Subject II: Plenary Session – The Debt-Equity Conundrum

Summary of discussion

The 66th Annual Congress of the International Fiscal Association (IFA) held in Boston, the United States, continued on the second day with the plenary session on Subject II "The Debt-Equity Conundrum".

General Reporter: Patricia Brown (United States)
Chair: Machiel Lambooij (Netherlands)
Panel members: Stijn Vanoppen (Belgium), Hélio Araújo (Brazil), Jean-Yves Hemery (France), Casey Plunket (New Zealand)
Secretary: Chris Callahan (United States)

Introduction

Brown began the session with presentation of the General Report that included discussion of the debt-equity conundrum, the major themes, and a summary of the contents of the branch reports. Brown noted that some of the same issues were covered in Subject I of the previous IFA Congress held in Munich in 2000, although that session was focused on the cross-border aspects.

Bias toward debt

The panel began with the discussion of a tax bias toward debt, which may lead to over-leveraging of entities. Such bias has been created by the fact interest payments, traditionally, have been deductible from the taxable income of corporations, while dividends have not. In addition, the common assumption has been that withholding tax on interest payments is lower than withholding tax on dividends.
However, such bias can be reduced or eliminated by, for example, an indirect tax credit or a participation exemption in a cross-border context.

In addition, no clear pattern has been observed regarding relative withholding rates on interest or dividends. In some jurisdictions, withholding rates on interest are higher than on dividends, especially for interest payments between related parties. Also, dividends paid out of taxed profits may not be taxed in some countries.

**Definition of debt and equity**

The panel then discussed the general approaches taken by selected countries for the definition of debt and equity.

(a) Non-tax classification

In some jurisdictions, classification of a financial instrument as debt or equity follows non-tax classification for, e.g. legal, rating, accounting, or regulatory purposes. Relying on non-tax classification may reduce or eliminate tax/non-tax arbitrage.

However, classification under legal, rating, accounting, or regulatory schemes serves a distinctive purpose from tax classification. Non-tax classification also faces the same challenge as classification for tax purposes.

Nevertheless, some guidance can be obtained from non-tax systems, such as a "continuum" approach (i.e. treatment of an instrument as part debt and part equity), as opposed to an "all or nothing (i.e. either all debt or all equity) approach for tax purposes, and a more substance-related classification based on analyzing separate legal instruments on an integrated basis, as opposed to analyzing each instrument individually.

In Belgium, tax classification follows a legal form and is determined by applying one decisive element, i.e. whether an
investor has a fixed right to repayment, even if only on liquidation or default. Under this approach, even perpetual debt instruments and debt mandatorily repayable in shares can qualify as debt.

(b) Statutory definitions

In other jurisdictions, debt or equity can be defined by statues. Australia was used an illustration, where a statutory rule provides that "financial scheme" is debt if it is "substantially more likely than not" that the value of the issuer's "effectively non-contingent obligations" to provide financial benefits will, at least, equal the benefits the issuer receives. The latter concept was generalized as whether the investor will receive more or less than the principal invested (money in vs money out). Under this definition, interest-bearing perpetual debt is generally debt.

(c) Anti-abuse rules

In some jurisdictions, anti-abuse rules apply in distinguishing between debt and equity for tax purposes.

(d) US paradigm

United States examines all the facts and circumstances for the debt or equity inquiry. This approach may offer significant flexibility, but provides no certainty for issues and investors. The essence of the inquiry is the degree of certainty regarding the issuer's obligation to repay the principal. Brown referred to the 5 statutory criteria in section 385 of the US Internal Revenue Code (IRC) and the 16 criteria used by the IRS, which include a requirement of a fixed maturity date. Accordingly, perpetual debt may not be classified as debt in the United States.

Hybrid instruments & Cross border mismatches

The panel began the discussion of the issue of hybrid instruments. This issue may arise in cross-border transactions involving sale
of instruments accompanied by a repurchase obligation (i.e. repo deals), where payments on the instruments may be classified as interest in one country and as dividends in another country, which may provide tax arbitrage opportunities.

Targeted anti-abuse rules to reducing the differences between debt and equity

The panel discussed targeted approaches that have been proposed or employed to prevent a tax bias toward debt by reducing the differences in the tax treatment of debt and equity, as follows:

- Interest rate caps: This approach places statutory limits on the rate of deductible interest by using a rate that is either fixed or dependent on the market-rate.

- Transfer pricing rules: These rules may apply to payments between related parties and restrict the rate of interest or the debt to equity ratio (i.e. the amount of debt).

- Thin capitalization rules: These rules place a maximum ratio of debt and equity, either statutory or group-ratio related, and may lead to the statutory consequence of non-deductibility of interest payments or reclassification of interest to dividends.

- Earning stripping and similar rules: These rules place a statutory limitation on domestic or cross-border payments of interest based on the issuer's profit levels (EBITDA).

- Transactions-based anti-abuse measures: These rules take different forms, e.g. abuse of law, substance over form, GAAR, etc, and have been more successful with respect to specific transactions than with respect to the overall debt structure of an entity.

Alternative methods (structural approaches) to reducing the differences between debt and equity
The panel further discussed alternative approaches that have been proposed or employed to prevent a tax bias toward debt by reducing the differences in the tax treatment of debt and equity, as follows:

- **Comprehensive business income tax (CBIT):** CBIT attempts to eliminate a tax bias by denying issuers interest deductions entirely. Under this regime, investors are not taxed on their investment income and thus CBIT may encourage tax arbitrage that uses cross-border mismatches.

- **Interest box (the Netherlands):** A proposal for defiscalization of certain group interest (i.e. lower rate of tax on interest related income) was made but then withdrawn.

- **Allowance for corporate equity (ACE):** Allows deductions with respect to equity. However, in practice, the deductions with respect to equity are more limited than those with respect to debt. The ACE system may be abused due to the mobility of capital and jurisdictions with ACE may become a tax haven for corporate groups.

- **Notional interest deduction (NID), introduced in Belgium,** allows a deduction for "notional" interest calculated on the entity's net equity base (i.e. capital and reserves for Belgian GAAR purposes).

- **Interest on capital (IOC), used in Brazil,** allows a deduction with respect to remuneration for paid-in-capital if it is distributed as IOC, calculated on the entity's adjusted equity base (i.e. capital and reserves).

- **Help to the Growth of Companies, adopted in Italy,** allows a tax deduction for increases in equity. This measure contains anti-abuse rules that prevent the Italian system from being abused for tax arbitrage purposes in cross border situations. Only equity contributed for the funding of an actual business
is eligible for the deduction, not equity contributed for flow-through group financing.

Impact of fiscal integration

The panel moved on to discuss the impact of fiscal integration. The debt and equity distinction is generally irrelevant for domestic intra-group financing because dividends from such financing are usually exempt and interest is either deductible or eliminated by consolidation. However, in cross-border intra-group financing, the distinction can be important because debt and equity are easily interchangeable in a group context, and the group members can choose the form that will provide the most favourable tax outcome.

The concept of the common consolidated corporate tax base (CCCTB) was proposed. The CCCTB regime contemplates cross-border consolidation of profits and losses, and consolidated tax base across member states.

Conclusion

The panel noted that it had provided no specific answers to the debt-equity conundrum and that domestic measures might not be effective without global cooperation because of the mobile nature of capital. The panel suggested that the preferred solution might be the one based on the arm's length principle.