TAX JUSTICE NETWORK

Haven Indicator 8: Fictional interest deduction

What is measured?

This indicator measures whether a jurisdiction offers fictional interest deduction to lower corporate income taxes. Since the deduction is given even though no actual interest is 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 4 accountant firms have also been consulted.

A jurisdiction receives a haven score of 100 points for this indicator if it has a fictional interest deduction regime. If there is no fictional interest deduction regime, a jurisdiction receives 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 points = maximum risk; 0 points = minimum risk]
Fictional Interest Deduction regime is available The jurisdiction offers a fictional interest deduction regime.	100
Fictional Interest Deduction is not available There is no evidence that the jurisdiction has introduced a fictional interest deduction regime.	0

All underlying data can be accessed in the Corporate Tax Haven Index 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 rather than through dividends (equity). Dividends are not deductible and are paid to shareholders only after tax has been paid, while interest payments on loans are one of the many deductible costs a company can make for corporate tax purposes. Thus the more debt a company takes on, the more interest it pays, and this 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 Malta,[11] and recently Poland[12] and Switzerland[13] (currently only in force for companies resident in canton Zurich)[14] have followed suit. Italy abolished the regime in the 2019 tax year, but reintroduced it the following year including with retroactive application to the 2019 tax year. The regime allows resident companies and permanent establishments of non-resident entities a 1.3% deduction on qualifying increases in equity.[15]

Given that excessive debt in financial firms creates negative spillover effects in the rest of the economy[16], 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.[17]

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 it may also shift the tax burden to other segments of society, especially labour and less mobile businesses. Additionally, in response to fictional interest deduction, other countries may decide 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.[18] 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.[19] 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.[20] 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.[21] This worsens inequality in the distribution of the tax contributions and aggravates human rights deficits.

Within the European Union, guidance on notional interest deduction was produced by the Group for the Code of Conduct for business taxation. Endorsed by the Council of the European Union in December 2019, the guidance aims to assist "Member States that would wish to implement a similar [notional interest deduction] regime to those already assessed as not harmful by the Group".[22] The guidance outlines a non-exhaustive list of the limitations of the scope of notional interest deduction and anti-abuse measures that place the burden of proof with the taxpayer. Examples of limitations to minimise the vulnerability of a regime to tax abuse include exclusion of a company's own shares, prohibiting the notional interest deduction from being applied where it would create or increase tax losses and limiting the regime to only new equity created after the starting date of the regime. Further, member states are required to maintain data to provide to the Code of Conduct Group on the number of taxpayers benefitting from the regime, how many of the companies benefitting are domestic or foreign owned companies, and the aggregate amount of income benefitting from the regime.[23] Nevertheless, in the

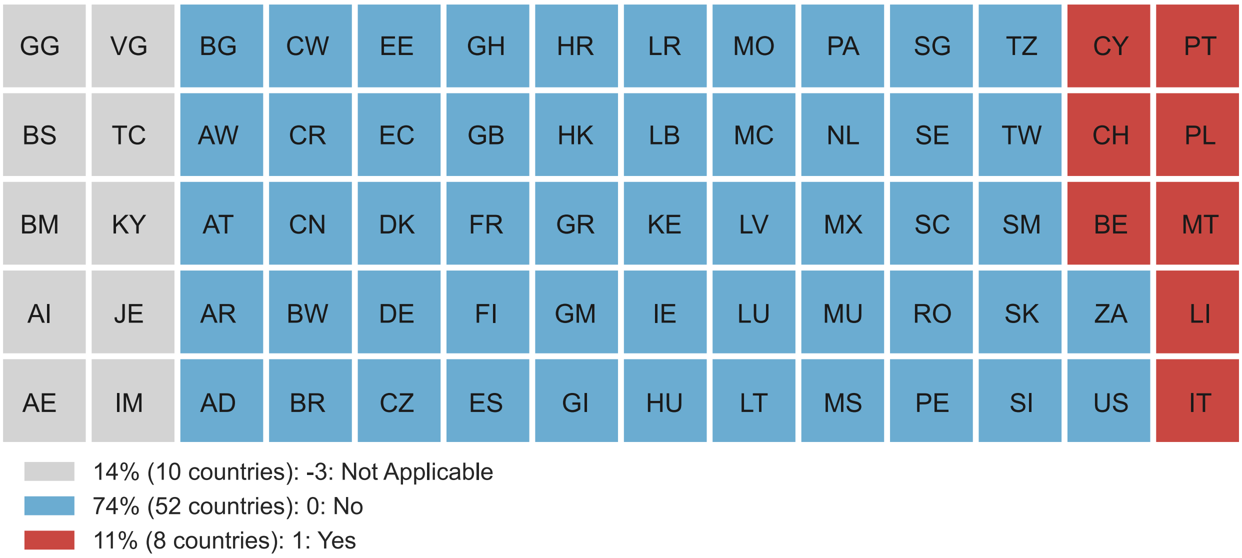
Corporate Tax Have Index, the differentiation between harmful and non-harmful notional interest deduction regimes by the European Union is considered as not sufficiently limiting the potential for tax abuse. In fact, the very existence of such regimes, even with all limitations and anti-abuse measures advised by the European Union, companies can still within a specific scope deduct hypothetical interest expenses. As such, EU member states with this regime that are considered “not harmful” are still awarded a full haven score in this indicator.

A possible solution for addressing the debt bias, supported by the International Monetary Fund and others,[24] is by introducing an Allowance for Corporate Equity (often referred to as ACE). Here, the deduction for interest is typically retained and a similar deduction for the normal return on equity is added.[25] Yet as indeed the Fund points out, ACE could induce tax planning similar to classical debt shifting spurred on by differences in CIT rates, creating yet another race to the bottom. Debt shifting would only be significantly curtailed if all countries were to adopt ACE, which is unlikely, while “an asymmetric adoption of ACE by only some countries can induce new forms of tax planning”.[26] Rather than adopting the fictional interest deduction regime or an allowance for corporate equity, further 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 [...]”.[27] Denying the deduction of interest on cross-border intra-company loans[28] 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.[29]

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. In addition, it may create tax arbitrage opportunities that add a substantial cost of administration and compliance, which in turn can have deleterious effects on corporate income tax.[30] 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

Figure 8.1: Fictional Interest Deduction Overview



Note: we conclude that fictional interest deduction is not applicable (N/A) for 10 jurisdictions because in Anguilla, the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands and the Turks and Caicos Islands no corporate income tax is imposed and in the Isle of Man, Jersey and the United Arab Emirates, the statutory tax rate is zero.

Haven Indicator 8: Fictional interest deduction

Table 8.2: Fictional Interest Deduction – Haven Indicator Scores

Haven Score	ISO2	Country Name
0	AW:	Aruba
100	AI:	Anguilla
0	AD:	Andorra
100	AE:	United Arab Emirates
0	AR:	Argentina
0	AT:	Austria
100	BE:	Belgium
0	BG:	Bulgaria
100	BS:	Bahamas
100	BM:	Bermuda
0	BR:	Brazil
0	BW:	Botswana
100	CH:	Switzerland
0	CN:	China
0	CR:	Costa Rica
0	CW:	Curaçao
100	KY:	Cayman Islands
100	CY:	Cyprus
0	CZ:	Czechia
0	DE:	Germany
0	DK:	Denmark
0	EC:	Ecuador
0	ES:	Spain
0	EE:	Estonia
0	FI:	Finland
0	FR:	France
0	GB:	United Kingdom
100	GG:	Guernsey
0	GH:	Ghana
0	GI:	Gibraltar
0	GM:	Gambia
0	GR:	Greece
0	HK:	Hong Kong
0	HR:	Croatia
0	HU:	Hungary
100	IM:	Isle of Man
0	IE:	Ireland
100	IT:	Italy
100	JE:	Jersey
0	KE:	Kenya
0	LB:	Lebanon
0	LR:	Liberia
100	LI:	Liechtenstein
0	LT:	Lithuania
0	LU:	Luxembourg
0	LV:	Latvia
0	MO:	Macao
0	MC:	Monaco
0	MX:	Mexico
100	MT:	Malta
0	MS:	Montserrat
0	MU:	Mauritius
0	NL:	Netherlands
0	PA:	Panama
0	PE:	Peru
100	PL:	Poland
100	PT:	Portugal
0	RO:	Romania
0	SG:	Singapore
0	SM:	San Marino
0	SK:	Slovakia
0	SI:	Slovenia
0	SE:	Sweden
0	SC:	Seychelles
100	TC:	Turks and Caicos Islands
0	TW:	Taiwan
0	TZ:	Tanzania
0	US:	United States
100	VG:	British Virgin Islands
0	ZA:	South Africa

Haven Score

Low Haven Score — High Haven Score

0 to <25 | 25 to <50 | 50 to <75 | 75 to 100

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

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[28] See haven indicator 15 on outbound intra-group interest payment treatment for further details, available at: cthi.taxjustice.net/cthi2021/HI-15.pdf; [accessed 8 March 2021].

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