

## Thin Capitalization rules (“still”) under consideration

### What is Thin Capitalization?

In worldwide tax system, a payment in the form of interest is typically treated as a deductible expense for corporate income tax computation. In order to utilize advantage of the said issue, multinational enterprises (MNEs) would consider setting up a company in a source country with excessive debt (Debt Financing) in order to shift profits derived therefrom in form of interest to be received in a low tax rate jurisdiction. This arrangement is called ‘Thin Capitalization’ and has been abrasive to source country tax base for a long time.

To prevent such international debt shifting, many countries have implemented thin-capitalization rules. The two most common types used in practice are “*safe harbor rules*” and “*earnings stripping rules*.” Safe harbor rules restrict the amount of debt for which interest is tax-deductible by defining a debt-to-equity ratio. Interest paid on debt exceeding this set ratio is not tax-deductible. Most countries only include internal debt in this ratio; some countries also include external debt. Earnings stripping rules limit the ratio of debt interest to pretax earnings and have emerged more recently.

### Thin Capitalization in Thailand

In Thailand, there is no specific anti-avoidance rule to prevent the bad faith tax avoidance. Borderline of tax planning, tax avoidance and tax evasion are unclear while the Thai Revenue Code (“TRC”) provides the general anti-avoidance mechanism in various parts of the TRC. However, it is a problematic under the rule of law to empower the government authorities to attack the tax avoidance without breach of constitution.

In the recent years, the Thai Revenue Department (“TRD”) conducted an in-depth study to revise the TRC for its improvement after the enactment in 1938 and major amendment for over 20 years ago. An interesting issue is the consideration of specific anti-avoidance rules to chase up the risky-tricky transactions in the modern trade.

## Anti-Tax Avoidance Rules

- Transfer pricing (TP)
- Thin capitalization (TC)
- Treaty shopping (TS)
- Controlled foreign company (CFC)
- General Anti-avoidance rules (GAAR)
- **BEPS (Base Erosion Profit Shifting)**

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The anti-avoidance rules in focus is to improve the transfer pricing guideline the TRD released in 2002. This guideline adopted in Thailand following to the concepts of the Australian Tax Office (“ATO”) and the OECD which was not a legislative part under the TRC. The guideline was provided for the Revenue authority in its practice to conduct a tax audit and advisory providing to taxpayers for transfer pricing (“TP”) at the market price (i.e. the TRD may apply the TP rules to restrict interest deductibility where the interest rate charged is higher than an arm’s length rate). At present, the Transfer Pricing laws came into effect in 2019 and will be fully implemented in 2020 onwards.

Thin capitalization (“TC”) is another transaction under the consideration of the TRD to set out as an attacking device against the impermissible financial transactions especially among the related parties. The idea is to follow the international standard of TC rules adopted in other countries, for example, debt and equity ratio (D/E ratio) should not exceed 3:1 or rely on EBITDA (Earnings

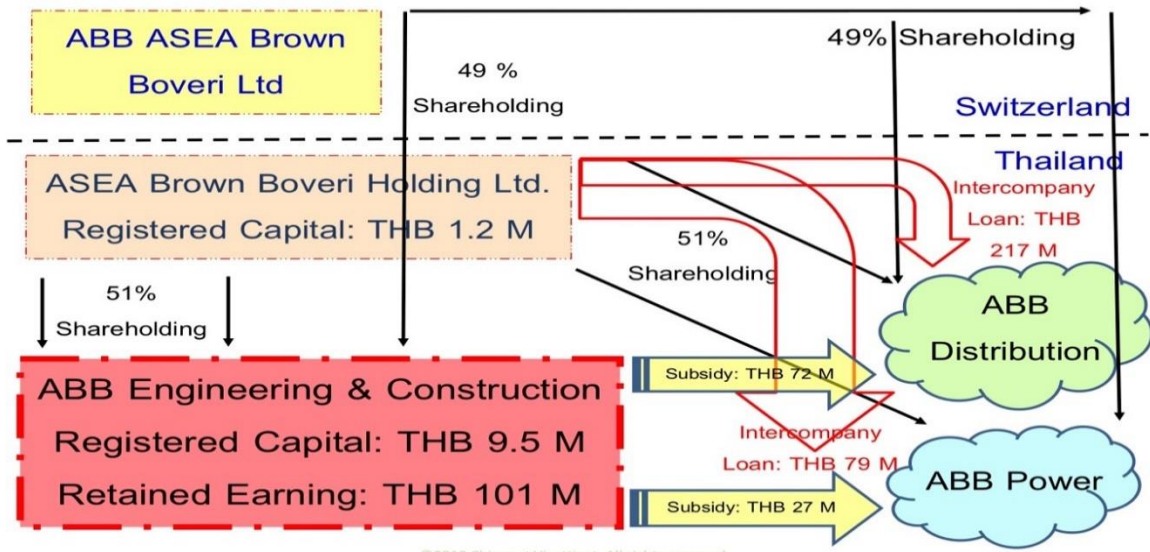
Before Interest Tax, Depreciation, Amortization). However, the clear direction and framework of TC rules in Thailand is in the process of discussion and expected to be enforceable in the near future.

Normally, an interest expense is allowed to be deductible for corporate income tax purposes except for the interest in certain transactions. Without the TC rules, in many cases, we found Thai taxpayers incorporate a company with low corporate capital and bear huge interest payable from intercompany loan. This strategy, however, will not be workable if such taxpayer is obtaining the investment promotion for tax and non-tax privileges from the Board of Investment (“BOI”) due to the D/E ratio requirement. In addition, for foreign business, D/E ratio is limited under the Foreign Business Law (“FBL”). Under the FBL, the foreign business operator is required to obtain the permission and license depending on nature of business prior to the commencement of business in Thailand. In practice, ratio under the BOI schemes is not exceed 3:1 while the FBL adopts the ratio not exceeding 7:1.

#### ONE Law's Comments

It is worthwhile to note that the TC rules is not only upcoming anti-avoidance rule to be launched in Thai tax practices but also the subsequent rules in practices of Thai tax authority will be adopted to attack the abusive tax avoidance. For example, the TRD challenged against the inter-company subsidy transactions among Thai related companies under the ‘Thin Capitalization Arrangement’ and the Supreme Court ruled in the 2015 tax case that the taxpayer intentionally involved in the abusive tax avoidance to pay 10% dividend tax. Under this tax case, the Court relied on ‘Substance over Form Concept’ and considered the ‘Economic Substance’ and ‘Business Purpose’ behind the related transactions [*ABB Construction & Engineering in Thailand v Thai Revenue Department*].

**ABB: Dividend Tax Case No. 13253/2558 (2015)**



It should be noted that the TRD introduced BEPS rules (Base Erosion Profit Shifting) during its public seminar in 2014 to the corporate and MNC taxpayers and it has continued to revise the Thai tax laws during Thailand Tax Reform process since 2015. As a result of BEPS, 'Transfer Pricing' now is a legislative tax law rather than 'Tax Guideline' practiced since 2008.

Accordingly, non-justifiable transactions should be under close monitoring and well-prepared tax planning should be adopted. In addition, a tax health check review should NOT be omitted.

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**Article Keywords:** Thin Capitalization, Debt-to-Equity Ratio, D/E Ratio, Low Capital & High Debt, Deductible Interest Expense, Intercompany Loan, Disguised Dividend, ABB Tax Case, Transfer Pricing, BEPS, Substance Over Form, Economic Substance, Business Purpose, Tax Avoidance, Tax Evasion, Abusive Tax Planning

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