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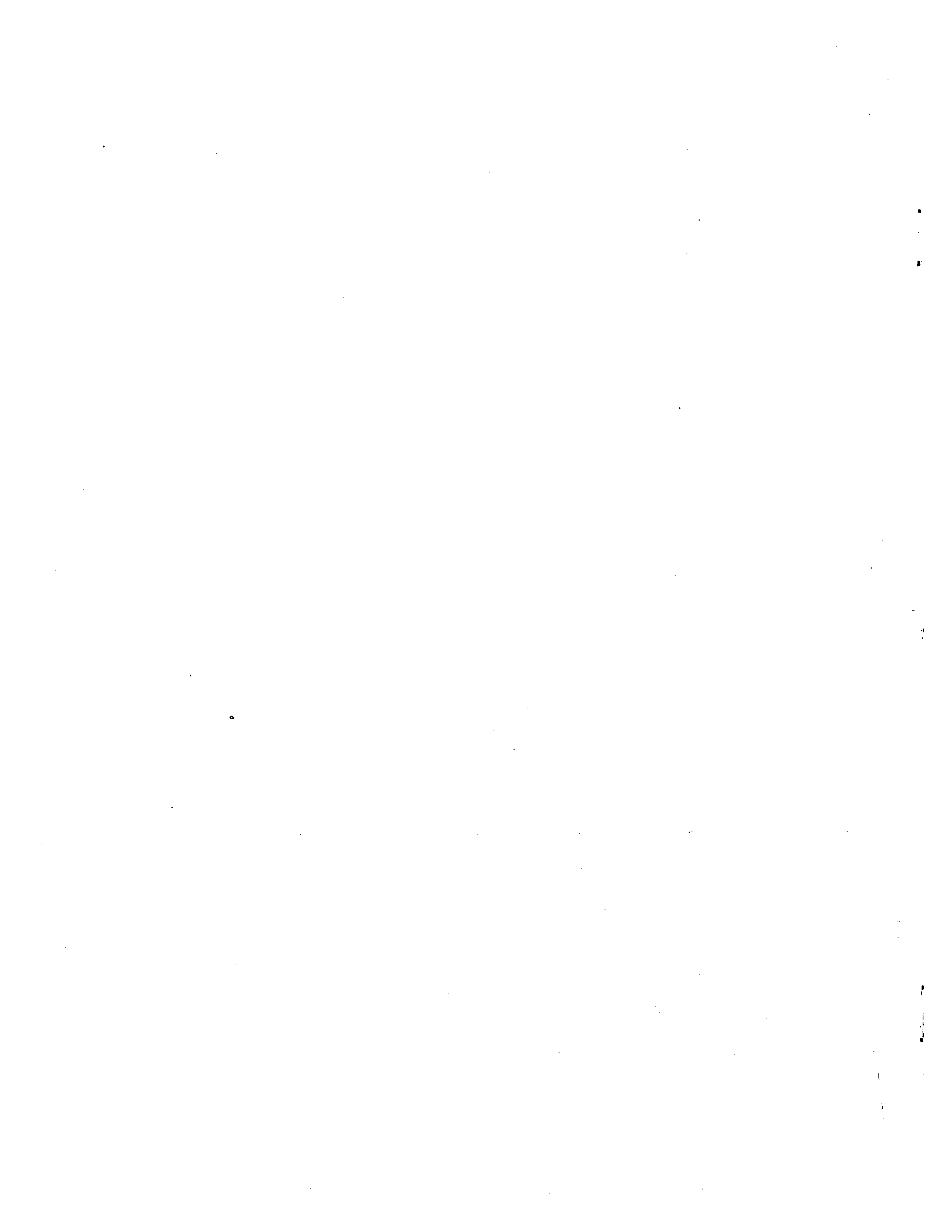
Local Control of Business and Tax Treatment of Interest



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and

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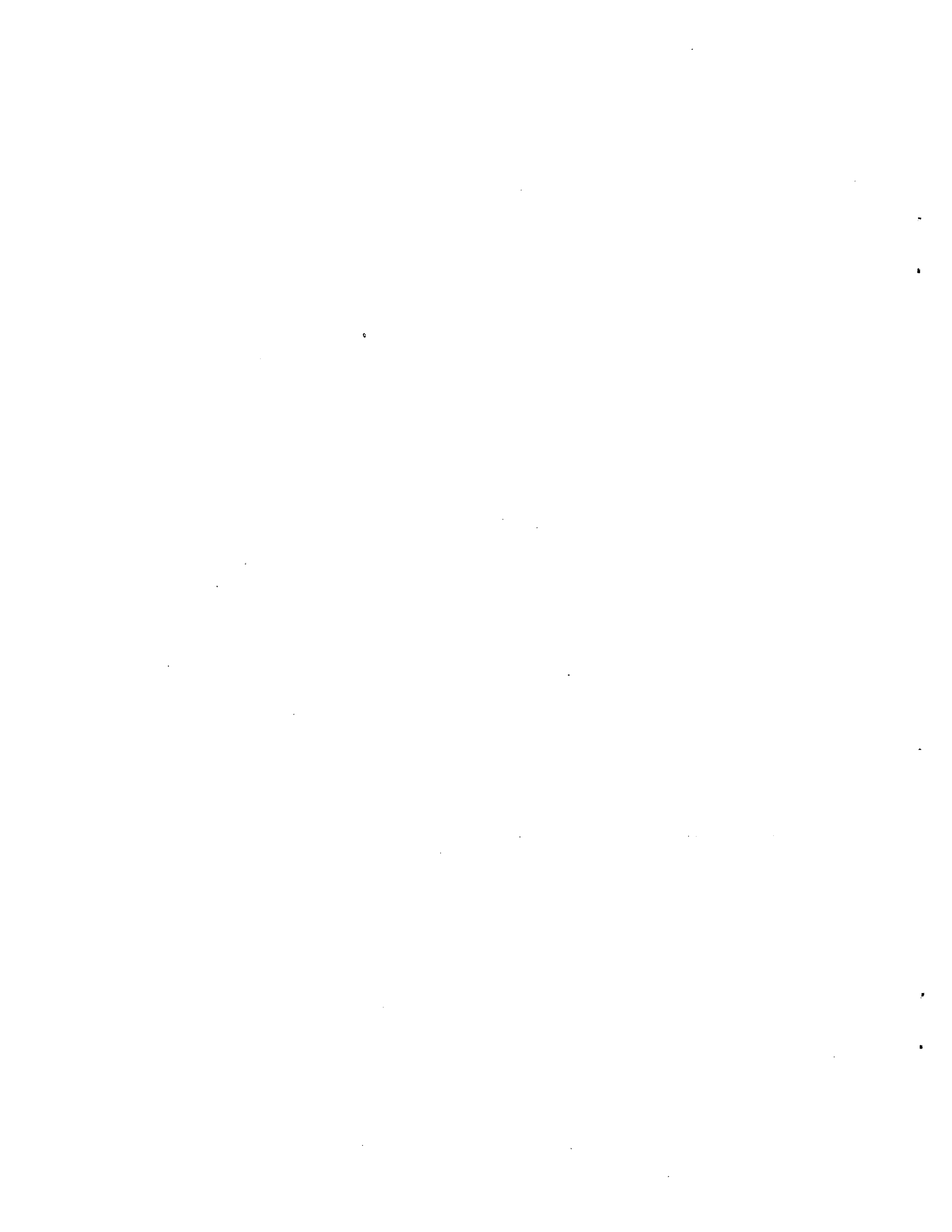

Local Control of Business and Tax Treatment of Interest*

INTRODUCTION

The purpose of this paper is to discuss an aspect of the treatment of interest for purposes of income tax which is likely to engage increasing attention in the CARIFTA countries because in recent policy formulations, accent is being placed on greater local decision-making in the economic sphere.[1]

Since in business equity and control go generally together if foreign control of business enterprises is to be reduced it is necessary to keep the foreign equity participation to the minimum. Consequently, there is a growing feeling in the region that a continuing effort should be made to firstly reduce foreign equity participation in existing industrial and commercial enterprises and at the same time to keep to the minimum foreign equity participation in the new enterprises coming up in the region.[2]

1/ See Trinidad and Tobago's Third Five-Year Plan 1969-1973. One of the principal structural problems highlighted in the Plan is that of "shifting the centre of decision-making in investment, production, employment, management and marketing from overseas controlled to locally controlled institutions". (See Page 5).

2/ Trinidad and Tobago's Third Five-Year Plan, for instance, calls for joint ventures between local and foreign firms and even Government equity participation, wherever fiscal concessions are granted to a foreign enterprise, "with a view to making such equity available to workers in the industry and to the people in general". (See Page 56). In Jamaica too, the Government has, in recent years encouraged greater Jamaican participation in the ownership of foreign enterprises, especially financial institutions. Already, a number of major foreign banks have gone 'Jamaican', and have offered a part of their equity to Jamaican investors who will eventually be offered 51% of the Bank's equity.

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* This paper has been written by Iqbal Gulati for publication, in two parts, in The Caribbean Tax Administrator.

Broadly speaking, business finance comes in two forms, namely equity and loans. To the extent that the countries in the region would still require, and therefore welcome, foreign finance, their preference would, in all probability, be for it to come in the form of loans rather than equity. One should hasten to add here that operation through branch rather than subsidiary, which is not uncommon in this region, involves neither equity nor loans. Financing of branch operations is done mostly through transfers from other offices of the company. Clearly, such operation would be as unwelcome, from now onwards, as operation through wholly-owned subsidiaries.

Since taxation is generally regarded as an important instrument of economic and social policy, the question is bound to arise: if hereafter CARIFTA countries were to prefer to secure foreign finance in the form of loans rather than equity should not the tax system play its due role in creating the necessary conditions in which foreign finances would rather flow into the region in the form of loans rather than equity.

The return on a loan accrues to the lender in the form of interest. The return on equity is represented by the profits of a company, part of which is usually distributed as dividend. A tax system can be said to create conditions favourable or unfavourable to one or the other form of financing depending on the treatment these two different types of returns are accorded in the matter of income taxation.

The paper is divided into two parts. The first part analyses the existing tax situation in the Commonwealth Caribbean and examines to what extent is the present treatment of interest for income tax purposes conducive to a particular pattern of business finance whereby foreign equity holding can be kept low. In the second part of this paper we examine whether preferential tax treatment of interest, and through that of loan finance, is by itself enough to ensure greater local control of business or whether something more has to be done alongside it.

Part I

OLD INCOME TAX SYSTEM

In the majority of the CARIFTA countries, the system of income taxation that obtains at present regards a company as an agent of the shareholder. It gives to the shareholder full credit with respect to his dividend receipts for what the company pays by way of income tax on its profits. Thus where the shareholder is an individual the portion of company profits that is distributed bears only the individual rate of tax and the portion that is retained by the company bears the company rate. Where the shareholder is a company, as, for example, would be the case with respect to intercorporate investment, the distributed as well as the undistributed portions bear the company rate of tax.

Under the same system of income taxation, interest-receipts accruing to a company would bear income tax at the company rate and those accruing to the individuals at the individual rate.

The principal difference in tax treatment, under this system, between the return on loan and the return on equity arises due to the fact that all interest is distributed but all profits need not, and do not have to be distributed. All CARIFTA countries make legislative provision empowering tax authorities to deem, in certain circumstances, profits to have been distributed even when they are actually retained by a controlled company. In actual practice, however, this provision has been found to be extremely difficult to administer and is therefore hardly ever invoked. Thus, where the recipient is an individual liable to tax at a marginal rate which is higher than the flat rate payable by a company, he stands to gain to the extent that the company retains its profits. Where, however, the recipient is a company, no such gain can be said to arise. It makes little difference whether the local operation is conducted through a subsidiary or a branch.

It can be argued that retention is made only for a period and that eventually a company must distribute all its profits. Then the gain to the individual shareholder can be said to arise from the fact of postponement of the payment of tax. But even this gain can be quite sizeable if the tax payment can be thus postponed for a substantial length of time. If, however, it is argued, that even though a company retains a part of its profits the shareholder receives them in the form of corresponding appreciation in the capital value of his equity, gain can still be said to have accrued to the shareholder so long as there is no or lower compensating tax on such capital gains.

Thus, broadly speaking, under this system of income taxation there is a slight bias in favour of equity finance as against loan finance.

NEW INCOME TAX SYSTEM

But the old system of income taxation is beginning to be replaced. Already Jamaica and Trinidad and Tobago have effected the change-over. The new[3] system of income taxation treats the company as a distinct entity paying tax on its own behalf and not on behalf of the shareholders. Therefore, the shareholders do not receive credit for the tax which a company pays on its profits. Under this system, therefore, a dollar of company profit pays tax at the company rate and again at the individual rate on the portion that is distributed. On the other hand, the interest-receipt continues to pay income tax only once, as under the old system, at the rate applicable to the recipient where the recipient is a resident and at a substantially lower rate where the recipient is a non-resident. There can be little argument that the new system of income taxation introduces a pronounced bias in favour of loan finance as compared to equity finance, especially where foreign finance is concerned.

3/ It is new only in the sense that it has only recently been introduced in this region.

In Trinidad and Tobago, for instance, on a $100 of company profits distributed as dividend to a non-resident parent company bears a total tax of $57.50, comprising of corporation tax @ 45%, special levy @ 5% and withholding tax 15%. For a non-resident individual, the corresponding total tax liability would be $62.50. If the same amount of $100 were to be paid to a non-resident company by way of interest, the tax payable thereon would be only $30. The corresponding figures for a non-resident individual would be $25.00.

The tax differential would work out to be even larger with reduced rates of withholding tax negotiated under tax treaties. This certainly could have revenue implications were there to be a major switch-over in the financing pattern of foreign companies, if the differentials are introduced more by reducing the tax on interest and less by increasing the tax on profits-cum-dividend. The differential against equity is reduced considerably for resident investors who are entitled to claim credit, through Dividend Income Allowance, for the major portion (but not all) of the tax that the company pays with respect to its distributed portion of profits.

Where a foreign company operates in the region through a branch (or branches) rather than through a subsidiary company (or companies), there arises under the new system of taxation the need for determining distribution. When and to what extent can profits of a branch be said to have been distributed to the head office raises problems. These problems are fairly well known wherever this system of income taxation obtains and different ways have been adopted to overcome them. Principally, the courses adopted fall into two categories. Either certain rules are laid whereby the tax authorities can deem certain types of transaction between the local branch and overseas offices of the foreign company as distributions. Or the total branch profits as such are made to bear a higher rate of tax than the company rate of tax so that the question of determining distribution need not arise at all. The course which Trinidad and Tobago has

adopted falls in the first category. In India, recourse has been taken to the latter type of solution. Whatever the course that is adopted, it still remains that taxwise, branch operation is less beneficial than operation based on loan finance under the new system of taxation. Thus, whatever be the other (and perhaps even weightier) justifications behind the trend started by Jamaica and Trinidad and Tobago to replace the old system of income taxation, this move towards the new system of income taxation clearly creates a pronounced bias for the inflow of private foreign funds in the form of loans.

SPECIAL EXEMPTIONS

All the Caribbean countries, whether following the old or new system of income taxation, grant exemptions from income tax to certain approved manufacturers and hoteliers on their profits and the dividends paid out of such profits. These exemptions are granted for a specified period. Some of these countries grant income tax exemptions with respect to interest also in the hands of recipients. But even in the countries where this latter exemption is granted, it is confined to much fewer types of operations and enterprises than is the exemption on profits and dividends.

Thus, in so far as the system of tax exemptions by itself is concerned its bias is generally in favour of equity finance rather than loan finance. Even in cases where interest is granted exemption from income tax along with profits and dividends, the tax position would, under the old system of income taxation, be neutral between two forms of finance. (We show later that a combination of the two exemptions may, even under the old system of income taxation, tilt the balance of tax advantages in favour of loan finance). Under the new system, however, a combination of exemption with respect to interest with the exemption on profits and dividend will maintain the preference for overseas loan finance because of the fact that the rate of withholding tax payable on interest remitted abroad tends to be

lower than the rate of company tax and this would be a consideration relevant to calculations for the period after the tax holiday has expired.

The combination of tax exemption on interest with that on profits and dividends does, even under the old system of income taxation, probably tip the balance of tax advantage in favour of loan finance because a) interest though tax exempt in the hands of the recipients is still a deductible expense for the borrower; b) there is no restriction on the rate at which such tax free interest can be paid; and c) the losses of the tax holiday period, if any, can be carried forward on the expiry of the tax holiday period. In such a situation, interest payments can be used as a device to reduce one's tax liability even after the tax holiday period.

Thus in cases where interest is granted tax exemption without adequate safeguard against possible abuse,[4] the bias under the old system of income taxation may in fact turn out to be in favour of loan finance. Under the new income tax system, the existence of this loophole in the tax exemption of interest will certainly make loan finance doubly attractive. But it is doubtful if allowing this loophole to remain is the best way of creating a preferential situation for loan finance.

There is also the more basic question to be raised: given that inflow of foreign finance is to be preferred in the form of loan, rather than equity participation, should not this objective be sought through the generally applicable system of income taxation rather than through the system of exemptions which applies to only specifically approved enterprises. The answer to this question would be fairly obvious that the choice would be for the former alternative.

4/ Of the countries offering exemption on interest, Barbados alone provides a safeguard in that it does not allow the deduction of tax free interest payment in the calculation of tax holiday losses.

However, granting that the general system of income taxation is appropriately structured, should the system of exemption seek to reinforce the bias further in favour of loan finance? The answer to this question need not necessarily be in the affirmative, provided the general system of income taxation already does an adequate job in this respect.

Part II

In the first part of this paper, the conclusions reached by us may be summed up as follows: 1) to the extent that considerations of business control demand that preference should be accorded to loan as against equity foreign participation in capital the tax system could contribute significantly towards creating such a preferential situation; 2) the system of corporate income taxation under which the profits of a foreign company arising locally are liable first to income tax and then to withholding tax when they are remitted creates a preferential tax situation for loan finance because interest on the company's borrowings or loan finance is liable to pay only the withholding tax; and 3) once the system of corporate income taxation embodies such a preferential situation adequately it may not only be not necessary but also inadvisable to create a further preference under each of the various incentive laws of a country.

UNDERLYING ASSUMPTION

The above conclusions were reached on the strength of a very important three-tier assumption. The starting point of this assumption was the observation that in business equity and control go generally together. Then followed the second step that if foreign control of business enterprises was to be reduced, or kept at the minimum, it was necessary to keep foreign equity participation to the minimum. As the third and final step, it was suggested that to keep foreign equity participation to the minimum, it was advisable to encourage foreign loan to equity

participation in capital. By the same token, foreign equity participation should be discouraged as against foreign loan participation in capital. To the extent, however, that this assumption does not fully hold, the conclusions of the first part of this paper will have to be suitably modified in the sense that the suggested tax change may be less effective in securing the desired results in terms of the objectives of business control.

BUSINESS CONTROL AND CAPITAL FINANCE

The difficulty arises with respect to neither the first nor the second step in the aforesaid assumption. Broadly speaking, ownership of equity and control of business do go together. Therefore, if the objective was to reduce foreign control of business restriction on foreign equity participation should help achieve the objective. But then does it necessarily follow that a shift in the pattern of capital financing, i.e. from foreign equity to foreign loan capital, will reduce the foreign control of a particular business enterprise?

Unfortunately, the shift in the pattern of financing from equity to loan capital need not, and indeed will not, by itself, reduce the foreign control of a business enterprise. Let us say that ordinarily a foreign enterprise would have financed its capital from equity and loan in the ratio of 60:40. Let us assume also that this foreign enterprise is planning to establish a fully owned subsidiary company; but the entire equity of the subsidiary is held by the parent company. Now the host country in which the subsidiary company is to be established changes its system of corporate income taxation so as to favour loan finance as against equity finance. If in response to this tax change the subsidiary company's capital is so structured as to take advantage of the favourable tax provisions for loan finance it's equity to loan capital ratio is bound to move in favour of the latter. Let us say that the ratio changes to 40:60 for equity to loan.

In the above illustration, the parent company holds the entire equity of the subsidiary whether the equity portion of the capital is 60% or 40%. The portion might indeed be as low as 5%, unless the host country's regulations preclude equity ratio from falling below a certain floor ratio. Whatever the ratio of equity to loan capital, so long as the parent company owns the equity, it can control business as well. The same would hold even if foreign ownership of equity is less than 100% but is still large enough to keep the control of business in foreign hands. Therefore, while in response to tax change of the type discussed in the first part of this paper there might well ensue a change in the pattern of financing of foreign enterprises, this latter change may still not serve to reduce the foreign control of these enterprises.

LOCAL PARTICIPATION IN EQUITY

Indeed, it might be argued that from the point of view of controlling business locally, it is much more relevant to create conditions, through tax and other measures, which encourage local participation in the equity of foreign enterprises than to create conditions favourable to loan as against equity financing of capital. This argument has considerable validity except that it assumes that the economy is generating adequate domestic savings and it is only a matter of re-channelling them towards the equity of foreign enterprises.

COMBINATION OF MEASURES

In actual practice, however, it would be much more realistic, in the context particularly of developing countries, to assume a relative shortage of domestic savings. In such circumstances, even if conditions favourable to local participation in the equity of foreign enterprises were created, there might not be enough domestic savings to take up the equity thus offered. Or, if the equity thus offered is taken up domestically, as might very well happen, this might leave inadequate domestic savings for other areas of investment. It is precisely in such circumstances, that

what might be called for is a combination of two sets of measures, one to create favourable conditions for foreign loan finance as against foreign equity finance of capital and the other to create favourable conditions for local participation in equity. The former will ensure that as large a proportion as possible of private funds is drawn <u>from abroad</u> in the form of loan capital and the latter set of measures will ensure that as large a proportion of equity capital as is considered desirable from the point of view of business control is taken up <u>locally</u> without, however, making excessive demands on domestic savings.

To continue with the earlier illustration, let us assume that the total capital requirements of the enterprise amount to $10 million. Let us assume also that the Government considers that domestic participation in its equity should be to the extent of 51%. If the Government took measures only to reduce the foreign equity participation without trying to influence the pattern of financing, this would mean that in order to secure 51% local participation in equity domestic savings to the tune of $3.06 million would have to be channelled to this enterprise, leaving the foreign equity participation to $2.94 million. The balance of $4 million would represent loan capital. If, however, as a result of the aforementioned combination of measures equity to loan ratio can be brought down from 60:40 to 40:60, the demand on domestic savings for participation in the equity of this enterprise would be reduced from $3.06 million to $2.04 million without reducing the proportion of equity in local ownership. This saving of $1.02 million, which would thus be available for domestic investments, would not have been forthcoming if the measures to secure the desired domestic participation in equity were not combined with the measures to change the pattern of capital financing in favour of loan as against equity.

Thus in a developing country while the effort to create a tax situation (and other conditions) favourable to loan capital as against equity capital will not by itself serve the objectives of business control, if this effort were combined with a set of measures which induces (or even forces) the requisite local participation in the equity of foreign enterprises, this should be an eminently effective step towards the achievement of the objective of local control of business.

A NECESSARY SAFEGUARD

In discussing the relative merits of foreign loan finance and foreign equity finance of a business enterprise it is important to bear in mind the source of foreign loan finance. In our discussion so far, the underlying assumption was that foreign loan finance would be drawn from abroad. In fact our whole case for preferential tax treatment of loan finance rests on the argument that it would help reduce the demand on domestic savings without at the same time jeopardizing the objective of business control. Therefore, in adopting measures meant to create conditions favourable to loan finance adequate safeguards might be necessary to take against the possibility that a switch-over to loan finance does not, in any way, divert foreign enterprises to local loan finance. In fact, if anything, the dependence of foreign enterprises on local loan finance should be sought to be reduced so that these funds are available for financing local investments.

In this connection, it might be of interest to note that foreign controlled businesses operating in the Caribbean seem to draw considerably on local loan finance. In Trinidad and Tobago, for instance, of the total loans and advances made by the commercial banks those made to non-residents accounted for as high as 28% at the beginning of 1970. Only after certain regulatory measures by the Central Bank did this proportion fall to 22% by the end of the year. (Reference is invited in

this context to the Economic Bulletin of the Central Bank Vol. I, November 3, pp. 27-28.) Thus any favourable treatment that is accorded to loan finance for tax purposes, as e.g. in the treatment of interest on loans for purposes of income tax, should be restricted only to loan finance drawn from abroad.

Under the new system of corporate taxation, payments made by way of interest and remitted abroad are subject only to a withholding tax. But if the same interest payments were due and paid to, say, a local bank they will be treated as the bank's incomings and will, after the deduction of the bank's expenses, be subject to both income and withholding taxes. (The latter tax would apply, no doubt, to that part of the bank's profits which is remitted abroad). One could say therefore that, broadly speaking, this particular system of corporation taxation is already weighted in favour of foreign loan finance rather than local loan finance. However, whether or not this weighting is adequate is a separate question altogether.

EXTENT OF TAX DIFFERENTIAL

Granting that the introduction of the new system of corporation tax can create a framework within which it is possible to create a tax situation favourable to loan financing of capital, the question would still remain as to the extent of the differential that should be allowed on interest payment as against profit-cum-dividend payment. It is the extent of this differential which would determine, no doubt, the attractiveness of the tax position. But it cannot be overlooked that the differential also involves cost to the exchequer in terms of revenue foregone for allowing interest payments to bear a lower rate of tax than profit-cum-dividends.

Here then will arise the perennial problem of balancing cost and benefit. In the illustration above, using the present Trinidad and Tobago rates, the cost to the exchequer would work out to be $55,000 a year in terms of lower tax revenue if we take into account only the amount of $2 million supposed to come additionally

in the form of foreign loan capital, instead of equity capital. This is based on the assumption of an interest rate of 10%. Actually, the cost should be much higher because whatever is the tax differential on interest payments it would apply with respect not to just $2 million raised in additional loan capital but to the entire $6 million of loan capital raised abroad. Using the Trinidad and Tobago rates once again, the cost would appear to be $165,000 a year. But in calculating this cost, it cannot be overlooked that with respect to the amount of loan which was being raised before the tax change, the new rate of withholding tax is to be compared with the old rate of income tax payable on interest remitted abroad (i.e. the rate which would have applied had the old system of corporate taxation obtained) and not with the new rate of income and withholding taxes payable on profit-cum-dividends. Taking the Trinidad and Tobago precedent, this factor should reduce the cost to the exchequer to something like $135,000 a year. (See Appendix for further details). But this cost of $135,000 a year to the exchequer will have to be set against only $1.02 million, the amount by which the demand on domestic saving was reduced. When one adds to it the interest payment net of tax the total annual cost of raising this additional capital abroad rather than locally would work out to a little below 18% a year.[5] Assuming that in order to secure the desired change in the pattern of capital finance from equity to loan tax differential in favour of interest payments has to be of the order now obtaining in Trinidad and Tobago, the question would naturally arise if it is worth the country's while to incur the cost of this order with a view to reducing the demand on domestic saving; and who knows the answer might well be no. In that case the Government might well

[5] In arriving at this figure of 18% we have netted the interest cost at the rate of 57.5%, the composite rate including withholding tax which is actually applicable to only profits remitted abroad, the reason being that it is at this rate that the earlier cost to the exchequer has been worked out.

decide against a tax differential of this order in favour of interest payments and be content with direct measures to limit foreign participation in equity.

CONCLUSION

In summing up, one could say that on considerations only of business control preferential tax treatment of interest is justified provided the measure introducing the differential in favour of loan finance is combined with a measure adequate enough to secure the desired shift in favour of local, as against foreign participation in equity. The system of corporation tax recently introduced in Jamaica and Trinidad and Tobago provides the framework within which a tax differential in favour of loan finance could be accommodated. But the extent of such differential is a matter of balancing cost and benefit.

Computation of Tax Cost for Changing the Pattern of Foreign Corporate Finance

I Assumptions

i) Rate of interest payable on borrowed funds is 10%.

ii) All borrowed funds come from abroad.

iii) Whatever the ratio of profits to equity, it is not less than 10% and all profits are distributed.

iv) Under the old system of corporate income taxation, interest paid abroad would have been taxable at the rate of 50% i.e. at the same rate at which corporate profits would have been taxable.

v) Under the new system of corporate income taxation, interest paid abroad is taxable at the rate of 30% whereas profits are taxable at the rate of 50% and distributions out of profit are taxable at the rate of 15%; thus the composite rate would be 57.5%.

II Computation:

A: Tax loss on $2 million raised as loan instead of as equity:

		$
i)	Tax @ 57.5% payable annually on profits-cum-distributions on the 10% of $2 million	115,000
ii)	Tax @ 30% payable annually on interest of 10% on $2 million remitted abroad	60,000
iii)	Loss of tax revenue	55,000

		$
B:	Tax loss on $4 million raised as loan:	
i)	Tax @ 50% payable on interest of 10% of $4 million remitted abroad under the old income tax system	200,000
ii)	Tax @ 30% payable on interest of 10% of $4 million remitted abroad under the new income tax system	120,000
iii)	Loss of tax revenue	80,000
C:	Total tax loss: (A + B)	135,000

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