KPMG

September 2017

Financing arrangements and interest expense deduction

Finding the middle ground!

By: Suleiman Yahaya, Kenneth Mgbemena and Mitaire Ono

Introduction

Companies primarily have two sources of funds - debt and equity, and the proportional mix of these funds makes up a company's capital structure. While dividend is paid to equity holders, interest is paid on debt. Reliance on debt in the capital structure commits a company to paying out a proportion of its income in the form of interest expense. These interest expenses are usually deductible in arriving at the income tax payable, thus providing companies with an incentive to finance their operations with debt rather than equity, especially in countries with high tax rates.

Essentially, the more debt a company has, the more the obligation to make interest payments; the more the obligation to pay interest, the more the tax deductible expenses from a company's earnings resulting from increased interest payments, thus leading to lower taxable income, and ultimately lower revenues from corporate taxes for the government.

Consequently, revenue authorities are concerned about the excessive interest deductions payable by companies to loan providers, especially related parties which is the primary focus of this discourse.

The issues

At present, there is no specific rule or legislative provision on the amount of loan that can be advanced between related parties in Nigeria. This invariably gives the Federal Inland Revenue Service (FIRS) the latitude to address potential tax leakages from interest payouts between related parties, arbitrarily.

Futthermore, financing arrangements involving the provision of loans between related parties could be used as a means of shifting profits from one jurisdiction to another. Typically, multinational enterprises may exploit the use of interest payments on related party loans advanced by an entity in a low tax jurisdiction to shift profits through excessive interest income derived from its related entity operating in a high tax jurisdiction.

To counter the negative consequences of loan financing with regards to tax collection, many countries have introduced measures to ensure that interest payments by companies operating in their jurisdictions are within 'reasonable limits' and do not erode the tax base.

Examples of measures taken to address the issue of interest deduction arising from related party financing arrangements can be seen in similar economies in Africa as well and more advanced economies such as US, Germany and China.

Specifically, in Ghana[1] and Kenya[2], issues around financial arrangements and interest deductions are addressed by the application of thin capitalization rules whereby a company (other than a financial institution) is deemed as thinly capitalized if the ratio of its interest bearing debt to its equity contribution held by its parent or associate of the parent is greater than pre-defined ratios of 2:1 and 3:1 respectively. Consequently, interest charges or exchange losses arising on the debt in excess of the ratio are disallowed in assessing entities in these countries to tax.

Similarly, in South Africa[3] , prior to 2012, its thin capitalization rules applied where loans granted by a non-resident related party (or a non-resident that held at least 25 percent of the equity share capital in a South African company), exceeded a 3:1 debt to equity ratio (calculated with reference to the proportion of equity held). Where this was the case, the excessive portion of interest was disallowed as a deduction from the taxable income of that South African company.

Based on the changes in 2012, South Africa's thin capitalization rules are now treated as part of its general TP regulations. Consequently, the 3:1 debt-to-equity ratio rule was replaced with the practice of conducting an analysis to determine whether the terms of the loans have been contracted at arm's length to align with the recommendations of the OECD TP guidelines.

To counter the negative consequences of loan financing with regards to tax collection, many countries have introduced measures to ensure that interest payments by companies operating in their jurisdictions are within 'reasonable limits' and do not erode the tax base.

© 2017 KPMG Professional Services, a partnership registered in Nigeria and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative. ("KPMG International"), a Swiss entity. All rights reserved.

Advanced economies such as the US, Germany and China also have measures aimed at addressing tax issues that border on interest deductions[4]. The US typically refers to its rules on related party financing arrangements and interest deductions as "earnings stripping rules"[5]. The rules include a restriction on interest paid by a company to its related party, if the company has a debt-to-equity ratio exceeding 1.5:1 and a net interest expense exceeding 50% of the company's adjusted taxable income.

Germany addresses the issue by limiting interest deductions to 30% of taxable income before interest, taxes on income, depreciation and amortisation. This is very similar to the recommendations of Base Erosion and Profit Shifting (BEPS) Action 4 of the Organisation for Economic Cooperation and Development (OECD)[6]. In China, the revenue authorities have put in place two safe-habour ratios with respect to debt-equity mix. Companies in the financial sector have ratio of 5:1, while others operate 2:1 ratio. These ratios are aimed at restricting excessive interest payments to non-resident related parties. Based on the extant rules, if these ratios are breached, the taxpayer may still have the opportunity to try to demonstrate that the transaction is consistent with the arm's length principle.

Way to go for Nigeria

Given the above situations, the FIRS may need to consider introducing regulations to ensure a clear cut approach to dealing with issues that border on financing arrangements and interest deductions between related entities such as rules on anti-profit shifting andd thin capitalization. These rules have been proven in other jurisdictions to provide guidance on the debt-equity mix adopted by taxpayers which helps to curtail excessive interest deductions.

Also, OECD's BEPS Action 4 recommends that net interest expense be restricted to a range of 10% to 30% of EBITDA. Interest expense above this range will be disallowed for tax purposes. Interestingly, the BEPS Action 4 gives countries the latitude to domesticate the BEPS recommendations with regard to setting the percentage of interest expense as a proportion of EBITDA.

Further, the FIRS could come up with a safe harbour[7] provision where interest rates for certain classes of loans are accepted by the FIRS where they are within a certain pre-determined range.

A number of benefits are derivable from the introduction of these regulations / provisions. Firstly, it will help entrench certainty in structuring of loan agreements between Nigerian companies and their offshore related parties in terms of the interest rates. Secondly, the certainty that the regulations will engender will bring about ease of doing business in Nigeria as well as raise the level of tax compliance by tax payers. Finally, the introduction will help bring about simplicity in administration of tax issues bordering on financing arrangements and interest deductions by the tax authorities.

Conclusion

As can be seen above, different measures are being adopted in different jurisdictions in addressing issues on financing arrangement and interest deduction. Apart from the obvious restrictions the rules place on excessive interest deductions, they also ensure certainty and clarity in tax administration and compliance.

Although, Nigeria does not currently have specific rules governing financing arrangement and issues bordering on interest deductions, the FIRS should consider introducing some rules to deal with the issues noted. An established rule will no doubt erase any sort of ambiguity with respect to how much loan a company can obtain from its related party offshore, and how much it should pay in interest. Overall, the rules will engender certainty in policy and approach to resolving areas of conflict between revenue authorities and tax payers as far as interest deduction is concerned.

We hold the view that domesticating BEPS Action 4 is one way the FIRS can show that it is ready to administer a modern tax system. Not only will it serve to curtail profit shifting, it will also ensure certainty and clarity in tax administration and compliance by revenue authorities and taxpayers, respectively.

1. https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/Ghana-Fiscal-Guide-2015-2016.pdf
2. https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/Kenya-Fiscal-Guide-2015-2016.pdf
3. https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/South-Africa-Fiscal-Guide-2015-2016.pdf
4. http://webarchive.nationalarchives.gov.uk/+/http:/www.hmrc.gov.uk/manuals/intmanual/INTM581010.htm
5. The rules prevent profit shifting by multinational enterprises from using interest payments as a means of escaping domestic taxes
6. The BEPS Action 4 recommends that net interest expense be restricted to a range of 10% to 30% of earnings before interest, taxes, depreciation and amortization (EBITDA)
7. A safe harbor refers to an arrangement which relieves taxpayers or certain transactions from the obligations imposed by a country's tax and transfer pricing rules.

Suleiman Yahaya is a Manager, Kenneth Mgbemena and Mitaire Ono are Senior Tax Advisers with KPMG Advisory Services, Nigeria

kpmg.com/socialmedia

kpmg.com.ng

© 2017 KPMG Professional Services, a partnership registered in Nigeria and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative. ("KPMG International"), a Swiss entity. All rights reserved.