Key Corporate Tax Haven Indicators

Haven Indicator 8:

Fictional Interest Deduction

What is measured?

This indicator measures whether a jurisdiction offers fictional interest deduction to lower corporate income taxes. Because the deduction is given even though no actual interest was paid, the interest deduction is referred to as "fictional" or "nominal". Fictional interest deduction allows a company with a capital structure with high equity (i.e. mostly financed by issuing shares instead of borrowing money) to deduct a certain sum of fictitious financial costs from its tax base. These fictitious costs are calculated as hypothetical interest expenses the company would have paid had it been financed with debt (i.e. a loan) instead of equity.

The data for this indicator has been collected primarily through the International Bureau for Fiscal Documentation's database (country analyses and country surveys),[1] the Centre for European Economic Research's 2017 Report[2], the International Monetary Fund's 2018 report[3] and the European Union Code of Conduct 2018 report[4]. In some instances, additional websites and reports of the Big Four accountancy firms have also been consulted.

A jurisdiction receives a haven score of 100 for this indicator if it has a fictional interest deduction regime. If there is no fictional interest deduction regime, a jurisdiction receives a whereas a zero haven score. The scoring matrix is shown in Table 8.1, with full details of the assessment logic presented in Table 8.3.

Table 8.1. Scoring Matrix Haven Indicator 8

Regulation	Haven Score [100 = maximum risk; 0 = minimum risk]
<u>**Fictional Interest Deduction regime is available**</u> The jurisdiction offers a fictional interest deduction regime.	100
<u>**Fictional Interest Deduction is not available**</u> There is no evidence that the jurisdiction has introduced a fictional interest deduction regime.	0

All underlying data can be accessed freely in the CTHI database.[5] To see the sources we are using for particular jurisdictions please consult the assessment logic in Table 8.3 and search for the corresponding info ID (ID 516) in the database report of the respective jurisdiction.

Why is this important?

The difference in the tax treatment of equity returns (i.e. dividends) and returns on debt (i.e. interest payments) is one of the key ways corporations and individuals can engage in tax avoidance. Companies can reduce tax liabilities by using hybrid financial instruments to restructure their finances internally, which often includes moving debt between affiliates from higher tax countries to tax havens.[6]

Many tax systems around the world offer tax advantages for corporations to finance their investments by debt. As opposed to dividends, which are not deductible and are paid to shareholders after tax has been paid, interest payments on loans are one of the many deductible costs a company can make for corporate tax purposes. The more debt a company takes on, the more interest it pays, which lowers its tax bill and leads to a debt bias, i.e., tax-induced bias toward debt finance. Evidence show that debt bias creates significant inequities, complexities, and economic distortions.[7] The 2008 economic crisis brought home the harmful economic effects of excessive levels of debt in the banking sector.[8]

To mitigate the different tax treatments of debt and equity financing and to reduce the level of debt bias, some countries have introduced a fictional interest deduction regime. The term "fictional interest deduction" refers to fictitious interest expenses that companies and sometimes also permanent establishments are entitled to calculate annually on the amount of their total equity and deduct for tax purposes, in the same way that interest on loans is tax deductible. The amount that can be deducted from the taxable base is equal to the fictitious interest cost on the adjusted equity capital.[9]

Belgium was one of the first countries to introduce a fictional interest deduction regime in 2005[10] and since then, other countries like Italy, Cyprus and recently Malta[11] have followed suit.

Given that excessive debt in financial firms creates negative spillover effects in the rest of the economy[12], countries should endeavour to prevent this bias towards debt. However, adopting a fictional interest deduction regime to neutralise the debt bias has significant drawbacks. First, the idea behind the fictional interest deduction regime is to apply an artificial interest deduction. Not surprisingly, such a fictitious vehicle may be vulnerable to tax abuse by multinational companies. And indeed, soon after the fictional interest deduction regime was introduced in Belgium, multinational companies used commonly applied techniques of abuse. Through double dipping, companies end up receiving two tax benefits: the tax deduction of interest paid on a loan and fictional interest deduction based on the capital increase with the funds made available by the loan. The latter includes artificially increasing equity through specific intra-group reorganisation.[13]

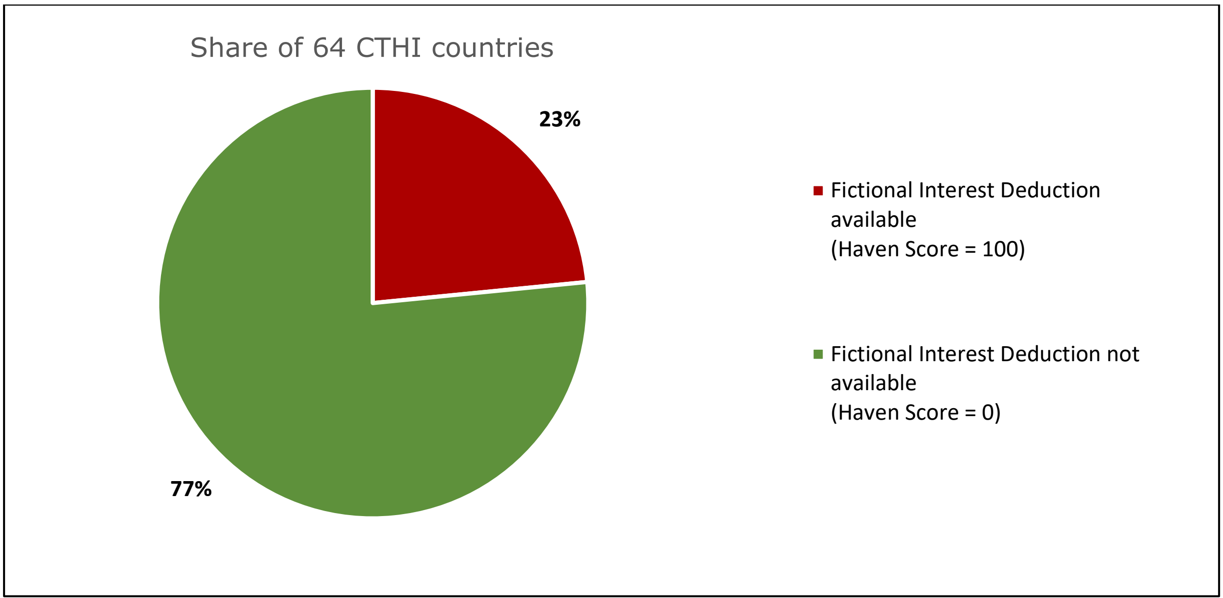
Second, since a company's tax base can be reduced through fictional interest deductions, the tax bills of multinational companies will shrink. As a result, in aggregate, this significantly reduces government revenues and thereby governments' ability to provide public services for the realisation of human rights, and/or it will lead to tax increases for other segments of society. Additionally, other countries may decide in response to fictional interest deduction to lower their tax rates in an attempt to lure more multinationals to invest. This accelerates the race to the bottom in corporate taxation. In terms of budgetary costs, some researchers suggest that narrowing the tax base through applying a fictional interest deduction regime or similar variants of allowances for corporate equity has a direct estimated revenue cost of approximately 15 per cent of corporate income tax revenue, or 0.5 per cent of GDP.[14] Research into Belgium's fictional interest deduction regime estimated that these allowances added up to approximately €6bn and reduced the corporate tax yield by slightly more than 10 per cent.[15] Indeed, as the regime turned out to be too costly for the Belgian government, the government has since decided to reduce the rate of fictional interest deductions in phases in subsequent years.[16] However, in similar cases, other governments have chosen to recoup the costs of a fictional interest deduction regime through raising value added taxes or other indirect taxes.[17] This worsens inequality in the distribution of the tax contributions and aggravates human rights deficits.

Therefore, rather than adopting the fictional interest deduction regime, alternative ways to mitigate excessive debt bias have been proposed by the International Monetary Fund, including "a partial denial of interest deductibility, only applied to intracompany interest [...]".[18] Denying the deduction of interest on cross-border intracompany loans[19] would force multinational companies either to borrow funds and share the risks among their local domestic subsidiaries or instead to borrow directly from the independent debt market. The effect of this would be to increase competition in countries where multinational companies operate. It would create a level playing field between multinational companies and other companies that solely operate domestically and thus do not have access to the more advantageous conditions that multinational companies enjoy in the international capital markets.[20]

In other words, constraining the deductibility of intra-group interest or allowing a fictional interest deduction are two solutions to address the debt bias. Yet fictional interest deduction regimes incentivise tax abuse by multinational companies and accelerate the race to the bottom in corporate taxation. Instead, constraining deductibility of intra-group interest can assist host countries in protecting their tax base and facilitate fair market competition in domestic markets.

Results Overview

Graph 8.1. Fictional Interest Deduction Overview



Results Detail

Table 8.2. Fictional Interest Deduction – Haven Indicator Scores

Country Name	Score	ISO	Country Name	Score	ISO
Andorra	0	AD	Kenya	0	KE
Anguilla	100	AI	Latvia	0	LV
Aruba	0	AW	Lebanon	0	LB
Austria	0	AT	Liberia	0	LR
Bahamas	100	BS	Liechtenstein	100	LI
Belgium	100	BE	Lithuania	0	LT
Bermuda	100	BM	Luxembourg	0	LU
Botswana	0	BW	Macao	0	MO
British Virgin Islands	100	VG	Malta	100	MT
Bulgaria	0	BG	Mauritius	0	MU
Cayman Islands	100	KY	Monaco	0	MC
China	0	CN	Montserrat	0	MS
Croatia	0	HR	Netherlands	0	NL
Curacao	0	CW	Panama	0	PA
Cyprus	100	CY	Poland	0	PL
Czech Republic	0	CZ	Portugal (Madeira)	100	PT
Denmark	0	DK	Romania	0	RO
Estonia	0	EE	San Marino	0	SM
Finland	0	FI	Seychelles	0	SC
France	0	FR	Singapore	0	SG
Gambia	0	GM	Slovakia	0	SK

Country Name	Score	ISO		Country Name	Score	ISO
Germany	0	DE		Slovenia	0	SI
Ghana	0	GH		South Africa	0	ZA
Gibraltar	0	GI		Spain	0	ES
Greece	0	GR		Sweden	0	SE
Guernsey	100	GG		Switzerland	0	CH
Hong Kong	0	HK		Taiwan	0	TW
Hungary	0	HU		Tanzania	0	TZ
Ireland	0	IE		Turks and Caicos Islands	100	TC
Isle of Man	100	IM		United Arab Emirates (Dubai)	100	AE
Italy	0	IT		United Kingdom	0	GB
Jersey	100	JE		USA	0	US

Maximum Risk (Haven Score 100)	Haven Score 76 - 99	Haven Score 51 - 75	Haven Score 26 - 50	Haven Score 1 - 25	Minimum Risk (Haven Score 0)

Table 8.3. Assessment Logic

Info_ID	Text_Info_ID	Answers (Codes applicable for all questions: -2: Unknown; -3: Not Applicable)	Valuation Haven Score
516	Fictional Interest Deduction: Does the jurisdiction offer a scheme that allows deducting from the corporate income tax base a notional return on equity?	0: No; 1: Yes	0: 0 1: 100

Reference List

Christoph Spengel, Frank Schmidt, Jost Heckemeyer, and Katharina Nicolay, *Effective Tax Levels Using the Devereux/Grifith Methodology- Project for the EU Commission TAXUD/2013/CC/120, Final Report 2017.* (January 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_effective_tax_levels_en.pdf> [accessed 27 December 2018]

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George Turner, *Tax Justice Network Briefing- Shifting Profits and Dodging Taxes Using Debt* (November 2017) <https://www.taxjustice.net/wp-content/uploads/2017/11/Dodging-taxes-with-debt-TJN-Briefing.pdf> [accessed 15 May 2019]

IBFD, *Tax Research Platform: Country Surveys, Country Analyses, Country Key Features*, Accessed 2018-2019, 2018 <https://research.ibfd.org/> [accessed 9 May 2019]

de Mooij, Ruud A., *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund Staff Discussion Note, May 3, 2011 (Washington, DC, 2011) <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf> [accessed 16 August 2018]

Shafik Hebous, and Alexander Klemm, *IMF Working Paper- A Destination-Based Allowance for Corporate Equity*, WP/18/239, November 2018 <https://www.imf.org/en/Publications/WP/Issues/2018/11/08/A-Destination-Based-Allowance-for-Corporate-Equity-46314> [accessed 27 December 2018]

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[1] IBFD, *Tax Research Platform: Country Surveys, Country Analyses, Country Key Features*, Accessed 2018-2019, 2018 <https://research.ibfd.org/> [accessed 9 May 2019].

[2] Christoph Spengel and others, *Effective Tax Levels Using the Devereux/Grifith Methodology- Project for the EU Commission TAXUD/2013/CC/120, Final Report 2017.* (January 2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_effective_tax_levels_en.pdf> [accessed 27 December 2018].

[3] Shafik Hebous and Alexander Klemm, *IMF Working Paper- A Destination-Based Allowance for Corporate Equity*, WP/18/239, November 2018 <https://www.imf.org/en/Publications/WP/Issues/2018/11/08/A-Destination-Based-Allowance-for-Corporate-Equity-46314> [accessed 27 December 2018].

[4] Council of the European Union, *Code of Conduct Group (Business Taxation) – Overview of the Preferential Tax Regimes Examined by the Code of Conduct Group (Business Taxation) since Its Creation in March 1998* (Brussels, 3 December 2018) <http://data.consilium.europa.eu/doc/document/ST-9639-2018-REV-2/en/pdf> [accessed 24 February 2019].

[5] http://www.corporatetaxhavenindex.org/database/menu.xml

[6] Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund Staff Discussion Note, May 3, 2011 (Washington, DC, 2011), 3 <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf> [accessed 16 August 2018].

[7] https://www.bis.org/review/r111215g.pdf; [accessed 31 March 2019].

[8] de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 3.

[9] The fictional interest deduction calculates the allowable deduction by multiplying the interest rate with the amount of (qualifying) equity of the taxpayer [Fictional interest deduction = fictional interest rate x adjusted equity], thus reducing the tax base and resulting in a lower effective tax rate. For further information, see https://www.loyensloeff.com/en-us/news-events/newsletters/notional-interest-deduction; [accessed 15 May 2019].

[10] Articles 205 *bis* to 2015 *novies* in the Belgium Income Tax Code, introduced by the law of June 22nd, 2005.

[11] Shafik Hebous and Alexander Klemm, *IMF Working Paper- A Destination-Based Allowance for Corporate Equity*, 22.

[12] de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 19.

[13] https://www.tiberghien.com/media/ACTL%20seminarie_Bernard&Thomas.pdf; [accessed 31 March 2019].

[14] de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 18.

[15] de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 17.

[16] Madalina Cotrut, *International Tax Structures in the BEPS Era*, 2015. pp. 110-112.

[17] de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 18.

[18] de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 19.

[19] See Haven Indicator 15 on Outbound Intra-Group Interest Payment treatment for further details, available at: http://www.corporatetaxhavenindex.org/PDF/15-Deduction-Limitation-Interest.pdf; [accessed 15 May 2019].

[20] George Turner, *Tax Justice Network Briefing- Shifting Profits and Dodging Taxes Using Debt* (November 2017), 4 <https://www.taxjustice.net/wp-content/uploads/2017/11/Dodging-taxes-with-debt-TJN-Briefing.pdf> [accessed 15 May 2019].