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

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Limiting Interest Deductions

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Limiting Interest Deductions and Other Financial Payments

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

The BEPS project puts the issue of interest squarely into focus. Action

I

- A debt instrument, classically a loan (from a bank, perhaps) or a bond (issued by a government or corporate borrower), entitles the holder to receive a fixed, periodic return, typically called interest. The holder does not have an ownership interest in the borrower, so the holder does not share in profits of the borrower. But, for the same reason, the holder ranks ahead of the owners of the borrower

The availability and use of debt is widely recognized as an important element of a healthy business environment. Indeed, a lack of credit can deter economic growth. This point is illustrated by the efforts of governments today to ensure that increased regulation of financial institutions is balanced against the

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

C. Related Party Debt in Capitalizing an Enterprise

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

> Example: Acme Corporation, a resident of Country X, seeks to create a subsidiary corporation, Beta Corporation, in Country Y. Beta requires initial funding of $1,000 in order to begin business. Acme could provide that funding by
>
> - Investing $1,000 of equity, or
> - Investing $500 of equity and $500 of debt (or any other combination of debt and equity).

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

i. Tax considerations

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

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

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

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

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

- Does Country Y impose a withholding tax on the interest payment to Acme, and, if so, what is the rate? How does the economic impact of that withholding tax compare to the potential economic benefit of the income tax deduction to Beta for the interest payment?

- What is the tax treatment of Acme in Country X? Is the interest taxable to Acme? At what rate? How does the tax treatment of the interest received by Acme in Country X compare to the tax treatment of a dividend received by Acme in Country X?

- If there is a withholding tax imposed by Country Y on dividends, or interest, or both, can that withholding tax be claimed as a credit against the Country X tax, or are there other considerations (e.g., excess foreign

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

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

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

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

iii. <u>Summary</u>

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

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

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

D. Branch Operations

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

Concerns regarding the deductibility of interest

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

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

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

1. Debt:Equity Ratios

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

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

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

ii. Interest as a Share of a Prescribed Financial Ratio

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

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

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

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

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

a. Debt:equity ratios

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

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

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

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

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

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

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

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

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

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

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

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

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

e. Summary

As a matter of policy, it is appropriate – and consistent with international norms – to deny a deduction for interest expense that is "excessive" by some measure. This tax policy parallels and reinforces non-

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

- For instance, many developing countries, including China and India, tax their multinational corporations on worldwide income. But, income earned outside the home country may be deferred for a period of time, before home country tax is imposed. If a resident company incurs interest expense within its home country, should some portion of that expense be allocated to the investments and income earned from those investments outside the home country? And, if so, should a portion of the current interest expense be disallowed (or deferred) until the foreign income is taxable in the home country? If the answer is yes, how should the allocable expense be determined?

- In countries with a territorial tax system, so that active earnings outside the home country of a taxpayer are not subject to home country tax, a similar issue arises. Should some portion of the home country interest expense be allocable to this exempt income and disallowed permanently?

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

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

There are several options:

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

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

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

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

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

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

1. Ease of administration. Treating all interest expense as a single item is generally easier for both taxpayers and tax administrators. Otherwise, taxpayers and tax officials must analyze the sources of debt and separate interest payments into different categories for purposes of tax deductibility. Further, if interest expenses are

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

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

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

D. Interest Paid to Related Parties

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

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

- Dart Corporation, resident in Country A, needs to borrow $1,000. It obtains a loan from Extra Corporation, resident in Country B, for $1,000 at an interest rate of 8%, or $80 annually.

- Dart pays the $80 to Extra, subject to a 10% withholding tax. So, Extra receives $72 in cash, plus a credit for the $8 that Dart withheld and remitted to the Country A tax authorities.

- Dart deducts the $80 of interest in determining its taxable income. The tax rate in Country A is 25%, and Dart has sufficient income to fully benefit from the $80 deduction. Dart saves $20 in Country A tax because of the tax deduction.

- Country A has received $8 in withholding taxes on the payment to Extra, but has foregone $20 in tax revenue it otherwise would have received from Dart. There is a negative tax rate arbitrage to the Country A fisc from this transaction, but the withholding tax reduced the revenue loss from $20 to $12.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- In some cases, the PE calculates its interest expense as if it were a separate legal entity from the parent, based on its own books and records; but

- In other situations, the PE determines its interest expense as a share of the total interest expense incurred by the enterprise of which it is a part. Article 7 (Business Profits) of the UN Model Double Taxation Convention specifically provides that, except in the case of a bank, a PE will not be allowed a deduction for any interest that is notionally charged to the PE by the head office (nor will the PE be considered to earn any interest that it notionally charges to the head office or another branch.) Instead, the PE will be entitled to a deduction for its “allocable share” of interest expense incurred by the enterprise as a whole.

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

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

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

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

VI. Conclusion

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

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