International Chamber of Commerce
The world business organization

Prepared by the ICC Commission on
Taxation

Limitations of deductions of interest payments

Highlights

- ICC notes that differences in the tax treatment of equity and debt financing have a potentially significant impact on investment decisions This may have been a contributory factor to overleveraging in some economies.
- In order to remove this distortion, ICC recommends that Governments consider introducing Allowance for Corporate Equity - an approach which has already been adopted by a small number of countries.
- An alternative theoretical approach is to eliminate tax deductions for interest expense. Given the preponderance of countries that allow a level of deduction for interest expense this would be a radical move and would be unlikely in practice to stimulate growth and international development.
- In making any changes Governments should be careful not to artificially restrict the deductibility of debt interest. This is especially important given the potential impact on existing business models and long-term investments.

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1. Background

The cost of capital is a key factor in investment decisions and tax has an impact on the cost of capital. Ideally, there should be neutrality between equity and debt financing from a tax point of view and investment decisions should be taken on the basis of economic facts and circumstances not influenced by tax systems. However, in reality the tax systems of most countries in the world: i) have an effect on the cost of capital, and ii) create distortions between debt and equity financing. To the extent there are limitations on deductions of interest payments, it is important to have a well-targeted system in harmony with a well-functioning international tax environment. The principle of net taxation and the avoidance of international double taxation must be upheld with a minimum of deviation, if any at all.

2. Systems that remove distortions between debt and equity financing

In theory there are two methods, within an income tax system, to eliminate distortions between equity and debt financing: the Allowance for Corporate Equity (ACE) and the Comprehensive Business Income Tax (CBIT). [1]

2.1 Allowance for corporate equity (ACE)

The ACE system provides for tax deductibility of actual interest payments and, in addition, a notional interest on equity is deductible from corporate profits. As the deduction of the notional return on equity is certain, a risk free nominal interest rate is applied, for example a government bond rate. An ACE system can achieve neutrality between debt and equity financing. The narrowing of the tax base through the deduction of actual and notional interest generally requires increased statutory tax rates or other base-broadening measures to achieve equal tax revenue from corporations. The international allocation of assets, functions and risks with the associated profit potential is incentivized by differences in statutory tax rates. In reality, ACE or ACE-like systems are rare and are only applied in a few countries, such as Brazil and Belgium.

Since some corporate shareholders are presently tax-exempt or taxed at a preferential tax rate, the introduction of an ACE system will tend to change the ownership structure. The part owned by tax exempt entities will decrease. The same applies for shareholders residing in low tax jurisdictions. The increased ownership by those shareholders presently having a high tax rate may mitigate the overall revenue loss. In fact, these shareholders often reside in the country and they will often incur other taxes on their increased received income, like consumption taxes or other levies.

[1] The systems and their impact on the welfare of states in the European Union are described in Taxation Paper No. 17, Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms, written by Ruud A. de Mooij and Michael P. Devereux

2.2 Comprehensive Business Income Tax (CBIT)

The CBIT system aspires to eliminate the favourable fiscal treatment of debt-financed investments by disallowing a deduction for interest paid. In order to avoid double taxation of interest, the disallowance needs to be combined with a tax exemption or credit system for interest received from CBIT entities. The broad corporate tax base of the system allows for low statutory tax rates which could attract mobile and highly profitable equity investments. However pure CBIT system has not been introduced in reality so far. The transition to a CBIT system could, even if the statutory corporate tax rate is reduced, result in an increase in the cost of capital for many businesses. The effect could be particularly pronounced for highly-leveraged entities, like banks. There is, of course, a risk that these entities in general, and banks in particular, would try to increase their profitability by increasing their margins. Private equity firms are also likely to face a substantial increase in their financing costs.

2.3 Combining ACE and CBIT

In the search for a more efficient approach to the treatment of interest deductibility, the idea of combining ACE and CBIT has been examined in a study by the Oxford University Centre for Business Taxation and prepared for the European Commission. This study concludes that such a revenue-neutral combination of ACE and CBIT improves efficiency as it reduces distortions in debt-equity choices. Welfare is found to expand slightly on account of this more efficient financial structure. Combinations of ACE and CBIT may reflect a simultaneous movement towards limitations of the deductibility of interest payments and reductions in the tax burden on the return on equity.

3. Tax reforms towards a CBIT system

3.1 General

Tax reforms which move in the direction of a CBIT system are often justified by the tax avoidance argument. These reforms usually aim at limiting tax deduction for interest paid by introducing debt-to-equity rules and/or earnings-stripping rules. If these base-broadening measures are not combined with a reduction of statutory tax rates, then they are harmful to international business development because they increase the cost of capital.

3.2. Limitation of interest deduction

The debt-to-equity or thin capitalization rules imply that interest is not deductible if debt in relation to equity exceeds a certain threshold. In addition to (or instead of) thin capitalization rules, some countries apply earnings-stripping rules. These rules limit the deduction of otherwise tax deductible interest to a certain percentage of (adjusted) taxable income.

4. Impact of limiting interest deductions on international business

The limitation of interest deductions with the tax avoidance argument leads to a broadening of the tax base and, consequently, an increase in the cost of capital. In addition, a double taxation of the interest may occur if the country of the interest-receiving entity does not provide for an exemption or a tax credit with respect to the interest not deductible at the level of the paying entity. Such double taxation is particularly harmful to international investment and should be avoided.

International business recognizes that under the currently prevailing tax systems, it is legitimate to limit the deduction of interest in abusive cases with wholly artificial arrangements. Any debt which is obtained within the arm's length principle of a company should not be reclassified with the abuse argument. For administrative simplification, tax laws may provide for safe harbour rules, for instance, by stipulating thin capitalization rules.

5. Conclusions and recommendations

The international business community would welcome a more favourable tax treatment of equity financing, thus reducing or eliminating the difference in the tax treatment of debt and equity-financed investments. However, the trend that is experienced by international business so far is that tax deductibility of interest is limited, but at the same time does not provide relief for equity financing or interest received. With the tax avoidance argument, an increasing number of countries have introduced restrictive limitations of interest deductions without providing any relief for equity financed investments. This has resulted in an increase of the cost of capital for investments. Furthermore, adequate income tax relief for non-deductible interest received from local and/or foreign affiliates has not been granted. It is of utmost importance to ensure that such legislative measures are targeted to not infringe upon conventional business transactions, which would ultimately result in double taxation. Consequently, ICC strongly recommends that the limitations of interest deductions be applied only to truly abusive cases.

Legislative changes towards a CBIT system lead to double taxation if not properly combined with tax relief at the level of the recipients of the interest and dividends. On the international level, the risk of double taxation increases substantially by legislative actions that limit tax deductibility of interest. Therefore, ICC urges legislators to avoid taking actions which are detrimental to international business and the free movement of capital.

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The International Chamber of Commerce (ICC)

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world.

The fundamental mission of ICC is to promote trade and investment across frontiers and help business corporations meet the challenges and opportunities of globalization. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the last century. The small group of far-sighted business leaders who founded ICC called themselves "the merchants of peace".

ICC has three main activities: rules-setting, dispute resolution and policy. Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade.

ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on vital technical and sectoral subjects. These include financial services, information technologies, telecommunications, marketing ethics, the environment, transportation, competition law and intellectual property, among others.

ICC enjoys a close working relationship with the United Nations and other intergovernmental organizations, including the World Trade Organization, the G20 and the G8.

ICC was founded in 1919. Today it groups hundreds of thousands of member companies and associations from over 120 countries. National committees work with their members to address the concerns of business in their countries and convey to their governments the business views formulated by ICC.

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Policy and Business Practices

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