United Nations E/C.18/2018/10

Economic and Social Council

Distr.: General
2 August 2018

Original: English

Committee of Experts on International Cooperation in Tax Matters
Seventeenth session
Geneva, 16–19 October 2018
Item 3 (c) (vi) of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest

Note by the Secretariat

1. In its resolution 2017/2, the Economic and Social Council recognized the progress made by the Financing for Sustainable Development Office of the Department of Economic and Social Affairs of the Secretariat in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and the national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in this area and to further develop its activities, including relevant practical tools.

2. One of the areas of focus of the above-mentioned programme is strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. The main tools developed in this area are: (a) the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*; and (b) a series of United Nations Practical Portfolios on Protecting the Tax Base of Developing Countries.

3. The Practical Portfolios are aimed at complementing and operationalizing the guidelines contained in the *United Nations Handbook* through more in-depth and hands-on practical guidance on dealing with various aspects of tax base erosion tailored to developing countries. To date, three Practical Portfolios have been completed and are

* E/C.18/2018/8.

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available in digital format on the website of the Financing for Sustainable Development Office (www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html).[1]

4. The paper contained in the annex to the present note is a summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest, which focuses on the deduction of interest and other financing expenses under the domestic law and tax treaties of developing countries from the perspective of potential tax base erosion and profit-shifting.

5. The Practical Portfolio on Interest is intended to assist tax officials from developing countries in reviewing the provisions of their domestic law and tax treaties dealing with the deduction of interest (any references to interest in the summary are intended to include other financing expenses) in order to identify the major risks of base erosion and the countermeasures that these countries might take to reduce or eliminate those risks.

6. One of the major risks of base erosion is transfer pricing abuses with respect to cross-border payments of interest between entities that are part of a multinational group. Transfer pricing is not dealt with extensively in the Practical Portfolios because the topic is covered separately in the *United Nations Practical Manual on Transfer Pricing for Developing Countries*. Instead, the Practical Portfolio on Interest presents a comprehensive identification of the risks of base erosion with respect to the deduction of interest expenses and the possible countermeasures to those risks in recognition of the widely varying experiences of developing countries and in order to provide tax officials from developing countries with as much information as possible. In the summary, however, only the most important risks of base erosion with respect to interest expenses are dealt with.

7. Neither the Practical Portfolio on Interest nor the summary deal with the domestic laws or tax treaties of particular countries. Instead, they deal with the basic patterns of taxation with respect to interest expenses that are commonly found in the domestic laws and tax treaties of developing countries. Thus, tax officials from developing countries should adapt the materials to their particular situation.

8. The Practical Portfolio on Interest contains four parts. Part 1 consists of a general introduction. Part 2 provides an analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the deduction of interest by residents and non-residents, the risks of base erosion with respect to such income and the possible countermeasures. Part 3 provides guidance for tax officials from developing countries on designing and drafting domestic legislation and negotiating tax treaties to counter base erosion. Part 4 provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with the deduction of interest expenses.

9. The Practical Portfolio on Interest is available only in English. The summary contained in the annex to the present note is intended to provide access to the basic contents of the Portfolio in the other five official languages of the United Nations. It is not intended as a substitute for the much more comprehensive analysis of the risks of base erosion and possible countermeasures presented in the Portfolio, and readers are encouraged to consult the full Portfolio for more detailed information.

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[1] United Nations, Department of Economic and Social Affairs, Financing for Development Office, United Nations Practical Portfolio series, 2017; “Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services”; “Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses”; and “Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties”.

Annex

Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest[a]

I. Major risks of base erosion with respect to the deduction of interest under domestic law

Introduction

1. Base erosion with respect to interest may occur in the following situations:

(a) The deductions of interest are excessive for some reason;

(b) Interest payments received by non-residents are not taxable or are taxable at a reduced rate by the country in which the payer is resident or carrying on business;

(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;

(d) Any combination of the preceding three situations.

Although all deductions of interest erode a developing country's tax base, in most circumstances, interest expenses represent legitimate expenses incurred to earn income that are properly deductible.

2. The risks of base erosion with respect to interest paid to non-residents are greater where:

(a) The payments are deductible by the payer against a developing country's tax base, but are not taxable to the recipient or are taxable at a reduced rate by that country under domestic law or an applicable tax treaty. For example, the deduction of interest will usually result in a reduction of corporate tax in the developing country, but will often not be completely offset by withholding tax on the interest, which will usually be imposed at a rate lower than the corporate rate;

(b) The deductions are excessive because the taxpayer has incurred too much interest expense relative to its debt or its financial earnings;

(c) The deductions are excessive because the interest is paid to a related person and the interest rate exceeds the arm's length rate or the taxpayer has incurred more than an arm's length amount of debt.

Basic concepts

3. Dealing effectively with base-eroding payments of interest requires the tax authorities to distinguish between interest and other payments, especially dividends, and their underlying obligations — debt and equity. Under the tax systems of most countries, interest paid on a company's debt is deductible but dividends paid on a company's shares are not deductible; further, interest received by a company is usually taxable but dividends received with respect to a substantial holding of shares in another company are often exempt from tax.

4. In general, interest is compensation for the use of money, whereas dividends are an after-tax return on an investment in shares of a company. The meaning of "interest"

[a] Prepared by Professor Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada.

for purposes of a developing country's tax system should ideally depend on the substance of the underlying obligation on which the interest is paid and not simply on the legal form of that obligation as debt. Moreover, amounts, such as discounts, that are economically equivalent to interest (that is, they are linked to a financing and computed as a percentage of principal) should ideally be treated the same as interest for tax purposes. For the purpose of the Practical Portfolio on Interest and the present summary, references to interest are intended to include any amounts that are economically equivalent to interest.

5. Hybrid financial instruments are instruments that are treated as debt by one country and as equity by another country; as a result of this inconsistent treatment, they can be used to erode the tax base of developing countries in certain circumstances. For example, a company resident in a country that is part of a multinational group may issue redeemable preferred shares to another group company resident in another country. The first country may treat the shares as debt and any payments on the shares as deductible interest payments, whereas the country in which the holder is resident may treat the shares as equity and the payments on the shares as exempt dividends.

6. In many countries, interest is deductible if it is incurred for the purpose of earning income that is subject to tax; as a result, it is often necessary to determine whether interest expense is incurred to earn taxable income. Three basic methods — tracing the use of borrowed funds, ordering rules under which a positive or negative assumption is made about the use of borrowed funds, and apportionment of borrowed funds to assets or income — are used to determine whether interest is deductible.

7. Where interest is paid by a resident of one country to a related person resident in another country, the potential for base erosion is increased. Transfer pricing is a serious concern where the interest charged is more or less than an arm's length rate, or if the amount of debt on which the interest is paid exceeds an arm's length amount of debt.

Excessive interest expenses

8. The most serious risks of base erosion through interest payments involve excessive payments of interest by resident entities to related non-residents, for example, payments of deductible interest by a subsidiary to its parent company. There are three aspects of the problem of excessive interest deductions:

(a) Transfer pricing issues, as mentioned above;

(b) Thin capitalization, where a resident company claims interest deductions for interest paid to non-residents on an excessive amount of debt relative to its equity;

(c) Earnings stripping, where a resident company claims interest deductions that are excessive relative to the company's earnings or to a standard financial measure of earnings, such as earnings before interest, taxes, depreciation and amortization.

Several countries, including some developing countries, have adopted thin capitalization rules or earnings-stripping rules to restrict excessive interest deductions. These rules are discussed below.

Residents incurring interest expenses to earn foreign-source income

9. There are two basic patterns for taxing residents:

(a) "Territorial" taxation, under which a country taxes only income that is sourced in or derived from its territory; foreign-source income is effectively exempt from tax;

(b) "Worldwide" taxation, under which a country imposes tax on the worldwide income of its residents, including any foreign-source income.

10. Under a territorial system, any interest expenses incurred by residents of a developing country to earn foreign-source income that is exempt from tax should logically not be deductible. It may be difficult for the tax authorities to determine whether interest expenses are properly allocated to exempt foreign-source income (and should in principle not be deductible) or to taxable domestic-source income (and should in principle be deductible). This determination depends on the method — tracing, ordering rules, or apportionment — used by the developing country to allocate interest to sources of income. If tracing is used for this purpose, as is the case in many countries, large enterprises will usually be able to structure their financing arrangements so that interest is deductible against the tax base of the residence country.

11. Even if a country taxes its residents on their worldwide income, including income from foreign countries, there is a risk of base erosion where:

(a) Foreign-source income is taxable on a preferential basis (for example, it is taxable at a lower rate than the generally applicable rate);

(b) The country allows a credit for foreign tax on the foreign-source income and the credit is not limited to the amount of domestic tax on such income (because otherwise the credit will reduce domestic tax on domestic-source income). For this purpose, it is necessary for any expenses incurred by a resident to earn foreign-source income, especially interest expenses, to be allocated to such income for purposes of computing the limitation on the foreign tax credit.

12. As noted above, whether a developing country exempts foreign-source income or taxes that income with a credit for the foreign tax on the income, the rules for determining the geographical source of the income and the allocation of expenses to the income are very important. Under a territorial system, in principle, any interest expenses allocated to domestic-source income should be deductible, but any interest expenses allocated to foreign-source income should not be deductible. Under a worldwide system, any interest expenses incurred to earn foreign-source income should be allocated to that income for purposes of the domestic limitation on the foreign tax credit.

13. A common form of base erosion encountered by many countries involves a resident company incurring interest expenses on borrowed funds used to acquire shares of a foreign company. In this situation, the interest is often deductible against the tax base of the country in which the parent company is resident (the residence country), but the income earned by the foreign company is not usually subject to tax by the residence country when it is earned and dividends received by the parent company may be exempt from tax by the residence country or may not be subject to tax until received in a subsequent year. Thus, interest is deductible currently in the year incurred even though the related income is exempt from tax, or is subject to preferential tax, or tax is deferred until dividends are received. In all three cases, the tax base of the residence country is effectively eroded by the mismatch in the timing of the interest deductions and the taxation of the dividends and by the difference between the tax saving from the interest deductions and any tax on the dividends received from the foreign company or on a gain from the disposition of the shares of the foreign company.

Withholding tax on interest

14. Many developing countries impose withholding tax on interest paid by residents to non-residents. Often, withholding tax on interest is shifted by the non-resident

lender to the resident borrower by requiring the borrower to gross-up the interest payments so that the lender receives a net amount after the deduction of the withholding tax equal to its expected rate of return on a loan not subject to withholding tax; in effect, the withholding tax is borne by the resident borrower and the economic effect is to increase financing costs for residents.

15. Withholding tax on interest paid to non-residents may serve to offset the revenue loss from the deduction of the interest by the resident payer. For example, assuming that a developing country has a corporate tax rate of 30 per cent and imposes withholding tax on interest paid to non-residents at a rate of 30 per cent, the withholding tax will completely offset the reduction in corporate tax as a result of the interest deduction. However, if the rate of withholding tax on interest is less than the corporate tax rate (which is the case in many countries because the withholding tax is imposed on the gross amount of interest or because the rate of withholding is reduced pursuant to a tax treaty), the reduction of the corporate tax will not be completely offset and base erosion will result.

Deduction of interest by non-residents

16. Typically, non-residents are taxable on their income derived from a developing country either on a net basis or a gross withholding tax basis. Where non-residents are taxable on a gross withholding basis (generally on investment income such as dividends, interest and royalties), no deductions are allowed and base-eroding payments of interest are not a concern. However, where non-residents are taxable by a developing country on a net basis, which usually occurs only where non-residents carry on substantial business activities in the country, they will usually be entitled to claim deductions for any expenses, including interest, incurred in earning the income. These interest expenses are legitimate expenses that are properly deductible, assuming that they are incurred for the purpose of earning the income taxable by the developing country. However, there is a risk that non-residents, when computing income taxable by a developing country, may claim interest expenses that are not properly allocated, in whole or in part, to the business activities carried on in that country. The allocation of interest expenses to income earning activities depends on the method of allocation — tracing, ordering rules, or apportionment — used by a country, as discussed above. If a country uses tracing, multinational enterprises can usually structure their financing arrangements to maximize their interest deductions.

17. Interest deductions claimed by non-residents in computing taxable income from a business carried on in a developing country erode the tax base of that country irrespective of whether the interest is paid to a resident or a non-resident of that country. However, the risks of base erosion are more serious where interest paid to non-residents is not subject to tax or is subject to a reduced rate of tax by the developing country.

18. The tax base of a developing country may be eroded by excessive payments of interest by non-residents that are taxable on a net basis in the same way as discussed above with respect to excessive payments of interest by residents. For example, non-residents may pay interest to related persons at a rate that exceeds an arm’s length rate; they may have excessive levels of debt compared with arm’s length parties; and they may pay interest that is excessive as regards their earnings (for example, interest in excess of a certain percentage of their earnings before interest, taxes, depreciation and amortization).

II. Major risks of base erosion with respect to interest under tax treaties

Introduction

19. The provisions of tax treaties may sometimes create opportunities for base erosion with respect to interest expenses because tax treaties often limit the taxes imposed by one contracting State on residents of the other contracting State. Obviously, for any particular developing country, the extent to which its bilateral tax treaties allow its domestic tax base to be eroded depends on: (a) how many tax treaties it has concluded; (b) the countries with which it has concluded tax treaties; and (c) the provisions of those tax treaties.

20. In general, tax treaties are based on either the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) and the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD Model Convention). Many developing countries negotiate the provisions of their tax treaties based on the United Nations Model Convention because it provides greater taxing rights for source countries.

21. Tax treaties do not generally impose tax; tax is imposed pursuant to a country's domestic law. Therefore, if an amount of income derived by a non-resident from a country is not taxable under that country's domestic law, it is irrelevant whether the country has the right to tax the amount under the provisions of an applicable tax treaty.

22. There are two major questions with respect to the treatment of interest 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 by residents of the other contracting State in circumstances where no deduction would be allowed under domestic law?

Withholding tax on interest

23. Under article 11 (2) of the United Nations and OECD Model Conventions, where interest arises in a contracting State and is paid to a resident of the other State, the gross amount of the interest may be taxed by the State in which the interest arises. If the recipient is also the beneficial owner of the interest, the rate of tax on the interest is limited to the rate agreed by the contracting States (the OECD Model Convention proposes 10 per cent of the gross amount of the interest payments). Interest arises in a contracting State where the payer is a resident of that State or where a non-resident has a permanent establishment (or fixed base) in that State, the debt was incurred in connection with the permanent establishment (or fixed base) and the interest is deductible in computing the profits attributable to the permanent establishment (or fixed base).

24. In general, if article 11 (2) applies, a developing country's withholding tax on interest paid to a non-resident is reduced to the rate specified in the article. Although this reduction in tax can be seen as a form of base erosion, by adopting article 11, the developing country has agreed to the reduction through bilateral negotiations with the other country as part of the entire package of tax treaty provisions. However, the tax authorities must administer the provisions of article 11 to ensure that a non-resident qualifies for its benefits. For this purpose, the tax authorities must determine that:

(a) The recipient of the interest is a resident of the other country under the treaty;

(b) The interest arises in the country;

(c) The non-resident recipient of the interest is the beneficial owner of the interest.

25. Where interest is deductible in computing the profits attributable to a non-resident's permanent establishment or fixed base in a country, the interest is deemed to arise in that country and the country is entitled to impose withholding tax on the payment; however, unless such a withholding tax is imposed under the country's domestic law, the treaty provision is irrelevant since the treaty itself does not impose tax. The imposition of withholding tax on the interest in this situation is important because it offsets the effect of the deduction of interest by the non-resident in computing the profits attributable to the permanent establishment or fixed base. For this purpose, it is important for the tax authorities of the developing country in which the permanent establishment or fixed base is located to verify that the debt is effectively connected to the permanent establishment or fixed base.

Deduction of interest under the provisions of tax treaties

26. In general, the deduction of interest is governed by domestic law rather than the provisions of tax treaties even where the provisions of a tax treaty require the income of a non-resident to be taxed on a net basis. However, tax treaties based on the United Nations Model Convention do impose limits on a country's domestic law with respect to the deduction of interest.

27. First, article 7 (3) of the United Nations Model Convention requires the country in which a permanent establishment is located to allow, when determining the profits attributable to a permanent establishment, deductions for the expenses incurred for the purposes of the business of the permanent establishment. It also provides that such deductions must be allowed irrespective of where the expenses are incurred (that is, in the country where the permanent establishment is located or elsewhere). In addition, the deduction of notional interest expenses for amounts advanced by a permanent establishment to its head office or by the head office to a permanent establishment is explicitly prohibited by article 7 (3) of the United Nations Model Convention, except in the case of financial institutions (in contrast, the commentary on article 7 of the OECD Model Convention indicates that the deduction of such notional interest expenses should be allowed in a wider set of circumstances). Thus, only actual interest expenses incurred by an enterprise for purposes of the business of a permanent establishment are deductible under the United Nations Model Convention.

28. Article 7 (3) deals with the issue of which expenses are attributable to a permanent establishment; it does not deal with the issue of whether those expenses attributable to a permanent establishment are deductible, which is a matter for domestic law (see paragraph 18 of the commentary on article 7 of the United Nations Model Convention, quoting paragraph 30 of the 2008 OECD commentary).

29. Second, although article 14 of the United Nations Model Convention does not contain any provision similar to article 7 (3), the commentary on article 14 provides that the same principles should apply to the computation of the income attributable to a fixed base, including the deduction of expenses.

30. Third, the United Nations Model Convention does not prescribe any particular method for determining the amount of debt and equity of a permanent establishment and the amount of interest to be allowed as a deduction in computing the profits attributable to a permanent establishment. Some guidance on this issue can be found in paragraphs 41 to 44 of the commentary on article 7 of the 2010 OECD Model Convention, as quoted in paragraph 18 of the commentary on the same article of the United Nations Model

Convention, as well as in the OECD *2010 Report on the Attribution of Profits to Permanent Establishments* (available from http://www.oecd.org/ctp/transfer-pricing/45689524.pdf).

31. Fourth, under article 24 (3) of both the United Nations and OECD Model Conventions, a contracting State is prohibited from taxing a permanent establishment of a resident of the other contracting State less favourably than it taxes its own enterprises carrying on similar activities. Thus, where a tax treaty containing article 24 (3) applies, a country must allow non-residents to deduct interest expenses attributable to a permanent establishment on the same terms and conditions that apply to the deduction of interest by residents. However, where a country levies a branch-level interest tax (that is, a tax on the amount of any interest deducted in computing the profits attributable to a permanent establishment), article 24 (3) does not apply because the tax is not levied on the permanent establishment, but on the enterprise to which the interest is considered to be paid. Article 24 (3) applies only to the tax imposed on a permanent establishment, and not to any connected requirements, such as information reporting and penalties. Finally, article 24 (3) does not apply to the taxation of income attributable to a fixed base under article 14 of the United Nations Model Convention.

Restrictions on the taxation of residents under tax treaties

32. Although tax treaties do not generally limit the power of a country to tax its own residents (a principle which is now expressly stated in article 1 (3) of the United Nations and OECD Model Conventions), there are a few exceptions to this general principle that are relevant with respect to interest.

33. First, under article 23 of both the United Nations and OECD Model Conventions, the residence country is under an obligation to provide relief from double taxation with respect to an item of income that is taxable by the source country in accordance with the provisions of the treaty. This obligation must be met by exempting that income from residence country tax or by granting a credit against the residence country's tax for the foreign tax paid on that income. As explained above, in principle, any interest expense incurred by a resident of a country to earn foreign-source income that is exempt from residence country tax would not be deductible; also, where foreign-source income is taxable by the residence country, any interest expense incurred to earn that income would be deductible but would be allocated to that income for purposes of computing the limitation on the foreign tax credit.

34. Second, article 24 (4) of both the United Nations and OECD Model Conventions requires a contracting State to allow the deduction of interest (and other payments) 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 does not apply to excessive payments of interest under article 9 or article 11 (6). For example, article 24 (4) would prevent a country from denying the deduction of interest paid by a resident to a non-resident where a deduction would be allowed for a similar payment of interest to another resident. Article 24 (4) would also prevent a country from applying thin capitalization rules or earnings-stripping rules to prevent the deduction of excessive interest paid to non-residents unless those rules are compatible with the arm's length standard under article 9 or are also equally applicable to interest paid to residents.

35. Third, under article 24 (5) of both the United Nations and OECD Model Conventions, resident enterprises of one State owned or controlled by residents of the other State must not be subjected to taxation or any connected requirement that is different from or more burdensome than the treatment of similar resident enterprises. For example, article 24 (5) would prohibit the application of rules for the deduction of interest paid by a resident company owned or controlled by non-residents that are

less favourable than the rules for the deduction of similar interest paid by resident companies owned by residents.

III. Countermeasures to prevent base erosion with respect to interest expenses

Introduction

36. Each developing country must decide for itself whether and to what extent it is concerned about the risks of base erosion identified above with respect to interest, and if so, how best to deal with those risks. This part of the summary identifies possible countermeasures that developing countries might adopt to deal with the major risks of base erosion arising from the provisions of a developing country's domestic law or from its tax treaties with respect to interest. The following material is intended as guidance, not as recommendations, for developing countries to consider in deciding whether to adopt countermeasures to prevent base erosion and in deciding on the application of those measures.

37. 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 with respect to payments of interest are clearly greatest where the payments are deductible against a country's tax base and are made to non-residents. Such interest payments ordinarily reduce the payer's income subject to tax and are not subject to tax or are subject to a reduced rate of tax to the non-resident recipient.

Countermeasures under domestic law

Restrictions on the deduction of excessive interest

38. As discussed above, interest may be considered excessive where the interest rate is higher than the interest rate on arm's length debt with similar terms, where the amount of debt is excessive, or where the amount of deductible interest is excessive based on some debt-equity ratio or interest-earnings ratio. A wide range of countermeasures is available to developing countries for dealing with the problem of excessive interest, although the effectiveness of these measures varies considerably. For example:

(a) Transfer pricing rules may be used to attack the deduction of excessively high interest rates and interest on excessive amounts of debt (see the *United Nations Practical Manual on Transfer Pricing for Developing Countries*); however, transfer pricing rules are difficult to apply effectively, especially for developing countries that may lack adequate administrative resources and expertise and they usually apply only to interest payments to related or associated enterprises;

(b) A general limitation restricting the deduction of expenses, including interest, to a reasonable amount; however, such a limitation is vague, general and uncertain and may be ineffective;

(c) A general anti-avoidance rule; however, a general anti-avoidance rule is usually targeted at sophisticated tax avoidance arrangements rather than excessive deductions.

As a result of these concerns, some countries have decided that specific restrictions on the deduction of excessive interest — thin capitalization rules or earnings-stripping rules — are more likely to be effective.

39. Thin capitalization rules are typically applied to deny the deduction of interest paid by a resident company to either:

(a) A substantial (defined as a shareholder that owns 5, 10 or 25 per cent or more of the shares of the resident company) or controlling non-resident shareholder that holds a disproportionate amount of debt of the resident company relative to its equity shares in the company. Under thin capitalization rules that apply in this manner, the excessive portion of the non-resident shareholder's debt in the resident company is considered to be disguised equity;

(b) Any non-resident if the resident company has excessive debt relative to its equity. Under thin capitalization rules that apply in this manner, any interest paid to non-residents is not deductible to the extent that the resident company's debt-equity ratio exceeds a specified ratio.

Earnings-stripping rules are similar in principle to the second type of thin capitalization rules, except that excessive interest is measured by reference to an entity's interest expenses relative to its earnings.

40. Developing countries may want to consider applying thin capitalization or earnings-stripping rules to interest deductions claimed by non-residents in computing income that is taxable on a net basis. In addition, the tax authorities of developing countries may want to ensure that non-residents do not deduct excessive interest expenses in computing net income earned in a country by allocating excessive debt to the business carried on in that country.

41. Developing countries that decide to adopt thin capitalization or earnings-stripping rules need to carefully consider many difficult tax policy issues in designing the rules. These legislative design issues and sample legislation with explanatory notes can be found in the Practical Portfolio on Interest.

Deductible interest payments to non-residents: withholding tax on interest

42. Since interest payments to non-residents that are deductible against a country's tax base reduce its tax base, in principle, the country should impose withholding tax on such payments at a rate that offsets the tax saving from the deduction. However, withholding tax on interest is often borne by resident borrowers and as a result, withholding tax levied on interest at a high rate may limit access of resident businesses to foreign capital markets. As a result, some countries may wish to impose withholding taxes on interest under domestic law or their tax treaties at a lower rate or even exempt certain payments of interest from withholding tax.

43. Developing countries should consider ensuring that any deductible interest payments made by non-residents to other non-residents are subject to withholding tax. Sample legislation with explanatory notes with respect to withholding tax on interest is included in the Practical Portfolio on Interest.

Restrictions on the deduction of interest by non-residents

44. Developing countries might consider the following countermeasures to deal with base erosion through deductible interest expenses incurred by non-residents:

(a) Deny the deduction of all interest expenses incurred by non-residents or all interest expenses paid by non-residents to non-resident lenders. Such a measure is generally viewed as arbitrary and inappropriate because interest expenses are legitimate income earning expenses that should be deductible. In addition, as discussed below, to the extent that a developing country has entered into tax treaties with a non-discrimination provision similar to article 24 (3) of both the United Nations and OECD Model Conventions, that provision will prevent the developing country from limiting or denying the deduction of interest by non-residents carrying on business through a permanent establishment unless similar restrictions are applied to residents of the developing country;

(b) Deny the deduction of interest paid by non-residents to non-resident lenders unless the non-resident payers withhold tax from such payments. As discussed below, to the extent that a developing country has treaties containing provisions similar to article 24 (3) of the United Nations and OECD Model Conventions, those provisions will prevent this type of condition on the deduction of interest unless it applies equally to resident payers;

(c) Apply robust audit and verification administrative measures to ensure that any interest deductions claimed by non-residents are appropriate.

Deductible interest expenses to earn exempt or preferentially taxed income

45. As mentioned above, base erosion from interest deductions claimed by residents is a serious problem for a country whenever the associated income is exempt from tax, is taxed at a preferential rate or can be deferred for a substantial period. For developing countries that are primarily capital-importing countries, this aspect of base erosion through interest payments is much less important than the other aspects of base erosion; therefore, the possible responses to this type of base erosion are discussed only briefly in the present summary.

46. Where a developing country exempts foreign-source income, it should not, in principle, allow the deduction of any expenses, including interest, incurred to earn such income.

47. Where a developing country imposes tax on foreign-source income earned by residents, it will usually allow a deduction for interest expenses incurred to earn the income and grant a credit for foreign tax on the income. The foreign tax credit should be limited to the developing country's domestic tax on the foreign-source income. Whether foreign-source income is exempt or taxable with a foreign tax credit, the developing country should consider having clear rules — tracing, ordering rules, or apportionment — to allocate interest expenses to foreign-source income and should consider vigorously enforcing these rules.

48. Similar responses should be used to deal with the risks of base erosion where residents of a developing country incur interest expenses to acquire shares of a foreign company. Where dividends received by a resident from the foreign company are exempt, any interest expenses incurred by the resident to acquire the shares should, in principle, not be deductible. Also, where dividends from foreign companies are taxable, the deduction of interest should in principle be deferred until dividends are received; if the country provides an indirect foreign tax credit for the underlying foreign corporate tax on the income out of which the dividends are paid, any interest expenses should in principle be allocated to that income for purposes of the limitation on the foreign tax credit. In both cases, developing countries require clear rules — tracing, ordering, or apportionment rules — for allocating interest expenses to the shares of non-resident companies, and the tax authorities should be vigilant in applying those rules to ensure that any interest expenses are properly allocated for this purpose.

Special risks and countermeasures

49. Taxpayers have opportunities to use back-to-back arrangements to avoid withholding taxes on interest and restrictions on the deduction of interest. For example, withholding taxes may be imposed only on payments of interest to non-residents with whom the payer does not deal at arm's length; as a result, a

non-resident may place funds on deposit with an arm's length financial institution on condition that the financial institution loan the funds to a resident company that does not deal at arm's length with the non-resident. The payments of interest to the financial institution would not be subject to withholding tax, but withholding tax would have applied if the non-resident had loaned the funds directly to the resident company. Developing countries might adopt specific anti-avoidance rules or apply a general anti-avoidance rule to deal with abusive back-to-back arrangements.

50. Where a foreign company acquires the shares of a company resident in a developing country, a common tax avoidance strategy is to use a "debt push-down arrangement" to shift the debt (and the related interest expense) used to finance the acquisition to the acquired company in the developing country. The result of such an arrangement is that the interest expense on the acquisition debt will be deducted against the tax base of the developing country rather than against the tax base of the country in which the foreign company is resident. Designing an appropriate response for debt push-down arrangements is very difficult because they can take different forms and because not all such arrangements are abusive. If a developing country has thin capitalization or earnings-stripping rules, those rules may limit, but not completely deny, the interest deductions from debt push-down arrangements. Developing countries might consider enacting specific anti-avoidance rules to deal with abusive debt push-down arrangements or applying a general anti-avoidance rule if it has such a rule.

Countermeasures under tax treaties

51. Tax treaties entered into by a country that contain provisions similar to articles 24 (4) and 24 (5) of the United Nations and OECD Model Conventions may prevent that country from applying thin capitalization or earnings-stripping rules that apply only to interest paid to non-residents. To avoid this result, a country might:

(a) Decline to enter into tax treaties;

(b) Refuse to agree to the inclusion of articles 24 (4) and 24 (5) in its tax treaties;

(c) Enact thin capitalization or earnings-stripping rules that apply to interest paid to both residents and non-residents;

(d) Provide an exemption from the thin capitalization or earnings-stripping rules where interest paid to non-residents complies with the arm's length standard in article 9;

(e) Insist on expressly excluding its thin capitalization or earnings-stripping rules from articles 24 (4) and 24 (5);

(f) Insist on limiting articles 24 (4) and 24 (5) to most-favoured-nation treatment rather than national treatment.

52. Article 24 (3) of the United Nations Model Convention may prevent a developing country from applying its thin capitalization or earnings-stripping rules to interest paid by non-resident enterprises resident in the other contracting State carrying on business in the developing country through a permanent establishment. To avoid this result, a developing country might:

(a) Decline to enter into tax treaties;

(b) Refuse to include article 24 (3) in its tax treaties, although other countries are likely to insist on its inclusion;

(c) Enact thin capitalization or earnings-stripping rules that apply equally to interest borne by permanent establishments and interest paid by resident companies;

(d) Insist on limiting article 24 (3) to most-favoured-nation treatment rather than national treatment.

53. A country’s tax treaties may prevent the country from imposing its withholding tax on certain payments of interest to residents of its treaty partners or may require it to reduce its rate of withholding tax on interest payments to residents of its treaty partners. Developing countries could insist on maintaining reasonable rates of withholding tax on interest, such as 10 or 15 per cent, in their treaties, which would reduce the extent of any base erosion through deductible interest payments. However, non-resident lenders may require resident borrowers to bear the cost of any withholding tax on interest by grossing up the interest payments. Countries should also ensure that any exemptions from withholding tax on interest are clearly justified.

54. In certain circumstances, article 7 (3) of the United Nations Model Convention could prevent a developing country from denying the deduction of interest in determining the profits attributable to a permanent establishment where the interest is incurred for the purposes of the permanent establishment (see para. 26).

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

IV. Tax administration issues

56. In most situations, non-residents are subject to final withholding taxes on the gross interest payments they receive from residents. The tax withheld is the final tax; the non-resident is not allowed to file a tax return and pay tax on a net basis, except perhaps where the non-resident carries on business in a country. To the extent that non-resident recipients of interest are subject to withholding, the obligations to identify non-residents subject to tax and the amount of the tax are effectively shifted to the withholding agents, although the tax authorities must audit withholding agents to ensure that they meet their obligations. Where non-residents are subject to tax on a net basis, they should be subject to the ordinary audit and verification process, especially with respect to interest paid to non-residents.

57. In order to effectively administer the provisions of domestic law and tax treaties, the tax authorities require the power to gather the necessary information from the taxpayer and other persons, such as financial institutions and withholding agents, and to audit and verify that the provisions of domestic law have been complied with. Therefore, developing countries should consider whether the disclosure and information reporting requirements under its domestic law for any restrictions on the deduction of interest by residents and non-residents, including thin capitalization, earnings-stripping and transfer pricing rules, and for withholding tax on non-residents receiving interest are adequate and whether the resources devoted to audit and verification activities are adequate for this purpose.

58. The tax authorities of developing countries also need to apply the provisions of their tax treaties with respect to the treatment of interest. In this regard, the application of tax treaties involves the determination of:

(a) The residence of a non-resident recipient of interest (often, certificates of residence from the foreign tax authorities are required for this purpose);

(b) Whether article 7 (or article 14 in the case of independent personal services) or article 11 of the treaty applies; in general, article 7 or article 14 will apply to interest received by a non-resident if the non-resident carries on business in the developing country through a permanent establishment or fixed base, the debt claim is effectively connected to the permanent establishment or fixed base, and the interest income is attributable to the permanent establishment or fixed base;

(c) Whether interest expense incurred by a non-resident is deductible in computing the profits attributable to a permanent establishment or fixed base under article 7 or article 14;

(d) Whether the non-resident qualifies for the benefits of the particular article of the treaty (for example, the non-resident must be the beneficial owner of the interest in order to qualify for the lower rate of withholding in article 11 (2));

(e) Any anti-treaty shopping or limitation-on-benefits provision must not apply.

Checklist of the major risks of base erosion and possible countermeasures

Risk	*Countermeasure*
Excessive interest deductions	
• Interest payments to related non-residents in excess of arm's length amount	• Apply transfer pricing rules • Enact thin capitalization or earnings-stripping rules
• Interest payments to substantial shareholders are in substance payments in respect of their equity investments	• Apply transfer pricing rules (tax treaties will prevent the application of the rules to non-controlling shareholders) • Enact thin capitalization rules or rules to treat some shareholder debt as equity and interest on that debt as not deductible
• Interest payments are excessive because the taxpayer has disproportionate debt relative to equity	• Enact effective thin capitalization rules
• Interest payments are excessive because they are disproportionate to the taxpayer's earnings (earnings before interest, taxes, depreciation and amortization)	• Enact effective earnings-stripping rules
• Provisions of tax treaties (article 24 (4) or article 24 (5)) may prevent the application of restrictions on excessive interest deductions	• Do not enter into tax treaties • Do not agree to include article 24 (4) or 24 (5) • Apply any restrictions on interest deductions to both residents and non-residents • Allow interest deductions if they conform to the arm's length standard in article 9 (1) • Exclude any restrictions on interest deductions from article 24 (4) and article 24 (5)
Withholding taxes on interest	
• No or reduced withholding tax on interest paid to non-residents under domestic law	• Impose high withholding taxes on all interest payments to non-residents (This response could have serious disadvantages)
• No or reduced withholding tax on interest paid to non-residents under tax treaties	• Maintain reasonable rates of withholding tax on interest paid to non-residents • Ensure that any exemptions are clearly justified
• No withholding tax on payments of deductible interest by non-residents to non-residents	• Ensure that withholding tax on interest applies to payments of interest by non-residents that are deductible in computing their business income earned in the developing country

Risk	*Countermeasure*
Deductible interest incurred by residents to earn exempt or preferentially taxed income	
•Interest is deductible but foreign-source income is exempt	•Deny deduction of interest •Adopt robust rules for allocating interest expenses to foreign-source income
•Foreign-source income is taxable but interest is not allocated to that income for purposes of the limitation on the foreign tax credit	•Limit foreign tax credit to domestic tax on the net foreign-source income •Adopt robust rules for allocating interest expenses to foreign-source income
•Interest expenses incurred to acquire shares of foreign companies:	•Deny deduction of interest
(a) where dividends are exempt	•Apply robust rules for allocating interest expenses to exempt dividends
(b) where dividends are taxable	•Defer any deduction of interest until dividends are received •Limit foreign tax credit to domestic tax on the dividends •Apply robust rules for allocating interest expenses to taxable dividends
Miscellaneous risks of base erosion through interest deductions	
•Back-to-back arrangements	•Adopt specific anti-avoidance rules to protect restrictions on interest deductions and withholding tax on interest •Apply a general anti-avoidance rule
•Debt push-down arrangements	•Adopt restrictions on interest deductions (for example, thin capitalization or earnings-stripping rules) •Adopt specific anti-avoidance rules or apply general anti-avoidance rule