Workshop on Double Tax Treaties and
Base-Eroding Payments for Developing Countries
Nairobi, Kenya, 21-24 March 2017

CASE STUDIES ON INTEREST

1. Case A

P Co, a corporation resident in Country P, establishes a subsidiary corporation, DC Co, in your country, Country DC. DC Co requires initial funding of 1,000 in order to begin business. That financing could be arranged by:

1. P Co providing 1000 of equity funding by subscribing for 100% of the shares of DC Co.
2. P Co providing 500 of equity funding by subscribing for 100% of the shares in DC Co and DC Co arranging a loan of 500 from:
    a. A domestic bank;
    b. A foreign bank;
    c. A related financing subsidiary of P Co located in a third jurisdiction;
    d. P Co itself.

How would the payments of interest by DC Co in each of these situations be treated under your domestic tax law? How would the payments of interest received by the lenders in each of these situations be treated under your domestic law?

What difference would it make if any of the foreign lenders were located in countries with which your country had a tax treaty with provisions similar to the United Nations Model Convention?

2. Case B

Assume that facts of the case are the same as in Case A, except that:

1. P Co provided 300 of equity funding and 700 was provided by the various lenders;
2. P Co provided 100 of equity funding and 900 was provided by the various lenders;
3. The rate of interest charged on the loan was 15%;

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4. The loan provided that payments would be made only if DC Co's profits exceeded certain levels.

3. Case C

Assume the facts of the case are the same as Case A but, in its first year of operation, DC Co had 100 of operating income and paid out 90 of interest to the lender.

4. Case D

Assume the facts of the case are the same as in Case A (2) (b) (i.e. DC Co is financed with 500 of equity and 500 from a foreign bank), but that prior to the loan from the bank, P Co made a loan of 500 to the foreign bank at an interest rate slightly lower than the rate charged by the foreign lender to DC Co.

5. Case E

Assume the same facts as Case A, but instead of organizing its operations in Country DC as a separately incorporated subsidiary, P Co sets up a branch operation or permanent establishment ("the Branch") and provides all the capital to the Branch. The books of the Branch show 500 of the funds as a loan bearing a stated interest rate, which the Branch "pays" to the head office of P Co.

1. Would your country allow a deduction for any interest expense shown on the books of the Branch in calculating the taxable business profits of the Branch? If so, how would the amount of the interest be calculated?
2. What is the effect of the treaty between Country DC and Country P?
3. Assume that in Case E the 500 loan shown on the books of the Branch represents a corresponding loan to P Co by:
    a. A bank resident in Country P with no security for the loan;
    b. A bank resident in Country DC with the assets of the Branch being pledged to secure the repayment of the loan.

6. Case F

DC Co, a corporation resident in Country DC, owns all of the shares of S Co, a corporation resident in Country S. DC Co financed the purchase of the shares of S Corp with the proceeds of a loan made to DC Co by a Country DC bank and pays interest to the bank on the loan.

1. How would dividends paid by S Co to DC Co be treated under the domestic law of your country?

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2. Would the interest paid on the loan by DC Co be fully deductible in calculating the taxable profits of DC Co under your country's domestic law? If not, how is the deduction limited?

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