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COMPARATIVE ANALYSIS OF THE ECONOMIC AND TAX-RELATED EFFECTS BROUGHT ABOUT BY THE METHODS OF FINANCING APPLIED WITHIN THE FRAMEWORK OF THIN CAPITALIZATION IN THE OECD MEMBER COUNTRIES

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ABSTRACT

The article is devoted to elaboration on the process of thin capitalization in the OECD Member Countries. The main objective is comparative analysis of two methods of financing of companies: the debt method and the equity one. The comparative analysis has been performed from the perspective of the tax-related consequences brought about by the two different methods of financing adopted within the framework of thin capitalization. The result of the analysis will allow to more fully assess which method of financing is more advantageous for the interested companies. One must remember that it is the tax policy of companies that exerts a direct effect on the economic consequences of their operation. The tax effects demonstrate how differently the process of thin capitalization may be perceived.

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INTRODUCTION

Thin capitalization has become a particularly significant phenomenon in times of economic globalization. Thin capitalization produces significant economic consequences for companies in the OECD Member Countries, and thus evaluation and analysis is necessary. The issue is especially important owing to the fact that there are two classic methods of financing of companies within the framework of thin capitalization: the equity and the debt method. These methods are different not only in terms of the mechanism of operation but also the economic consequences that companies suffer because of them. Despite the fact that thin capitalization is a strictly economic process, the tax effects that it leads to must be analysed. In essence, the tax-related consequences are the ones that determine the commencement of this process in companies as well as the selection of the particular method of financing.
As Clausing (2007) states it, "it is noteworthy that highly developed countries of OECD introduce tax rates which maximise income derived from income tax". (p. 118). This burden is borne mainly by economic entities having a business status of a company.

The way (or method) of carrying out the process of thin capitalisation constitutes a factor which must inevitably be taken into account in the assessment of this process. Companies may chose from two methods: debt or equity financing. However, in order to chose the appropriate and the most suitable method, it is necessary and essential to define the tax-related consequences of this method. This is because companies should bear in mind that no general rule exists and each of them should asses their situation individually taking into account the very tax-related consequences. Moreover, it is important that the issue of thin capitalisation is presented in the light of the standards of the OECD Model Tax Convention which is applicable for the EU countries.

The argument of this paper is that thin capitalization carried out with the debt method is considerably more advantageous than thin capitalization carried out with the equity method. An attempt is made to justify this claim by demonstrating that the tax effects of thin capitalization carried out with the equity method of financing are negative from the economic point of view. Whereas the tax effects of thin capitalization carried out with the debt method are positive from the economic perspective.

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In order to support this claim, it is necessary to perform analysis of the tax regulations applicable to companies financing thin capitalization both with the debt and the equity method. Only such a comparative analysis will make it possible to draw conclusions allowing to indicate all the economic consequences that entrepreneurs acting as companies suffer.

As Froud, Haslam, Jokal and Williams (2000) rightly note, "discussing this issue is vital since economy does not pay much attention to the issue of the economic consequences of the phenomenon of thin capitalisation". (p. 1260).

Thin capitalization – the character and models of functioning

A phenomenon widely known as thin capitalisation is related to the process of selecting a method for financing companies by shareholders or entities – directly or indirectly – affiliated with the shareholders. Neither the term nor its definition have been introduced into the tax law.

The term was first used by tax authorities of OECD member countries for the purpose of naming a practice of multinational groups of companies who, linked by equity, establish subsidiaries with a minimal share capital on the territory of countries known for imposing heavy tax burdens and subsidise these subsidiaries with the debt financing method (Wells, 1993: 9). As Froud *et al*. claim (2000: 1261), the fact that large private economic entities are given more and more attention (though not enough considering the role they serve in the contemporary economy) contributes considerably to this process.

There are two basic methods of financing a company:

1. the method of equity financing, and
2. the method of debt financing.

The method of equity financing is based on financing companies with either their own funds or funds provided by the shareholders. Choosing funds for financing is thus dependent on an entity. One of the sources of capital may be the profit allocated for distribution among the entitled entities; this amount is not distributed by way of a resolution adopted at the shareholders' meeting (i.e., the General Meeting of Shareholders) to increase the share capital. In the case of financing by means of the company's own funds, the share capital is increased through retaining the profit. This model is referred to as self-financing and exemplifies internal financing means. In contrast, financing with the funds provided by the shareholders may be considered external financing (Brzezi ski & Hayder, 1997: 34).

The method of debt financing consists of making the capital available to the company in a form of a loan, credit or bonds, which establishes the relationship of creditor – debtor between the financing entity, i.e., the shareholder, and the financed company. Consequently, this situation causes the financing entity to play a double role in relation to the company, one as the creditor and the shareholder.

The phenomenon of thin capitalisation emerges when the activity of a company, or any other legal person, is largely financed by means of loans/credits and at the same time, in view of the statutory provisions, the initial capital of these entities is limited to the minimal level (Paczulski, 2001: 165). If such an approach is adopted, thin capitalisation is tantamount to excessive implementation of the debt financing method by the shareholders. This means that the volume of the share capital is too small in comparison to the amount of a company's debt owed to the shareholders.

As far as thin capitalisation is concerned, the need to select a method for financing arises from the necessity to optimise the value of taxation of a company. To a large extent, the method of debt financing is much more attractive for the shareholders who employ it, especially when compared with the method of equity financing. Overesch & Wamser (2010: 569) state that this advantage is perceivable not only on the domestic level, i.e., when the shareholder and the financed company are residents of the same country, but also on the international level, where these entities are residents of two different countries.

The provisions that regulate taxation of the income derived from interest paid to the shareholders, who have chosen the method of debt financing, allow a company to include its expenses incurred in connection to this operation into the category of tax-deductibles. Consequently, the income of the company that is subject to taxation is lowered; such income is considered the positive result of subtraction of tax-deductibles from the revenue.

As Laconick & O'Sullivan (2000: 987) rightly observe, the fact that companies operating in the European and international markets seek financing in external sources in the capital market or by taking out bank loans highlights an important phenomenon influencing the occurrence of thin capitalisation.

Depending on the chosen method of financing, the differences in taxation of income are more visible in the case of cross-border settlements where the financing entity is a shareholder residing or having a registered office within the territory of a different country than the one in which the financed company has its registered office. In this case, the rules governing taxation of income may be altered on the basis of stipulations provided in bilateral agreements concerning the avoidance of double taxation (Lipowski, 1999: 16). According to Palpaceur (2008: 1122), this process is especially noticeable when institutional investors become more significant for the shareholders and when the influence exerted by banks and other entities operating within the financial markets on the strategies of large companies (which are often affiliated) is growing.

In practice, the fact that the method of debt financing is frequently adopted by companies indicates that tax-related aspects constitute the main reasons behind selecting this method. As a result, fiscal authorities and the legislature itself undertake strenuous action with respect to this financing solution. Such strenuous reaction arises because the basic

function of tax, as a public levy, is to constitute, first, a source for covering the state's demand for public income, and second, a means of exerting a certain influence on the economic behaviour of taxable persons, which is the so called non-fiscal function of taxes (Gomułowicz & Małecki, 2002: 119-120; Gajl, 1992: 124-125).

Consequently, it is possible to agree with a claim (Litwi czuk, 1999; Karwat, 2003) that in this context, thin capitalisation is perceived as an instance of tax avoidance that may be classified as choosing the option involving the least taxation.

The debt method of thin capitalization – tax issues

Legal regulations in OECD member countries are consistent in one way, which is that the interest paid to the shareholders is taxed in a different way than dividends (Hariton, 1994: 500). The basic difference is that interest constitutes an expense of a company classified as tax-deductible, unless legal provisions state otherwise. These provisions are especially relevant where regulations limit the phenomenon of thin capitalisation in OECD member countries that have introduced a ban on deducting interest from a company's revenue in the event of excessive debt financing employed by the shareholders.

The following consequences for the tax law arise due to inclusion of interest in the category of expenses constituting tax-deductibles:

1. the expenses incurred by a company from this source are deducted from its revenue, which directly influences the volume of income subject to taxation with corporate income tax; the relevant act of law in Poland: Act of 15 February 1992 on Corporate Income Tax (i.e., Journal of Laws of 2000 No. 54, item 654, as amended);
2. interest is not subject to double taxation in the economic sense, while in the case of dividends such double taxation results from the fact that they are not counted as tax-deductibles;
3. most countries tax interest with tax at source thus the obligation to calculate, collect the tax, and afterwards transfer it to the account of a relevant tax authority is imposed on the debtor – in this case the company distributing the interest – i.e., the taxpayer; the rate of this tax is diverse and may sometimes be reduced in accordance with the stipulations of agreements on avoiding double taxation; it is usually lower than the rate of tax at source for dividends, e.g., in Belgium, Norway, Switzerland or Sweden (Plitz, 1994); and
4. the tax burden of equity tax (or capital tax) does not arise when the method of debt financing is employed even though internal statutory regulations anticipate it (Becker & Fuest, 2011: 595); usually if a company gains capital in the form of a loan or credit, it is subject to tax on civil law transactions; the relevant act of law in Poland: Act of 9 September 2000 on Tax on Civil Law Transactions (Journal of Laws of 2005, No. 41, item 399, as amended).

Considering the abovementioned rules, it must be stated that debt financing is more beneficial than equity financing for the financed company and, above all, for the financing entity. Interest deducted from a company's revenue as a tax-deductible may cause an erosion of income subject to taxation. This phenomenon pushes the governments of many countries to impose tax regulations limiting the option to employ the method of debt financing, especially if the interest is paid to shareholders who are residents of a different country than the one where the company distributing the interest has its registered office (Essers, Michielse, De Bont & Offermans, 1994). Such an approach seems justified as it results directly from the uneven distribution of tax jurisdiction stipulated in the bilateral agreements on avoidance of double taxation (Becker & Fuest, 2011: 600). It is very often the case that the country where the company distributing the interest has its registered office refrains from taxation of the income derived from this source – thus exempting the interest from the tax at source – and simultaneously classifies the interest as a tax-deductible leading, which in consequence creates an increased reduction of income subject to taxation (Report, 1987).

In conclusion, as a consequence of employing the debt financing method, the income of shareholders derived from interest – considered a tax-deductible for the company/debtor – does not bear the economic burden of tax imposed on a company's income before its division and distribution of dividends, as opposed to the dividends payed. As a result, the creditor – the shareholder – is the only entity bearing the burden of income tax imposed on the interest. The choice of the debt financing method also determines the rate of tax on interest stipulated in agreements on avoiding double taxation.

The equity method of financing of thin capitalization – tax issues

An important aspect of thin capitalization is the tax effects of the equity method of financing of companies. Analysis of these consequences shows significant differences when the method is compared with the debt method of financing companies. In the case of equity financing, the income arising from a share in the profit of a company is especially significant. Such income is payable to the shareholders as dividend (Niels, 2010: 259). A share in the company's net profit is paid as dividend. The net profit is calculated by deducting the corporate income tax from the total profit. Such profit may be utilised in the following ways:

1. the total amount is retained in the company and utilised for the purposes of further development;
2. the total amount is allocated for distribution among the shareholders;
3. the total amount is proportionally divided into a part constituting retained profit and a part allocated for distribution (Litwi czuk, 2003).

Profit allocated to dividend is the part of a company's profit allocated for distribution among the entitled entities and a dividend is an income derived from a share in this profit per each shareholder in a company. It should be noted that as opposed to the right to share in the annual profit of a company, the right to dividend is not unconditional (Bandrzewski, 1996: 8). The right to dividend is manifested in the fact that

shareholders may share the part of a company's annual profit which is allocated for distribution. The decision concerning allocation of a part of the annual profit for distribution among the entitled entities is made during the shareholders' meeting (i.e. the General Meeting of Shareholders) by way of a resolution (Helminen, 1999: 232).

It is noteworthy that both the dividends and other income derived from a share in the profit of a company are expenses incurred by the distributing company which are not considered tax deductibles in the light of income tax acts. Since there is no possibility to deduct such expenses as tax deductibles, the phenomenon of – economic double taxation – is observed. Thus the method of equity financing becomes less appealing if its tax-related aspects are considered.

The phenomenon of economic double taxation constitutes the most significant consequence of choosing the method of equity financing. Since the tax-related consequences are highly influential, the phenomenon of economic double taxation makes this method of financing less appealing for companies. Double taxation consists in taxation of a company's profit two times; first, the company pays income tax on the profit and; second, the shareholders pay tax on their dividends. This means that the same object, i.e. an economic phenomenon, is taxed twice only two different entities pay the tax on it (Fiszer, 1990: 76; Głuchowski, 1983: 59). The fact that both the company and the shareholders are taxable persons and the fact that tax is imposed on both income and capital constitute direct causes of the phenomenon of double taxation (Komar, 1996: 55; Helminen, 1999: 232). This phenomenon does not emerge when debt financing is employed because income calculated by way of deducting interest from a company's revenue as tax deductibles does not bear the burden of tax on the company's income.

Depending on whether the shareholder of the company distributing dividends is another company or a natural person, the phenomenon of economic double taxation may be considered from two different perspectives. Double taxation of companies acting as shareholders is a major impediment to building organizational and capital relationships between holding companies and subsidiaries within Holdings (Gajewski, 2004: 97).

However, it is possible for the holding company to benefit from equity financing. If the method of equity financing is employed and the holding company contributes to the majority of the subsidiary's share capital, the dividends paid to the holding company will be treated by the OECD member countries in a privileged manner (Report, 1987: 34; Portner, 1996: 266). This is because these countries make effort to alleviate the problem of economic double taxation by allowing deduction of the tax on profit allocated for distribution paid by the subsidiary from the tax payable on income that the holding company derives from dividend or exempting dividend from tax in the case of the holding company (Poterba, 2004: 551).

Tax credit, on the other hand, serves to deduct the tax on profit allocated for distribution paid by the subsidiary. Tax credit is granted to the holding company both on the basis of internal legal regulations and bilateral agreements concerning avoiding double taxation (it is the so called indirect credit). Participation exemption also has a similar application as it serves tax exemption of dividends paid by subsidiaries to the holding company (Dziedzic-Wach & Michalszczyn, 1997: 2).

Some OECD member countries (such as Austria, the Netherlands, and Luxemburg) have introduced tax solutions ensuring full integration of taxes imposed on the profits of a company distributing dividends. The system comes down to eliminating income derived from dividends received by the holding company by way of tax exemption. In order for the system to be implemented, it is necessary for the holding company to provide a certain contribution to the subsidiary's capital of at least 25% of its nominal value and to hold the shares for a certain period of time (Vogel, 1997: 710; Sasseville, 1995: 32).

Eliminating double taxation of dividends is much more complicated in the case of natural persons acting as shareholders. The difficulty that lies at the heart of the problem is that, in most OECD member countries, dividend is counted together with income arising from other sources and is taxed with a tax rate relevant for the total income of the taxable person. Statutory regulations of only a few countries, such as Poland, differ in this matter (Aleksandrowicz, Fiszer & J drzejewski, 1995: 9). The income derived from a share in a company's profit and income derived from other sources of revenue are not aggregated in these countries. Income arising from a share in a company's profit is taxed on the basis of its gross value with a separate tax rate of corporate income tax in line with the act of 26 July 1991 on corporate income tax (Journal of Laws of 2010 No. 51item 307 as amended).

The equity method of thin capitalization – economic consequences

In some OECD countries, the method of equity financing is subject to capital tax or tax on the nominal value of capital, capital transfer tax or the tax on legal and civil transactions whose object of taxation is the performance of a legal transaction consisting in contributing to a company's capital in exchange for receiving the right to share in its profit (Białobrzeski, 1998). Such tax types are operative in most OECD member countries, inter alia: Australia, Belgium, France, Ireland, Spain, the Netherlands, Japan, Luxemburg, Poland, and Switzerland. Shareholders' contributions to the capital are neutral from the point of view of taxation in other countries, apart from certain taxes on legal and civil transactions (Doernberg, 1995: 12).

An interesting phenomenon related to taxation is that some countries (Germany, Switzerland, and Italy) introduced taxes whose object of taxation is the value of capital (i.e. the net worth tax) and it is imposed on the value of shares held by natural persons (Hamaekers, Holmes, Głuchowski, Kordach & Nykiel, 2006: 134; Sieker, 1997: 222).

Bearing in mind the abovementioned factors, the shareholders planning to adopt the method of equity financing must take into account these additional tax burdens – related to taxation of a company's profit and income arising from a share in this profit. Besides double taxation of a company's profit in the economic sense, the ban on deducting dividends as tax deductibles by companies constitutes another tax-related difference between the methods of debt and equity financing. It is not surprising that countries which introduced the taxes mentioned above (the capital tax and the net worth tax) perceive thin capitalization and consequently introduce legal regulations limiting this phenomenon (Hayder, 2000: 41).

In conclusion, when considering choosing the method of equity financing in the light of tax law, the following factors must be born in mind:

- as a rule, dividends are not considered tax deductibles for a company distributing them and thus may not be deducted from the revenue of this company;
- statutory regulations of some OECD member countries contain such rules concerning taxation of companies' profits and dividends – as part of the profit – that take into account the phenomenon of thin capitalization in the economic sense;
- share capital may be subject to capital tax;
- net worth tax may be imposed on shareholders;
- the distributed dividend may be taxed with the so called withholding tax which is calculated, collected and paid by the distributing company; if the receiver of the dividend is a resident of a different country than the country in which the company has its registered office, agreements concerning double taxation may stipulate reduction of the rate of the withholding tax; such agreements are based on Article 10 of the OECD Model Agreement (Fuest & Hemmelgarn, 2005: 512).

The phenomenon of economic double taxation of income derived from dividend is the most serious and the most widespread factor causing companies to refrain from adopting the method of equity financing. Shareholders are forced to search for other alternative methods of financing. Moreover, the way of separation of the jurisdiction of the country at source and the jurisdiction of the country of residence is also an important matter stipulated in bilateral agreements based on the OECD Model Agreement concerning avoiding double taxation. In accordance with the OECD Model Agreement, both countries of the parties entering an agreement may impose tax on dividends, however, the right to impose tax on income derived from this source is limited in case of the country at source and the country of residence is obliged to adopt a relevant method of avoiding double taxation (OECD, 1992: 108). Nevertheless, practice unfortunately differs among OECD member countries. On the one hand, if the country at source relinquishes the right to impose tax on the income derived from dividends, foreign investors will be encouraged, on the other hand, this will cause loss to the budget since less money will be collected as income tax (Becker & Fuest, 2011).

From the point of view of taxpayers, the method of equity financing is definitely much less appealing for companies than the method of debt financing. In the case of thin capitalization, the choice of a method of financing is dependent on the need to optimize taxation in companies. The method of debt financing is predominantly more appealing for the shareholders who employ it (Overesch & Wamser, 2010). The benefit brought about by this method is especially perceivable in comparison to the method of equity financing. The difference may be recognized on both the domestic level, i.e. when the shareholder and the financed company are residents of the same country but also on the international level when these entities are residents of different countries (Valchy, 2008: 660).

Legal regulations concerning taxation of income derived from interest paid to shareholders who have chosen the method of debt financing allow to classify the expenses incurred by the company with respect to this operation as tax deductibles. Consequently, the income of the company which is subject to taxation is lowered; such income is considered the positive result of subtraction of tax deductibles from the revenue.

Differences related to taxation with respect to the chosen method of financing are more visible in the case of cross-border settlements when the financing entity is a shareholder residing or having a registered office on a territory of a different country than the one in which the financed company has its registered office. In this case, the rules governing taxation of the income discussed in this paper may be altered on the basis of stipulations provided in bilateral agreements concerning prevention and avoidance of double taxation (Lipowski, 1999: 16).

The fact that the method of debt financing is frequently adopted by companies in practice point to a conclusion that tax-related aspects constitute the main reasons behind choosing the method of debt financing. As a result, fiscal authorities and the legislature itself undertake strenuous action with respect to this financing solution. Such strenuous reaction arises due to the fact that the basic function of tax is being a public levy serving, first of all, as a source for covering the state's demand for public income and, second of all, as means of exerting a certain influence on the economic behaviour of taxable persons, which is the so called non-fiscal function of taxes (Gomułowicz & Małecki, 2002; Gajl, 1992).

As Laconick and O'Sullivan rightly observe (2000: 980), the evaluation of the tax-related and economic consequences of the method of equity financing demonstrates their influence on the policy of American and European companies manifesting itself in the growing number of companies seeking external financing sources on the capital market or getting into debts granted by banks. According to Palpaceur (2008: 1120) such policy leads to an increase in the importance of banks and other financial institutions among shareholders – institutional investors – and the increased influence of these entities over the strategy of companies forming corporations.

The consequences of thin capitalization in the light of the OECD model agreement

It seems necessary to discuss the issue of interest taxation in view of the OECD Model Agreement. From the legal

perspective, the rules governing the way countries that enter an agreement distribute their tax claims with respect to income derived from interest among each other are similar to those serving the avoidance of double taxation of dividends. Demarcation of jurisdiction between the country constituting the source of the interest and the country where the receiver resides is regulated by the OECD Model Agreement.

The OECD Model Agreement acknowledges the right of both of the countries to tax income arising from interest. As with dividends, the country of source has a limited right to tax interest at source; this means that it may tax this income, however, the imposed tax may not exceed – as the matter of principle – 10 per cent of the gross interest. This forces the country of residence of the receiver of the interest to adopt one of the methods that allows it to avoid double taxation on the interest – usually the method of a tax credit. In such a case, the tax on interest collected in the country of source is treated as an advance on the tax on income from interest payable to the country of residence of the shareholder (Lüthi, 1991; Sieker, 1997). Nevertheless, the fact that tax on interest paid at source is counted towards the tax payable to the country of residence of the receiver of the interest may turn out to be unfavourable to the second country. This is because in accordance with the rules of granting a tax credit, income generated in the country of residence of the receiver is amalgamated with income generated abroad and tax is calculated on the amount determined by way of amalgamation. Then, the tax on interest paid at source is deducted from the calculated tax (Fuest & Hemmelgarn, 2005: 521). Deduction of the tax paid abroad does not encompass the whole amount, but only a part not exceeding the part of the tax before deduction, which is pro rata to the income generated abroad (Vogel, 1997: 712; Białobrzeski, 1998: 80). Consequently, the shareholders making a decision to adopt the method of debt financing must first and foremost take into account the rate of tax on interest in the country of their residence (Wiliamson, 1991: 185-186; Portner, 1996: 267-268).

The analysis of the abovementioned tax measures leads to the conclusion that the OECD Model Agreement causes the legal situation of a shareholder to be different depending on the method of financing that they adopt. The freedom to alter the provisions of the OECD Model Agreement inclines many countries to exempt interest from tax at source on the basis of bilateral agreements – which is contrary to Article 11 section 2 of the OECD Model Agreement – and de facto means waiving the right to tax this income (Plitz, 1994). This practice is followed in Denmark, Finland, Germany, Norway, the United States, Sweden, and Switzerland. The remaining OECD member countries reserve the right to tax interest at source, however, they impose a lower rate of the tax at source to the principle than the rate of tax at source on dividends (Plitz, 1994; Essers, Michielse, de Bont & Offermans, 1994).

The OECD Model Agreement stipulates that the interest sourced in one country entering an agreement and paid to a party residing or having a registered office in another country entering an agreement may be taxed by the country of residence of the receiver of this interest. As with dividends, the relevant provision of the OECD Model Agreement does not imply that the country of residence is the only party entitled to tax the income arising from the source (Jackson, 1990: 319-320; Hughes & Collier, 1989: 4-5).

The rules governing taxation of the income derived from interest generated in the country of source are also stipulated in the OECD Model Agreement. It proposes that the country of residence of the debtor, or where the debtor has their registered office and the interest has its source, has a limited right to tax interest at source (Gouthiere, 1990: 296-297; de Hosson & Michielse, 1989: 476-477). However, the right of the country of source to choose a method of collection of this tax is not constricted by the OECD Model Agreement, which also grants perfect freedom as to the form of satisfaction of this tax liability.

The country of source has the right to impose tax on income if one of the following criteria are met

1. the income from interest is generated on its territory as stipulated by the OECD Model Agreement; a country entering an agreement is considered a source of interest, if the debtor resides or has the registered office or any other permanent establishment, such as a plant or a factory, in it; these two conditions stand in the relationship of a rule and an exception: it is a rule to take into account the place of residence or the place of the registered office of the debtor but it is an exception to take into account the place where a permanent establishment, such as a plant or a factory is situated;
2. the interest is paid in favour of a person residing or having a registered office in a territory of the other country entering an agreement; and
3. the receiver of interest is simultaneously the beneficial owner of the income derived from this source and not a formal one – i.e., not an agent, plenipotentiary or proxy of the actual receiver of the interest; the concept of a beneficial owner is relevant for both categories of income that shareholders are entitled to according to the method for financing they choose (Sasseville, 1995: 33).

In the three cases above (items 1-3), the tax collected by the country of source may not exceed 10 per cent of gross interest. This rate is considered a reasonably minimal tax burden on interest because the country of source is entitled to tax income generated on its territory, which arises from investments financed with capital raised from the receivables on which the interest is actually paid. However, countries entering an agreement may decide upon a different rate than 10 per cent of the tax at source. The country of source may exempt interest from tax at source, which in fact means waiving the right to tax this income. Such a practice is adopted by OECD member countries whose internal legal regulations do not stipulate the taxation of interest, e.g., the Netherlands (Doernberg, 1995: 12). According to Devereux, Lockwood & Redoano (2008: 1221), these conclusions are of special significance in the period of harmonisation of the tax policy on corporate income tax, especially in the context of the global economic crisis.

Provisions concerning the taxation of interest stipulated in bilateral agreements may lead to excessive adoption of the method of debt financing. The financed company and the shareholder may formulate an agreement postulating an excessive interest rate, i.e., interest calculated at a significantly higher rate than the one usually established when transactions take place between unaffiliated entities. Thus, it is rightly assumed that in such a case the value of interest is not in line with the arm's length principle. Therefore, tax authorities gain the right to question the interest rate and make corrections of the profit derived from it in accordance with the provisions regulating the phenomenon of shifting income between affiliated entities (Valchy, 2008: 661). In consequence, part of the interest exceeding the interest rate adopted in trading between unaffiliated entities may be deemed the so-called constructive dividend. The excessive interest may eventually be taxed as income derived from participation in shares (Gäverth, 1999). The issue of interest in breach of the arm's length principle is also regulated by Article 11 section 6 of the OECD Model Agreement. The provisions of this agreement indicate that the part of interest regarded as excessive may be exempted and correction of the profit transferred in this form is allowed. It also stipulates that the correction made may not exceed the amount of interest that parties would have agreed upon if they had acted irrespectively of the particular relationship between them, which led to the inflated interest rate in the first place. Such a correction may consist of changing the classification of the income arising from the excessive interest to the so-called constructive dividend, and should take into consideration the legal nature of such income – i.e., the type of receivables on which interest is paid, its economic purpose and the substance of liability – like the mutual rights and obligations of the parties. If excessive interest is paid on the receivables of a company towards the shareholders, then nothing prevents taxing such excess in line with the rules on taxation of income from dividends (Helminen, 1999).

CONCLUSIONS

The comparative analysis of the two methods of financing of companies constitutes a study of an immense importance. In particular, comparison based on the tax effects reveals a richer picture of thin capitalization carried out with the equity and debt methods.

Bearing in mind the abovementioned factors, it is possible to draw a conclusion that although the method of equity financing is "safer" for companies, since it is less likely to be challenged by tax authorities, it is less beneficial than the method of debt financing due to the tax-related advantages brought by it. Undoubtedly, the adverse phenomenon related to the method of equity financing is economic double taxation. This phenomenon causes the costs of adopting this method to increase, which, from the economic perspective, has direct influence over the decisions made by companies.

As Devereux, Lockwood, and Redoano (2008) justly state the phenomenon of economic double taxation will influence the process of harmonization of the tax policies of OECD member countries concerning the corporate income tax, especially at the time of crisis. (p. 1220).

The analysis of the tax-related consequences of providing funds for companies using the method of debt financing chosen by shareholders leads to the conclusion that debt financing is more beneficial than equity financing. From the point of view of taxation, the fundamental differences between debt and equity financing are as follows:

- interest, in contrast to dividends, is considered a tax-deductible for the financed company;
- interest is deducted from the revenue, which does not lead to double economic taxation as in the case of dividends;
- from an international perspective on the matter, the rate of tax at source on interest collected in the country of residence of a company is lower than the rate of tax at source imposed on dividends in this country;
- many bilateral agreements drafted on the basis of the OECD Model Agreement postulate that the country of source relinquishes its right to tax income derived from interest, which rarely happens in the case of dividends because the renouncement of the right to tax income from dividends with tax at source by the country of residence of a company distributing the dividends is exceptional; this results from the necessity to employ the method of a tax credit in the country of residence to avoid double taxation of income arising from dividends (Avery Jones, De Broe, van de Wiele, Ellis, van Raad & Fonteneau, 1996:128).
- in the OECD member countries whose legislation suggests taxation of capital, tax obligations arise as a consequence of adopting the method of debt financing as opposed to equity financing.

It is indisputable that a company should reasonably assess the tax-related consequences connected to the process of financing before choosing between the method of debt or equity financing. This tax-related effect constitutes one of the basic factors influencing a company's economic position. Because the tax-related consequences when using the method of debt financing are much more beneficial for companies than those of equity financing, they clearly exert influence on the economic effect. Because every economic entity takes an economic point of view aiming to choose the least burdensome tax policy for itself, allowing it to achieve its financial goals.

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