



The Debt-Equity Bias in Corporate Taxation

**Paris, cercle de prospective fiscale
29 January 2013**

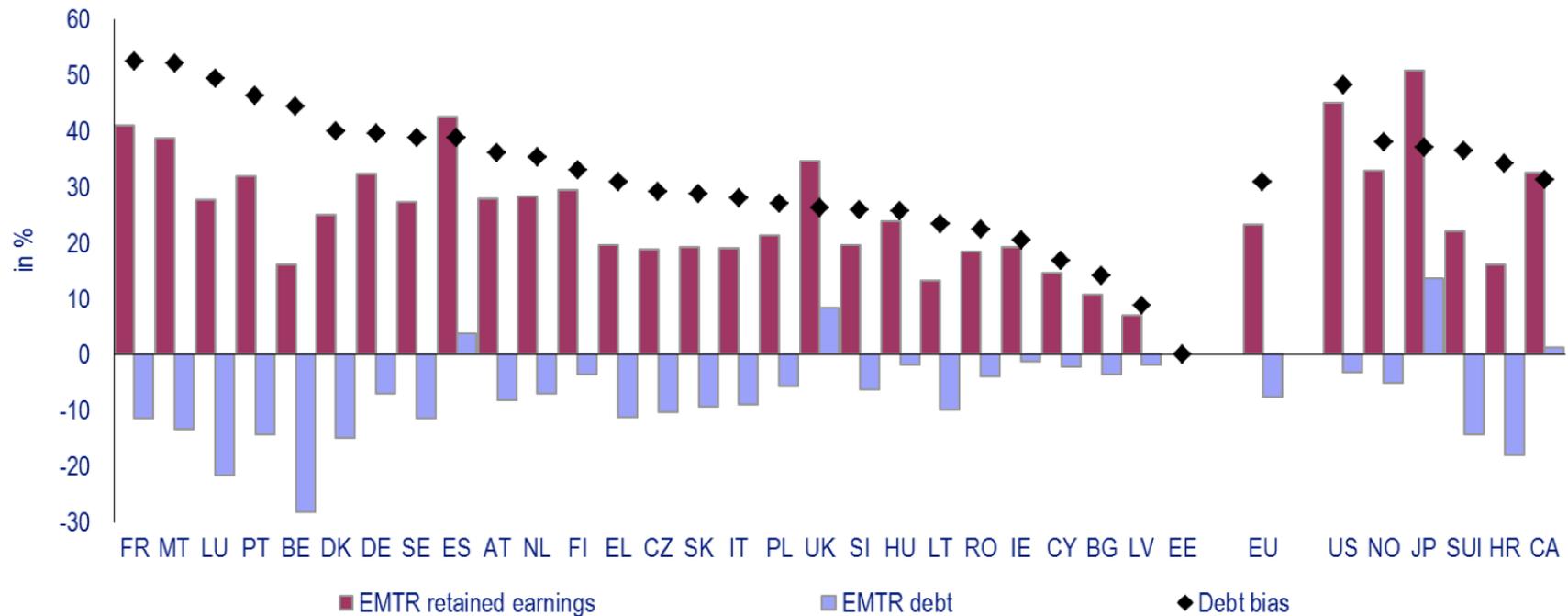
Gaëtan Nicodème

**Opinions expressed are those of the author only
and shall not be attributed to the European Commission**

Debt-Equity Bias: summary

- Under most CIT system, interest payments on debt are tax-deductible. No similar treatment for equity-financing.
- Problems: (a) tax bias towards indebtedness, fragility of companies, esp. Financial sector. (b) opportunities for profit-shifting (debt-bias, hybrid instruments, etc).
- AGS 2013: The corporate tax bias towards debt-financing should be reduced.
- Solutions: TCR, ESR, ACE, CBIT, ACC, CFT

Corporate Debt-Equity Tax Bias



Note: EU is arithmetic average

Source: ZEW (2012)



Corporate Capital Structure

- Modigliani-Miller (1958): $V_U = V_L$
- Tax shield value of debt: $V_L = V_U + tD$
- Bankruptcy costs (costs of financial distress)
- Agency costs: limit discretion of managers (FCF)
- Signalling effects
 - Repayment capacity
 - Lack of internal resources (market for lemons)
 - Pecking order theory (Myers and Majluf, 1984): retained earnings, debt, new equity.

Corporate Capital Structure

- Evidence (Graham and Leary, 2011): non-linear
 - Quantile 4: large, old, tangibles, high taxes, less R&D
 - Quantile 5: small, young, R&D intensive

Rationale for discrimination?

- Problems: liquidity constraints, fragility, hybrid instruments (e.g. convertible bonds).
- Distinction based on criteria: maturity, control by management, variability of claim, etc.
- Devereux and Gerritsen (2010): no objective legal reason.
- Traditional view: dividends = remuneration of capital, interest = business cost (hence deductible).
- Link with PIT.

Evidence

- Well-established link between CIT and leverage
 - De Mooij (2011): Meta analysis of 267 regressions,
 - mean tax elasticity of 0.65
 - Increase over time
 - Internal debt even more responsive
 - Keen and de Mooij (2011): financial institutions
 - Higher leverage
 - Similar size of response
- Well-established debt-shifting
 - E.g. Huizinga et al (2008), 10% tax rate increase in parent country leads to 2.4% leverage increase in parent and 0.6% leverage decrease in foreign affiliate

Options

- Thin Capitalization Rules
 - Buettner et al. 2012: TCR impact on leverage
 - Blouin et al. 2013:
 - significant effect of TCR
 - TCR reduces overall D/A by 1.9%, internal D/A by 5.7%
 - TCR reduce sensitivity of debt to CIT
 - Automatic remedy better more significant than Arm's length
- Earnings-stripping rules:
 - IT, DE, BG, FR – NI/EBITDA
- Consolidation (CCCTB)

Options

- Comprehensive Business Income Tax (CBIT)
 - No deductibility for interest
 - Base broadening
 - But rents affected by tax rate, not base
 - Treatment of pre-existing debt ?
 - No tax on interest received ?
- Allowance for Corporate Equity (ACE)
 - Notional interest for equity
 - BE, LV, IT, PT
 - Tax on rents: zero EMTR
 - Princen (2012): impact on leverage, not investment

Options

- Allowance for Corporate Capital (ACC)
 - Boadway and Bruce (1984), Kleinbard (2007, 2011)
 - Deductible notional risk-free return to capital
 - De Mooij and Devereux (2011): simulations with CORTAX
- Cash-Flow Taxation
 - Immediate expensing
 - Taxation of pure rents
 - Consumption tax



Thank you for your attention!