Bangkok Post

Bangkok Post
Circulation: 70,000
Ad Rate: 1,500

Section: Business/NATIONAL
Date: Tuesday 21 August 2012
Volume: - **No:** - **Page(s):** B2(Top Right)
Col.Inch: 41.64 **Ad Value:** 62,460 **PRValue (x3):** 187,380 **Clip:** Full Color
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LEADING THE WAY

PWC THAILAND

THIN CAPITALISATION, ITS USES AND ABUSES [PART I]

In the *Revenue Department News* dated June 15, 2012, director-general Satit Rungkasiri made reference to new measures to prevent "abusive tax planning". Included in these measures was a proposal to introduce "thin capitalisation" or "thin cap" rules.

In media reports in April, Mr Satit said a thin capital tax was widely used by developed countries to encourage corporations to use more equity for investment rather than obtaining massive loans.

"Many businesses invest by obtaining large amounts of loans, but if the business collapses, their equity assets cannot cover the liabilities as well as taxes. By using a thin capital tax, these companies will need to be more cautious when it comes to investment," he was quoted as saying in the *Bangkok Post*.

"Indebted companies, say those with a debt-to-equity ratio of more than 3:1, may no longer be allowed a tax deduction on interest payments," he was quoted as saying by *The Nation*.

Companies with little capital and which rely heavily on large loans pose risks to both creditors and financial stability, said Mr Satit. They also pay less tax, as they enjoy large deductions on interest payments.

Some countries limit such companies' tax deductions on interest or do not allow deductions on loan services, which discourages firms from too much borrowing, he said.

These reports lead us to understand that the proposed thin capitalisation rules would apply not only to loans from related parties but to all debt including third-party debt. If this is the case, there appears to have been a misunderstanding as to the intention and actual effects of thin cap rules.

Those "developed countries" that have thin capitalisation rules apply them only to related-party loans. The basic intention is to limit the extent to which companies can remit profits in the form of deductible interest as opposed to non-deductible dividends. By imposing limits on the amount of interest that is deductible, the rules preserve taxable profits and, therefore, tax payments.

The rules, therefore, prevent corporate taxpayers from using related-party debt to manipulate profits and reduce tax payments. There is no logic to extending the rules to debt from unrelated parties, as such parties have no interest in manipulating the taxpayer's profits.

Thin capitalisation rules that applied to all debt would damage competitiveness and disadvantage banks and other lenders. They would also damage investment by both domestic and foreign enterprises. It is also highly unlikely that the rules would result in companies borrowing less debt.

Before expanding on these points, it is worth understanding the concept and the mechanism of the thin capitalisation rules. Thin cap rules are a mechanism in the tax law to prevent "base erosion" of a home country tax jurisdiction.

Capital structures of companies are usually a mixture of share capital (equity) and debt. One of the key distinctions between equity and debt in most developed tax jurisdictions is that interest on debt is tax-deductible, while dividends paid on share capital are not. Therefore, from a pure tax efficiency standpoint, it is beneficial to have more debt than equity.

Equity or share capital is by its nature contributed by the shareholder(s). However, debt can be third-party debt (such as bank loans or debentures issued to financial institutions or the public) or loans from, or debentures issued, to the shareholder(s).

Groups of companies have always used a mixture of debt and equity funding for their subsidiaries. There are a number of reasons for this including cost (debt is generally cheaper to fund than equity), ease of repayment and management of risk.

However, the use of debt is also a way of reducing effective tax rates.

The most common method employed is to have one group member company (usually in a low or zero-tax jurisdiction) lend to another group company in a high-tax jurisdiction. The company in the high-tax country pays interest and gets a tax deduction at a high rate and the lender company either pays no tax or a low rate of tax on the interest income it receives. Thus, there is an "erosion" of the tax base in the high-tax country.

In most cases the high-tax country will also impose a withholding tax on the outward remittance of the interest. However, the withholding tax rate is usually significantly lower (either because of a tax treaty or just due to local law) than the corporate tax rate at which the interest expense is deducted. Thus, the group benefits from rate arbitrage.

Several countries have instituted in their tax laws what are known as thin capitalisation or debt/equity rules to limit the erosion of their tax bases. In the next column we will take a more detailed look at how these rules need to be drafted and should be applied.

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