripping rules that apply to interest paid to both residents and non-residents
- It may provide an exemption from the thin capitalization or earnings-stripping rules where a taxpayer complies with the arm's length standard in Article 9 (Associated enterprises)
- It may insist on expressly excluding its thin capitalization or earnings-stripping rules from Article 24 (4) and (5)
- It may insist on limiting Article 24 (4) and (5) to most-favoured-nation (MFN) treatment rather than national treatment

These responses are discussed in section 4.2.2.5 below.

In choosing among the possible responses to deal with the risks of base erosion through interest payments, countries should consider the complexity of the rules and the compliance and administrative burden imposed on taxpayers and tax officials.

4.2.2.2 Thin capitalization rules

Developing countries that do not have any rules to prevent the deduction of excessive payments of interest to non-residents (other than transfer pricing rules) should consider the adoption of such rules.

[31] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

Countries that have thin capitalization rules should review those rules periodically to ensure that they are effective in preventing base erosion.

The major risks that may render thin capitalization rules ineffective in preventing base erosion are as follows:

1. *Risk*: The rules are not sufficiently broad in scope with respect to the payments of deductible interest by residents to non-residents.

   Possible responses: The rules should be reviewed to ensure that they apply to all deductible payments of interest by resident entities and non-residents, including payments by partnerships, trusts and other entities. If a country's thin capitalization rules apply only to non-resident shareholders (or to controlling or substantial non-resident shareholders) of resident corporations, the rules could be extended to payments of interest to non-residents related to those shareholders.

2. *Risk*: The rules are not sufficiently broad in scope with respect to their application to payments that are economically equivalent to interest.

   Possible response: The rules could be extended to all deductible payments that are economically equivalent to interest.

3. *Risk*: The debt/equity ratio is too generous.

   Possible response: The ratio should be reviewed and adjusted periodically.

4. *Risk*: Not all relevant types of debt are taken into account for purposes of the debt/equity ratio.

   Possible response: Depending on the underlying policy of a country's thin capitalization rules, it should consider expanding the rules to cover all forms of debt, including, for example, guaranteed debt and back-to-back financing arrangements.

5. *Risk*: The rules can be avoided through temporary infusions of equity into resident entities.

   Possible responses: Equity for purposes of the debt/equity ratio could be calculated as an average of monthly or quarterly calculations of equity. Alternatively, a country could adopt a specific anti-avoidance rule to prevent temporary infusions of equity from being used to avoid the rules.

4.2.2.3 Earnings-stripping rules

Developing countries that do not have any rules to prevent the deduction of excessive payments of interest to non-residents (other than transfer pricing rules) should consider the adoption of such rules. Countries that have earnings-stripping rules should review those rules periodically to ensure that they are effective in preventing base erosion.

The major risks that may render earnings-stripping rules ineffective in preventing base erosion are as follows:

1. *Risk*: The rules are not sufficiently broad in scope with respect to the payments of deductible interest by residents to non-residents.

   Possible responses: The rules should be reviewed to ensure that they apply to all deductible payments of interest by resident entities and non-residents, including payments by partnerships, trusts and other entities. If a country's earnings-stripping rules apply only to non-resident shareholders (or to controlling or substantial shareholders) of resident corporations, the rules could be extended to payments of interest to non-residents related to those shareholders.

2. *Risk*: The rules are not sufficiently broad in scope with respect to their application to payments that are economically equivalent to interest.

   Possible response: The rules could be extended to all deductible payments that are economically equivalent to interest.

3. *Risk*: The ratio of interest expenses to earnings is too generous.

   Possible response: The ratio should be reviewed and adjusted periodically.

4. *Risk*: The rules might be avoided in various ways.

   Possible response: Countries could consider adopting specific anti-avoidance rules to prevent the avoidance of the earnings-stripping rules.

4.2.2.4 Excessive interest deductions claimed by non-residents

1. *Risk*: Non-residents subject to net-basis taxation by a country may claim excessive interest deductions. This risk is

most likely to apply where non-residents carry on business in the source country through a PE or fixed base.

Possible response: Restrictions on interest deductions by non-residents are as necessary as they are for residents. Thus, a country's thin capitalization rules or earnings-stripping rules (or any other rules restricting the deduction of interest) should apply equally to non-residents carrying on business in the country.

2. *Risk*: Non-residents may allocate and deduct excessive interest expenses in computing net income earned in a country.

   Possible response: Developing countries should have clear rules — tracing, ordering or apportionment rules — for allocating interest expenses to income, and the tax authorities should be vigilant in applying those rules to interest deductions claimed by non-residents.

4.2.2.5 Tax treaty provisions

Since tax treaties generally prevail over the provisions of domestic law, developing countries that have enacted restrictions on the deduction of excessive interest payments in their domestic law should carefully consider whether the provisions of their tax treaties prevent the application of those rules.

1. *Risk*: For developing countries that have thin capitalization or earnings-stripping rules that apply only to interest paid to non-residents, any tax treaties that they enter into with a provision similar to Article 24 (4) of the United Nations Model Convention will prevent the application of the rules to residents of those treaty partners.

   Risk: For developing countries that have thin capitalization or earnings-stripping rules that apply only to interest paid by resident enterprises owned or controlled by non-residents, any tax treaties that they enter into with a provision similar to Article 24 (5) of the United Nations Model Convention will prevent the application of the rules to residents of those treaty partners.

   Possible responses: Developing countries that want to avoid having tax treaties prevent the application of their thin

capitalization or earnings-stripping rules have the following options:

(a) A country may decline to enter into tax treaties. This is a drastic remedy with many consequences that go well beyond base erosion through interest deductions. Therefore, although developing countries may decide that it is undesirable for them to enter into tax treaties, that decision should not be based solely or primarily on the desire to avoid having such treaties prevent the application of thin capitalization or earnings-stripping rules.

(b) A country may refuse to agree to the inclusion of Article 24 (4) and (5) in its tax treaties. Since Article 24 (4) and (5) reflects longstanding features of the United Nations Model Convention and the OECD Model Convention,[32] some countries may be unwilling to enter into treaties without these provisions, or may agree not to include them only if other concessions are made.

(c) A country may enact thin capitalization or earnings-stripping rules that apply to interest paid to both residents and non-residents. Such rules would not violate Article 24 (4) or (5). However, interest paid by a resident entity to another resident of the same country does not present the same base-erosion concerns as interest paid to non-residents because, ordinarily, the country's tax on the recipient of the interest offsets the reduction in tax from the interest deduction.

(d) A country could include a provision in its thin capitalization or earnings-stripping rules allowing a taxpayer to deduct interest in excess of the amounts allowed by the debt/equity ratio or the interest/earnings ratio if the taxpayer complies with the arm's length standard. Article 24 (4) is expressly subject to Article 9 (1), and Article 24 (5) is implicitly subject to Article 9 (1); therefore, any restrictions on the deduction of amounts paid

[32] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

by a resident enterprise to a non-resident that comply with the arm's length standard in Article 9 (1) cannot be considered to be discriminatory under Article 24 (4) or (5). However, this response adds considerable complexity to the thin capitalization or earnings-stripping rules in terms of compliance by taxpayers and administration by the tax authorities.

(e) A country could insist on expressly excluding its thin capitalization or earnings-stripping rules from Article 24 (4) and (5) of any tax treaties that it enters into. Possible wording to accomplish this result is provided in part 3, chapter 4, section 4.3.2.

(f) A country could insist on limiting Article 24 (4) and (5) to most-favoured-nation (MFN) treatment rather than the national treatment provided in accordance with the provisions of the United Nations Model Convention. Under MFN treatment, a country would agree not to discriminate against payments to the residents of a treaty partner compared to payments to the residents of any other foreign country or to discriminate against resident enterprises owned or controlled by residents of a treaty partner compared to resident enterprises owned or controlled by residents of any other foreign country. If Article 24 (4) and (5) of a country's tax treaties is limited to MFN treatment, the country would be able to apply its thin capitalization or earnings-stripping rules only to interest payments to non-residents. Possible wording for MFN treatment under Article 24 (4) and (5) is provided in part 3, chapter 4, section 4.3.2.

(g) A country could insist on including a saving clause in its treaties similar to the saving clause proposed by the OECD/G20 BEPS Action 7: 2015 Final Report: Preventing the Artificial Avoidance of Permanent Establishment status,[33] as long as any such clause does

[33] Available from http://www.oecd.org/tax/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm.

not exclude Article 24. Such a saving clause provides that a contracting State is entitled to tax its residents as if the treaty did not exist. See part 3, chapter 4, section 4.3.2 for the wording of such a provision.

2. *Risk*: For developing countries that have thin capitalization or earnings-stripping rules that apply to interest paid by non-resident enterprises, any tax treaties that they enter into with a provision similar to Article 24 (3) of the United Nations Model Convention will prevent the application of the rules to enterprises resident in the other contracting State.

   Possible responses: Developing countries that want to avoid having tax treaties prevent the application of their thin capitalization or earnings-stripping rules to non-residents have the following options, some of which are similar to the options discussed above with respect to Article 24 (4) and (5):

   (a) A country may decline to enter into tax treaties. (See 1 above.)

   (b) A country may refuse to agree to the inclusion of Articles 24 (3) in its tax treaties. Since Article 24 (3) is a longstanding feature of the United Nations and OECD Model Conventions, some countries may be unwilling to enter into treaties without this provision or may agree not to include it only if other concessions are made.

   (c) A country could insist on expressly excluding its thin capitalization or earnings-stripping rules from Article 24 (3) of any tax treaties that it enters into. Possible wording to accomplish this result is provided in part 3, chapter 4, section 4.2.2.

   (d) A country could insist on limiting Article 24 (3) to MFN treatment rather than the national treatment provided in accordance with the provisions of the United Nations Model Convention. Under MFN treatment, a country would agree not to discriminate against the residents of a treaty partner carrying on business in the country through a PE compared to the

residents of any other foreign country. If Article 24 (3) of a country's tax treaties is limited to MFN treatment, the country would be able to apply its thin capitalization or earnings-stripping rules to non-residents carrying on business through a PE. Possible wording for MFN treatment under Article 24 (3) is provided in part 3, chapter 4, section 4.2.2.

4.3 Withholding taxes on interest

1. *Risk*: A country's tax base is reduced by deductible interest payments to non-residents, but those non-resident recipients of interest are not subject to tax or are subject to reduced tax by the country on those interest payments.

   Possible responses: The obvious response to this type of base erosion is for a country to impose withholding tax on payments of interest by residents to non-residents at a rate that approximates the corporate tax rate. However, such a high withholding tax on interest may have the unintended result of increasing the cost of borrowing for the country's residents. Therefore, the imposition of withholding taxes on interest and similar payments involves difficult judgments about balancing the need to prevent base erosion against the need to allow residents access to foreign capital markets.

   Several countries have decided that the disadvantages of imposing high withholding taxes on interest outweigh the advantages; as a result, they either exempt certain interest payments from withholding tax or subject them to relatively low rates of withholding tax under their domestic law. Even countries that maintain high rates of withholding tax on interest under their domestic law often agree to reduced withholding tax rates on interest in their tax treaties. For these countries, deductible interest payments to non-residents represent a serious erosion of the tax base. Therefore, such countries may wish to consider other measures, such as thin capitalization rules or earnings-stripping rules, to prevent base erosion through interest payments

to non-residents. In this case, the thin capitalization rules or earnings-stripping rules should be carefully designed to protect the tax base effectively, as discussed in sections 4.2.2.2 and 4.2.2.3 above.

2. *Risk*: A country's tax treaties may prevent the country from imposing its withholding tax on certain payments of interest to residents of its treaty partners or may require it to reduce its rate of withholding tax on interest payments to residents of its treaty partners. Thus, base erosion will result to the extent that the reduction in a country's tax as a result of the deduction of interest paid to non-residents is not offset by the country's withholding tax on such interest.

   Possible responses: One possible response to this risk of base erosion is not to agree to any reduction in withholding taxes in tax treaties. However, such a position is unlikely to be acceptable to other countries and is inconsistent with international practice. Alternatively, countries could insist on maintaining reasonable rates of withholding tax on interest—such as 10 or 15 per cent—in their treaties, which would reduce the extent of any base erosion through deductible interest payments. However, non-resident lenders may require resident borrowers to bear the cost of any withholding tax on interest by grossing up the interest payments, as explained in chapter 1, section 1.4. Countries should also ensure that any exemptions from withholding tax on interest are clearly justified.

3. *Risk*: Where non-residents carrying on business in a country and deducting interest against that country's tax base make interest payments to non-residents, those interest payments may not be subject to withholding tax.

   Possible response: Developing countries should ensure that deductible interest payments made by non-residents to other non-residents are subject to withholding tax.

In summary, the problem posed by deductible interest payments is extremely difficult and there are no easy answers. Perhaps a reasonable solution to minimize base erosion is for a developing country to agree to a low-rate, broad-based withholding tax on interest payments

to non-residents in its tax treaties. Developing countries should be especially cautious about entering into tax treaties that provide for different rates of withholding on interest, since tax treaties with low rates or exemptions from withholding tax may encourage treaty shopping by non-residents.[34]

4.4 Risks of base erosion with respect to deductible interest payments by residents to earn exempt or preferentially taxed foreign source income

4.4.1 Introduction

As noted in section 4.1 above, interest deductions claimed by residents of a country are problematic from the perspective of base erosion where the income in respect of which the expenses were incurred is exempt from residence country tax, or is subject to preferential residence country tax, or where the residence country tax on the income is deferred. In theory, this problem can be addressed if the country taxes all income comprehensively. However, no country imposes such a comprehensive income tax. In practice, several types of income are either exempt from tax or subject to preferential tax. Furthermore, in theory this problem occurs whether the income in respect of which the interest expenses are incurred is derived from domestic sources or foreign sources. However, since the present *Portfolio* is concerned with base erosion arising from cross-border payments and transactions, this section focuses exclusively on the deduction of interest expenses in respect of funds used to earn foreign source income.

In general, base erosion from interest deductions claimed by residents is a problem for a country whenever the associated income is not taxable in the same period as the interest expenses are deducted. However, the problem is especially serious where the associated income is exempt from tax, is taxed at a preferential rate or can be deferred for a substantial period. Therefore, the provisions of a country's law

[34] See generally Peter Barnes, "Limiting interest deductions", in *Handbook on Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), chapter IV, 155–186, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

should be reviewed to determine any situations in which the country provides exemptions, preferential taxation or deferral that make the country's tax system susceptible to base erosion from interest deductions. For developing countries, which are primarily capital-importing countries, this aspect of base erosion through interest payments is much less important than the other aspects of base erosion discussed in sections 4.2 and 4.3 above. Nevertheless, the risks of base erosion with respect to foreign investment by residents are discussed here in the interest of comprehensiveness.

Where residents of a country earn foreign source income, that income will either be taxable by the residence country or exempt from residence country tax. If the income is exempt from tax, any expenses incurred to earn that income should not be deductible in computing the resident taxpayer's income. However, if the income is subject to residence country tax, typically any interest expenses incurred on funds used to earn the income are deductible in computing the amount of net income subject to residence country tax. In both cases, the residence country must ensure that, although the interest expenses are deductible, they are allocated to the foreign source income for purposes of the limitation on the foreign tax credit. Note that it is irrelevant in these situations whether the resident taxpayer pays interest to another resident or to a non-resident.

Section 4.4.2 below deals with the risks of base erosion with respect to foreign source income that is exempt from residence country tax. Section 4.4.3 below deals with the risks of base erosion with respect to foreign source income that is subject to residence country tax but for which a credit against that tax is allowed for foreign tax on the foreign source income.

Sections 4.4.2 and 4.4.3 both deal with situations in which residents of a country earn income from another country directly; in other words, they receive payments such as dividends, interest and royalties from residents of the other country, or they carry on business in the other country through a branch, PE or fixed base. The residents of a country may also earn income from another country indirectly through a non-resident corporation in which they own shares. Section 4.4.4 deals with situations in which residents of one country incur interest expenses on funds used to acquire shares of non-resident corporations.

4.4.2 Exemption for foreign source income—the exemption method

Risk: If a country exempts foreign business income but allows the deduction of any interest expenses incurred to earn that income, the deduction will erode the country's tax base. This risk applies regardless of whether the foreign source income is subject to source country tax on a net or a gross basis through a withholding tax. The rules used by the residence country to determine whether interest expenses are allocated to foreign income are obviously important for this purpose. If taxpayers can manipulate the rules so that interest expenses are not properly allocated to foreign source income, the result may be the erosion of the residence country's tax base.

Possible response: Developing countries should consider disallowing the deduction of interest expenses incurred to earn exempt foreign source income. For this purpose, they should have clear rules—tracing, ordering or apportionment rules—for allocating interest expenses to income, and the tax authorities should be vigilant in applying those rules to interest deductions claimed by residents to earn exempt foreign source income.

4.4.3 Credit for foreign taxes on foreign source income—the credit method

Risk: If interest expenses incurred to earn foreign income are not allocated to the foreign income for purposes of calculating the limitation on the foreign tax credit, the limitation on the credit will be overstated and the country's tax on its domestic source income will be reduced inappropriately. This risk applies to both passive investment income and active business income.

Possible response: Developing countries that use the credit method to provide relief from double taxation should review their domestic rules to ensure that the credit for foreign taxes is limited to its domestic tax on the foreign source income. For this purpose they should have clear rules—tracing, ordering or apportionment rules—for allocating interest expenses to the foreign source income, and the tax authorities should be vigilant

in applying those rules to ensure that any interest expenses are properly allocated to foreign source income for purposes of the limitation on the foreign tax credit.

4.4.4 Foreign source income earned by residents indirectly through foreign corporations

4.4.4.1 Introduction

Residents of one country can finance a foreign corporation in a variety of ways, only some of which cause problems of base erosion. For example, if a resident taxpayer uses borrowed funds to make an interest-bearing loan to a foreign corporation, the interest expenses may be deductible, but the interest payments received from the foreign corporation will be included in the resident's income (and may also be subject to withholding tax). As a result, the only risk of base erosion is if the rate of interest on the resident's borrowed funds is unreasonably higher than the rate of interest on the loan to the foreign corporation so that the transaction is not in accordance with the arm's length principle. However, if a resident taxpayer uses borrowed funds to acquire shares in a foreign corporation, the interest may be deductible currently but the payment of dividends on the shares may be exempt from residence country tax or, even if taxable, the tax will usually be deferred until dividends are paid. This situation causes base erosion problems for many countries, especially since dividends from foreign corporations often qualify for exemption from residence country tax. As is the case for foreign business income earned directly, the base-erosion problem for foreign income earned through a foreign corporation depends on the method used by the residence country to provide relief from double taxation.

4.4.4.2 Interest expenses on debt used to acquire shares in foreign corporations—exemption method

Risk: Where a country provides an exemption for dividends received by residents from non-resident corporations, base erosion results if interest expenses incurred to acquire the shares are deductible against the country's tax.

Possible response: Any interest expenses incurred by residents for the purpose of acquiring the shares of non-resident corporations where the dividends on the shares are exempt from tax should not be deductible. If the country imposes tax on any gain realized by resident shareholders on the disposition of the shares of non-resident corporations, any interest expenses that are not deductible could be added to the cost of the shares in order to reduce the amount of the gain. However, if the residence country exempts the gain on the disposition of the shares from residence country tax, it is unnecessary to add any disallowed interest to the cost of the shares.

Developing countries require clear rules—tracing, ordering or apportionment rules—for allocating interest expenses to the shares of non-resident corporations, and the tax authorities should be vigilant in applying those rules to ensure that any interest expenses are properly allocated for this purpose. If tracing rules are used for this purpose, taxpayers may be able to manipulate those rules to obtain interest deductions that erode the domestic tax base.

4.4.4.3 Interest expenses on debt used to acquire shares in foreign corporations—credit method

Risks: Where a country imposes tax on dividends received by resident shareholders from non-resident corporations, there are two risks of base erosion. First, there will be a timing problem if interest expenses are deductible currently but dividends are subject to tax only when received. Second, a country's tax base will be eroded if interest expenses are deductible but are not allocated to the income out of which the dividends are paid for purposes of computing the limitation on the foreign tax credit when dividends are received.

Possible responses: For any interest expenses incurred by residents for the purpose of acquiring the shares of non-resident corporations where the dividends on the shares are taxable, the deduction of the interest should be deferred until dividends are received. If a country provides an indirect foreign tax credit, any interest expenses should be allocated to the income out of

which the dividends are paid for purposes of computing the limitation on the credit.

Developing countries require clear rules—tracing, ordering or apportionment rules—for allocating interest expenses to dividends from non-resident corporations, and the tax authorities should be vigilant in applying those rules to ensure that any interest expenses are properly allocated for this purpose. If tracing rules are used for this purpose, taxpayers may be able to manipulate those rules to obtain interest deductions that erode the domestic tax base.

4.5. Debt push-down arrangements

Risk: The term "debt push-down" is often used to refer to arrangements that result in debt used to acquire the shares of a corporation resident in a particular country being shifted to that corporation. Although there are many ways in which debt push-downs may be accomplished, consider the following example:

> Company A, resident in Country A, is going to acquire all the shares of Company B, resident in Country B. If Company A borrows the necessary funds to make the acquisition, the interest expenses would be deductible in computing Company A income and would reduce the tax base of Country A. However, Company A may wish to have the interest deductible against Company B profits in Country B. Therefore, Company A may cause the incorporation of a new company in Country B, Newco, to make the acquisition of the shares of Company B. Company A might use the borrowed funds to lend to Newco, and Newco could use those funds to acquire the shares of Company B. The interest paid by Newco to Company A would ordinarily be deductible by Newco. It may be possible for Newco and Company B to merge into one corporate entity, in which case the interest expenses will be deductible in computing the profits of the merged corporation. In effect, the interest expenses of Newco will be deductible against the profits of Company B. Alternatively, if Country B has a consolidation regime for companies in a related group

to consolidate their profits and losses for income tax purposes, the same result can be achieved because Newco's interest expenses will be consolidated with the profits of Company B. The interest paid by Newco to Company A will be included in the Company A income but will be offset by the interest deductions of Company A.

The result of this arrangement is that the interest expenses incurred on the debt to finance the acquisition of the shares of Company B have been effectively shifted to Company B, and the interest will usually be deductible against the tax base of Country B.

Possible responses: A country may consider a variety of ways to protect its tax base against abusive debt push-down arrangements. For example, a country might adopt thin capitalization or earnings-stripping rules to limit the amount of interest that a resident company can deduct. However, thin capitalization and earnings-stripping rules may not deny the deduction of all the interest expenses shifted into a country pursuant to a debt push-down arrangement; they will allow the deduction of interest to the extent of the limits permitted by those rules.

It is very difficult for a country to deny the deduction of all interest expenses shifted into a country through a debt push-down arrangement because of the various ways in which such arrangements can be structured. Moreover, not all debt push-down arrangements are abusive (for example, where a domestic purchaser could have financed the acquisition on the same terms). A country might attempt to enact specific anti-avoidance rules to deal with debt push-down arrangements that it considers offensive or to apply a general anti-avoidance rule to counter such arrangements.

Table 3
Risks of base erosion and possible responses

A

Risks of base erosion through excessive interest deductions and possible responses

Risk	Possible responses
Interest payments to related non-residents in excess of arm's length amounts	1. Apply transfer pricing rules 2. Enact thin capitalization or earnings-stripping rules
Interest payments to substantial shareholders are in substance payments in respect of their equity investments	1. Apply transfer pricing rules (tax treaties will prevent the application of rules to non-controlling shareholders) 2. Enact thin capitalization rules or rules to treat shareholder debt as equity and interest as dividend
Interest payments are excessive because the taxpayer has disproportionate debt relative to equity	1. Enact thin capitalization rules ▫ See section 4.2.2.2 for the risks of base erosion as a result of ineffective thin capitalization rules
Interest payments are excessive because they are disproportionate to the taxpayer's earnings	1. Enact earnings-stripping rules ▫ See section 4.2.2.3 for the risks of base erosion as a result of ineffective earnings-stripping rules
Provisions of tax treaties (Article 24 (4) or (5)) may prevent the application of restrictions on excessive interest deductions	1. Do not enter into tax treaties 2. Do not agree to include Article 24 (4) or (5) 3. Apply any restrictions on interest deductions to both residents and non-residents 4 Allow interest deductions if they conform to the arm's length standard in Article 9 (1) 5. Exclude any restrictions on interest deductions from Article 24 (4) and (5)

	6. Limit Article 24 (4) and (5) to most-favoured-nation (MFN) treatment 7. Include a saving clause that does not exclude Article 24
Non-residents subject to net-basis tax may claim excessive interest deductions	1. Apply restrictions on interest deductions — for example, thin capitalization or earnings-stripping rules — to non-residents 2. Adopt robust rules for allocating interest expenses
Provisions of tax treaties (Article 24 (3)) may prevent the application of rules to disallow excessive interest deductions	1 Do not enter into treaties 2. Do not agree to include Article 24 (3) 3. Apply any restrictions on interest deductions to residents and non-residents 4. Exclude any restrictions on interest deductions from Article 24 (3) 5. Limit Article 24 (3) to MFN treatment

B

Risks of base erosion — withholding taxes on interest — and possible responses

Risk	Possible responses
No or reduced withholding tax on interest paid to non-residents under domestic law	1. Impose high withholding taxes on all interest payments to non-residents ▫ This response could have serious disadvantages
No or reduced withholding tax on interest paid to non-residents under tax treaties	1. Maintain reasonable rates of withholding tax on interest paid to non-residents 2. Ensure that any exemptions are clearly justified
No withholding tax on payments of deductible interest by non-residents	1. Ensure that withholding tax on interest applies to payments of

	interest by non-residents that are deductible in computing their income from business earned in the source country

C

Risks of base erosion with respect to deductible interest payments by residents to earn exempt or preferentially taxed income

Risk	Possible responses
Interest is deductible but foreign source income is exempt	1. Deny deduction of interest 2. Adopt robust rules for allocating interest expenses
Foreign source income is taxable but interest is not allocated to the income for purposes of the limitation on the foreign tax credit	1. Limit foreign tax credit to domestic tax on the net foreign source income 2. Adopt robust rules for allocating interest expenses
Interest expenses are incurred to acquire shares of foreign corporations:	
(a) Where dividends are exempt from tax	1 Deny deduction of interest 2. Apply robust rules for allocating interest expenses to exempt dividends
(b) Where dividends are taxable	1. Defer any deduction of interest until dividends are received 2. Limit foreign tax credit to domestic tax on the dividends 3. Apply robust rules for allocating interest expenses to taxable dividends

D

Miscellaneous risks of base erosion through interest deductions

Risk	Possible responses
Back-to-back arrangements	1. Adopt specific anti-avoidance rules to protect restrictions on interest deductions and withholding tax on interest

	2. Apply a general anti-avoidance rule
Debt push-down arrangements	1. Adopt restrictions on interest deductions (for example, thin capitalization or earnings-stripping rules) 2. Adopt a specific anti-avoidance rule

Part 3

Designing and drafting domestic legislation and negotiation of tax treaties to prevent base erosion with respect to payments of interest

Chapter 1

Introduction

As discussed previously, the risk of base erosion from deductible interest payments arises in three broad situations, where:

- Deductions of "excessive" interest payments, however defined under domestic law, are claimed by residents of a country or non-residents carrying on business in that country. In most cases, these excessive payments are made by residents of a country to non-residents. For either tax or non-tax reasons, however, the interest deductions may be limited even when the interest is paid to a resident of the same country.
- Deductible interest payments are exempt from that country's withholding tax or are subject to reduced withholding tax.
- Deductions of interest are claimed by residents of a country or non-residents carrying on business in the country where the funds are used to earn income that is either deferred, exempt or taxed in a favourable manner. The income may be either foreign source income or domestic source income. The potential base erosion occurs when the interest expenses are deductible but the associated income is not subject to full, current residence-country tax.

As discussed in part 2, chapter 4, these three concerns generally require different responses in order to prevent base erosion effectively. In the case of excessive interest payments, the goal is to define what is excessive in a manner that limits base erosion through interest deductions and is reasonably administrable by both taxpayers and tax administrators. In the case of withholding taxes on interest, the goal is to collect tax from non-resident recipients of interest in order to offset

the reduction of tax resulting from the deduction of interest. In the case of interest paid to earn income that is deferred, exempt or favourably taxed, the goal is to match the level and timing of interest deductions to the level of domestic tax imposed on the associated income.

Chapter 2

The major design elements in drafting domestic legislation to counter base erosion with respect to payments of interest

2.1 Disallowance of "excessive" interest expense

The issue of determining whether a taxpayer has paid an "excessive" level of interest has vexed tax administrators for decades. There is no fixed standard for what is excessive, and views differ widely on the issue. Significantly, the question is not solely a question for tax administrators; increasingly, corporate regulators and third-party lenders have a view on whether a particular taxpayer has a reasonable or an excessive level of debt. If regulators and lenders view the debt level as reasonable, it may be more difficult for the tax system to assert that the interest is excessive and a portion of the payment should be disallowed; however, tax policy officials must be aware that regulators and lenders are not concerned about base erosion, which is a central concern for tax policy officials.

As described in part 2, chapter 1, section 1.3, several countries have adopted tax rules that disallow the deduction of interest expenses where those expenses are considered to be excessive. The process for designing rules to disallow the deduction of excessive interest expenses involves several difficult policy decisions. In general terms, the major design elements to be considered are as follows:

(a) The scope of application of any restrictions on the deduction of excessive interest deductions is perhaps the most important single feature of the rules. As noted many times in the present *Portfolio*, all interest deductions erode a country's tax base; however, most interest expenses represent legitimate costs of earning income that should be

deductible in computing a taxpayer's net income subject to tax. Therefore, the fundamental objective of restrictions on the deduction of excessive interest is to distinguish between interest deductions that are acceptable even though they erode a country's tax base and interest deductions that are unacceptable because they erode the country's tax base excessively. The scope of restrictions on the deduction of excessive interest involves both the entities and the interest payments to which the restrictions are applied.

(i) *Entities covered*

In principle, any restrictions on the deduction of interest should apply to all entities, both resident and non-resident, that are entitled to deduct interest in computing their income subject to a country's tax, since all interest deductions erode a country's tax base and are potentially excessive. If a country adopts restrictions on excessive interest deductions that do not apply to certain entities, taxpayers may structure their investments in that country through the exempt entities in order to avoid the restrictions.

The risk of base erosion through excessive interest deductions is most serious with respect to resident entities that are controlled by non-residents and branches or permanent establishments (PEs) of non-residents. For such controlled entities, the possibility of intercorporate or intra-entity debt increases the risk that the interest rate or the amount of such debt will be excessive compared to the arm's length standard. The obvious response to this concern is to apply the country's transfer pricing rules to prevent excessive interest deductions. However, many countries prefer to adopt specific restrictions on interest deductions rather than rely on their transfer pricing rules.

If the problem of excessive interest deductions is considered to go beyond intercorporate or intra-entity debt held by controlling non-residents, any restrictions can be extended to resident companies with substantial non-resident shareholders, or to all resident entities.

(ii) *Interest payments covered*

Restrictions on the deduction of interest can apply to all interest payments by the entities covered by the restrictions or only to interest payments made to non-residents. If a country decides to target only interest payments to non-residents, the rules could apply to interest payments to:

- All non-residents
- Related non-residents
- Substantial non-resident shareholders, including controlling shareholders, or
- Controlling shareholders

Thus, the scope of restrictions on excessive interest deductions can reflect a variety of combinations of the entities covered by the rules and the recipients of the interest payments, depending on tax policy decisions about the balance between the need for broad rules to protect the tax base and the need for narrower rules to avoid discouraging investment. For example, the restrictions could apply to resident entities controlled by non-residents but extend to all interest payments by such entities. Alternatively, the restrictions could apply to resident entities controlled by non-residents and apply only to interest payments made to controlling non-resident shareholders and non-resident persons related to such shareholders.

If restrictions on the deduction of interest apply to all interest paid by an entity irrespective of the recipient of the interest, the rules may be easier to apply from a compliance and administration perspective, because it is unnecessary for taxpayers or the tax authorities to identify the extent to which a resident entity pays interest to non-residents or to certain non-residents. However, if a resident entity pays interest to resident lenders, it is questionable whether restrictions on the deduction of interest are necessary in terms of dealing with cross-border base erosion through interest payments.

(b) In order to determine whether interest expense is excessive, what test is appropriate for any particular country? The two primary approaches are to consider whether an entity is thinly capitalized by reference to its debt/equity ratio, or whether its earnings are being stripped by reference to the ratio of its interest expenses to a measure of its earnings, such as EBITDA (earnings before interest, taxes, depreciation and amortization).

(i) *Thin capitalization rules*

Most countries use thin capitalization rules based on a debt/equity ratio, under which interest deductions are disallowed to the extent that an entity has debt in excess of a fixed debt/equity ratio. The critical tax policy decision is the establishment of the debt/equity ratio. Although many countries use ratios ranging from 1.5:1 to 3:1, each country must select a ratio that reflects its needs based on the factors discussed in part 2, chapter 1, section 1.3.2.2. Whatever ratio a country adopts, it must be reviewed from time to time to ensure that it continues to be effective in preventing base erosion.

If a country decides to adopt thin capitalization rules, it must resolve several other design issues, including:

- The computation of an entity's debt for purposes of the debt/equity ratio, including what amounts are treated as debt and when the amount of debt should be determined.
- The computation of an entity's equity for purposes of the debt/equity ratio, including what amounts are treated as equity and when the amount of equity should be determined.
- The tax consequences for any interest on debt in excess of the fixed debt/equity ratio. Although the deduction of such interest is generally disallowed, the disallowance may apply to all interest paid by an entity irrespective of the recipient of the interest, only to interest paid to non-residents, only to interest paid to substantial non-resident

shareholders, or only to interest paid to controlling non-resident shareholders. It is important to note in this regard that the issues of what debt is taken into account for purposes of the debt/equity ratio and what interest is not deductible are separate. For example, all debt owing by an entity may be taken into account to determine the amount of debt for purposes of the debt/equity ratio, but only the deduction of interest on certain debt (for example, debt owed to non-residents or to substantial non-resident shareholders) may be disallowed. Further, it must also be decided how the disallowed interest should be characterized (as interest or as dividends) and whether it can be carried over and deducted in other years.

(ii) *Earnings-stripping rules*

Some countries restrict the deduction of interest through earnings-stripping rules, under which the deduction of interest is disallowed if an entity's interest expenses exceed a fixed percentage of its earnings. As discussed in part 2, chapter 1, section 1.3.4, the BEPS Action 4 Final Report[1] rejects thin capitalization rules and recommends as best practices that all countries adopt earnings-stripping rules to prevent base erosion through interest payments.

The most important tax policy decision with earnings-stripping rules is the fixed interest/earnings ratio. Countries use a wide variety of ratios; the BEPS Action 4 Final Report recommends that a ratio between 10 to 30 per cent of earnings should be used. Each country must select a ratio of interest to earnings that reflects its needs based on the factors discussed in part 2, chapter 1, section 1.3.3.2. Whatever ratio a

[1] Available from http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm.

country adopts, it must be reviewed from time to time to ensure that it continues to be effective in preventing base erosion.

If a country decides to adopt earnings-stripping rules, it must resolve several other design issues, including:

- Should interest for purposes of the ratio be an entity's gross interest expenses, or should any interest income received by the entity be netted against the interest expenses? See part 2 chapter 1, section 1.3.3.3.
- How should earnings be computed? Earnings should probably be based on tax information rather than financial accounting information and could be based on a familiar financial measure of earnings, such as EBITDA.
- How should situations in which entities have losses be dealt with?
- Should there be a de minimis rule, so that all interest expense will be allowed as a deduction as long as the total expense is below a certain threshold? Such a rule may simplify compliance and tax administration when the risk of base erosion is small.
- What exceptions, if any, should be permitted when a taxpayer's interest expenses exceed the allowable interest/earnings ratio? The exceptions suggested by the BEPS Action 4 Final Report are to allow the deduction of additional interest expense where the taxpayer's leverage does not exceed the leverage of the worldwide group to which the taxpayer belongs or where the project being financed has significant public benefits. The worldwide-group exception involves considerable complexity because it requires access to information about the interest expenses and earnings of the worldwide group.
- Should any disallowed interest expenses be

allowed to be carried forward or back and deducted in the relevant years? Such a carry-over, although complex, addresses the unfairness of denying an interest deduction in a year when a taxpayer may have low earnings or a loss for reasons unrelated to its interest expenses. A similar issue arises where a taxpayer's interest expenses for the year are less than the allowable limit. Can the unused capacity be carried forward to future years to allow additional interest deductions in those years? Once again, such a carry-over adds significant complexity to the rules.

- The tax consequences for interest expenses in excess of the allowable interest/earnings ratio present several issues. Should limitations on the deduction of interest expense apply to all interest expenses incurred by an entity irrespective of the recipient of the interest, or should the limitations apply more narrowly to interest paid to non-residents or only to interest paid to related non-residents? The perceived abuse with respect to excessive interest payments relates primarily to payments to related non-residents. When the interest is paid to arm's length parties, the tax authorities can have some confidence that the debt and level of interest paid are commercially reasonable. On the other hand, if the concern is that a taxpayer may unfairly erode the tax base, or if there are non-tax concerns about the level of debt adopted by taxpayers, then applying the rules to all interest or all interest paid to non-residents may be more appropriate.
- When the borrower and the lender are in the same jurisdiction, the interest deduction is generally matched by an interest inclusion for the lender. Arguably in such a situation, there is no base erosion. However, base erosion may occur where the lender may be tax-exempt, or have losses, or be taxable at a favourable rate. In such

a case, there is the same risk of base erosion that arises in a cross-border payment of interest.

These design questions can lead to extremely complex rules regarding the identification and disallowance of excessive interest. Alternatively, tax authorities can adopt simplified rules, with few or no exceptions. The challenge is to identify the proper balance point between precision and ease of administration.

These design questions are further complicated by the fact that, in a perfect world, the rules would be dynamic, or at least adjusted from time to time. For instance, in periods of high interest rates, it may be appropriate for a taxpayer to incur, and deduct for tax purposes, a higher level of total interest as measured against other financial data (for example, pre-tax income). Similarly, in periods of low interest rates, it may be appropriate to allow a taxpayer to have a higher debt/equity ratio, because the cost of that debt is comparatively lower than in a time of high interest rates. Although it is not practical for restrictions on the deduction of interest to be adjusted annually, periodic adjustments that reflect changing conditions in the business environment may be appropriate.

2.2 Withholding taxes on interest

Where residents of a country pay interest or other similar amounts to non-residents, the country's tax base will be eroded if the interest payments are deductible by the resident payers. This risk of base erosion can be countered in part by imposing a withholding tax on the non-residents receiving the interest payments. The withholding tax will not completely offset the tax savings from the deduction of the interest payments unless it is imposed at a rate that equals or exceeds the country's corporate tax rate.

A withholding tax on interest and other similar amounts must carefully consider the identification of the types of payments that will be subject to tax. The withholding tax should apply to any amounts that are not interest, but are economically equivalent to interest; otherwise, such payments may be used to avoid the withholding tax on interest.

Since lenders, especially commercial lenders, usually incur significant expenses in earning interest, they may require borrowers to bear

any withholding tax imposed on interest. Typically, the non-resident lender will require the resident borrower to gross up the amount of the interest payments so that the lender receives an amount after tax equal to the interest on the loan that would have been charged if no withholding tax had applied. In this case, the effect of the withholding tax may be to increase the cost of borrowing for residents. This effect of a withholding tax on interest can be minimized by exempting interest paid to arm's length lenders entirely or by reducing the rate of withholding tax on such interest.

A country's withholding tax on interest should be designed in the context of the country's withholding taxes on other amounts paid to non-residents, such as dividends and royalties. If the rates of withholding tax imposed on various amounts (under domestic law or under the country's tax treaties) are identical, the withholding taxes will be easier for payers/withholding agents to comply with and for the tax authorities to administer. However, if the rates vary widely, the compliance and administrative burden with respect to the withholding taxes will be increased. Similarly, the costs of compliance and administration will be increased to the extent that amounts are exempt from withholding tax (under domestic law or the country's tax treaties) because withholding agents and tax authorities will be required to determine whether payments qualify for the exemptions.

Withholding tax should also apply to interest payments by non-residents if those interest payments are deductible in computing the non-resident's profits subject to tax by a country. This will usually be the case where a non-resident carries on business in a country or, where a tax treaty applies, where a non-resident carries on business through a PE or fixed base in the country. In these situations, the non-resident's profits are taxable on a net basis and any deductible interest payments will reduce the country's tax base.

If a withholding agent fails to withhold tax on an interest payment to a non-resident, countries could consider denying the deduction of that interest, in addition to other penalties.

2.3 Interest expenses incurred by residents to earn exempt or preferentially taxed income

As discussed in part 2, chapter 1, section 1.2.3, there are three basic methods for allocating interest expense to income: tracing, ordering rules and apportionment. While each of the three methods may be appropriate in a particular situation, the first two options — tracing and ordering rules — create a greater risk of manipulation and controversy than the third option of apportionment.

Apportionment is based on the view that money is fungible, and as a result, interest expense is allocated to income or assets on the basis of a formula. This method generally does not allow taxpayers or tax administrators to "look through" the transactions and trace funds to specific uses. It should be acknowledged, however, that some countries allow tracing as an exception to apportionment in certain circumstances; the most frequent exception is when a taxpayer obtains a mortgage secured by a specific piece of real property.

In drafting legislation, tax authorities and legislators need to consider the following issues:

(a) Is apportionment of interest expense the most reasonable method for allocating interest expense to investments that yield exempt or favourably taxed income?

- Should there be a de minimis rule, so that all interest expense is deductible as long as the total interest expense is below a certain threshold? Such a rule promotes ease of administration when the potential tax loss from allowing the deduction is small.

(b) If apportionment is adopted as the most appropriate method for allocating interest expense, should there be exceptions for certain types of investments? For example, as noted above, should interest expense associated with real property and secured by a mortgage be "traced" to the real property, and allowed as a tax deduction, without regard to the general apportionment formula?

Another potential exception to disallowance of interest expense would be interest paid to third-party lenders on loans used to fund a project with public benefits. Although this exception can be difficult to apply, the BEPS Action 4 Final Report specifically endorses such an exception for

countries to adopt on an optional basis.

If apportionment is adopted, what formula should be adopted? For example, should the total interest expense be apportioned by a ratio of exempt income to total income, and the allocable share of income then be disallowed? Alternatively, should the apportionment formula operate on the basis of a taxpayer's assets?

- Income that is preferentially taxed is particularly challenging under this approach. For instance, many countries tax capital gains at a reduced rate. In the case of interest expense allocated to capital gains (or property that will give rise to capital gains), should the interest deduction be reduced in proportion to the reduced capital gains rate? For example, if capital gains are taxable at half the regular tax rate, should only half of the interest expense allocated to the capital be deductible? While this approach is technically feasible, tax administrators may conclude that it is too difficult to apply such a rule, and therefore disallow interest expense only when the income is fully exempt from tax. A simpler approach may be to disallow the deduction of all the interest expenses, but to allow half of those expenses to be added to the cost of the property so that any capital gain realized in the future will be reduced accordingly.
- A further—and equally challenging—situation arises when income is subject to tax but the tax is deferred until a later date. For instance, foreign source income or income earned by a foreign subsidiary may be subject to tax only when remitted; while the income will ultimately be taxed, there is a mismatch (and base erosion) if the interest expense is deductible currently while the associated income is taxed only in a future year. Tax administrators may elect to apply a rule that defers the deduction of any interest expense allocated to particular income until the associated income is subject to tax.

In determining what rule should be adopted, it is important for a country to balance the desire for precision (and fairness) with respect to taxpayers with the need for efficient tax administration. Just as safe harbours and other simplified methods can be useful in the case of transfer pricing administration, simple rules may be useful in determining what interest expense should be disallowed.

Chapter 3

Sample legislative provisions with explanatory notes

3.1 Introduction

This section provides some sample legislative provisions that are designed to reduce the risks of base erosion through deductible interest payments. The sample provisions presented here deal exclusively with restrictions on interest deductions and withholding taxes on interest paid to non-residents, and deal only with situations in which the risks of base erosion are likely to be most serious. In addition, this section presents sample provisions only with respect to those provisions that deal exclusively with interest, rather than to provisions that deal with deductions generally (including interest).

THE SAMPLE PROVISIONS IN THIS SECTION ARE NOT INTENDED TO BE INCLUDED IN ANY COUNTRY'S DOMESTIC LAW AS IS. THEY ARE PROVIDED FOR GUIDANCE ONLY.

3.2 Thin capitalization—sample legislation with explanatory notes

1. *Where a resident company, other than a financial institution, makes a payment of interest in a taxation year [to a non-resident] [to a non-resident with whom the company does not deal at arm's length] [to a related person], 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.*

2. *Where a resident company is a financial institution as defined in _____, any interest paid by the financial institution in a taxation year shall not be deductible in that year to the extent of the portion of the financial institution'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 financial institution's average debt for the year exceeds __ times the financial institution's average equity for the year.*
3. *For the purposes of paragraphs 1 and 2,*

   "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;

   "average debt" means the [aggregate of the amount of debt of a company] [greatest amount of debt of a company] that is outstanding [on 31 March, 30 June, 30 September and 31 December] [during each quarter] of a taxation year;

   "average equity" means the aggregate of the amount of the equity of a company on 31 March, 30 June, 30 September and 31 December of a taxation year plus the company's retained earnings at the beginning of the year.
4. *Any interest that is not deductible in a taxation year as a result of the application of paragraph 1 or paragraph 2 shall be deemed to be a payment of interest by the company for the immediately following taxation year and any excess debt of the company for a taxation year shall be included in computing the average debt of the company for the immediately following year. For the purpose of this paragraph, "excess debt" means the amount of a company's average debt for a taxation year in excess of __ times the company's average equity for the year.*
5. *For the purposes of [list other relevant provisions of a country's tax laws], any interest that is not deductible in a taxation year as a result of the application of paragraph 1 or paragraph 2*

*shall be deemed to be a dividend paid by the company and received by the person who receives the interest.**

6. *Where a resident company is a partner in a partnership, the portion of any debt of the partnership equal to the company's percentage interest in the partnership shall be deemed to be a debt of the company for the purposes of paragraphs 1 and 2. [It may also be necessary to have similar rules with respect to trusts.]*
7. *Where a non-resident carries on business in [name of country] [through a permanent establishment or fixed base], for the purposes of applying paragraphs 1 and 2:*
   (a) The non-resident shall be deemed to be a resident company;
   (b) The non-resident's average equity shall be deemed to be [40 per cent where the ratio in paragraph 1 is 1.5:1; 33 1/3 per cent where the ratio in paragraph 1 is 2:1; and 25 per cent where the ratio in paragraph 1 is 3:1] of the amount of the average cost of property used in carrying on business in [name of country] on the first day of each month in the year; and
   (c) The non-resident's average debt shall be deemed to be the [average amount of debt of the non-resident] [greatest amount of debt of a company] that is outstanding [on the first day of] [during] each month in a taxation year and that may reasonably be considered to relate to the business carried on in [name of country].
8. *Notwithstanding paragraph 1 or 2, where a resident company can establish that a reasonable arm's length amount of interest exceeds the amount of interest deductible in a taxation year after the application of paragraph 1 or 2, the company shall be entitled to deduct the reasonable arm's length amount of interest for the year.*

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*Paragraph 5 should not be included if a country decides to allow a carry-forward for any disallowed interest deductions, such as the carry-forward in paragraph 4. A carry-forward for any disallowed interest deductions implicitly means that the payments retain their character as interest.

9. *For the purposes of paragraph 8, a reasonable arm's length amount of interest for a taxation year in respect of a particular resident company is the amount of interest deductible by other resident companies, other than resident companies to which the particular company is related, in similar circumstances.*

Explanatory notes

Paragraph 1 provides the basic rule to limit the deduction of interest by a resident company to the portion of the interest paid by the company that does not exceed a fixed ratio of its debt to equity. The fixed debt/equity ratio must be established by each country according to its particular situation. The components of the ratio — average debt and average equity — are defined in paragraph 3. Paragraph 1 does not apply to financial institutions, which usually have much higher debt/equity ratios than industrial and commercial companies. Paragraph 2 provides a higher debt/equity ratio for financial institutions.

The restrictions on the deduction of interest in paragraph 1 apply to all resident companies. The broadest version of paragraph 1 applies to any interest paid by a resident company regardless of whether the interest is paid to residents or non-residents. However, alternatively, paragraph 1 could be limited to interest paid to non-residents, or to interest paid to substantial non-resident shareholders of a resident company, or to related or non-arm's length non-residents, depending on what each country considers to be serious risks of base erosion through interest deductions. Many countries take the position that interest paid to arm's length non-residents does not present a serious risk of excessive interest deductions where the relationship between the resident company and the lender is arm's length.

Paragraph 1 applies to "payments of interest". If a country allows interest to be deductible when it becomes payable or accrues, rather than when it is paid, the wording of paragraph 1 would need to refer to interest that is payable or accrued.

Paragraph 2 provides a limitation on the interest deductions of financial institutions that is similar to the limitation in paragraph 1, but uses a higher debt/equity ratio in recognition of the fact that financial institutions are more highly leveraged than other corporations.

Paragraph 2 requires a definition of "financial institution" unless such a definition exists in a country's domestic law for other purposes.

Paragraph 3 provides several definitions of important terms used in paragraph 1. Depending on the meaning of "interest" under a country's domestic law, it may be necessary for a country to define the term "interest" to include certain amounts that are economically equivalent to interest so that the restrictions in paragraph 1 apply to those amounts.

The definition of "debt" for purposes of the thin capitalization rules is intended to be very broad and to include all amounts owing by a resident company. The wording of the definition of "debt" may require modification to reflect the legal concepts of each country. Debt should include any amounts that are treated in the same way as debt for tax purposes, in the sense that payments in respect of the debt are deductible in the same manner as interest. Non-interest-bearing loans or debt, however, are not treated as debt for purposes of the thin capitalization rules because they do not pose any risk of base erosion. A country may decide to treat non-interest-bearing debt as equity.

The definition of "equity" consists of two components: the share capital of the company and any amounts contributed to the company by shareholders for which the shareholders do not receive any shares. The reference to share capital is intended to be the amount for which the shares were originally issued by the company, and will require modification in light of the corporate law of each country. Similarly, the concept of contributed surplus, which is intended to mean amounts contributed to a company by its shareholders where no shares are issued to the shareholders, may require modification in light of the corporate law of each country. Share capital is not intended to be calculated by reference to the cost or fair market value of the shares of the company to the shareholders. Equity does not include the retained earnings of a company because, unlike share capital and contributed surplus, retained earnings can be easily calculated only on an annual basis. The amount of a company's retained earnings is included in the definition of its "average equity".

"Average debt" is the total of the amount of debt of a company outstanding on the last day of each quarter during the year. Therefore, although the amount of a company's debt may vary throughout a

year, average debt reflects the average amount of debt calculated on a quarterly basis. Alternatively, average debt could be calculated on an annual or semi-annual basis to reduce compliance costs. If a country is concerned about the possibility that taxpayers might manipulate the amount of debt outstanding in order to avoid the thin capitalization rules, it could define average debt as the greatest amount of debt outstanding at any time during a quarter, half-year or year. Such an approach will avoid manipulation of the amount of debt, but may result in the overstatement of debt for purposes of the debt/equity ratio in paragraph 1.

"Average equity" is calculated on the same basis as "average debt" to mean the total of the company's equity on the last day of each quarter of the year plus the company's retained earnings at the beginning of the year. "Retained earnings of a company" is intended to mean the after-tax undistributed profits of the company. Alternatively, average equity could be calculated on a semi-annual or annual basis to reduce compliance costs. However, the less frequently that equity is calculated, the greater the risk that taxpayers will be able to inject capital into a company in order to artificially increase its equity. Countries may wish to consider whether a general anti-avoidance rule (assuming that the country has a general anti-avoidance rule) would prevent an artificial inflation of equity or whether a specific anti-avoidance rule may be necessary for this purpose.

Paragraph 4 provides a carry-forward for any interest the deduction of which is disallowed by paragraph 1 or 2. Paragraph 4 deems any disallowed interest to be paid in the immediately following taxation year and the related excess debt to be debt of the taxpayer in the immediately following year, with the result that the interest is deductible in that year subject to the application of the restrictions on the deduction of interest in paragraph 1 or 2 for that year. For example, assume that a country has thin capitalization rules with a 2:1 debt/equity ratio and that a particular resident company has debt of 300 with interest of 30 and equity of 100 in a particular year. In this situation, interest of 10 on 100 of the company's debt would not be deductible in that year. If, however, in the following year the company has 150 of debt with interest of 15 and 100 of equity, the disallowed interest deduction (10) and the excess debt (100) from the previous year would be treated as debt and interest of the company for the following year. Therefore, in the second year, the company would

have interest expenses of 25 and a debt/equity ratio of 250:100; the maximum allowable interest deductions would be 20, with the result that the deduction of interest of 5 would be disallowed. However, the disallowed interest of 5 and the related debt of 50 would be carried forward to the following year.

In effect, the carry-forward allowed by paragraph 4 is indefinite because any disallowed interest for one year is deemed to be interest paid in the following year. It is not a one-year carry-forward. Some countries may wish to limit the carry-forward of any disallowed interest expense for one year to a fixed period of years — for example, 3 or 5 years.

If a country decides not to allow any carry-forward for disallowed interest, it should omit paragraph 4.

Paragraph 5 deems any interest that is disallowed as a deduction by paragraph 1 or 2 to be a dividend for certain specified purposes of the country's tax laws, such as the imposition of withholding tax. Paragraph 5 may or may not be appropriate for a country depending on the tax treatment of any disallowed interest. For example, paragraph 5 is inappropriate if a country decides to allow a carry-forward for any disallowed interest deductions because, in that case, the disallowed interest retains its character as interest. However, if a country does not impose withholding tax or imposes a reduced rate of withholding tax on interest under its domestic law or under its tax treaties, but does impose withholding tax on dividends or imposes a higher rate of withholding tax on dividends than on interest under its domestic law or its tax treaties, it may wish to have any disallowed interest deemed to be a dividend. Alternatively, countries that treat payments of dividends and interest similarly may choose to omit paragraph 5.

Paragraph 6 is intended to ensure that the thin capitalization rules apply to interest on debt of a partnership in which a resident company is a partner. Paragraph 6 is necessary if a country treats partnerships as transparent rather than as separate entities for tax purposes. If a country treats partnerships as separate entities, paragraph 1 should apply to both resident companies and partnerships. However, if a country treats partnerships as transparent, paragraph 6 is necessary to prevent the thin capitalization rules from being avoided through loans to a partnership in which a resident company is a partner rather than to the company directly. Paragraph 6 prevents

this result by deeming any debt of a partnership in which a resident company is a partner to be debt of the company to the extent of the company's percentage interest in the partnership. Thus, for example, if a resident company has 60 per cent interest in a partnership, 60 per cent of any debt of the partnership will be deemed to be debt of the company. A similar provision may be necessary with respect to the debt of trusts in which a resident company is a beneficiary, depending on how trusts are treated for purposes of a country's tax laws.

Paragraph 7 makes the restrictions on the deduction of interest in paragraphs 1 and 2 applicable to non-residents carrying on business in the country. Paragraph 7 should apply to any situations in which non-residents are subject to tax on a net basis and their interest expenses are deductible in computing their income subject to tax. In such situations, the interest deductions claimed may be excessive and erode the country's tax base inappropriately. In most cases, non-residents will be subject to net-basis tax by a country only if they are carrying on business in that country (perhaps through a permanent establishment (PE) or fixed base) and, where a tax treaty applies, only if they are carrying on business in the country through a PE or fixed base located in the country.

For the purposes of applying paragraph 1 or 2 to a non-resident, it is necessary to make certain adjustments to the concepts of debt and equity. First, only the debt of a non-resident that is used for the purposes of carrying on the business in the country is taken into account, not all the debt of the non-resident, as is the case for a resident company. Second, equity cannot readily be based on the share capital, contributed surplus and retained earnings of a non-resident company because those amounts do not relate exclusively to the business carried on in the country. Instead, therefore, equity in respect of a non-resident company means the cost of the property used in carrying on the business in the country. Under sub-paragraph 7 (a), a non-resident's average equity is the appropriate percentage of the average cost of the property used in carrying on the business in the country calculated on a monthly (or quarterly) basis. Information about the cost of such property should be readily available to the tax authorities. For purposes of applying paragraph 1 or 2, a non-resident's average equity is only a percentage of the cost of the property, which is intended to produce the same effect as the debt/equity ratio. For example, if a debt/equity ratio of 1.5:1 is used in

paragraph 1, then 40 per cent of the average cost of the non-resident's property used in carrying on business in the country is the amount of the average equity for the purpose of applying paragraph 1. Thus, if a non-resident uses property with an average cost of 1 million in carrying on business in a country and has average debt related to the business of 600,000, the non-resident would be entitled to deduct interest on debt of 600,000, since the debt does not exceed 1.5 times the non-resident's average equity, which is 40 per cent of 1 million. However, the deduction of any interest on debt in excess of 600,000 would be disallowed.

Paragraphs 8 and 9: Paragraph 8 allows a resident company to deduct interest in excess of the limits in paragraph 1 or 2 if the company can establish that other arm's length resident companies in similar circumstances deduct more interest. This type of measure is necessary for countries that have entered into tax treaties with non-discrimination provisions similar to Article 24 (4) and (5) of the United Nations Model Convention.[2] Those provisions are generally considered to prevent the application of thin capitalization rules based on a fixed debt/equity ratio. However, if the thin capitalization rules allow the deduction of interest that is in accordance with the arm's length standard in Article 9 of the United Nations Model, although such interest deductions would be disallowed by the application of the debt/equity ratio, Article 24 would not apply to prevent the application of the thin capitalization rules. Paragraph 8 adds significant complexity with respect to compliance and administration of the thin capitalization rules. Alternatively, as discussed in [reference to relevant paragraph], countries might consider negotiating their tax treaties such that those treaties cannot prevent the application of their thin capitalization rules.

3.3 Earnings-stripping rules—sample legislation with explanatory notes

1. *Where a resident company [other than a financial institution] makes a payment of interest in a taxation year [to a*

[2] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

non-resident] [to a non-resident with whom the company does not deal at arm's length] [to a related person], 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 __ per cent of the company's adjusted earnings for the year.

2. *For the purposes of paragraph 1,*

   "interest" [means] [includes] …

   "adjusted earnings" means the income or profits of a company for a taxation year computed in accordance with the provisions of [reference to 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. (If appropriate, refer to the specific provisions of the Act that deal with the deduction of interest, taxes, depreciation of tangible capital assets and amortization of intangible capital property.) [Alternatively, adjusted earnings could be calculated as the average earnings of a resident company for a period of years (for example, 3 or 5 years) in order to reduce the impact of volatile earnings and losses.]

3. *Paragraph 1 does not apply [to a resident company that makes payments of interest] [to a non-resident] [to a non-resident with whom the company does not deal at arm's length] [to a related person] that do not exceed [a de minimis amount specified in the country's currency].*

4. *For the purposes of paragraph 1, any interest paid by a resident company with respect to a public benefit project shall not be taken into account in determining the total of the payments of interest for the year by the company. A "public benefit" project means …*

5. *Any interest that is not deductible in a taxation year as a result of the application of paragraph 1 shall be deemed to be a payment of interest by the company for the immediately following taxation year.*

6. *For the purposes of [list other relevant provisions of a country's tax laws], any interest that is not deductible in a*

taxation year as a result of the application of paragraph 1 shall be deemed to be a dividend paid by the company and received by the person who receives the interest.[**]

7. *Where a resident company is a partner in a partnership, the portion of any interest [paid] [or received] by the partnership equal to the company's percentage interest in the partnership shall be deemed to be interest [paid] [received] by the company for the purposes of paragraph 1. [It may also be necessary to have similar rules with respect to trusts.]*
8. *Where a non-resident carries on business in [name of country] [through a permanent establishment or fixed base], for the purposes of computing the income of the non-resident for the year, any interest paid by the non-resident in the year shall not be deductible to the extent that the portion of such interest that reasonably relates to the business carried on in [name of country] exceeds__ per cent of the company's adjusted earnings for the year that reasonably relates to the business carried on in [name of country].*
9. *Notwithstanding paragraph 1, where a resident company can establish that a reasonable arm's length amount of interest exceeds the amount of interest deductible in a taxation year after the application of paragraph 1, the company shall be entitled to deduct the reasonable arm's length amount of interest for the year.*
10. *For the purposes of paragraph 9, a reasonable arm's length amount of interest for a taxation year in respect of a particular resident company is the amount of interest deductible by other resident companies, other than resident companies to which the particular company is related, in similar circumstances.*

[**]Paragraph 6 should not be included if a country decides to allow a carry-forward for any disallowed interest deductions, such as the carry-forward in paragraph 5. A carry-forward for any disallowed interest deductions implicitly means that the payments retain their character as interest.

Explanatory notes

Paragraph 1 provides the basic rule to limit the deduction of interest by a resident company to the portion of the interest paid by the company that does not exceed a percentage of its adjusted earnings. The percentage of adjusted earnings specified in paragraph 1 must be established by each country according to its particular situation. The terms "interest" and "adjusted earnings" are defined in paragraph 2. A special rule to limit the interest deductions of financial institutions may be necessary. If this is the case, paragraph 1 would not apply to financial institutions. For this purpose, it would be desirable to provide a clear definition of "financial institution".

The restrictions on the deduction of interest in paragraph 1 apply to all resident companies. The broadest version of paragraph 1 applies to any interest paid by a resident company regardless of whether the interest is paid to residents or non-residents. However, alternatively, paragraph 1 could be limited to interest paid to non-residents, or to interest paid to substantial non-resident shareholders of a resident company, or to related or non-arm's length non-residents, depending on whether a country wants to target its earnings-stripping rules broadly, against base erosion through interest deductions, or narrowly, against the more serious risks of base erosion through interest deductions. Many countries take the position that interest paid to non-residents does not present a serious risk of excessive interest deductions where the relationship between the resident company and the lender is arm's length.

Paragraph 1 applies to "payments of interest". If a country allows interest to be deductible when it becomes payable or accrues, rather than when it is paid, the wording of paragraph 1 must refer to interest that is payable or accrued.

Paragraph 1 applies to the gross amount of interest payments made by a resident company during a taxation year. However, this may result in double-counting where a resident company receives interest from a related company. Therefore, paragraph 1 could be worded to apply only to the net amount of a resident company's interest payments in excess of its interest receipts for a taxation year.

Paragraph 2 provides definitions of the terms "interest" and "adjusted earnings" used in paragraph 1. Depending on the meaning

of "interest" under a country's domestic law, it may be necessary for a country to define the term "interest" to include certain amounts that are economically equivalent to interest so that the restrictions in paragraph 1 apply to those amounts.

The term "adjusted earnings" is defined in paragraph 2 to mean a resident company's income or profits as determined under the provisions of a country's domestic tax law; however, no deductions of interest, taxes, depreciation of tangible property or amortization of intangible property are allowed for this purpose. In effect, adjusted earnings is the well-known financial measure of EBITDA (earnings before interest, taxes, depreciation and amortization) computed in accordance with tax rules. Countries that are concerned about the application of the restrictions on the deduction of interest in paragraph 1 to resident companies with volatile earnings or losses may wish to determine a company's adjusted earnings on the basis of the company's average earnings over a period of years. In this case, "adjusted earnings" could be defined to mean "[one third] of the total amount of income or profits of a company for a taxation year and each of the [two] immediately preceding taxation years computed in accordance with the provisions of [reference to 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".

Paragraph 3 provides a de minimis threshold exemption from the restriction on the deduction of interest in paragraph 1 that is intended to eliminate from the restriction companies that pay relatively small amounts of interest in a taxation year. Although the interest paid by these companies may exceed the specified percentage of their adjusted earnings, it does not constitute a serious erosion of a country's tax base. The de minimis threshold must be set at an amount that eliminates a significant number of resident companies from the restriction in paragraph 1, but does not permit significant base erosion.

It may be necessary for a country that adopts a de minimis exemption also to adopt a specific anti-avoidance rule to prevent a resident company from creating subsidiaries in order to multiply access to the de minimis exemption. Such a specific anti-avoidance rule may be unnecessary if a country has a general anti-avoidance rule that would apply to prevent multiple access to the de minimis exemption.

Paragraph 4 provides an exemption from paragraph 1 for interest paid by a resident company in connection with a "public benefit" project. A "public benefit" project should be carefully defined for purposes of this exemption. The exemption should be limited to projects in which there is a general public interest and which meet stringent conditions; for example, it should apply only to long-term assets that have been granted by a public sector entity and where the amount of the financing does not exceed the value of the asset and the financing is arranged on a non-recourse basis.

Paragraph 5 provides a carry-forward for any interest the deduction of which is disallowed by paragraph 1. Paragraph 5 deems any disallowed interest to be paid in the immediately following taxation year, with the result that the interest is deductible in that year subject to the application of the restrictions on the deduction of interest in paragraph 1 for that year.

In effect, the carry-forward allowed by paragraph 5 is indefinite because any disallowed interest for one year is deemed to be interest paid in the following year. It is not a one-year carry-forward. Some countries may wish to limit the carry-forward of any disallowed interest expense for one year to a fixed period of years — for example, 3 or 5 years.

If a country decides not to allow any carry-forward for disallowed interest, it should omit paragraph 4.

Paragraph 6 deems any interest that is disallowed as a deduction by paragraph 1 to be a dividend for certain specified purposes of the country's tax laws, such as the imposition of withholding tax. Paragraph 6 may or may not be appropriate for a country depending on the tax treatment of any disallowed interest. For example, if a country does not impose withholding tax or imposes a reduced rate of withholding tax on interest under its domestic law or tax treaties, but does impose withholding tax on dividends or imposes a higher rate of withholding tax on dividends under its domestic law tax treaties, it may wish to have any disallowed interest deemed to be a dividend. Alternatively, countries that treat payments of dividends and interest similarly may choose to omit paragraph 6.

Paragraph 7 is intended to ensure that the earnings-stripping rules apply to interest on debt of a partnership in which a resident

company is a partner. Paragraph 7 is necessary if a country treats partnerships as transparent rather than as separate entities for tax purposes. If a country treats partnerships as separate entities, paragraph 1 should apply to both resident companies and partnerships. However, if a country treats partnerships as transparent, paragraph 7 is necessary to prevent the earnings-stripping rules from being avoided through loans to a partnership in which a resident company is a partner rather than to the company directly. Paragraph 7 prevents this result by deeming any interest [paid] [or received] by a partnership in which a resident company is a partner to be interest [paid] [or received] by the company to the extent of the company's percentage interest in the partnership. Thus, for example, if a resident company has 60 per cent interest in a partnership, 60 per cent of any interest paid by the partnership will be deemed to be debt of the company. A similar provision may be necessary with respect to interest [paid] [or received] by trusts in which a resident company is a beneficiary, depending on how trusts are treated for purposes of a country's tax laws.

Paragraph 8 applies restrictions on the deduction of interest similar to those in paragraph 1 to non-residents carrying on business in the country. Paragraph 8 applies to any situations in which non-residents are subject to tax on a net basis and their interest expenses are deductible in computing their income subject to tax. In such situations, the interest deductions claimed may be excessive and erode the country's tax base inappropriately. In most cases, non-residents are subject to net-basis tax by a country only if they are carrying on business in that country (perhaps through a permanent establishment (PE) or fixed base) and, where a tax treaty applies, only if they are carrying on business in the country through a PE or fixed base located in the country.

For the purposes of paragraph 8, only the interest deductions and the adjusted earnings that reasonably relate to the business of the non-resident carried on in the country are taken into account. In effect, a non-resident's interest deductions and earnings attributable to the business carried on in the country must be determined on some reasonable basis. Information about a non-resident's earnings from a business carried on in the country and the interest deductions claimed by the non-resident should be readily available to the tax authorities from the non-resident's tax return and its books and records.

Paragraphs 9 and 10: Paragraph 9 allows a resident company to deduct interest in excess of the limit in paragraph 1 if the company can establish that resident companies with which it deals at arm's length and that are in similar circumstances are entitled to deduct more interest. This type of measure is necessary for countries that have entered into tax treaties with non-discrimination provisions similar to Article 24 (4) and (5) of the United Nations Model Convention. Those provisions are likely to prevent the application of earnings-stripping rules that apply only to interest paid to non-residents. However, if a country's earnings-stripping rules allow the deduction of interest that is in accordance with the arm's length standard in Article 9 of the United Nations Model, although such interest deductions would be disallowed by the application of the fixed ratio of interest to earnings in paragraph 1, Article 24 would not apply to prevent the application of the earnings-stripping rules. Paragraph 8 adds significant complexity with respect to compliance and administration of earnings-stripping rules. Alternatively, as discussed in [reference to relevant paragraph], countries might consider negotiating their tax treaties such that those treaties cannot prevent the application of their earnings-stripping rules.

3.4 Sample withholding tax provision with explanatory notes

1. *Any person not resident in Country X shall pay tax of __ per cent 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;*
   - *(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) …*

2. *A person resident in Country X that pays any amount described in paragraph 1 to a non-resident person shall withhold tax on behalf of such non-resident person at the rate of __ per cent of the gross amount paid and remit that amount to _____.*
3. *If a person resident in Country X fails to withhold tax as required by paragraph 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 paragraph 1.*
4. *If a person resident in Country X fails to withhold tax as required by paragraph 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 paragraph 1, if a person who is not resident in Country X (referred to in this paragraph 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.*
6. *For the purposes of paragraph 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 paragraph 1, if a partnership in which a non-resident person is a partner receives an amount described in paragraph 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.*
8. *Paragraph 1 does not apply to …*

Explanatory notes

Paragraph 1 imposes tax on interest and amounts that are economic equivalents of interest paid by residents of Country X to non-residents. The tax is imposed on the gross amount paid, without any deductions

for expenses incurred by the non-resident recipient in earning the payments. The tax imposed under paragraph 1 is intended to apply broadly to amounts paid or credited to a non-resident as, on account of, or in lieu of, interest and the other amounts listed in paragraph 1.

Interest (and the other amounts) referred to in paragraph 1 are not defined for purposes of the withholding tax; as a result, the term "interest" and the other amounts referred to in paragraph 1 have the meaning that they have under the domestic law of Country X.

Where a country imposes withholding tax under paragraph 1, it should consider the relationship between that tax and the provisions of any tax treaties that it enters into. Under Article 11 (2) of the United Nations Model Convention and the Organisation for Economic Co-operation and Development (OECD) Model Convention,[3] a contracting State is entitled to impose tax on interest paid by a resident of that State; however, if the interest is paid to a resident of the other contracting State who is the beneficial owner of the interest, the first State's tax is limited to, in the case of the United Nations Model Convention, the percentage of the gross amount of interest payment agreed to by the States pursuant to bilateral negotiations, and in the case of the OECD Model Convention, 10 per cent of the gross amount of the payment. Thus, if a country enters into tax treaties with provisions similar to Article 11 of the United Nations or OECD Model Conventions, the country's withholding tax on payments of interest by its residents to non-residents will be limited to the maximum rate specified in Article 11.

Moreover, Article 11 is limited to payments of interest as defined in Article 11 (3) of the United Nations and OECD Model Conventions. Therefore, to the extent that a country's domestic withholding tax on interest and other amounts applies to amounts that are not covered by Article 11, any treaties with provisions similar to Article 11 of the United Nations and OECD Model Conventions that the country has entered into will preclude the country from imposing its withholding tax. However, if those treaties contain provisions similar to Article 21 (Other income) of the United Nations Model Convention, the country

[3] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014)

will be entitled to impose its withholding tax on amounts that arise in the country in accordance with Article 21 (2). Any treaties that contain provisions similar to Article 21 of the OECD Model Convention will preclude a country from taxing amounts that are not covered by Article 11 (or any other provision of the treaty) because, under Article 21 of the OECD Model Convention, other income is taxable exclusively by the country in which the recipient of the payment is resident

If interest is paid by a resident of one contracting State to a resident of the other contracting State who carries on business through a permanent establishment (PE) or fixed base in the first State, and the interest is effectively connected to the PE or fixed base, the provisions of Article 7 or 14, rather than Article 11, will apply. Thus, the interest will be taken into account in computing the profits attributable to the PE or fixed base, which must be taxed on a net basis in accordance with Article 7 or 14.

Paragraph 2 imposes an obligation on any resident person that pays an amount described in paragraph 1 to a non-resident person to withhold the amount of the tax from such payments and remit it to the tax authorities on behalf of the non-resident. The amount withheld pursuant to paragraph 2 is considered to be tax paid by the non-resident person and satisfies the non-resident's obligation to pay tax under paragraph 1.

If a resident person fails to withhold as required by paragraph 2, that person is liable for the tax payable by the non-resident person under paragraph 1 to the extent that the amount of that tax is not withheld. Thus, both the non-resident person and the resident payer are liable for the same amount, and the tax authorities may take collection action against either the non-resident person or the resident person, or both. Any amount collected by the tax authorities from one of the parties is considered to satisfy the liability of both parties. The tax authorities shall not collect in total more than the amount of tax payable under paragraph 1. To the extent that a resident person pays an amount under paragraph 3, that person shall have the right to recover that amount from the non-resident person. [These ancillary issues should probably be dealt with explicitly in the legislation.]

A failure to withhold under paragraph 2 should also be subject to interest and penalties. However, such interest and penalties should

apply generally to all withholding taxes, not just to withholding taxes in respect of interest and other financing expenses.

As an alternative or additional mechanism to enforce the obligation to withhold under paragraph 2, paragraph 4 provides that, to the extent that a resident person fails to withhold as required by paragraph 2, that person will not be entitled to deduct interest or other amounts paid to a non-resident person.

Paragraph 5 extends the tax under paragraph 1 and the obligation to withhold under paragraph 2 to non-residents of Country X who make interest and other similar payments to other non-resident persons by deeming such non-resident payers to be residents of Country X. However, non-resident payers are deemed to be residents for this purpose only to the extent that the payments are deductible in computing their income subject to tax under the tax law of Country X. In general, payments by non-residents described in paragraph 1 will be deductible in computing income under the tax law of Country X only if non-residents are carrying on business in Country X through a PE or fixed base. In the absence of paragraph 5, a country would not have any legal basis for imposing an obligation on non-residents to withhold tax from interest and other similar payments to non-residents because paragraph 1 applies only to payments by residents.

Paragraphs 6 and 7 extend the tax under paragraph 1 to circumstances in which a partnership pays interest or other similar amounts to a non-resident or receives such amounts from a resident. These provisions are necessary only if a partnership is treated as a transparent or flow-through entity for purposes of the country's domestic tax law. If a partnership in which a resident of the country is a partner pays interest or another amount described in paragraph 1 to a non-resident person, the partner resident in that country may not be considered to have paid the partner's pro rata share of the amount paid by the partnership. Thus, if the partnership is not considered to be a resident person, there would be no liability to withhold from the payment by the partnership for either the partnership or the resident partner. By deeming the partnership to be a resident of the country, paragraph 6 has the effect of making the partnership liable to withhold under paragraph 2.

Similarly, if a partnership in which a non-resident person is a partner receives interest or another amount described in paragraph 1

from a person resident in the country, the non-resident partner may not be considered to have received the partner's pro rata share of the amount received by the partnership. Thus, if the partnership is not considered to be a non-resident person for purposes of the country's tax law, there would be no liability to pay tax under paragraph 1 for either the partnership or the non-resident partner. By deeming the partnership to be a non-resident of the country, paragraph 7 has the effect of making the partnership liable for tax under paragraph 1 and the resident payer liable to withhold the tax under paragraph 2.

Paragraph 8 provides any exemptions from withholding tax on interest that a country considers appropriate.

Chapter 4

Negotiation of tax treaties to prevent base erosion with respect to base-eroding payments of interest and other financing expenses

4.1 Introduction

Tax treaties are bilateral agreements that result from negotiations between the contracting States. They reflect not only the relative negotiating power of the contracting States, but also the prevailing international consensus about the provisions of tax treaties, as shown in the provisions of the United Nations and OECD Model Conventions.[4] Any attempt by a country to deviate significantly from the provisions of these model treaties is likely to be resisted by other countries. Therefore, although the following discussion makes several suggestions for provisions in tax treaties to limit the risks of base erosion, these provisions may not be acceptable to many countries. If a country decides that it wishes to include some of these provisions in its tax treaties, it must realize that other contracting States may not agree, or may agree only if the country makes concessions with respect to other provisions of the treaty.

The OECD/G20 and the United Nations Committee of Experts on International Cooperation in Tax Matters are currently engaged in a project to limit base erosion and profit shifting (BEPS). This project is likely to result in several changes to the United Nations and OECD

[4] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Model Conventions. Therefore, a country may find that other countries are more willing to agree to anti-base erosion provisions if these provisions are included in one or both of the model treaties or if a multilateral agreement to amend existing treaties is successfully concluded, as proposed in BEPS Action 14 (Making Dispute Resolution Mechanisms More Effective).

Tax treaties have the effect of limiting the taxes imposed under the domestic laws of the contracting States. When a country is negotiating a tax treaty, it should be aware that the treaty may prevent the country from applying the provisions of its domestic law to prevent base erosion if those provisions conflict with the provisions of the tax treaty. Therefore, in general, if a country decides to enter into tax treaties, it should carefully consider including a specific provision in its tax treaties to allow it to apply the provisions of its domestic law designed to prevent base erosion, as suggested in part 2, chapter 4, section 4.2.2.5.

The following discussion examines provisions that might be included in a country's tax treaties to prevent base erosion. The discussion is organized on the basis of the provisions of the United Nations Model Convention dealing with interest—both the taxation of interest and the deduction of interest—as they affect residents of a country and residents of the other contracting State. (These provisions of the United Nations Model Convention are discussed in part 2, chapter 2, section 2.3.2.) It assumes that a country's tax treaties are based on the United Nations Model Convention and that the relevant income is taxable under a country's domestic law.

At a broad conceptual level, a country can protect its tax base from base-eroding interest payments in two basic ways: imposing tax on the recipient of the interest and denying or limiting the deduction of the interest by the payer. As discussed in chapter 3, if a country's domestic tax law does not impose tax on the recipient of interest and/or deny or limit the deduction of interest by the payer, the country's tax treaties will not provide any protection from the erosion of its tax base. Tax treaties limit a country's domestic tax; therefore, if the country does not impose tax on base-eroding interest payments under its domestic law, the provisions of its tax treaties, which allow it to impose withholding tax on interest, will not allow it to impose tax on those payments. Similarly, if a country's domestic law allows a deduction for

base-eroding interest payments, the provisions of its tax treaties will not provide authority for it to deny or limit such deductions.

However, if a country does impose tax on the recipient of interest and/or deny or limit the deduction of interest by the payer under its domestic law, the country's tax treaties may prevent it from imposing tax on the interest or denying or limiting the deduction of the interest. Therefore, if a country wants to protect its domestic tax base from base-eroding interest payments, it must be careful when negotiating any tax treaties to ensure that the provisions of those treaties do not limit its ability to tax interest payments or deny deductions for interest payments.

4.2 The effect of tax treaties on non-residents

4.2.1 Introduction

As discussed above in the introduction to this chapter, a country can protect its domestic tax base from base-eroding payments of interest and other financing expenses by taxing such payments to the recipient or by denying or limiting the deduction of such payments by the payer. In the case of non-residents, a country can restrict the deduction of interest by non-residents in certain circumstances and can impose tax on interest payments received by non-residents in certain circumstances. Therefore, with respect to the negotiation of tax treaties, countries that want to combat base erosion by non-residents through interest and other similar payments should ensure that the provisions of any tax treaties they enter into allow them to restrict the deduction of interest by non-residents in certain circumstances and allow them to impose tax on interest payments received by non-residents in certain circumstances.

4.2.2 Deduction of interest by non-residents

If a resident of one contracting State carries on business in the other contracting State through a permanent establishment (PE) located in that other State or performs professional or other independent services in that other State through a fixed base in that other State, the other State is entitled to tax the profits attributable to the PE or fixed base

under Article 7 (Business profits) or Article 14 (Independent personal services) of the United Nations Model Convention, as the case might be. Under Article 7 (3),[5] the other State must tax the profits attributable to the PE on a net basis (that is, it must allow deductions for the expenses, including interest, incurred by the non-resident that are properly allocated to the PE or fixed base). However, Article 7 (3) does not mean that all interest expenses incurred for the purposes of a PE or fixed base must be deductible. (This aspect of Article 7 is widely misunderstood.) The deductibility of expenses is a matter of each country's domestic law. Therefore, if a country restricts the deduction of interest expenses incurred by non-residents to earn income through a PE or fixed base in the country, Article 7 (3) will not prevent the application of those restrictions.

However, the non-discrimination protection in Article 24 (3) becomes relevant at this point. Under Article 24 (3), a country is prohibited from taxing a PE (but not a fixed base) of a resident of the other contracting State less favourably than it taxes its own residents carrying on similar activities. If a country's tax treaties contain provisions similar to Article 24 (3) of the United Nations Model Convention, it will be unable to apply any restrictions in its domestic law on the deduction of interest by non-residents carrying on business through a PE in the country unless those restrictions also apply to its own residents. Therefore, to the extent that a country's tax treaties contain a provision similar to Article 24 (3), that country must allow the deduction of any interest expenses incurred by a resident of a treaty country on borrowed funds that are used for the purposes of a PE in the country. These deductions will erode the country's tax base. However, Article 24 (3) will not affect any restrictions in a country's law on the deduction of interest by non-residents carrying on business through a fixed base in the country.

[5] Although Article 14 of the United Nations Model Convention does not contain explicit wording requiring the deduction of expenses incurred for the purpose of a fixed base, paragraph 10 of the Commentary on Article 14, quoting paragraph 3 of the Commentary on former Article 14 of the OECD Model Convention, indicates that the same principles for the computation of the profits attributable to a PE under Article 7 of the OECD Model Convention, including the deduction of expenses, should apply for purposes of Article 14.

If a country wants to apply any restrictions in its domestic law on the deduction of interest by non-residents carrying on business in the country through a PE, it might consider:

(a) Not agreeing to include Article 24 (3) in its treaties;

(b) Including a most-favoured-nation (MFN) version of Article 24 (3), under which it would agree to treat residents of the other contracting State carrying on business in the country through a PE no less favourably than the residents of any other foreign country carrying on business in the country through a PE. This MFN version of Article 24 (3) could be worded as follows:

> *(3) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of a third State carrying on the same activities… .*

(c) Including a specific exception in Article 24 (3) for any restrictions on the deduction of interest by non-residents under the country's domestic law. Such an exception could be worded as follows:

> *(3.1) Notwithstanding paragraph (3), a Contracting State shall be entitled to apply any provision of the taxation laws of that State relating to the deductibility of interest and which is in force on the date of signature of the Convention or which is adopted after that date as long as such subsequent provision does not change the general nature of the provision in effect at the date of signature of the Convention.*

Under this type of provision, a country would be able to apply its restrictions on the deduction of interest by non-residents carrying on business in the country through a PE, but would not be able to tax such non-residents less favourably in any other respect.

Although the deduction of base-eroding interest expenses in computing the profits of a PE or fixed base is legitimate, it raises several concerns. First, a country's tax administration must ensure that non-residents do not claim excessive interest deductions in computing

the profits attributable to a PE or fixed base. Second, the country should not agree to a version of Article 7 (such as Article 7 of the OECD Model Convention) or Article 14 that would allow a non-resident to deduct notional interest expenses on amounts advanced to the PE or fixed base. If the country enters into a treaty that allows non-residents to deduct notional interest expenses, it will not be able to impose withholding tax on notional payments of interest; as a result, its tax base will be eroded by the deduction of the notional interest, but it will be unable to tax those notional payments. Third, the country should impose withholding tax on payments of interest by non-residents to the extent that those payments are deductible in computing the profits attributable to a PE or fixed base in the country and are paid to non-resident lenders. In most cases, such a withholding tax will be enforceable because of the presence of a PE or fixed base in the country. Article 11 (5) of the United Nations Model Convention deems such payments to arise in the country in which a PE or fixed base is located. Therefore, a country should ensure that it includes a provision similar to Article 11 (5) in its tax treaties.

4.2.3 Withholding tax on interest

As discussed in part 2, chapter 2, section 2.3.1.2, under Article 11 of the United Nations Model Convention, a contracting State is entitled to impose a final withholding tax at an agreed rate on interest paid by residents of that State to residents of the other contracting State. Countries will usually be expected to agree to a provision similar to Article 11. If they do so, Article 11 will limit any withholding tax on interest payments under their domestic law to the payments identified in Article 11 and the rate specified in Article 11 (2). Therefore, countries should consider carefully the extent to which a provision similar to Article 11 of the United Nations Model Convention will require them to give up their withholding tax on interest under domestic law.

Two issues are most important in this regard: the definition of interest and the rate of withholding tax.

First, the definition of interest will determine the scope of the payments that are subject to the withholding tax on interest. If a payment is not a payment of interest, obviously it is not subject to the provisions of Article 11; however, it may be subject to another provision

of the treaty, and as a matter of last resort, may be covered by Article 21 (Other income). Article 11 (3) of the United Nations Model Convention defines interest as income from debt claims of every kind. The definition does not refer to or depend on the definition of interest under a country's domestic law. Therefore, countries should review their withholding taxes on interest payments to determine whether those withholding taxes apply to payments that are not covered by the definition in Article 11 (3) of the United Nations Model Convention. If a country's withholding tax applies to payments that are not covered by the definition in the United Nations Model Convention, it may consider trying to get the other country to agree to expanding the definition of interest in Article 11 (3) to cover those payments.

If payments by a resident of one contracting State to a resident of the other contracting State are not within the treaty definition of interest and are not dealt with in any of the other distributive provisions of the treaty (Article 6 to Article 20), Article 21 will apply to the payments as other income. According to Article 21 (1) of the United Nations Model Convention, other income may be taxed by the country in which the taxpayer who receives the income is resident, wherever the income arises; however, such income may also be taxed in the country in which it arises under Article 21 (3). Unlike Article 11 (2), Article 21 (3) does not place any limit on the tax imposed by the source country on other income. Therefore, to the extent that a country imposes withholding tax on financing expenses that are not within the definition of interest in Article 11, Article 21 may allow that country to tax any such payments that arise in the country in accordance with its domestic law without any limitation imposed by the treaty. Countries should consider carefully whether a discrepancy between their withholding tax on interest and their withholding tax on other financing expenses is desirable. If they decide that such a discrepancy is undesirable, as mentioned above, they could attempt to get their treaty partners to agree to include financing expenses other than interest in the definition of payments covered by Article 11. Alternatively, they might agree to limit the domestic rate of tax imposed on other income under Article 21 (3) to the same percentage as the percentage of interest payments agreed to for purposes of Article 11 (2).

Second, the contracting States must agree on the maximum rate of withholding tax on interest. In general, a particular country

will be expected to agree to a rate of withholding tax on interest that is less than the rate imposed under its domestic law. Determining the maximum rate of withholding tax on interest that is acceptable to any particular country is a difficult decision and requires a delicate balancing of many considerations, including:

- The maximum rate of withholding tax on interest agreed to in the country's other treaties
- The relative cross-border flows of interest between the country and the other contracting State
- The extent to which resident lenders in the other contracting State can require borrowers resident in the country to pay the withholding tax through grossed-up payments of interest, and
- The impact of the withholding tax on foreign investment in the country

4.3 Residents

4.3.1 Elimination of double taxation

As discussed in part 2, chapter 2, section 2.3.2.2, under Article 23 of the United Nations Model Convention (Methods for the elimination of double taxation), a contracting State is required to provide relief from the double taxation of income derived by its residents by exempting the relevant income from tax or by allowing a credit for the foreign tax paid on the relevant income. This obligation to relieve double taxation applies to any income derived by a resident of a contracting State that is taxable in the other contracting State in accordance with the provisions of the treaty.

A country will be expected to agree to provide relief from double taxation in accordance with Article 23 A or 23 B of the United Nations Model Convention in negotiating a tax treaty with another country. In general, a country can agree to include Article 23 A or 23 B in its tax treaties without any concern about creating opportunities for base erosion. Neither Article 23 A nor Article 23 B requires a contracting State to give up domestic tax on its residents. Under Article 23 A, a contracting State is required to exempt only income that is taxable by the other contracting State in accordance with the treaty. Under

Article 23 B, a contracting State is required to allow a credit for the taxes paid to the other contracting State only to the extent that the income on which the foreign tax is imposed is taxable by the other contracting State in accordance with the treaty.

If a country agrees to include Article 23 A, the exemption method, in its tax treaties, it will be required to exempt any income derived by its residents, other than dividends, interest and royalties, that is taxable by the other contracting State under the terms of the treaty. Therefore, the country would be required to exempt any interest income that is attributable to a PE or a fixed base in the other contracting State if the debt claim is effectively connected to the PE or fixed base.[6]

On the other hand, a particular country would not be required to exempt the following interest income, but would be required to provide a credit for the taxes imposed by the other contracting State on such income:

(a) Any interest that is paid by a resident of the other contracting State to a resident of the particular country; in this case, the credit is limited to the lesser of the tax paid to the other contracting State on the interest in accordance with Article 11 (2) and is also limited to the particular country's tax on the interest;

(b) Any interest derived by a resident of the particular country, other than interest described in (a), arising in the other contracting State that is taxed in that State in accordance with Article 21 (3) (Other income). In this case, the treaty does not impose any limit on the tax imposed by the other contracting State. However, the particular country is required to allow a credit for the other State's tax only to the extent of the particular country's tax on the interest.

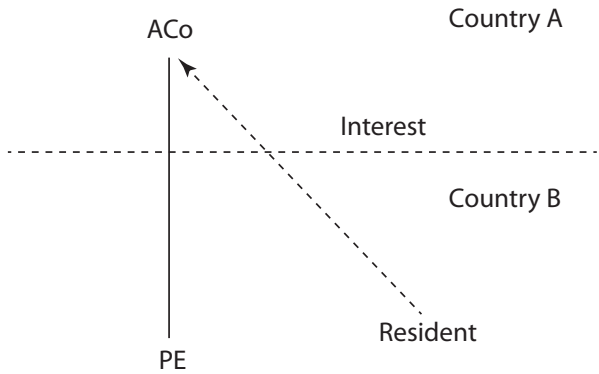
A country is not obligated to exempt interest income or give a credit for any foreign tax on interest income that is derived by a resident but does not arise in the other contracting State. For example, if a resident of Country A receives interest from a resident of Country B, but the interest is borne by a PE or fixed base that the resident of Country B has in Country A or in a third country, the interest is not

[6] Article 11 (4) of the United Nations Model Convention.

taxable by Country B in accordance with Article 11 because it does not arise in Country B (see Article 11 (5)). Nor is the interest taxable by Country B under any other provision of the United Nations Model Convention. Therefore, Country A would not be required by Article 23 to exempt the interest from tax or to give a credit for any tax imposed by Country B on the interest.

Example 1

ACo, a resident of Country A, carries on business through a PE in Country B. ACo receives interest on a debt owed to it by a resident of Country B. The debt is effectively connected with the PE of ACo in Country B and the interest on the debt is included in the profits attributable to the PE. Assuming that Country A and Country B have entered into a tax treaty with provisions identical to the provisions of the United Nations Model Convention, including Article 23 A, Country A would be required to exempt from tax the interest received by ACo because that interest is taxable by Country B in accordance with Article 11 (4) and Article 7 of the treaty.

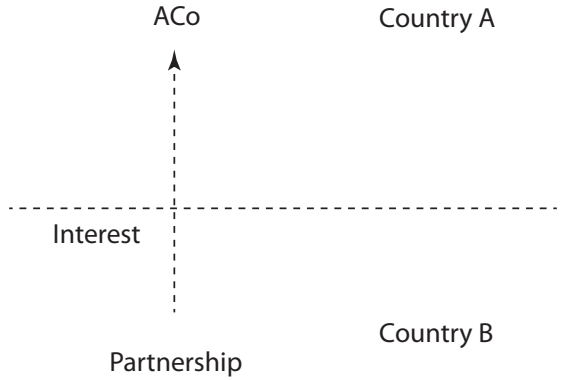


- Interest is paid by the resident of Country B to ACo
- Debt is effectively connected with the PE
- Interest is included in computing profits of the PE

If the debt owed by the resident of Country B to ACo is not effectively connected to the PE of ACo in Country B, the treaty would not require Country A to exempt the interest from tax. Instead, if Country A imposes tax on the interest, it would be required to allow a credit for any tax paid to Country B on the interest in accordance with Article 11 (2) of the treaty.

Example 2

ACo, a resident of Country A, receives interest from a partnership organized under the laws of Country B. The partnership is not subject to tax under the laws of Country B and therefore it is not a resident of Country B for purposes of the treaty between Country A and Country B. As a result, Article 11 of the treaty does not apply to the interest because it is not paid by a resident of Country B. Under Article 21 (3) of the treaty, Country B is entitled to tax the interest paid to ACo if it arises in Country B. Assuming, therefore, that the interest arises in Country B and Country B imposes withholding tax on the interest payment, Country A would be required to exempt the interest from Country A tax on ACo.



- The partnership pays interest to ACo
- The partnership is not a resident of Country B
- Article 11 does not apply

Article 23 of the United Nations Model Convention does not provide detailed rules for the operation of either the exemption method under Article 23 A or the foreign tax credit method under Article 23 B; as a result, these rules must be supplied by domestic law. Each country should ensure that the rules for exemption or foreign tax credit under its domestic law are adequate to protect its domestic tax base. In particular, each country should ensure that any interest expenses that are properly attributable to the foreign source income are allocated to that income for purposes of the exemption of such income or for purposes of the limitation on the foreign tax credit, as explained in part 2, chapter 4, sections 4.4.2 and 4.4.3.

4.3.2 Non-discrimination (Article 24 (4) and (5))

As explained in part 2, chapter 2, section 2.3.2.3, Article 24 (4) requires a country to allow the deduction of interest paid by its resident enterprises to residents of the other contracting State under the same conditions that would apply if the interest were paid to its own residents. Therefore, Article 24 (4) prevents a country from applying any rules in its domestic law that restrict the deduction of interest paid to residents of the other contracting State unless those rules also apply to the country's own residents.

Similarly, as explained in chapter 2, section 2.3.2.4, Article 24 (5) prevents a country from imposing taxes on its resident enterprises owned or controlled by residents of the other contracting State that are different from or more burdensome than the taxes imposed on similar resident enterprises. Therefore, Article 24 (5) prevents a country from applying any rules in its domestic law that restrict the deduction of interest paid by its resident enterprises to residents of the other contracting State that own or control those resident enterprises unless those rules also apply to interest paid by resident enterprises that are not owned or controlled by residents of the other contracting State.

Article 24 (4) and (5) does not prevent the application of a country's transfer pricing rules to adjust the amount of debt or the interest charged on any debt, and therefore the amount of deductible interest of a resident enterprise. In addition, Article 24 (4) and (5) does not prevent a country from taxing any excessive interest payments resulting from a special relationship between the payer and the beneficial owner of the interest, as provided in Article 11 (6). These exceptions are expressly included in the words of Article 24 (4) and, according to the Commentary on Article 24 (5), are implicit in Article 24 (5).[7]

It is widely considered that thin capitalization and earnings-stripping rules that restrict the deduction of interest paid to non-residents constitute a violation of Article 24 (4) and (5). Whether or not this view is correct, there is a significant risk that Article 24 (4) and (5) might prevent a country from applying its thin capitalization

[7] See paragraph 4 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 79 of the Commentary on Article 24 of the OECD Model Convention.

or earnings-stripping rules to protect its domestic tax base. Therefore, if a country wants to apply thin capitalization or earnings-stripping rules to limit the deduction of interest paid to non-residents by resident enterprises where the provisions of a tax treaty apply, it should consider one or more of the following actions:

(a) Provide an exception in the country's thin capitalization or earnings-stripping rules for situations in which the financial position (amount of debt) and the interest deductions claimed by resident enterprises conform to the arm's length standard in Article 9 (1) of the United Nations Model Convention. In this way, the country's rules would fit within the exception in Article 24 (4) and (5) for provisions that are compatible with Article 9 (1). However, it must be recognized that such an exception in a country's thin capitalization or earnings-stripping rules will raise many questions of interpretation and application and may reduce the effectiveness of the rules.

(b) Expressly exclude the country's thin capitalization or earnings-stripping rules from Article 24 (4) and (5). Such a provision could be included in Article 24 and might be worded as follows:

(5.1) Notwithstanding paragraphs (4) and (5), a Contracting State shall be entitled to apply any provision of the taxation laws of that State relating to the deductibility of interest and which is in force on the date of signature of the Convention or which is adopted after that date as long as such subsequent provision does not change the general nature of the provision in effect at the date of signature of the Convention.

(c) Modify Article 24 (4) and (5) so that it provides most-favoured-nation (MFN) treatment rather than national treatment. In other words, a country would agree to allow the deduction of interest paid to residents of the other contracting State no less favourably than the deduction of interest paid to residents of any other foreign country, and to treat resident enterprises owned or controlled by residents of the other contracting State no less favourably than resident enterprises owned or controlled by residents

of any other foreign country. However, such a country would not agree to allow the deduction of interest paid to residents of the other contracting State on the same basis as interest paid to its own residents. If Article 24 (4) and (5) are limited to MFN treatment, they might be worded as follows:

(4) Except where the provisions of paragraph 1 of Article 9, paragraph 7 of Article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of any third State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of any third State.

(5) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries.

The above version of Article 24 (5) is found in paragraph 5 of the Commentary on Article 24 of the United Nations Model Convention.

(d) Include a saving clause in a country's tax treaties, which allows it to tax its residents as if the tax treaty did not exist. The OECD/G20 BEPS *Action 6: Final Report: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,*[8]

[8] Available from http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm.

proposes to add a saving clause to the OECD Model Convention, reading as follows:

> *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 A [23 B], 24 and 25 and 28.*

The saving clause proposed by the BEPS Action 6 Final Report contains an exception for treaty benefits granted to residents under Article 24. The reference to Article 24 should be omitted from the saving clause if the saving clause is intended to allow a country to deny or limit the deduction of interest paid by its resident enterprises to residents of the other contracting State.

Part 4
Tax Administration Manual

Chapter 1
Introduction

Part 4 of the *Practical Portfolio* on base-eroding payments of interest deals with issues of tax administration with respect to the taxation of interest income and the deductibility of interest expenses; it focuses on the prevention of base erosion and profit shifting. Chapter 2 deals with disclosure and information reporting requirements. Chapter 3 deals with audit and verification activities by tax officials to detect and counter base erosion and profit shifting with respect to deductible interest expenses. Chapter 4 examines the issues involved in the administration of the provisions of a country's tax treaties with respect to the taxation of interest income and expenses.

As with the other parts of this *Practical Portfolio* on base-eroding interest payments, part 4 concentrates on the risks of base erosion and profit shifting with respect to deductible interest expenses. Each country must decide for itself whether and to what extent it is concerned about the risks of base erosion and profit shifting, and if so, the appropriate action to take to combat those risks. Countries must consider a wide variety of factors in addition to the risks of base erosion in establishing their tax policy for the taxation of non-residents on interest income and the deductibility of interest expenses by both residents and non-residents. Therefore, the material in the present *Portfolio* should not be regarded as providing recommendations that developing countries should adopt to prevent base erosion; instead, the *Portfolio* is intended to provide guidance for developing countries to consider in deciding whether to adopt measures to prevent base erosion and, if they decide to adopt such measures, guidance concerning the application of those measures.

The tax administration issues involved in combating base erosion with respect to deductible interest expenses depends on each country's situation: its domestic tax legislation, its tax treaties and the

organization of its tax administration. The guidance provided in part 4 is general and must be adapted and modified to the needs of any particular country.

Tax is imposed pursuant to a country's domestic law. Tax treaties generally limit the tax imposed under domestic law. Therefore, if a country does not impose tax on interest income derived by non-residents under its domestic law, the provisions of its tax treaties are irrelevant. If a country imposes tax on non-residents under its domestic law, then that country must ensure that the tax is correctly determined and collected and that any limitations on domestic tax available under a tax treaty are properly applied. Similarly, to the extent that a country allows the deduction of interest under its domestic law, the provisions of its tax treaties are irrelevant. However, if a country disallows the deduction of interest under its domestic law, the provisions of the country's tax treaties must be considered to determine if they require the country to allow the deduction of that interest.

As noted several times in this *Practical Portfolio*, the risks of base erosion are greater with respect to non-residents receiving interest income than they are with respect to residents earning such income. Payments of interest by residents or non-residents carrying on business in a country are usually deductible against that country's tax base. If such payments of interest are received by residents of the same country (that is, the country that bears the deduction of the interest payments), they will usually be subject to tax by that country. However, if the payments of interest are received by non-residents, the payments are more likely not to be taxable, or to be taxable at a reduced rate by the country that bears the deduction of those payments. Accordingly, part 4 focuses more on the tax administration issues with respect to non-residents.

In general, non-residents are subject to tax on interest income in two fundamental ways, depending on the circumstances. First, in some situations (usually where they carry on business and derive profits in the form of interest), they may be taxable on their net income in the same manner as residents. In this case, they are usually required to file tax returns showing their income subject to tax and the tax payable. The interest that they receive may be subject to withholding tax, but such withholding is provisional and represents payments on account

of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. The tax finally assessed may be more than the amount of tax withheld, in which case the non-resident is liable to pay the balance, or it may be less than the tax withheld, in which case the non-resident is entitled to a refund of the excess. Second, in other situations non-residents may be subject to final withholding taxes on the gross interest payments they receive from residents. In this case, the tax withheld is the final tax; the non-resident is not allowed to file a tax return and pay tax on a net basis.

The tax administration issues differ significantly depending on whether non-residents are subject to interim or final withholding tax or are taxable only by assessment. Where non-residents are taxable by assessment, compliant taxpayers will file tax returns that provide the tax authorities of the country with a starting point to verify the amount of income and tax payable. However, if non-residents are not compliant, either intentionally or inadvertently (because they do not consider that they are subject to tax by the country), then the tax authorities of the country face the difficult task of identifying non-residents that it considers to be subject to tax as a preliminary step to ensuring that such non-residents comply with their tax obligations under domestic law. These difficulties can be minimized if payments of interest to non-residents are subject to interim or final withholding. To the extent that non-residents are subject to withholding, the obligations to identify non-residents subject to tax, and the amount of the tax, are effectively shifted to the withholding agents.

Chapter 2

Disclosure and information reporting requirements

2.1 Introduction

The tax authorities of a country require various types of information to apply the provisions of domestic law and tax treaties in order to ensure that interest income derived by residents and non-residents is taxed properly and that interest expenses are properly deducted so that the country's tax base is not eroded. With respect to residents of a country, the information required by the tax authorities depends on whether the residents are exempt from tax in that country on foreign income or are taxable with a credit for the foreign taxes on the foreign income (as discussed in part 2, chapter 1, section 1.6), and also on whether that country disallows or limits the deduction of interest expenses (as discussed in part 2, chapter 1, section 1.3). As noted in chapter 1 above, the type of information necessary with respect to non-residents depends on whether they are taxable on a net basis or subject to interim or final withholding taxes.

Most of the following information is collected from taxpayers or third persons such as withholding agents and financial institutions. Countries should balance the need for and usefulness of any information against the burden imposed on taxpayers and third parties to provide that information. Also, countries should not require taxpayers and third parties to provide information that the tax authorities do not have the capacity or intention to use.

2.2 Disclosure and information reporting requirements for residents incurring interest expenses to earn income from foreign sources

In general, the information necessary for purposes of properly taxing residents of a country on their income from sources outside the country,

and in particular, interest expenses incurred to earn such income, can be obtained from the resident taxpayers themselves. Although information about a resident's foreign source income may be available from the tax authorities of another country with which the residence country has a tax treaty providing for exchange of information, the foreign tax authorities are unlikely to have access to better information than the residence country's tax authorities concerning interest expenses incurred by its own residents. However, they will have information about the amount of interest expense claimed as a deduction in their country, and this information may be useful for the residence country in determining the appropriate relief from international double taxation — that is, the amount of foreign source income exempt from tax or the amount of foreign tax to be allowed as a credit against the residence country's tax on the foreign source income.

If residents of a country are taxable on their worldwide income, they can be required by that country to provide information in their tax returns or supporting schedules with respect to the amount of such income, the country or countries in which the income is earned, and the amount of foreign tax on the income. This information is necessary to determine a resident's worldwide income subject to tax, as well as the possible entitlement of the resident to a foreign tax credit for foreign taxes on the foreign income. Perhaps the best evidence of the amount of the income earned in another country and the amount of tax paid to that country is the taxpayer's foreign tax return.

Even if a resident is not subject to tax on certain foreign source income, such as active business income earned in foreign countries, a country may require the resident to provide information about that income. This information can be used to verify that the resident is not claiming an exemption for foreign income in excess of the amount of such income, and also to ensure that any interest expenses incurred in earning that income are not deductible against the resident's domestic source income. In addition, for countries that exempt a resident's foreign source income but take that income into account in determining the rate of tax (exemption with progression), such information is important to verify that the tax rate applied is correct.

Where residents pay interest to non-residents with whom they do not deal at arm's length, the tax authorities need information about those transactions in order to apply transfer pricing rules.

Thus, residents can be required to provide information to the tax authorities about payments of interest to related or non-arm's length non-residents. Such information can be provided either in a resident's tax return or in separate information returns. The information should include at least the name and address of the recipient of the payment, the country of residence of the recipient, the amount of the payment, and the nature and amount of the indebtedness in respect of which the interest is paid.

If a country has tax treaties with other countries, it can request its treaty partners to provide any relevant information pursuant to the exchange of information provisions in those treaties.[1]

2.3 Disclosure and information reporting requirements with respect to thin capitalization and earnings-stripping rules

2.3.1 Introduction

If a country has enacted thin capitalization rules or earnings-stripping rules to prevent excessive interest deductions, the tax authorities require various types of information to apply such rules effectively. The precise information required depends on the details of the domestic legislation. This information can be obtained from the taxpayers to which the rules apply, and for this purpose, all taxpayers should be required to maintain the books and records necessary to support the application of thin capitalization or earnings-stripping rules. Useful information may also be obtained from public sources, such as public financial information. As noted above, countries should balance the need for and usefulness of any information against the burden imposed on taxpayers and third parties to provide that information. Also, countries should not require taxpayers and third parties to provide information that the tax authorities do not have the capacity or intention to use. In some circumstances, it may be useful for the tax authorities to obtain information from other

[1] See Diane Ring, "Transparency and disclosure", in *Handbook on Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), chapter X, 497–568, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

government agencies, such as securities and banking regulators, that require information reporting.

2.3.2 Thin capitalization rules

If a country adopts thin capitalization rules to limit interest deductions, it requires information to determine the entities to which the rules apply. If the thin capitalization rules apply to all resident entities irrespective of the recipients of the interest paid by those entities, the identification of the relevant entities is relatively easy, although it may be difficult for the tax authorities of many developing countries to audit and verify the application of rules that apply so broadly. If the thin capitalization rules apply more narrowly to resident entities that pay interest to non-residents, or to substantial non-resident shareholders, or to controlling non-residents and related non-residents, the tax authorities require information about the recipient of interest payments by resident entities in order to determine whether the rules apply. This information can be obtained from the resident entities either in a special information reporting form or in a schedule to the tax return. Such information can be cross-checked against the information reporting with respect to payments of interest to non-residents (see section 2.4 below).

The tax authorities also require information about the payments covered by the thin capitalization rules. Resident entities can be required to provide this information to the tax authorities either in a special form or in a schedule to their tax returns. If the thin capitalization rules apply to payments that are economic equivalents of interest, the tax authorities need sufficient information in order to determine whether any payments are interest or economic equivalents of interest. The required information may need to be detailed and comprehensive. Depending on the scope of a country's withholding tax on payments of interest and other similar amounts, the information reporting required for withholding tax purposes may also be useful for purposes of the thin capitalization rules.

Thin capitalization rules operate on the basis of a debt/equity ratio, and therefore the tax authorities require information about the debt and equity of the resident entities to which the rules apply. Taxpayers can be required to provide this information in a special information reporting form or in a schedule to their tax returns.

If a country's thin capitalization rules allow any disallowed interest deductions for a taxation year to be carried forward to subsequent years or back to prior years, it will be necessary for the tax authorities to keep track of any disallowed interest deductions and their use in prior or subsequent years. The administrative burden on the tax authorities to keep track of this information and, in the case of a carry-back, to reopen tax returns of past years, should not be underestimated.

2.3.3 Earnings-stripping rules

If a country adopts earnings-stripping rules to limit interest deductions, it requires information to determine the entities to which the rules apply. If the earnings-stripping rules apply to all resident entities irrespective of the recipients of the interest paid by those entities, the identification of the relevant entities is relatively easy, although it may be difficult for the tax authorities of many developing countries to audit and verify the application of rules that apply so broadly. If the earnings-stripping rules apply more narrowly to resident entities that pay interest to non-residents, or to substantial non-resident shareholders, or to controlling non-residents and related non-residents, the tax authorities require information about the recipient of interest payments by resident entities in order to determine whether the rules apply. This information can be obtained from the resident entities in a special information reporting form or in a schedule to the tax return. Such information can be cross-checked against the information reporting with respect to payments of interest to non-residents (see section 2.4 below).

The tax authorities also require information about the payments covered by the earnings-stripping rules. Resident entities can be required to provide this information to the tax authorities either in a special form or in a schedule to their tax returns. If the earnings-stripping rules apply to payments that are economic equivalents of interest, the tax authorities need sufficient information in order to determine whether any payments are interest or economic equivalents of interest. The required information may need to be detailed and comprehensive. Depending on the scope of a country's withholding tax on payments of interest and other similar amounts, the information reporting required for withholding tax purposes may also be useful for purposes of the earnings-stripping rules.

Earnings-stripping rules apply on the basis of a taxpayer's gross or net interest expenses as a percentage of its earnings for a taxation year. Therefore, the tax authorities require information about the taxpayer's gross interest payments, its interest receipts (if the rules apply on the basis of net interest expenses) and its earnings for a year. If the amount of a taxpayer's earnings is calculated on an average of multiple years, information is necessary for all the relevant years. All this information should be available from the taxpayer's tax return and its books and records.

If a country's earnings-stripping rules allow any disallowed interest deductions for a taxation year to be carried forward to subsequent years or back to prior years, it will be necessary for the tax authorities to keep track of any disallowed interest deductions and their use in prior or subsequent years. The administrative burden on the tax authorities to keep track of this information and, in the case of a carry-back, to reopen tax returns of past years should not be underestimated.

If a country's earnings-stripping rules contain any exemptions, the tax authorities require sufficient information to ensure that the exemptions are claimed properly. For example, if a country has a de minimis exemption based on the amount of interest deductions claimed by a taxpayer in a year, this information should be available from the taxpayer's tax return and its books and records. It might be useful for taxpayers to be required to indicate either in an information reporting form or in their tax returns that they are claiming the exemption, so that the tax authorities can then verify whether the exemption is valid.

2.3.4 Non-residents subject to thin capitalization or earnings-stripping rules

If a country's thin capitalization rules or earnings-stripping rules apply to non-residents, the tax authorities should be able to determine without much difficulty the non-residents covered by the rules. In effect, the rules should apply to any non-resident that is entitled to pay tax on a net basis and that claims interest deductions. With respect to these non-residents, the tax authorities require information about a non-resident's debt, assets, interest deductions, or earnings related to its business activities

carried on in the country. This information should be available from the non-resident's tax return and the books and records it is required to maintain. However, it may be difficult for the tax authorities to verify that the debt and assets or earnings reported by a non-resident as related to its business activities in the country are accurate.

2.4 Disclosure and information reporting requirements for non-residents

2.4.1 Introduction

In general, the information necessary to tax non-residents on their interest income properly and to ensure that their interest expenses are properly deductible is available from five main sources:

- The non-resident
- A local agent or representative of the non-resident
- Persons, usually residents, making interest payments to non-residents
- The tax authorities of other countries with which a country has a tax treaty providing for exchange of information, and
- Public information

The following parts of this section are organized on the basis of the type of information that a country needs to tax non-residents on their interest income properly and to ensure that the deduction of their interest expenses is appropriate. The sources for the information are discussed in each section.

It is assumed for the purposes of the following discussion that the tax authorities of a country have the authority under domestic law to obtain the necessary information from the taxpayer, the person making payments to a non-resident, or other persons.

2.4.2 Identification of non-residents

In order to impose tax on non-residents deriving interest income from a country, it is necessary, at a minimum, to know the names and addresses of those non-residents. For non-residents carrying on

business in a country, this information may be provided pursuant to business registration requirements, in applications for taxpayer identification numbers or in tax returns. In other situations, if interest payments to non-residents are subject to withholding tax, the withholding agent can be required to obtain and supply this information in order to comply with its withholding obligations.

Some countries require non-residents engaged in business activities in the country to register with the tax authorities or with some other government agency. Sometimes non-residents may also be required to obtain taxpayer identification numbers or to appoint a local agent or representative.[2] However, where non-residents are present in a country for only a short period of time, it may be difficult or impossible to identify them and to impose tax effectively on the interest and other income they derive. In such situations, the only effective way to identify non-residents deriving interest income from a country may be to require the payers of interest to non-residents to provide information concerning the identity of the non-resident recipients as part of an obligation to withhold tax from the interest payments. The administrative aspects of withholding taxes on interest and other similar payments are dealt with below in chapter 4, section 4.7.2.

Some countries may link the obligation on residents to withhold tax from interest payments to non-residents to the non-resident being subject to tax on a net basis. If a non-resident carries on business in a country and is subject to tax in the country on a net basis — because, for example, the non-resident carries on business through a permanent establishment (PE) or fixed base in the country — any interest income earned by the non-resident as part of that business will be subject to tax by that country. Therefore, it may be considered unnecessary in these circumstances to require residents paying interest to such non-residents to withhold tax from those payments. However, it may be difficult for payers to determine whether a non-resident recipient of interest is subject to taxation on a net or gross basis. (See section 2.4.3 below.)

[2] See Colin Campbell, "Taxation of non-residents", in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*, (New York: United Nations, 2013), chapter IV, 173–191, available from http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

2.4.3 Amount of income derived by non-residents

Where non-residents are taxable by a country on their net income, they will be required under that country's domestic law to provide information necessary to compute their net income subject to tax. This information, which is usually provided in a tax return or other supporting schedules, provides a starting point for the tax authorities to determine whether the amount of income is correctly reported. In particular, these non-residents should be required to keep financial books and records that are necessary to support the computation of their net income for tax purposes, including any interest income earned and any deductible interest expenses. The general requirement to keep books and records for non-residents who are subject to tax in a country on a net basis should be the same as that for residents.

Other information may also be useful. For example, it would be useful to have information from persons resident in a country or non-residents with a PE or fixed base in the country who make interest payments to non-residents taxable by the country on a net basis. If such payments are subject to interim or final withholding taxes, the withholding agent could be required to supply information concerning the name and address of the non-resident recipient, the amount of the payment, the amount and nature of the indebtedness on which the interest is paid, and whether the payer is related to the non-resident. However, even if the payments are not subject to withholding, a country might require the payers to provide such information. As discussed in section 2.4.5 below, for this purpose a country may wish to consider providing prescribed forms that withholding agents can use to provide this information.

If a country has a tax treaty with the country in which a person earns income in the first country, that country can request the other country to provide information about the person. This source of information is unlikely to prove fruitful unless the tax authorities know at least the name of the non-resident in order to make a request for information.

2.4.4 Information concerning related-party interest payments

Where a non-resident receives interest from a resident of a country who is related to or does not deal at arm's length with the non-resident,

the possibility arises that the interest paid by the resident may not be equal to the interest that would have been paid if the parties were not related or were dealing with one another at arm's length. The interest rate on the indebtedness may be more or less than an arm's length rate of interest, or the amount of the indebtedness on which the interest is paid may be more or less than the indebtedness that arm's-length or related parties would have agreed to. Some countries may be concerned where the amount paid by their residents is more or less than the arm's length amount of interest. If the interest paid is greater than the arm's length interest, the resident payer may be claiming an excessive amount as deductible interest expenses against a country's tax base. If the amount paid is less than the arm's length interest, the amount of any withholding tax imposed on the interest payment will be less than it should be.

Most countries have transfer pricing rules that require the prices charged for goods and services, including interest, in transactions between a resident and a related non-resident to be adjusted if they are not equal to the prices that parties dealing at arm's length would charge. Also, any tax treaties that a country has entered into will likely contain provisions similar to Article 9 (Associated enterprises) of the United Nations and the Organisation for Economic Co-operation and Development (OECD) Model Conventions.[3]

A country may wish to consider requiring business enterprises resident in the country and non-resident enterprises with a PE or fixed base in the country that make interest payments to related non-residents to provide information to the tax authorities about those payments. Taxpayers may already be required to provide such information pursuant to the country's transfer pricing rules. If so, the tax authorities need to ensure that the information is also available to the officials who deal with withholding taxes. The requirement to provide this information might be limited to interest payments that are deductible by the payers. This information

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

reporting requirement could also be extended to individuals paying interest to non-residents; however, the compliance burden on individuals might be considered to be inappropriate and the requirement might be difficult to enforce.

The type of information that might be required includes:

- The name and address of the non-resident recipient
- The legal relationship between the payer and the non-resident recipient
- The amount of the payment
- The amount and nature of the indebtedness on which the interest is paid, and
- Whether the non-resident service provider has a fixed place of business in the country

Transfer pricing rules typically apply only to related or associated enterprises such as corporations and other legal entities. However, similar issues can arise with respect to interest paid by individuals resident in a country to related non-resident individuals (or other non-corporate entities). If the amount of interest paid is more or less than the arm's length amount of interest, a country's tax base may be eroded. Therefore, the tax authorities may also require resident persons, other than entities subject to the transfer pricing rules, to provide information about payments of interest to related non-residents. As with transfer pricing documentation, this information reporting might be limited to deductible interest payments.

Such information may also be important for purposes of applying Article 11 (6) of the United Nations Model Convention dealing with interest payments that are excessive because of a special relationship between the payer and the recipient. Under Article 11 (6), the excessive portion of the interest payments will not qualify for the reduced rate provided in Article 11 (2), but will be taxable in accordance with the domestic laws of the contracting States with due regard to the other provisions of the treaty. Article 11 (6) applies where the interest rate is excessive, but not where the amount of the underlying indebtedness is excessive. Thus, Article 11 (6) does not permit a country's tax authorities to recharacterize excessive debt as equity.

2.4.5 Information forms

It would be useful for countries to prescribe forms for taxpayers and withholding agents for use in providing information required by their tax authorities with respect to interest payments to non-residents. Such forms will help to ensure that the proper information is provided and that the information is uniform and consistent. Penalties can be imposed for failure to provide the forms, failure to provide them on a timely basis, and failure to provide all the required information.

A sample information form is shown below.

Payments of interest to non-residents	**Year: ____**
Name and address of non-resident recipient	
Taxpayer identification number of non-resident recipient	
Name and address of payer	
Taxpayer identification number of payer	
Amount paid	
Tax deducted	
Relationship of payer with non-resident recipient	

This type of form can be required to be filed for each interest payment to a non-resident that is subject to withholding tax under domestic law. The payer can also be required to provide a copy of the form to the recipient. In addition, it would be useful for payers to be required to file an annual form showing the total interest payments made to non-residents during the year, the amount of tax deducted, the amount of tax remitted to the tax authorities and the total number of forms filed for payments of interest to non-residents during the year. This information would be useful for audit and verification purposes.

Chapter 3

Auditing and verifying interest income and interest deductions

3.1 Introduction

Chapter 3 deals with the audit and verification activities of a country's tax authorities to ensure that the provisions of domestic law with respect to deductible interest expenses and withholding taxes on interest have been complied with. The audit and verification activities undertaken by the tax authorities are dependent upon the provisions of the country's domestic law. For purposes of this discussion, it is assumed that a country taxes all interest payments to non-residents by residents of the country or by non-residents carrying on business in the country. Even if a country chooses not to impose tax on certain interest income derived by non-residents, it is necessary for the tax authorities to verify that any exemptions are properly claimed.

This chapter is not intended to provide basic guidance regarding standard auditing techniques. The same auditing techniques that are used with respect to other types of deductible payments that erode a country's tax base are equally applicable to interest payments. This chapter focuses on base-eroding interest payments, although such payments are merely one aspect of non-compliance. The tax authorities should perform an assessment of the risks of non-compliance by residents and non-residents generally, and with respect to deductible interest payments specifically, based on the guidance provided in part 2, chapter 4 of this *Practical Portfolio*. They should target their audit resources on areas where the greatest risks of non-compliance exist and where the taxes generated by enforcement efforts are likely to be greatest.

As noted above, the audit and verification activities of the tax authorities are dependent upon the provisions of domestic law with

respect to deductible interest expenses. In particular, it is worth noting that if interest paid to non-residents is treated differently under a country's domestic law depending on various factors, such as the nature of the debt on which the interest is paid, whether the interest is paid to a related party, and whether the interest is deductible by the payer, the compliance burden imposed on withholding agents and the administrative burden imposed on the tax authorities will be significantly greater than if all interest payments to non-residents are treated similarly. For example, if all deductible interest payments to non-residents are subject to withholding, whether provisional or final, at the same rate, withholding agents will not be required to distinguish between various types of interest payments. Auditing activities by the tax authorities will be similarly simplified.

3.2 Auditing the taxation of residents with respect to the deduction of interest

3.2.1 Introduction

If a country has enacted any restrictions on the deduction by residents of interest expenses incurred to earn foreign source income or interest paid to non-residents, the auditing and verification of those deductions is similar to the auditing and verification of any deductions claimed by resident taxpayers generally.

3.2.2 Auditing the deduction of interest paid by residents to non-residents—thin capitalization and earnings-stripping rules

As discussed in part 2, chapter 1, sections 1.3.2 and 1.3.3, some countries limit the amount of deductible interest paid by resident entities to non-residents through the application of thin capitalization rules or earnings-stripping rules. The auditing requirements with respect to these rules depend on the precise details of the rules.

The challenge of administering thin capitalization or earnings-stripping rules can be significant, especially if a country applies thin capitalization rules based on a fixed debt/equity

ratio or earnings-stripping rules based on a fixed ratio of interest expenses to earnings. With respect to both thin capitalization and earnings-stripping rules, the tax authorities must verify that the rules have been applied by all resident entities and non-residents subject to the rules. Thus, if the rules are broad in scope (that is, if they apply to all resident entities and non-residents carrying on business in the country), more entities are subject to audit and verification activities, but no other conditions for the application of the rules would have to be checked. On the other hand, if the rules are narrow in scope, fewer entities are subject to audit and verification activities, but the additional conditions for the application of the rules (for example, where the rules apply only to interest paid to non-residents, or to substantial non-resident shareholders, or to controlling and related non-residents) must be checked.

With respect to thin capitalization rules, the tax authorities must verify that the amounts of debt and equity for purposes of the debt/equity ratio are properly computed, with all the relevant amounts taken into account and calculated at the required times. With respect to earnings-stripping rules, the tax authorities must verify that the amount of an entity's earnings for purposes of the rules is calculated properly. With respect to both types of rules, the tax authorities must verify that:

- Where the rules apply to payments that are economically equivalent to interest, all such payments subject to the rules are taken into account
- Where a carry-over for any disallowed interest deductions is allowed, the amount of any deduction is claimed for such interest in another taxation year, and
- Any supporting rules, including specific anti-avoidance rules, are applied properly

3.2.3 Checklist

1. Excessive interest deductions:
   - If a country has thin capitalization or earnings-stripping rules that limit the deduction of interest, verify that the rules have been applied properly

2. Related-party transactions:
   - Verify that any interest payments by residents to related non-residents are not more or less than the arm's length amount
   - Apply the country's transfer pricing rules
3. Withholding taxes on interest:
   - Verify that tax on interest paid to non-residents has been withheld by the resident payers properly (see section 3.4 below)
4. If interest income from foreign sources is taxable:
   - Verify the amount of foreign interest income earned in each foreign country from the resident's tax return, supporting books and records, and foreign tax return
   - Verify the amount of foreign tax paid to each foreign country on the interest income earned in that country from its foreign tax return (assuming that such information is relevant for the purposes of the country's foreign tax credit)
   - Verify that the limitation on the foreign tax credit is properly computed
     - Interest expenses should be allocated to foreign source income properly
5. If interest income from foreign sources is exempt:
   - Verify the amount of foreign interest income qualifying for exemption from the resident's tax return, supporting schedules, and foreign tax return
     - If foreign income is taken into account to determine the resident's tax rate, verify that the rate is calculated properly
   - Verify that expenses allocated to exempt foreign income are not deductible against the country's tax base (assuming, of course, that expenses incurred to earn exempt income are not deductible under the country's domestic law)

3.3 Auditing the taxation of interest income earned by non-residents on a net basis

Usually, non-residents carrying on business in a country, often through a permanent establishment (PE) or fixed base, are subject to tax on their interest income on a net basis. If this is the case, the audit and verification activities of that country's tax authorities can focus on the books and records of the PE or fixed base. As noted in section 2.4 above, any non-residents carrying on business in a country, including but not limited to carrying on business through a PE or fixed base, should be required under that country's domestic law to keep the necessary books and records to support the computation of their income in accordance with domestic rules. The books and records should be similar to the books and records that resident taxpayers engaged in business must keep.

The tax authorities can check the non-resident's books and records to determine whether they have been maintained properly and to verify amounts against original documents such as invoices and banking records.

Where non-residents are subject to provisional withholding on interest payments received from residents of a country or from non-residents with a PE or fixed base in the country, the tax authorities can use the information provided by the withholding agents to verify that any payments made to non-residents have been included in their income. This assumes that the withholding agents are required to provide useful information, as discussed in section 3.4 below, and that the tax authorities have the necessary resources to use the information effectively.

3.4 Provisional or final withholding taxes

If certain persons — usually residents and non-residents carrying on business through a PE or fixed base in a country — are required to withhold tax from payments of interest to non-residents, the tax authorities need to audit the withholding agents to ensure that they have withheld the proper amounts. Where non-residents are subject to provisional withholding and are entitled to file tax returns and pay tax on a net basis, the tax authorities will have access to both the information

provided by the non-residents in their tax returns and the information provided by the withholding agents. These two sources of information can be cross-checked to determine whether the non-residents have reported the correct amount of interest income and tax payable and the withholding agents have withheld the correct amounts.

Where non-residents are subject only to a final withholding tax on interest, the only issue for the tax authorities to verify is whether the withholding agents have withheld the proper amount from any interest payments to non-residents; the only source of information for this purpose is information provided by or in the hands of the withholding agents. As discussed in chapter 2 above, withholding agents should be required to provide certain information with respect to the amounts withheld and remitted to the tax authorities. This information can be checked against the withholding agent's books and records and its banking records. For example, if a resident payer claims a deduction for interest paid to a non-resident service provider, the payer's books and records and the information provided in its tax returns or information reporting forms can be cross-checked against the information provided with respect to the amounts withheld.

If withholding agents are subject to serious penalties for failure to withhold properly, they will be more likely to withhold properly in order to avoid the penalties. Such penalties may reduce the need for the tax authorities to audit withholding agents with respect to interest payments to non-residents. For example, if persons paying interest to non-residents fail to withhold, they may be made liable for the tax payable by the non-resident and/or they might not be allowed to claim a deduction for the interest paid.

Countries must carefully consider the compliance burden imposed on payers to withhold tax from interest payments to non-residents and provide information about such payments. Where the payers are individuals resident in a country and do not claim any deduction for the interest, it may be difficult to enforce withholding obligations on such individuals.

If a country provides waivers from the obligation to withhold tax from interest payments, it will be necessary for the tax authorities to review and audit the waiver programme to ensure that it operates properly.

In some cases, domestic law may provide for exceptions from withholding tax on certain payments of interest. For instance, some treaties provide that interest paid to banks or financial institutions in the other jurisdiction are exempt from withholding tax, or are subject to a reduced rate of withholding tax. In such cases, the taxpayer should be required to provide adequate proof that the payment is exempt from withholding tax.

3.5 Checklist

1. If non-residents are subject to tax on interest on a net basis:
   - Identify the non-resident recipients of interest
     - If interest payments to non-residents are subject to provisional withholding, verify that payers are withholding properly on the basis of withholding information returns, payers' tax returns and other information
   - Determine whether any threshold is met
     - Is there a PE, fixed base, presence for a minimum number of days, or other domestic threshold?
     - Verify that non-residents are not improperly avoiding any threshold requirement
   - Verify the amount of income subject to tax from tax returns, supporting books and records, and third-party information returns
   - If thin capitalization or earnings-stripping rules apply to non-residents, ensure that the limitations on interest deductions are applied properly
2. If non-residents are subject to tax on a withholding basis:
   - Verify that payers (residents and non-residents with a PE or fixed base in the country) are withholding tax properly on the basis of withholding information returns, payers' tax returns, books and records, and other information
   - Cross-check against the deduction of interest paid to non-residents by residents and non-residents with a PE or fixed base in the country

3. Payments of interest to related non-residents:
   - Verify that any interest payments by residents to related non-residents are equal to the arm's length amount
     - Apply transfer pricing rules
4. Thin capitalization and earnings-stripping rules:
   - Verify that the restrictions on the deduction of interest paid by resident enterprises to non-residents have been complied with
   - If carry-over rules apply, ensure that taxpayers have proper records to ensure compliance on a multi-year basis

Chapter 4

Administration of tax treaty provisions to counter base-eroding payments of interest

4.1 Introduction

If a country does not tax non-residents on certain interest payments under its domestic law or allows the deduction of interest expenses under its domestic law, then the provisions of its tax treaties are irrelevant. This result is due to the fundamental proposition that, for most countries, tax treaties do not have the effect of imposing tax; they limit the tax imposed under a country's domestic law. Therefore, if a country's tax base is being eroded with respect to interest payments because its domestic tax law does not impose tax on interest payments or limit the deduction of interest, the country may wish to consider whether its domestic law is appropriate in this regard or whether the law should be amended to impose tax on interest paid to non-residents or restrict the deduction of interest in certain circumstances. Part 3 of the present *Portfolio* provides a discussion of the provisions of domestic law that might be adopted to prevent base erosion and profit shifting with respect to interest payments.

However, even if a country imposes tax on interest income derived by non-residents under its domestic law and restricts the deduction of interest expenses under its domestic law, it may be required to give up that tax or allow those deductions pursuant to the provisions of the tax treaties that it enters into. Part 3 of this *Practical Portfolio* also provides guidance for developing countries to minimize the risks of base erosion with respect to the provisions of their tax treaties dealing with interest income and deductions. Like the provisions of domestic law, the provisions of a country's tax treaties are not self-executing. The tax authorities must ensure that any treaty provisions are applied properly so that the benefits of a treaty are given only in situations

where the taxpayer is entitled to those benefits. This chapter deals with the administration and application of the provisions of tax treaties by developing countries to minimize base erosion, and provides guidance for the tax officials of developing countries in applying the provisions of their tax treaties dealing with interest.

This chapter focuses primarily on the risks of base erosion with respect to the provisions of tax treaties dealing with interest. As emphasized throughout this *Practical Portfolio*, base erosion with respect to interest payments occurs in two ways: interest payments received by non-residents may not be subject to tax by a country (or may be subject to tax at reduced rates) or interest expenses may be deductible by residents of the country or non-residents carrying on business in the country. Therefore, this chapter deals with the application of tax treaty provisions that affect both the taxation of non-residents receiving interest payments from a country and the deduction of interest expenses by residents of the country and non-residents carrying on business in the country through a permanent establishment (PE) or fixed base. However, it does not deal with the provisions of tax treaties requiring the elimination of double taxation or the administration and application of tax treaties generally. For information and guidance concerning the administration of tax treaties generally, including the organizational structure of the tax administration and the relationship between tax treaties and a country's domestic law and between its tax treaties and its trade and investment treaties, see *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.[4] As the *Handbook* explains, tax treaties do not contain many rules dealing with the application of their provisions. Thus, the rules for the application of the provisions of a tax treaty must be found in a country's domestic law; yet few countries have such provisions. As a result, the *Handbook* suggests that developing countries may wish to consider adopting uniform legislative or administrative rules for the application of the provisions of their tax treaties. Most importantly, these rules would deal with the procedural requirements for non-residents to qualify for claiming the benefits of a tax treaty.

[4] United Nations, Department of Economic and Social Affairs, *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

4.2 Identification of non-residents deriving interest income

As discussed in section 2.4.2 above, the first step for any country that imposes tax on any income of non-residents, including interest, is to identify those non-residents. This step is crucial for the imposition of domestic tax as well as the application of the provisions of an applicable tax treaty. If a country cannot identify non-residents deriving income from the country, the issue of whether such non-residents are entitled to treaty benefits is irrelevant. Therefore, countries should have strategies in place to identify non-residents doing business in the country or deriving interest that is subject to tax under their domestic law, as discussed above in chapter 2.

For the purposes of this chapter dealing with the application of tax treaties, it is assumed that countries have identified non-residents receiving payments of interest that are subject to tax and non-residents claiming deductions of interest under their domestic tax law. Therefore, the basic issues in this chapter are:

(a) Is a non-resident entitled to a reduction or exemption from a source country's tax on interest under a tax treaty and, if so, how are the provisions of the treaty applied by the tax authorities of the source country?

(b) Are non-residents carrying on business in a source country through a PE or fixed base entitled, under the provisions of a tax treaty, to deduct any interest expenses incurred in earning income attributable to the PE or fixed base, and, if so, how are the provisions of the treaty applied by the tax authorities of the source country for this purpose?

(c) Are residents of a country entitled, under the provisions of a tax treaty, to deduct interest paid to residents of the other contracting State, and, if so, how are the provisions of the treaty applied by the tax authorities of the residence country for this purpose?

4.3 Determining the country of residence of the non-resident recipient of interest in order to establish the relevant treaty

4.3.1 Residence for purposes of tax treaties

Assuming that a country has identified a non-resident receiving interest income that is taxable under the country's domestic tax law, the first step in applying the provisions of a tax treaty is to determine whether the country has a treaty with the country in which the recipient of the interest is a resident. Only residents of a contracting State are entitled to the benefits of that State's tax treaties. Therefore, in order to determine if a particular non-resident is entitled to the benefits of a country's tax treaties, it must be determined whether the non-resident is a resident of a country with which the country has a tax treaty. As set out in Article 4 (Resident) of the United Nations Model Convention,[5] the test of residence usually depends on whether the non-resident is liable to tax under the laws of the other country on the basis of residence, domicile, place of management, place of incorporation or any other similar criterion, which might include nationality or substantial periods of presence.

The important point about the determination of residence of a taxpayer for tax treaty purposes is that the question must be determined under the law of the treaty partner, not under the source country's law. Article 4 states that a person is a resident of a country if the person is liable to tax "under the laws of that State". A source country's tax authorities may not be knowledgeable about the laws of its treaty partners regarding the residence of taxpayers. Therefore, where a taxpayer claims the benefits of a tax treaty, it is customary for the tax authorities to verify that the taxpayer is a resident of the other country by requesting the taxpayer to provide a certificate from the tax authorities of the other country confirming that the taxpayer is a resident of that other country.

The use of residence certificates is widespread. Where there is substantial cross-border activity between the two contracting States, it may be beneficial to formalize the use of residence certificates (as well

[5] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

as other matters, as discussed below) through an agreement between the competent authorities of the treaty partners, as provided by Article 25 (Mutual agreement procedure) of the United Nations Model Convention. The efficiency of the use of residence certificates can be improved if special forms for the purpose are created in the relevant languages of the two countries. In this way, the taxpayer can obtain a certificate from its country of residence and provide it to the country from which treaty benefits are claimed. Alternatively, the tax authorities of the country of residence can send the form directly to the tax authorities of the source country.

A country may require the tax authorities of the other country to certify other things besides residence. For example, a country may require the foreign tax authorities to certify that the taxpayer is the beneficial owner of interest in order to get the benefit of the reduced rate of source country tax under Article 11 (2) of the United Nations Model Convention. This assumes that, like residence, beneficial ownership is determined under the law of the treaty partner rather than under the source country's law.

There are potential problems with the requirement of residence and other certifications from the tax authorities of the other countries. Although the requirement of a certificate of residence imposes some additional compliance burden on the taxpayer and administrative burden on the tax authorities, this additional burden does not seem overly onerous if it is simply an annual requirement. If, however, a separate certificate is required for each payment, the burden could be significant. Another problem is the potential delay in obtaining the benefits of the treaty caused by the necessity to obtain residence or other certifications from the foreign tax authorities. The delay is dependent upon how frequently such certificates are required and how much information about the tax affairs of the taxpayer must be certified by the foreign tax authorities.

Unfortunately, some countries do not apply rigorous standards in granting residence certificates to taxpayers, since it is another country's tax that will be reduced. Therefore, countries should be cautious about accepting residence certificates without any verification.

Some countries allow withholding agents to reduce the amount withheld pursuant to a treaty based on the address of the recipient. In

effect, if the non-resident's address reflects a location in the treaty partner, treaty benefits in the form of lower withholding tax are granted. Relying on addresses in this way makes the delivery of treaty benefits much more efficient, but it is also susceptible to abuse. Therefore, countries may consider not allowing a withholding agent to rely on a recipient's address if the agent has reason to suspect that the recipient is not a resident of the other contracting State. In this case, the taxpayer or the withholding agent could be required to obtain a residence certificate in order to obtain the benefit of the lower treaty rate of withholding. Otherwise, withholding agents are likely to withhold the higher amount required by domestic law, in which case non-residents will be required to apply for refunds.

In order for a taxpayer to qualify as a resident of a country for tax treaty purposes, the taxpayer must be a "person" for purposes of the treaty. Tax treaties based on the United Nations Model Convention provide a broad definition of "person", which includes individuals and legal entities. The definition of a person is discussed below in connection with the qualification for treaty benefits.

In addition to the requirement that a person must be a resident of one of the contracting States to obtain the benefits of a tax treaty, some treaties contain anti-treaty shopping provisions (also known as "limitation-on-benefits" provisions) to further restrict the granting of treaty benefits to "real" residents of a country.[6] For example, a resident of one country may wish to make an investment in another country. If there is no treaty between those two countries, the investor may establish a shell company in a country that does have a treaty with the country in which the investment will be made. However, that company may have little or no substance (that is, no employees, no business in the country in which it is established, and no assets other than the investment in the other country). The anti-treaty shopping rule in the Commentary on Article 1 of the United Nations Model Convention would prevent such a company from getting the benefits of the treaty in these circumstances. See part 2, chapter 1, section 1.2.5 for a discussion of the use of back-to-back financing arrangements to obtain treaty benefits improperly.

[6] See paragraph 20 of the Commentary on Article 1 of the United Nations Model Convention for a discussion of this type of provision.

4.3.2 Dual residence

Situations in which a taxpayer is considered to be resident in both contracting States for purposes of a tax treaty are frequently encountered because countries' domestic residence rules tend to be overly broad. In these dual-resident cases, the United Nations Model Convention and the OECD Model Convention[7] provide tie-breaker rules to allocate residence exclusively to one contracting State for purposes of the treaty. Under Article 4 (2) of both Models, a hierarchy of four tie-breaker rules is provided for individuals, whereas under Article 4 (3) the tie-breaker rule for other persons (legal entities) is the person's place of effective management. The Commentary on both Models allows countries to substitute an alternative version of Article 4 (3), under which the dual residence of entities other than individuals is resolved on a case-by-case basis pursuant to the mutual agreement procedure instead of by reference to the entity's place of effective management.[8] The BEPS Action 6 Final Report[9] recommends that Article 4 (3) of the OECD Model Convention should be replaced by the alternative version in the Commentary under which dual-residence cases are resolved by the mutual agreement procedure and, in the absence of any agreement, treaty benefits would be denied.

The application of the tie-breaker rules has important implications for the contracting States to a tax treaty because it determines which country must give up its taxing rights. Consequently, the application of the tie-breaker rules should be carefully considered. For individuals, the tie-breaker rules are intensely factual and should be applied on a balanced basis to give residence to the country with which the individual is more closely connected. However, dual-resident entities are usually used for tax avoidance purposes. Therefore, when the tax authorities of a country encounter dual-resident entities, they

[7] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[8] See paragraph 10 of the Commentary on the United Nations Model Convention, quoting paragraph 24.1 of the Commentary on Article 4 of the OECD Model Convention.

[9] Available from http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm.

should consider whether the entities have been used for tax avoidance purposes, and if so, whether such tax avoidance can be countered by anti-abuse rules in the country's domestic law or in its tax treaties.

Example 1

ACo is considered to be a resident of Country A because its place of management is located in Country A. ACo is also considered to be a resident of Country B because it is incorporated under the laws of Country B. Assume that ACo carries on business in Country B and also in Country A and pays interest of 100 to another company resident in Country A. Assume that Country B imposes a withholding tax of 10 per cent on interest payments to non-residents. If Country B and Country A have entered into a tax treaty with provisions identical to those of the United Nations Model Convention, under Article 4 (3) ACo would be considered to be resident where its place of effective management is located. Although place of effective management is not precisely the same as place of management, assume that the place of effective management of ACo is considered to be in Country A. As a result, ACo would be considered to be resident in Country A for purposes of the treaty between Country B and Country A. Therefore, Country B would be required to provide the benefits of the treaty to ACo. This would likely mean that Country B could not tax ACo on the income it derives from carrying on business in Country B unless ACo has a PE or fixed base in Country B and the business is carried on through that PE or fixed base. However, the provisions of the treaty would not eliminate the obligation on ACo under Country B domestic law to withhold tax from the interest payment of 100 to the company resident in Country A. ACo is a resident under the domestic law of Country B for purposes of Country B withholding tax; the tie-breaker rule in the treaty makes ACo a resident of Country A only for purposes of the treaty, not for all purposes. Note, however, that many countries have provisions in their domestic law that allow withholding agents to withhold only the amount required under an applicable tax treaty if the payments are made to a resident of that treaty country.

4.4 Determining the applicable provision of the treaty

Once the tax authorities of a country have determined that a non-resident taxpayer is a resident of a country with which the country has a tax treaty, they must decide which provision of that treaty applies to the interest payments received by the non-resident. The relevant

treaty provisions are Articles 7 (Business profits), 11 (Interest) and 14 (Independent personal services) of the United Nations Model Convention. If both Articles 7 and 11 apply, Article 11 takes priority pursuant to Article 7 (6). However, if a non-resident carries on business in a country through a PE in that country and the debt claim in respect of which the interest is payable is effectively connected with the PE, Article 11 (4) provides explicitly that the provisions of Article 7 apply. Therefore, Article 7 will apply to interest income derived from a country if:

(a) The non-resident carries on business in the country through a PE in the country;

(b) The debt claim is effectively connected with the PE; and

(c) The interest is attributable to the PE.

If Article 7 applies, the source country is entitled to tax the net profits attributable to the PE, including any interest income, at the applicable rate under its domestic law (that is, the treaty does not limit the rate of tax imposed by the country).

A similar analysis applies with respect to Article 14, although there is no specific conflict rule in Article 14 similar to Article 7 (6). If a non-resident provides professional or other independent services in a country through a fixed base in that country and the debt claim in respect of which the interest is payable is effectively connected with the fixed base, Article 11 (4) provides explicitly that the provisions of Article 14 apply. Therefore, Article 14 will apply to interest income derived from a country if:

(a) The non-resident performs professional or other independent services in the country through a fixed base in the country;

(b) The debt claim is effectively connected with the fixed base; and

(c) The interest is attributable to the fixed base.

If Article 14 applies, the source country is entitled to tax the net profits attributable to the fixed base, including any interest income, at the applicable rate under its domestic law (that is, the treaty does not limit the rate of tax imposed by that country).

Otherwise, any interest income derived from a country by a resident of the other contracting State is subject to Article 11, under which the source country is entitled to impose tax on the gross amount of interest paid at the rate specified in Article 11 (2).

4.5 Qualification for treaty benefits

Once the tax authorities have determined whether Article 7, 11 or 14 applies to the interest income derived by a non-resident taxpayer, they must determine whether the non-resident satisfies all the conditions for entitlement to the benefits of the particular article. The requirements of Articles 7 and 11 of the United Nations Model Convention dealing with interest are discussed in detail in part 2, chapter 2, section 2.3.1. In this section, the issue is how the tax authorities verify or ensure that the requirements for entitlement to treaty benefits are met.

A comprehensive list of the requirements for entitlement to treaty benefits under Articles 7 and 14 would include that:

- The non-resident must be a person
- The non-resident must be a resident of the other country for purposes of the treaty
- The non-resident must have a PE or fixed base in the source country or be present in that country for a minimum period of time
- The income must be attributable to the PE or fixed base (or derived from activities performed in the source country in the case of a non-resident who stays in that country for more than 183 days)
- Any anti-treaty shopping or limitation-on-benefits provision must not apply (see section 4.3.1 above for a brief discussion of such provisions)

A comprehensive list of the requirements for entitlement to treaty benefits under Article 11 would include that:

- The non-resident must be a person
- The non-resident must be a resident of the other country for purposes of the treaty
- The non-resident must be the beneficial owner of the interest

- The interest must be paid by a resident of the source country or be borne by a PE or fixed base in that country
- Any anti-treaty shopping or limitation-on-benefits provision must not apply (see section 4.3.1 above for a brief discussion of such provisions)

As mentioned above, often the non-resident's residence in the other country is verified through a certificate of residence obtained from the tax authorities of the other country. Similarly, the treaty partner might be requested to certify that the non-resident is the beneficial owner of the income. (Note that this assumes that the meaning of beneficial owner is determined under the law of the recipient's country of residence. It is unclear under the provisions of the United Nations and OECD Model Conventions and their Commentaries which country's law should be applied for the purpose of determining who is the beneficial owner of the relevant payment.) However, all the other requirements for entitlement to treaty benefits must be determined by each country's tax authorities on the basis of their own information and expertise.

Where the provisions of the treaty (Article 7 or 14) require a country to tax a non-resident's interest income on a net basis, the country must determine, first, whether the non-resident has a PE or fixed base in the country and, second, the income attributable to the PE or fixed base. The domestic laws of most countries require any non-resident carrying on business in the country through a PE or fixed base to register and file a tax return. If a non-resident files a tax return on the basis that it has a PE in the country, usually the tax authorities can simply accept the non-resident's position that it has a PE. These tax returns and the supporting financial information should provide the tax authorities with the necessary information to determine the amount of income and tax payable under domestic law and the relevant treaty. If a non-resident does not file a tax return or does not file one on a timely basis, interest on unpaid tax and penalties should be imposed. However, in most situations where non-residents are claiming treaty benefits, they are likely to attempt to comply with the source country's laws.

Therefore, the primary challenges with respect to the application of Article 7 or 14 consist of verifying:

(a) The taxpayer's claim that it has a PE or fixed base in the source country or that it has spent the requisite amount of time in the source country so that the interest income is taxable on a net basis; and

(b) The amount of income attributable to the PE or fixed base.

For this purpose, the tax authorities will likely start with the information provided by the taxpayer and then use standard audit techniques to verify that information.

The primary challenges of applying Article 11 consist of verifying that the recipient of interest is a resident of the other contracting State and the beneficial owner of the interest. For this purpose, the tax authorities will likely rely on information supplied by withholding agents and information from the tax authorities of the other State.

If a country has imposed withholding on interest paid to non-residents that is taxable on a net basis under the terms of the treaty, the country must allow the non-residents to apply for a refund of any tax withheld in excess of the tax payable in accordance with the provisions of the treaty. Issues with respect to withholding taxes are discussed below in section 4.7.2.

4.6 Computation of income

Although the amount subject to tax by a source country in accordance with the provisions of an applicable tax treaty may be limited, the rules for the computation of the income are the rules for that purpose under that country's domestic law. For example, each country's tax rules determine what amounts are included in income, what amounts are deductible in computing income, and the timing of those inclusions and deductions. Where interest income derived by a non-resident is subject to tax on a net basis under Article 7 or 14 of a treaty based on the United Nations Model Convention, the treaty provides some basic rules for computing the amount of income that is attributable to a PE or fixed base. The rules in Article 7 of the United Nations Model Convention with respect to interest expenses may be summarized as follows:

- The deduction of expenses is a matter of the domestic law of the country in which the PE is located; however, the deduction of

expenses incurred on behalf of the PE cannot be denied on the basis that the expenses are incurred outside that country

- No deductions are allowed for interest paid by a PE to its head office or other parts of the enterprise (except for banking enterprises)
- Interest charged by a PE to its head office or other parts of the enterprise (except for banking enterprises) must not be taken into account
- If it has been customary to determine the profits of a PE on the basis of apportionment, such an apportionment is acceptable if the result is in accordance with the principles of Article 7
- The profits of a PE must be determined consistently from year to year unless there is a good reason to make a change

Although Article 14 of the United Nations Model Convention does not provide rules similar to those in Article 7 for the computation of the profits attributable to a fixed base, it is generally considered that similar rules apply.

In addition, where interest income is derived from transactions between an enterprise that is resident in one country and a related or associated enterprise resident in the other country, the transfer pricing provisions of the treaty (Article 9) will apply. Similarly, under Article 11 (6) of the United Nations Model Convention, interest payments that are excessive — because of a special relationship between the parties — are not taxable in accordance with the provisions of Article 11 to the extent that they are excessive. Therefore, the tax authorities must determine whether interest payments between related parties are in accordance with the arm's length standard in Article 9 of the treaty and whether interest payments between parties with a special relationship are excessive, and if they are non-arm's length or excessive, how they should be treated.

Where interest received by a non-resident is taxable under a country's domestic law and under the treaty on a gross basis, the amount subject to withholding is the amount under that country's domestic law as limited by the treaty. For example, if a treaty allows a country to tax interest paid to a resident of the other country at a maximum of 15 per cent of the gross amount paid, but the country imposes a withholding

tax on interest of 30 per cent under its domestic law, the treaty requires the country to refund any withholding tax levied in respect of payments to the resident of the treaty partner in excess of 15 per cent.

4.7 Collection of tax

4.7.1 Tax imposed on a net basis

If a treaty requires a country to tax certain interest income on a net basis under Article 7 or 14, it does not mean that the country cannot collect the tax through a withholding tax. Instead, it means that to the extent that the withholding tax exceeds the tax on the net income subject to tax by that country in accordance with the treaty, the country must refund the excess to the non-resident. Similarly, if the withholding tax is less than the country's tax on the non-resident's net income, the non-resident would be required to pay the difference. Alternatively, a country can collect tax from non-residents earning interest income in the same way that it collects tax from residents. Therefore, for example, some countries may require residents and non-residents carrying on business in the country to pay installments of tax on a periodic basis and then pay any balance owing when the tax return for the year is due. The installments of tax should probably be set at an amount that approximates the amount of tax payable for the year and could be based on the tax payable for the previous year.

However, these techniques may not be effective with respect to non-residents that do not have significant assets in a country or are not physically present in a country. As discussed in section 4.7.3 below, Article 27 (Assistance in the collection of taxes) of the United Nations Model Convention provides a mechanism whereby a country can request its treaty partner to collect any tax owing to the country by a resident of the treaty partner as if the tax were tax owing to the treaty partner.

4.7.2 Withholding tax

Under Article 11 of the United Nations Model Convention, a country is entitled to impose tax on the gross amount of interest paid by a resident of the country or a non-resident with a PE or fixed base in the country to a resident of the other contracting State. If the recipient

is the beneficial owner of the interest, the rate of tax levied by the country cannot exceed the rate specified in Article 11 (2) of the treaty. Most countries tax interest received by non-residents by imposing an obligation on the payer of the interest to withhold tax on behalf of the non-resident. The provisions of tax treaties do not specify how countries should impose or administer withholding taxes on interest.[10]

Although withholding taxes are imposed on non-residents deriving interest, the taxes are collected by requiring the payers to withhold an amount from the interest payments and remit that amount to the tax authorities as tax on behalf of the non-residents. The obligation to withhold is usually imposed on residents of a country and non-residents carrying on business in a country through a PE or fixed base. As discussed in part 2, chapter 1, section 1.4, many countries provide for a variety of exemptions from the obligation to withhold from interest payments to non-residents. Residents of a country and non-residents with fixed places of business in a country have substantial connections to the country, and that country can take enforcement action against them if they fail to withhold. Various penalties can be imposed on withholding agents to ensure that they withhold properly. These penalties include interest and financial penalties, liability (together with the non-resident) for any tax that should have been withheld, and the denial of any deduction for the interest payments to a non-resident if tax is not withheld.

Where the treaty specifies a maximum rate of tax, it does not prevent a country from requiring payers to withhold at a higher rate; however, if it does so, the country would be required to refund any tax withheld in excess of the maximum rate provided in the treaty.

Since tax treaties do not deal with how a country imposes tax, the method of taxation is a matter of domestic law. Therefore, countries have flexibility in determining how to apply their withholding taxes. First, withholding can be imposed on an interim or provisional basis or as a final tax. If withholding is imposed on an interim basis, the taxpayer is entitled or obligated to file a tax return and determine the amount

[10] See paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraphs 12 and 13 of the Commentary on Article 11 of the OECD Model Convention.

of income — usually on a net basis — and tax owing. This type of withholding imposes a considerable compliance burden on taxpayers and an administrative burden on the tax administration. Taxpayers must file returns and the tax administration must establish a unit to process those returns and make refunds of any excessive tax withheld. In contrast, under a final withholding tax, the amount withheld is the tax payable; no tax returns are filed and no refunds of tax are made.

Second, countries have flexibility to establish the rate of withholding in their domestic law at a rate that is more than, less than, or equal to the rate specified in the treaty. If the domestic rate is less than or equal to the treaty rate, a country will meet its treaty obligations simply by applying its domestic law. For example, as discussed in part 2, chapter 4, section 4.3, the rate of withholding on interest paid to arm's length non-residents under domestic law may be less than the treaty rate in order to prevent non-resident lenders from passing on the cost of the withholding tax to resident borrowers. If the domestic withholding rate imposed by a particular country is greater than the treaty rate, the country must provide a procedure for non-residents to claim a refund for the excess tax withheld in order to meet its treaty obligations. If withholding agents are liable for the tax payable by non-residents in the event that the agents fail to withhold properly, the agents will likely be unwilling to accept the risk of withholding less than the full amount required by domestic law. As a result, countries may consider allowing withholding agents to withhold at the treaty rate under certain conditions (for example, by obtaining certificates of residence and beneficial ownership from the treaty country or filing a form with certain information).

Some countries have adopted procedures that allow non-residents or their withholding agents to apply to the tax authorities for waivers from the obligation to withhold. Such procedures require a significant commitment of resources. However, if the conditions imposed for reduced withholding are too onerous, the withholding agent is likely to withhold at the domestic rate, thus forcing non-residents to apply for a refund. As a result, some countries have provisions in their domestic law that allow withholding agents to withhold at the rate specified in the treaty.

In summary, the application of reduced rates of withholding taxes provided by tax treaties requires a difficult balancing between

the need to deliver treaty benefits in an efficient manner and the need to ensure that those benefits are not given in situations where they are unjustified. It may also be noted that the problems become more serious as the number of a country's tax treaties grows, especially if there are many exemptions from withholding tax on interest and the limits on the rate of withholding tax in the treaties vary.

4.7.3 Assistance in collection

If a country has provisions in its tax treaties similar to Article 27 of the United Nations and OECD Model Conventions on assistance in collection, the country may request its treaty partner to collect tax owing to it by a resident of that treaty partner. Article 27 requires the requested country to collect the taxes owing as if they were taxes owed to that country. However, Article 27 is a relatively recent addition to the United Nations and OECD Model Conventions and some countries may not have that Article in any of their tax treaties.

In the absence of a provision similar to Article 27 of the United Nations and OECD Model Conventions, a country is usually unable to enforce a judgment that it obtains from its own courts for the recovery of unpaid tax owing by a resident of another country in the courts of that country.

4.8 Checklist

1. Determine whether the non-resident who receives interest is a resident of a country with which the source country has a tax treaty
   - ➤ Residence certificates will often be useful for this purpose
2. Determine whether Article 7, 14 or 11 of the treaty is applicable to the interest derived by the non-resident
   - ➤ Depending on whether the interest payments are derived as part of a business, as part of a business of providing professional or other independent services, or otherwise
3. Determine whether the non-resident qualifies for the benefits of the particular article

- Article 7:
  - Is the non-resident a person?
  - Is the non-resident a resident of the other country?
  - Does the non-resident have a PE in the source country?
  - Are the activities performed at the PE purely preparatory and auxiliary activities?
  - Is the interest income derived by the non-resident attributable to the PE in the source country?
- Article 14:
  - Is the non-resident a resident of the other country?
  - Does the non-resident have a fixed base in the country that is regularly available?
  - Does the non-resident perform professional services or other personal services of an independent character through the fixed base?
  - Is the interest income derived by the non-resident attributable to the fixed base in the source country?
- Article 11:
  - Is the non-resident a person?
  - Is the non-resident a resident of the other country?
  - Is the interest paid by a resident of the source country or a non-resident with a PE or fixed base in the source country?
  - Is the non-resident the beneficial owner of the interest? It is particularly important to consider the method by which the lender derived the funds used to make the loan, and whether there are back-to-back arrangements that should be disregarded.
  - Does the non-resident carry on business through a PE or fixed base in the source country, and is the interest deductible in computing the profits or income attributable to the PE or fixed base?
  - Is the amount of income paid excessive because of a special relationship between the payer and the payee?