Bangkok Post

Section: Business/NATIONAL
Date: Tuesday 4 September 2012
Volume: - No: - Page(s): B2(Center)
Bangkok Post
Circulation: 70,000
Ad Rate: 1,500
Col.Inch: 59.73 Ad Value: 89,595 PRValue (x3): 268,785 Clip: Full Color
Column: LEADINGTHE WAY: THIN CAPITALISATION AND RELATED-PARTY LOANS (PART II)

THIN CAPITALISATION AND RELATED-PARTY LOANS (PART II)

LEADING THE WAY

PWC THAILAND

In our last column on Aug 21, we noted a proposal by the Thai Revenue Department to develop "thin capitalisation" rules. The aim would be to encourage companies to fund more investment from equity instead of borrowing, by limiting the tax deductibility of loan interest, among other features.

However, as we pointed out, Thai authorities appear to be basing their plan on a belief that thin-cap rules should apply to all forms of debt including third-party loans when in fact they generally apply only to related-party financial transactions within a group.

All developed countries that have adopted thin-cap rules apply them only to shareholder (or related-party) debt. They are never applied to third-party debt. The reason is that third-party debt, by its nature, will seldom be excessive. A lender such as a bank, in order to limit its risk, will ensure the borrower is able to both service the debt and to repay. In effect, the lender "polices" the borrower.

Obviously a borrower's financial condition can change over time and may deteriorate, causing a loss to the lender, but at the time the loan is made the third-party lender will be comfortable with the level of debt. Should a borrower default, the lender will seize assets or force bankruptcy, thus causing a loss to the shareholders' equity.

In contrast, shareholder or related-party loans are in essence economically no different from equity or share capital. Should the borrower run into financial difficulty, the shareholder will not force a bankruptcy but will merely inject funds as additional share capital or perhaps forgive the debt. Thus the shareholder or related-party lender does not run the risk of a loss.

Limitation on interest deduction: Thin capitalisation regimes operate to limit the deduction of interest by the borrower to some formulaic amount. There are generally two mechanisms for calculating the limitation: a prescribed debt-to-equity (D/E) ratio; or an earnings limitation based on a fixed percentage of taxable income, cash flow or some other measurement base.

✦ D/E limitation schemes: The tax law will specify a fixed D/E ratio for related-party debt. Interest on any such debt in excess of the ratio will be not be tax-deductible. For example, if the law provides a D/E limit of 3:1 debt and there is equity of 1,000 and related-party debt of 5,000 at 5% interest, then the interest paid would be 250 but only 150 would be deductible.

✦ Earnings limitation schemes: The law will specify a fixed percentage of some measurement base and limit the interest deduction to that amount. For example, if the law says related-party interest is limited to 50% of taxable income (before the deduction of the related-party interest) and that amount is 400, then if related-party interest is 250, only 200 is tax-deductible and 50 is disallowed.

While simple in theory, thin capitalisation rules can be quite complex. A number of common issues arise and must be addressed. Some of these are:

What is equity? In a D/E regime, there must be a definition of equity and a point in time to measure it. Some regimes define equity as being only share capital and paid-in surplus. Others also include retained earnings (or deficit). Some measure equity in the year the related-party debt is incurred, while others measure it annually at year-end.

What is debt? Does related-party debt include short-term or just long-term debt? Most regimes will exclude short-term debt such as accounts payable for purchases and accrued expenses from the definition. Generally, only related-party debt that is due in more than one year is considered debt in calculating the D/E ratio and a formulaic limitation.

But what about third-party debt that is guaranteed by a related party? Since the lender is looking to the credit of the related party, some regimes will treat such debt as related-party debt. What about arrangements such as a non-explicit guarantee or "comfort letter" or "letter of patronage"? Clearly, drafting the rules requires careful consideration.

Treatment of disallowed interest: A number of questions arise, starting with whether interest is completely disallowed or just deferred. Generally, those regimes employing a D/E approach treat the

Bangkok Post
Section: Business/NATIONAL
Date: Tuesday 4 September 2012
Volume: - **No:** - **Page(s):** B2(Center)
Bangkok Post
Circulation: 70,000
Ad Rate: 1,500
Col.Inch: 59.73 **Ad Value:** 89,595 **PRValue (x3):** 268,785 **Clip:** Full Color
Column: LEADINGTHE WAY: THIN CAPITALISATION AND RELATED-PARTY LOANS (PART II)

excess interest as a permanent disallowance. However, a number of the regimes that use the earnings limitation approach will provide that the excess interest in any given year is not disallowed but deferred. The excess amount can be deducted in a future year when the company has sufficient capacity under the formula.

Using the numbers for the above example, where 50 of interest was disallowed, if in the next year taxable income before related-party interest is 600 and current-year interest is 250, then the limit will be 300, allowing the 50 deferred in the prior year to be deducted.

If the excess interest is deferred, the next question is how long is the carry-forward period? Most regimes allow unlimited carry-forward, but some impose a time limit.

Another question is whether the disallowed interest is subject to withholding. If so, at what rate? In most regimes, the disallowed interest is still treated as interest and subject to the withholding tax applicable to interest. However, an alternative approach — which is not common and makes little sense — is to treat the excess as a dividend subject to the withholding tax rate applied to dividends.

Who is a related party? Most regimes will define a related party as any group company in which there is direct or indirect common ownership of some percentage. Percentages of either 50 or 80 are the most common. Generally only foreign related parties are covered, as in the case of a domestic related party, there is no "base erosion" due to interest expenses and revenue being in the same country.

Interest rate: Generally most thin capitalisation regimes do not specify an interest rate or a limit on the interest rate. This is normally left to the separate transfer pricing rules which provide that intercompany interest rates must be arms-length. If the rate is higher than a third-party lender would charge, the excess is disallowed as a transfer price adjustment, not a thin capitalisation adjustment.

Lessons learned: While the thin-cap regimes around the world differ from each other in small ways, they share a number of the features discussed above. An unfortunate tendency is for tax authorities to make them more complicated than they need to be. This is a burden on both the taxpayer and the tax administrator, as it often leads to disputes over one aspect or another. An ideal thin capitalisation regime should be easy to understand, simple to calculate and easy to administer.

Above all else, the sole purpose of the regimes is to maintain tax revenue. They do not exist to protect creditors, increase financial stability or prevent excessive borrowing. Nor should they. The rules are included in the tax law and concerned with tax revenue. Other laws or simply good business and banking practices exist to achieve the other objectives.

Greg Lamont is a partner at PwC Thailand. We welcome your comments at leadingtheway@th.pwc.com