

THIN CAPITALIZATION RULES IN THE CONTEXT OF THE CCCTB

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WP 08/04

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Abstract:

In the context of the proposed European CCCTB there is clearly a perceived need for the introduction of a common thin capitalization rule. This rule would be aimed at dealing with inbound investment emerging from both third countries, and from Member States opting out of the CCCTB. The principal aim of this paper is to establish whether such a need does indeed exist, and if so, which considerations should guide the design of a thin capitalization rule for the CCCTB. The paper starts by providing a broad summary of the varying approaches of Member States to thin capitalization. It then makes the case for the introduction of a thin capitalization rule in the context of the CCCTB, from both an economic and a legal perspective, and sets out the general principles which should guide the design of such a rule.

* Faculty of Law, University of Lisbon and Centre for Business Taxation, University of Oxford, respectively. We are grateful to the economists working and visiting at the Centre for Business Taxation, University of Oxford, for their unwavering willingness to discuss, in particular, the issues covered in part III.1. We would also like to thank Judith Freedman for her bibliographic suggestions as regards the United Kingdom's thin capitalization regime. The usual disclaimer applies.

I. INTRODUCTION

A company is said to be ‘thinly capitalized’ when it has a high proportion of debt capital in relation to its equity capital.¹ The significant differences that apply in most countries to the tax treatment of debt on one hand, and equity on the other,² have made thin capitalization a popular method of international tax planning. As a result, many, although not all, Member States apply anti-thin capitalization rules. For years, however, this divergence in Member States’ treatment of thin capitalization has been acknowledged as a potential source of difficulties (not least of which, double taxation). Several commentators have therefore advocated (albeit to no avail) the harmonisation of thin capitalization as the ideal solution.³ Ironically, the CCCTB might, indirectly, accomplish just that. In fact, within the context of the CCCTB, and assuming that debt and equity will remain subject to divergent tax treatments,⁴ there is clearly a *perceived* need for the introduction of a common thin capitalization rule. Therefore the principal aim of this paper is to establish whether such a need does indeed exist, and if so, which considerations should guide the design of a thin capitalization rule for the CCCTB.

The paper is divided as follows. Part II provides a broad summary of the varying approaches of Member States to thin capitalization; ranging from non-existence of thin-capitalization rules, to the application of very detailed, albeit divergent, rules. In Part III we make the case, from both an economic and a legal perspective, for the

¹ See International Bureau for Fiscal Documentation (IBFD), *International Tax Glossary*, 4th Edition, IBFD (2005) at p. 357.

² Alternative systems of taxing debt and equity, which essentially eliminate any differences in treatment between the two, have been suggested, and applied in practice by a minority of countries, including a few Member States, see A.J. Auerbach, M. Devereux and H. Simpson, “Taxing Corporate Income”, *Oxford University Centre for Business Taxation Working Paper Series*, WP07/05, March 2007. These alternative systems are, as follows: the Allowances for Corporate Equity, or ACE method; and the Comprehensive Business Income Tax, or its variant the Dual Income Tax, known as the CBIT method. There is growing economic literature on both these methods; amongst the most recent are: A.D. Klemm, “Allowances for Corporate Equity in Practice”, *IMF Working Paper Series*, WP 06/259, November 2006; P.B. Sorensen, “Dual Income Taxation – Why and How?”, (2005) *FinanzArchiv* 61(4), 559-589; and D.M. Radulescu and M. Stimmelmayer, “ACE vs. CBIT: Which is Better for Investment and Welfare”, *CESifo Working Paper Series*, WP 1850, 2006.

³ See O. Thoemmes, *et al*, “Thin Capitalization Rules and Non-Discrimination Principles – An analysis of thin capitalization rules in light of the non discrimination principle in the EC Treaty, double taxation treaties and friendship treaties” (2004) *Intertax* 32(3), 126-137, at pp. 136-137; and N. Vinther and E. Werlauff, “The need for fresh thinking about tax rules on thin capitalization: the consequences of the judgment of the ECJ in *Lankhorst-Hohorst*” (2003) *EC Tax Review* 2, 97-106, at p. 106.

⁴ The European Commission has recently commissioned a study to the Centre for Business Taxation, University of Oxford on the economic effects of eliminating the tax differences between debt and equity, either by introducing an ACE, or alternatively, by introducing a CBIT, see Contract Award Notice TAXUD/2007/DE/322,

introduction of a thin capitalization rule in the context of the CCCTB,; and set out the general principles which, in our view, should guide the design of such a thin capitalization rule.

II. MEMBER STATES' THIN CAPITALIZATION RULES

1. Current Approaches Towards Thin Capitalization

At present, national practices towards thin capitalization diverge substantially across Member States.⁵ Not only do a considerable number fail to apply thin capitalization rules, but equally, amongst those that do, there are significant differences regarding the specific design of those rules, namely insofar as their scope and their effect are concerned. In broad terms, Member States can be divided into three categories on the basis of their approach to thin capitalization:

- those which do not apply any thin capitalization rule;
- those which do not apply specific thin capitalization rules, but do apply other rules with similar effects; and
- the majority, which apply specific thin capitalization rules.

1.1 No Thin Capitalization Rules

Despite the growing popularity of these rules,⁶ as per 2007 data,⁷ seven Member States do not apply a thin capitalization regime: *Cyprus, Estonia, Finland, Greece, Malta, Slovakia* and *Sweden*.⁸

1.2 No Specific Thin Capitalization Rules

From 1 January 2008 onwards, four Member States – Austria, Germany, Ireland and Luxembourg – do not have specific legislation against thin capitalization but apply measures, either through other tax rules, or administrative practice, which have a similar effect.

⁵ As acknowledged by the European Commission itself, see *International Aspects in the CCCTB*, CCCTB Working Group, Working Paper, Meeting to be held on 8 December 2005, CCCTB\WP\019, 18 November 2005, at p. 14.

⁶ See point III.1.1 below.

⁷ In particular, see IBFD, *European Tax Surveys* database.

⁸ It is worth pointing out that in Slovakia, thin capitalization rules were only abolished with effect from 1 January 2004, see European Commission, *Taxation Trends in the European Union – Data for the EU Member States and Norway*, 2007 Edition, Eurostat statistical books, at p. 211.

1.2.1 Austria

In Austria, the Administrative Court has established broad guidelines, which are used to determine whether from a commercial perspective the equity is adequate. If it is not adequate, a portion of the debt to shareholders may be regarded as equivalent to shareholders' equity. In addition, interest paid on loans, which are deemed to be 'disguised capital', are treated as hidden profit distribution, and as such will not be deductible from the taxable income.⁹

1.2.2 Germany

Thin capitalization rules in Germany were introduced for the first time in 1994, but were subject to amendments in 2001 and then again in 2003; the latter in the aftermath of the *Lankhorst-Hohorst* ruling.¹⁰ However, with effect from 1 January 2008, Germany no longer applies thin capitalization rules, but instead applies an alternative, the so-called "earnings stripping rule". Similarly to the thin capitalization rules, the aim of this new rule is "to encourage financing by equity instead of debt capital, increasing German companies' low equity ratios and stopping the shifting of profits abroad". The new rule appears to be considerably more restrictive than the previous thin capitalization rules, with the main motivation for the change, according to German authorities, being "to avoid the net tax revenue loss exceeding €5 billion."¹¹

Under the earnings stripping rule, the maximum net interest deductions is limited to 30% of earnings (before interest, tax, depreciation, and amortization) and is applicable to German and foreign partnerships, sole traders and corporations. Although, generally, businesses will be defined on an entity per entity basis, exceptionally, companies belonging to a German consolidated group can be regarded as one business. Interest expenses so disallowed can generally be carried forward indefinitely and may be used in future years in which a threshold of 30% is not exceeded. Three exceptions for these new rules are applicable, as follows:

⁹ See P. Knörzer and Y. Schuchter, "Austria", point A.7.3, in IBFD, *European Tax Surveys*..

¹⁰ For an analysis of the circumstances which led to 2004 amendments, see A. Korner, "The New German Thin Capitalization Rules: Tax Planning; Incompatibility with European Law" (2004) *Intertax* 32(8/9), 401-415; T. Eckhardt, "Germany to Update on Thin Capitalization Regime" (2004) *Tax Notes International* 35, 124-126; W. Kessler, "Germany's Expanded Thin Capitalization Rules Affect International Holding Structures" (2004) *Tax Notes International* 34, 67-71; O.F.G. Kerssenbrock, "Third Party Comparison in New Germany Thin Capitalization Law: is a 'Fourth Party Comparison' Required?" (2005) *Intertax* 33(4), 179-188; and R. Schonbrodt and U. Woywode, "Treatment of Secured Unrelated-Party Loans Under German Thin Capitalization Rules" (2005) *Tax Notes International* 38, 145-150.

¹¹ See S. Ditsch and B. Zuber, "Germany: 2008 World Tax Supplement", (2007) *International Tax Review* 18, 190-207.

- the net interest expense of the German business is less than €1 million a year;
- the German business is not part of a group of companies; or,
- the business is part of a group and the equity ratio of the German business is not lower than the respective ratio of the overall consolidated group, so a 1% negative difference would not be harmful (the so-called escape clause).

Another characteristic of the new rules is that, in the case of the disallowance of the interest, no withholding tax on a deemed dividend is triggered.¹²

1.2.3 Ireland

In Ireland interest paid to a 75% non-resident parent or co-subsiary is disallowed and deemed to be a dividend in certain cases. This does not apply to payments made: to companies resident in EU Member States, to companies resident in tax treaty countries; or (with effect from 1 February 2007) to companies resident in a non-treaty country, provided that the payment was made in the ordinary course of the trade of the paying company and the company elects for the payment not to be treated as a dividend. In addition, subject to certain conditions, the deemed-dividend provision does not apply to payments of interest by banks to non-resident parent companies.¹³

1.2.4 Luxembourg

Finally, in Luxembourg, interest payments may be regarded as hidden profit distributions if the lending company is a shareholder of the borrowing company. In practice, the tax administration applies a debt/equity ratio of 85:15 for the holding of participations.¹⁴

1.3 Thin Capitalization Rules

Although all other Member States currently apply specific thin capitalization rules, these rules vary according to the method adopted, their scope of application, and their effect. However, the scope of application of these rules, in particular, diverges substantially.

In terms of the basic methods used for determining the existence of thin capitalization, the two most common approaches – in an international context – are the arms' length principle and the debt/equity fixed ratio. Some countries also combine both methods,

¹² For a more detailed analysis see *ibid.*

¹³ See P. Bater, "Ireland", point A.7.3, in IBFD, *European Tax Surveys*.

¹⁴ See J. O'Neal, "Luxembourg", point A.7.3, in IBFD, *European Tax Surveys*.

using the fixed ratio as safe harbour.¹⁵ Under the arm's length method, a comparison is made between the actual financing structure, and that which would have arisen had the parties involved not been related. The onus is on the taxpayer to prove that the same loan could have been obtained from a third party under the same circumstances and conditions. What will constitute proof, may differ from country to country, but usually will include aspects such as interest rates, the extent to which the lender and borrower are related, a comparison of debt/equity ratio and also whether the loan is subordinate to the rights of other creditors.¹⁶ Application of a fixed debt/equity ratio is, in principle, the more straightforward method: under this method, tax consequences emerge where the debtor exceeds a certain proportion of its equity. In practice, however, and as highlighted below, the fixed ratio method often operates in a much more complex fashion, as the application of the ratio is usually dependent on various other conditions.

Within the EU, amongst Member States which currently apply thin capitalization rules, only the United Kingdom applies the arms' length principle, and even then, only since 2004.¹⁷ All other Member States – who do apply thin capitalization rules – establish the existence of excess debt by reference to a fixed ratio of debt/equity, with some allowing taxpayers the opportunity to show that the transaction was made at arm's length, as in the case of Italy.

In terms of the scope of application of Member States' thin capitalization rules, the differences are much more significant.¹⁸ Some rules appear to amount to a mere statement of principle – *e.g.* Hungarian and Romanian rules; whilst others are extremely detailed – *e.g.* French rules. Some rules have a very wide scope of application, reflected in the application of either a strict fixed ratio – *e.g.* Belgium – or a low participation rule – *e.g.* Italy and Slovenia – or both – *e.g.* Germany's regime until January 2008; whilst others seem to have a more limited scope of application – *e.g.* Czech Republic. Some apply a general fixed ratio rule for all transactions; whilst others, apply more than one fixed ratio depending on the parties involved in the

¹⁵ See IBFD, *International Tax Glossary*, IBFD, 4th Edition (2005), at p. 357. The OECD makes a distinction between two categories of thin capitalization rules: fixed and flexible. The first category, as the name indicates, includes rules which adopt a fixed debt/equity ration approach; flexible thin capitalization rules, on the other hand, are those which are able to take into account taxpayers' individual circumstances, see *Thin Capitalization and Taxation of Entertainers, Artists and Sportsmen*, Committee on Fiscal Affairs, Issues in International Taxation No. 2, Paris, OECD (1987).

¹⁶ See L. Brosens, "Thin capitalization rules and EU law", (2004) *EC Tax Review* 4, 188-213, at p. 190.

¹⁷ See point II.1.3.16 below.

¹⁸ See Table below.

transactions – *e.g.* Belgium. Finally, various Member States limit further the application of these rules through the introduction of exceptions. The most common exceptions are those applied to the Member States on the basis of the size of either the transaction (transactions below a certain amount are disregarded, *e.g.* France), or the overall turnover (companies with turnover below a certain amount are excluded from the scope of the thin capitalization rules, *e.g.* Italy); and those excluding financial institutions from the scope of the general rules, *e.g.* Hungary and Latvia.

The impact of European Court of Justice’s (ECJ) rulings, and in particular that of *Lankhorst-Hohorst*,¹⁹ upon the scope of application of national thin capitalization provisions, is also note worthy. Until 2002, most Member States applying thin capitalization rules (similarly to other OECD countries) limited its scope of application to situations of “inbound investment”, *i.e.* where the lender is a non-resident company. However, the release of the ECJ ruling in *Lankhorst-Hohorst*, that same year, fundamentally changed this approach. This case held that German thin capitalization rules, insofar as they applied exclusively to non-residents, contravene the freedom of establishment, as set out in the EC Treaty.²⁰ In light of this decision, it became clear to many Member States that their own thin capitalization rules would not pass the so-called ‘EU test’, and would be deemed to be in contravention of EU law, if they were so challenged.²¹ In order to ensure compatibility with EU law, in a post-*Lankhorst-Hohorst* world, two avenues of action seemed available to Member States, as follows:

- to extend the scope of application of thin capitalization rules, in order to include resident companies; or
- to limit the scope of application of thin capitalization rules, in order to exclude EU-resident companies.²²

¹⁹ Albeit not exclusively, the influence of other ECJ rulings upon the national thin capitalization approaches is best highlighted by the case of the Netherlands, which until 2003 did not apply a thin capitalization rule but introduced one that year, reportedly in response to the ECJ ruling in *Bosal Holding*, 18 September 2003, C-168/01, *Bosal Holding BV v Staatssecretaris van Financiën*, [2003] ECR I-9409. See M. de Wit and V. Tilanus, “Dutch Thin Capitalization Rules ‘EU Proof’?” (2004) *Intertax* 32(4), 187-192; and A.C.P Bobeldijk and A.W. Hofman, “Dutch Thin Capitalization Rules from 2004 Onwards” (2004) *Intertax* 32(5), 254-261.

²⁰ Case C-324/00, *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, [2002] ECR I-11779. For a more comprehensive analysis of this ruling, as well of its potential impact upon the design of a thin capitalization rule for the CCCTB, see point II.2 below.

²¹ See for example, for an account of the situation in Denmark, where thin capitalization rules were said to have “considerable similarities” to the German ones, but which would have been typical of many European countries, N. Vinther and E. Werlauff, *EC Tax Review* 2003.

²² Immediately following *Lankhorst-Hohorst*, a third avenue was suggested: that Member States might react simply by dropping thin capitalization rules altogether and thus face “the full risk of base erosion”,

The reaction from Member States was not uniform. Some Member States, such as Germany and Denmark, followed the first approach.²³ Others, such as Spain and Portugal, followed the second. This has led to further discrepancies in the scope of application of the various thin capitalization rules within the EU.

As regards the effect of the thin capitalization rules, virtually all Member States, which apply thin capitalization rules, deem the excess debt to be non-deductible for tax purposes. However, in addition, some Member States also re-characterise the interest as dividends for tax purposes, *e.g.* Belgium and Spain.²⁴

1.3.1 Belgium

In Belgium, two rules are applicable to thin capitalization.²⁵ First, a 1:1 debt/equity ratio applies to loans granted by individual directors, shareholders and non-resident corporate directors to their company. Interest relating to debt in excess of this ratio is re-characterized as a non-deductible dividend. Also, the interest rate must not exceed the market rate. Second, a 7:1 debt/equity ratio applies to debt if the creditor (resident or non-resident) is exempt or taxed at a reduced rate in respect of the interest paid on the debt. Interest relating to debt in excess of this ratio is considered a non-deductible business expense.²⁶ Until recently, interest could, under certain circumstances, also be re-characterised as dividends.²⁷

1.3.2 Bulgaria

In Bulgaria, the deduction of interest paid on loans taken from shareholders or third parties is limited to the total amount of interest income received by the company plus 75% of its positive financial result (computed without taking into account interest

see D. Gutmann and L. Hinnekens, “The *Lankhorst-Hohorst* case. The ECJ finds German thin capitalization rules incompatible with freedom of establishment” (2003) *EC Tax Review* 2, 90-97, at p. 96. This concern, however, never seem to materialise; quite the opposite, as the overall number of Member States with thin capitalization rules has increased since 2002, rather than decreased.

²³ Although, some commentators were sceptical of whether this approach would indeed bring domestic laws in line with EU law, see O. Thoemmes *et al*, *Intertax* 2004, at p. 135; and A. Korner, *Intertax* 2004, at pp. 410 *et seq.*

²⁴ See for Spain, E. Cencerrado, “Controlled foreign company and thin capitalization rules are not applicable in Spain to entities resident in the European Union” (2004) *EC Tax Review* 3, 102-110.

²⁵ The fact that these rules are still in place in Belgium is interesting in itself, as Belgium is one of the few countries, and only Member State, which currently applies, since 2006, an ACE system of taxing equity and debt, see fn. 2 above.

²⁶ See R. Offermanns, “Belgium”, point A.7.3, in IBCFD, *European Tax Surveys*.

²⁷ The Belgian provisions, which required interest payments to be reclassified as dividends, where they were made to directors of foreign companies, but not where they were made to directors of Belgian companies, has been recently deemed to be in breach of Articles 43 and 48 of the EC Treaty, see ECJ 17 January 2008, C-105/07, *NV Lammers & Van Cleeff v Belgische Staat* (hereafter “*Lammers*”).

income and expenses). However, the rules only apply if the borrowed capital of the company exceeds three times its equity. Interest on bank loans and interest paid under financial lease agreements are subject to thin capitalization rules only where the arrangement is between related parties. The interest expenses that have been non-deductible under the thin capitalization rules in a tax year may be deducted in the following 5 years if the general conditions for the deduction (including thin capitalization rules) are met.²⁸

1.3.3 Czech Republic

In the Czech Republic, interest paid on credits or loans provided by related parties in excess of the ratio 4:1 between the aggregate value of debt and all equity of the company is not deductible for tax purposes. The ratio for banks and insurance companies is 6:1. Loans used for the acquisition of fixed assets and any interest-free loans are not treated as debt for thin capitalization purposes.²⁹

1.3.4 Denmark

Thin capitalization rules apply to resident companies and to non-resident companies having a permanent establishment in Denmark,³⁰ where certain conditions are met, e.g. where a controlled debt exceeds DKK 10 million.³¹ The main test of control is direct or indirect ownership of more than 50% of the share capital or direct or indirect control of more than 50% of the voting power. The thin capitalization rules apply if a company's debt-to-equity ratio exceeds 4:1. Interest expenses relating to debt to controlling persons in excess of that ratio are not deductible. Capital losses on such debt are also not deductible. Those losses may, however, be carried forward to be set off against future capital gains in respect of the same debt relationship.

From 1 July 2007, two additional limitations apply. First, the deductibility of net financing expenses is limited to a cap computed by applying a standard rate of 6.5% (for 2007) on the tax value of the company's business assets as listed in the law. However, expenses below DKK 20 million are always deductible under this rule. The second limitation is based on annual profits: the net financing expenses may not exceed 80% of the annual taxable profits.

²⁸ See K. Lozev, "Bulgaria", point A.7.3, in IBFD, *European Tax Surveys*.

²⁹ See T. Mkrtchyan, "Czech Republic", point A.7.3, in IBFD, *European Tax Surveys*.

³⁰ Thin capitalization rules amended in Denmark in 2004, to include application to resident companies, in light of the ruling *Lankhorst-Hohorst*, see N. Vinther and E. Werlauff, *Intertax* 2004.

³¹ It is worth point out that Denmark is also currently introducing alterations to their tax treatment of debt and equity, which much resemble a CBIT type of system, see fn. 2 above.

If the debt-to-equity ratio of 4:1 is exceeded, a company can avoid the limitation on the deductibility of its interest expenses to the extent it substantiates that a similar loan relationship could exist between unrelated persons. Non-deductible interest expenses are not re-characterized as distributions of profits, *i.e.* dividends.³²

1.3.5 France

In France, new thin capitalization rules are applicable since 1 January 2007.³³ The new rules apply to ‘associated companies’. Two companies are ‘associated companies’ if (a) one of them has a direct or indirect holding of a minimum of 50% in the capital of the other or controls the other company *de facto*; or (b) a third company has a direct or indirect holding of a minimum of 50% in the capital of the two companies, or exercises a *de facto* control over the two companies. The deductibility of interest paid to associated companies will be limited by the application of two tests:

- the overall indebtedness (related party debt-to-equity ratio) of 1.5:1. This ratio is determined by comparing the loans from the associated companies with the equity capital of the borrower; and
- the ratio of the interest paid to the realized profits of the company (the borrower?).

Interest exceeding the higher of the above limits will not be tax deductible, but can be carried forward within certain limits. Moreover, the interest deduction will be reduced by 5% annually from the second year of the carry-forward period. As a safe haven measure, interest will be fully deductible if the company (the borrower) can demonstrate that its own total debt (related and third-party) does not exceed the worldwide group's debt. Furthermore, the interest limitations will not apply to certain financial transactions and to small transactions the non-deductible interest of which is less than EUR 150,000.³⁴

³² See E. Nilsson, “Denmark”, point A.7.3, in IBFD, *European Tax Surveys*.

³³ Discussions regarding the potential need to review French thin capitalization rules in light of *Lankhorst-Hohorst*, start emerging immediately following the release of that ruling, see O. Roumelian, “The End of French Thin Capitalization Rules?” (2003) *Intertax* 31(6/7), 244-247. However, the review process was somewhat prolonged and only in 2007 did the new thin capitalization rule come into force, see O. Dauchez and G. Jolly, “Thin Capitalization in France: A Story Still in the Making” (2004) *Tax Notes International* 35, 719-722; and M. Collet, “France to Reform Thin Capitalization Rules” (2005) *Tax Notes International* 40, 119-122.

³⁴ See S. Baranger, “France”, point A.7.3, in IBFD, *European Tax Surveys*.

1.3.6 Hungary

In Hungary, where debt exceeds three times the company's equity, the excess interest paid by a company is not tax deductible. This rule does not currently apply to financial institutions.³⁵

1.3.7 Italy

Italy only introduced thin capitalization rules in 2003.³⁶ These rules apply always to holding companies and also to companies whose turnover exceeds EUR 7.5 million. If during the tax year, the average debt exceeds four times the adjusted equity with reference to a qualified shareholder or its related parties, the consideration on the excessive loans granted or guaranteed, directly or indirectly, by a qualified shareholder or its related parties is not deductible for tax purposes and, if received by a qualified shareholder, is re-characterized as a dividend. In determining the debt/equity ratio, loans granted or guaranteed by the shareholder's related parties should be taken into account.

For thin capitalization purposes, a 'qualified shareholder' is a shareholder that directly or indirectly controls the debtor according to the Civil Code or owns at least 25% of the share capital of the paying company. 'Related parties' are defined as companies that are controlled according to the Civil Code or relatives as defined in the tax law. Thin capitalization rules do not apply if the overall debt/equity ratio with reference to all qualified shareholders and their related parties does not exceed 4 to 1, or if the debtor proves that the excess debt is justified by its own credit capacity, and so that also a third party would have granted it.³⁷

1.3.8 Latvia

With effect from 31 December 2002, thin capitalization restrictions apply in Latvia. Interest payable is disallowed to the extent that the associated liabilities exceed four times the equity capital of the company at the beginning of the taxable period concerned, as reduced by the fixed asset revaluation reserve and other reserves not formed from distributable profits. Where a company would otherwise suffer a reduction in interest allowable as a result of this rule and the general restriction on interest payable, only the larger of the reductions is made.

³⁵ See R. Szudoczky, "Hungary", point A.7.3, in IBFD, *European Tax Surveys*.

³⁶ For a comprehensive analysis of these new provisions, see M. Rossi, "Italy's Thin Capitalization Rules" (2005) *Tax Notes International* 40, 89-100. See also A. Circi and M. Di Bernardo, "Italy Issues Guidelines on Thin Capitalization" (2005) *Tax Notes International* 38, 1038-1043.

³⁷ See G. Chiesa, "Italy", point A.7.3, in IBFD, *European Tax Surveys*.

This rule will not apply to interest paid by credit institutions or insurance companies or in respect of borrowings, loans or leasing services provided by credit institutions registered in Latvia or another EU Member State, the Latvian State Treasury, the Nordic Investment Bank, the World Bank Group or (since 1 January 2007) a resident of Latvia.³⁸

1.3.9 Lithuania

Under Lithuanian thin capitalization legislation, interest and currency exchange losses on the debt in excess of the debt/equity ratio of 4:1 are non-deductible for tax purposes. This is applicable in respect of the debt capital provided by a creditor, who:

- directly or indirectly holds more than 50% of shares or rights (options) to dividends; or
- together with related parties, holds more than 50% of shares or rights (options) to dividends, and the holding of that creditor is not less than 10%.

This rule is not applicable where the taxpayer proves that the same loan could exist between unrelated parties. Financial institutions providing leasing services are also excluded from the scope of this rule.³⁹

1.3.10 Netherlands

Under Dutch thin capitalization rules, introduced in 2004,⁴⁰ the deduction of interest is restricted with regard to loans provided by a taxpayer to a group company or related company excessively financed by debt capital. ‘Group company’ is defined as a company that is part of an economic unit in which legal entities are linked organizationally. ‘Related company’ is defined as a company in which the taxpayer has a participation of at least one third or a third company that holds a participation of at least one third in the taxpayer.

A company is deemed to be excessively financed by debt capital if its average annual debt exceeds a 3:1 debt/equity ratio for tax purposes and the excess is greater than EUR 500,000. Equity is determined in accordance with Netherlands tax law and does not include tax-allowable reserves. Companies may, however, opt that the excessive debt is determined by multiplying the difference between the average annual debts and the average annual equity using a multiplier based on the commercial debt/equity ratio

³⁸ See Z.G. Kronbergs, “Latvia”, point A.7.3, in IBFD, *European Tax Surveys*.

³⁹ See R. Degesys, “Lithuania”, point A.7.3, IBFD, *European Tax Surveys*.

⁴⁰ See point II.1.3 above.

of the group. The multiplier is equal to the average annual debts divided by the average annual equity as included in the consolidated accounts of the group. The maximum non-deductible interest is the amount of the interest paid on loans provided by related companies less the interest received from related companies on loans provided to those companies.

The thin capitalization rule applies to resident companies, non-resident companies with a permanent establishment in the Netherlands and foreign permanent establishments, which are treated as a distinct and separate entity.⁴¹

1.3.11 Poland

In Poland, under the current thin capitalization rules,⁴² interest paid on a loan is not deductible if a debt/equity ratio of 3:1 is exceeded and the loan is granted by either of the following:

- a shareholder owning at least 25% of the share capital or by a group of shareholders owning in aggregate at least 25% of the share capital; or
- between companies in which another company owns at least 25% of the share capital.⁴³

1.3.12 Portugal

In Portugal, as a general rule, interest paid by a resident company in respect of excessive debt to a non-resident related party is not deductible. Two companies are deemed to be related parties for thin capitalization purposes if one is in a position to exercise directly or indirectly a significant influence over the management of the other. The related party test is triggered, in particular, in situations involving:

- a company and its participators who hold directly, or together with family members or a 10%-associated entity, at least 10% of the capital or voting rights in that company;

⁴¹ See R. Offermanns, “Netherlands”, point A.7.3, in IBFD, *European Tax Surveys*.

⁴² The evolution of the scope of thin capitalization rules in Poland is somewhat interesting. Introduced in 1999, Polish rules applied initially to both residents and non-resident entities; the scope of these rules had however been amended in 2001, limiting their application to non-resident companies. In 2004, and in light of the ECJ ruling in *Lankhorst-Hohorst*, Poland had to return to their initial formulation, to include both resident and non-resident companies within the scope of their thin capitalization provisions. See R. Dluska, “Poland: How the new thin-capitalization rules work”, (2005) *International Tax Review*, May.

⁴³ See M. van Doorn-Olejnicka, “Poland”, point A.7.3, in IBFD, *European Tax Surveys*.

- two companies in which the same participators hold directly, or together with family members or a 10%-associated entity, at least 10% of the capital or voting rights;
- a company and its directors (including any member of its board of directors or supervisory board) or their family members;
- two companies in which the majority of the directors (including any member of their board of management or supervisory board) are either the same individuals or members of their family;
- companies under unified control or managerial subordination. Unified control exists if a group of companies is subject to a unified and common management; a managerial subordination exists if a company entrusts the management of its business to another company;
- a parent company and its 90% or more owned subsidiaries;
- companies which, due to their commercial, financial, professional or legal links, are interdependent in carrying on their business; or
- a resident company and an entity that is a resident of a listed tax haven, irrespective of any holding relationship.

Excessive debt is the part of the total debt, with non-resident related parties, which exceeds twice the amount of the corporate borrower's net worth held by such non-residents. However, interest on excessive debt may be deducted, except where the borrower is a resident of a listed tax haven, if the taxpayer can prove (on the grounds of the kind of activity, the sector in which operates, its size, or any other relevant criteria, and provided that the risk factor in the transaction does not involve any related party) that the loan conditions are comparable to those agreed by non-related parties in comparable transactions under the same circumstances.⁴⁴

From 1 January 2006, Portuguese thin capitalization rules do not apply to EU resident entities.⁴⁵

1.3.13 Romania

⁴⁴ See P. Dias de Almeida, "Portugal", point A.7.3, in IBFD, *European Tax Surveys*.

⁴⁵ For a comprehensive analysis of the Portuguese thin capitalization rules, see F. Sousa da Camara and J. Almeida Fernandes, "Thin Capitalization Rules" (2007) *International Transfer Pricing Journal* 2, 119-123. See also, F. Sousa da Camara, "Thin Capitalization Rules Violated EC Treaty, Lisbon Court Says" (2006) *Tax Notes International* 44(4), 272-274; and F. Sousa da Camara, "Portugal Enacts Safe Haven Exception to Thin Capitalization Rules" (1996) *Tax Notes International*, 585.

In Romania, interest and foreign exchange losses relating to long-term loans taken from entities other than authorized credit institutions (including leasing companies) are not deductible if the debt/equity ratio exceeds 3:1. Any excess interest may be carried forward until full deductibility is reached.⁴⁶

1.3.14 Slovenia

Until 2007, Slovenian thin capitalization rules established that interest on loans taken from shareholders holding, directly or indirectly, at least 25% of the capital or voting rights of the taxpayer, was tax deductible only if the loan did not exceed eight times the value of the share capital owned. The debt/equity ratio, however has changed in 2008 to 6:1; this ratio will apply until 2010, and then change again to 5:1 in 2011 and finally to 4:1 from 2012 onwards. However, if the taxpayer proves that the excess loan could be granted also by a non-related entity, the thin capitalization rules do not apply. Loans granted by a shareholder also include loans granted by third parties if guaranteed by the shareholder, and loans granted by a bank if granted in connection with a deposit held in that bank by the shareholder.⁴⁷

1.3.15 Spain

As with many other Member States, Spain introduced substantive amendments to its thin capitalization rules in the wake of the *Lankhorst-Hohorst* ruling.⁴⁸ If the average total (direct and indirect) loans made to a company resident in Spain (other than those subject to special debt/equity ratio requirements), by a non-EU resident related company, during the tax year is more than three times the amount of the borrower's average net worth in that year (excluding profits of the period), the amount of interest attributable to the excess will be re-characterized as a dividend for tax purposes (*i.e.* it cannot be treated as a deductible expense and is subject to dividend withholding tax). A different ratio may be applied if the taxpayer so requests and the lender does not reside in a listed tax haven.⁴⁹

1.3.16 United Kingdom

With effect from 1 April 2004, the thin capitalization rules are repealed and replaced by new legislation that forms part of the extended transfer pricing regime. Previously, excess interest payments from thinly capitalized resident companies could be treated as

⁴⁶ See R. Badea, "Romania", point A.7.3, in IBFD, *European Tax Surveys*.

⁴⁷ See J. Dolšak, "Slovenia", point A.7.3, in IBFD, *European Tax Surveys*.

⁴⁸ See point II.1.3 above.

⁴⁹ See A. de la Cueva González-Cotera and E. Pons Gasulla, "Spain", point A.7.3, in IBFD, *European Tax Surveys*.

dividend payments. Only the excess of what would have been paid between unconnected parties dealing at arm's length, having regard to the debt/equity ratio, rate of interest and other terms that would have been agreed, was treated as a dividend. There was no fixed debt/equity ratio, but a ratio of 1:1 was normally acceptable. The rule applied only to 75% subsidiaries, or where both the paying and the recipient companies were 75% subsidiaries of a third company.⁵⁰ After the *Lankhorst-Hohorst* decision, however, it was feared that this legislation would be in contravention of EU law, and thus a total overhaul of the thin capitalization regime was envisaged.

Being part of the transfer pricing regime has significant consequences in terms of method, scope and effects of thin capitalization. Two of the most importance consequences are the following. First, the decision as to whether thin capitalization is taking place is assessed on a case-by-case basis; in considering whether the conditions of a loan respect arm's length conditions, several factors should be taken into consideration, including: the amount of the loan, whether the loan would have been done if the companies involved were not related; and, the interest rate applied. Second, interests are no longer treated as distribution.

Excluded from the scope of these new rules are small and medium size companies in respect of transactions made between related parties, resident in the United Kingdom or in a country with which the United Kingdom has signed a double taxation treaty.⁵¹

Table 1 below is a summary of Member States' different approaches to thin capitalization, as well as the basic characteristics of existing thin capitalization rules within the EU where available.

⁵⁰ See P. Bater, "United Kingdom", point A.7.3, in IBFD, *European Tax Surveys*. For a detailed analysis of the United Kingdom's previous thin capitalization regime, see A.K. Rowland, "Thin Capitalization in the United Kingdom" (1995) *Bulletin for International Fiscal Documentation* 49(12), 554-558.

⁵¹ See L. Brosens, *EC Tax Review* 2004, at p. 202; and J. Vanderwolk, "Finance Act Notes: transfer pricing and thin capitalization – sections 30-37 and Schedule 5" (2004) *British Tax Review* 5, 465-468.

TABLE 1: MEMBER STATES' APPROCHES TO THIN CAPITALIZATION

	Thin Capitalization Rule	Method Used			Scope		Effect	
		Arms' Length Principle	Fixed Ratio	Debt/Equity Ratio	Participation Rule	Excess Debt Non-Deductible	Interest Re-characterised as Dividend	
Austria	Yes ⁵²						×	×
Belgium	Yes		×	1:1 / 7:1			×	×
Bulgaria	Yes		×	3:1			×	
Cyprus	No							
Czech Republic	Yes		×	4:1 / 6:1			×	
Denmark	Yes		×	4:1	50%		×	
Estonia	No							
Finland	No							
France	Yes		×	1.5:1	50%		×	
Germany	No ⁵³						×	
Greece	No							
Hungary	Yes		×	3:1			×	
Ireland	Yes ⁵⁴				75%			×
Italy	Yes		×	4:1	25%		×	×
Latvia	Yes		×	4:1			×	
Lithuania	Yes		×	4:1	50%		×	
Luxembourg	Yes ⁵⁵		×	85:15				
Malta	No							
Netherlands	Yes		×	3:1	33%		×	
Poland	Yes		×	3:1	25%		×	
Portugal	Yes		×	2:1	10% / 90% / Other		×	
Romania	Yes		×	3:1			×	
Slovakia	No							
Slovenia	Yes		×	6:1	25%		×	
Spain	Yes		×	3:1			×	
Sweden	No							
United Kingdom	Yes	×						

⁵² No specific thin capitalization rule, but guidelines set out by the Austrian Administrative Court.

⁵³ Thin capitalization rules have been substituted by a new "earnings stripping rule", with effect from 1 January 2008.

⁵⁴ No specific thin capitalization rule, but rules emerge from general tax provisions.

⁵⁵ No specific thin capitalization rule, but rules emerge from administrative practice.

III. THIN CAPITALIZATION RULE FOR THE CCCTB

As already discussed,⁵⁶ the introduction of a thin capitalization clause has been perceived as a fundamental aspect of combating tax avoidance within the context of the CCCTB.⁵⁷ However, prior to introducing such a clause, consideration must be given to both the economic and legal dimensions of thin capitalization clauses.

1. Economic Considerations

Introduction of a thin capitalization clause, within the context of the CCCTB, should be preceded by consideration of its economic consequences. In particular it should be asked, first, whether from an economic perspective thin capitalization rules are in fact necessary; and second, whether there is evidence of their economic impact, and if so, of what type. This is particularly true for those Member States, which at present do not apply thin capitalization rules.⁵⁸ These Member States will in effect, by virtue of the CCCTB, apply a new thin capitalization rule, and as such, consideration of its potential impact upon their economy appears to be of special relevance.

1.1 Thin capitalization phenomenon from an economic perspective

Thin capitalization is one well-known, and generally thought to be common, method of international profit shifting. What is less well known however, is exactly how common it is, *i.e.* to what extent is (or is not) thin capitalization a widespread phenomenon. Unfortunately, although the causes, manifestations and effects of profit shifting are well documented within economics literature, the same cannot be said of thin capitalization in particular.

Notwithstanding the above, the last few years have seen an emerging body of work within economics dealing with this matter. These studies seem to suggest that thin capitalization is indeed a significant phenomenon within the international sphere.⁵⁹ In 2003, R. Altshuler and H. Grubert found, using available data from the United States of America (US), that 1% higher tax rate in foreign affiliates of US multinationals raises the debt/equity ratio in those affiliates by 0.4%.⁶⁰ One year later, a study

⁵⁶ See point 1 (Introduction) above.

⁵⁷ See European Commission's Working Papers: *Related Parties in CCCTB*, CCCTB Working Group, Working Paper, Meeting to be held on 13 December 2006, CCCTB\WP\041, 5 December 2006; and also *Dividends*, CCCTB Working Group, Working Paper, Meeting to be held on 12 September 2006, CCCTB\WP\042, 28 July 2006, at p. 6.

⁵⁸ See point 2.1 above.

⁵⁹ For a comprehensive survey of these studies, see R.A. de Mooij, "Will Corporate Income Taxation Survive?" (2005) *De Economist* 153(3), 277-301, at p. 292.

⁶⁰ See "Taxes, repatriation strategies and multinational financial policy" (2003) *Journal of Public Economics* 87, 73-107.

conducted by three other American academics confirmed these findings: a 10% increase in the tax rate can have an impact of 3-5% higher debt/equity ratio.⁶¹ A similar study for Europe was conducted in 2006 by H. Huizinga, L. Laeven and G. Nicodeme. Looking at evidence collected from over 90,000 subsidiaries, across thirty-one European countries, they found that an increase in the effective tax rate of 0.06% in the subsidiary's country, will result in a 1.4% increase in its debt over total assets ratio.⁶² The results of this study confirm those of an earlier research, conducted by A. Weichenrieder, in 1996, which gave an early indication of the potential dimension of the problem in Germany. The study shows that in the early 1990s (prior to the introduction of a thin capitalization rule in Germany),⁶³ more than three quarters of German inward foreign direct investment consisted of loans, while German investment abroad consisted primarily of equity.⁶⁴

The adverse consequences, in terms of collected revenue, of such a widespread phenomenon are obvious. When seen in this context, it is therefore hardly surprising that the introduction of thin capitalization rules is on the increase, not only within the EU,⁶⁵ but more generally, amongst OECD countries.⁶⁶ The two-fold aims of these rules are clear: to curtail international tax planning, and consequently, to increase revenue. From an economic perspective, however, it does not seem to be at all obvious that attempts to restrict any type of tax planning are effective in the long term. Furthermore, even if they are, it is unclear either whether businesses' response to such restrictions are, more generally, economically beneficial for the imposing country.⁶⁷

A review of the economic effects of thin capitalization rules should therefore, start by considering whether the stated aims of these rules have been achieved, and then, moving beyond those aims, assess what would be the overall effects for the economy of the imposing country, as a whole.

1.2 Economic effects of thin capitalization rules

⁶¹ M.A. Desai *et al*, "A Multinational Perspective on Capital Structure Choice and International Capital Markets" (2004) *The Journal of Finance* LIX(6), 2451-2487.

⁶² See "Capital Structure and International Debt Shifting", *CEB Working Paper Series*, WP 07-015, 2007

⁶³ See point II.1.2.2 above.

⁶⁴ See "Fighting international tax avoidance: the case of Germany" (1996) *Fiscal Studies* 17, 37-58.

⁶⁵ The number of Member States which apply a thin capitalization rule appears to have been steadily increasing in the last ten years, for comparison purposes see R.A. Sommerhalder's 1996 overview in "Approaches to Thin Capitalization" (1996) *European Taxation* 3, 82-93. See also general comments by O. Thoemmes *et al*, *Intertax* 2004, at pp. 127-128.

⁶⁶ T. Buettner *et al* note that whilst in 1996 only half of the OECD countries applied a thin capitalization rule, by 2004 that number had increased for almost 75%, see "The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions", *CESifo Working Paper Series*, WP No. 1817, October 2006, at p. 2.

⁶⁷ See *ibid*, at p. 1.

The effectiveness (or not) of thin capitalization rules has been the subject of a few recent economic studies, all of which originating in Germany.⁶⁸ In 2006, a team lead by T. Buettner found, based on a survey of all OECD countries, that there was a definite correlation between the application of thin capitalization rules and the financial structure of multinationals.⁶⁹ The findings were confirmed, and further developed, in a further study by M. Overesch and G. Wamser, released the following year.⁷⁰ Using German inbound investment data from 1996 to 2004, the latter study considers whether thin capitalization rules effectively restrict the tax planning behaviour of multinationals. German legislative amendments to the rules in 2001 and 2004 are exploited in order to detect differences in business behaviour. The study found that consideration of thin capitalization rules is crucial for multinationals' capital structures, *i.e.* they induce significantly lower internal borrowing. In particular, the findings suggest that some companies, where affected by a stricter thin capitalization rule, subsequently adjusted their capital structure. Thus, the authors concluded that thin capitalization rules are indeed effective in restricting multinationals' profit shifting, even in high-tax countries such as Germany.

Yet another group of German economic researchers is currently taking these studies one step further, by assessing the effects of these findings in terms of company's efficiency levels. The premise is that, if thin capitalization rules can indeed reduce the debt/equity ration, then, it will not only prevent tax planning, but theoretically, they can also bring firms' decisions closer to optimal efficiency levels. At present, however, there is no definite evidence that this will be the case in practice.⁷¹

In light of the above, and despite the scarcity of studies in this area, it seems therefore that thin capitalization rules are indeed effective, in terms of their aims. However, even if this is the case, the question still remains as to whether there are negative economic consequences to introducing thin capitalization, which might potentially deem their introduction to be non-beneficial, for the economy of a country as whole. Of particular concern here, is the eventual impact of thin capitalization rules on levels of investment.

⁶⁸ One potential explanation for the special interest from German economists in the topic, is that, as opposed to most other Member States, Germany has substantially amended its thin capitalization rules various times over the last fifteen years, thus providing a better comparative framework for understanding the economic impact of thin capitalization rules.

⁶⁹ See *CESifo Working Paper Series* 2006.

⁷⁰ Paper dated September 2007, to be published as "Corporate Tax Planning and Thin-Capitalization Rules: Evidence from a Quasi Experiment", (2008) *Applied Economics* (in press).

⁷¹ See A. Haufler and M. Runkel, "Thin Capitalization rules: Do they yield a double dividend or do they promote corporate tax competition?", Presentation at *European Tax Policy Forum (ETPF) Meeting*, 18 October 2007, Madrid.

Although not much has been said on the economic effects of thin capitalization, and the rules to combat them specifically, there is a relatively well established literature on the economic effects of anti international tax planning policies. In this regard, theoretical economic studies have tended to conclude that, imposing restrictions on certain types of international tax planning is likely to result in adverse consequences in terms of investment undertaken by multinationals in high-tax countries. There is also evidence that such policies are likely to reinforce tax competition.⁷²

Notwithstanding the above, insofar as thin capitalization is concerned, empirical evidence only partially confirms these results. Having also looked at this economic aspect of thin capitalization rules, the study conducted by T. Buettner's team concluded that, no adverse effect could be found at investment level, *i.e.* the amount of capital invested is not lower in those countries which impose a thin capitalization rule.⁷³ It did, nevertheless, find evidence of decreased tax sensitivity as a result of application of thin capitalization rules. This can constitute a significant limitation for the introduction of thin capitalization rules, in particular when read in light of, what has been designated as, "tax-rate-cut-cum-base broadening rule".⁷⁴ the tendency, witnessed amongst OECD countries, to reduce corporate tax rate,⁷⁵ whilst at the same time introducing anti profit shifting rules.⁷⁶ If thin capitalization rules do in fact reduce tax sensitivity, then the economic impact of potential corporate tax reductions would be limited. Consequently, so too would the ability of Governments to stimulate the economy (by increasing foreign investment), through the introduction of those reductions. The decrease of tax sensitivity should therefore constitute an important consideration by Member States intending to introduce thin capitalization rules.

1.3 A thin capitalization rule for the CCCTB: an economic argument

In terms of the CCCTB, the question then is whether any of the above should constitute an impediment to the introduction of a thin capitalization rule. We do not believe so. The above analysis has demonstrated that, introducing thin capitalization rules has positive effects in terms of their ability to curtail this form of international tax planning. It has also highlighted that, although some concerns have been expressed

⁷² For one of the most recent studies on the matter, see S. Peralta *et al*, "Should countries control international profit shifting?" (2006) *Journal of International Economics* 68, 24-27.

⁷³ See *CESifo Working Paper Series* 2006, at p. 25. The authors do, however, acknowledge that these results can be due to the decision to not to take into account certain factors in their calculations.

⁷⁴ See A. Haufler and G. Schjelderup, "Corporate tax systems and cross country profit shifting" (2000) *Oxford Economic Papers* 52(2), 306-325.

⁷⁵ For comprehensive analysis of the trend towards reducing corporate tax rates, see M. Devereux, "Developments in the Taxation of Corporate Profit in the OECD since 1965: Rates, Bases and Revenues", *Oxford University Centre for Business Taxation Working Paper Series*, WP 07/04, December 2006.

⁷⁶ This tendency has been closely connected to the increase in both capital mobility and the importance of multinational firms, see C. Fuest and T. Hemmelgarn, "Corporate tax policy, foreign firm ownership and thin capitalization" (2005) *Regional Science and Urban Economics* 35, 508-526.

over their potential impact on investment levels, the most recent empirical studies have failed to establish, in practical terms, a connection between thin capitalization rules and investment levels. There are remaining concerns over an eventual decrease of tax sensitivity, as a result of the introduction of thin capitalization rules. However, whilst this should most likely constitute, for the reasons set out above, a significant factor for individual Member States (or any other countries) to take into account, when considering the introduction of thin capitalization rules; in the context of the CCCTB, it should not be regarded as a decisive factor on the discussion over the introduction, or not, of these type of rules. This conclusion is based on two fundamental considerations: first that, since it has already been demonstrated that thin capitalization rules are effective, their introduction will protect the tax base, and consequently revenues, both of which would otherwise be subject to erosion; second, and perhaps equally important, failure to include such rules could in itself give rise to much more significant economic distortions. The first consideration is one, which is always at the forefront of individual countries decisions to introduce thin capitalization rules. The second, however, is a consideration which is particular to the nature of the CCCTB.

As regards this second consideration, one further point which should be noted is the fact that economic analysis seems to point towards the veracity of the following general preposition: in the presence of both foreign firm ownership and thin capitalization, countries gain from a coordinated broadening of the tax base,⁷⁷ such as that facilitated by the introduction of thin capitalization rules. More specifically, from the perspective of the operation of a consolidated corporate tax basis, the general consensus seems to be that common anti abuse provisions, such as thin capitalization rules, are necessary in order to ensure neutrality.

As discussed above,⁷⁸ at present Member States have very different approaches to thin capitalization. Non-inclusion of a common thin capitalization rule within the context of the CCCTB could potentially mean that Member States would continue to apply their own provisions, as they currently stand. Although this might seem an attractive practice from a pragmatic point of view, in practice, if different national rules are applicable, this would undeniably facilitate tax planning. As C. Spengel and C. Wendt explain, in a very clear and uncontroversial fashion: “thin capitalization rules could be evaded if a company first grants a loan to a subsidiary resident in a country without thin capitalization rules, and afterwards this loan is directed to the relevant company

⁷⁷ *Ibid.*

⁷⁸ See point II above.

via intra-group transactions”.⁷⁹ This is essentially made possible by the consolidated nature of the CCCTB: the fact that intra-group transactions will not be subject to tax. Ultimately therefore, maintaining application of national rules, to deal with different forms of international tax planning, would not only be non-neutral, but furthermore, failure to introduce common rules could result in severe economic distortions.

Finally, authors have also highlighted to other problems failing to introduce common anti-abuse provisions, such as risks of double non-taxation and increased compliance costs (resulting from having to deal with different national anti-abuse provisions).⁸⁰ In this context, therefore, there is a strong economic argument for the introduction of anti-avoidance provisions, such as a thin capitalization rule, in the context of the CCCTB.

2. Legal Considerations

If, from an economic point of view, thin capitalization rules do not seem to cause relevant adverse effects at the investment level, and are even recommended in order to avoid economic distortions, from a legal point of view, certain considerations must also be taken into account. In this respect, it is clear that options will have to be made, namely as regards the following:

- the option between either introducing a general anti abuse clause or specific anti abuse provisions (namely, the thin capitalization provision) within the CCCTB has to be justified;
- the object and scope of a thin capitalization rule within the CCCTB have to be determined, *i.e.*, the qualifying groups under the CCCTB have to be identified and the meaning of a major shareholder for the purposes of applying a thin capitalization rule has to be determined;
- it also has to be decided whether to include a single thin capitalization regime or multiple thin capitalization regimes;
- the choice of basic method to determine the existence of thin capitalization, *i.e.* arm’s length principle, fixed debt/equity ratio or a combination of the two, has to be undertaken;

⁷⁹ See “A Common Consolidated Tax Base for Multinational Companies in the European Union: Some Issues and Options”, *Oxford University Centre for Business Taxation Working Paper Series*, WP 07/17, June 2007, at pp. 41-42.

⁸⁰ *Ibid*, at p. 42; see also J. Barenfeld, “A Common Consolidated Corporate Tax Base in the European Union – A Beauty or a Best in the Quest for Tax Simplicity?” (2007) *Bulletin for International Taxation* 6/7, 258-271, at p. 270.

- the drafting of (a) thin capitalization regime(s) within the CCCTB has to be compatible with the EC Treaty fundamental freedoms and with the OECD requirements; and finally,
- simplicity and low compliance costs should not be forgotten.

2.1 General anti-abuse clause vs. Specific anti-abuse provisions: the relevance of certainty and administrative simplicity, also taking into account ECJ case-law on fundamental freedoms

As a starting point, and in our opinion, application of specific anti-abuse provisions would be preferable to the introduction of a general anti-abuse clause. The reasons for this are two-fold: firstly not all Member States apply a general anti-abuse clause, and many of those that do have experienced difficulties in their application; secondly, application, by different Member States, of a general anti-abuse clause would in practice entail a broad level of discretion, potentially leading to diverging standards of application and consequent economic distortions. Thus, even if the ECJ was to contribute to clarification of its scope of application, such a general clause would ultimately prove to be a significant source of legal uncertainty. In comparison to a general anti-abuse clause, therefore, specific anti-abuse clauses will have the benefit of providing higher levels of certainty, as well as being, most likely, simpler to administer.

It should, however, be noted that the application of specific anti-abuse clauses to situations, which fall within the scope of EC law, and namely of Article 43 of the EC Treaty, is subject to limitations. As the Court has consistently reiterated in recent rulings, these clauses are only permissible under EC law, insofar as they allow for “the consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement” – *i.e.*, they cannot constitute irrefutable presumptions.⁸¹ Any thin capitalization rule applicable under the CCCTB, which will cover situations falling within the scope of Article 43 of the EC Treaty,⁸² will have to respect these requirements. In practice though, and from an administrative

⁸¹ See ECJ 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, [2007] ECR I-2107 (hereafter “*Thin Cap Group Litigation*”), at pars 81-82; and *Lammers*, at pars 28-29. See also, ECJ 12 September 2006, C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, [2006] ECR I-7995 (hereafter “*Cadbury Schweppes*”), at pars 65 and 75. The recent ruling in *Columbus Container Services* does not change this case-law, see ECJ 6 December 2007, C-298/05, *Columbus Container Services BVBA & CO vs. Finanzamt Bielefeld Innenstadt*. For a commentary to this case see T. O’Shea, “German CFC Rules Compatible with EU Law, ECJ Says” (2007) *Tax Notes International* December, 1-5.

⁸² Essentially this will occur most where the companies involved are resident within the EU, but outside the CCCTB, *i.e.* non-consolidated related EU companies, see European Commission’s Working Papers: CCCTB/WP/041, at p. 3; and *Summary Record of the Meeting of the Common Consolidated Corporate Tax Base Working Group – Meeting Held in Brussels on 27-28 September 2007*, CCCTB/WP/059, 13 November 2007, at pp. 8-9. See also point III.2.2 below for a more comprehensive analysis of the scope of Article 43 of the EC Treaty, as interpreted by the ECJ.

perspective, providing evidence as to “valid commercial justifications underlying a loan”, will undeniably result in increased complexity as regards the application of such a rule.

In this respect, it will be necessary to establish criteria in order to determine: which tax administration would be in charge of ascertaining whether there is a purely artificial arrangement underlying the loan; or, more generally, criteria for determining which would be the competent authority for controlling application of thin capitalization rules to the Group’s loans. It seems to result from the Commission paper on the “*elements of the administrative framework*”, that two possibilities are available in this respect:⁸³ either the principal tax administration,⁸⁴ or the tax administration of the borrowing company within the Group. The first option would appear to offer the most benefits. Not only would the application of the principal tax administration criteria most likely result in a simpler and more coherent application of the thin capitalization rule where a Group is concerned; but, equally, if the amount of deductible interest (and the level of the borrowing) is to be done on a consolidated basis (not taking into account every single company or PE belonging to the Group), application of the thin capitalization rule by the principal tax administration seems to be the adequate solution.

In any event, and notwithstanding the above, specific anti-abuse provisions remain simpler to administrate, when compared to general anti-abuse clauses, and thus represent the better solution, in our view, insofar as the CCCTB is concerned. Moreover, and specifically as regards thin capitalization, the provision can, and will most likely be applied by self-assessment, albeit subject to tax administration control, therefore further facilitating its practical application.

2.2 The object and scope of a thin capitalization rule within the CCCTB

In order to draft a thin capitalization rule, we also need to establish what should be its object and scope. Thus, we need to identify the different CCCTB qualifying groups and some of the hypothetical cases that will be covered by the aforementioned rule. The general assumption outlined by the Commission in its technical document – *i.e.*, that consolidation will be mandatory for all companies qualifying and opting for the CCCTB, which have a qualifying subsidiary or a PE in another State in the EU (the all-in all-out principle) – is accepted here.⁸⁵

The aim here is to establish whether, and how, a thin capitalization regime would apply to each of these groups.

⁸³ See *CCCTB: possible elements of the administrative framework*, CCCTB/WP/061, 13 November 2007.

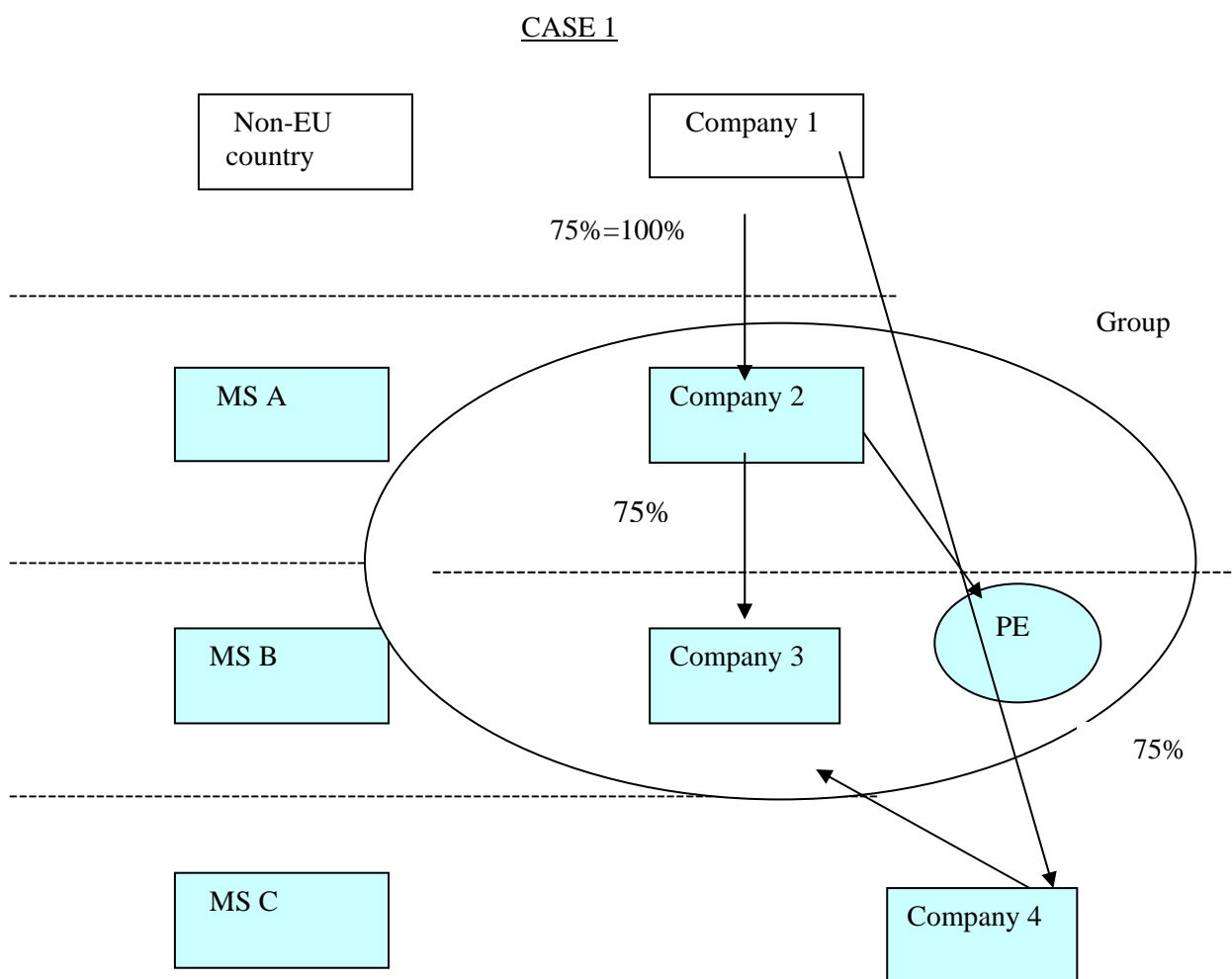
⁸⁴ See for the concept of principal tax administration, *ibid* at p. 7, pars 23 *et seq.*

⁸⁵ See *CCCTB: possible elements of a technical outline – Annotated*, CCCTB\WP57, 20 November 2007, at pars 85-86.

2.2.1 CCCTB Qualifying Groups and hypothetical loan finance cases

The groups described below correspond to the ones identified in the Commission working paper on the *possible elements of a technical outline*;⁸⁶ whilst, the hypothetical cases of loan finance are inspired in the ones analysed by the Court in *Thin Cap Group Litigation*.

(A) Group comprises an EU resident parent company and its EU subsidiaries and PEs, regardless of whether or not the EU resident parent is controlled by a non-EU parent company



If company 2 (or company 3, or even the PE) takes up loans from company 1, the issue is whether interest is always deductible in MS A or MS B.

Outbound dividends paid to company 1 will probably be withheld in MS A, if the issue is not considered to be covered by the free movement of capital, but exclusively by the

⁸⁶ See *ibid* at pp. 21-23, in particular at pars 87-88.

freedom of establishment, and as the latter one is not applicable to Third States.⁸⁷ The fact that company 3 will not directly pay dividends to company 1, as these will be paid to company 2 and therefore MS B cannot tax those dividends under the parent subsidiary directive, does not justify that MS B prohibits deduction of interest directly paid by company 3 or the PE to company 1. As a general rule, taxation at arm's length of outbound dividends paid to a major shareholder resident in a Third State, makes deduction at arm's length of outbound interest paid to parent companies (or major shareholders) resident in Third States consistent with the concept of taxation of net income.

It should be stressed, that the Commission's view on this matter appears to be that even in case of exemption of inbound dividends from major shareholdings, "interest on loans taken up for the acquisition of such shareholdings should in principle be deductible", as "[t]o deny interest deductions would make the CCCTB extremely unattractive for EU groups with subsidiaries outside the EU".⁸⁸ Thus, as a rule, interest paid to a non-resident major shareholder will be deducted.

Let us now assume that company 1 provides a loan finance to company 2, and company 4 provides another loan finance to company 3.

A thin capitalization rule, regarding interest paid by a resident company ("the borrowing company"), applies only to situations where the lending company has a definite influence on the financing decisions of the borrowing company, or is itself controlled by a company that has such an influence.⁸⁹ Thus, thin capitalization rules primarily affect the freedom of establishment and are to be considered in the light of Article 43 (and 48) of the EC Treaty.⁹⁰ As company 1 is resident in a Third State, it does not fall under the scope of Article 43.

Regarding the loan provided by company 4 to company 3, let us first assume, that company 4 has a share of 25% in company 3 and a definite influence on its decisions. A thin capitalization regime applicable to the interest paid to company 4, is covered under Article 43, and therefore, in this case, the doctrine in *Lankhorst-Hohorst* and in *Thin Cap Group Litigation* is applicable.

⁸⁷ See ECJ 10 May 2007, C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emmendingen*, at par 28 and ECJ, 24 May 2007, C-157/05, *Winfried L. Holböck v Finanzamt Salzburg-Land*, at par 22-24. For an analysis of the implications of these and other recent cases on the application of fundamental freedoms to third countries, see A. Cordewener *et al*, "Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with *Lasertec*, *A and B* and *Holbock*" (2007) *European Taxation* 8/9, 371-376.

⁸⁸ See CCCTB/WP061, at par 130.

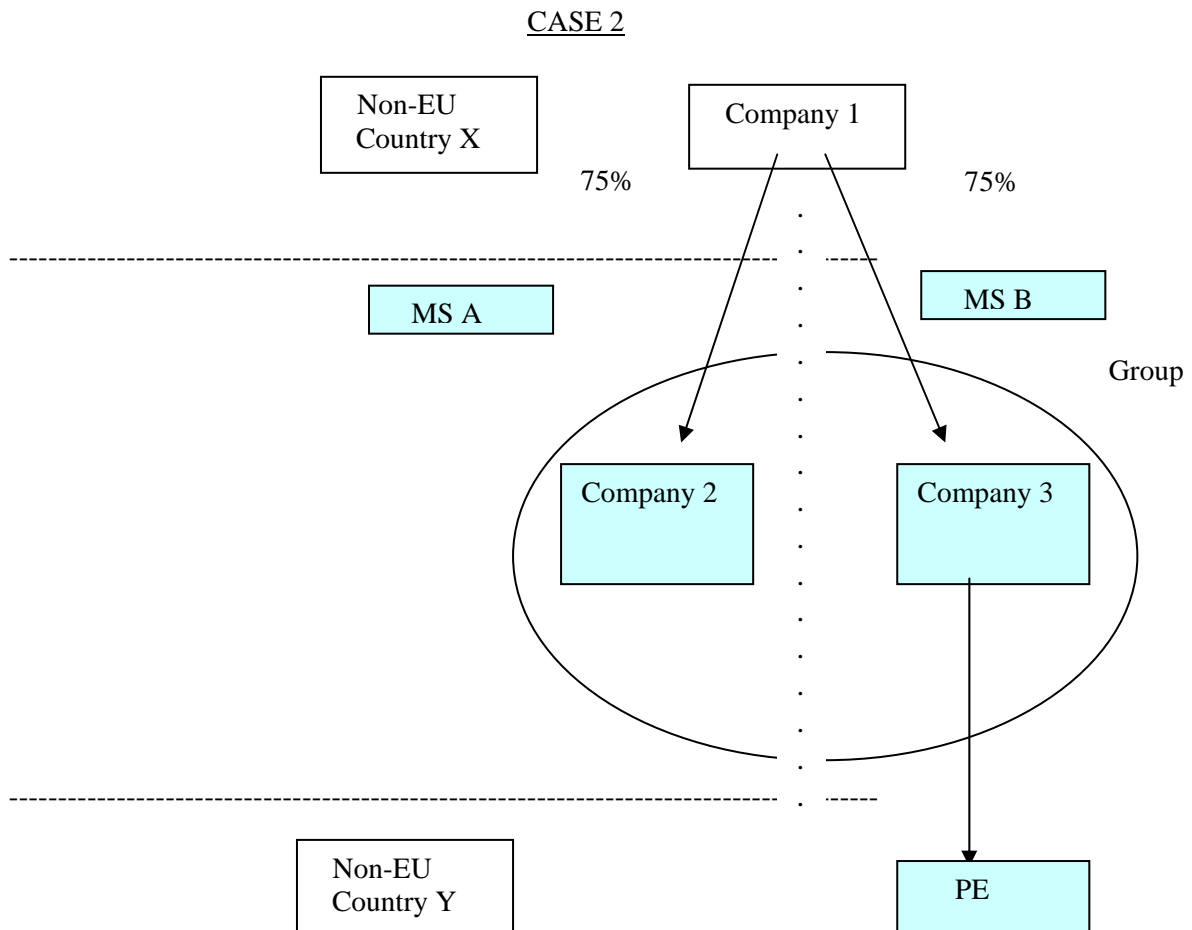
⁸⁹ *Thin Cap Group Litigation*, at par 31.

⁹⁰ *Ibid.*

Let us now assume, that company 4 does not itself have a controlling shareholding in the borrowing company 3. According to paragraph 98 of *Thin Cap Group Litigation*, “Article 43 has ... no bearing on the application of national legislation such as the legislation at issue in the main proceedings [a thin cap rule] to a situation in which a resident company is granted a loan by a company which is resident in another Member State and which does not itself have a controlling shareholding in the borrowing company, and where each of those companies is directly or indirectly controlled by a common parent company which is resident, for its part, in a non-member country”.⁹¹

This is the case, where the Member State does not apply a thin capitalization rule to this situation. Otherwise, the meaning of controlling shareholding would have to be determined according to the Member States’ criteria.

(B) It also comprises: Group of EU resident subsidiaries under the common control of a non-EU resident parent

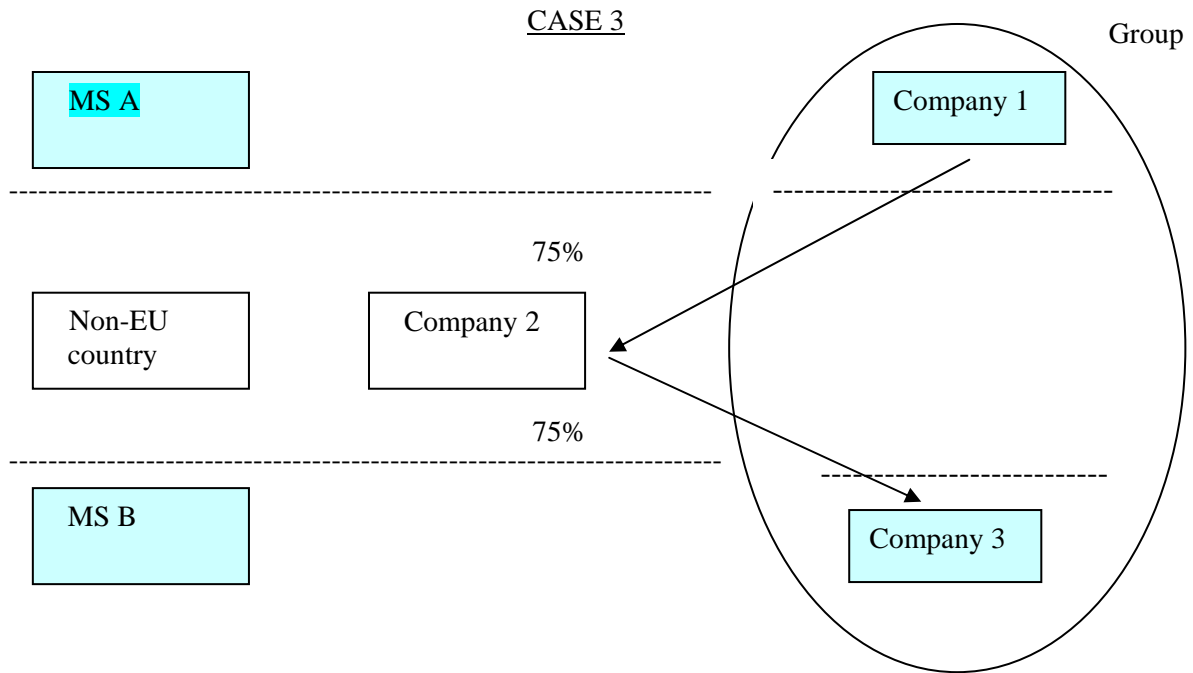


⁹¹ For a comprehensive analysis of the impact of the ruling in *Thin Cap Group Litigation* upon the protection of third countries on the basis of the fundamental freedoms, see C. HJI Panayi, “Thin Capitalization *Glo et al.* – A Thinly Concealed Agenda?” (2007) *Intertax* 35(5), 298-309. See also, R. Fontana, “Direct Investments and Third Countries: Things are Finally Moving... in the Wrong Direction” (2007) *European Taxation* 10, 431-436.

In this case, the PE provides a loan finance to company 2 and let us assume 2 situations:

1. Company 3 does not itself have a controlling shareholding in the borrowing company. As with the above mentioned case, this situation is not protected under Articles 43 and 48 of the EC Treaty.
2. Company 3 holds 75% of company 2 (and company 1 holds 25% of company 2). It results from paragraph 100 (paragraphs 99-102) of the *Thin Cap Group Litigation a contrario*, that this situation is protected under Articles 43 and 48 of the EC Treaty.

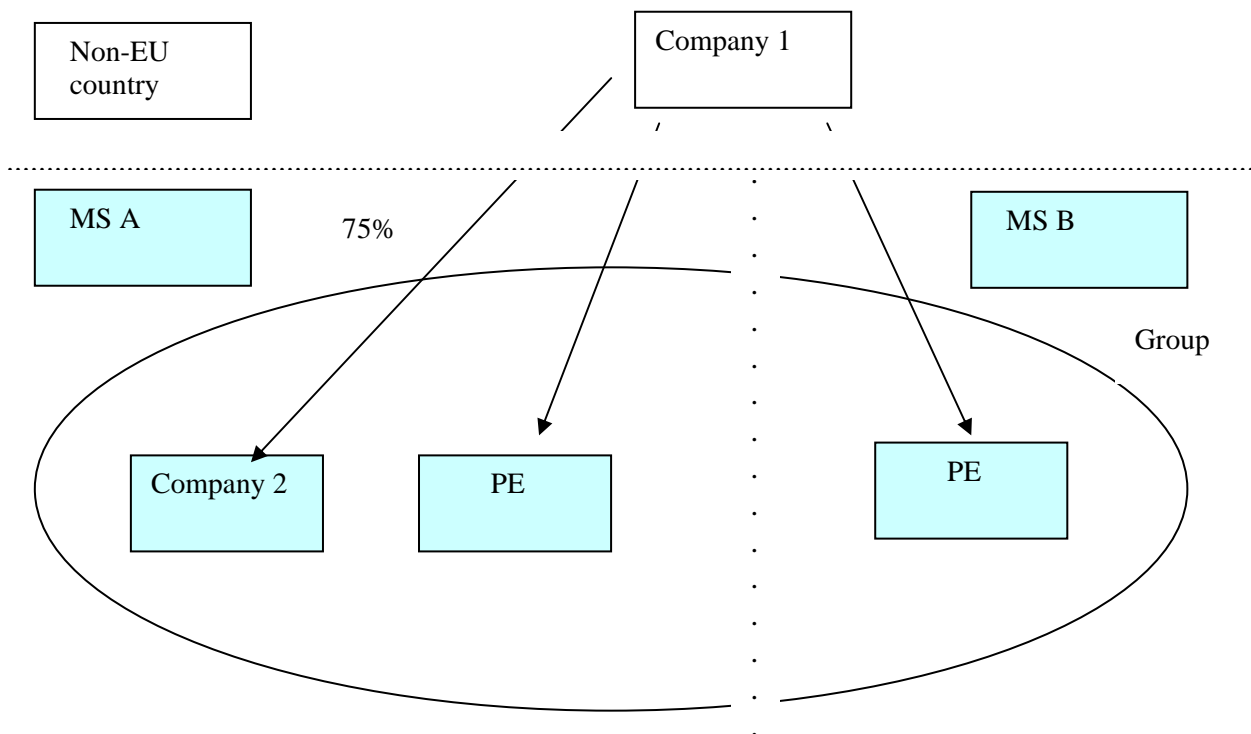
(C) *Group of EU resident subsidiaries under the common control of a non-EU resident parent even if the ownership chain of a group of EU companies includes a non-EU link company (the so-called 'sandwich' situation).*



In this case, company 2 grants a loan to company 3. According to paragraph 95 of the *Thin Cap Group Litigation*, this situation is protected under Articles 43 and 48 of the EC Treaty.

(D) It covers PEs in two MS of a non-EU resident company group and a PE and subsidiary in two MS of a non-EU resident company or group.

CASE 4



In this case, company 1 grants a loan to the PE in MS B. The situation is outside the scope of the EC Treaty, as indirectly results from par 100 of the *Thin Cap Group Litigation* and para 25-28 of *Lasertec*.

2.3 The meaning of major shareholder for the purpose of a thin capitalization regime within the CCCTB

Departing from the described CCCTB Qualifying Groups, and in order to further determine the object of the thin capitalization rule, it will also be necessary to define, in a manner which is compatible with the EC Treaty, what constitutes a “major shareholder” for the purposes of a thin capitalization rule within the CCCTB. In particular, consideration should be given as to, which of the following criteria, would be the most preferable to apply:

- 1) The criterion adopted in the CCCTB, *i.e.* at least 75%;

- 2) The definition of “parent company”, as set out in the Parent-Subsidiary Directive;⁹²
- 3) The criterion of associated enterprises, as set out in the Arbitration Convention,⁹³ or in the OECD Model Convention; or,
- 4) The ECJ case law based criterion of “definite influence”, defined in *Thin Cap Group Litigation* as: “where the two companies in question are subject to common control in the sense that one of them participates directly or indirectly in the management, control or capital of the other company concerned or a third party participates directly or indirectly in the management, control or capital of both the other companies concerned”.⁹⁴

Adopting the CCCTB criterion of at least 75% would, not only be a simple solution, but equally one that would most likely contribute to the overall cohesion of the regime (one single threshold). However, it might also be too narrow, in order to achieve the anti-abuse purpose of a thin capitalization rule, which is normally applicable to associated enterprises.

Adopting the formal criterion of the parent-subsidiary Directive (15% lowering to 10%), on the other hand, although also capable of bringing simplicity and certainty, would nevertheless depart too much from the CCCTB Group meaning, and be too broad and too formal. It may also be incompatible with the ECJ case law. Applying a fixed threshold to any shareholder holding at least 15% of the Group shares would constitute an irrefutable presumption, and as such, might be considered contrary to the ECJ case law, which requires a case-by-case analysis of the meaning of abuse.⁹⁵ This would seem to be the case, regardless of the fact that thin capitalization rule would (have to) be applicable to domestic, EU and Third States’ major shareholders, in order to avoid being discriminatory. Alternatively, a fixed threshold could be accompanied by the possibility of giving evidence that the holding does neither signify a direct nor an indirect control.

Looking at the thin capitalization rules applicable by the Member States, we can see that different thresholds are adopted to define associated companies: direct or indirect

⁹² Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20.8.1990, p. 6, as last amended by Council Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation, by reason of the accession of Bulgaria and Romania, OJ L 363, 20.12.2006, p. 129 (hereafter “Arbitration Convention”).

⁹³ Convention 90/463/EEC of 23 July 1990, OJ L 225, 20.8.1990, p. 10.

⁹⁴ See also ECJ 13 April 2000, C-251/98, *C. Baars v Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem*, [2000] ECR I-2787 (hereafter *Baars*), at par 22.

⁹⁵ For an analysis of the meaning of abuse within the ECJ case law, see R. de la Feria, “Prohibition Of Abuse of (Community) Law – The Creation of a New General Principle of EC Law Through Tax?” *Oxford University Centre for Business Taxation Working Paper Series*, WP07/23, December 2007.

ownership of more than 50% of the share capital (Denmark, France, Lithuania); 33% (The Netherlands); 25% (the previous German regime, Italy, Poland, Slovenia); 10% (Portugal); 75% (Ireland).⁹⁶ The Commission's documentation regarding the CCCTB does not focus on this point, and therefore it is unclear whether Member States' agreement on such threshold would be easily reached.

Introducing a definition of associated enterprises would probably result in some level of legal uncertainty from a taxpayers' perspective, as it would entail a case-by-case analysis of the set requirements. It would however be preferable to adopting the "definite influence" criterion,⁹⁷ as set out by the ECJ – which in itself is rather vague and thus of difficult application – unless it was subject to further clarification, in order to reduce its indeterminacy.⁹⁸

Consequently, and in light of the above, applying a thin capitalization rule at arm's length criteria to associated enterprises, as defined in the Arbitration Convention and in the ECJ case-law, appears to be a consistent, and possibly the best solution. Such definition of associated enterprises could be compiled by a fixed threshold (for example 25%), with a reversal of the burden of proof, if agreement amongst Member States could be reached.

2.4 One thin capitalization regime vs. Multiple thin capitalization regimes

In light of what has already been said, in theory, the CCCTB could potentially include four different thin capitalization regimes.

A first regime aimed at situations in which EC law, and in particular the freedom of establishment, is not applicable (see cases 1, 2 and 4 above); but, nevertheless, both the OECD's commentaries on Article 9 of the OECD Model, and the OECD's guidelines as regards transfer pricing, will still apply.⁹⁹ This rule could then be sub-divided into two others: one, applicable to situations involving a parent company resident in a Third State, which adopts a *clearly more favourable* tax regime, and which does not engage in exchange of information (in which case, a thin capitalization rule, drafted as an irrefutable presumption, could be applied); and a second one, applicable to situations involving a parent company resident in a Third State, which albeit falling outside the scope of the freedom of establishment, falls within the scope of transfer pricing rules established under *bilateral tax treaties*.

⁹⁶ See point 2 and Table 1 above.

⁹⁷ See *Thin Cap Group Litigation*, at par 27.

⁹⁸ As exemplified in *ibid*, at par 31.

⁹⁹ See *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* OECD, Paris, (1995).

A third regime targeted at situations falling within the scope of the EC Treaty, namely where the lending parent company is resident in a Member State not adopting the CCCTB (assuming that Member States will have an opt-out choice). In which case, the *Lankhorst-Hohorst* ruling would be applicable.

Finally, a fourth regime aimed at situations falling within the scope of the EC Treaty and the CCCTB (where either the lending company, or PE, or the parent company of the borrowing company belonging to the CCCTB Group, is resident in a Member State).¹⁰⁰

Alternatively, a single thin capitalization regime could be adopted, which would deal with all of the above described situations. Were this to be the case, this single regime would have to comply with, both EC law requirements (despite the fact that EC fundamental freedoms have no bearing on the application of CCCTB rules); and, regarding issues not (yet) covered by EC law, the OECD commentaries and guidelines (insofar as they are not incompatible with EC law).¹⁰¹ This would seem to constitute a much simpler solution, both from the perspective of tax administrations, and from that of CCCTB Groups, as it would substantially reduce potential administrative and compliance costs.¹⁰²

2.5 Pure arms' length approach vs. Combined arms' length / fixed ratio approach

In principle, a thin capitalization rule for the CCCTB could follow one of the three methods, usually adopted for determining the existence of thin capitalization: the arms' length principle, a debt/equity fixed ratio, or a conjugation of both.¹⁰³ Different factors militate in favour of the adoption of the arms' length method. Firstly, it is clear from the Commission's CCCTB documentation that arms' length would seem to constitute the preferred approach to deal with thin capitalization.

¹⁰⁰ It is interesting to note that not all countries applying a corporate consolidated tax basis, apply a thin capitalization rule to this group of situations: Canada, for example, does not apply a provincial thin capitalization rule (disallowing interest expense incurred on indebtedness to a non-provincial corporations), although it applies one as regards international transactions, see J. Mintz, "Corporate Tax Harmonization in Europe: It's All About Compliance", (2004) *International Tax and Public Finance* 11, 221-234, at p. 225.

¹⁰¹ For an early assessment of the compatibility of thin capitalization rules with the OECD Model Convention, see G.M.M. Michielse, "Treaty Aspects of Thin Capitalization" (1997) *Bulletin of International for International Taxation* 12, 565-573.

¹⁰² This position is also in line with W. Hellerstein and C McLure comments that, whatever the reasons why companies are not included within the scope of the CCCTB it "should not matter", as "in all instances, the excluded affiliate is effectively a 'stranger' for the CCBT group, and we see no reason as a matter for principle why the CCTB should treat these 'strangers' differently", in "The European Commission's Report on Company Taxation: What the EU can Learn from the experience of the US States" (2004) *International Tax and Public Finance* 11, 199-220, at p. 206.

¹⁰³ See point 2 above.

“[T]hin capitalization which would apply to inward investment from non-consolidated related companies (EU and third countries) would be governed by the general arms’ length principles (ALP) applied (i) interest and (ii) the amount of debts. However, comments on whether the latter condition (the AL borrowing capacity of a company) could be considered too complicated to be assessed in practice were requested.”¹⁰⁴

Secondly, a pure debt/equity fixed ratio (unless it allows for consideration of “objective and verifiable elements”) would most likely be deemed incompatible with EC law, in particular with Article 43 EC Treaty as interpreted by the ECJ in *Thin Cap Group Litigation*.¹⁰⁵ In this regard, it is interesting to note that in this ruling, the Court refers specifically to arms’ length principles, stating that national thin capitalization rules can only be justified by the need to combat abusive practices if, and insofar as, the interest paid by a resident subsidiary to a non-resident parent company “exceeds what those companies would have agreed upon on an arm’s length basis”.¹⁰⁶ The manner of this reference seems to indicate that, from a fundamental freedoms perspective, the Court too would favour this type of approach in order to deal with thin capitalization.

Finally, the OECD has also expressed preference for what it designates as “flexible thin capitalization rules”, *i.e.* those which are able to take into account individual circumstances of taxpayers.¹⁰⁷ Significantly, this preference has been attributed precisely to the need “to accommodate its findings that any domestic thin capitalization rules must be consistent with the arm’s length principle”.¹⁰⁸

Notwithstanding the above, and in practice, the adoption of purely arm’s length principles to deal with thin capitalization issues is not unproblematic. The most significant concern is the fact that it is, by its own nature, subjective and thus has the potential to give rise to high levels of legal uncertainty. In the United Kingdom, where a similar approach has been in place since 2004,¹⁰⁹ there is significant evidence of this fact. In light of these difficulties, in June 2007, the United Kingdom tax authorities issued a consultation paper with the aim of reviewing its transfer pricing regime (of which, as discussed above, the thin capitalization rules are part). By their own admission, the regime has the potential to “impose significant compliance burden on companies to demonstrate, by assembling evidence, that arm’s length results have been

¹⁰⁴ See CCCTB/WP/059, at p. 9; see also CCCTB/WP/041, at pp. 7-8.

¹⁰⁵ See point III.1.1 above.

¹⁰⁶ *Thin Cap Group Litigation*, at par 80. The same language was used by the Court recently in *Lammers*, at par 30.

¹⁰⁷ See OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

¹⁰⁸ See A.M.C. Smith and P.V. Dunmore, “New Zealand’s Thin Capitalization Rules and the Arm’s Length Principle” (2003) *Bulletin for International Taxation* 10, 503-510, at p. 505.

¹⁰⁹ See point II.1.3.16 above.

used”; as well as to “involve complex analysis and specialist knowledge which can make disputes difficult and lengthy to resolve”.¹¹⁰ In fact, previous informal consultations with companies, professional advisors and other interested parties had already indicated that “the cost of complying with transfer pricing rules was an even greater concern for businesses than the time taken to resolve enquiries”; and that “the main concern for businesses involved knowing what sort of evidence HMRC would find acceptable and how to apply a risk based approach in assembling it”.¹¹¹ These findings are in line with previous surveys, undertaken by the European Commission, which highlight the significance of transfer pricing issues, in the context of compliance costs for EU groups of companies.¹¹²

In the context of the CCCTB, these problems have the potential to be significantly exacerbated. The subjective nature of the arm’s length principle would leave a wide discretion to Member States as regards its application. The potentially emerging discrepancies could result in precisely the same type of economic distortions that the CCCTB is aimed at eliminating.¹¹³ If, therefore, the flexibility provided by the arm’s length approach constitutes its biggest advantage, it can also be regarded as its greatest weakness. It is important to keep in mind that, the CCCTB aims precisely at avoiding the disadvantages of the transfer pricing methodology within the EU.

In light of the above, we believe that the best solution, in order to deal with thin capitalization in the context of the CCCTB, would be one which encapsulates the benefits of the arm’s length approach, but mitigates its disadvantages. We therefore propose the adoption of a hybrid method, similar to those already in use within several countries,¹¹⁴ which combines arm’s length principles with the adoption of a fixed debt/equity ratio, and where the latter acts as a safe harbour.¹¹⁵

¹¹⁰ HM Revenue & Customs, *HMRC Approach to Transfer Pricing for Large Business*, Consultation Document, 20 June 2007, at p. 6, available at: <http://customs.hmrc.gov.uk/>.

¹¹¹ *Ibid*, at pp. 7-8.

¹¹² B.J.M. Terra and P.J. Wattel, *European Tax Law*, Fourth Edition, Kluwer Law International (2005), at pp. 577 *et seq.*

¹¹³ See C. Spengel and C. Wendt, *Oxford University Centre for Business Taxation Working Paper Series*, 2007, at pp. 1 and 8; and European Commission, *Company Taxation in the Internal Market*, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, COM(2001) 582 final, 23 October 2001, at p. 10.

¹¹⁴ *E.g.* New Zealand, see A.M.C. Smith and P.V. Dunmore, *Bulletin for International Taxation* 2003.

¹¹⁵ In the United Kingdom, the introduction of safe harbours, in the context of the review of the transfer pricing regime, has been subject to debate. Although acknowledging that such a measure would “provide certainty to companies”, the tax authorities have however come out strongly against its introduction, see HM Revenue & Customs, *HMRC Approach to Transfer Pricing for Large Business*, at pp. 12-13.

3. Proposal for a Thin Capitalization Rule within the CCCTB: Main Guidelines

In light of the above, and insofar as combined EC law and OECD requirements provide adequate protection against abusive practices involving Third States, we propose the following:

- adoption within the scope of the CCCTB of a specific anti-abuse provision to deal with thin capitalization, rather than the adoption of a general anti-abuse clause;
- adoption of a single thin capitalization regime, rather than multiple thin capitalization regimes applicable to different factual circumstances;
- adoption of a hybrid arms' length / fixed ratio approach in order to establish the existence of thin capitalization, rather than either a strict arm's length principle approach, or a fixed debt/equity ratio.

If the proposed solution is adopted, drafting of a thin capitalization regime should still observe the following conditions:

1. Be compatible with EC law, and in particular EC Treaty provisions on the fundamental freedoms, as interpreted by the ECJ in the *Lankhorst-Hohorst* and *Thin Cap Group Litigation* rulings, and the OECD commentaries and guidelines on the matter.
2. The above would mean in practice that application of the thin capitalization regime should result in principle, in the deductibility of interest, but the proposed regime should also allow verification of specific factors, namely:
 - 2.1 Whether the loan can be regarded as a loan, or should be regarded as some other kind of payment, in particular a contribution to equity capital;
 - 2.2 Whether the loan would have been made if it were at arm's length;
 - 2.3 Whether the amount of the loan itself observes arm's length conditions;
 - 2.4 Whether the amount of interest paid observes arm's length amount (what would have been agreed at arm's length between the parties and between the parties and a third party).
3. In case of re-characterisation of interest as profits, these should correspond to the profits that would have accrued at arm's length.
4. Reversal of the burden of proof is not only acceptable, but arguably required, in light of the practicability principle, as long as the administrative compliance requirements are not disproportionate.

5. Allow for the possibility of providing evidence as to any commercial justification for the transactions, without being subject to any undue administrative constraints.
6. Be simple, in order to ensure low compliance costs (for example, the interest deduction limitations may be excluded to small transactions).
7. Express cross-reference to the OECD commentaries and guidelines is advisable, in order to avoid a regime that is too detailed, and thus too complex.
8. Express cross-reference to the Arbitration Convention, as regards situations covered under Article 43 of the EC Treaty, but not under the CCCTB.

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