Deductions for Interest

Peter A. Barnes
Duke University

Background

- In determining taxable income, business taxpayers are generally allowed to deduct reasonable expenses, including interest
- Availability and use of debt is an important element of a healthy business environment.
  - *Lack of credit can deter economic growth.*
- An enterprise may incur debt for many reasons
  - *As part of capital, along with equity investment*
  - *In connection with the purchase of property (e.g., mortgage secured by real property)*
  - *Line of credit for working capital*

“Excessive” Debt

- For both tax and non-tax reasons, governments are concerned about “excessive” debt
  - *Tax: interest expense can erode tax base. Concern may be heightened*
    - When payments are made to related parties
    - When payments are made cross-border
  - *Non-tax: prudential concerns arise from both government regulators and private lenders*
    - Regulators want to avoid risk of business failures, with negative impacts on workers, suppliers, customers
    - Customers/lenders often impose limits on debt, to minimize risk

Tax Limitations on Deductions

- Tax rules generally do not – indeed, cannot – forbid an enterprise from having “excessive” debt. Tax rules simply limit deductions.
- Operating rules differ among countries
  - *Debt:equity ratios. Ratios are hard to measure and do not take into account impact of changing interest rates*
    - Financial institutions are a special case
  - *Interest as a percentage of earnings or other financial measures. Positive incentive to reduce debt as interest rates rise, but no clear threshold for what is “excessive”*

Issues/Tentative Conclusions

- In fashioning limits on interest deductions:
  - *There should be a withholding tax on cross-border payments of interest.*
    - Difficult to determine the appropriate rate, but a withholding tax secures some revenue and limits tax arbitrage on the use of debt.
  - *All interest should be treated the same, regardless of how that interest expense arises (e.g., as part of capital, or a line of credit)*
    - Different treatment for different types of interest invites planning and controversy.

Issues/Tentative Conclusions

- In addition,
  - *No distinctions should be made between related party debt and borrowings from unrelated lenders.*
    - Extremely difficult to determine when a lender is related. No compelling benefit in treating third-party debt more generously.
  - *In limiting interest deductions, best method is probably a limit based on percentage of pre-tax income (or another financial measurement)*
    - Debt:equity rules are hard to administer and do not readily adjust with changes in interest rates