



**Papers on Selected Topics in Protecting the Tax Base  
of Developing Countries**

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**Limiting Interest Deductions**

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## Limiting Interest Deductions and Other Financial Payments

*Peter A. Barnes*

For many decades – indeed, long before the G-20 and the OECD launched their project on Base Erosion and Profit Shifting (BEPS) – the proper tax treatment of interest payments has challenged tax authorities. The issues include very basic questions (what is interest?) and practical concerns of tax administration (how to determine what is “excessive” interest).

The BEPS project puts the issue of interest squarely into focus. Action Item 4 is titled “Limit base erosion via interest deductions and other financial payments.” The description states, in part, that this action item will

*Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.*

Reflecting, perhaps, the difficulty of this task, Action Item 4 will be completed in the second wave of BEPS projects, in September 2015.

This paper examines many of the issues that will likely be addressed in the OECD paper on the deductibility of interest payments, but with a special focus on the challenges faced by tax administrators in developing countries. As discussed more fully below, developing countries face many of the same challenges with respect to interest payments as developed countries, but with fewer resources to audit taxpayers and enforce the laws, and with a greater need to attract investment capital. Accordingly, developing countries may choose to adopt more bright-line rules with respect to the tax treatment of interest payments than developed countries, where often complex and over-lapping limitations and exceptions apply.

### I. Background

#### A. Debt and Equity

Intuitively, taxpayers and tax administrators know what is meant by the terms “debt” and “equity.”

- A debt instrument, classically a loan (from a bank, perhaps) 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.

For business taxpayers, interest payments generally are viewed as an ordinary business expense and may be deducted by the taxpayer in determining its taxable income. The interest payment is treated as income to the recipient in determining the recipient's taxable income.

Payments with respect to equity, on the other hand, are typically not deductible by the payer, since the payments represent an after-tax return on a capital investment. The tax treatment of the equity payment in the hands of the recipient depends on the tax system applicable to the recipient; in some cases, the payment will be fully taxable in the recipient's home country, but, in other cases, the payment is 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.)

Although it is often clear that a particular instrument should be classified as debt or equity – and, therefore, the proper tax treatment for payments on that instrument can be readily determined under the applicable tax laws – there are some instruments that are not clearly debt or equity. For instance, an instrument may provide for fixed payments of interest but also provide for a share of profits, in the event the profits exceed a certain level. It is beyond the scope of this paper to discuss the variations in financial instruments that exist today (and new instruments are being designed regularly by financial engineers) but it is important to acknowledge that determining whether a particular payment is “interest” for tax purposes is not always easy.

A most difficult issue for tax officials seeking to prevent improper tax base erosion and profit shifting is the proper treatment of hybrid instruments: financial instruments that are treated as debt by one taxing authority but as equity by another taxing authority. Hybrid instruments are the subject of BEPS Action Item 2 and are dealt with in the paper by Peter Harris.

## B. Use of Debt by Taxpayers

The availability and use of debt is widely recognized as an important element of a healthy business environment. Indeed, a lack of credit can deter economic growth. This point is illustrated by the efforts of governments today to ensure that increased regulation of financial institutions is balanced against the need for these institutions to readily lend to growing businesses. The importance of credit is also illustrated by the wide support for micro-lending and other programs to extend credit markets to small businesses (including individuals) in developing countries, as a means for generating economic growth.

For a business, the availability of debt is often essential to growth. There are several reasons why an investor may need to borrow funds to grow a business (and, accordingly, make interest payments):

First, debt may be incurred as part of the capitalization of the enterprise, in combination with equity.

- i. Using debt, the initial investor increases the pool of available capital, by bringing in additional sources of capital that want the comparative safety of being paid before equity investors receive a return.
- ii. Debt allows the owners to expand the business without diluting control. If expansion can only be funded through new equity, the original owners will have a reduced stake in the larger enterprise.
- iii. Economic studies have shown that the use of debt can bring discipline to the operation of an enterprise, resulting in long-term improved profitability and operation.

Second, debt may be incurred in connection with the purchase of property or goods. For instance, real property may be purchased with a mortgage, or goods may be purchased with extended payment terms that trigger interest on unpaid balances. In each of these situations, the lender typically has a priority right to the property or goods, as security for the loan, and therefore may be willing to extend the loan on favorable interest terms.

Third, an enterprise will typically require a line of credit to provide working capital, or to support working capital. This line of credit may be drawn upon, or it may simply be available for a future need.

In each of these situations, the interest expense incurred in connection with the debt is generally treated as an ordinary and necessary business expense and will be allowed as a deductible expense in computing the taxable income of the enterprise. While these deductible payments “erode” the tax base of the

enterprise, they are inherently no different than any other ordinary and necessary deductible expenses, such as wages, rents or purchases of services and raw materials.

### C. Related Party Debt in Capitalizing an Enterprise

As noted above, debt may be used in connection with the capitalization of an enterprise. One situation deserves special focus: the simultaneous use of debt and equity by a single investor (or an investor and its related affiliates) to capitalize a new investment.

*Example: Acme Corporation, a resident of Country X, seeks to create a subsidiary corporation, Beta Corporation, in Country Y. Beta requires initial funding of \$1,000 in order to begin business. Acme could provide that funding by*

- *Investing \$1,000 of equity, or*
- *Investing \$500 of equity and \$500 of debt (or any other combination of debt and equity).*

The choice of whether to use equity only, or a combination of debt and equity, generally will depend on a complex blend of both tax and non-tax considerations.

#### i. Tax considerations

If Acme Corporation invests wholly with equity, Beta will not be required to make any interest payment (because there is no debt) and Beta will, of course, have no tax deduction related to its initial funding. Acme's return on the investment will be entirely in the form of dividends.

If the initial funding is partly in the form of equity (say, \$500) and partly in the form of debt (\$500), Beta Corporation's payments of interest on the \$500 of debt generally will be deductible in Country Y, reducing the corporate income tax expense for Beta Corporation.

This deduction for an interest payment generally is a positive benefit for Acme and Beta, taken as a group. However, other tax considerations also arise:

- Does Beta have sufficient taxable income against which to deduct the interest payments to Acme so that the deduction for interest expense is economically valuable? If no deduction is available in the current year, will the deduction be available in a future year? The answer to this

question requires consideration of both future earnings of Beta and Country Y's rules on the carry-forward of losses.

- Does Country Y impose a withholding tax on the interest payment to Acme, and, if so, what is the rate? How does the economic impact of that withholding tax compare to the potential economic benefit of the income tax deduction to Beta for the interest payment?
- What is the tax treatment of Acme in Country X? Is the interest taxable to Acme? At what rate? How does the tax treatment of the interest received by Acme in Country X compare to the tax treatment of a dividend received by Acme in Country X?
- If there is a withholding tax imposed by Country Y on dividends, or interest, or both, can that withholding tax be claimed as a credit against the Country X tax, or are there other considerations (e.g., excess foreign tax credits for Acme) that make the withholding tax imposed by Country Y a deadweight cost? If the debt investment to Beta is not made by Acme, but by an affiliate of Acme and Beta in a third country, Charlie Corporation in Country Z, then the analysis of the tax consequences of the interest payments will be made with respect to Charlie Corporation.

Of course, Acme and Beta (and Charlie) have some information (but not complete information) to determine whether the interest deduction will benefit the two related companies as a group, and that information will guide the decision whether to invest in Beta wholly with equity or with some combination of debt and equity. But it is useful to recognize that the decision whether to invest with debt (and therefore potentially "erode" the local tax base through deductible interest payments) requires a complex projection of both current and future business and tax developments.

ii. Non-tax considerations

While tax issues are often an important driver whether to use debt to capitalize an investment, there can be significant non-tax considerations as well. Two factors deserve focus here.

First, it is usually very difficult to reduce the level of equity investment in a corporation. To use the example above, if Acme invests \$1,000 entirely as equity into stock of Beta, the corporate law of Country Y generally limits the ability of Acme to reduce that equity investment, even if the full \$1,000 is no longer required in order to operate the Beta business.

For instance, corporate law may require Acme (and Beta) to seek court approval for a capital reduction, with extensive notice to creditors (and potential creditors) as well as submissions to the court of detailed financial information. The proceeding can be lengthy and expensive, and it may or may not be successful.

Accordingly, Acme may choose to capitalize Beta in part with debt, even though an all-equity investment would potentially be more tax-efficient. Using debt as part of the capital for Beta allows Acme to withdraw the debt at a future time (by having Beta repay the debt, possibly by means of obtaining alternative debt from other parties). This capital flexibility for Acme can be an important factor in determining how best to capitalize Beta.

A second non-tax factor for Acme to consider is the accounting treatment for any debt investment that it makes in Beta. The applicable accounting rules can be fiendishly complex, but, in simple terms, Acme or Beta may be required to recognize on a quarterly basis certain gain and loss from any currency fluctuations related to the debt. This would arise, for instance, if the functional currency for Acme is different from the functional currency for Beta, which is often the case for two companies located in two different countries. In such a case, the debt instrument necessarily will be denominated in a non-functional currency for one party or the other. Depending on the currency in which the debt is denominated, whether that debt can be properly hedged, and other factors, the use of debt to partially capitalize Beta may result in the recognition of substantial quarterly gain or loss for purposes of financial reporting.

This non-tax consideration may drive Acme to capitalize Beta with equity.

### iii. Summary

This example and the considerations that influence the way in which Acme chooses to capitalize its new investment in Beta, sets a framework for the issues discussed below. Although the analysis for any specific investment can be complex, two general observations are widely applicable:

- There is no simple rule that dictates whether the use of all-equity or some combination of debt and equity to capitalize an investment yields the most favorable tax result, taking into consideration both home and host country tax considerations.
- Taxpayers, of course, have flexibility in their decision-making on this issue, and will generally seek to maximize the benefits from the

investment, taking into account both tax and non-tax considerations. Whether the benefits are, indeed, maximized often depends on future business consequences that are not entirely knowable at the time of the investment.

#### D. Branch Operations

The discussion of debt and equity above assumes that a corporation in one country (e.g., Acme in Country X) will establish a separate legal entity in the other country (e.g., Beta in Country Y). In many cases, of course, there is no separate legal entity; rather, Acme may establish a branch or permanent establishment in the other country. Typically, Acme would be taxable in Country Y on the profits of its branch here.

Concerns regarding the deductibility of interest – and the possible erosion of tax base – arise in connection with branches, just as they arise in connection with related corporations. Many of the considerations and concerns are the same for corporations and for branches, but some issues are different. The concerns regarding interest payments for branches are discussed below at section IV.

## II. Non-Tax Concerns Regarding “Excessive” Debt

Although the focus of this paper is on tax issues and the appropriate limitations under tax law for “excessive” interest, it is important to recognize that erosion of the tax base is only one driver – and often a limited driver – for legal limits on the use of debt by business enterprises. An equally strong motivation for limiting debt in most countries is a concern over corporate governance and a prudential limit on the amount of risk that a business enterprise can assume. Tax rules must respect and be integrated with these non-tax concerns regarding excessive debt and the resulting excessive interest payments.

Government regulators may seek to limit the amount of debt that an enterprise takes on, in order to reduce the risk that a business failure would have knock-on effects for workers, suppliers, customers and others. Businesses are necessarily linked to each other in national and international economies. The most forceful example of these connections arose during the fiscal crisis of 2007-2009. At that time, the failure of some businesses and the potential failure of many more businesses demonstrated the consequences to the global economy that arise when a single business takes on too much risk and fails, triggering a succession of failures at other businesses.

Government restrictions may be explicit (e.g., specific debt/equity limits imposed by law, at the time the business is created and, in some cases, on an

annual or periodic basis going forward.) Or, the government restrictions may be applied in a more flexible fashion, such as reviews by financial regulators in many countries requiring financial institutions to seek approval (and demonstrate financial soundness) before paying dividends or making certain acquisitions.

In addition to legal limits on the assumption of debt and debt/equity ratios, there are business realities imposed by market forces. For instance,

- In order to secure contracts, especially from governments but also from non-government customers, an enterprise often must provide a balance sheet and other financial information that demonstrates financial fitness.
- Lenders often impose financial covenants that limit an enterprise's ability to borrow.
- Rating agencies review creditworthiness, with a view toward excessive debt.

These non-tax limitations on debt are consistent with, but separate from, any tax rules that limit the ability of an enterprise to take a tax deduction for interest payments on "excessive" debt. In some cases, although not all cases, the non-tax considerations will be significantly greater factors than the tax concerns in a taxpayer's decision regarding how to capitalize a new investment.

### III. Tax Considerations Regarding Thin Capitalization and Related Concerns

A quick word on terminology: "Thin capitalization" is the preferred term for the condition in which a taxpayer is determined to have excessive debt and therefore excessive interest expense. In most cases – but not all cases – tax rules regarding thin capitalization focus on the debt owed and the interest paid to nonresidents. Since the global financial crisis in 2008, non-tax regulators increasingly are focused on thin capitalization without regard to whether the debt is owed to residents or nonresidents.

In the preliminary work on Action Item 4 of the BEPS project, the OECD and outside commentators identified a wide range of issues to consider with respect to thin capitalization and related concerns. But, at core, there are five primary areas for inquiry:

- i. What is the best way to determine whether a taxpayer has "excessive" debt, such that some portion of the interest expense incurred should be disallowed either temporarily or permanently? This is the classic problem of defining "thin capitalization" and is discussed in Section A.

- A related question is how to identify interest expense that arises in connection with exempt or deferred income. This issue most frequently occurs in connection with a taxpayer that earns foreign-source income that is taxed favorably in the taxpayer’s home country. Although the interest expense may not be “excessive,” allowing a current deduction for the interest expense may improperly erode the tax base. This issue is discussed in Section B.
- ii. Should certain types of debt (and the associated interest expense) be treated differently from other types of debt with respect to tax deductibility? Or, should all of a taxpayer’s debt and interest expense be considered as a single tax item for deductibility or limitation? These issues are discussed in Section C.
  - iii. Is related-party debt particularly susceptible to abuse, so that related-party debt and the associated interest expense should be subject to special limitations? If limitations are deemed appropriate, how could (and should) those limitations be designed? This concern is discussed in Section D.
  - iv. What role can withholding taxes play in preventing erosion of a country’s tax base in connection with cross-border payments of interest? This matter is discussed in Section E.

In discussing these important issues, the paper seeks to emphasize the competing considerations that developing country tax authorities must weigh to design laws that properly prevent erosion of the tax base while ensuring availability of credit to support and grow business activities.

#### A. Determining Whether a Taxpayer has “Excessive” Debt

Tax laws in a country generally do not – indeed, cannot – forbid an enterprise from having an “excessive” level of debt, however that limit is defined. Rather, other government agencies 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 debt, and the limitations prevent taxpayers from incurring so much debt that the relevant tax base is eroded.

Taxpayers may argue that the tax law should not limit interest deductions; so long as the taxpayer is compliant with non-tax rules establishing the level of debt that can lawfully be incurred (and any prudential limitations imposed by lenders or others), then the interest expense incurred is a reasonable business cost and should be deductible in determining taxable income. But tax laws often set limits on deductible expenses as a matter of tax or public policy; examples include deduction limitations for entertainment, advertising, and highly compensated personnel. And, in similar fashion, tax laws sometimes allow exceptional deductions (for research and development, or the purchase of capital equipment) as a statement of policy.

It is consistent with the use of tax rules as an instrument of policy to impose limitations on the deductibility of interest when that interest is determined to be “excessive.” These tax rules work in parallel with the non-tax rules that limit the amount of debt an enterprise may incur when the company is formed or at particular times after formation.

In order to determine whether an enterprise has “excess” interest, authorities typically consider one or both of two measurements.

1. Debt:Equity Ratios

The most frequently adopted measure for whether an enterprise has a reasonable amount of debt is the debt:equity ratio of the enterprise. This is frequently expressed as a fixed ratio; for instance, an industrial company may be required to have a debt:equity ratio no higher than 3:1, or lower, while a financial institution may be required to have a debt:equity ratio no higher than perhaps 6:1. There is an admittedly arbitrary element in using a test involving debt:equity ratios, because there is no “correct” ratio for businesses. But, standards can be identified by observing ratios found in a broad range of businesses.

The higher ratios generally permitted for financial institutions arise because the assets of financial institutions are generally viewed as more readily marketable. For instance, a bank may hold as assets loans or receivables for which there is an easily identifiable market and market price, in the event the bank needs to sell the assets to raise cash (assuming there is not a financial crisis). Furthermore, financial institutions are in the business of “intermediation,” so borrowing is a fundamental part of the business model. An industrial company, on the other hand, may have plant and equipment as its major assets, which are more difficult to sell quickly. The higher debt:equity ratios for financial institutions are readily observable in the marketplace.

Tax rules may disallow interest expense that arises from a debt:equity ratio higher than the prescribed ratio. The fact that the taxpayer's capital structure appears to have excessive debt supports a conclusion that the related interest expense is "excessive" and should not be allowed as a deduction for tax purposes.

ii. Interest as a Share of a Prescribed Financial Ratio

An alternative approach adopted by some countries is to disallow interest expense if the amount of interest exceeds some prescribed financial ratio. For instance, a taxpayer may be denied a deduction for the portion of interest expense (or, alternatively in some countries, net interest expense) that exceeds a fixed percentage (e.g., 50%, or 30%) of a prescribed financial measurement, such as gross income less certain expenses, or the familiar EBITDA (earnings before interest, tax, depreciation and amortization).

Some governments in developed countries are currently examining whether new ratios would be useful in testing for excessive interest. For instance, the ratio of debt to EBITDA provides information on the number of years that would be required for a taxpayer to pay off its debt if the borrower's cash flow were entirely dedicated to repayment; therefore, this ratio could be a useful measure of the borrower's ability to repay the debt. Financial lenders sometimes use this ratio as a covenant.

Determining "excessive interest" by means of a financial ratio or using the more traditional test of a debt:equity ratio are not mutually exclusive approaches. The United States, for instance, combines the two tests under Section 163(j) of the US Internal Revenue Code. That provision, generally referred to as the "earnings stripping" provision of the Code, applies to US companies that pay interest to foreign lenders, often related parties. A portion of the US taxpayer's interest expense is disallowed if the taxpayer breaches both a debt:equity limitation and the interest expense exceeds 50% of adjusted taxable income.

iii. Considerations in Selecting a Tax Test for "Excessive" Interest

Both approaches for determining whether a taxpayer has excess interest expense that should be disallowed are fully consistent with international norms. Both approaches have strengths and vulnerabilities.

a. Debt:equity ratios

Balance sheet calculations. Debt:equity ratios are typically determined by examining a taxpayer's financial balance sheet. For larger companies, and companies that are publicly traded, such a balance sheet is often regularly

available. For smaller companies, there may not be a need (other than for purposes of this tax rule) to create such a balance sheet.

This approach offers ease of administration, but raises important questions.

Under financial accounting, the equity of an enterprise is often based on historical measures, such as the initial equity investment plus retained earnings. This may undervalue the asset side of the enterprise. For instance, if the enterprise has assets that have appreciated in value, or if the enterprise has substantial goodwill, then the ratio of debt to equity may be over-stated if the debt is measured at current values but equity is measured on historical data or pursuant to a formula.

On the other hand, if the enterprise seeks to measure its equity on a fair market value basis, that valuation can be costly and complicated. Valuations also potentially create controversy between the taxpayer and tax authorities.

Fluctuating interest rates. Determining whether an interest deduction is allowable based on compliance with a maximum debt:equity ratio has one interesting, and often overlooked, shortcoming: the approach does not take into consideration the rate of interest paid on the debt. And yet, the interest rate can be keenly important in determining whether a particular amount of debt is “reasonable” or “excessive.”

Specifically, in a low-interest rate environment, an enterprise may be able prudently to carry a higher level of debt than the same enterprise can carry in a higher interest rate environment. For instance, the amount of income required for a company (or an individual) to comfortably support a loan may be very different when the loan carries an interest rate of 4% than when the loan carries an interest rate of 12%.

Interestingly, countries have been reducing the levels of debt for which interest is deductible in recent years, even though interest rates have fallen and therefore the amount of interest required to carry a fixed amount of debt has likewise fallen. These reductions are sound only if the consensus view of the maximum amount of appropriate interest expense has declined even more sharply than the decline in interest rates.

Financial institutions. One challenge for determining appropriate debt:equity ratios in the case of financial institutions is the fact that such institutions differ significantly in their business models. These differences arise with respect to both funding (e.g., banks that rely on deposits versus banks that rely on short-term borrowing in the commercial paper markets) and in the assets in

which they invest (e.g., readily marketable securities or credit card receivables, versus capital goods leased to customers). These differences in funding and in assets are reflected in the marketplace; different financial institutions have significantly different debt:equity ratios.

For a tax rule, this creates the challenge of whether to try to apply a single rule to all institutions (e.g., a permissible ratio of 6:1 or 3:1) as a bright-line test, or whether to seek to permit different ratios, based on different business models.

Determining the disallowed interest. A mechanical – but sometimes challenging – issue is how to determine the amount of interest that should be disallowed, in the event a taxpayer exceeds a permissible debt:equity ratio. Presumably, the best approach is a form of proration, in which interest is disallowed based on the degree to which the enterprise exceeds the debt:equity limitation. But that test may be easier to describe than apply.

#### b. Prescribed financial ratios

As an alternative to capping the allowable interest expense based on a ratio of debt to equity, some countries limit deductible interest to a stated percentage of the enterprise's earnings before tax, or other financial measurements. Like a measurement based on a debt:equity ratio, this approach has both strengths and weaknesses.

Base erosion. This approach has one primary virtue: it directly limits base erosion. A taxpayer cannot deduct interest in excess of the limitation amount. By contrast, a test that uses debt:equity ratios has only an indirect limitation on base erosion. For instance, depending on interest rates, two enterprises with the same, permissible debt:equity ratios will have different levels of interest expense – and one enterprise's deductible interest expense may be much higher than the other enterprise's level of interest expense.

The approach does not, of course, ensure that every enterprise will have positive income and pay taxes; the enterprise may be limited in its interest deduction but have other expenses that generate a loss, or a low taxable income. But, if the concern is that an enterprise may have excessive debt and excessive interest expenses that improperly erode or reduce the tax base, then this approach tackles the concern directly.

Fluctuating interest rates. Unlike limitations based on debt:equity ratios, a tax rule that denies (or defers) interest deductions based on a prescribed financial ratio automatically causes taxpayers to adjust their behavior as interest rates fluctuate. This approach creates positive incentives for an enterprise to reduce its

debt and accompanying interest expense when interest rates are rising. In this way, such a rule reinforces the goal of non-tax regulations that generally seek to drive an enterprise to reduce its debt level in such a situation.

Disallowed interest expense. In the case of a rule that disallows interest in excess of a certain prescribed financial measure, determining the disallowed interest is generally easy: it is the amount of interest expense in excess of the limitation.

c. Net interest or gross interest? Net debt or gross debt?

One important issue lies hidden in the discussion above: in seeking to determine whether a taxpayer has excessive interest, so that some portion of the interest expense should be disallowed,

- Should the debt:equity test be based on gross debt (treating cash as an asset) or net debt (so that gross debt is reduced by cash); and
- Likewise, should the calculation whether an enterprise incurs interest expense in excess of a prescribed limitation be made on the basis of gross interest expense, or net interest (gross interest expense minus interest income)?

There is, of course, no single right answer. And, both approaches are readily administrable, since the data required to apply either approach lies in the financial statements and tax return information.

There are differences in the two approaches, however. For instance, a taxpayer may have high debt, but also high cash balances. Should interest payments on the debt be viewed as excessive and base eroding, or does the fact that the company has available cash (which may be earning interest income) dampen any tax concern about base erosion?

The key point for tax administrators and taxpayers to recognize is that the question of whether to adopt a test that uses gross debt and gross interest, or net debt and net interest expense will have a major impact on what ratios or financial limitations should be adopted.

d. Tax treatment of disallowed interest

Assuming that a taxpayer has “excess” interest in a taxable year, the question arises whether the excess amount should be permanently disallowed as an interest deduction, or whether the interest should be carried forward and allowed

as a deduction in a future year, when the taxpayer fully satisfies the limitations on interest expense?

Because of business cycles, some measure of carry-forward may be appropriate. The interest expense would be allowable in the future year only to the extent the enterprise incurs interest expense in the future year that is less than the amount otherwise allowable in that future year. Such a carry-forward rule would, of course, create administrative challenges for both government tax examiners and taxpayers.

In the event there is not a carry-forward rule, then a question arises as to how to characterize the disallowed interest payment. Should the payment be treated as a dividend in the current year? If so, would the applicable withholding tax be the rate of withholding on dividends, rather than the rate on interest? What is the tax impact of the recharacterization in the recipient's country?

These issues can all be answered, but they require explicit rules to be issued in order to minimize tax disputes.

#### e. Summary

As a matter of policy, it is appropriate – and consistent with international norms – to deny a deduction for interest expense that is “excessive” by some measure. This tax policy parallels and reinforces non-tax limitations on the amount of debt that an enterprise may incur. There are two primary methods for determining whether interest is excess: measuring the debt:equity ratio, or measuring the interest expense as a percentage of some financial measure such as pre-tax income. Each method has strengths and weaknesses, but each approach can be usefully adopted.

#### B. Interest Allocable to Exempt or Deferred Income

In addition to a disallowance of interest on excessive debt – however “excessive” is defined – a related issue arises in connection with income that is either exempt from taxation or on which the tax is deferred. The issue arises most frequently when a taxpayer earns income sourced outside of its home country and the income receives favorable tax treatment in the home country.

This is a challenging topic that could usefully be discussed in a paper much longer than this one; in many countries, there has been a long, high-octane debate on how best to allocate interest that may be attributable to deferred or exempt income, especially foreign-sourced income such as dividends from foreign corporations. But, at least a few concerns need to be noted.

This issue is not limited to developed countries. It affects developing countries as well.

- For instance, many developing countries, including China and India, tax their multinational corporations on worldwide income. But, income earned outside the home country may be deferred for a period of time, before home country tax is imposed. If a resident company incurs interest expense within its home country, should some portion of that expense be allocated to the investments and income earned from those investments outside the home country? And, if so, should a portion of the current interest expense be disallowed (or deferred) until the foreign income is taxable in the home country? If the answer is yes, how should the allocable expense be determined?
- In countries with a territorial tax system, so that active earnings outside the home country of a taxpayer are not subject to home country tax, a similar issue arises. Should some portion of the home country interest expense be allocable to this exempt income and disallowed permanently?

The concern for developing countries will increase, as more multinational corporations grow within developing countries and out-bound investment from developing countries increases. In the near future, Lenovo (China), Arcelor-Mittal (India) and the other existing multinationals resident in developing countries will be joined by a dramatically increasing number of home country peers.

In determining how to allocate interest expense to out-bound investment, countries have struggled to balance appropriate tax rules with a public policy desire to encourage and support home country champions as they invest abroad. As a result, there is no single approach that has garnered consensus support.

There are several options:

- i. Countries can impose no (or very modest) limits on the deduction for interest expense on debt incurred to support out-bound investment. This approach is not “pure,” but garners support on the well-grounded theory that a home country benefits when companies headquartered in that country have strong investments outside the country. Having the headquarters of an MNC in a country typically brings with it well-paying jobs for executives, business opportunities for suppliers, philanthropy, and other benefits. But – and this

is an important caution – such an approach can be viewed as favoring multinational companies over companies that operate purely domestically, since the rate of tax paid on the foreign income may be lower than the rate incurred by domestic companies that earn all of their income in the home country.

- ii. Countries can impose a proxy charge to account for interest expense that may be attributable to exempt or deferred income. For instance, some countries exempt certain foreign income from home country tax but limit the exemption to, say, 95% of the income. Local country tax is imposed on 5% of the income, as a proxy for disallowing expenses attributable to earning that foreign income. This approach is applied by several countries with respect to dividends paid by nonresident corporations to resident corporations that hold a substantial interest in the foreign corporations.
- iii. Finally, a country may seek to allocate and apportion interest expense between home country income (which typically is subject to full tax currently) and income that is exempt or deferred. The interest expense attributable to that exempt or deferred income will, likewise, be denied as a deduction or the deduction will be deferred until the income is taken into account for tax.

There are precedents for each of these options, but no clear consensus on the most appropriate approach. As corporations resident in developing countries increasingly engage in out-bound investment, each country will need to determine which rules for interest allocation best serve its national development goals and its sense of fairness.

### C. Is All Interest Equal?

As discussed previously, debt (and the associated interest expense) may arise from any of several different business needs:

- A need for initial capital to form the business, or to fund subsequent expansion, in which case the debt and interest can be viewed as a substitute (or companion) for equity.
- Debt may be incurred for a specific purpose, such as a mortgage obtained to purchase a piece of real property, or a loan associated with the purchase of

a piece of capital equipment. When a business obtains goods from a supplier on extended terms, the business may pay interest if the payment is delayed beyond a certain period (such as 30 or 60 days). In this case, the debt can be traced (sometimes) to the specific asset, and the asset often serves as security for the debt.

- Debt may be in the form of a line of credit, or other generalized borrowing, as a source of funding for on-going operations of a business. This debt may, of course, be closely analogous to debt incurred as part of the initial capital of the business, or debt incurred to purchase property or equipment.

It is frequently said that “money is fungible,” which suggests that all debt is equivalent, if not fungible. Under this view, all interest expense should be considered as a single item of expense for determining whether some or all of that interest should be deductible in determining taxable income. But, this view is not the only approach that may be adopted.

For instance, tax rules may treat debt incurred on initial capital differently (and, generally, less favorably) than debt incurred for the on-going operations of a business, either the purchase of goods or services, or for a line of credit. If an enterprise is deemed to have excess debt related to its formation (e.g., a debt:equity ratio that exceeds a stated level), then some of the interest on that debt may be disallowed. But, interest attributable to specific purchases of goods or services would be viewed as ordinary business expenses and fully deductible.

In determining whether to treat all interest alike (as a single expense item), or whether to treat some interest differently from other interest in terms of deductibility, there are several factors to consider:

1. Ease of administration. Treating all interest expense as a single item is generally easier for both taxpayers and tax administrators. Otherwise, taxpayers and tax officials must analyze the sources of debt and separate interest payments into different categories for purposes of tax deductibility. Further, if interest expenses are treated differently for tax purposes, depending on the source of the debt, taxpayers will be encouraged to favor certain kinds of debt (e.g., debt associated with the purchase of specific real property, equipment or goods) and dis-favor other kinds of debt (most frequently, debt that would be a substitute for equity).
2. Perceptions of “base erosion.” On the other hand, some kinds of debt may be perceived as more susceptible to abuse than other kinds of debts. As discussed further in the next section, and as

discussed previously at section 1C, an investor into a company may invest \$1000 of equity and no debt, or some combination of equity (say, \$400) and debt (\$600). Interest paid on this initial debt – which is often, although not always, paid to a related person – may be viewed as being created artificially and more likely to be an improper “base erosion” payment than interest paid to an unrelated party in connection with a mortgage on real property.

3. Policy. Allowing full deductibility for interest on purchases of real property, capital goods and supplies encourages business operation and expansion. The same argument could be made for allowing full deductibility of interest paid on initial debt investment into the capital of a company, but the argument is generally more immediate and persuasive in the case of debt related to on-going operations.

In weighing these factors, different countries have and will continue to reach different conclusions.

#### D. Interest Paid to Related Parties

The most controversial – and emotional – issue regarding the deductibility of interest payments arises in connection with the payment of interest to related parties. The example of Acme Corporation, Beta Corporation and Charlie Corporation was outlined above. Although interest payments to related parties most frequently arise in connection with the initial formation of a company – and the decision of how much investment to make with equity, and how much (if any) to make with debt – the issue of related party debt arises in other situations as well. Related parties are often suppliers and customers of each other, and payments in connection with these transactions may incur interest charges. And, a related party may serve as a source of regular funding, either through fixed loans or a line of credit.

Related party payments are a concern only when the related party receiving the interest is outside the country of the party that is paying the interest. If the two related parties are in the same country, and each company is subject to local country tax, there should be no concern. But, when the related party receiving interest is located outside the country of the interest payer, the debt and associated interest payments are viewed as a major risk for improper “base erosion.” This suspicion arises for several reasons:

- i. Although the decision whether (and how) to extend a loan to a related party can be complex, as discussed previously, the related parties can and do work together to try to fashion a loan that is most favorable in its tax result. In most cases, the payment of interest is more tax-advantaged to the borrower and lender, considered together, than an investment of equity. In some cases, the payment is very favorable, as when the interest is deductible to the borrower and subject to low or no tax in the hands of the lender.
- ii. Related party loans are not subject to market discipline, in the way that a debt from an unrelated party would be. The amount of the loan may be in excess of the amount that a third-party would be willing to lend, or the loan may be for an extended period or subject to fewer conditions than a third-party would demand.
- iii. Importantly, there can be transfer pricing concerns with respect to the rate of interest paid and other terms of the loan.

Recognizing these concerns does not, however, suggest a single answer as to whether interest paid on related party debt should be subject to different (presumably, less favorable) tax terms than interest paid on debt to parties that are not related.

From the perspective of the country in which the interest expense arises, the key question is whether it is relevant that the recipient of the interest payment is related to the payer. The answer may be yes:

- There is a potential for transfer pricing abuse, and disallowing some or all of the interest paid to a related party is a prophylactic means of addressing that potential abuse.
- Even if the amount of interest paid is appropriate (and would be allowed if paid to a third party), there is a concern that the interest may not be properly taxed in the hands of the recipient. To prevent base erosion on a global basis, the country of the payer may limit the interest deduction.

On the other hand, treating related party interest less favorably creates costs. In particular,

- As discussed previously, there are non-tax reasons as well as tax reasons why an investor may choose to invest partially with debt and not wholly with equity. If tax rules impose additional costs on the use of debt, that may affect investment decisions; not all investors will be willing to bear those additional tax costs.
- Enforcing special rules on related party lending creates administrative costs, because it can be difficult to define what is a related party for purposes of the rule. For instance, a nominal lender may be an unrelated party; but, the loan would not have been made but for a deposit with the lender from a party related to the borrower. Or, a party related to the borrower may offer a guarantee to the lender; such guarantees vary considerably, from formal and binding agreements to “comfort letters” that have no legal consequences. If special rules are applied to related party lending, there will need to be anti-avoidance rules to prevent abuse.

Another factor to consider is whether a country’s tax administration can minimize the risk that related party lending would abuse the tax system. The risk that related party lending will be on non-arm’s-length terms can be addressed by stronger transfer pricing enforcement, including the possibility of published permissible lending rates, although efficient and effective application of transfer pricing rules is a challenge for all tax authorities. Excessive base erosion can be addressed through limits on the deductibility of all interest expense, whether paid to a related party or unrelated parties, so long as the rules are consistent with any applicable treaty limitations.

At bottom, the question for tax administrators is whether the potential abuse that can arise from related party lending is sufficiently great that it warrants special rules, or whether the potential concerns can be minimized through other, less restrictive means.

#### E. Withholding Taxes

Developing countries traditionally favor withholding taxes on payments of interest to non-resident lenders. The withholding tax is perceived as a tax cost to the non-resident lenders, with the benefit of raising tax revenue that partially offsets the tax cost of the local interest deduction.

An example may be useful:

- Dart Corporation, resident in Country A, needs to borrow \$1,000. It obtains a loan from Extra Corporation, resident in Country B, for \$1,000 at an interest rate of 8%, or \$80 annually.
- Dart pays the \$80 to Extra, subject to a 10% withholding tax. So, Extra receives \$72 in cash, plus a credit for the \$8 that Dart withheld and remitted to the Country A tax authorities.
- Dart deducts the \$80 of interest in determining its taxable income. The tax rate in Country A is 25%, and Dart has sufficient income to fully benefit from the \$80 deduction. Dart saves \$20 in Country A tax because of the tax deduction.
- Country A has received \$8 in withholding taxes on the payment to Extra, but has foregone \$20 in tax revenue it otherwise would have received from Dart. There is a negative tax rate arbitrage to the Country A fisc from this transaction, but the withholding tax reduced the revenue loss from \$20 to \$12.

Historically, it was generally believed (and probably true) that most lenders could absorb the withholding tax as a credit against home country taxes that the lender would otherwise pay. So, the withholding tax -- \$8 in our example -- did not increase costs to the lender (or the interest rate that the lender would charge the borrower), but rather the economic burden of the withholding tax was transferred to the fisc of the country in which the lender was a taxpayer. In the example above, Extra would claim a foreign tax credit in Country B for the \$8 in withholding taxes it paid to Country A. Extra's total tax cost to Countries A and B would be unchanged but Country B would receive \$8 less revenue.

This traditional perspective has eroded in recent years. Lenders are often able to minimize the taxation of interest income, so that withholding taxes are real costs. Accordingly, lenders regularly request a "gross-up" for any taxes withheld, so that the borrower bears the cost of the withholding tax in the form of a higher interest charge.

The higher interest charge, of course, is generally tax deductible, which has the effect of increasing the tax deduction available to the borrower and reducing the borrower's home country taxes.

The decision whether to impose a withholding tax on cross-border payments of interest, and at what rate to impose withholding, requires juggling several factors.

The availability of local funds for lending. If a country has sufficient funds within its jurisdiction to meet all reasonable needs for borrowing, then it is more beneficial to impose a withholding tax. China may be an example of such a country, where there is no perceived shortage of funds available for new investment.

When a company borrows funds from a lender within the same country, the interest paid on the loan is not subject to a withholding tax. (Or, in the few countries that impose withholding on domestic payments, the withholding tax is generally treated as a pre-payment of tax that will be calculated on a net basis.) The lender receives the interest income and will be subject to tax on a net basis. The ready availability of local funds for lending sets a market rate of interest that applies equally to lenders from offshore. Any withholding tax and gross-up requirement will not affect the economics of the transaction, because the borrower has local lenders available as competition to the offshore lender.

On the other hand, if a country needs investment capital from offshore, a withholding tax will likely increase local borrowing costs, and a gross-up provision will increase that cost further. To return to the example, if Extra Corporation insisted on a gross-up for its loan, Dart Corporation would remit \$80 to Extra, plus \$8.80 in withholding taxes to the local authorities. The gross-up would yield an additional \$0.80 in taxes to Country A, but at a cost of an additional tax deduction of \$8.80 for Dart Corporation and a tax cost to Country A of 25% of that amount, or \$2.20.

Determining an appropriate withholding tax rate. When the local income tax rate (25% for Country A in our example) is higher than the withholding tax rate (10% in the example), there is a tax rate arbitrage that reduces tax revenues. It is natural to assume that the best way to avoid the arbitrage is to set the withholding tax at the same rate as the local income tax rate.

But, there is another perspective: the withholding tax rate arguably should be set at a level that mirrors what tax revenues would be raised if the lender is a domestic company. In that case, a fairly low withholding tax rate may be appropriate as a proxy for a tax on net income.

The lender will often be a financial institution, which has an interest expense of its own associated with raising the funds that are lent to the borrower. In our example, assume that Dart Corporation borrows the \$1,000 from Forest Corporation, a financial institution in Country A.

Because financial institutions often have high leverage ratios (e.g., 6:1, or even 20:1), Forest Corporation will have substantial interest expense of its own

arising from the \$1,000 that it raised for the loan to Dart. This interest expense will reduce the net income taxable on the \$80 of interest income that it received from Dart. In many cases, Forest may have net taxable income of only \$8 or less (\$80 of interest income, reduced by an assumed \$72 of interest expense) from the Dart transaction. At a 25% income tax rate, Forest will pay tax of \$2 on its net income.

In such a case, even a 10% withholding tax (which yielded \$8 on the interest payment to Extra Corporation) would appear too high, compared to the tax revenue derived from Forest Corporation on its domestic loan to Dart. When the corporate income tax in Country A is imposed on the small net interest income of Forest Corporation, the total tax revenue raised may be equivalent to a withholding tax on cross-border interest of only 1% or 2%, well below the withholding tax rate generally imposed on cross-border interest.

Summary. One way to address the difficulty of determining an appropriate withholding tax rate on cross-border payments of interest is to adopt differential rates, and this is often the approach followed in tax treaties. When the lender on a loan is a financial institution, a treaty may impose lower withholding tax rates than when the loan is extended by a non-financial institution that may not have significant interest expense of its own. The challenge for a developing country in considering withholding taxes on interest is to balance the desire to minimize tax costs from the tax deduction for interest against the need to ensure any withholding tax does not increase costs (through a gross-up or higher interest rates) or limit the availability of needed investment.

#### IV. Branch Operations

The discussion above generally assumes that taxpayers are conducting business through separate corporations. In such a case, each corporation keeps its own books and records, and each corporation is expected to deal at arm's-length with all related entities.

In many cases, of course, multinational operations are conducted through branches, not separate corporations. Many, but not all, of the tax issues relating to branches are substantially identical to the issues that apply to corporations. And interest expense is one issue where there can be differences.

In order to determine the taxable income of a branch, the branch must keep books and records of its income and expenses. Under Article 7 of most treaties based on the UN or OECD Model Conventions, a corporation that has a taxable presence (a "permanent establishment" or PE) in another country is taxable in that

other country on the profits “attributable to” the permanent establishment, determined by treating the PE as if it were a separate legal entity from the parent.

With respect to interest expense, however, there is some inconsistency.

- In some cases, the PE calculates its interest expense as if it were a separate legal entity from the parent, based on its own books and records; but
- In other situations, the PE determines its interest expense as a share of the total interest expense incurred by the enterprise of which it is a part. Article 7 (Business Profits) of the UN Model Double Taxation Convention specifically provides that, except in the case of a bank, a PE will not be allowed a deduction for any interest that is notionally charged to the PE by the head office (nor will the PE be considered to earn any interest that it notionally charges to the head office or another branch.) Instead, the PE will be entitled to a deduction for its “allocable share” of interest expense incurred by the enterprise as a whole.

If a branch is allocated and apportioned a share of the interest expense incurred by the parent enterprise, that amount may, of course, be greater or smaller than the amount that would be determined by treating the branch as a separate entity. The argument in favor of allocation, however, is that the PE is not a separate legal entity and so its assets and liabilities are not separate from the assets and liabilities of the larger enterprise, at least in terms of the exposure to creditors.

It is important for a country to make clear how interest expense of a PE will be determined, in order to minimize tax disputes.

## V. Relevance of Tax Treaty Provisions

In fashioning rules that affect the taxation of interest to a recipient, or that limit the availability of deductions for interest expense, countries do not have unfettered discretion, at least where a country has entered into tax treaties with other countries. By treaty, countries mutually limit their taxing authority, in order to foster trade and economic growth.

For instance, Article 11 of the UN Model Double Taxation Convention sets forth principles regarding the tax treatment of interest “arising” in one state and paid to a resident of another contracting state. Article 24 of the model convention provides assurances of non-discrimination for residents of one treaty state that invest in the other treaty state. The language in different treaties varies, but, in general, the taxation of nonresidents should not be “other or more burdensome” than the taxation of a country’s own residents, and the taxation of a permanent

establishment “shall not be less favorably levied” than the taxation a country levies on its own enterprises.

The parameters of Articles 11 and 24 are often debated, and occasionally these provisions give rise to legal disputes. But the basic concepts of these treaty provisions are clear and do limit some actions that a country may wish to take with respect to the taxation of interest paid to or incurred by nonresidents.

## VI. Conclusion

Loans and the free flow of credit are vital to international business and to economic growth. Interest payments are an ordinary business expense and generally will be deductible by the borrower in calculating both financial statement income and taxable income. The interest income generally will be taxable income to the lender.

But, as the BEPS project has recognized, debt can be a strong tax-planning tool. In some circumstances, interest payments may be considered excessive, so that the relevant tax base is improperly eroded. Tax professionals have struggled for many years to determine when interest payments are excessive, so that tax deductions for those payments should be limited. The BEPS project, and the work of many countries seeking to apply the learning of BEPS, promises to shine new light on this continuing challenge.

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