Lecture 7

11/7/2024

International Taxation

Chapter 3 The Source of Income

Topics covered Today

Source rule in general

Interest Income

- Source Rule of Interest Income
- Thin Capitalization Rule
- Earning stripping
- Exceptions

Source Rule in General

Implications of source of income

Foreign Persons

- Whether a foreign person needs to pay tax to the U.S. government.

U.S. Persons

Implications of source of income

Foreign Persons	• Whether a foreign person needs to pay tax to the U.S. government.
U.S. Persons	• Whether the foreign taxes paid can be credible as an offset against U.S. taxes.

Source Rule for U.S. Persons

- **Tax credits**

Source of income determines → the **extent of allowable credits** for foreign taxes as offsets to U.S. income tax

mechanism of a limitation on the foreign tax credit

- Example : Case of Mr. Jordan

Angola taxes income

US

U.S. source

Not creditable

taxes payable to the

Creditable

U.S. tax rules

Angolan source

Source Rule for Foreign Persons

- Foreign persons are subject to U.S. tax only on their **income from sources** within the United States.

Business profits	• Trade or business income from U.S. • Was regular graduated rates, 21% flat rate after Dec 31, 2017 • With allowance for deductions
Nonbusiness income (e.g., passive income)	• U.S. source income • 30% withholding tax • Without allowance for deductions

FDAP Income

U.S. source passive investment income	
Taxed at a flat rate (generally 30%)	Without allowance for deductions

- FDAP Income: includes fixed or determinable annual or periodic gains, profits, and income.
  - Interest
  - Dividends
  - Royalties
  - Rents

US Source Rules

Types of income

- Interest
- Dividends
- Royalties
- Rents

Single Source vs Multiple sources

- Compensation for services
- Gains from sales of property
- Income from insurance underwriting

Rule of Interest Income

Interest Income

Interest income is the amount paid to an entity for lending its money or letting another entity use its funds.

Interest expense is the cost of borrowing money from financial institutions, banks, bond investors, or other lenders.

Interest Income

In a lending contract, we have **lender, borrower, place of loan origination, place of interest payment, place of the funding project**, which place should we care about in terms of source rule?

A U.S. bank initiated $500 million commercial loan to a French company at 850bps of interest spread from its branch in Spain. This loan is projected to launch a new manufacturing unit in Mexico.

What is the source of interest income?

Source rule of Interest Income

As a general rule, interest paid by an individual, a partnership, or a trust takes its source from **the payor's place of residence**, while interest paid by a corporation has its source in the **place of incorporation.**

Interest Income

<table>
<tr><th>Who pays the interest</th><th>Source</th></tr>
<tr><td>Individual</td><td rowspan="3">The payor’s place of residence</td></tr>
<tr><td>Partnership</td></tr>
<tr><td>Trust</td></tr>
<tr><td>Corporation</td><td>The place of incorporation</td></tr>
</table>

Interest Income

- Discussion

"Interest could derive its source from a tracing of the proceeds of borrowing to their actual place of use. "

Is this more accurate?

- Not Necessary

A borrower's ultimate borrowing capacity probably depends as much on the extent and location of his assets overall as on the use to be made of a specific borrowing.

Interest Income

- the place of payment
- the place where the debt is located
- the recipient's location
- the currency used to make the payment

irrelevant factors

Might **raise both difficulty and opportunity** in the day-to-day operation.

Source rule of Interest Income

The source rule of interest income reflects the broad expectation that a borrower is most likely to put borrowed money to work where he resides and pay the interest from funds available at that place.

Interest Income

A foreign bank lending to a U.S. resident may receive **U.S. source interest** even if the loan is initiated outside the United States and finances operations entirely outside the United States.

Interest Expense

"Interest expense incurred by a nonresident alien shall be considered to be connected with income effectively connected with a United States trade or business … to the extent that interest expense is incurred with respect to liabilities that are **secured by assets that generate such effectively connected income**."

Practice

- Determine the source of income below:

An interest payment of $1,000 made by Ramli, a Malaysian citizen who is present in the United States for the whole year during which the payment was made, and whose only gross income for all years consists of interest and dividend income from investments in Malaysia.

Marcel's U.S. Venture

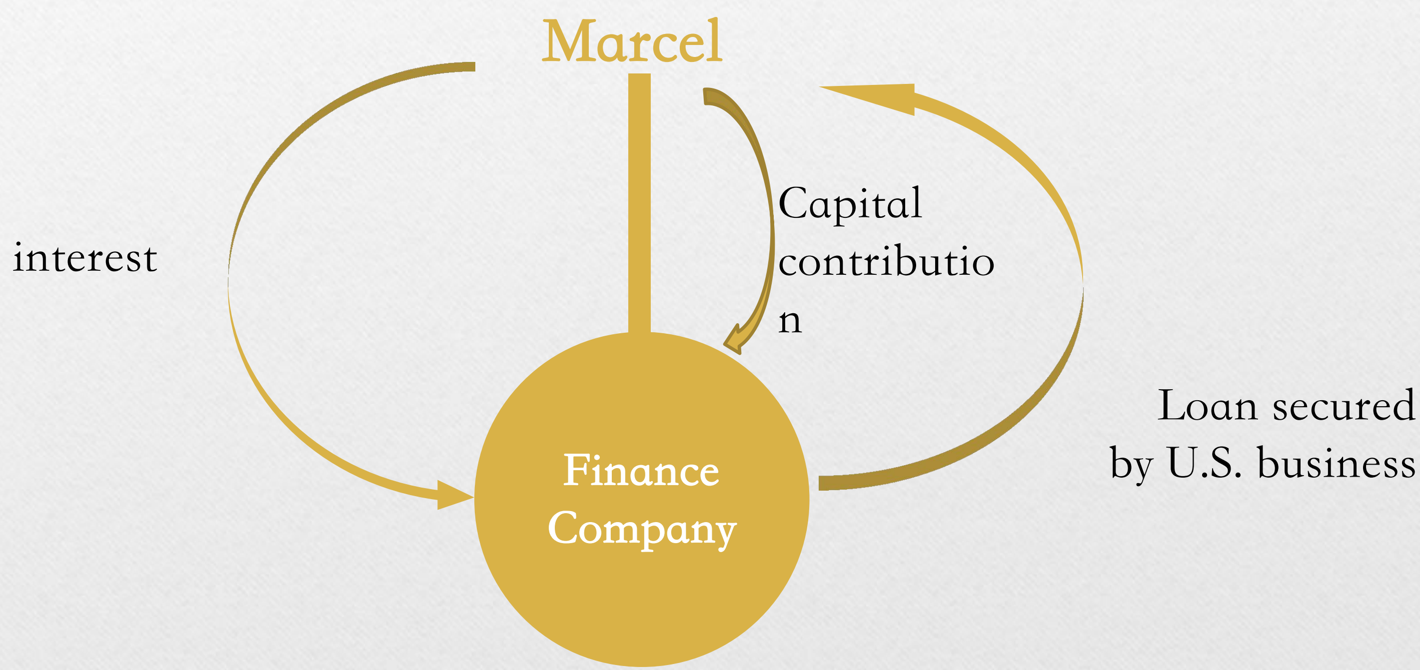
Marcel's U.S. Venture

Suppose that Marcel, a citizen and resident of Freedonia, has the opportunity to acquire for $1 million a U.S. business producing $150,000 of income per year. If Marcel simply buys the U.S. business directly with his own funds, the annual income of $150,000 will attract U.S. income tax of $52,500 at 35% rates.

Marcel's U.S. Venture

Instead, Marcel borrows $800,000 of the purchase price at 12% interest rate from a foreign corporation of which he owns all the stock and to which he has previously transferred the funds as a contribution to capital, securing the loan from the corporation with the U.S. business assets.

Marcel’s U.S. Venture



Marcel's U.S. Venture

Finance Company

Zero Tax

No tax obligation to U.S. because the payer of the interest income is a non-U.S. resident.

Marcel's U.S. Venture

Why?

- Why not borrowing $1 million at 15%?

Problem 1: Arm's length price doesn't allow 15% of interest rate. if you can raise money at 12% from an independent lender, why give your finance company a premium rate at 15%?

Problem 2: The **allowable** interest deduction in such patterns is limited to interest on debt not exceeding **80%** of the assets of the U.S. business paying the interest.

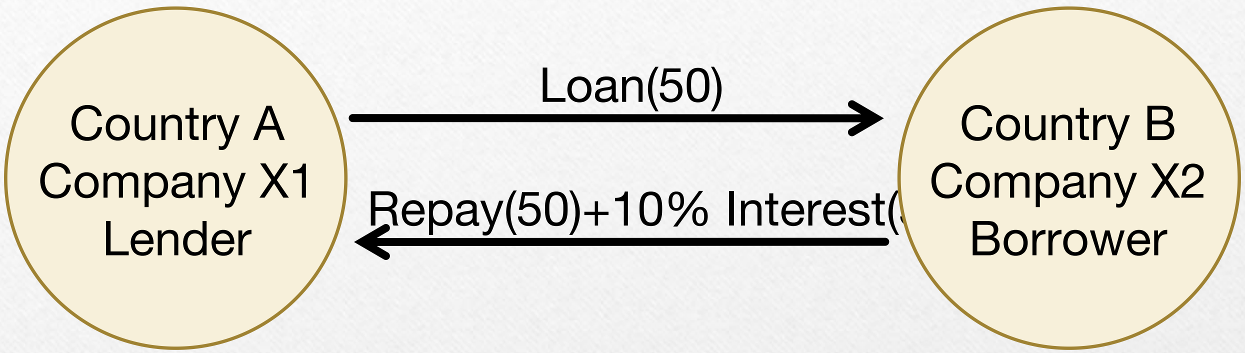
Thin Capitalization Rule

Thin Capitalization

A company is typically financed (or capitalized) through a mixture of debt and equity. "Thin capitalisation" refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as "highly leveraged" or "highly geared."

	EQUITY	DEBT
	Own resources	Other party resources
Financier (Provider of funds)	Shareholders → Payment = equity contribution	Lenders → Payment = loan
Financed (recipient of funds)	Company Return to financier = dividends of increase in share value	Company Return to financier = interest Normally a deductible expense in the jurisdiction of the payer

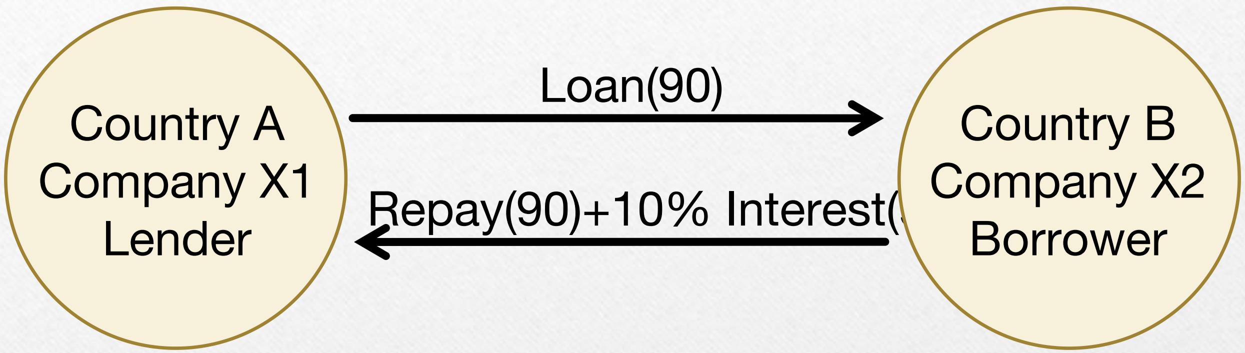
Example 1



Company X2 is financed by:
50 Equity / 50 Debt

Pre-tax and pre-interest taxable profit:15
Deduction of interest payment:-5
Post-interest taxable profit:10
Tax rate:30%
Tax revenue:3

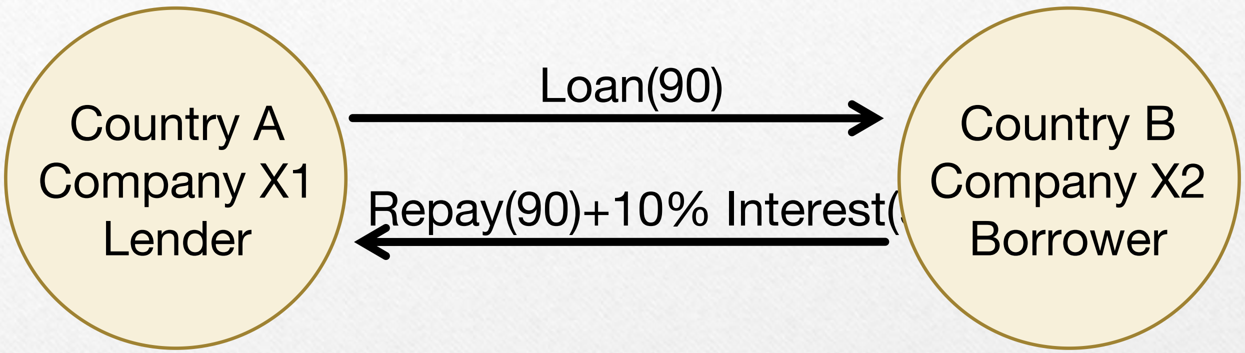
Example 2



Company X2 is financed by:
10 Equity / 90 Debt

Pre-tax and pre-interest taxable profit:15
Deduction of interest payment:-9
Post-interest taxable profit:6
Tax rate:30%
Tax revenue:1.8

Example 2



Company X2 is financed by:
10 Equity / 90 Debt

Country B might withhold tax on interest paid to non-residents.
Eg:
Withholding tax of 10% of 9 interest
Withholding tax: 0.9

+

Pre-tax and pre-interest taxable profit:15
Deduction of interest payment:-9
Post-interest taxable profit:6
Tax rate:30%
Tax revenue:1.8

Total tax revenue：
0.9+1.8=2.7

Thin Capitalization Rule

The manner in which a company is capitalised can have a significant effect on the amount of profit it reports, and thus the amount of tax it pays.

Country tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes.

Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country's tax base.

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Thin Capitalization Rule

The "arm's length" approach

- Under this approach, the maximum amount of "allowable" debt is the amount of debt that an independent lender would be willing to lend to the company i.e. the amount of debt that a borrower could borrow from an arm's length lender.
- Also known as safe harbor rules.

Thin Capitalization Rule

The “ratio” approach

- Under this approach, an affiliate’s interest deductions (either for inter-affiliate debt or for all debt) are restricted to some maximum fraction of some specified notion of income, typically earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA).
- Also known as Earnings (Interest) Stripping rules.

Example of ratio 2:1

Country A
Company X1
Lender

Loan(90)

Repay(90)+10% Interest(

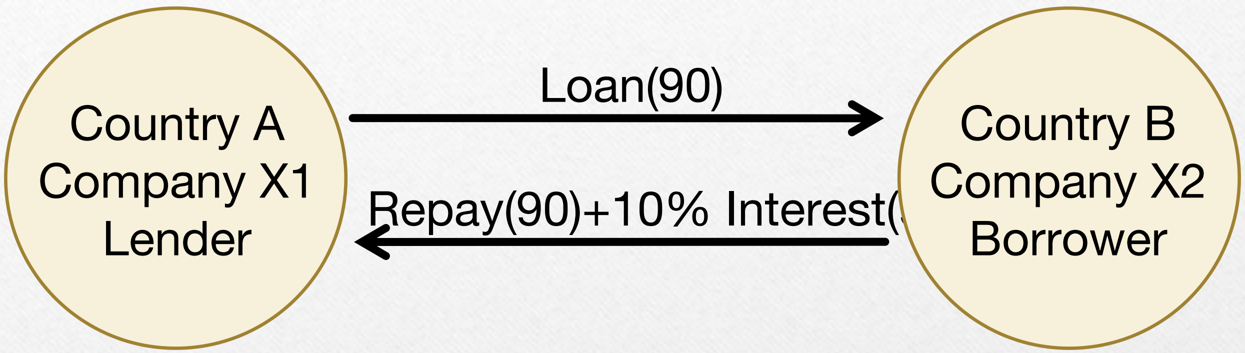
Country B
Company X2
Borrower

Company X2 is financed by:
10 Equity / 90 Debt

Pre-tax and pre-interest taxable profit:15
Deduction of interest payment:-9
Post-interest taxable profit:6
Tax rate:30%
Tax revenue:1.8

BUT if the ratio is applied
Interest on any debt that is in excess of 2x equity will not be deductible
Limit on debt:2×10 = 20
Deduction of interest allowed:10% of this 20 = 2
Post-interest taxable profit:13
Tax rate:30%
Tax revenue:3.9

Example of limit to interest (30% EBITDA)



BUT if the limit is applied
Limit to the deductibility:30% of EBITDA = 30% of 15 = 4.5
Deduction of interest payment:-4.5
Post-interest taxable profit:10.5
Tax rate:30%
Tax revenue:3.15

Pre-tax and pre-interest taxable profit:15
Deduction of interest payment:-9
Post-interest taxable profit:6
Tax rate:30%
Tax revenue:1.8

TCR in China

财政部 国家税务总局关于企业关联方利息支出税前扣除标准有关税收政策问题的通知

财税[2008]121号　　2008-09-23

各省、自治区、直辖市、计划单列市财政厅（局）、国家税务局、地方税务局、新疆生产建设兵团财务局：

为规范企业利息支出税前扣除，加强企业所得税管理，根据《中华人民共和国企业所得税法》（以下简称税法）第四十六条和《中华人民共和国企业所得税法实施条例》（国务院令第512号，以下简称实施条例）第一百一十九条的规定，现将企业接受关联方债权性投资利息支出税前扣除问题通知如下：

一、在计算应纳税所得额时，企业实际支付给关联方的利息支出，不超过以下规定比例和税法及其实施条例有关规定计算的部分，准予扣除，超过的部分不得在发生当期和以后年度扣除。

企业实际支付给关联方的利息支出，除符合本通知第二条规定外，其接受关联方债权性投资与其权益性投资比例为：

(一)金融企业，为5：1；

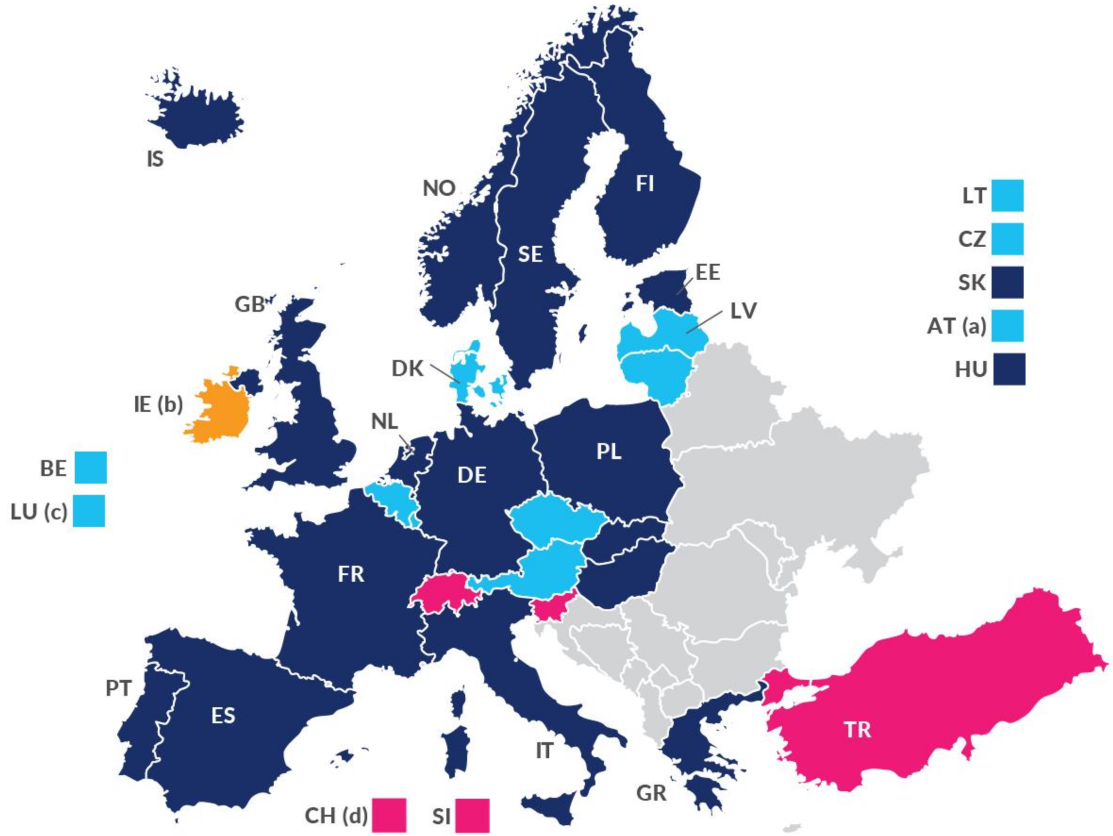
(二)其他企业，为2：1；

TCR in U.S.

The 2017 US tax legislation moved the US from a safe harbor debt-equity ratio (of 1.5 to 1) to an earnings stripping rule limiting interest deductions more broadly to 30% of income – see 26 U.S.C. § 163(j).

Thin-Cap Rules in Europe

Type of Thin-Cap Rules in Place, as of 2021



Notes:

(a) Austria uses the Arm's Length Principle to limit interest deductions; there is no formal safe harbor debt-to-equity ratio, but an informal 4:1 ratio typically suffices.

(b) Ireland has no specific thin-cap rules but interest paid by a non-trading company to a nonresident parent can be reclassified as dividends under certain conditions.

(c) Luxembourg uses an informal 85:15 debt-to-equity ratio.

(d) Switzerland's debt-to-equity ratio varies by asset class.

Source: Bloomberg Tax, "Country Guides: Anti-Avoidance Provisions - Thin Capitalization/Other Interest Deductibility Rules;" and PwC, "Worldwide Tax Summaries: Corporate - Group taxation."

- Interest-to-Pretax-Earnings Limit
- Debt-to-Equity Ratio
- Both
- No Thin-Cap Rules

TAX FOUNDATION @TaxFoundation

Earnings Stripping

Marcel's U.S. Venture

Finance Company

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No tax obligation to U.S. because the payer of the interest income is a non-U.S. resident.

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Earnings Stripping

- Earnings stripping usually refers to the payment of excessive deductible interest by a U.S. corporation to a related person when such interest is tax exempt (or partially tax exempt) in the hands of the related person.
- The result is a major reduction in the level of U.S. tax on domestic operations of the group through deductible interest payments to foreign members of the overall group that are subject to little or no U.S. tax.

Earnings Stripping

- Earnings stripping

U.S. corporation —excessive deductible interest→ **Related person**

↓

reduction in the level of U.S. tax on domestic operations of the group

Marcel's Earnings-Stripping Plan

Self-loan between himself and his wholly-owned finance company

The U.S. tax system generally acknowledges

Separate identity of corporations

BUT

The Revenue Service might **question the reality and business purpose** of the foreign finance company.

Marcel’s Earnings-Stripping Plan

- Further against IRS Attack.

By enlarging the range of economic activity. E.g.,
engaged in business or invested elsewhere in the world
financed other projects
lent to ventures other than Marcel
borrowed from other sources
had other owners besides Marcel

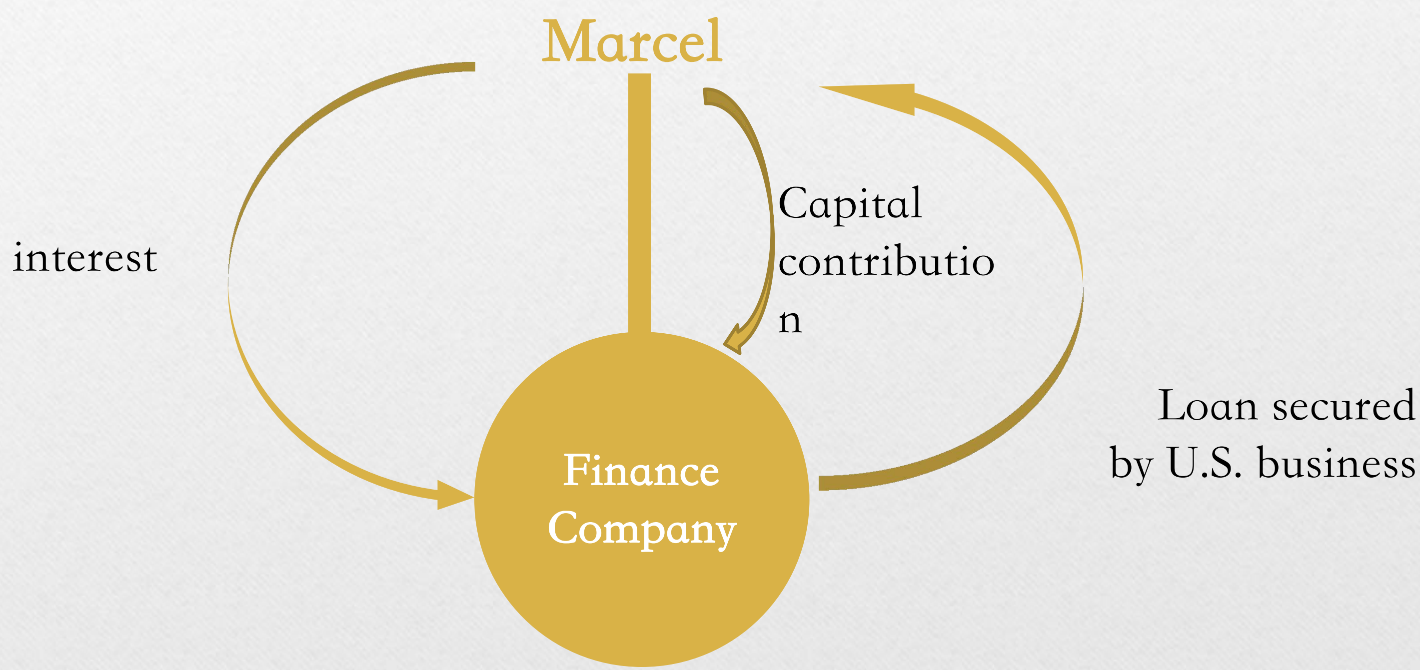
But Marcel's structure is solid as it stands with permanent assets and owns and retains the interest it receives from Marcel.

Limitations of Marcel's Earnings-Stripping Plan

- Limitations

1. It only works for U.S. business operations directly owned by **foreign individuals**.
2. The plan cannot be used for a petrochemical plant or automobile assembly line.

Marcel's U.S. Venture



Foreign Taxes Consideration

Deductible interest

Untaxed escape of some business

Marcel's country of residence

If it imposes low or no income tax?

If it is a high-tax country?

Exceptions

Some Exceptions

- Interest income received from **U.S. residents or domestic corporations**
- U.S. source income.

The 80-Percent Rule

- Interest income received from a **foreign corporation**
- foreign source income.

The Branch Interest Rule

The 80-percent Rule

- Interest paid by an alien resident individual or from a domestic corporation on obligations issued before August 10, 2010 has **foreign source** if 80 percent or more of the payor's gross income during the three years preceding the year of payment was itself "active foreign business income."
- Active foreign business income is foreign source income attributable to the active conduct of a trade or business outside the United States.

The 80-percent Rule

Interest

- paid by an alien resident individual or a domestic corporation
- on obligations issued before August 10, 2010

if

- 80 percent or more of the payor's gross income during the three years preceding the year of payment was "active foreign business income."

foreign source

The Branch Interest Rule

- Under section 884(f)(1), " in the case of a foreign corporation **engaged in a trade or business in the United States**···any interest paid by such trade or business in the United States shall be treated as if it were paid by a U.S. branch business of a foreign corporation has U.S. source.
- Such interest is known as "branch interest."

"Look-through" Rules

- The 80-percent rule and the branch interest rule are known as "look-through" rules because they look through the formal place of charter of a corporation to its underlying operations.
- The 80-percent rule and the branch interest rule cut in nearly opposite directions. The former softens the inflexibility of the source rule, while the latter closes off an easy escape from U.S. taxation.

“Look-through” Rules

- “look-through” rules
  - 80-percent rule
    - softens the inflexibility of the source rule
  - branch interest rule
    - closes off an easy escape from U.S. taxation