Shifting profits and dodging taxes using debt

Using debt is a very common way that companies engage in tax avoidance. In this briefing we look at how companies use debt to avoid tax, what governments are doing to prevent debt being used in this way, the problems with the current approach to combating this form of tax avoidance, and what more needs to be done.

What is the issue?

Corporation tax is a tax on profit, which is what is left over from revenues after costs are deducted.

Interest payments on loans are one of the many deductible costs a company can make for corporation tax purposes. So, the more debt a company takes on, the more interest it pays and the lower its tax bill.

This briefing only looks at debt as a deductible cost, but many of the same issues arise for other deductible costs, such as management fees, insurance contracts or intellectual property fees.

Dividends, which are the usual way that profits are distributed to shareholders by a company, are not deductible. They are paid out to shareholders after tax has been paid by a company.

The difference in the tax treatment of equity returns (dividends) and returns on debt (interest payments) is one of the key mechanisms by which corporations and individuals can engage in tax avoidance.

A simple way to extract money from a company tax free is for the owners of that company to loan money to it. In this case, instead of paying out a dividend after tax, a company pays out interest to a shareholder. The shareholder, who may be offshore, receives the profits tax free, and the company pays a lower amount of corporation tax than if it had not taken any loans.

A similar technique is used by multinational companies to shift cash to tax havens. In this case, a multinational may set up a finance company in a tax haven. That company lends money to another company owned by the same multinational. The company receiving the loan pays interest to the tax haven company. Both companies remain under the control of the multinational, but through this process multinationals can move money from higher tax countries to tax havens.

External debt, or debt borrowed from a third party (e.g. a bank) can also be used as a mechanism to avoid taxation through leveraged buyouts, or financial asset stripping. In this scenario a company is bought using borrowed money by a company based offshore. As the acquisition takes place the borrowed money is transferred to the company which has been the target of the acquisition. Often this process involves the target company taking on huge amounts of external debt.

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The Arm's-length principle

The main principle employed by many jurisdictions is the arm's-length principle. This means that interest payments on loans from related parties are only deductible from corporation tax if the interest rate on the loans are similar to the rate that would be granted by an unrelated party, for example a bank or other independent financial institution.

The theory behind this is the idea that a company acts in its own best interests. If the company decides it needs to take a loan, it is free to do so. Once the company has made the decision to borrow money, it makes no difference to the tax authority if a loan received by a company was given to it by a shareholder or an unrelated bank, if the terms of that loan are equal.

However, if the company is borrowing money from shareholders at above market interest rates, this is a sign that the company is seeking to shift cash to shareholders tax free.

So, if a bank were willing to lend $10m to a company at an interest rate of 5%, then in theory the company could equally borrow that much from its shareholders and the interest payments would be tax deductible.

The company which has been bought now has a large debt to pay and is not making any profit. The value of that company as a result is low. As the company pays off the debt and returns to its normal level of profits it becomes a more valuable company. The owner sells it on, but rather than selling the company itself, it sells the shares in an offshore holding company it has created to hold the shares of the target company. Any capital gain is therefore booked offshore.

Policy responses

The extraction of profits via related party loans is one of the simplest ways to avoid taxation. For that reason, governments have sought to introduce rules around how inter-company debt and shareholder loans can be treated for tax purposes.

BEPS

The OECD BEPS process (the G8 mandated process designed to introduce a new international agreement on combating tax avoidance by multinationals) introduced new rules on how interest should be treated for tax purposes.

The proposal put forward by the BEPS process is to put a hard cap on the tax deductibility of interest payments. The recommended cap is between 10% and 30% of earnings before interest, tax, depreciation and amortisation (EBITDA). In practice this means that companies would not be able to deduct interest payments from the pre-tax profits of a company if they exceeded the fixed percentage of operating profit. This cap applies to both related party debt and loans from unrelated sources.

Both Germany and Italy already had in place similar rules, and the EU is mandating all member states to apply them via the Anti-Tax Avoidance Directive.

Problems with current approaches

The problem with the arms-length rule for debt is that it is incredibly complex to administer. Each loan relationship has to be examined on its own merits and assumptions have to be made about what a commercial loan relationship might look like. This results in the creation of a large amount of work for tax consultancy firms, such as the big four accountancy firms, who are employed by corporations to create evidence to support the tax structures they create.

The tightening of the rules under the BEPS initiative is much needed and a welcome step in the right direction. The UK government for example, has estimated that the interest deduction cap will result in an additional £1bn in taxes being paid by corporations every year.

However, the rules represent a very light touch approach, and do not go nearly far enough in actually addressing the real issue. For example, a ratio capping interest payments to 30% of earnings is a very high ratio, and implies a very high level of indebtedness, particularly in today's world of low interest rates. For example, if we assume an interest rate of 5%, a company will have borrowed almost twice its equity value by the time it hits the 30% interest cap.

When the OECD looked at the real level of interest payments made by multinational companies in 2013, they found that 75 out of 79 companies they surveyed had a net interest expense to EBITDA ratio below 10 per cent.

Almost all of the countries currently adopting the new OECD rules have chosen the highest cap of 30%, therefore guaranteeing that the measure will only impact a very small group of highly indebted companies. The UK government estimates that the new rules will only apply to 5% of corporations.

In addition, under proposed rules countries are free to include a number of exemptions which will render the rules less effective in tackling the issue.

For example, in the UK there are exemptions for real estate companies, public infrastructure projects (which may be delivered by the private sector) and others.

In Germany, the cap is exclusively applied to related party loans, only if the subsidiary has a higher debt/equity ratio than the entire corporate group, and only for interest payments of above 3 million Euros per year. The 3 million threshold was inserted in 2009 to replace a lower and tighter 1 million Euro threshold as a result of corporate lobbying.

Solutions

It is easy to see why external debt is considered to be a cost of doing business and is deducted from profits before tax. However, as a general principal, we see no reason why loans from related parties should be tax deductible.

From a practical standpoint there is little difference between a shareholder loan and a dividend, other than the fact that interest payments are normally paid at a fixed rate, and dividends are variable. However, even this is not always the case as some companies use so-called hybrid instruments, such as profit participating loans, which further blur the distinction.

It is highly unlikely that any company would ever go bankrupt involuntarily by defaulting on a shareholder or related party loan. More likely, the shareholder would forgive the debt rather than put their own company into bankruptcy. The risk of bankruptcy is likely to be considerably higher when borrowing from the bank.

In effect, all that is happening when a company borrows money from a shareholder or a related party is that the shareholder is drawing profit from the company before tax is paid via an interest payment, rather than a dividend after corporation tax is collected.

It is therefore our view that governments should count all related party debt as equity for the purposes of calculating corporation tax payments, so there is no deductions for related party interest.

Multinational companies often argue that intra-company loans are hard wired into their business model. Often within the structure of a multinational company, borrowing is managed centrally by the Chief Financial Officer, and one company borrows funds

from an external source on behalf of the entire group. The use of intra-company loans is required to pass on that borrowing to group companies down the chain. There is a positive side to this as each member of the corporate group gets to pool their risk and have access to a lower interest rate on their borrowing.

Removing the intra group interest deduction would increase the cost of passing debt on within a multinational company by no more than a couple of percent. At this point, a company would need to decide whether it would be more advantageous to borrow funds centrally and pool risk (however at a marginally higher cost), or instead to borrow directly from the independent debt market.

The effect of this would be to increase competition in the countries where multinational enterprises operate. Firms that solely operate domestically do not have access to the more advantageous conditions that multinational companies enjoy in the international capital markets. Removing the interest deduction would therefore remove some of that advantage, creating a level playing field between multinational and local companies, and subsequently rebalancing the economy in favour of local and smaller businesses.

Last but not least, disallowing intra-group interest deduction provides an important building block in the direction of implementing unitary taxation. By subjecting an entire multinational group's subsidiaries to uniform consolidated tax accounting, all intra-group transactions, which include loans, fees and other transactions, would be disregarded anyway.

Even if deductions for interest payments via intra-company loans were disallowed entirely, the need to implement a cap on deductible interest payments would still be in place, in order to discourage companies from over-leveraging themselves. We recommend that in addition to disallowing all intra company loans, countries adopt the tightest interest deduction cap under the OECD cap of 10% of EBITDA. In the long term, the TJN recommends that countries move towards the equal treatment of debt and equity for tax purposes.

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