

Trends in Treaty Rates for Withholding Tax on Interest

Dennis L. Nerland, QC

Background of BEPS

- OECD adopted Declaration on BEPS in 2013 at the request of G20 Finance Ministers
- BEPS is a “serious risk” to tax revenue, tax sovereignty, and trust in domestic regimes¹
- Comprehensive Action Plan (CAP)
- Debt financing and hybrid mismatches

1. OECD Declaration on Base Erosion and Profit Shifting, Adopted 29 May 2013.
2. OECD Centre for Tax Policy and Administration, BEPS – Frequently Asked Questions, 51
3. *Ibid.*

Background of BEPS

- Dual goals for CAP:
 - Counter abusive tax planning
 - Do not curb foreign direct investment
- Existing Countermeasures:
 - Related-group thin capitalization rules
 - General interest barriers to third-party thin capitalization
 - Non-deductibility of interest related to tax-exempt dividends
 - Withholding taxes on interest

OECD Action Plan

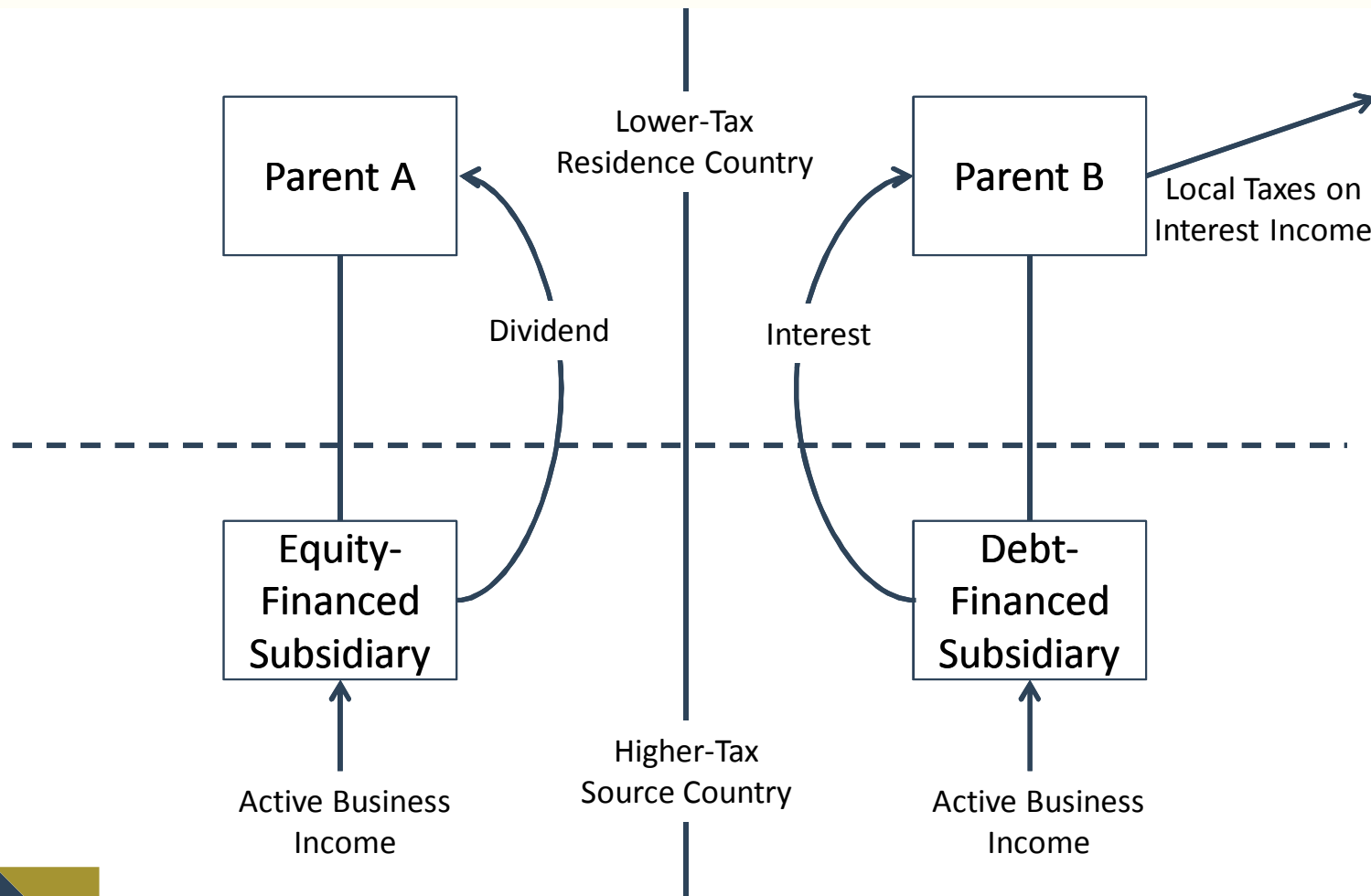
- OECD identified 15 Actions to address BEPS
- Base erosion via hybrid mismatch and interest deductions (Actions 2 & 3) are a small subset of many tools used to shift profits

Debt Bias in Financing International Operations¹

- Group financing presents tax arbitrage opportunities
- Two conditions required:
 1. Deductible interest vs. non-deductible dividends
 2. Differential tax rates in source and residence countries

1. Johanna Hey, "Base Erosion and Profit Shifting and Interest Expenditure" Bulletin for International Taxation June/July 2014, pp. 332-345.

Debt Bias in Financing International Operations



31-Oct-14

Debt Bias in Financing International Operations

	Equity Financed 5% Withholding Tax	Debt Financed 10% Withholding Tax	Debt Financed No Withholding Tax
Earnings before Interest and Taxes	\$ 100.00	\$ 100.00	\$ 100.00
Interest Deduction	\$ -	\$ 66.67	\$ 66.67
Taxable Income	\$ 100.00	\$ 33.33	\$ 33.33
Source Country Tax (35%)	\$ 35.00	\$ 11.67	\$ 11.67
Available for Repatriation by Dividend	\$ 65.00	\$ 21.67	\$ 21.67
Withholding Tax	\$ 3.25	\$ 7.75	\$ 1.08
Resident Country Tax (25%)	\$ -	\$ 16.67	\$ 16.67
Total Taxes Paid	\$ 38.25	\$ 36.08	\$ 29.42
Net income received by Parent	\$ 61.75	\$ 63.92	\$ 70.58

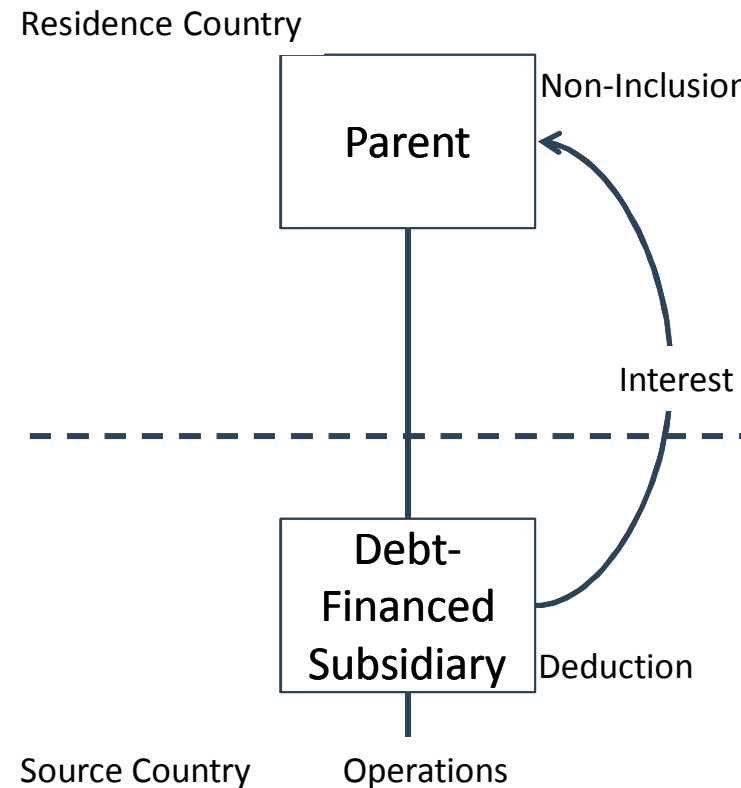
Assumptions:

1. Dividend income is exempt in the Resident Country
2. Interest income is taxed in the Resident Country
3. Source country has a thin capitalization rule limiting the Debt to Equity ratio to 2:1

31-Oct-14

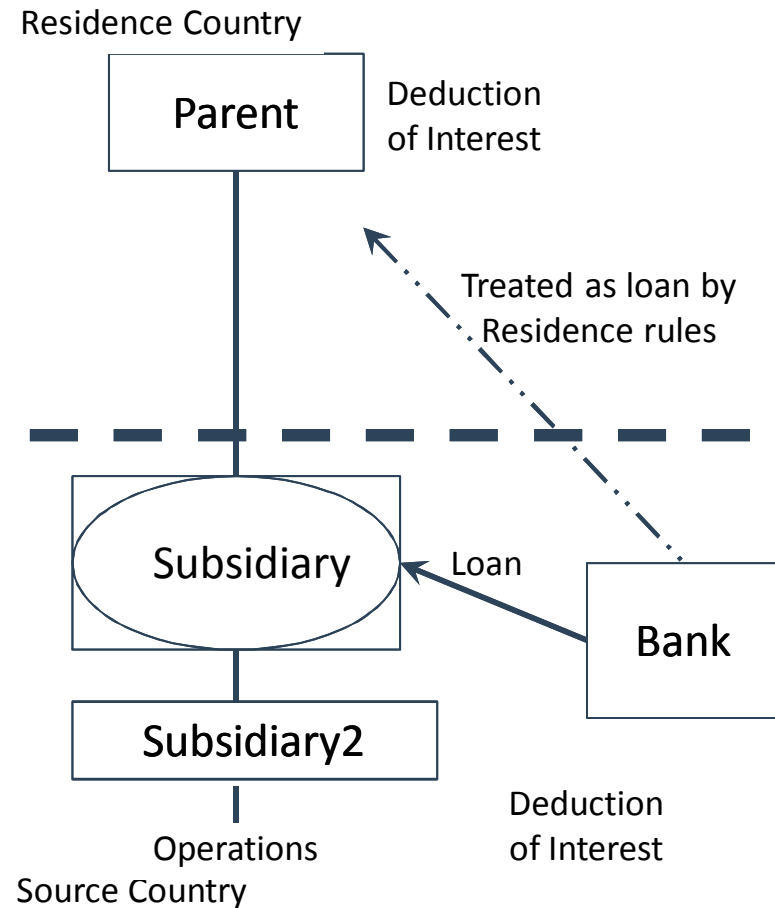
Hybrid Mismatch Arrangements

- Companies may produce tax arbitrage from differences in tax treatment by different countries
- Amounts deductible in Country A may not be included in income in Country B



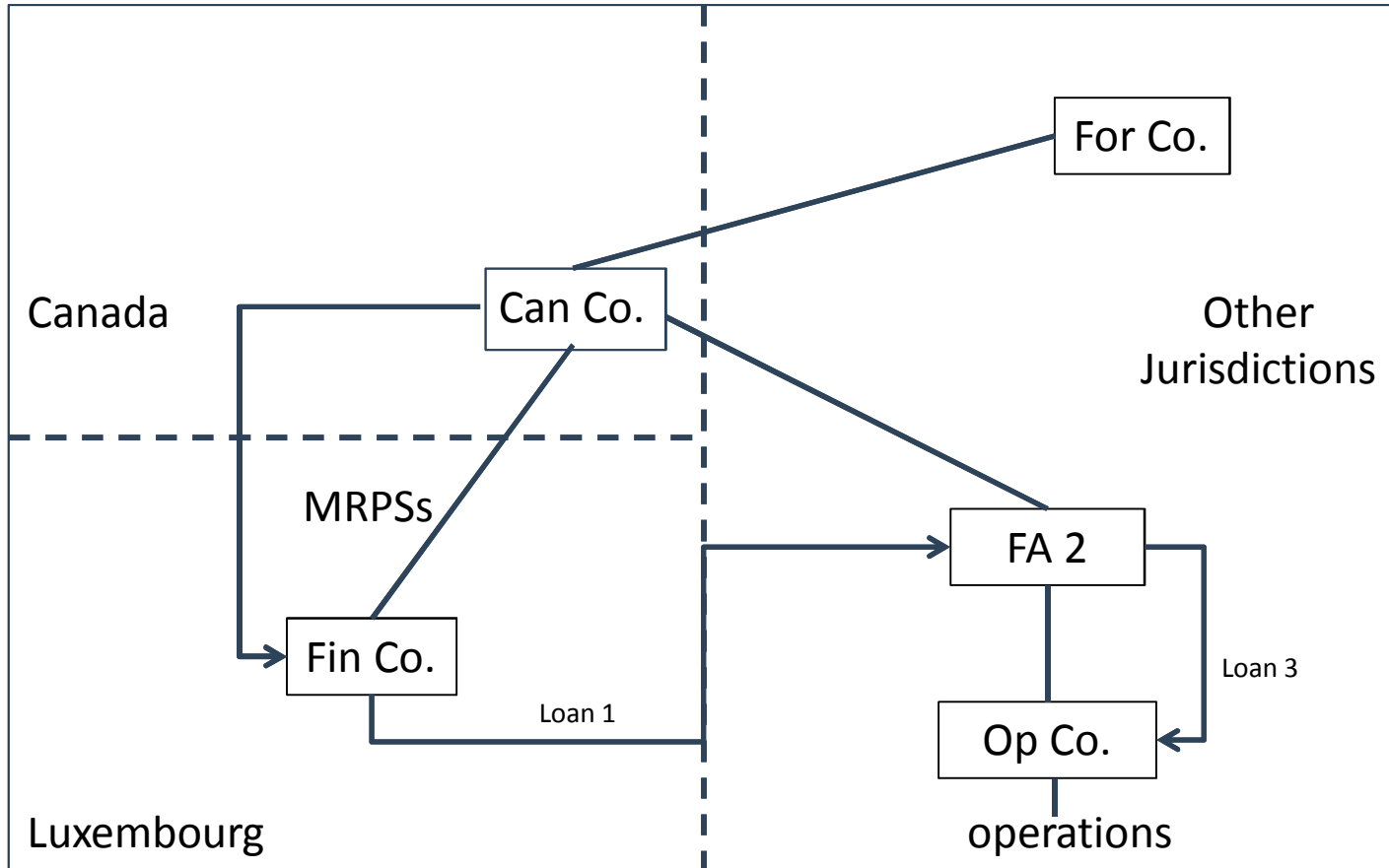
Double Dip Arrangements

- Hybrid entities may allow deduction of one expense in two jurisdictions



31-Oct-14

Canada-Luxembourg MRPS Double-Dip



Effect of Debt Financing and Double Dip on After-Tax Cost of Capital

	100% Equity Financed	2:1 D/E Ratio	3:1 D/E Ratio	Double Dip, 3:1 D/E Ratio
Capital Required	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Equity Portion	\$ 100.00	\$ 33.33	\$ 25.00	\$ 25.00
Debt Portion	\$ -	\$ 66.67	\$ 75.00	\$ 75.00
Cost of Equity	10%	10%	10%	10%
Interest Rate	5%	5%	5%	5%
Cost of Debt after Tax Shield	N/A	3.25%	3.25%	2.00%
Weighted Average Cost of Capital	10.00%	5.50%	4.94%	4.00%

Source tax rate of 35%; Residence tax rate of 25%

31-Oct-14

Effect of Debt Financing and Double Dip on NPV

	100% Equity Financed	2:1 D/E Ratio	3:1 D/E Ratio	Double Dip, 3:1 D/E Ratio
Initial Value of Corporation	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Annual Growth Rate	15%	15%	15%	15%
Value in 10 Years	\$ 404.56	\$ 404.56	\$ 404.56	\$ 404.56
WACC	10.00%	5.50%	4.94%	4.00%
PV	\$155.97	\$236.84	\$249.85	\$273.30

31-Oct-14

Empirical Impact of BEPS

- Multinational firms in high-tax countries reallocate only 2% of profits to low-tax jurisdictions¹
- Average OECD member country raises 8.8% of total tax revenue from corporations²
 - Reallocated amount is only **0.2%** of total tax revenue
- Is the BEPS focus on debt-bias justified?

1. James R. Hines Jr., "Policy Forum: How Serious is the Problem of Base Erosion and Profit Shifting?" (2014) 62:2 Canadian Tax Journal 443-52, citing Dhammika Dharmapala and Nadine Riedel, "Earnings Shocks and tax-Motivated Income-Shifting: Evidence from European Multinationals" (2013) 97:1 *Journal of Public Economics* 95-107.
2. *Ibid.*, citing Organisation for Economic Co-operation and Development, *OECD.StatExtracts* (<http://stats.oecd.org>).

31-Oct-14

Trends in Withholding Tax

- Source countries eliminating withholding tax on interest
 - E.g.: Canada-U.K. Tax Treaty Protocol, signed July 21, 2014.
- Some countries waive withholding tax on interest under domestic law
 - Reduced taxes to attract foreign investors
- In contrast, dividends are typically non-deductible and subject to $\geq 5\%$ withholding tax

31-Oct-14

Trends in Withholding Tax

Year 2004 - Maximum Treaty Withholding Tax Rates on Interest between G8 Countries and China									
	Canada	France	Germany	Italy	Japan	Russia	UK	US	China
Canada	x	10%	10%	10%	10%	10%	10%	10%	10%
France	10%	x	Eliminated	10%	10%	Eliminated	Eliminated	Eliminated	10%
Germany	10%	Eliminated	x	10%	10%	Eliminated	Eliminated	Eliminated	10%
Italy	10%	10%	10%	x	10%	10%	10%	10%	10%
Japan	10%	10%	10%	10%	x	10%	10%	10%	10%
Russia	10%	Eliminated	Eliminated	10%	10%	x	Eliminated	Eliminated	10%
UK	10%	Eliminated	Eliminated	10%	10%	Eliminated	x	Eliminated	10%
US	10%	Eliminated	Eliminated	10%	10%	Eliminated	Eliminated	x	10%
China	10%	10%	10%	10%	10%	10%	10%	10%	x

- Domestic rules often lower or eliminate withholding tax rates even further

Trends in Withholding Tax

Year 2014 - Maximum Treaty Withholding Tax Rates on Interest between G8 Countries and China									
	Canada	France	Germany	Italy	Japan	Russia	UK	US	China
Canada	x	10%	10%	10%	10%	10%	Eliminated	Eliminated	10%
France	10%	x	Eliminated	10%	10%	Eliminated	Eliminated	Eliminated	10%
Germany	10%	Eliminated	x	10%	10%	Eliminated	Eliminated	Eliminated	10%
Italy	10%	10%	10%	x	10%	10%	10%	10%	10%
Japan	10%	10%	10%	10%	x	10%	Eliminated	Eliminated	10%
Russia	10%	Eliminated	Eliminated	10%	10%	x	Eliminated	Eliminated	10%
UK	Eliminated	Eliminated	Eliminated	10%	Eliminated	Eliminated	x	Eliminated	10%
US	Eliminated	Eliminated	Eliminated	10%	Eliminated	Eliminated	Eliminated	x	10%
China	10%	10%	10%	10%	10%	10%	10%	10%	x

- Domestic rules often lower or eliminate withholding tax rates even further

31-Oct-14

Conclusion

- Trends in Withholding Tax on interest are at odds with OECD concerns
- Domestic governments in better position to respond to shifting of profits through debt bias
- Domestic solutions may be sufficient to address majority of BEPS concerns

31-Oct-14