Deductibility of Interest for Corporation Tax

The Tax Journal reported the establishment of the Oxford University Centre for Business Taxation in November 2005. This is an independent research centre initially created with generous financial support from the Hundred Group. The Centre held its inaugural conference "The impact of business tax in an international context" in March 2006, and appointed its first research staff from Autumn 2006.

The first research output of the Centre was a report on the deductibility of interest for UK corporation tax, which was presented at a workshop in December 2006 on the "Deductibility of financing costs for UK corporation tax". This article summarises some of the main elements of the report, and gives a brief description of other work in the Centre. (The report and details of the workshop are available on the Centre's website at www.sbs.ox.ac.uk/tax).

Interest deductibility for UK corporation tax

Relief for interest payments is obviously a significant feature of virtually all corporation taxes around the world. But this stands in stark contrast with the advice from the economics literature, which argues that there is no good economic reason to treat debt differently from equity. One commonly-argued rationale for giving relief for debt is that interest is an expense of doing business. In this case, corporation tax could be thought of as an attempt to levy the income accruing to the shareholder, the owner of the company. This might be part of a tax system which seeks to tax all income and increases in wealth. But this would imply that interest received at the personal level should be taxed at a much higher rate than dividend income. It is possible to design a tax system of this form, and the Scandinavian dual income taxes are similar to this.

However, in most countries – and in the UK specifically – overall tax rates on the return to debt and equity are not generally the same, even for resident investors. (And the taxation of corporate income owned by non-resident investors doesn't sit well with a line of argument based on the corporate level tax being a substitute for taxing the shareholder directly). As a result, the existing tax system encourages too much use of debt. It also requires the HMRC to identify a distinct line between debt and equity.

But while these are good arguments for a more neutral tax treatment of debt and equity, they have been well understood for some time. The current impetus for reform comes from more pressing developments. Until the recent decision of the European Court of Justice in the FII Group Litigation case, there was a real possibility that the UK would have to give up its claim to tax foreign source dividend income. And even though that threat has subsided, it is clear that the government is continuing to consider such a reform. In its Pre-Budget Report, the government announced consultation over this issue during 2007; it is expected to produce a consultative document in due course.

The treatment of interest is not directly linked with the treatment of foreign source dividends. But if the latter 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, the return on which would never be taxed in the UK. In that context it would seem reasonable in principle to introduce a restriction of some sort. One response to such a possible restriction 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, it could be argued that there is already a case for restricting relief for interest.

Evidence from economic data

The report presented 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 compared 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 would be 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 evidence presented in the report was not consistent with this hypothesis.

Evidence from interviews

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 included both UK and US parented multinationals, and covered a broad range of sectors. The interviews covered two issues: how tax affects the existing financial structure of the groups, and how hypothetical reforms to the UK corporation tax might affect decisions regarding financial structure.

Broadly, the results of the interviews indicated that UK multinationals typically hold 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. The Finance (No.2) Act 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. 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 largely 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.

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 practice without creating considerable administrative and compliance cost, and uncertainty.

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. 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.

A number of respondents expressed a preference for other, more broad-brush measures instead of apportionment. For example, some form of arms 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 also gained some support.

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.

Future research

Although various policy options were discussed in the report, no recommendations were made – for good reason. Although this is a central topic for the design of corporation taxes, it is better to consider the design of the whole tax, rather than any one part of it. One important linked issue is the treatment of foreign source income, though there are many others. Considering these issues both separately and jointly is part of the role of the Oxford Centre: its central aim is to promote effective policies for the taxation of business, both in the UK and elsewhere.

There are many basic questions which need to be answered about business behaviour, taxation and more general economic welfare before better tax policy can be designed. The research staff of the Centre are already engaged on a range of projects, and there are plans for many more, balancing comment on specific policy issues with research on long-term, fundamental issues in business taxation. Broadly, the existing research plans are built around five main areas: the impact of taxes on business behaviour; the impact of business behaviour on economic welfare; tax administration, avoidance and governance; external influences and the international taxation of profit; and the balance of taxation. I hope to report further instalments of the Centre's work in due course.

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