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Examination of Methods for Limiting Interest: Systematic Literature Review

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ABSTRACT

The study employs a literature review. We acquired and deliberated over findings through online scholarly publications, news articles, and official guidelines. Most countries have implemented the Thin Capitalization Rule (TCR) to restrict interest deductions that exceed a certain debt threshold. Multiple nations employ the safe harbor rule, while others utilize earnings-stripping measures or employ both methods together. The Debt-to-Equity Ratio (DER) is the prevailing rule for thin capitalization worldwide. The OECD advocates for the enhancement of DER. The OECD does not support using DER as a TCR in the final report of BEPS Action 4. Instead, they recommend implementing restricted costs or income-stripping rules. The OECD recommends that countries establish a consistent baseline ratio of 10% to 30%. Many developed countries have implemented a 25-30% limitation on EBITDA, TAX EBITDA, or Adjusted Income. Malaysia and other developing nations limit interest deductions to a maximum of 20%. Indonesia has committed to transition from thin capitalization to earnings stripping restrictions, which aligns with BEPS Action Plan 4, which involves applying the net interest/EBITDA ratio. This commitment was made after the enactment of Tax Law Number 7 Year 2021, which aims to harmonize tax regulations. Meanwhile, Indonesia is actively addressing the issue.

Keywords: DER; interets limitation; OECD; thin capitalization rule; earning stripping rule

ABSTRAK

Penelitian ini menggunakan tinjauan literatur. Kami memperoleh dan mempertimbangkan temuan melalui publikasi ilmiah online, artikel berita, dan pedoman resmi. Sebagian besar negara telah menerapkan *Thin Capitalization Rule* (TCR) untuk membatasi pemotongan bunga yang melebihi ambang batas utang tertentu. Banyak negara menerapkan aturan pelabuhan aman (safe harbour rule), sementara negara lain menerapkan tindakan pengurangan pendapatan, atau menggunakan kedua metode tersebut secara bersamaan. *Debt to Equity Ratio* adalah aturan yang berlaku untuk kapitalisasi tipis di seluruh dunia. OECD mengadvokasi peningkatan DER. OECD tidak mendukung penggunaan DER sebagai TCR dalam laporan akhir Aksi BEPS 4. Sebaliknya, mereka merekomendasikan penerapan aturan pembatasan biaya atau pengurangan pendapatan. OECD merekomendasikan negara-negara untuk menetapkan rasio dasar yang konsisten berkisar antara 10% hingga 30%. Banyak negara maju yang menerapkan pembatasan 25-30% pada EBITDA, *TAX EBITDA*, atau Pendapatan Disesuaikan. Malaysia dan negara berkembang lainnya membatasi pemotongan bunga maksimal 20%. Indonesia telah berkomitmen untuk melakukan transisi dari pembatasan kapitalisasi tipis ke pembatasan pendapatan, sejalan dengan BEPS Aksi 4, yang mencakup penerapan rasio EBITDA. Komitmen tersebut dilakukan pasca diundangkannya Undang-Undang Pajak Nomor 7 Tahun 2021 yang bertujuan untuk menyelaraskan peraturan perpajakan. Sementara itu, Indonesia secara aktif mengatasi masalah ini.

Kata Kunci: DER; pembatasan bunga; OECD; thin capitalization rule; earning stripping rule

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1. INTRODUCTION

Companies prefer debt financing over equity financing (Desai & Dharmapala, 2015). Multinational corporations can utilize internal debt to redirect profits away from nations with high tax rates. It can be achieved through two methods: strategically determining the quantity of internal debt and setting interest rates accordingly (Gresik et al., 2017). The decisions regarding a company's capital structure are frequently influenced to a great extent by tax considerations (Faccio & Xu, 2015). The interplay between capital structure and taxes can impact the cost of capital, cash flow, and the overall financial performance of a company. Enterprises in jurisdictions with low effective tax rates exhibit lower leverage levels than those operating in jurisdictions with high effective tax rates (Faulkender & Smith, 2016). When a firm grants a loan, it will incur interest payments. Under the corporate income tax framework, interest payments are considered a deductible expenditure. As the deductible interest expenditure increases, the taxable income or the company's profit decreases. Concurrently, financing through shares will provide dividends that are liable to income tax on dividends. Hence, corporations exhibit a preference for utilizing debt financing options over equities.

Leverage involves utilizing borrowed capital (debt) to fund a company's activities or ventures. A low leverage ratio signifies the company's comparatively tiny debt to its equity or assets (Hussan, 2016). Consequently, the company's reliance on borrowed cash is reduced, resulting in a smaller debt load and lower leverage. Consequently, the organization exhibits excellent financial stability and flexibility. Reducing leverage can decrease interest expenses and financial vulnerability when a corporation has less debt to repay. Companies prefer alternative sources of finance rather than loans, such as raising money through issuing shares or selling fixed assets or inventories.

The relationship between debt and taxes is a complex and multifaceted topic in finance. Various studies have examined this relationship and provided insight into how taxes can influence corporate decisions regarding debt financing. The international taxation framework allows multinational companies to shift their profits to the jurisdictions of other countries with lower tax rates. Companies may prefer to allocate debt to high-tax jurisdictions because paying interest on debt is tax-deductible (Goldbach et al., 2021). Doing so can reduce their taxable income in high-tax jurisdictions and shift profits to low-tax jurisdictions.

Differences in tax rates in various countries cause multinational companies to shift profit. Profit shifting refers to shifting profits from one jurisdiction to another to minimize tax liability (Dowd et al., 2017). MNCs can save on taxes by shifting debt to high-tax affiliates, even for a fixed interest rate. The tax savings from a reduced interest in high-tax countries exceed the tax liability of the parent company. This incentive implies that affiliates in countries with high tax rates must have relatively high debt-to-asset ratios and excessive interest deductions compared to other affiliates (Schjelderup, 2016).

Sources of debt financing can be internal and external debt. In the context of multinational corporations (MNCs), internal and external debt refer to the sources of debt financing available to an MNC for its operations in different countries. Internal debt for MNCs is a loan or financing obtained from subsidiaries or affiliates in various countries. MNCs have many subsidiaries in different countries, and they can use intercompany loans or issue bonds within their corporate structures to raise funds. These intercompany loans or bonds create internal debt. MNCs usually include internal debt interest payments in their financing structures so that funds remain within the MNC's network of subsidiaries. This strategy triggers profit shifting, shifting group company profits to subsidiaries or affiliates in jurisdictions with lower tax rates.

In addition to the debt-shifting strategy, multinational companies shift profit through transfer pricing and thin capitalization. Transfer pricing involves determining the transfer price of products and services or intellectual property between two different entities within a multinational company. At the same time, thin capitalization involves using debt relative to equity in subsidiaries, which allows the company to reduce interest payments and taxable income. This strategy often takes advantage of tax deductions on interest payments in certain jurisdictions. Differences in tax rates and regulations in different countries facilitate this profit-shifting strategy. Multinational companies can exploit this difference to minimize their tax burden and maximize profits (Buettner et al., 2016; Schindler & Schjelderup, 2016).

Profit shifting has become a significant concern for countries, including Indonesia. The OECD has led in working with nations worldwide to solve the profit shifting issue and stop Base Erosion and Profit Shifting (BEPS). The OECD has developed a comprehensive framework of guidelines and recommendations to address aggressive tax planning strategies that multinational corporations (MNEs) use. This framework is known as the BEPS Project. The BEPS Project aims to prevent tax evasion by multinational companies by fixing loopholes in current international tax laws.

The OECD BEPS project has had a significant impact on international tax rules and regulations, influencing tax systems around the world. Many countries have adopted or modified their domestic laws to align with OECD recommendations, increasing transparency and cooperation among tax authorities to combat profit-sharing and ensure fair taxation. Implementation and enforcement of these measures may vary from country to country. Ongoing efforts are underway to address challenges and monitor the effectiveness of the BEPS Project in curbing profit-shifting practices. The BEPS Project consists of 15 action points addressing various aspects of international tax planning and profit transfer. Some of the main action points relevant to profit transfer include Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 3: Strengthening CFC Rules: Controlled Foreign Company (CFC) rules, Action 4: Limiting Base Erosion via Interest Deductions and Other Financial Payments, Action 7: Preventing the Artificial Avoidance of Permanent Establishments (PE), Action 8 – 10: Aligning Transfer Pricing Outcomes with Value Creation. BEPS Action 4 recommends drafting rules to prevent base erosion through interest payments and double non-taxation from both inbound and outbound perspectives (Cencerrado et al., 2015). Implementation of Action 4 requires coordination and cooperation between countries to ensure consistent implementation and prevent shifts in the tax base between jurisdictions.

Previous studies have studied the implementation of earnings-stripping rules in other countries. The Norwegian earnings stripping rule increased corporate tax revenues and reduced excessive interest expenses that eroded the corporate tax base. The earnings stripping rule may have had unintended effects by decreasing the affected enterprises' economic activity. Limiting the amount of interest that can be deducted could raise capital expenses and reduce investment (Toikka, 2021). A separate study assessed the earnings stripping regulations in light of EU legal requirements and economic theory. The guidelines, which treat debt and equity differently and use various financing arrangements, are the second-best way to address BEPS. Due to the need for more differentiation between domestic and cross-border scenarios in their implementation, the guidelines most likely do not violate EU legislation (Stevens, 2020).

The guidance provided by the BEPS Project offers a framework for countries to develop regulations that appropriately limit interest deductions and minimize the opportunities to transfer profits associated with financing arrangements. However, it should be noted that implementing Action 4 and other BEPS Actions may vary between countries, and specific regulations and approaches may differ depending on individual jurisdictions. Each country is responsible for adopting and implementing measures consistent with the OECD BEPS recommendations, taking into account their respective country's legal and administrative framework.

This study aims to analyze the implementation of taxes on financial transactions, namely the reduction of interest expenses, by examining the various approaches used in different developing nations, including Indonesia. The identification results are subsequently utilized to examine strategies for restricting interest deductions in Indonesia and modifications to tax rules implemented as a manifestation of the Indonesian government's dedication to accepting and executing BEPS Action recommendations. The research was undertaken by examining prior research publications that addressed limitations on interest deductions and other reference sources that described the practice of interest deductions in other nations.

2. LITERATURE REVIEW

a. Profit Shifting

The international tax framework allows a multinational company to finance debt. Multinational companies can use internal debt to divert profits from countries with high taxes (Gresik et al., 2017). This change led to a change in profitability by employing a loan program. If

subsidiaries from low-tax countries lend to subsidiaries in high-tax countries, internal debt becomes a vehicle for tax planning and profit shifting within an MNC (Buettner et al., 2016).

Debt shifting is a tax planning strategy used by multinational corporations to move debt or financing arrangements between linked firms in various countries (Møen et al., 2011). The primary goal is to optimize the allocation of interest deductions and reduce overall tax liabilities. Multinational companies operating in multiple jurisdictions may establish intercompany loans or other debt arrangements among their subsidiaries. These loans can be structured to maximize interest deductions in high-tax jurisdictions and minimize taxable income in low-tax jurisdictions (Goldbach et al., 2021).

In most countries, debt interest payments are often tax deductible (Schjelderup, 2016). By increasing the amount of intercompany debt or restructuring existing debt, companies can increase interest expense deductions, thereby reducing their taxable income and lowering their tax liabilities in high-tax jurisdictions. Debt shifting often involves transfer pricing, which is the pricing of transactions between related entities within the same multinational group. Transfer pricing regulations require that intercompany transactions, including intercompany loans, be conducted at arm's length (Chand, 2016). Tax authorities carefully examine transfer pricing to guarantee that interest rates on intercompany loans are adequately established and do not lead to fake profit shifting.

The Action Plan on BEPS was supported by G20 Leaders in September 2013, demonstrating their support for its ambitious and comprehensive nature. The BEPS project aims to tackle issues over the use of aggressive tax planning tactics, specifically focusing on the practice of debt shifting. The project's objective is to counteract tax avoidance and profit shifting through the creation of global standards and guidelines that tax authorities can utilize to tackle these behaviors. For the first time, all countries belonging to the Organisation for Economic Co-operation and Development (OECD) and the Group of Twenty (G20) have collaborated on an equal basis to develop shared strategies in addressing global tax issues. Consensus was reached on establishing minimum criteria primarily to address situations when inaction by certain countries could have resulted in detrimental consequences, including as negative spillovers and unfavorable effects on the competitiveness of other countries. The BEPS package encompasses a standardized method that will aid in the alignment of national practices among participating countries to restrict the erosion of tax bases caused by excessive interest payments, such as those arising from loans between related parties or third parties. It also addresses the need to counteract hybrid mismatches that undermine the tax bases of countries or their partners using appropriate domestic legislation and relevant treaty provisions. A consensus has been reached on recommendations for formulating domestic regulations and model treaty clauses, accompanied by comprehensive guidance on executing them (OECD/G20, 2016b).

Fundamental differences distinguish the tax treatment of debt and equity in corporate income tax. In most nations, interest is generally taxable or eligible for tax deductions. In contrast, dividends are distributed from profits that have already undergone taxation and do not go into the computation of a company's taxable income. Shareholders may be eligible for partial tax exemptions or tax credits on dividends. Within a multinational group, when one member lends money to another, the interest payments made by the borrowed business increase the taxable income of the lending company while simultaneously decreasing the taxable income of the borrowing company. In a cross-border scenario, the income is subject to taxation in the state where the lender resides rather than the borrower's state.

Several nations with high tax rates have introduced legislation limiting the permissible level of interest expenses to prevent the possible misuse of tax-deductible expenses. These laws also prevent firms from using intercompany loans excessively to gain tax benefits, helping to maintain a fair approach to taxing financial transactions inside multinational entities.

b. Restrictions of Deduction Interest Costs

Thin capitalization laws are government regulations that limit the tax deductibility of debt financing for businesses, especially when related parties provide the debt. The purpose of these restrictions is to prevent multinational corporations from engaging in profit shifting and other methods of tax avoidance. Thin capitalization rules refer to tax regulations restricting the extent to which a firm can deduct

interest expenses for tax purposes (OECD, 2012). The law is enforced to prevent firms from employing undue leverage to transfer earnings to jurisdictions with lower tax rates or exploit tax benefits. Thin capitalization regulations are commonly expressed as a debt-to-equity ratio, which establishes an upper limit for the amount of debt financing a firm can have about its equity. Should a corporation exceed this limit, its interest expense will be invalidated or subjected to specific limitations, leading to an increased tax obligation (Wallstreetmojo, n.d.). The TCRs can be classified into two primary categories: earnings stripping rules (ESRs) and safe harbor rules (SHRs). ESRs impose limitations on the internal or total interest costs, restricting them to a certain proportion of companies' EBITDA (earnings before interest, taxes, depreciation, and amortization). On the other hand, SHRs directly limit the internal or total debt-to-equity ratio (Gresik et al., 2017).

They are earning stripping regulations, which are often referred to as interest deduction limitations. Do governments impose laws limiting the amount of interest expenses a firm can deduct for tax purposes? Earnings stripping is a lawful method of tax evasion that exploits a gap in the tax legislation to diminish the tax liability owed to the government (Hussain, 2022). These regulations aim to deter the practice of profit-shifting and tax evasion techniques often linked to the excessive use of interest deductions. The primary purpose of implementing earnings-stripping laws is to prevent corporations from manipulating their financial arrangements by burdening their operations with excessive debt to transfer profits to countries with lower tax rates or exploit advantageous tax deductions. These rules aim to enhance equity in taxation and mitigate the erosion of the tax base by imposing restrictions on the amount of interest deductions. In general, interest payments made by a business to linked entities are the main focus of earning stripping restrictions, mainly when such affiliated entities are located in jurisdictions with lower tax rates. The guidelines address scenarios where a firm deliberately increases its interest payments to decrease taxable income in a jurisdiction with higher taxes and transfers profits to a country with lower taxes.

BEPS Action 4 proposes the implementation of the earnings stripping rule, which involves the use of EBITDA. It emphasizes the potential of interest deductions, independent of how the lender treats the income. A comprehensive strategy must be implemented in the BEPS action plan to address this discrepancy in treatment. Nevertheless, it is acknowledged in multiple BEPS initiatives that the disparate tax treatment of debt and equity results in a favorable inclination toward debt financing. In order to provide a cohesive and thorough approach, it is necessary to enhance the coordination between the efforts on BEPS action four and other action items that address the deductibility of interest payments (Hoor & Donnell, 2015). Nations can retain their current regulations or incorporate the OECD suggestions into their national tax legislation.

According to the OECD's Revised Section E on Safe Harbours in Chapter VI of the Transfer Pricing Guidelines 2013, a safe harbor in the transfer pricing regime is a provision that applies to a specific group of taxpayers or transactions. It allows eligible taxpayers to be exempt from certain obligations that would otherwise be imposed by a country's general transfer pricing rules. A safe harbor provides less complex requirements as an alternative to the general transfer pricing rules. One possible provision could enable taxpayers to set transfer pricing in specific ways, such as by utilizing a streamlined transfer pricing approach offered by the administration. Alternatively, a safe harbor provision could exempt a specific group of taxpayers or transactions, excluding them from applying all or some general transfer pricing regulations. Frequently, taxpayers who meet the criteria for the safe harbor provision will be exempted from onerous compliance duties, which may include specific or all transfer pricing documentation requirements (Tambunan, 2021).

The safe harbor rule is a clause within thin capitalization regulations that establishes an upper limit for the amount of debt financing a company can have about its equity. If a company's debt-to-equity ratio falls within the acceptable threshold, its interest expense will be deemed eligible for tax deduction. There is no formal safe harbor rule in some jurisdictions, such as Belgium, but an informal 4:1 debt-to-equity ratio applies (Locher, 2021). The safe harbor rule is an essential aspect of thin capitalization rules, as it provides a clear framework for companies to structure their financing arrangements tax-efficiently while avoiding excessive debt financing that could

lead to tax base erosion and profit shifting (Asen, 2019).

3. RESEARCH METHOD

This study employs a systematic literature review. We discovered journals by searching databases using specific terms such as interest limitation, thin capitalization rule, and earnings stripping rule. The previous research was conducted a decade ago. This limitation is implemented to ensure that the study remains current. However, previous studies on revenue stripping restrictions have constraints, especially regarding implementing this policy. The online article imposes restrictions on reducing interest rates, a common occurrence. The information is sourced from the websites of tax consultants in Malaysia, Japan, the Netherlands, and other countries that impose restrictions on interest deductions. The tax consultant website's research explains how these countries implement it, starting with the underlying policies and concluding with the ultimate computation. This study utilizes documentation in conjunction with a literature review. Adopting interest deduction restrictions necessitates compliance with OECD paperwork and tax regulations as a legal foundation.

The research selection techniques were described in compliance with the recommended reporting items in Systematic Reviews and meta-analyses (PRISMA) (Moher et al., 2010). The first step is identification. Records identified through database searching using keywords in 2012-2023 are divided into online journals as 50 journals, regulation as three, and online articles as five. The second step is screening. Records after duplicates were removed because they were written in other English languages and had no full text as 20 journals; meanwhile, online articles and regulations are still the same. The third step is eligibility. Records are excluded because they do not include the interest limitation method, thin capitalization rule, and earnings stripping rule as 13 journals. So, the fourth step is screening and studies in the systematic literature review, which consists of seven journals, three regulations, and five online articles from the consultant website. We also use the OECD website's Regulations Governing Transfer Pricing Taxation Guidelines for Financial Transactions. We use this data as a reference for applying the method of limiting interest deductions in that country. Thus, this research can provide a more valid picture of the application of this method because it is based on applicable tax regulations.

4. RESULT

The research data used in Table 1 and Table 2. Table 1 contains information on articles and regulations that were reviewed. Table 2 contains information regarding transfer pricing profiles in several countries as an illustration.

Table 1
Reviewed Article

Title	Source	Categorized Data	Content
The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms (Buettner et al., 2012)	ScienceDirect	Online Journal	This study utilizes a comprehensive dataset of multinational enterprises at a micro-level to examine the impact of thin-capitalization laws on the financial structure of overseas subsidiaries situated in OECD nations from 1996 to 2004. The results suggest that thin-capitalization regulations successfully diminish the motivation to employ internal loans for tax avoidance purposes but lead to an increase in external debt.
Firm's Financial Choices and Thin Capitalization Rules under Corporate Tax Competition (Haufler & Runkel, 2012)	ScienceDirect	Online Journal	The author demonstrates that implementing synchronized measures to restrict thin capitalization becomes advantageous for both countries despite the fact that it amplifies competitiveness through tax rates. When there is a disparity in size between countries, the smaller country not only opts for a lower tax rate but also adopts a more forgiving, thin capitalization regulation.
Thin Capitalization Rules and Multinational Firm Capital Structure (Blouin et al., 2014)	IMF Working Paper	Online Journal	Thin capitalization regulations impact multinational firms significantly, decreasing subsidiary debt ratios (1.9%), parent-to-equity borrowing (6.3%), and affiliate debt-to-assets ratios (0.8%). These regulations, particularly when automatic, indirectly reduce overall debt, total interest expenditure, and the firm's valuation.
The Effect of Tax Haven on Host Country Welfare (Gresik et al., 2015)	SSRN	Online Journal	We demonstrate that lenient, thin capitalization restrictions may be necessary in developing nations to attract Foreign Direct Investment (FDI). However, the extent of debt financing permitted by these lenient limits encourages more assertive transfer pricing, leading to a decrease in the overall welfare of the host country.
Why Countries Differ in Thin Capitalization Rules: The Role of Financial Development (Mardan, 2017)	ScienceDirect	Online Journal	The author demonstrates that welfare is more significant under a safe haven rule compared to an earnings stripping rule, assuming firms cannot control the interest rate on internal loans. Under an earnings stripping rule, welfare can potentially increase if corporations can adjust the interest rate on internal loans. Additionally, they demonstrate that the ideal amount of internal interest deductions declines as the host country's financial development increases. The outcomes we obtained align with the policy decisions made by various governments.
Curbing Corporate Debt Bias: Do Limitations to Interest Deductibility Work? (Hebous & De Mooij, 2018)	ScienceDirect	Online Journal	The Debt-to-Equity Ratio (DER) stands out as the widely recognized thin capitalization regulation implemented globally. In 2016, 49 out of 60 countries with explicit thin capitalization rules embraced the DER as their primary framework for determining the deductibility of interest.

Title	Source	Categorized Data	Content
Makin Better Indonesia's Thin Capitalization Rules (Lesson Learn from China) (Susilawati, 2019)	ACHITS 2019: Proceedings of the 1st Asian Conference on Humanities, Industry, and Technology for Society	Online Journal	In Indonesia, despite stringent regulations addressing tax issues, the perceived leniency of the debt-to-equity ratio (DER) suggests room for improvement. Proposed measures include a DER review, consideration of the arm's length principle, and regulatory enhancements for clarity on interest financing, fines, and the treatment of interest revenue and expenses. These suggestions draw insights from China and non-disincentive tax policies, contributing to a more robust, thin capitalization framework in Indonesia.
Action Plan on Base Erosion and Profit Shifting (OECD, 2013)	OECD	Regulation	The goal of BEPS Project Action 4 is to restrict base erosion through the regulation of interest deductions and other financial transactions. Each country is granted the flexibility to adopt and implement these measures according to its own discretion.
OECD/ G20 Base Erosion and Profit Shifting project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report (OECD, 2015)	OECD	Regulation	The primary advantage that the debt-to-equity ratio provides is its straightforwardness in implementation. The designated ratio facilitates the use of taxable income calculations and assessments for both firms and tax authorities. The simplicity can also result in reduced costs and increased adherence. The OECD recommends that nations establish their benchmark fixed rules within the range of 10% to 30%.
Governement Regulation No. 55 year 2022 (Government, 2022)	Government	Regulation	These regulations should explicitly and comprehensively address restrictions on deductions related to interest expenses. The rules govern adjustments within the realm of income tax as a whole.
Memahami Konsep Thin Capitalization (Mukarromah, 2019)	DDTC	Online Article	TCR does not consistently employ the DER strategy. While numerous countries adopt the concept of DER, alternative ways include the subjective approach, the retained profits strategy, the arm's length principle approach, and the international gearing debt approach.
Earnings Stripping Rules and The Potential Impact on Asset Deals in Japan (Masato Iwajima, 2021)	Delloite	Online Article	Pre-2019 tax reform, Earnings Stripping Rule (ESR) limited deductions for net interest expenses above 50% of TAX-EBITDA. Post-reform, the threshold reduced to 20%. Non-deductible net interest expenses under ESR can be carried forward for seven years, capped at 20% of TAX-EBITDA, potentially increasing after 60 months with full goodwill amortization.
Tightening of The Earnings Stripping Rule (KPMG, 2023)	KPMG	Online Article	Under Dutch GAAP, starting from 1 January 2022, the ESR imposes a restriction on an entity's ability to deduct interest, limiting it to a maximum of 20%. The accounting treatment

Title	Source	Categorized Data	Content
			prescribed by the Generally Accepted Accounting Principles (GAAP) is identical to the accounting treatment prescribed by the International Financial Reporting Standards (IFRS).
Thin Capitalization and Other Restrictions to Interest Deduction (Jan Van Daele, 2023)	Orbitax	Online Article	Starting from 1 January 2019, the amount of net interest expenditure that can be deducted in a given year is limited to either 30% of EBITDA or EUR 3 million, whichever is lower. Any surplus of non-deductible interest in a given year can be carried forward indefinitely. Belgium issued revised instructions on 12 January 2023, which provide updated information on the limits of interest deduction, clarify the calculation of EBITDA, and address many other technical issues of the ESR. The TCR 5:1 debt-to-equity ratio is also applicable to the interest payments made on debt. Belgium employs hybrid financial tools or strategies.
Malaysia Releases Rules and Guidelines on Interest Expense Limitation (Global Tax Alert, 2019)	Earnest & Young	Online Article	Excess interest expenses beyond 20% of Tax-EBITDA can be carried forward for deduction in future assessments, capped at 20% of tax EBITDA per year until fully utilized, even if no interest expense occurs in subsequent years.

Source: Data, 2023

Table 2
Transfer Pricing Country Profile (based on OECD website)

Country	Regulations Governing Transfer Pricing Taxation Guidelines for Financial Transactions	References
Malaysia	Malaysia, in accordance with BEPS Action 4, restricts interest expense deductions under Section 140C of the Income Tax Act 1967 and Income Tax (Restriction on Deductibility of Interest) Rules 2019 [P.U.(A) 175], effective from 1 July 2019. Detailed guidelines can be found in Public Ruling No. 2/2011, "Interest Expense and Interest Restriction."	Income Tax Act 1967 (ITA), Section 140C and Section 33(2); Income Tax (Restriction on Deductibility of Interest) Rules 2019 [P.U.(A) 175]; Interest Expense and Interest Restriction Public Ruling No. 2/2011
France	Under Article 39 of the General Terms and Conditions, partner interest is deductible if rates stay below bank averages. Article 212 bis in the General Tax Code limits corporations' net financial charge deduction to 30% of profit before tax, EBITDA, or EUR 3 million, with stricter rules for under-capitalized enterprises. The anti-hybrid rule (Article 205 B, GTC) restricts deductions when the recipient's taxable income lacks income from a hybrid asymmetry.	Article 39 and Article 212 of the General Tax Code

Country	Regulations Governing Transfer Pricing Taxation Guidelines for Financial Transactions	References
Netherlands	Anti-abuse provisions could be utilized to constrain interest deduction, with these rules encompassing the 30% EBITDA rule (BEPS Action Plan 4/ATAD) and restrictions on interest deductions related to financing transactions with affiliated parties.	Article 10a, 10b, 13ab, and 15b CIT Act
United States	IRC Section 163(j) constrains interest deductions as outlined in Action 4, while IRC Section 267A restricts deductions for interest and certain payments in hybrid situations per Action 2. Numerous additional rules pertaining to the tax treatment of financial transactions are too extensive to enumerate here.	IRC 163(j) and 267A, among others
Japan	Article 66-5 to 66-5-3 of ASMT provide rules to limit interest deductions that are in line with BEPS Action 4	Article 66-5 to 66-5-3 of ASMT
Panama	Panama is currently reviewing interest deductibility limitation based on BEPS Action 4	-
Finland	Finland's laws include clauses that limit the deductibility of interest payments under specific conditions. There are also provisions concerning hybrid mismatch arrangements, which may apply, among other things, to financial transactions. Importantly, these rules are distinct from transfer pricing regulations.	For interest deductions. Sections 18a - 18b of the act on the taxation of business income. For hybrid mismatch arrangements: Act on taxation of certain cross border hybrid mismatch arrangements
Norway	Norway has implemented rules to limits interest deductions. Norway will as of July 1, 2021 implement a withholding tax on interest payments to related parties tax resident in low tax jurisdictions.	The Tax Act section 6 - 41
Germany	Limitation of interest deductions: The Germany interest limitation rule was introduced in 2008 and limits the deduction of excesive net interest expenses. The OECD and G20 have recommended under BEPS Action Item 4 that an interest deduction restriction comparable to the Germany interest limitation rule be introduced	Section 4h Income Tax Act; Section 8a Corporation Tax Act

Source: OECD, 2023

5. DISCUSSION

a. Interest Limitations Method in Indonesia and Other Country

Most countries have implemented the Thin Capitalization Rule (TCR) to limit the amount of interest deductions that exceed a certain level of debt. The TCR evaluates the suitable debt ratios based on various factors such as total assets (in the context of New Zealand), total equity, internal equity from a single related party, total internal equity, total internal foreign equity, or total foreign equity (Blouin et al., 2014). Many countries use the safe harbor clause to limit the deduction of interest charges. Japan, Iceland, Germany, Malaysia, Norway, and the Netherlands enforce earnings-stripping legislation. However, several countries, such as Denmark and the United States, combine both laws.

The host country's government must weigh the benefits of attracting more significant investment from financially constrained organizations against the potential risk of profit manipulation by financially well-endowed firms. The government establishes the most efficient thin capitalization regulation using a two-step method. In the first stage, the government chooses a thin capitalization regulation, such as a fixed debt-to-equity rule, safe harbor, or earnings-stripping rule. Next, they determine the strictness of the thin capitalization restriction. A more stringent Thin Capitalization Rule decreases welfare, while an earnings-stripping rule results in higher welfare than a safe harbor rule (Haufler & Runkel, 2012). "Planned welfare" refers to the benefit amount allocated per person. The level of strictness in thin capitalization requirements varies between countries, with nations with more sophisticated financial systems typically enforcing stricter regulations (KOF Bulletin, 2017). Indonesia lacks safe harbor legislation for specific businesses, taxpayers, or transactions (OECD, 2021).

More developed nations typically have more stringent Thin Capitalization Rules, whereas less developed nations frequently have more lax rules (Mardan, 2017). By restricting the amount of debt that multinational firms can finance and, thus, their tax burden, these regulations help to avoid profit shifting and erosion of the tax base (Gresik et al., 2015; Mardan, 2017). It is essential to understand, though, that although these regulations aim to safeguard the welfare of the host nation, they may unintentionally hurt it by discouraging foreign direct investment and reducing external finance for domestic businesses. It is so that multinational companies can avoid paying taxes in their home countries by shifting their profits to low-tax jurisdictions (Gresik et al., 2015).

The Debt-to-Equity Ratio (DER) is a commonly employed thin capitalization guideline globally, with 49 out of 60 nations implementing it to determine the deductibility of interest in 2016 (Hebous & De Mooij, 2018). Nevertheless, the OECD acknowledges certain disadvantages associated with using DER as the Thin Capitalization Rule, such as the limited flexibility in adjusting interest rates and the possibility of manipulation. The OECD recommends implementing changes in these areas (OECD/G20, 2016a).

Article 18 of the Indonesian Income Tax Law (UU Pajak Penghasilan) regulates thin capitalization to minimize excessive interest deductions on debts owed to overseas affiliates, thereby tackling possible profit shifting and tax avoidance. The Debt-to-Equity Ratio (DER), also known as the Thin Capitalization Rule, was first implemented by Indonesia in 1984, with a maximum allowable debt-to-equity ratio of 3:1. Nevertheless, this regulation was promptly halted a few months after it was put into effect (Mukarromah, 2019). In 2015, Indonesia's Minister of Finance released Minister of Finance Regulation No 169/PMK.010/2015 to determine the comparability of debt and capital for income tax purposes.

According to the new laws, debt now encompasses the average amounts owed for both long-term and short-term loans and interest-bearing trade payables. On the other hand, equity is calculated based on the balances at the end of each month, following the Indonesian Financial Accounting Standards, and includes non-interest-bearing loans from related parties. Indonesian resident taxpayers cannot deduct borrowing costs if their debt-to-equity ratio exceeds 4:1, as stipulated by the rules. Regardless of the 4:1 ratio, borrowing costs for related party loans must adhere to arm's length rules to be fully deductible (Orbitax, 2015). Indonesia has implemented strict, thin capitalization requirements that are more restrictive than many other nations. These rules tackle tax difficulties related to multinational firms and Base Erosion and Profit Shifting (BEPS) (Susilawati, 2019).

Indonesia has enforced transfer pricing restrictions (Minister of Finance Regulation No. 213/PMK.03/2016) to guarantee that transactions, including interest rates on loans between related parties, adhere to the arm's length concept. These restrictions ensure that the pricing and terms of such transactions are in line with what unconnected parties would agree upon in similar situations.

The final report of the OECD's Base Erosion and Profit Shifting (BEPS) Action 4 advises against utilizing the Debt-to-Equity Ratio (DER) as a Thin Capitalization Rule (TCR). Instead, it proposes alternate measures such as constraining interest expenses or adopting an earnings stripping/earnings threshold. This method establishes a proportion by comparing interest with EBIT or EBITDA (Mukarromah, 2019). The earning stripping rule, also known as the interest-to-EBITDA ratio, measures the percentage of interest paid from the revenue it is derived from (OECD/G20, 2016b). The Earning Stripping Rule (ESR) typically establishes a specific percentage of earnings that can be deducted as the maximum allowable interest expense in taxable income (Rulman, 2017).

It is worth noting that industrialized countries uniformly support the implementation of an earnings-stripping regulation. The disparities in financial development among countries may be associated with differences in the strictness of thin capitalization laws (Mardan, 2017). More developed nations with more advanced financial systems usually impose more rules. Internal loans are effectively limited due to restrictions on the tax deductibility of interest expenses. Research conducted by Blouin et al. (2014) and Buettner et al. (2012) has demonstrated that implementing a stricter thin capitalization condition in U.S. foreign data affiliates leads to decreased debt-to-asset ratios.

b. Implementation of Earnings Stripping Rules

The OECD suggests that countries establish a predetermined ratio as a benchmark from 10% to 30%. Each country is granted the autonomy to establish the benchmark fixed ratio at a level they deem sufficient to mitigate base erosion and profit shifting. Typically, the computation of Earnings Stripping Rules is as follows:

a. Net interest expenses	xxxx
b. xx% of Tax EBITDA (Adj. Income)	xxxx
c. Disallowed interest expenses (a – b)	xxxx

Point C represents a net interest charge not eligible for deduction according to the Earnings Stripping Rules (ESR). In addition, each country has the autonomy to establish the fiscal period for carrying forward and subtracting from taxable income.

The interest cost deduction in Norway was first limited to 30% of EBITDA and then revised to a 25% maximum. In Norway, these restrictions only cover interest on debt owned by the country, not debt borrowed. In 2014, Finland imposed a regulation comparable to Norway's, capping Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) at 25%. A deduction for company tax expenses is unavailable for any amount over this cap. Germany introduced a new set of thin capitalization criteria in 2008 when it replaced its previous safe harbor regulation with the European Social Report (Løkholm & Thornes, 2017).

Germany, a prominent adopter of the earning stripping rule, permits the subtraction of net interest costs up to 30% of a company's EBITDA. Interest expenses, such as payments on loans and accumulated interest, can be fully deducted as long as they do not exceed the amount of interest income. Interest payments are fully deductible for payments below 3 million Euros, entities without group status, or entities that are part of a group with an equity ratio within two percentage points of the group's ratio. Germany's legislation allows for the carryforward of non-deductible interest for a maximum of five fiscal years (Rulman, 2017).

Before implementing the 2019 tax reform, the earnings stripping rules (ESR) imposed restrictions on the deductibility of net interest expenses that were more than 50% of Japanese companie’s adjusted taxable income (TAX-EBITDA). The 2019 tax adjustment decreased the previously established threshold from 50% to 20%. The ESR does not permit the subtraction of net interest costs. However, these expenses can be carried over and subtracted from taxable income for seven years, with

a maximum deduction of 20% of TAX-EBITDA. It is essential to highlight that after 60 months, the deduction ceiling may rise as the goodwill has been wholly amortized (Masato Iwajima, 2021).

Malaysia has adopted ESR early on, in line with the initiatives taken by the United Nations, the United Kingdom, Japan, and European Union member countries. Section 140C, a new provision restricting the deduction of interest, was added to the Income Tax Act 1967 on January 1, 2019. If a company's interest expense exceeds 20% of its Tax-EBITDA, the excess can be carried forward and deducted from its adjusted income in future assessment years. The maximum permissible deduction for interest in a specific Year of Assessment (YA) is capped at 20% of tax EBITDA. The rate determines the maximum allowable amount of deductible interest expenses that can be attributed to financial assistance provided by foreign-controlled entities. Next, the actual spending rate linked to foreign-controlled financial aid will be examined, and any excess amount will be forbidden. Although there will be no interest next year, a business can still use the remaining interest expense from previous years until the surplus amount is used up (Global Tax Alert, 2019).

After enacting Tax Law Number 7 Year 2021 concerning the Harmonization of Tax Regulations, Indonesia is committed to shifting from thin capitalization to earning stripping rules according to BEPS Action Plan 4 (using net interest/EBITDA). Indonesia is working on this in the meantime. On 22 December 2022, Indonesia issued Government Regulation No. 55 of 2022 concerning the Adjustment of Regulations in the Field of Income Tax. This regulation was issued as an effort by the Government of Indonesia to implement the Income Tax Law (ITL) amendments introduced under the Harmonization of Tax Regulations Law. GR-55 combines several government regulations that have been issued before. Other implementing regulations (i.e., other than GRs) remain valid to the extent that they do not contradict GR-55. Under the HPP Law, all implementing rules are now initially mandated to a GR. Under the previous ITL, many of the implementing rules were instead initially mandated by the Minister of Finance (MoF) Regulation (Peraturan Menteri Keuangan/PMK). GR-55 will consolidate the features of these PMKs into this GR to accommodate this new hierarchical mandate. This GR streamlines the existing rules governed under existing GRs, PMKs, and the ITL (Tax Team, 2022). GR-55 stipulates the types of benefits in kind that are taxable, tax-exempt, and tax-deductible, as well as determining their value for tax purposes. The regulation also outlines the tax obligation for the employer/remuneration provider and the recipient/employee. GR-55 extends the powers of the MoF to prevent tax avoidance (Himawan, M. & Muslimin, 2023).

Instruments for preventing tax evasion are regulated in Article 32. In that Article, it is explained that the Minister has the authority to prevent tax avoidance practices as an effort by taxpayers to reduce, avoid, or delay the payment of tax that should be owed, which is contrary to the intent and purpose of the provisions of laws and regulations in taxation sector. Article 32, paragraph 2 explains in detail the application of prevention of tax avoidance practices (Presiden RI, 2022). In the business world, a level of borrowing costs or a ratio between debt and capital (DER) is considered reasonable. If the borrowing costs or the comparison exceeds the reasonable limit, the company will be considered as doing thin capitalization and in an unhealthy condition. To calculate taxable income, the Minister may determine the existence of hidden capital.

Imposition of the number of borrowing costs that can be charged for tax calculations carried out by the Minister can use the method of determining a certain ratio between debt and capital, the method of determining a certain percentage of borrowing costs compared to business income before deducting borrowing costs, Income Tax, depreciation, and amortization, or any other method. The explanation is outlined in Article 42 GR-55 (Presiden RI, 2022). Provisions regarding the determination and implementation procedures of the methods used to limit the amount of loan cost are regulated in the Ministry Regulation. EBITDA (Earnings Stripping) is a method to determine a certain percentage of loan cost compared to earnings before interest, income tax, depreciation, and amortization (EBITDA) has yet to be regulated in the Ministry Regulation and is currently being drafted.

Limitations on loan cost are expected to be applied based on EBITDA (based on company profitability) (Tax Prime, 2023).

Every nation possesses full authority over its tax rules, which encompasses the ability to determine the approach for restricting interest deductions. Every approach has the potential to impact the well-being of the nation that adopts it. The term "tax welfare" in this context refers to the revenue generated via taxes. The amount of tax revenue generated and the proportion of welfare losses compared to tax revenues are influenced by not just the applicable tax rates but also the expenses associated with defaults and the volatility of EBIT (earnings before interest and taxes).

6. CONCLUSION AND RECOMMENDATION

Conclusions

Profit shifting is an important issue that is of concern to countries in the world. Each country tries to find thin capitalization rules that suit the characteristics of its country. Countries must be able to determine which thin capitalization rules to choose from and then measure their stringency. The welfare referred to in this case is per capita income and investment levels. Thin capitalization rules influence the investment level of the host country. The level of welfare is the primary consideration for a country in determining the method of limiting interest deductions. The tighter the thin capitalization, the lower the country's welfare.

Following the Harmonization of the Tax Regulations Law, the Indonesian Government modified the tax treatment of financial transactions by transitioning from the thin capitalization rule to the earnings stripping rule, thereby altering the debt-to-equity ratio. Government Regulation Number 55 of 2022 pertains to the modification of regulations in the domain of income tax. It is a legal framework that governs corporate debt and capital tax implications. The Indonesian Government is implementing ESR with EBITDA, as recommended by the OECD, as part of its transformation efforts. Nevertheless, up until the completion of this study, there were no specific guidelines governing the adoption of ESR in Indonesia, including the prescribed EBITDA rates.

Recommendations

Various impediments constrain this research, specifically its reliance on a literature review with a restricted quantity of research data. The primary aim of this research is to analyze the diverse strategies employed by different nations to restrict interest rates while also elucidating the specific circumstances prevailing in Indonesia—the lack of laws about ESR results in shortcomings in this research. Further investigation is needed to examine the adoption of earnings-stripping regulations in Indonesia, as the OECD BEPS Plan recommends.

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