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

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UN Committee on Taxation
Deductibility of Interest

Introduction/Overview

In determining taxable income, business taxpayers are generally allowed to tax administration and corporate governance and therefore are in a strong position to implement recommendations from the OECD projects.

- Less developed countries, such as the members of the UN tax committee, generally have less institutional support for tax administration and corporate governance.

- Purpose of this paper is to examine the issue of debt and deductible payments for interest from the perspective of these developing countries.

Background: Why Businesses Use Debt

An enterprise may incur interest expense for any of several reasons and the use of debt is not inherently either positive or negative.

- Debt may be incurred as part of the capitalization of the enterprise, in combination with equity.

  i. Using debt increases the pool of available capital, by bringing in additional sources of funding.
  ii. Debt allows the owners to expand the business without diluting their control.
  iii. Economic studies have shown that the use of debt can bring discipline to the operation of an enterprise, resulting in long-term improved profitability and operation.

- Debt may be incurred in connection with the purchase of property or goods. For instance, real property may be purchased with a mortage, or goods may be purchased with extended payment terms that trigger interest on unpaid balances.

- An enterprise will typically require a line of credit to provide working capital, or to support working capital.

In each of these cases, the interest expense is connected to the operation of the enterprise and, generally, will be allowed as a deductible expense in computing the taxable income of the enterprise.

- One issue for tax legislation (and tax administrators) is whether the deductibility of interest payments should differ, based on the reason the debt is paid.

i. Distinctions are made today, in some cases. [Expand, discussing, for example, interest linked to a mortgage on property.]

ii. Making distinctions encounters at least two challenges: it is not clear whether the distinctions are rational, since economists generally assert that "money is fungible," and administering a system in which some debt (and interest) is treated differently than other debt (and interest) creates challenges.

Why Does a Government Care About "Excessive" Debt?

Although debt is common in business operations, excessive debt – and excessive interest expense – creates concerns. Some of these concerns relate to tax; other concerns are not tax driven but rather involve public perception (or the government's perception) of proper business norms.

<u>Tax concerns</u>: Excessive debt and the resulting high levels of interest expense can result in erosion of the enterprise's tax base. The full analysis, however, can be complicated.

- Concern is heightened when the interest payments are made to related parties, either the owner of the enterprise making the payment or a related party to the borrower.

  i. For related parties, the return on debt may be a substitute for the return on additional equity. Whether the debt is more favorable to the larger enterp or the transaction may be a back-to-back loan through a third party. Guarantees come in many varieties and the relevance of the guarantee can be difficult to determine.

iv. [Discuss the recent Canadian legislation that attempts to address related party borrowings.]

- In addition, there is generally heightened concern from a tax perspective when the interest payment is made to a lender located

b. The full analysis, of course, would require understanding the tax consequences of the interest paid by the financial institution to the parties (often depositors) that lend the funds to the financial institution; the full analysis is essentially unachievable, as the never-ending chain of borrowers and lenders extends across the economy.

c. The key point is that there is no certain way to know whether a cross-border lending transaction is more favorable, or less favorable, to the fisc, assuming there is a withholding tax on interest payments to foreign lenders.

Non-tax concerns: Concerns about eroding tax base are only one driver – and often a limited driver – for legal limits on the use of debt and the resulting payments of interest. An equally strong concern is corporate governance and a prudential limit on the amount of risk that a business enterprise can assume.

- Government regulators may seek to limit the amount of debt that an enterprise takes on, in order to reduce the risk that a business failure would have knock-on effects for workers, suppliers, customers and others.

  i. Businesses are necessarily linked to each other in a national and international economy. The most forceful example of these connections arose during the fiscal crisis of 2007-2008.

  ii. The failure of some businesses and the potential failure of many more businesses demonstrated the consequences to the global economy that arise when a single business takes on too much risk and fails, triggering a succession of failures at other businesses.

  iii. Government restrictions may be explicit (e.g., specific debt/equity limits imposed by law, at the time the business is created and, in some cases, on an annual or other periodic basis going forward.) Or, government restrictions may be applied in a more flexible fashion.

  [Discuss specific examples, including the US Federal Reserve guidance to lenders, plus China, Australia and elsewhere.]

- o In addition to legal limits on the assumption of debt and debt/equity ratios, there are business realities imposed by market forces. For instance,

  i. In order to secure contracts, especially from the government but also from non-government customers, an enterprise must often provide a balance sheet and other financial information that demonstrates financial fitness.

  ii. Lenders often impose financial covenants that limit an enterprise's ability to borrow.

  iii. Rating agencies review creditworthiness, with a view toward excessive debt.

  These non-tax limitations on debt are consistent with, but separate from, any tax rules that limit the ability of an enterprise to take a tax deduction for interest payments on "excessive" debt.

Tax Restrictions on Excessive Debt

Tax rules in a country generally **do** not – indeed, cannot – forbid an enterprise from having an "excessive" level of debt, however that limit is defined. Rather, other government agencies impose (and measure) whether an enterprise exceeds acceptable levels of debt.

Tax rules, however, frequently limit the amount of interest that may be deducted by an enterprise in determining its taxable income.

- o The tax limits are measured in different ways. Most frequently, interest may be deducted only to the extent that the enterprise does not have debt greater than a statutorily established maximum (e.g., a debt:equity ratio of 3:1, or some higher ratio for financial services companies.) Interest attributable to that higher level of debt is not allowed (or is deferred) as a deduction in determining taxable income.

- o This approach, while common, raises important questions.

  i. Measurement of the debt:equity ratio can be challenging.

     a. For instance, equity may be based on historical measures (e.g., initial equity plus retained earnings) that undervalue the actual value of the enterprise. If the enterprise has assets that have appreciated in value, or if the enterprise has substantial goodwill, then the ratio of debt to equity can be over-stated if the debt is measured at current values but equity is measured on historical data or pursuant to a formula.

b. On the other hand, if the enterprise seeks to measure its equity on a fair market value basis, that is costly and complicated, and this approach potentially creates controversy with tax authorities.

ii. Allowing interest deductions based on a maximum ratio of debt to equity does not take into consideration the rate of interest paid on the debt. But, the interest rate is keenly important in determining whether the amount of debt is “reasonable” or “excessive.”

a. Specifically, in a low interest rate environment, an enterprise can prudently carry a higher level of debt than the same enterprise can carry in a higher interest rate environment. [Cite examples, based on mortgage information and other current lending.]

b. Interestingly – and, perhaps, contrary to common sense – countries have been reducing the levels of debt for which interest is deductible in recent years, even though interest rates have fallen and therefore the amount of interest required to carry a fixed amount of debt has likewise fallen. [Examples.] These reductions are sound only if the consensus view of the maximum amount of appropriate interest expense has declined even more sharply than the decline in interest rates.

iii. Basing the amount of interest expense that is deductible to a fixed ratio of debt to equity is particularly problematic in the case of financial institutions.

a. For a financial institution, cash is essentially the raw material for production and interest expense is equivalent to the “cost of goods sold” for an industrial company. Furthermore, because the assets held by a financial institutions are typically more “liquid” than the assets of an industrial company, financial institutions regularly have a higher debt:equity ratio than industrial companies.

b. But, determining how much higher the debt:equity limit for financial institutions should be than the limit for industrial companies is a judgment call, with no fixed parameters. In addition, financial services companies and their regulators recognize that prudent debt:equity limits depend on the nature of the underlying assets held by the institution. (For instance, readily marketable securities or credit card receivables merit a higher debt:equity ratio than less liquid financial assets.)

c. Traditional guidelines for the permissible debt:equity ratio for financial services companies are simply that: guidelines. There is no firm wisdom in the ratios allowed.

- As an alternative to capping the allowable deductible interest expense based on a ratio of debt to equity, some countries limit deductible interest to some percentage of the enterprise’s earnings before tax, or other financial measurements.

  i. This approach has the merit of limiting the impact of interest deductions in reducing the tax base of an enterprise. But, there is no certain anchor for what percentage of an enterprise’s pre-tax income (or other financial measure) should be allowed as a deductible interest expense.

  ii. This approach creates positive incentives for an enterprise to reduce its debt and accompanying interest expense when interest rates are rising. Thus, this approach reinforces the goal of non-tax regulations that an enterprise should reduce its debt level in such a situation.

As discussed previously, tax authorities frequently have heightened concerns when interest is paid to a non-resident, or to a related party. In some situations, these concerns are well-placed.

- In the case of a non-resident lender, it is difficult to know whether (or how) the interest income will be taxed in the hands of the lender. If the lender has a favorable tax treatment for the interest income, there is a global tax arbitrage with respect to the interest payment, whether or not the lender is related to the borrower. Countries may find this tax arbitrage objectionable.

i. Note, however, that the favorable tax treatment of the interest expense in the hands of the lender may result in a reduced interest rate for the borrower, which has the effect of reducing the interest deduction achieved by the borrower. Whether or not this reduced rate exists can be difficult to measure.

ii. As discussed above, if the country of the borrower imposes a

b. Or, a party related to the borrower may offer a guarantee to the lender. Such guarantees vary considerably, from formal, legally binding agreements to "comfort letters" that have no legal effect.

c. [Examples to show how difficult it can be to identify related party transactions.]

(Very Tentative) Conclusions

Limitations on deductible interest expense are well-established in international tax law.

- These limitations reasonably protect a country's tax base from excessive erosion through deductible payments.

  It is important to acknowledge, however, that the use of debt is a reasonable business decision, with positive benefits for economic growth. Excessive limitations on the deductibility of interest payments (or, excessive non-tax limits on the use of debt financing) would likely inhibit economic growth.

- Without limitations on the deduction of interest expense, there is the potential for parties to develop structures (principally, related party loans from favorable tax jurisdictions) that would substitute debt for equity and generate substantial benefits from tax arbitrage.

- Tax limitations on interest deductions are consistent with, and complementary to, non-tax restrictions on the use of debt, however those limitations are defined.

In fashioning limits on interest deductions, a developing country will likely benefit by adopting the following guidelines:

- There should be a withholding tax on cross-border payments of interest. Although it is difficult to determine what level of withholding tax mirrors the tax consequences of a loan from a domestic lender, the withholding tax secures some tax revenue for the borrower's country of residence and reduces the tax arbitrage from the use of debt.

- All interest expense should be treated the same, regardless of how that interest expense arises (e.g., as part of the capitalization of the enterprise, connected with specific property such as a mortgage on real estate, or interest paid on credit extended by a supplier.) A taxpayer has substantial control over how interest expense is incurred, and different tax treatment for different types of interest expense invites inappropriate tax planning and controversy between taxpayers and tax administrators.

- Although related party debt can raise concerns that do not exist in the case of third-party debt, determining when debt is "related party debt" is extremely difficult and likely beyond the capacity of many developing country tax administrators. It is probably sensible for developing countries to apply tax rules limiting the deductibility of interest expense without distinguishing whether the debt is related party debt or unrelated party debt.

- In fashioning limitations on the deductibility of interest expense, it is probably better to use a limitation based on a percentage of pre-tax income (or other financial measurement), rather than a limitation based on whether the enterprise has a particular ratio of debt to equity, however that ratio is determined. Such a rule is more easily administered and avoids the concerns raised by a rule based on a debt:equity ratio.

Possible additional topics:

1. Transfer pricing and other rules to ensure that the interest paid on debt is arm's-length. This would include a brief discussion of guarantee fees.

2. Coordination between the tax rules governing the deductibility of interest expense and non-tax rules limiting the amount of debt that an enterprise can assume.