The Jaime Fernández de Araoz Award was presented in Madrid last week. This prize honours the memory of this young investment banker, trained at Cunef and seasoned at Citicorp, Lehman Brothers and Banco Santander, who died in an accident at the age of only 37. Fernández de Araoz was already a consummate expert on mergers and acquisitions in Spain, the job dreamt of by young financial brokers starting to work in these times of crisis.

The Fernández Araoz Award, dedicated to Corporate Finance and now in its fifth edition, has been gaining an excellent reputation thanks to the efforts of Jaime’s family and friends, which include the Prince of Asturias, who always tries to participate in their presentation.

This year, the jury granted the award to the work of a trio of foreign economists entitled Capital Structure and Taxes: What Happens When You (Also) Subsidize Equity? The authors are the Mexicans Francisco Pérez-González, Pablo Villanueva and the Belgian Frédéric Panier. Their research analysed the results caused in Belgium by the introduction in 2006 of a tax deduction on capital, similar to deductions on interest over debt existing in other countries.

The study shows to what extent taxation allows shaping corporate capital structures, something which has an effect on the whole economy. In the case of Spain, for example, we still suffer the strategic flaw of just stimulating deductions on debt interest at a time when an uncontrolled stream of money was flowing into the country. This led many companies to place debt in Spain while they made every effort to offshore their profits in order to optimise their tax bill. The result was that corporations joined a process in which families where already heavily in debt, aggravating it.

Tax incentives for financing with debt are rewarded by this capital deduction

In the case of Belgium, due to a community regulation, their Government had to approve a tax reform in 2006 that created the Notional Interest Deduction. This is a deduction on the company’s capital to which a fictional interest which is calculated every year, is applied. This rate is based on the 10-year bond rate. In 2013, it was 3% and for SMEs, 3.5%.

For example, if a company increases its capital with equity, it can deduct 3% or 3.5% of said amount. This corrects the tax incentive to seek financing through indebtedness
(to be rid of interest) instead of strengthening equity. The study concludes that the new deduction managed to “level the financial field for corporations”, reducing their leverage and aggregate indebtedness of the economy and improved company capitalisation. But perhaps what is most important is, as the authors say, “that the study demonstrates the potential role of tax policy in modifying risk distribution” in corporate capital.

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