Colombia: FAD Workshop
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Thin Capitalization

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What is Thin Capitalization?

- Interest expense is generally deductible in determining taxable profits.
- Excessive debt (or “thin” equity) reduces taxes paid.
  - Profits taxed at 30% + 10% tax on dividends for a total tax burden of 37%
  - Interest subject to only 10% withholding tax (unless reduced by treaty)
- Countries have introduced provisions to protect their tax base from the deduction of excessive interest payments.

First Line of Defense: Interest Withholding

- Withholding on interest paid to non-residents reduces the tax differential between debt and equity finance
- Chile:
  - 35% withholding on interest paid to non-residents
  - 4% withholding on interest paid on loans granted by foreign banks or financial institutions
  - Thin capitalization rules are applicable when the debt generating the interest subject to the 4% withholding is guaranteed by a related party

Four Approaches

- Rely on transfer pricing rules (United Kingdom)
- Limit the debt/equity ratio—a balance sheet test (Canada)
- Limit net interest expense—an income statement test (Germany)
- Require government approval of debt (Ethiopia for mining agreements)

Thin Cap Rules in Latin America

- No thin capitalization rules
  - Guyana, Jamaica, Paraguay, and Trinidad and Tobago
- Debt-equity limit (only applies to related party debt)
  - 2:1 ratio: Argentina, Brazil,
  - 3:1 ratio: Chile, Ecuador, Mexico
- Debt-equity limit (applies to all debt)
  - 3:1 ratio: Colombia
- Interest on related party loans cannot exceed 30 percent of interest paid to third parties: Bolivia

What is Related Party Debt?

- Back to back loans (parent to bank to subsidiary)?
- Related party guarantee of bank loan?
- Cross guarantees within a joint venture?
- Debt-equity loans? Related party puts money on deposit and subsidiary issues preference shares to bank (redeemable in 5 years with a return close to the interest rate)?

Rely on Transfer Pricing Rules

- Applies only to related-party debt however defined
- Debt/equity is excessive if an unrelated party under similar circumstances would not lend, say, 70 percent of the capital costs.
- Interest rate is excessive if an unrelated party under similar circumstances would not charge such a high rate on the debt
- Should safe-harbor be used (e.g. Libor + 2%)?
- Better to have a uniform rule that applies to all debt

Debt/Equity Ratio

- Maximum debt/equity ratio set in the tax law
  - Based on the financial or tax balance sheet?
  - Tested daily or based on the average of beginning and end-of-year debt/equity ratios?
- Excess interest is non-deductible
  - Treat excess as a dividend?
- Should the limit apply to all debt or only related-party debt (broadly defined)?
  - Difficult to identify-related party debt (back-to-back loans parent guarantees). Therefore, should apply to all debt

Net Interest Expense Limit

- Net interest expense (interest expense net of any interest income) cannot exceed, say, 30 or 50 percent of taxable income before interest expense
  - Excess interest carried forward—could be deductible in a future year?
- Limit could apply to a company in a low-profit year when debt is not excessive.
  - Carryforward of excess interest mitigates this.
- Should carryfoward of excess interest be time limited?

Government Approval

- A development agreement for a resource project could require that loans be specifically approved by the government
- This would give some protection for the government
  - Criteria for approval would need to be included in the agreement
- Better to apply a uniform rules to all taxpayers; more transparent

BEPS

- Base Expansion Profit Shifting (BEPS)—an OECD initiative
- Focus on double non-taxation (or less than single taxation) through "cracks" in the interaction of domestic tax systems
- 15 Actions in the BEPS Action Plan (July 2013)

Action 4

- Action 4--Limit base erosions via interest deductions
- Discussion Draft of December 2014 sets out best practice options

  http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf

- Work to be completed in September 2015

Two Best Practice Options

- Option 1
  - General rule: group wide interest allocation
  - Carve out: For entities which meet a low fixed ratio test
- Option 2
  - General rule: Fixed ratio rule
  - Carve out: For entities that meet a group ratio test

Group-Wide Interest Allocation

- Deduct interest expense up to an interest cap equal to an allocation of the group's net third party interest expense based on a measure of earnings or assets
- A country may allow disallowed interest expense to be carried forward and set against unused interest cap in a future period
- Rule may be complex to apply

Fixed Ratio Test

- Entity would be able to claim relief for deductible net interest expense up to a fixed percentage of its earning or assets
- Fixed ratio would be set at a level lower than currently applied in many countries

Concerns Raised

- Group-wide test is impractical
  - A few advanced countries have adopted group-wide test
  - May not be suitable for small, developing countries
- Fixed ratio test is overly restrictive
- There will be instances of double taxation
  - If all countries do not adopt the same approach
  - Countries have different accounting rules

A Way Forward

- Adopt a debt/equity rule or a net interest rule
- Apply rule to all debt to avoid the need to identify related-party debt broadly defined.