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

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For further information, please contact:

United Nations
Department of Economic and Social A airs
Financing for Development O ce
United Nations Secretariat
Two UN Plaza, Room DC2-2170
New York, N.Y. 10017, USA
Tel: (1-212) 963-7633
Fax: (1-212) 963-0443
E-mail: Tax dCapDev@un.org

Protecting the Tax Base
of Developing Countries against Base-eroding Payments: **Interest and Other Financing Expenses**

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Chapter 1

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 pro t shi ing (BEPS). e work on BEPS was a natural outgrowth of the OECD work on exchange of information as a means of counter ing international tax avoidance and evasion. In their June 2012 meet ing, the G20 nance ministers emphasized “the need to prevent base erosion and pro t shi ing”. In February 2013, in response to the G20, the OECD issued a short reporret b43 2d8tsponse to tvoa(C)0s Tc 4.2(c 4.n

established a Subcommittee on Base Erosion and Pro t-Shi ing with
a mandate to consider the implications of BEPS for developing- coun

¾ An explanatory note to identify the risks of base-eroding payments

¾ A paper on tax policy considerations related to counter-measures to such base-eroding payments

¾

with respect to cross-border interest payments should take into account many aspects that are not dealt with, or are dealt with only brie y, in this Portfolio For example, some measures may be e ective in coun tering BEPS but may have the e ect of discouraging non-residents

of cross-border interest payment. e 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 o cials 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.

(b) e 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

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. e interest paid is usually deductible by the payer against the country's tax base. Withholding tax on the interest serves to o set the e ect of the deduction of the interest, but may not o set that e ect 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 inter-est (measured by reference to some nancial 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) e risks of base erosion are exacerbated where inter-est 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 appli-cation of transfer pricing rules. However, transfer pricing rules are not dealt with in detail in this

1.2 Basic concepts

1.2.1 e d e nition of interest and other nancing expenses

In analysing the potential base-erosion risks that arise in connection with payments of interest, the threshold question, of course, is how to de ne a payment that quali es as "interest" for tax purposes. is 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":

¾ 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 xed, periodic return, typically called interest. e holder does not have an ownership interest in the borrower, so the holder does not share in pro ts 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.

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be partially or wholly exempt. e 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 di erence between debt and equity—interest is deductible; dividends are not deductible—there are usually other di erences 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 o en limited to certain speci c types of corporate transactions. Tax-deferred rollovers are o en allowed with respect to several types of transactions involving shares of a corporation, whereas rollovers for transactions involving debt are generally more limited.

 e treatment of a payment as “interest” should depend eeith redebt ar

Any rules with respect to the taxation of interest or the deduc tion 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. e 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 countou ansactions

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e 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 nancial instrument may be designed with a combination of debt and equity features primarily for commercial rather than tax reasons. Nonetheless, the many variations of nancing instruments give rise to challenging issues of tax administration.

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

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

e Organisation for Economic Co-operation and Development (OECD) has recognized the many challenges raised by hybrid nancial instruments in connection with its BEPS project. e issues are discussed in the OECD/G20 BEPS Action 2: Final Report: Neutralising the E ects of Hybrid Mismatch Arrangements.[34] 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 e ectively. For most countries, it is likely to be su cient 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 ari risal -1.182 Td 1h hybrioa27.3(h7(c)-17((h)8.9(e

Under an apportionment approach, interest expenses or debt is allocated to assets or gross income on the basis of a formula. e assumption underlying an apportionment method is that money is fungible, so that all sources of funds (and, in particular, debt) support or nance 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.

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

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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. is 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 o set 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

1.2.5 Back-to-back nancing 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 inter

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

e di culty in identifying the correct lender in the case of back-to-back arrangements is even more challenging when the inter mediary, such as a nancial 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. at same bank then lends 1,000 to CCo. Should the loan to CCo be treated by Country C as a loan by ACo?

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 gener ally, whether the amount of interest expense claimed by the subsidiary against the tax base of Country Y is excessive. e di cult 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 deduc tion 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

e 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 o en the target of thin capitalization and earnings-stripping rules, discussed in sections 1.3.2 and 1.3.3 below. e deduction of excessive interest expenses by non-residents is also discussed in those sections and in section 1.5.3 below.

" in 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 nancial 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.

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

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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 o en de ned in the same way as control is de ned for purposes of the transfer pricing rules, namely, legal control (generally, the ownership of a su cient 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 su cient 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 nance resident companies with debt rather than equity. is 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 de ned as a shareholder that owns shares of the company representing at least a speci ed 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.

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. e 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

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. is 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. e 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 ow-through entities, the thin capitalization rules should apply to any debt of a partnership in which a resident company is a partner.

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1.3.2.2 Establishing a debt/equity ratio

One of the most important decisions in developing thin capitalization

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

ent of

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. erefore, 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. is 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. e 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. erefore, 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 signi cantly more complex if they operate on a consolidated basis. erefore, it may be preferable for the rules to

apply on an entity-by-entity basis and require non-resident companies to arrange their nancing 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.

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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. e 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. is result would apply irrespective of the fact that the debt and equity of ACo non-resident shareholders do not exceed the allowable ratio.

debt for purposes of the debt/equity ratio? Although such arm's length debt itself is not problematic from a base-erosion per-spective, 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.

¾ Should arm's length debt of a resident company that is guar-anteed 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 guar-antee arm's length debt of a subsidiary in order to allow the sub-sidiary 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.

¾ Are special anti-avoidance rules necessary? Special anti-avoidance rules are probably necessary to prevent the use of back-to-back nancing arrangements to avoid the thin capi-talization rules. For example, instead of borrowing from its non-resident parent company, a resident company might borrow from an arm's length nancial institution, which in turn bor-rows an equivalent amount on similar terms from the parent company. See section 1.2.5 above for a discussion of back-to-back arrangements.

¾ When should the amount of debt of a company be measured? ere are several possibilities in this regard, including a par-ticular 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 opportu-

length debt shortly before the relevant date and re-establishing the debt shortly a er 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. e 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

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

1.3.2.6 Speci c anti-avoidance rules

Speci c 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:

- ¾ Rules to deal with back-to-back arrangements (see section 1.2.5 above), and
- ¾ Rules to prevent arti cial increases in equity

e addition of speci c anti-avoidance rules will obviously increase the complexity of the rules.

1.3.3 Earnings-stripping rules

1.3.3.1 Entities covered

e 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. us, 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

- ¾ A higher ratio which may be appropriate if a country does not provide a carry-over for disallowed interest
- ¾ A higher ratio which may be appropriate if a country applies additional restrictions on the deduction of interest
- ¾ A higher ratio which may be appropriate if a country has relatively high interest rates
- ¾ A higher ratio which may be appropriate if a country's economic policy is focused on increasing investment in infrastructure projects
- ¾ e need to attract foreign investment
- ¾ e size of the multinational group to which a resident entity belongs

e arbitrariness of limiting interest deductions to a xed percentage of earnings can be mitigated by allowing disallowed interest to be carried over and deducted in other years and by providing speci c exceptions to the rules, as discussed in sections 1.3.3.5 and 1.3.3.4 below, respectively. e BEPS Action 4 Final Report recommends that countries adopt a xed 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). e gross interest expense approach has the bene t of simplicity. e net interest approach is more complicated, but avoids the duplication of interest expenses as a result of intergroup loans. e e ects of this duplication can be seen in example 9.

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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 e ectively double-counted as interest expense of both ACo

¾ Interest on arti cial debt where no additional funds are raised

(b) An entity would be permitted to deduct its net interest expense

In tax treaties, the challenge of establishing a proper withhold-ing tax rate is o en addressed by setting a lower rate for loans from nancial 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 e ectively clawing back some of the tax revenue associated with the tax deduction for the inter-

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 nancing 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

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. ese responses are o en considered to be Draconian and arbitrary. In addition, they will not be e ective 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 buse ./5DC

country or to non-residents. However, the risks are clearly more

interest and other expenses in computing the pro ts 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 nancing expenses to earn foreign source income

1.6.1 Introduction

ere 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

e deduction of interest and other nancing 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 di er 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 nancing 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 di cult to apply in practice because money is fungible. It is di cult 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. e 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 e ective or are easily avoided by taxpayers.

e 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 follow ing examples.

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

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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 ow 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 o en 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. e e ect 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. erefore, 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.

country or item-by-item), residents of a country may be able to obtain

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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

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. e e ect 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 1 Tw -1.572 58.043 TBredr

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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.

is 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.

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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. erefore, there are two major questions with respect to the treatment of interest and other nancing 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?

e 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. is chapter exam ines the provisions of tax treaties dealing with interest payments and interest deductions in order to provide is cha31.8(ha31.8(ha31.8()-5.7(s)-2.

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

If the debt was not e ectively connected with the PE of X in Country A (that is, the interest was not deductible in computing the pro ts attrib utable 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 e deductibility of interest expenses under the provisions of tax treaties

2.3.1.3.1 Introduction

In general, the deduction of interest and other nancing expenses is governed by domestic law rather than the provisions of tax treaties.

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]

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[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.

In addition, it is important to understand that Article 7 (3) deals only with the expenses attributable to a PE. As the Commentary

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

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.

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

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

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. e Commentary on both Model Cone.623 -1.773 Td .5

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

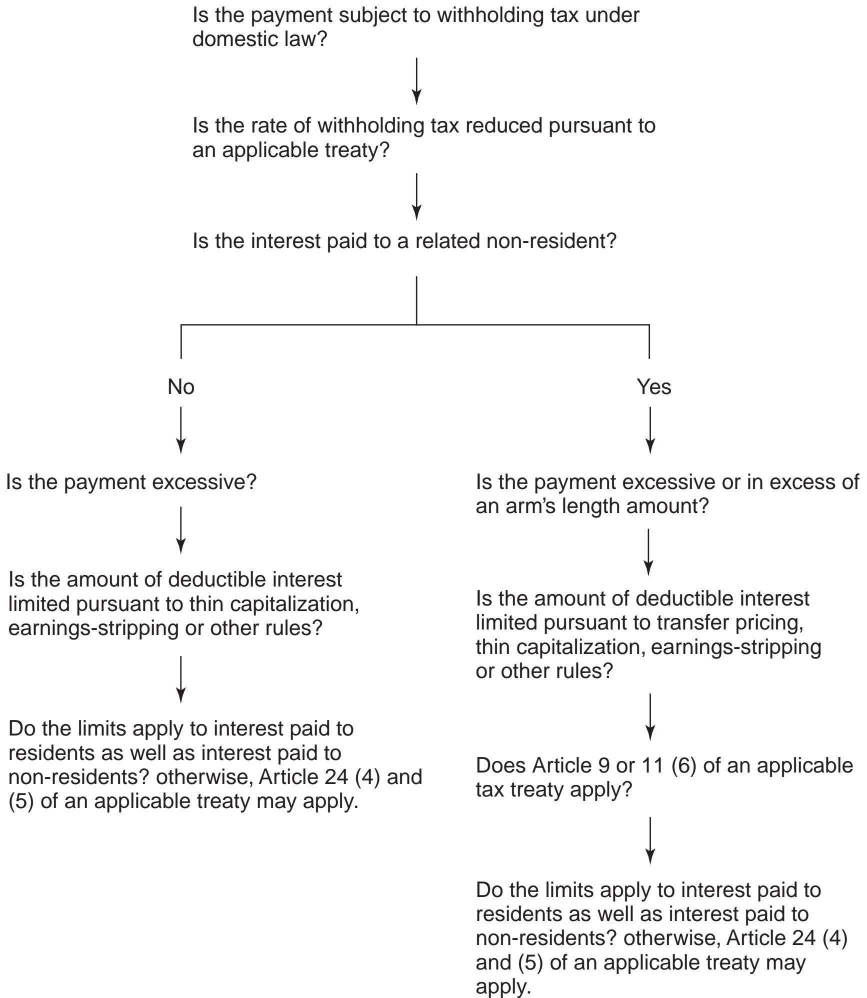
to shareholders resident in the other country. Although Article 24 (5) does not contain the exceptions for Articles 9 (1), 11 (6) and 12 (6) that are contained in Article 24 (4), the Commentary indicates that those exceptions apply equally to Article 24 (5).[27]

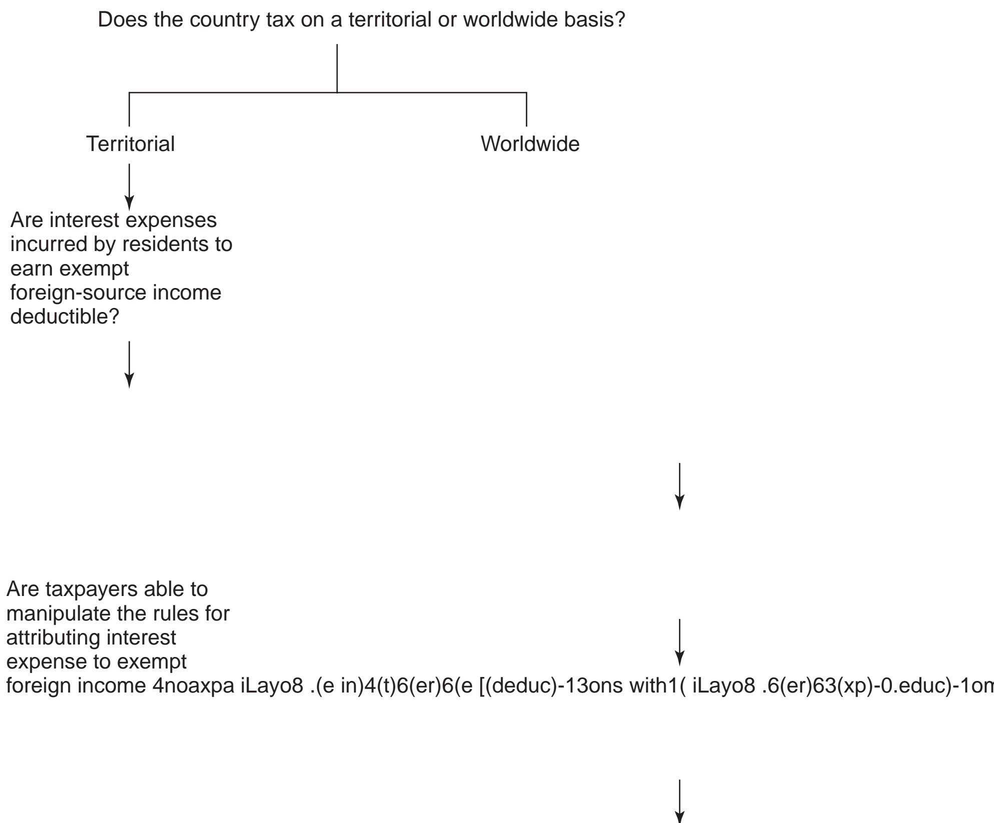
2.3.3 Other relevant treaty provisions

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.

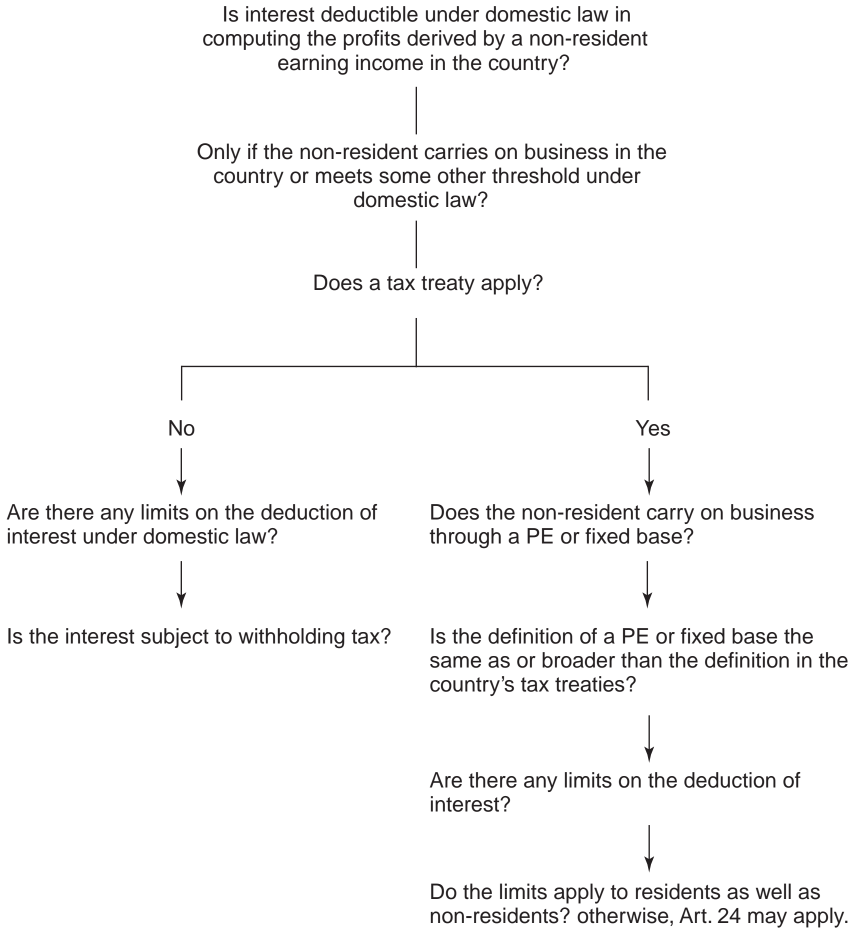
[27] Ibid.

Flow chart 1
Residents paying interest to non-residents




Does the country tax on a territorial or worldwide basis?
Territorial
Worldwide
Are interest expenses incurred by residents to earn exempt foreign-source income deductible?
Are taxpayers able to manipulate the rules for attributing interest expense to exempt foreign income 4noaxpa iLayo8 .(e in)4(t)6(er)6(e [(deduc)-13ons with1(iLayo8 .6(er)63(xp)-0.educ)-1om

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



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 nancing84(h a)-12 otal

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

Information on interest and other nancial 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 signi cant 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 nancial equivalents

It might be useful to know the amounts of interest and other -nan cial equivalents paid by residents of a country to di erent types of non-resident lenders— nancial institutions, non- nancial corpora tions, other entities, individuals, etc.

3.2.7 Resident payers

3.4 Deductions of interest and other similar amounts

It would be useful for tax policy analysis to have a wide variety of

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

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.

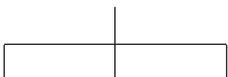
e discussion of the risks of base erosion through deducti ble interest payments in this chapter follows the framework set out in the introduction to chapter 1. In section 4.2, the risks of base erosion through deductible interest payments by both residents and non-residents of a country that are excessive 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.

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

e risks of base erosion through deductible interest payments are greatest where the interest deductions against a country's tax base

Table 2
Continuum of base erosion from deductible interest payments

Deductible interest (related income is taxable, interest is taxable to recipient, interest is not excessive, and recipient and payer are arm's length)	Deductible interest but related income is preferentially taxed (interest is taxable to recipient, interest is not excessive, recipient and payer are arm's length)	Deductible interest, but interest is not taxed to recipient or taxed at a preferential rate (interest is not excessive, recipient and payer are arm's length)	Deductible interest is excessive (related income is taxable, interest is taxable to recipient, and recipient and payer are arm's length)	Deductible interest is paid to related non-resident (related income is taxable, interest is taxable to recipient, interest is not excessive)	Deductible interest and various combinations of 2, 3, 4, and 5	Deductible interest, but related income is not taxable, interest is not taxable to recipient, interest is excessive, and payer and recipient are not arm's length



of those deductions represent legitimate costs of doing business and

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.

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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 e ective in preventing base erosion.

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

1. Risk e rules are not su ciently broad in scope with

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

Possible response: Restrictions on interest deductions by non-residents are as necessary as they are for residents. us, 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 response: Developing countries that want to avoid having tax treaties prevent the application of thei

capitalization or earnings-stripping rules have the follow-ing options:

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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

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: e 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. erefore, the imposition of withholding taxes on interest and similar payments involves di cult judgments about balancing the need to prevent base erosion

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

2. Risk

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. is 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. e 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 se tae t expensesu on0.9(c)-2.7(o3(x)74.1(n

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 nance 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. is situation causes base erosion problems for many countries, especially since dividends from foreign corporations o en 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

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 authol

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 uo r rxse(w)-3.3(l)9.9(e)-7(i)-5.6(s p)12.8(u)-17.5(r)-23.

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

e result of this arrangement is that the interest expenses incurred on the debt to nance the acquisition of the shares of Company B have been e ectively shi ed 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 shi ed 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 di cult for a country to deny the deduction of all interest expenses shi ed into a countat

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 à See section 4.2.2.2 for the risks of base erosion as a result of ine ective thin capitalization rules
Interest payments are excessive because they are disproportionate to the taxpayer's earnings	1. Enact earnings-stripping rules à See section 4.2.2.3 for the risks of base erosion as a result of ine ective 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 0 10 232.125 179.701 Tm [(A)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-strip

	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 speci c anti-avoidance rules to protect restrictions on

	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 speci c anti-avoidance rule

Part 3

Designing and dra ing domestic legislation

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

e major design elements in dra ing domestic legislation to counter base erosion with respect to payments of interest

2.1

deductible in computing a taxpayer’s net income subject to tax. erefore, 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 excessive.2(v)( )7.6( )-190482 Td [(e20)-27.3(ha)1.1(an-GB)-(e s

(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:

à All non-residents

à Related non-residents

à Substantial non-resident shareholders, including controlling shareholders, or

à Controlling shareholders

us, the scope of restrictions on excessive interest deductions can re ect.4([(n)11 Tw 1s)]TJ EMC /Span <</Lan

(b) In order to determine whether interest expense is excessive,

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/

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 signi cant complexity to the rules.

- à e 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? e 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 con dence 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.
- à 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

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 a er tax equal to the interest on the loan that would have been charged if no withholding tax had applied. In this case, the e ect of the withholding tax may be to increase the cost of borrowing for residents. is e ect 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 pro ts subject to tax by a country. is 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 xed base in the country. In these situations, the non-resident's pro ts 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

D

Chapter 3

Sample legislative provisions with explanatory notes

3.1 Introduction

is section provides some sample legislative provisions that are designed to reduce the risks of base erosion through deductible interest payments. e 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).

2. Where a resident company is a nancial institution as de ned in _______, any interest paid by the nancial institution in a taxation year shall not be deductible in that year to the extent of the portion of the nancial 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 nancial institution's average debt for the year exceeds __ times the nancial 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 xed base], for the purposes of applying paragraphs 1 and 2:

   (a) e non-resident shall be deemed to be a resident company;

   (b) e non-r

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

Paragraph 2 requires a de nition of “ nancial institution” unless such a de nition exists in a country’s domestic law for other purposes.

Paragraph 3 provides several de nitions 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 de ne the term “interest” to include certain amounts that are economically equivalent to interest so that the restrictions in paragraph 1 apply to those amounts.

e de nition 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. e wording of the de nition of “debt” may require modi cation to re ect 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 capi talization rules because they do not pose any risk of base erosion. A country may decide to treat non-interest-bearing debt as equity.

e de nition 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. e reference to share capital is intended to be the amount for which the shares were originally issued by the company, and will require modi cation 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 modi cation 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. e amount of a company’s retained earnings is included in the de nition of its “(o)11.9(mi)-1d402.9(u)>>BDC1.8(a)18.9(wC /Span <</L10(e)

have interest expenses of 25 and a debt/equity ratio of 250:100; the maxi-
mum 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 e ect, the carry-forward allowed by paragraph 4 is inde nite 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 xed period of years—for example, 3 or 5 years.

If a country decides not to allow any carry-forward for disal-

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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. us, 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 bene ciary, depending on how trusts are treated for purposes of a country's tax laws.

Paragraph 7 makes the restrictions on the deduction of inter- est in paragraphs 1 and 2 applicable to non-residents carrying on busi- ness in the country. Paragraph 7 should apply to any situations in which non-residents are subject to tax on a net basis and their inter-

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. us, if a non-resident uses property with an average cost of 1 million in carrying

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 pro ts 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 speci c 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 speci ed in the country's currency].

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

Explanatory notes

Paragraph 1 provides the basic rule to limit the deduction of-inter est by a resident company to the portion of the interest paid by the company that does not exceed a percentage of its adjusted earnings. e percentage of adjusted earnings speci ed in paragraph 1 must be established by each country according to its particular situation. e terms “interest” and “adjusted earnings” are de ned in paragraph 2. A special rule to limit the interest deductions of nancial institutions may be necessary. If this is the c4.1(s “)4r .1(4.1(s “)4r)-14.506go(p)10.4(h m6182 Td [(e)-712(s)1pe n.9(5(s ¿35.6(e)4.1(n6)-17(0.1(n)20.46506g)460.

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

e term “adjusted earnings” is de ned in paragraph 2 to mean a resident company’s income or pro ts 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 e ect, adjusted earnings is the well-known nancial 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 de ned 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 speci ed percentage of their adjusted earnings, it does not constitute a serious erosion of a country’s tax base. e de minimis threshold must be set at an amount that eliminates a signi cant number of resident companies from the restriction in paragraph 1, but does not permit signi cant base erosion.

Paragraph 4 provides an exemption from paragraph 1 for interest paid by a resident company in connection with a “public bene t” project. A “public bene t” project should be carefully de ned for purposes of this exemption. e 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 nancing does not exceed the value of the asset and the nancing 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 5 Tc 0.13 Tw -28.231 /Spa0.4(o)12.8(n)0.5(y)10.5(e)-5.7(

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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. is 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. ose 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 -inter est that is in accordance with the arm's length standard in Article 9 of the United Nations Model, although such interest deductions

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 " rst person") pays or credits an amount to another person who is not resident in Country X, the rst 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 rst 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. e tax is imposed on the gross amount paid, without any deductions

for expenses incurred by the non-resident recipient in earning the payments. e 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 de ned 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 bene cial owner of the interest, the rst 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. us, 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 speci ed in Article 11.

Moreover, Article 11 is limited to payments of interest as de ned in Article 11 (3) of the United Nations and OECD Model Conventions. erefore, 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

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

apply generally to all withholding taxes, not just to withholding taxes in respect of interest and other nancing 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 xed 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. ese provisions are necessary only if a partnership is treated as a transparent or ow-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. us, 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 e ect 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. us, if the partnership is not considered to be a non-resident person for purposes of the country's

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

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[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).

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. erefore, 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 e e ect 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 nancing 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. erefore, with respect to the negotiation of tax treaties,

under Article 7 (Business pro ts) 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 pro ts attrib- utable 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 xed base). However, Article 7 (3) does not mean that all interest expenses incurred for the purposes of a PE or xed base must be deductible. (is aspect of Article 7 is widely misunderstood.) e deductibility of expenses is a matter of each country's domestic law. erefore, if a 54.5())27.2(. H)15.8(o)18.9(w(e)-7.1(s -

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. is MFN version of Article 24 (3) could be worded as follows:

> (3) e 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 speci c 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

the pro ts attributable to a PE or xed 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 xed 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. ird, 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 xed 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 xed 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 xed base is located. erefore, 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 nal 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 identi ed in Article 11 and the rate speci ed in Article 11 (2). erefore, 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 de nition of interest and the rate of withholding tax.

First, the de nition 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 de nes interest as income from debt claims of every kind. e de ni tion does not refer to or depend on the de nition of interest under a country's domestic law. erefore, countries should review their with holding taxes on interest payments to determine whether those with holding taxes apply to payments that are not covered by the de nition in Article 11 (3) of the United Nations Model Convention. If a coun try's withholding tax applies to payments that are not covered by the de nition in the United Nations Model Convention, it may consider trying to get the other country to agree to expanding the de nition 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 de nition of

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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

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. erefore, 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.

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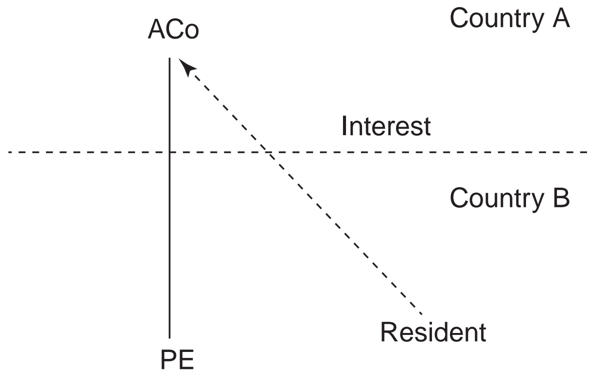

Interest is paid by the resident of Country B to ACo
Debt is e ectively connected with the PE

If the debt owed by the resident of Country B to ACo is not-e ec tively 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.

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Article 23 of the United Nations Model Convention does not

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or earnings-stripping rules to protect its domestic tax base. erefore, 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 nancial 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 t 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 e ectiveness of the rules.

(b) Expressly exclude the country's thin capitalization or earnings-stripping rules from Article 24 (4) and (5). Such

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 pro ts 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 resi dent 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) E

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 pro t shi ing. Chapter 2 deals with disclosure and information reporting requirements. Chapter 3 deals with audit and veri cation activities by tax o cials to detect and counter base erosion and pro t shi ing 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 pro t shi ing 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 pro t shi ing, 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. erefore, the materiald [(i)-1732the present 96M.1(e)-g.8(c)-17(t)-4n

1.9(f b)1.9(a)-13.1(s)-4.7(e e)4.1(r)g53tf baf baoase r4.1(b7s)5eoo9(f b)1.9(a)aehasr ne

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

Tax is imposed pursuant to a country's domestic law. Tax trea ties generally limit the tax imposed under domestic law. erefore, if a country does not impose tax on interest income derived by non-residents under its domestic law, the provisions of its tax trea ties 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

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Chapter 2

Disclosure and information reporting requirements

2.1 Introduction

e 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 nal withholding taxes.

Most of the following information is collected from taxpayers or third persons such as withholding agents and nancial 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. is 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. is 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.

us, 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. e information should

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If a country's thin capitalization rules allow any disallowed interest deductions for a taxation year to be carried forward to -subse

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. erefore, 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. e 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 su cient 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

carried on in the country. is 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 di cult 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 ve main sources:

¾ e non-resident

¾ A local agent or representative of the non-resident

¾ Persons, usually residents, making interest payments to non-residents

¾ e tax authorities of other countries with which a country has a tax treaty providing for exchange of information, and

¾ Public information

 e following parts of this section are organized on the basis of the type of information that a country needs to tax non-residents on

business in a country, this information may be provided pursuant to business registration requirements, in applications for taxpayer identi cation 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 identi cation numbers or to appoint a l182 T7.1(22

the possibility arises that the interest paid by the resident may not be

reporting requirement could also be extended to individuals paying interest to non-residents; however, the compliance burden on indi viduals might be considered to be inappropriate and the requirement might be di cult to enforce.

e type of information that might be required includes:

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 di erently 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 signi cantly 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 nal, 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 simpli ed.

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 veri cation of those deductions is similar to the auditing and veri cation 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 coun

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2. Related-party transactions:
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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, o en through a permanent establishment (PE) or xed base, are subject to tax on their interest income on a net basis. If this is the case, the audit and veri cation activities of that country's tax authorities can focus on the books and records of the PE or xed 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 xed 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. e books and records should be similar to the books and records that resident taxpayers engaged in business must keep.

e 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 xed 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. is 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 e ectively.

3.4 Provisional or nal withholding taxes

If certain persons—usually residents and non-residents carrying on business through a PE or xed 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 le tax returns and pay tax on a net basis, the tax authorities will have access to both the information

3. Payments of interest to related non-residents:
   - h Verify that any interest payments by residents to related non-residents are equal to the arm's length amount
     - Apply transfer pricing rules
4. in capitalization and earnings-stripping rules:
   - h Verify that the restrictions on the deduction of interest paid by resident enterprises to non-residents have been complied with
   - h 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

where the taxpayer is entitled to those bene ts. is 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 o cials of developing countries in applying the provisions of their tax treaties dealing with interest.

is chapter focuses primarily on the risks of base erosion with respect to the provisions of tax treaties dealing with interest. As empha

4.2 Identi cation of non-residents deriving interest income

As discussed in section 2.4.2 above, the rst step for any country that imposes tax on any income of non-residents, including interest, is to identify those non-residents. is step is crucial for the imposition of domestic tax as well as the application of the provisions of an appli

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 identi ed a non-resident receiving interest income that is taxable under the country's domestic tax law, the rst 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 bene ts of that State's tax treaties. erefore, in order to determine if a particular non-resident is entitled to the bene ts 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.

e 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. erefore, where a taxpayer claims the bene ts 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 certi cate from the tax authorities of the other country con rming that the taxpayer is a resident of that other country.

e use of residence certi cates is widespread. Where there is substantial cross-border activity between the two contracting States, it may be bene cial to formalize the use of residence certi cates (as well

[5] United Nations, Department of Economic and Social A airs, 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. e e ciency of the use of residence certi cates 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 certi cate from its country of residence and provide it to the country from which treaty bene ts 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 bene cial owner of interest in order to get the bene t of the reduced rate of source country tax under Article 11 (2) of the United Nations Model Convention. is assumes that, like residence, bene cial ownership is determined under the law of the treaty partner rather than under the source country's law.

e ect, if the non-resident's address re ects a location in the treaty partner, treaty bene ts in the form of lower withholding tax are granted. Relying on addresses in this way makes the delivery of treaty bene ts much more e cient, but it is also susceptible to abuse. erefore, countries may consider not allowing a withholding agent to rely on a recipient's address if the agent has reeot t5(s)3.2(u)-17.2p(o)-3.2(e)-3.6(c)-17(f t)

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

should consider whether the entities have been used for tax avoidance purposes, and if so, whether such tax avoidance can be countered by

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 speci ed in Article 11 (2).

4.5 Quali cation for treaty bene ts

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 satis es all the conditions for entitlement to the bene ts of the particular article. e requirements of Articles 7 and 11 of the United Nations Model Convention dealing with interest are discussed in detail in part 2, chapter-2, sec [illegible]

(a) e taxpayer's claim that it has a PE or xed base in the source country or that it has spent the requisite amount of

expenses incurred on behalf of the PE cannot be denied on the basis that the expenses are incurred outside that country

¾ No deductions are allowed for interest paid by a PE to its head o ce or other parts of the enterprise (except for banking enterprises)

¾ Interest charged by a PE to its head o ce or other parts of the enterprise (except for banking enterprises) must not be taken into account

¾ If it has been customary to determine the pro ts 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

¾ e pro ts 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 pro ts attributable to a xed base, it is generally considered that simi lar rules apply.

In addition, where interest income is derived from transactions between an enterprise that is resident in one country and a related or

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 di erence. Alternatively, a country can collect tax from non-residents earning interest income in the same way that it collects tax from residents. erefore, 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. e 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 e ective with respect to non-residents that do not have signi cant 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 xed base in the country to a resident of the other contracting State. If the recipient

of income—usually on a net basis—and tax owing. is type of with

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

h 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?