

Interest Deductibility for UK Corporation Tax

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Preface

There is currently much interest and debate in the UK about the structure and scope of corporation tax. The debate has included a wide set of issues, ranging from the level of the headline rate, and the impact of various European Court of Justice decisions on a variety of issues, to the extent to which the administration of tax creates uncertainty and additional costs for business.

The role of the deductibility of interest costs against corporation tax has also played a prominent role in this debate, and this is why this topic was chosen as the subject of this first report from the Centre.

Given the technical nature of some of the issues involved, the Centre was fortunate to be able to use the services of two tax professionals from business. Peter Wharrad has worked extensively in business, most recently for Vodafone. James Pennock joined the Centre for a period on secondment from PricewaterhouseCoopers; the Centre is very grateful to PwC for its support. The other two authors are members of the Centre: Michael Devereux is the Director, and Socrates Mokkas is a Research Fellow.

Thanks are due to a number of people and organisations: first, to the Hundred Group of Finance Directors, whose donation enabled the Centre to be established and which has effectively funded the research described in this report; second, to the individuals and companies who took part in the interviews described in Section 5; and third, to Stephen Bond, Giorgia Maffini and Simon Loretz for helpful comments on the research reported here. However, responsibility for the report remains solely with the authors.

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Executive Summary

This report discusses the treatment of the relief for interest payments against UK corporation tax. In particular, it addresses whether the existing treatment is in need of reform, and also considers whether some specific reforms would be beneficial.

Relief for interest payments is a significant part of virtually all corporation taxes around the world. This stands in stark contrast to economics literature, which argues that there is no good economic rationale for treating debt differently from equity. But the impetus for reform in the UK comes instead from more pressing developments. In particular, a recent decision of the European Court of Justice has cast doubt on the existing UK treatment of controlled foreign companies, and an opinion of the Advocate General has similarly cast doubt on the continuation of taxing receipts of dividends from foreign subsidiaries.

The treatment of interest is not directly linked to these issues. But if foreign source dividends became exempt from UK tax, the question would arise as to whether it would continue to be appropriate to give relief for interest on borrowing to finance overseas activity, which would never be taxed in the UK. One response to a possible restriction on interest relief is that, to a large extent, the UK does not tax foreign source dividends under the existing system; so changing to an exemption system would make little difference. But this response cuts both ways: in that case, there is already a case for restricting relief for interest.

This report considers two complementary sources of evidence on the impact of existing tax systems on the use of debt. First, using aggregate data and unconsolidated accounting data, it compares the use of debt across countries to that country's tax rate. As might be expected, a higher tax rate is associated with a greater use of debt. The obvious explanation is that the relative benefit of debt over equity increases with the tax rate, and hence so does the use of debt.

It also seems likely that companies that are part of multinational groups are more sensitive to the host country tax rate than purely domestic companies. However, although there is some evidence of this in the academic literature, the simple evidence presented here is not consistent with this hypothesis.

The second source of evidence presented in the report is a set of structured interviews held with the tax directors of 14 large multinational groups in the UK. These groups include both UK and US parented multinationals, and cover a broad range of sectors. The interviews covered two issues: how tax affects the existing financial structure of the groups, and how potential reforms to the UK corporation tax might affect decisions regarding financial structure.

Broadly, the results of the interviews indicate that UK multinationals typically hold all third party debt in the UK. Having raised debt in the UK, it is then disseminated around the group as needed, using both equity and debt, and taking into account the tax profile of both the funding and receiving countries. Few UK multinational companies now make use of hybrid entities or hybrid-based financial products. Legislation in 2005 significantly limited the scope for such activity, and most respondents considered that highly structured tax-driven products had only a short shelf life.

Respondents were asked to comment on a number of hypothetical reforms to the UK tax regime.

There was some agreement about the logic of introducing some form of interest apportionment to restrict relief to interest on borrowing to finance activity in the UK. However, a consensus view was that it would be impossible to introduce any form of apportionment in practice without creating considerable administrative and compliance cost, and uncertainty.

As might be expected, the option of simply reducing the rate of tax at which interest could be relieved – say, to 15% - met with little support.

The consensus view expressed was that such a reform would impose considerable costs, and reduce the attractiveness of the UK as a location for economic activity.

However, a rather more favourable response met the hypothesis that the tax rate on interest received would also be cut. Most respondents considered that a 15% rate on interest received and paid would be sufficiently competitive such that the incentive for offshore financial planning would be removed. Debt would be pushed down to subsidiaries, reducing the overall UK expense, while there would also be an incentive to remit interest to the UK. Perhaps not surprisingly again, reducing the corporation tax rate on all activity also met with a positive response. Profit repatriation generally would be encouraged should this change be coupled with an exemption from tax for overseas dividends.

1 Introduction

Virtually all the world's corporation taxes are based on the return to equity finance. The tax base is the return from investment, net of the cost of debt finance. By contrast, virtually all the economics literature on this issue has argued that taxes on profit should treat equity and debt finance in the same way. One interesting issue is how this divergence came about¹. A more pressing issue though, and one considered here in the context of the UK, is whether a government should consider reforms which remove, or reduce, the advantage to debt finance.

The fact that almost all corporation taxes do permit interest payments to be deducted from taxable profit raises an important question as to the social costs of having this potential distortion to economic behaviour. This is a difficult question, and one which this report does not attempt to answer directly. However, the report does offer some indirect evidence, by presenting information on the extent to which existing taxes induce greater use of debt finance.

Distinguishing between debt and equity raises practical as well as broader conceptual issues. The most obvious question is what are the distinguishing characteristics of a financial contract which indicate that, for tax purposes, it is debt rather than equity? Beyond that, differences in tax rates across countries create tax planning opportunities. Suppose a multinational company operates in country A and country B, and country A has the higher tax rate. Then (other things being equal) the company has an incentive to borrow in A rather than B, since the value of the interest deduction is greater. Unsurprisingly, governments typically seek to limit these planning opportunities. They do so in a number of ways – such as limiting interest relief with reference to the size of the interest payment relative to income, or, by introducing rules which are intended to allocate debt between that used at home and that used abroad.

¹ In the context of the USA, this is the subject of a paper by Robert Walsh (2001).

This report addresses the role of interest deductibility for the UK corporation tax. In Section 2 some of the conceptual issues which arise in an economic analysis of the design of a tax on company profit are addressed. It also sets out a broad outline of alternative approaches for reform. Section 3 describes the UK treatment of interest deductibility in more detail, and compares the UK to other major tax regimes worldwide.

Sections 4 and 5 present new evidence on the impact of interest deductibility on business behaviour in the UK and elsewhere. Section 4 uses both aggregate data on foreign direct investment and accounting data from unconsolidated companies across Europe to analyse the relationship between the use of debt finance and tax rates. For example, it describes the average leverage in a number of European countries, and also compares the position for companies which are part of a multinational group and those which are independent companies.

Section 5 reports the results of a survey of large UK businesses. Businesses were asked about their current financial policies and the influence of taxes in determining those policies. They were also asked how those policies would be likely to change in the event of various hypothetical tax reforms. Section 6 briefly concludes the report.

2 Conceptual issues

The UK corporation tax, along with virtually all others, is based on the gross return to an investment in the case of equity finance and the net return, after interest is paid, in the case of debt finance.

The starting point for an analysis of this differential tax treatment must be a definition of these two forms of finance. In principle, both represent a financial contract between a supplier and user of finance; for the purposes of this report, the latter is a limited liability company. It is the conditions included in the contract which differentiate debt and equity.

Typically, there are three key differences:

- Debt has a prior claim to income generated; equity receives the residual after debt has been paid.
- Debt receives a return which is determined in advance (in the absence of bankruptcy); equity receives a variable return depending on the income generated.
- The suppliers of equity typically have voting rights; suppliers of debt typically do not.

2.1 Should debt be treated more favourably in corporation tax?

Starting from a clean sheet, would any of these conditions lead us to consider that debt and equity income should be treated differently by the tax system?

One possible answer might be that all three of these conditions imply that interest paid is an expense of doing business. The supplier of equity finance – the shareholder - is the owner of the company, who receives profit after paying interest. Corporation tax should be thought of as simply an attempt to tax the income accruing to the shareholder.

In fact, this is often how corporation tax is justified. The argument is that the tax system ought to attempt to tax all sources of income to, and increases in wealth of, an individual (ideally at the same rate). This is clearly very difficult in the case of that part of an individual's increase in wealth which takes the form of retained corporate profit. A corporation tax, while not perfect in this respect, nevertheless compensates to some extent for not taxing the individual shareholder directly. This view of corporation tax also justifies relatively light personal tax treatment of dividends and capital gains on shares; any personal tax represents "double taxation" of this income.

But this argument does not justify the absence of any tax on the return to debt. Instead, it would imply that since the lender has also received an income, he should also be taxed accordingly. This raises the question of how interest income is taxed at the personal level: if corporation tax is intended to be a tax only on equity income, then we might expect there to be an equivalent personal tax which is levied on interest income. Of course there is, at least for some shareholders.

In the clearest example, consider the case in which there is a corporation tax at 25%, but that dividends and capital gains on shares are not taxed at the personal level. Suppose also that there is a personal income tax on interest received, also at 25%. Finally, suppose that the corporation makes a profit before interest of £100. If it is financed by equity, there would be a corporation tax charge of £25, and dividends could be paid which would be worth a net £75 to the shareholder. If it is financed by debt, then the company can pay interest of £100 to the lender, who must pay income tax of £25, earning again a net £75. Hence the tax treatment would be equivalent. This is essentially the basis of the dual income taxes seen in Scandinavian countries, where it is aimed to tax all capital income at the same rate.

However, there are two broad problems with the argument that equity and debt might be similarly treated taking into account personal as well as corporate taxes. First, in general, and specifically in the UK, these tax rates are not the same. For example, higher rate taxpayers may pay

additional taxes on dividend income or on capital gains on shares. Or tax-exempt lenders may pay no tax on interest income. Either of these circumstances (or many others) would rule out the equivalence of the simple example. In most cases, the overall effect is still to benefit debt relative to equity.

Of course, the provider of finance may also be non-resident, and not subject to personal taxes, at least in the country of residence of the company. In this case, incentives depend on the personal taxes which the provider of finance eventually faces in his own country. But the revenue effects are different, since this personal tax is collected elsewhere.

These differences may clearly affect the incentives of both the company and the supplier of finance. It may be, for example, that the two participants would prefer an equity contract, but that the tax system induces them to choose a debt contract. When the tax system induces changes of behaviour of this sort, there is generally some welfare cost. In this case, for example, higher debt is likely ultimately to lead to higher bankruptcy.

The second problem is that a system in which equity income is taxed at the level of the company and income from debt taxed at the personal level requires both tax systems to be able to draw a clear distinction between the two forms of finance. At the corporate level, there is an incentive to create a financial instrument which resembles debt and which therefore benefits from interest deductibility. At the personal level, the reverse is true. By contrast, if the income from debt and equity was treated the same at both levels, then no important distinction would need to be drawn. This is part of a more general issue to which we now turn.

2.2 What are the important conceptual differences between equity and debt?

The distinction between debt and equity drawn above rested on three broad factors. But financial contracts can be very flexible. It is clearly possible to construct contracts that have some, but not all, of the characteristics of debt set out above. For example, a financial contract may give voting rights, but a fixed rate of return; or it may give a fixed rate of return plus some proportion of residual income; or it may pay a fixed return but not have the prior claim to income. Any combination of these, and more detailed aspects of financial contracts, could be drawn up between two contracting parties. This raises two questions.

First, if there were an argument for differential treatment of debt and equity, then on what characteristic of the financial contract should it depend? On the priority of the claim? Or on the rights to residual income? Or on voting rights? Taking the argument this extra step seems to further undermine any possible rationale for differential treatment. It is hard to see precisely what aspects of debt are vital for justifying its favourable tax treatment.

Second, if governments aim to maintain such tax regimes (as they clearly do), they need to be able to distinguish the return to equity and the return to debt. But hybrid financial products, almost by definition, combine elements of debt and equity. To maintain this distinction therefore requires complex rules which are costly to enforce and comply with. It may also introduce uncertainty into the tax system, since taxpayers may not know whether a new financial instrument will be treated as debt or equity if the tax administration is not able or willing to give binding guidance. This is particularly important in an international context.

2.3 The welfare costs of maintaining differential treatment, and of reform

As a general principle, an efficient tax system would require that the tax system has no effect on the choice of in what form to save. The tax distinction between equity and debt is not generally consistent with this principle. But how much does that matter? What are the welfare costs associated with this distortion?

The most obvious behavioural effect of favourable treatment for debt is that financial contracts will be more likely to take the form of debt. The welfare costs of such a distortion are hard to measure, and we have been unable to find such measures in the academic literature. A greater use of debt is clearly associated with a greater propensity for bankruptcy. There may also be more subtle effects, given that lenders typically do not receive voting power in the company.

A rather different potential cost is the creation of tax planning opportunities. Any difference in overall tax rates between debt and equity may give rise to such opportunities. As noted above, these are particularly important in an international context. Interest payments are generally deductible, and interest received is taxable. This gives rise to the incentives described above: there is a clearly an incentive to borrow in high tax countries, and to use equity in low tax countries. Governments have introduced complex rules to try to prevent what they consider to be tax avoidance which makes use of these differences. There are two separate welfare costs here: the fact that the financial structure of corporations is affected by this tax treatment, and the costs associated with tax planning, compliance and administration of complex anti-avoidance rules.

Of course, there may also be welfare cost if there is a reform of interest deductibility. Companies have structured their activities in the expectation that interest will continue to be deductible. Clearly any revenue-neutral reform will generate gainers and losers. The extent to which companies may lose depends partly on whether they

(and investors) can change their financing patterns, and the costs of implementing such changes. Probably large business can, although it will take time, and there will be costs which are greater the more complex the financial operations of the business. Further, it may be the case that some smaller businesses cannot change their financing patterns, though in turn that may depend on the willingness of banks and venture capital firms to change their mode of financing.

2.4 Proposals for fundamental reform

The economics literature has considered two broad ways in which debt and equity could be given equal treatment. The most straightforward is to disallow interest payments as an expense. This is essentially the “Comprehensive Business Income Tax”, or CBIT, proposal made by the US Treasury Department in a 1992 report.²

The opposite approach is to attempt to give equity the same tax treatment as debt. This is more difficult to achieve, but one method was proposed by the Institute for Fiscal Studies in 1991.³ They proposed that the amount of relief given was based on accumulated new equity plus retained taxable income.⁴ The net effect of this proposal is to shift the corporation tax into a tax on economic rent: that is, it applies only to profit over and above the minimum required rate of return (which is not taxed, whether it is financed by debt or equity).

Taxing only economic rent has long been advocated by economists (see, for example, the report of the Meade Committee (1978)). The reason is that decisions at the margin are, in principle at least, not affected by tax, since the marginal investment is not taxed. However, a tax on economic rent does have disadvantages. One important factor is that, to raise the same amount of tax revenue, it would need to have a higher headline tax rate. This would increase the incentive for companies to

² US Treasury Department (1992).

³ Institute for Fiscal Studies (1991).

⁴ Belgium has recently introduced a notional interest deduction along these lines.

shift profit out of the UK. By contrast, moving in the direction of the CBIT would permit a reduction in the tax rate, which would lessen the incentive to shift profits abroad, and may even reverse the incentives.

2.5 Proposals for less fundamental reform

Broad economic principles undoubtedly make a case to be made for a reform of the corporation tax treatment of the return to debt and equity finance. However, there are other considerations apart from these broad principles.

Recent decisions of the European Court of Justice, and opinions expressed by the Advocate General, have raised several questions in the design in corporation taxes in the EU, some of which are outlined in more detail in Section 3. In the UK, these cases have raised questions over two of the building blocks of corporation tax. One question is whether it is any longer wise to attempt to tax foreign source dividends flowing into the UK from foreign subsidiaries of UK-resident companies. Of course, there are also broader economic arguments for and against such taxation, but we will not address those here. A second question is whether existing CFC rules can be used and relied upon in preventing avoidance by shifting profit abroad.

Neither of these questions is directly related to the deductibility of interest in the UK. It is true that exempting foreign source dividends from UK tax throws into sharper relief the fact that the UK generally permits interest paid to be deducted, even when the activity funded by the borrowing may take place elsewhere (although there is some indication that HMRC are increasingly challenging this, especially for companies whose parent is not in the UK). But even under the existing system, in which the UK taxes dividend income, but with a credit for underlying taxes paid abroad, the UK in effect barely taxes foreign source income. Thus, if there is an argument that there should be a restriction on interest paid on debt that is used outside the UK, then this argument almost certainly already applies under the existing system.

A related case for apportionment seems less strong. One argument is that, given current uncertainty about CFC regimes, if the UK moved to a dividend exemption system it might open the floodgates to a significant part of UK taxable income moving abroad, where it could be more lightly taxed and then returned to the UK. Given this, anything which strengthened the tax base, such as restricting interest relief, may help to maintain tax revenue. But if this were a potential problem, it would be due to failings of the CFC regime, rather than a movement to dividend exemption. As such, a prior attempt at a solution should lie with the CFC regime, rather than an attempt to restrict the deductibility of interest.

Nevertheless, it seems plausible that the government will feel constrained to introduce some modification of the deductibility of interest. In this report we therefore consider alternative approaches, paying some attention to practical considerations as to whether such an apportionment can be carried out at reasonable cost. More specifically, in Section 5, we put various options for reform to leading tax directors of large multinational companies, to find their reactions and how they thought their company might respond. These options included reducing the tax rate generally; reducing the rate as applied to relief for interest paid; and also lowering the tax rate as applied to interest received. We also considered various forms of apportionment of interest.

3 A brief guide to the UK treatment of interest for corporation tax

Although the previous section of this report was based on the notion that interest expense was deductible for UK corporation tax, the details are far from straightforward. This section outlines in a little more detail the relevant aspects of the structure of the UK corporation tax regime, and compares it to that in other countries.

Relief for expenses relating to debt financing, in particular interest expense, is generally given for UK corporation tax purposes under Schedule D Case III. Interest expense can first be offset against any current year Schedule D Case III income (e.g. interest income). After this, it can be offset against three other forms of income: (a) other current year income of the UK company, (e.g. trading income, chargeable gains or dividend income); (b) Schedule D Case III income of the UK company in the previous 12 months; or (c) current year profits chargeable to UK corporation tax of another UK resident company⁵ within the same group as the first UK company. Any surplus after these options have been exhausted must be carried forward to set against future non-trading profits of the UK company that incurred the deficit. In practice, this will clearly only be possible if the company has non-trading income.

For UK tax purposes, interest expense is generally available as shown in the company's statutory accounts, provided these conform to generally accepted accounting practice.⁶ However, that leaves open the issue of differentiating interest from a dividend. The UK tax code defines a variety of circumstances where a payment to a provider of

⁵ Or a UK permanent establishment ("PE") of a foreign company.

⁶ Where a loan exists between two connected parties, relief is available on an accruals basis only, and where the lender is a connected foreign tax resident, relief is only available on an accruals basis where the interest is paid by the UK tax resident company within 12 months of the accounting period in which it accrues. The timing of payment of the interest in these circumstances can be delayed where clearance has to be sought in advance from Centre for Non Residents to settle the interest at a reduced rate of UK income tax under the terms of the relevant double taxation agreement, or under the terms of the EU Interest and Royalties Directive.

finance should be characterised as a dividend, rather than as interest (and hence not deductible from tax). These characteristics broadly relate to the distinctions between debt and equity set out above.

For example, the following would be treated as a dividend, rather than interest: interest paid in excess of a commercial return on the loan principal or where the payment is dependent on the results of the company's business, and interest paid on debt which is convertible into equity on terms not reasonably comparable with those of quoted securities. There are also rules which distinguish between debt and equity in order to determine ownership for tax grouping purposes. And there are also provisions which classify a transaction as either debt or equity where this might be unclear. For example, "repo transactions" involve the sale and repurchase of shares by a UK company where the difference between the sale and repurchase price constitutes a finance charge; in prescribed circumstances these are treated as debt.

3.1 Anti-avoidance

UK tax relief for interest expense is subject to a number of anti-avoidance provisions that restrict relief where certain criteria are met. We summarise these under two headings. "Thin capitalisation provisions" refer to legislation that denies relief by reference to the amount and terms of the debt. "Tax base erosion" refers to legislation that denies relief where it is perceived that the purpose the debt is issued is to reduce taxable profits.

3.1.1 Thin capitalisation provisions

Mechanism of the thin capitalisation rules

The key focus of the UK thin capitalisation provisions is the arm's length principle. The main consideration is whether debt financing is excessive by reason of the relationship between the borrowing and lending companies, in which case interest payments are disallowed to

the extent that they exceed the arm's length arrangement. That is, it is necessary to determine what arrangements would have been extended by an unconnected party, including whether the loan would have been made at all, what amount would have been lent, and what rate of interest and other terms would have applied to the loan.

There is no statutory definition of the methodology to be used for determining the arm's length nature of borrowing. In practice, HMRC accepts a range of different measures, including consideration of the nature of the underlying industry, business and asset base of the UK company, the underlying risk of the UK company, and the cash-flows of the UK company. Often the UK company will agree debt covenants with HMRC – that is, financial ratios that must be met each year in order for all interest expense on related party debt to be deductible. HMRC has provided guidance in Tax Bulletin 17 that it would not normally consider a UK grouping with a debt:equity ratio of 1:1 or less, and an income cover ratio of at least 3:1, to be thinly capitalised, although this is not a statutory safe harbour.

Thin capitalisation rules in other tax jurisdictions are generally more prescriptive than in UK, and tend to follow explicit safe harbour/financial ratio tests. For example, in France, Germany, the Netherlands, Spain, the USA and Japan a fixed measure of debt:equity is currently used to determine thin capitalisation, with the methodology to be used also prescribed.

Spain and France also have provisions which determine the maximum rate of interest for which a tax deduction is available. The USA's earnings stripping rules apply to limit the deductibility of interest with respect to related party debt where the interest income is not subject to US taxation. Any interest that is deductible in the USA after meeting the debt:equity test is further limited by reference to a percentage of current year taxable profits. The USA also allows carry forward of relief for any interest not deductible in the current year. The Netherlands allows interest to be deductible as long as a Dutch company's debt:

equity position does not exceed that of the consolidated group to which it belongs. New French rules which will take effect from 2007 also include these last three provisions.⁷

The forthcoming German 2008 tax reform is of some interest here. These proposals repeal existing thin capitalisation rules and introduce interest stripping rules, which appear similar in function to US earnings stripping rules. Current details of the proposals suggest that interest payments exceeding €1m per annum will only be deductible to the extent that they do not exceed 30% of Earnings Before Interest and Tax (“EBIT”). It will be possible to carry forward any excess interest expenses for offset against profits in future periods, subject again to the 30% EBIT test. The interest stripping rules will not apply where the German company can demonstrate that its debt:equity position does not exceed that of the group to which it belongs.

Response to Lankhorst

In December 2002, the European Court of Justice gave its judgement in the Lankhorst case, finding that the then German thin capitalisation rules were in breach of the freedom of establishment provisions of the EC Treaty. The UK thin capitalisation rules were similar to the German provisions, in that neither applied to loans between domestic entities. In response to this judgement, Finance Act 2004 repealed the main existing UK thin capitalisation legislation. With effect from 1 April 2004, thin capitalisation provisions apply to all related party financing transactions, including those between related UK companies.

This response to the Lankhorst decision can be compared with that of other member states. Germany and the Netherlands also extended their thin capitalisation rules to domestic related party financing transactions. Spain chose to revise domestic thin capitalisation rules such that they

⁷ In Japan, the thin capitalisation rules apply to borrowings from foreign related parties, although in addition tax relief is denied for interest expense in a period when a dividend is received from a Japanese subsidiary which is acquired using debt finance; this is on the basis that the dividend is exempt from tax.

do not apply to borrowings from related parties that are resident in the EU. France’s current thin capitalisation rules only apply where the lender is non-EU resident and their application is not prevented under the terms of a double tax agreement. Ireland has not introduced thin capitalisation rules, although in principle any interest paid by an Irish company to an overseas affiliate is treated as a distribution and hence is not deductible.⁸

3.2 Tax base erosion provisions

There are two key provisions in the UK that aim to prevent interest relief where the aim or purpose of issuing debt is to gain a UK tax advantage through interest relief.

3.2.1 Loan relationships for unallowable purposes

Finance Act 1996 introduced detailed legislation governing the taxation of “loan relationships”, and includes a provision to deny relief for interest expense where the UK company’s purposes for entering into the debt (or for entering into a transaction which is related to the debt) include an “unallowable purpose”. In turn, “unallowable purpose” is defined as a purpose which is not amongst the business or other commercial purposes of the company, including a main purpose that constitutes a “tax avoidance purpose” -aiming to secure a UK tax advantage.

Where an unallowable purpose is identified, the company must allocate the interest expense, on a just and reasonable apportionment, to that unallowable purpose, and no relief is available for that part. The legislation does not define the methodology either for determining whether a transaction is for an unallowable purpose, or for allocating the interest expense.

⁸ The Irish company can elect to claim an Irish tax deduction where the interest is paid in the ordinary course of its trade and the interest is paid either to a company resident in an EU country or to a company resident in a non-EU country that has concluded a double tax agreement with Ireland.

3.2.2 Avoidance involving Tax Arbitrage

Finance (No.2) Act 2005 introduced “Avoidance involving Tax Arbitrage” provisions. Broadly, these aim to deny UK tax relief for expenses, including interest, associated with transactions which have a main purpose of eroding the UK tax base through the use of hybrid entities or arrangements, which may either generate a double deduction for tax purposes for the same expense, or the receipt corresponding with the expense giving the UK tax deduction is not taxable.

This only applies upon issuance of a notice by HMRC, and this can be done when they consider that four conditions are met. Condition A requires the UK company to be party to a transaction that is part of a scheme involving a hybrid entity or a hybrid effect. The term “scheme” generally refers to transactions that would not occur in the same form independently. Hybrid entities are defined as entities which are opaque for the purpose of one tax jurisdiction, but whose profits are treated as those of another person for the purpose of another tax jurisdiction. Hybrid effect includes convertible instruments, instruments of alterable character, or instruments issued as debt but treated as equity for accounting and tax purposes. Condition B requires the UK company, as a result of the transaction, to claim a UK tax deduction. Condition C requires one of the main purposes of the scheme to be the avoidance of UK tax. Condition D is that the UK tax advantage is more than minimal.

These provisions have affected US multinationals in particular. US tax law allows non-US companies to elect to be disregarded as separate entities, which implies that for US tax purposes the income of the non-US company will be consolidated with the US parent. Interest paid by a UK company to a US parent would therefore not be taxed in the US. A UK company which has elected this meets the test of being a hybrid entity; hence in principle interest paid by the UK company to its US parent may no longer be deductible if it results from a scheme where one of the main purposes is the avoidance of UK tax.

HMRC have issued guidance on their interpretation of the four conditions, particularly focussing on their approach to the application of Condition C. In general, the guidance suggests that it is important to consider what the comparative transaction would have been had no hybrid been used. Where the transaction giving rise to the UK tax deduction would not have happened in the absence of the hybrid, then this is a likely indicator of a UK tax advantage main purpose.

Provisions in other territories

As with thin capitalisation rules, tax base erosion provisions in France, Germany, Ireland, Japan, the Netherlands, Spain and the USA are generally more explicit than the UK provisions. Germany,⁹ France,¹⁰ the Netherlands and Ireland all have rules that prevent relief for related party interest expense where the loan is incurred by a resident company to acquire shares in an affiliate. Ireland has certain commercial exemptions from these provisions. For example, interest expense accruing with respect to a related party borrowing made to finance a share subscription by an Irish company remains deductible if the purpose of transaction is to increase the capital of a trade or business, and the purpose of the transaction does not include the provision of funds to the lending party. The Netherlands has similar provisions.

Spain and France similarly have “abuse of law” provisions which allow transactions to be challenged and reclassified where they are performed for domestic tax avoidance rather than genuine business purposes; these can be used to prevent relief for the associated interest expense.

The Netherlands and Ireland also have specific provisions with respect to the deductibility of interest expense associated with third party acquisitions. For Dutch tax purposes, relief for related party interest

⁹ These rules will be repealed by the German 2008 tax reform.

¹⁰ For French purposes this is limited to where a French company enters into a related party borrowing to acquire shares in a French affiliate which then joins the French consolidated tax group.

expense may be deferred for a number of years where no or little third party finance is obtained to finance the acquisition. Irish legislation sets out specific conditions that must be met to ensure the deductibility of any interest associated with the financing of acquisitions.

In the US, whilst interest relief is denied in specific circumstances, it is the earnings stripping rules that are the key provision for determining the deductibility of interest expense. The German 2008 tax reform also leaves the key provision determining the deductibility of interest being interest stripping rules. In Japan the key provisions with respect to interest deductibility are the thin capitalisation rules; there are no other specific tax base erosion provisions in the Japanese tax code.

4 Interest flows in Europe: an analysis of aggregate data and financial accounts

We now examine empirical evidence on the effects of the differential tax treatment of debt and equity on the financial structure of companies in Europe. In particular, we aim to compare the average leverage ratio of companies resident in each country to the tax rate in that country. Other things being equal, we would expect companies resident in high tax rate countries to use more debt than companies resident in low tax rate countries.

Beyond that, we would also like to analyse whether the financial structure of a subsidiary of a multinational company is more sensitive to differences in tax rates than a stand-alone company (which we define as a company not owned by a parent company, and which has no subsidiaries). This is plausible. A stand-alone company must trade-off the tax benefits of debt finance against other costs, in particular, the higher cost of bankruptcy. By contrast, a company which is a subsidiary of a multinational company may be able to use intra-company debt without encountering the possibility of bankruptcy.

These issues have been investigated to some extent in the recent academic literature, although there have not been a large number of studies. For example, Mills and Newberry (2004) estimate a model of debt financing that tests whether non-US multinationals' tax incentives influence their US debt policy. They find the foreign multinationals with relatively low foreign tax rates use more debt in their US subsidiaries than those with relatively high foreign tax rates. Desai, Foley and Hines (2004) analyse the determinants of the capital structures of foreign affiliates of US multinational firms. They find that 10% higher local tax rates are associated with 2.8% higher leverage, with internal borrowing being particularly sensitive to taxes. Using Amadeus data, Huizinga, Laeven and Nicodeme (2006), find evidence that the leverage of companies owned by multinationals is more sensitive to tax rates than stand-alone domestic companies.

To examine these issues, we make use of two independent data sources. First, we use aggregate data on foreign direct investment. The IMF Balance of Payments Statistics publication, contains data on flows of direct investment between countries. The most recent available data is for 2004. Direct investment is investment in which a resident entity in one economy acquires a lasting interest in an enterprise resident in another economy; it includes the initial transaction and all subsequent transactions between the resident entity and affiliated enterprises, both incorporated and unincorporated.

These flows of direct investment are also split between debt and equity (new equity flows plus reinvested earnings).¹¹ Using these data, we can calculate the percentage of net inflows of investment into each country which is financed by debt. Note that these are cross-border flows. They therefore include flows of funds used for greenfield investment and for acquisitions. However, they do not include investment by the subsidiary of a multinational which is financed locally.

The second source is the Amadeus database compiled by Bureau Van Dijk. This database contains accounting data on the largest approximately 250,000 companies in Europe, with consolidated and unconsolidated data. In particular, it contains summary balance sheet and profit and loss statements, including information on the use of debt and payments of interest. The most recent year for which we are able to construct a sample of significant size is 2003. However, even this year contains missing data. Taking only unconsolidated accounts which contain enough information to reliably measure a leverage ratio, our sample size is just under 70,000 companies spread over 15 countries. To make the aggregate IMF data comparable with the accounting data, we also analyse the same 15 countries in the aggregate data.

¹¹ Debt flows are referred to as Other Capital, and cover borrowing and lending of funds, including debt, securities and trade credits between direct investors and direct investment enterprises and between two direct investment enterprises that share the same direct investors. Equity Capital covers equity in branches, all shares in subsidiaries and associates. Reinvested earnings capital is the direct investors' shares of the undistributed earnings of the direct investment enterprise..

The Amadeus database also contains details of the ownership structure of companies: both the parents and subsidiaries of each company are recorded. In principle it is therefore possible to identify the structure of groups: multinational groups which operate through companies in more than one country, and domestic groups which operate only in one country. To identify a company which is part of a multinational group, we define a parent company to be a company that has a shareholding of at least 50%. Following a chain of ownership through the data enables us to identify companies which are members of the same multinational group.¹² Any company that does not have a parent company defined in this way is treated as independent. In Table A.1 in the Appendix, we break down companies in our sample according to whether they are stand-alone, belong to a domestic group, or belong to a multinational group. More information on the Amadeus dataset is also included in the Appendix.

4.1 Aggregate data on flows of debt into countries

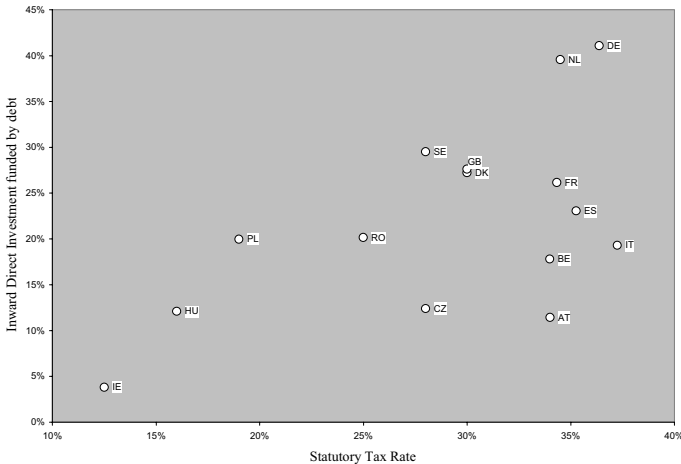
We begin by considering the aggregate data on flows of direct investment, which we interpret as flows from a parent company which are financing an affiliate in a foreign country. Other things being equal, it is more likely that such flows would take the form of debt if the corporation tax rate in the host country is higher, since the return payable is likely to be untaxed at the corporate level.

Figure 1 shows this relationship for 15 European countries for which we also have Amadeus data. It is clear that the data are consistent with the hypothesis. There seems to be a clear upward relationship in the data: higher tax rates in the host country are associated with a higher proportion of inward direct investment taking the form of debt. At one extreme, Ireland has a 12.5% tax rate but almost all inward investment takes the form of equity. At the other extreme, Germany's tax rate is nearly 40%, and 40% of inward investment takes the form of debt.

¹² This process is complicated by the fact that we do not have data on some intermediate companies, even though they are named as a parent. This is usually because the company is not resident in Europe.

Of course, the Figure does not make an allowance for a range of other factors which may affect the flows of debt. Nevertheless the pattern in Figure 1 is striking, and suggestive of a significant impact of taxation on the form of the direct flow.

Figure 1: Percentage of Inward Direct Investment in form of Debt v Corporation Tax Rate



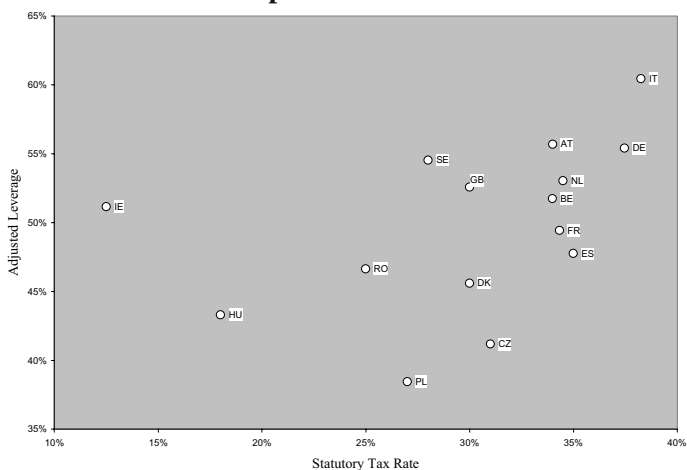
4.2 Data from unconsolidated financial accounts

By using disaggregated data we are able to at least partially control for other factors. It is clear from the analysis of the Amadeus sample of companies shown in the Appendix that they vary considerably both by sector and by size. It also seems plausible that leverage could also depend on these factors. The relationship between leverage and tax rates in a chart such as Figure 1 might therefore be affected by these factors.

To control for these factors, we first estimate a simple regression equation in which the leverage of each company in 2003 is regressed on four variables: company size, a dummy variable reflecting the sector it operates in, a set of dummy variables indicating the country of residence of the company, and the same set of country dummy

variables multiplied by another dummy variable indicating whether the company is part of a multinational group or not.¹³ We take the coefficient on the country dummy variable on its own as a measure of the average “adjusted leverage” in that country. That is, it reflects the average leverage in each country after controlling for the effects of size and sector. The resulting average adjusted leverage is plotted against the tax rate in Figure 2.

Figure 2. Average Adjusted Leverage of Unconsolidated Companies v Corporation Tax Rate



As with the aggregate data shown in Figure 1, Figure 2 seems to identify a clear positive relationship between adjusted leverage and the statutory tax rate. A very rough estimate based on Figure 2 would be that a 10 percentage point rise in the tax rate is associated with a 10 percentage point rise in leverage. By and large, countries with low tax rates such as Hungary, Poland, Romania and Czech Republic are characterised by low tax rates and low average adjusted leverage.

However, it is necessary to be cautious in claiming causation: it is possible that countries with low tax rates are also countries which have

¹³ It turns out that size does have a significant impact on leverage, but the effect is very small.

other characteristics which may explain low leverage. For example, the four countries named tend to have less developed banking systems, which could limit the amount domestic companies can borrow.

That suggests that it would be interesting to compare the leverage of purely domestic companies and companies that are part of multinational groups, who have rather different options for borrowing. That is, independent companies may need to rely on local sources of finance. They also have to balance the tax benefits of using debt against the costs of becoming more highly leveraged, and hence more prone to face bankruptcy. By contrast, companies that are part of a multinational group can use intra-group debt and avoid the need to borrow locally. Indeed, the results of interviews presented below indicates that large UK multinationals tend to lend directly to overseas subsidiaries, rather than have the subsidiaries borrow on their own account. While the overall group may face an overall constraint on its use of debt, this need not apply to an individual company within the group. This may mean that the company which is part of a multinational group has more flexibility in the use of debt; in turn this implies that it may be more sensitive to differences in tax rates.

To explore this, we compare the leverage of companies which are part of a multinational group with companies that are not part of such a group. Using the same regression as described above, we measure the additional effect in each country of the company being part of a multinational group by the coefficients on the interacted dummy variables. That is, these coefficients indicate the degree to which such companies borrow on average more in a particular country than purely domestic companies. We refer to this as the difference in adjusted leverage: it reflects the average leverage for companies which are part of a multinational group less the average leverage for other companies.

Figure 3 presents the relationship between this difference in adjusted leverage and the tax rate. A positive difference indicates that on average a company which is part of a multinational group has a higher leverage

than other companies in that country. A negative value indicates that it has a lower leverage.

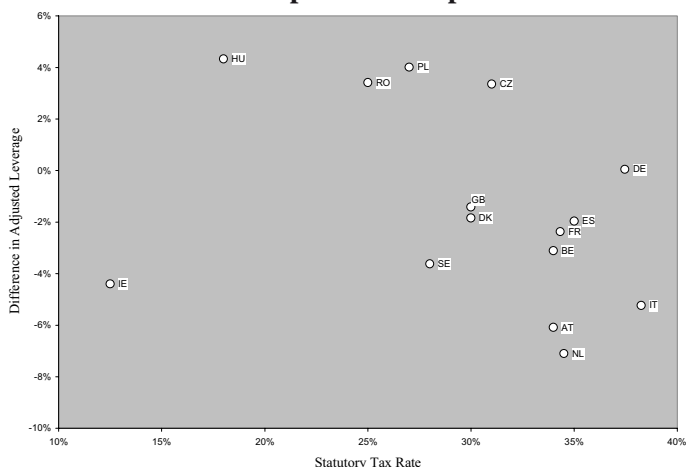
The results of this exercise are rather surprising. If anything the relationship between this difference and the tax rate is negative, rather than positive. That is, there is no clear indication that companies which are part of multinational groups are more sensitive to tax rates than other companies: if that were true, then the difference ought to become higher as tax rates increase. If anything, with the exception of Ireland, the relationship is negative. That is, companies which are part of a multinational group respond less to changes in tax rates than domestic companies.

In the absence of a more detailed analysis we can only speculate as to why the leverage of companies which are part of a multinational is not more sensitive to tax rates.¹⁴ There are at least two possible explanations.

First, Figure 3 contains different types of countries. In particular, the four countries where multinational companies do have higher leverage are Hungary, Poland, the Czech Republic and Romania: three new EU members and one country about to become a member. This may indicate that the use of debt by domestic companies in these counties may be affected by limited local availability.

¹⁴ And note that, using a more sophisticated approach, Huizinga et al (2006) do find evidence that the leverage of subsidiaries of multinational companies were more sensitive to host country tax rates.

Figure 3. Difference in Average Adjusted Leverage of Unconsolidated Companies v Corporation Tax Rate



Excluding these countries, however, does not provide the expected relationship either. In most other countries, the difference in adjusted leverage is close to zero or negative, indicating that domestic companies have higher leverage, although that may be due to other factors. But additionally, there is no clear positive relationship between the difference in adjusted leverage and the tax rate, which would be observed if the leverage of companies which are part of a multinational group were more sensitive to the tax rate.

A second possibility is that anti-avoidance measures are typically successful in not permitting multinational companies to borrow excessively in high tax rate countries. A related explanation would be that for multinational companies, leverage decisions are determined primarily by factors other than the potential saving through a high tax rate. To investigate this possibility in more detail, in the next section we turn to the results of a set of structured interviews with large multinational companies, which is partly aimed at illuminating such issues.

5 The practice and views of UK large business

The data presented in the previous section give an overall picture of the use of the debt in different countries, and the relationship between the use of debt and the host country tax rate. But analysis of such data can only provide a general description. It is difficult, for example, to use the results to identify the likely impact of potential tax reform in the UK.

To complement this analysis, we have therefore also undertaken a set of structured interviews with tax directors of 14 large multinational groups in the UK. The sample included both UK and US parented multinationals and covered a broad range of sectors. The multinationals varied from those for whom the UK generated a minimal percentage of the group's profits to those for whom the UK was the main profit centre. In order to generate a comprehensive discussion with each respondent, we agreed to treat individual responses as confidential. Here we summarise the answers we received, without identifying the response of any particular company or individual.¹⁵

We asked two sets of questions. The first concerned existing use of debt, based on the tax systems in the UK and elsewhere. These included questions about the location of third party debt and intra-group debt, the main vehicles used for intra-group debt, and the factors which are important in determining those locations. We also explored the use of hybrid entities and other hybrid instruments, and in particular asked about the effects of the 2005 "tax arbitrage" provisions. We also explored the likely effects of recent judgements of the European Court of Justice in determining financial structure.

The second set of questions concerned the possibility of tax reform, and explored how financial tax planning would be likely to be affected by some specific reforms. These reforms were chosen to illustrate

¹⁵ Some respondents also preferred to remain anonymous. In order to preserve their anonymity in a small sample, we do not provide a list of respondents.

the likely impact of major potential change. They were not chosen as a prediction of likely UK tax reform, nor were any of the reforms advocated.

The principle regime changes discussed were as follows:

1. Reduction of the UK corporation tax rate to 15%
2. Reduction of the rate of relief for interest expense to 15%
3. Introduction of an 'interest box' regime where interest receipts and expense are both taxed at 15%
4. Reduction of the UK corporation tax rate to 15%, but no relief for interest expense.

In addition, questions were asked about the possibility of introducing some form of interest apportionment, with the objective of restricting interest deductibility to costs related to only UK activities. Various potential methods of allocation were considered.

Finally, we also considered the possible impact of developments in the law on Controlled Foreign Companies (CFCs) as well as the potential for introduction of an exemption from tax for foreign sourced dividends. There is no necessary link between interest deductibility and CFCs as such, although the overall cost of the UK's interest regime will create an incentive or disincentive for multinationals to engage in tax planning of the kind that CFC legislation is intended to prevent. There is some argument for a link between interest deductibility and a dividend exemption, in that there is an implied tax relief in the UK which creates income which in turn may never be subject to UK tax. However, a counter-argument would be that the existing regime also effectively allows for no tax to be paid on foreign source dividends. Nevertheless, it is clear that changes to either of these may elicit different responses from multinationals.

We now turn to setting out a summary of the responses.

5.1 Organisation of financing activity

Based on the responses from the interviews, it appears that UK multinationals typically hold all third party debt in the UK, and most commonly in the top company. Third party debt is generally raised outside the UK only by exception. This may occur either where particular circumstances dictate that a subsidiary has its own, usually local, third party debt or where access is needed to particular capital markets. In the latter case, groups generally use a Special Purpose Vehicle (SPV) to issue the debt, and on-lend back to the UK to the extent that the funds are not required in the issuing territory. Therefore, even where debt is raised outside the UK it is effectively UK debt, and it is invariably issued under a top company guarantee.

The key drivers for the location of third party debt are access to capital markets, continued satisfaction of commercial banking covenants and a desire in a number of groups to keep central treasury functions near to the group centre. There is also the practical benefit of only having to demonstrate investment grade debt status for one (or at the most a very limited number) of legal entities within the group. It is much easier for groups to manage third party debt centrally. The typical model is therefore one of centralised fund raising with a system below that for disseminating funds to other territories. Therefore most third party debt is either physically or economically held in the UK.

Once funds have been received they are disseminated around the group as needed. This is done by way of both debt and equity, typically according to the tax profile of both the funding and receiving territories. Groups aim to manage the gearing of overseas subsidiaries according to commercial need, but lean more towards debt in territories with higher tax rates and equity in territories with lower tax rates. (The data presented in the previous section confirms this for a wider set of companies). For treasury management reasons companies tend not to inter-lend between overseas territories. Companies use intermediate financing vehicles, either UK or non-UK, to carry out this activity. Those with non-UK intermediate financing vehicles can manage

circulation of cash around the group outside the UK without passing those funds through the UK.

Inbound multinationals have a similar overall group approach, with the result that the UK is funded by a combination of debt and equity from group sources rather than third party sources. The key tax planning parameter, especially for US inbounds, tends to be home country tax optimisation rather than UK tax optimisation.

Few companies make any significant use of hybrid entities or hybrid-based financial products. The 2005 legislation significantly limited the scope for this activity, and respondents generally saw this activity as peripheral or opportunistic rather than structural. The effect of the Tax Avoidance Disclosure rules is that highly structured tax-driven financial products tend to have a very short shelf-life, and most respondents preferred to use more stable funding methods. This view was corroborated by one banking respondent who commented that very few such products are now sold to large UK corporate groups.

5.2 Factors in determining the location of a finance vehicle

In deciding where to locate finance activity, companies typically consider a range of factors, of which taxation is only one. In fact, tax matters are often not the deciding factor. More important than the current tax system is regime stability, both politically and in terms of having clarity and certainty on tax outcomes. Other important factors are access to good quality professional finance staff and regulatory and company law issues. It is typically after considering these issues that companies will consider tax issues, including matters such as deductibility of interest, quality of the treaty network and withholding tax rates as well as the overall CT rate. Generally there would also be a preference for locations nearer to head office rather than further away, and a preference for EU locations.

A number of companies commented that the UK ranked very highly on all of these measures apart from tax. Specific disadvantages cited in

the UK tax were withholding tax on long interest, a relatively high CT rate and relatively poor certainty of tax treatment. Inbound companies commented that the 2005 hybrid and financial avoidance rules had damaged the UK's reputation in this regard and had had a material impact in terms of perceived certainty, even apart from the need to change existing structures. Comments on the practical outworking of the clearance procedures for these rules were generally though not wholly favourable. Few UK groups in the sample felt that these rules had had a material impact on their financial structuring, though some commented that they had suffered 'collateral damage' with previously safe or even approved structures falling foul of the widely drawn rules.

5.3 Consideration of the impact of regime changes

Beyond describing the impact of taxes, and interest deductibility in particular, on existing financial structures, the interviews also gave an opportunity to examine the likely effects of conceivable reforms in the UK.

5.3.1 Reduction of the UK corporation tax rate to 15%

Comments on this scenario were somewhat tainted by respondents' uncertainty about the quid pro quo for such a change; generally a move toward a broader corporation tax base, or further extension of the indirect tax base would make the proposition unwelcome. One respondent mentioned the one-off accounting impact of reduction of the carrying value of tax assets.

However, setting aside considerations of wider changes and considering the scenario as it stood, most companies agreed that this would be highly favourable. The impact of a significant reduction in the CT rate was not just seen in terms of a lower tax bill, but in terms of the directional changes that would follow. Companies commented that the set of competitor countries for new manufacturing investment now included locations such as Ireland along with traditional competitors such as France, Germany and the US. Companies make investment

decisions on a post tax basis, and with a lower UK tax rate, a number of companies would expect new manufacturing to be located in the UK rather than elsewhere, although other commercial factors would provide inertia against moving existing manufacturing activity onshore. Activity in research and development and intellectual property activity would tend to move towards the UK. Whilst some groups would still chase a lower tax rate elsewhere, the majority view was that at 15% any remaining economic downside compared to competitor locations was overcome by the other non-tax advantages of operating in the UK.

There would also be a significant impact on financial activity. At 15%, the UK rate would be at the lower end of tax rates for most groups, and such a reform would therefore create a structural incentive to push debt down into subsidiaries rather than maintain a UK deduction at only 15%. Some companies also commented that if this change were allied with an exemption for overseas dividends they would remit substantial sums to the UK that are currently held overseas.

5.3.2 Reduction of rate of tax relief on interest to 15%

This is effectively a disallowance of 50% of interest costs, and was considered as an alternative to alternative allocation methods. It was, unsurprisingly, seen as very negative. The cost would be substantial for many companies, with a high impact on reported effective tax rates. Companies were concerned about the impact on UK competitiveness.

The scale of the financial impact would force companies to try to restructure to mitigate the cost. Likely responses include significant repatriation of overseas earnings or capital (in order to reduce UK debt), and other more aggressive debt pushdown structures. A move of this scale would make the UK sufficiently unattractive that a number of respondents anticipated questions from their boards about how much activity could be moved out of the UK or even whether the company itself should relocate; this was seen as quite a realistic outcome in a case of a major merger or takeover, when residence issues are anyway routinely considered.

Apart from competitiveness issues there was a strong feeling that, subject to existing thin capitalisation limits, UK based activity should have full interest relief on debt incurred to finance it.

5.3.3 Introduction of a 15% ‘Interest Box’ regime

In this scenario, interest receipts and payments would both be subject to a 15% tax rate regime. Clearly there would be complications with the banking sector, but it should in principle be possible to define a regime that applied to interest income and expense other than that arising in the course of a financial trade.

The overall reaction to this from UK based multinationals was favourable. Most respondents would see a UK 15% interest box regime as sufficiently competitive to remove the incentive for offshore financial planning, although some felt that the rate would need to be lower than 15% to achieve that. If this change were linked to an exemption from tax for overseas dividends, there was also a strong response that there would be significant repatriation of overseas earnings.

Effectively this was seen as representing a policy choice to make a competitive response to the European Court of Justice ruling in the Cadbury CFC case, rather than further developing the UK’s CFC rules. The regime would provide an economic incentive for groups to push debt down to subsidiaries, thus reducing overall UK interest expense, and would also provide an incentive to maximise remittance to the UK, thus increasing UK interest income. The majority view from the respondents was that this scenario would probably be favourable from the companies’ perspective and positive for the exchequer.

There would be winners and losers, as with any significant change. Whilst the benefits to financing activity are clear, the change would be detrimental for companies with large UK operations relative to the overall group activity, and domestic manufacturing would suffer a competitive disadvantage. There is still a presumption that UK based activity should have full interest relief on debt incurred to finance

it, although the offsetting effect of lower tax on interest income substantially helps. Respondents offered various refinements, including some form of order of set-off, so that interest expense is first dealt with in the 15% pool, but any excess is relievably against mainstream taxable income at 30%.

Some respondents commented that this scenario would be very good for UK based multinationals, but could prove less helpful for inbound investors; the similar system currently proposed for the Netherlands is optional, and they would see that as more attractive.

5.3.4 Reduction of CT rate to 15% and reduction of rate of relief on interest to 0%

This scenario would equalise the tax treatment of debt and equity, and offer a compensating adjustment in the CT rate.

This was seen as having a significant adverse impact on competitiveness. Every other major regime allows tax relief for debt to at least some extent. Some regimes have considered bringing the treatment of debt and equity into line, but have done so by giving some form of relief for equity rather than restricting relief for debt. Whilst respondents appreciated the economic logic (set out here in section 2), they saw a significant ‘first mover’ disadvantage for the UK in implementing this.

In practice, companies would restructure around the change, though this would take some time. In the meantime, there would be a major dislocation of funding. One respondent pointed out that most debt instruments allow for a call at face value (rather than par) in the case of a major change in the tax regime such as this; there could therefore also be a significant impact on the bond markets. There would need to be different treatment for banks and the implied difference in tax treatment of interest expense and interest income was cited as a negative factor.

However, a number of respondents felt that such a system could be workable once they had restructured accordingly. This scenario would mean a system where the prize was substantially removed from financial tax planning in the UK and there would be more certainty of outcome than at present. Likely responses included aggressive debt pushdowns to overseas subsidiaries in order to retain some measure of debt tax relief within the group.

5.3.5 Introduction of interest apportionment

The final set of interview questions considered a possibly less radical reform of the corporation tax system, but one which nevertheless could be very important: the introduction of a form of interest apportionment, where relief is restricted for interest paid on borrowing which is undertaken to finance overseas activity.

The logic for an apportionment of interest expense is that it is inappropriate for the UK to grant a general tax relief for debt funding where there is no prospect of the business in which that funding is invested ever generating taxable income in the UK. Arguably, this would especially be the case if an exemption for overseas dividends received in the UK were introduced. Such an exemption would result in lower tax receipts, and arguably an interest apportionment rule might then become necessary.

However, not surprisingly, respondents made several counter arguments to these propositions. In fact very little UK tax is presently collected on the receipt of overseas dividends. Companies put varying, but sometimes substantial, resource into ensuring that their underlying foreign tax credits are sufficient to cover any UK liability on such dividends. Other overseas earnings are simply not remitted. There are numerous techniques to allow repatriation of cash without payment of dividends, should the parent company need it, and companies are anyway able to create reserves to support shareholder dividends or share buybacks. To that extent, the existing system looks complicated for little gain in tax revenue, and most respondents saw the introduction

of an exemption system as a welcome simplification measure. Some would actively seek to remit more foreign earnings under an exemption system. An exemption system was also seen as favourable for inbounds because the removal of the complexity of the current system would be perceived as a positive, investment friendly move.

There is an argument that interest apportionment of some sort is needed if there is a dividend exemption system to prevent abuse by companies who bring back substantial tax free dividends and reinvest in equity funded finance vehicles situated in lower tax territories overseas. However, several respondents made the point that they are free to organise in this way now if they wish; a dividend exemption system is not a requirement for this sort of tax planning. Respondents generally argued that the right tool to tackle this concern is CFC legislation, rather than an interest apportionment system which would impact all multinationals regardless of the nature of their tax planning.

However, if interest apportionment were introduced, it could be in principle done in a number of different ways, and a range of possibilities was considered in the interviews. Respondents identified significant practical difficulties in all the cases considered.

Suppose interest were apportioned on the basis of foreign versus domestic income, for example. An important disadvantage of this approach is that the degree to which interest is deductible would become uncertain. Moreover, the calculation itself would be highly complex for any group that had a significant number of legal entities. The consensus of respondents was that this could only be workable if the UK also introduced consolidated tax filing for UK groups; without this an income based approach would give wildly varying results for different companies within the UK groups and would need another system of group relief to ensure the outcome is equitable. It would therefore introduce even more uncertainty into tax forecasting. Apart from the resource implications for companies, the view was also expressed that HMRC would need to gear up significantly to be able to audit the volume of data that this process would produce. Finally,

whilst an income based approach provides a reasonable proxy for value of investments, it is difficult to apply in industries with a long investment lead times.

An alternative is apportionment on the basis of capital employed. This was seen by many as being too easily manipulated, although others saw it as a reasonable measure with some degree of external rigour. Use of an equity-based allocation key was also considered. However, historic equity invested overseas is not workable as it produces very diverse results dependent solely on how long the company has held its overseas investment. By contrast, a market value approach brings with it significant compliance effort and a high degree of uncertainty of outcome, since it would necessitate annual revaluations of all the companies in a group. Groups that currently do this for US purposes report it as being complex and capable of giving bizarre results.

One respondent reflected that the US allocation system is very difficult to operate and should not be seen as a model for the UK to emulate. Apportionment in any form would raise the issue of the competitiveness of the UK, since it would emphasise complexity and uncertainty.

A number of respondents expressed a preference for other, more broad-brush measures instead of apportionment. For example, some form of arm's length test for UK debt might be workable, if the UK was viewed as a consolidated entity and the debt measure was net debt. This effectively views the issue from the other perspective, i.e. from the UK domestic business rather than seeking to apportion interest to overseas interests. Alternatively, some form of earnings stripping rule might be preferable. Use of the parent company or group debt/equity ratio as a safe harbour was also supported.

However, none of these would be generally welcomed or even seen as necessary. Rather, they were seen by some as preferable or more workable solutions if some restriction on interest relief had to be put in place. The balance of opinion was that apportionment in any form would be complex to legislate, difficult to administer, uncertain in

outcome and damaging to UK competitiveness. Some respondents took the view that the implementation issues were so difficult that they would prefer to see a partial dividend exemption instead, though this view was far from universal and a number of groups were strongly against it.¹⁶

¹⁶ And, subject to the outcome of the Franked Investment Income Group Litigation Order at the European Court of Justice a partial exemption might itself be susceptible to challenge.

6 Conclusions

This report discusses the treatment of relief for interest payments against a UK corporation tax charge. It has four main sections. The first outlines conceptual issues and addresses the question: is there a good economic justification for treating debt differently from equity. The second provides more detail of the existing UK system, including various restrictions on interest deductibility that currently exist. The next two sections provide new evidence on the impact of existing rules on financing patterns, and on the likely impact on financial behaviour of various potential reforms.

Where does this analysis leave us?

On broad conceptual grounds, there is no good economic case for treating equity differently from debt. Both are ways of raising funds to support investment. The contractual arrangements are different, but there is no obvious reason why any particular aspect of the contractual arrangements should justify different treatment. These considerations have led to proposals to equalise the treatment of debt and equity – either by removing the relief for interest payments or by granting equivalent relief for equity.

Of course, the UK is not unique in its differential treatment of debt and equity – rather the reverse: it would be virtually unique if it treated them equally. Differences between countries lie not in the basic structure of the taxation of debt and equity, but in the details, and in particular in anti-avoidance legislation.

The treatment of interest in the UK and elsewhere clearly has an impact on the financial structure of companies, and on aggregate flows between countries. Section 4 presents evidence of the extent to which the form of cross-border flows depend on corporation tax rates. It also provides complementary evidence from unconsolidated accounting data that the use of debt in both independent companies and subsidiaries of multinationals are influenced by corporation tax rates. This is also

confirmed by interviews with 14 large multinational companies with operations in the UK.

Given that the UK corporation tax treatment of interest is broadly in line with that in other countries, fundamental reform raises some risks. On the one hand, companies have arranged their financial structure in the light of the existing tax system. At best, many companies would find it costly to change that structure. At worst, simply removing interest deductibility may leave many companies unable to afford tax payments, and hence facing bankruptcy. This may be particularly true of smaller companies, although they are not the main focus of this report.

On the other hand, it is possible that bold reform of corporation tax could improve the UK's competitive position in terms of corporation tax. For example, a reform which financed a substantial reduction in the corporation tax rate by restricting interest deductibility might improve the attractiveness of the UK. Of course, this too is uncertain: the position of equity financed investment would improve but that of debt-financed investment would worsen.

A fundamental reform might be likely to have other advantages as well. For example, a reform which substantially cut the tax rate applied to interest receipts and payments met with some approval from the large companies interviewed for this report. Most saw a 15% tax rate on interest receipts and payment to be sufficiently low to remove the incentive for offshore financial planning; debt would be pushed down into overseas subsidiaries, reducing the overall UK interest expense. Allied to a possible exemption of taxation of foreign source dividends, such a reform might significantly increase repatriation of overseas earnings. Of course, with such a reform, careful consideration would have to be given for the continued taxation of financial companies.

Apart from considering such fundamental reform, the report also considers the case that other factors are driving a need for the UK to consider limiting interest relief. These factors are ultimately driven

by judgements from the European Court of Justice. Two issues are raised by recent judgements. One concerns the UK Controlled Foreign Company regime, under which the HMRC effectively asserts the right to tax income accruing overseas on the grounds that the income effectively originated in the UK and has been moved abroad for the purposes of avoiding UK tax. The second arises from difficulties in taxing the foreign source dividends paid to UK companies by foreign subsidiaries.

One response to the latter issue could be to exempt such dividends from UK tax. This raises one conceptual issue and one very practical issue of tax revenue. The conceptual issue is whether it is right for the UK to grant relief for interest on debt raised in the UK, but which is funding overseas activities which will not be taxed in the UK. It seems reasonable to restrict relief under these circumstances. But note that in practice, very little revenue is actually raised from taxing foreign source dividends: exempting such dividends is therefore not a substantial change from a conceptual viewpoint. Of course, this argument cuts both ways: it could be used to justify restricting interest relief even if foreign source dividends remained taxable.

The practical issue is whether exempting such dividend payments would be likely to lead to an outflow of taxable income from the UK (which could be returned, tax free, as a dividend). However, this is most obviously an issue for the CF regime. If the CFC is unable to prevent a large-scale outflow of taxable income, then the UK corporation tax has a serious problem. It is possible that restricting interest relief may compensate the foregone revenue to some extent, but it would not be targeted towards correcting the problem.

In any case, there is a further practical issue here: is it feasible to apportion interest paid in the UK according to whether the underlying debt is financing activity in the UK or abroad? In the interviews with large companies, respondents pointed to important shortcomings for several possible ways of implementing such apportionment. The balance of opinion was that apportionment in any form would be

complex to legislate, difficult to administer, uncertain in outcome and damaging to UK competitiveness.

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Appendix Amadeus Data

As indicated in the main text, we use unconsolidated financial data on just under 70,000 companies in 2003. Table A.1 gives a breakdown of this sample by country, and whether the company is stand-alone, part of a domestic group or part of a multinational group.

Table A.1 Sample of companies used

Country	Stand-Alone	Domestic Group	Multinational Group	Total
Austria	274	166	170	610
Belgium	2358	1334	1,483	5,175
Czech Rep	2237	58	170	2,465
Denmark	679	1253	924	2,618
France	4244	5138	4,963	14,345
Germany	1773	1253	856	3,882
Hungary	1018	55	145	1,218
Ireland	366	47	55	468
Italy	8395	396	845	9,636
Netherlands	377	647	352	1,376
Poland	2236	326	455	3,017
Romania	1828	237	167	2,232
Spain	4418	1878	1,148	7,444
Sweden	1189	2167	1,532	4,888
United Kingdom	2476	5080	2,849	10,405
Total	33868	19797	16,114	69,779

Note that there are relatively few companies in Germany, given its size. It is under-represented because not all companies are obliged to publish accounts. Note that the multinational group of which a company is part need not be wholly European, and the ultimate parent company need not be European.

In determining the measure of leverage, owing to missing data, we were not able to use a measure of long term debt. Instead, we follow the approach of Huizinga et al (2006) who also investigate the impact of taxes on leverage using Amadeus data. Their measure, which we also use is defined as: total liabilities minus cash minus accounts payable as a percentage of total assets minus cash minus accounts payable. The sample shown in Table A.1 consists of companies for whom we

are able to construct a reasonable measure of leverage, and where the percentage lies between 0 and 100%.

As explained in the text, we attempt to control for differences across companies due to their size and sector. Information on these variables is presented in Tables A.2 and A.3. Table A.2 presents a split of the sample according to broad sector of activity.

Table A.2 Split by Sector

Sector	Frequency	Percent
Agriculture, Hunting and Forestry	785	1.1
Construction	4348	6.2
Electricity, Gas and Water Supply	1543	2.2
Fishing	54	0.1
Manufacturing	22617	32.4
Real Estate, Renting and Business Activities	15196	21.8
Transport, Storage and Communication	4149	6.0
Wholesale and Retail Trade, Repairs of Vehicles Personal and Household Goods	21087	30.2
Total	69779	100

Table A.3 presents a split by size, and by whether the company is part of a multinational group. We follow European Commission’s definition of “large”: that is, companies with more than 250 employees. As shown in the Table, companies which are part of multinational groups are split evenly into large and small. But domestic companies (stand-alone and those which are part of domestic groups) are much more likely to be small. These differences make it important to control for company size before comparing leverage ratios.

Table A.3 Split by size and group

Size	Domestic	Multinational	Total
Small	59.8%	11.9%	71.7%
Large	17.1%	11.2%	28.3%
Total	76.9%	23.1%	100.0%

