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Deduction of Interests in the International Context

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Policy options

Policy options (I)

- July 2013: BEPS Action Plan
- 18 December 2014: Public Discussion Draft: BEPS Action 4: Interest Deductions and Other Financial Payments
- **5 October 2015: Final Report: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments**
- 11 July 2016: Elements of the Design and Operation of the Group Ratio Rule
- 28 July 2016: Approaches to Address BEPS Involving Interest in the Banking and Insurance Sectors

Policy options (II)

- **Piltz, IFA General Report, 1996**:
- *„The erosion of the tax basis, which countries fear, comes as a result of their own legislative decisions:*
  - *The recognition for tax purposes of a loan relationships between subsidiary company and shareholder and hence the deductibility of interests from the profits of the enterprise, and*
  - *The fact that little or no withholding tax is levied on the interest paid abroad as a result of national law or a double taxation convention“*
- ***„It is astonishing that the same countries are now introducing provisions to correct the effects of their own decisions“***

Policy options (III)

- ***Three (overlapping) policy options:***
  - Hidden equity rule
  - Thin capitalisation rule
  - Interest barrier rule

  - But: different aims!

Policy options (IV)

- Substance over form distinction between debt and equity – not an option at an international level
- Difficulty of distinguishing between interests and dividends (article 10 vs. article 11 OECD MC)
- Thin capitalization rules
  - ➢ *„One argument against such a standard is the fact that in economic reality, there is no uniform debt to equity ratio, either by country, industry or any other yardstick“* (Piltz, 1996)
- Interest barriers as mere anti-avoidance rules with no goal of achieving a substance over form distinction between debt and equity
- Is there a need for a limitation in a domestic circumstance?

Article 9 OECD MC

Article 9 OECD MC

- 1. Where
- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,
- or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
- and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Article 9 OECD MC

- What is the scope of article 9 OECD?
- OECD Commentary, article 9 para. 3:

- "As discussed in the Committee on Fiscal Affairs' Report on Thin Capitalisation, [2] there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:
- **a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;**
- b) the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;
- c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties."

- Arm's length price commitment or protection of discriminatory thin cap rules?
- Interaction between domestic SAAR and tax treaties

Article 9 OECD MC

Case law:

- Tax Court, Canada, Specialty Manufacturing Ltd. v. Her Majesty the Queen, 18 May 1999
- Conseil D'État, France, Andritz Sprout Bauer, 30 December 2003
- Hoge Raad, The Netherlands, 21 September 2011

Article 9 OECD MC

- Is article 9 OECD MC indeed limiting interest barriers?
- *In the author's view, the point of departure should be that article 9 is not relevant to the issue of whether elements of the profits of a company are taxable or deductible, but only to the issue of whether these elements are indeed attributable to the company. […] [A]lthough a high debt/equity ratio may be an indication of non-arm's length dealing, thin cap rules that only determine the non-deductibility through a standard debt/equity ratio test do not seem to assimilate the profits to an amount corresponding to what the profits would be in an arm's length situation."* (Marres 2015)
- **Interest barriers are in general not prohibited by article 9 OECD MC**

Article 24 OECD MC

Article 24 (4) OECD MC

- *"4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State."*

Article 24 (4) OECD MC

- Why is there a need for a *"article 9 carve out"?*
- In most states non-arm's length prices will not affect the tax base – therefore, there might be a need for different treatment of domestic and cross-border transactions
- Interest limitation rules do not require adjustments in the other state
- → If article 9 OECD MC applies, the respective rules must not be in line with article 24 (4) OECD MC

Article 24 (4) OECD MC

- OECD, Final Report, BEPS Action 4:
- *“If a country does not introduce a group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination.”*
- Does the group ratio rule indeed allow you not to apply article 24 (4) OECD MC?

Article 24 (5) OECD MC

- The purpose of article 24 (5) OECD MC is to prevent discrimination based on ownership.
- Article 24 (5) OECD MC does not prohibit discrimination based on the residency of the recipient.
- Interest limitation rules are in general not problematic under article 24 (5) OECD MC.
- However, see regarding the potential discriminatory effect of fiscal unity rules Hoge Raad, 21 September 2011

Conclusions

- Different policy options required by different policy goals
- An interest barrier is not aiming at a substance over form distinction between interests and debt!
- Limited protection of article 9 OECD MC against interest limitation rule
- Article 24 (4) OECD MC still an important provision for the design of domestic interest limitation rules!
- Group ratio rule would allow discriminatory interest limitations