

Debt Finance Instruments from the Tax Law Perspective

Abstract

Without finances, there is no business. Financial resources for a new business plan or expansion of an existing business can be provided by existing or new capital investors, or the business can temporarily borrow them, either from public markets or from a bank. The various types and forms of financing also influence the economic prosperity of entrepreneurial activities through their impact on taxation and, consequently, on overall profitability.

This paper focuses on debt financing, its specifics, and the legal-economic aspects from the perspective of tax law. Its main objective is to assess and critically evaluate the scope and consequences of public tax law intervention in the private economic sphere of business decision-making regarding corporate financing. It concludes that the traditional historical tax advantage of debt financing compared to equity financing significantly affects decisions on the overall debt and capital structure of businesses. The result is the incentivization of excessive corporate debt, leading to undesirable profit shifting from countries where actual business activity takes place to countries with lower taxation, thus eroding their tax base and reducing tax revenue collection. Simultaneously, the resulting undercapitalization of companies affects their resilience to economic shocks, which can have societal consequences during economic crises. Efforts to correct this process by introducing new and stricter conditions for deducting debt financing costs reduce its incentivization but do not conceptually resolve the historical asymmetry between debt and equity financing. In this context, the paper also addresses the possibility of incentivizing equity through a notional capital cost deduction, as the possibility of tax-deductible expenses associated with obtaining equity is generally not available. However, capital is not free.

The work is structured into four main parts. The first economic-legal part addresses the fundamental aspects of the influence of tax law on the choice between equity and debt financing from the perspective of legal and economic theory. The second theoretical-legal part examines historical approaches to the problem of excessive debt financing, including the impact of international cooperation among states within the framework of the Organisation for Economic Co-operation and Development (OECD) and through the normative initiatives of the European Commission under the EU legal system.

The third part of the paper focuses on the development of debt financing regulations in Czech law. It also examines the peculiarities of certain financial instruments within the Czech tax law framework, specific transactions including typical acquisition scenarios, and specific types of enterprises such as banks, insurance companies, and companies reporting under International Financial Reporting Standards (IFRS). It also evaluates the influence of interpretative activities of the Czech tax administration and court jurisprudence, including the doctrine of tax abuse in the area of financing. The final, fourth part evaluates the legal framework for taxing debt financing costs in selected countries, including a comparison of the results of implementing recent significant rules limiting the deductibility of financing costs to their operating income under the European Anti-Tax Avoidance Directive (ATAD).

Key words

debt financing, debt-equity bias, tax deductibility of borrowing costs