Deductions for Interest

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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.*
- Although it is often easy to identify whether an instrument is debt or equity, that is not always the case (e.g., hybrid instruments)

Reasons to Use Debt

- 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.

- What is “excessive” interest? Currently, there is no international consensus.
  - *Threshold issue: net interest or gross interest? Net debt or gross debt?*

Identifying “Excessive Interest”

- Operating rules differ among countries
  - *Debt:equity ratios. Although a common approach, ratios are hard to measure and do not take into account impact of changing interest rates*
    - Financial institutions are a special, challenging 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”*

Exempt or Deferred Income

- Even if interest is not excessive, it may be appropriate to limit deductions in some cases:
  - *Disallow deductions for interest allocable to exempt income?*
  - *Defer deductions for interest allocable to deferred income?*
- As developing country investors grow global operations, this issue increases in importance

Is All Interest Equal?

- Interest may be incurred for many reasons; should all interest expense be treated the same?
  - *Single rule is generally easier to administer*
    - Different treatment for different types of interest invites planning and controversy.
  - *BUT, some interest expense (e.g., borrowing to invest in capital equipment) may be viewed more favorably than other interest expense*

Related Party Interest

- Interest paid to related parties is the most controversial – and emotional – issue.
  - *Related party debt generally is an issue only when the lender is outside the country of the borrower*
    - Potential transfer pricing abuse
    - Interest income may be subject to low or no tax
  - *However, treating related party interest differently creates costs*
    - Reduced availability of credit
    - Enforcement/administrative challenges
- Is potential abuse so serious that special rules are needed? Or, will strong enforcement suffice?

Withholding Taxes

- Most developing countries impose w/h taxes on cross-border interest payments
  - *Withholding tax partially offsets lost revenue from the interest deduction.*
- Challenge is whether the w/h tax creates more harm than benefit
  - *Is there a gross-up provision or higher interest rate, which decreases available credit and/or increases the deduction for interest paid?*

Summary

- Tax rules do not limit the use of debt, but
  - *Such rules compliment non-tax limits on interest deductions, and*
  - *Can help protect a country's tax base*
- Big challenge – on which there is no single consensus – is determining when the amount of interest paid is "excessive"
  - *Also, countries must determine whether related party payments create a sufficient risk that special rules are necessary*