Universidade do Minho
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Debt Bias in Corporate Taxation: Possible Consequences and Solutions

Abril de 2016

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Dissertação de Mestrado
Mestrado em Direito dos Negócios, Europeu e Transnacional

Trabalho efetuado sob a orientação do
Professor Doutor João Sérgio Ribeiro

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Abstract

This research first addresses the different tax treatment that is given to debt and equity financing, showing that the benefits associated with debt make this source of financing more attractive. The different treatment of these two forms of finance incentivizes debt exploitation, by which deductibility of interest payments decreases the tax base in a high-tax jurisdiction, preferably ending up in a low-tax jurisdiction's tax base. This project shows that the deductibility of interest for tax purposes combined with the existence of a myriad of different tax systems leads to a number of possibilities for tax arbitrage, especially through international debt-shifting and hybrid financial instruments.

It then demonstrates that the most popular response given by countries to mitigate this debt bias problem has been the adoption of thin capitalization rules which are aimed at limiting the deduction of interest that is deemed excessive. This research intends to look at these rules in the context of the OECD, tax treaties and EU law.

The work presented concludes by providing two alternatives (the ACE and the CBIT systems) in order to achieve more neutrality between debt and equity.

Keywords: group financing, multinational companies, tax arbitrage, thin capitalization rules, interest deduction.

Resumo

Esta pesquisa começa por abordar o diferente tratamento fiscal que é dado à dívida e à equidade, mostrando que os benefícios associados com a dívida tornam esta fonte de financiamento mais atractiva. A diferença de tratamento entre estas duas formas de financiamento incentiva a exploração da dívida, através da qual a dedutibilidade de juros diminui a base tributária numa jurisdição de alta tributação, de preferência terminando numa jurisdição que aplique baixas taxas de imposto. Este projeto mostra que a dedutibilidade de juros para efeitos fiscais, combinada com a existência de uma miríade de diferentes sistemas fiscais, leva a uma série de possibilidades para arbitragem fiscal, especialmente através do deslocamento da dívida a nível internacional e de instrumentos financeiros híbridos.

É, seguidamente, demonstrado que a resposta mais popular dada pelos países para atenuar este problema de recurso excessivo ao financiamento por endividamento tem sido a adopção de regras de subcapitalização, que visam limitar a dedução dos juros considerada excessiva. Esta pesquisa pretende analisar estas regras no contexto da OCDE, dos tratados fiscais internacionais e da legislação Europeia.

Na sua parte final, este trabalho oferece duas alternativas (os sistemas CBIT e ACE) com vista a alcançar mais neutralidade entre as duas formas de financiamento.

Palavras-chave: financiamento intra-grupo, empresas multinacionais, planeamento fiscal agressivo, regras de subcapitalização, dedutibilidade de juros.

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Abbreviations

ACE - Allowance for Corporate Equity

ATA Directive - Anti-Tax Avoidance Directive

BEPS - Base Erosion and Profit Shifting

CBIT - Comprehensive Business Income Tax

CCCTB - Common Consolidated Corporate Tax Base

CFC - Controlled Foreign Company

CIT - Corporate Income Tax

CJEU - Court of Justice of the European Union

EBIT - Earnings before Interest and Tax

EBITDA - Earnings before Interest, Taxes, Depreciation and Amortization

EU - European Union

G20 - Group of the Twenty Major Economies

IBFD - International Bureau of Fiscal Documentation

INE - Interest on Net Equity

IRD - Interest and Royalties Directive

MAP - Mutual Agreement Procedure

MS - Member States

NID - Notional Interest Deduction

OECD - Organisation for Economic Co-operation and Development

OECD-COM - OECD Commentaries

OECD-MC - OEDCD Model Convention

PSD - Parent and Subsidiary Directive

TFEU - Treaty on the Functioning of the European Union

UK - United Kingdom

UN - United Nations

US - United States

WACC - Weighted Average Cost of Capital

Introduction

The development of international trade and the growth of new business strategies have turned the world into a massive global market. As a result of increasing globalization and competitiveness, companies are vigorously reconsidering their business models and operational structures by relocating capital and labour from one country to another.[1] Companies operating in an international environment are usually provided with greater opportunities to enter new and more appealing markets and to produce at lower costs.

However, companies also face costs and difficulties when operating in different countries and these are usually associated with economic and cultural reasons[2] and with non-harmonized legal structures[3]. Tax systems represent a typical example of this. On this subject studies have suggested that tax harmonization may be an unlikely scenario, at least in the near future, and the history of the European Union has also shown the difficulty of designing a common tax framework for countries, even if they have common trade interests.[4]

Direct tax systems fall within the sovereign competence of the states and, as a result, different tax rates are applied.[5] Different tax rates and different tax treatment lead to tax competition, which gives taxpayers the possibility to choose jurisdictions that provide them with better tax opportunities. The main purpose of a business is to maximize profits and to reduce costs and since taxes are a major cost that companies have to face, they will try to exploit tax differentials in order to achieve tax optimization.

The methods by which a company is financed are thus very important given that they will influence the taxation of corporate income. Company financing can be done by means of equity and debt[6]. This research will first look at the different treatment that is given to these capital structure strategies and show that, because most countries tax debt and equity in a

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[1] Finnerty, et al., *"Fundamentals of International Tax Planning"*, IBFD, 2007, p.252.

[2] For a more detailed overview see Dunning, *"The Eclectic (OLI) Paradigm of International Production: Past, Present and Future"*, International Journal of the Economics of Business, Vol. 8, No. 2, 2001, pp. 173-190.

[3] Wendt, *"A Common Tax Base for Multinational Enterprises in the European Union"*, Gabler: Wiesbaden, 2009, pp.12 et seq.

[4] Mitchell, *"The Economics of Tax Competition Harmonization vs. Liberalization"*, Adam Smith Institute, November 2009, pp. 1-12.

[5] Considering direct taxation, this autonomy, however, may be considerably restricted by secondary EU law in the form of directives and by international tax treaties.

[6] Zaburaite, *"Debt and Equity in International Company Taxation"*, in International Group Financing and Taxes, Wien: Linde, 2012, pp. 11-32.

different manner, there is a tax-induced bias towards debt financing.[7] This study will then demonstrate that the different treatment given to these types of funding can lead to aggressive tax planning in the sense that multinational companies have the opportunity to finance their foreign subsidiaries, usually residents in high-tax jurisdictions, by replacing equity financing with a high proportion of debt-financing.[8]

Aggressive tax planning is a subject of broad and current interest in the international policy agenda given that many countries face high levels of debt and huge pressure to generate tax revenue. For this study two types of tax arbitrage are particularly relevant: hybrid financial instruments and debt-shifting within international groups.

We have witnessed a sort of cat-and-mouse game between companies - trying to reduce their tax liability through exploiting loopholes in existing tax rules; and governments - subsequently concerned with the loss of tax revenues.[9] States try to counteract this process by adopting standards aimed at combating specific behaviours and situations that, because of the risks they involve, deserve special attention.

One of the specific measures adopted is the thin capitalization regime, which attempts to prevent, on the one hand, excessive debt and, on the other, the movement of income for states whose tax jurisdictions are more attractive. In order to preserve their own tax revenues, many OECD countries have adopted thin capitalization rules.

Over the last few years, thin-capitalization rules have attracted considerable attention due to their possible interference with EU law and interaction with tax treaty provisions. This project addresses the compatibility of national thin capitalization rules with the European Union law, specifically with the fundamental freedoms of the TFEU. Assuming that closing loopholes usually leads to refinements and complexities of tax laws, the final goal of this paper is to see if thin capitalization rules are a viable instrument and an effective solution to the problem of debt bias.

This research concludes by providing two possible solutions to the debt bias problem in order to achieve more neutrality in the treatment that is given to debt and equity.

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[7] Vleggeert, *"Interest Deduction Based on the Allocation of Worldwide Debt"*, Bulletin for International Taxation, volume 68, No 2, 2014, p.103.

[8] Haufler and Runkle, *"Firms" Financial Choices and Thin Capitalization Rules under Corporate Tax Competition"*, CESifo working paper, October 2008, p.1.

[9] Fuest, Spengel, Finke, et al., *"Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform"*, Discussion Paper No. 13-078, 2013.

Part I- The bias towards debt in current tax systems and tax arbitrage

1. Equity vs. Debt

1.1. A legal perspective

Group financing is a major concern for international tax law policy makers because the methods companies choose to finance their operations will have impact on the taxation of corporate income[10]. In order to raise capital and expand or save the business, companies need to explore financial resources. External financing can therefore be achieved by virtue of new equity or new debt.

Equity financing comprises the sale of ownership shares in the company in exchange for advanced payment per share. With this financing method, shareholders expect to recover their money by taking part in the company's growth. The return on investment will, therefore, be in accordance with the prosperity of the company.

With debt financing, capital is made available through a loan from a bank or a lender or through the sale of bonds. The money has to be paid back at a fixed interest rate within a stipulated period of time. Independently from the performance of the company in the following years, the terms of the loan usually remain the same as the return on investment that the lender expects to receive.

Even though equity and debt share the same economic purpose- to provide finance to the business, the fact is that most jurisdictions treat equity and debt differently and thus some properties are used in order to distinguish them. Debt holders have a legal right to receive a return that is previously established, regardless of the financial status of the debtor. In what concerns equity holders, they receive a return that is changeable since it is dependent on the company's performance. In the case of insolvency debt holders have a prior claim to the company's assets while equity suppliers receive any residual claims only after debt has been paid.[11] Also, suppliers of equity usually have control rights over the company while debt holders do not.

For tax purposes, the most significant difference is that interest payments are deductible for corporate income tax purposes while equity returns are not. While equity

[10] Sommerhalder, *"Approaches to Thin Capitalization"* European Taxation, March 1996, p.82.

[11] Schön, et al., *"Debt and Equity: What's the Difference? A Comparative View"*, Competition and Tax Law Research Paper 09-09, Munich: Max Planck for Intellectual Property, 2009.

investment seeks to create a return for the investor in the form of a distribution of taxable profits, the return on a loan investment is, for the payer, an expense that has to be met before the profits can be determined.[12] Moreover, the return on equity is taxed twice- at the level of distributing company and then in the hands of a recipient of dividends; whereas the return on the loan is taxed only once. Against this background, it may be more advantageous for companies to finance their investments with debt rather than equity capital.[13]

Debt and equity features still leave scope for a wide variety of interpretive approaches making tax laws highly complex. Hybrid financial instruments, which will be addressed later in this research, are the major cause of this essentially because they combine some characteristics of equity and others of debt, ending up being an attractive channel for tax arbitrage.

1.2. Economic approach

Miller and Modigliani (MM) developed a theorem regarding capital structure, company value and tax effects, which strongly contributed to the shaping of modern thinking. The MM capital-structure irrelevance theory, developed in 1958, suggests that the financial leverage of a company has no effect on its market value and, as such, the company value relies on cash-generating power rather than on the capital structure.[14] In this sense, the WACC[15] remains constant as the firm's leverage grows.

This theory, however, fails by not taking into consideration real market conditions, such as, asymmetric information, taxes, transaction costs, bankruptcy costs, agency conflicts, adverse selection, among others. Independently from how a company borrows, there will not be any tax benefit from interest payments and, consequently, no alterations or benefits to the

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[12] Soshnikov, *"Structure and Elements of National Thin Capitalization Rules"*, in International Group Financing and Taxes, Wien: Linde, 2012, p.57.

[13] Gouthière, *"A Comparative Study of the Thin Capitalization Rules in the Member States of the European Union and Certain Other States: Introduction",* European Taxation, 2005, p.367.

[14] Modigliani and Miller, *"The Cost of Capital, Corporate Finance and the Theory of Investment"*, American Economic Review, vol. 48, No. 3, 1958.

[15] Weighted average cost of capital (WACC) is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted.

WACC. In addition, as no changes or benefits derive from an increase in debt, the capital structure does not affect the company value in the market.

In 1963 the MM model was revised and updated by adding, among others, a tax dimension and going against what had been previously established. This is especially because when taxes are integrated into this theory, a benefit is conferred to debt as, to a certain degree, interest payments protect earnings from taxes.[16] The trade-off theory of leverage acknowledges that tax advantages come from interest payments, since interest paid on debt is deductible and dividends paid on equity are not.[17]

In summary, the main difference between the two theories is that, while in the MM I theory, where taxes are not considered, the amount of a firm's debt and equity is irrelevant, in the MM II, with corporate taxes, a firm which has more debt is more valuable due to the interest tax shield.

Following evidence shows that tax benefits, among other factors, influence financing choices.[18] However, opinions diverge regarding which factors are considered to have more importance and how they may influence firm's value.

1.3.Potencial risks of excessive debt

When a firm increases its debt beyond the amount estimated by the optimal capital structure, the cost to finance debt usually rises given that the lender is now placed in a situation where he is more vulnerable to risk.

Even though in the trade-off theory of leverage, a firm's value is increased when it is approximately 100% debt financed, realistically, this does not help maintain the firm's operations totally sustainable. The theory, however, recognizes that firms do not use as much debt when the expected costs associated with financial distress are high. Firms are usually influenced to prefer lower levels of debt especially because of the presence of agency, bankruptcy, and signaling costs.

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[16] Modigliani and Miller, *"Corporate income taxes and the cost of capital: a correction"*, American Economic Review, vol. 53, No. 3, 1963.

[17] Zaburaite, *"Debt and Equity in International Company Taxation", in International Group Financing and Taxes"*, Wien: Linde, 2012, pp. 11-32.

[18] Graham, *"A Review of Taxes and Corporate Finance"*, vol. 1, No. 7, 2006, pp. 573–691; *See,* also, Shyam-Sunder and Myers, "Testing Static Tradeoff against Pecking Order Models of Capital Structure", Journal of Financial Economics 51, 1999, pp.219-244.

Agency costs are related to negotiations that have to take place between stakeholders, particularly shareholders, bondholders and managers, in order to reach a consensus regarding the decision-making process of the company. Conflict of interests may arise where, for example, managers want to engage in risky activities- expecting to achieve higher returns for shareholders; but bondholders prefer a safer investment and place constraints on the use of their money in order to mitigate their risk.[19]Costs aimed at achieving a coordination of interests between the different stakeholders are called agency costs. Managers may have to convince shareholders that a specific type of financing will guarantee advantages to the business. Company value maximization alone is not sufficient. In this way, agency costs may interfere with leverage choices and mitigate the tax advantages offered by debt.[20]

Bankruptcy costs, which usually increase with the level of debt, involve both direct and indirect costs. Direct costs comprise expenses like fees that a firm has to pay to lawyers, accountants, trustees, among others. Indirect costs are those that derive from a negative reaction in the market when the company is facing the possibility of bankruptcy. For example, suppliers may decrease payment terms, customers may consume less as they are concerned with the company's ability to guarantee future assistance, and managers will be focused on the company's survival, rather than looking for new business opportunities.[21] The closer to bankruptcy, the higher the costs. Highly leverage companies are more exposed to shocks and, consequently, to the risk of bankruptcy.

Debt issuance may also cause signaling costs. On this matter, authors' opinion differ and empirical studies are, to a certain degree, inconclusive. On the one hand, debt issuance may suggest external investors that the company is confident in its capability to repay the debt (Ross 1977)[22]. On the other hand, Myers and Majluf (1984) claim that debt issuance can be viewed as a signal of bad health due to, for example, a lack of liquidity or internal resources in the company. In the pecking order theory, Myers and Majluf sustain that, first, companies resort to internal financing, then, and once this means is exhausted, they turn to debt issuance and, only when it is no longer reasonable to issue debt, do the firms resort to external equity.

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[19] Jensen, *"Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers"*, American Economic Review, vol. 76, No. 2, May 1986, pp. 323-329.

[20]Van Horne and Wachowicz, *"Fundamentals of Financial Management"*, Harlow: Pearson Education, 13th edition, 2008, p.427.

[21] Warner, *"Bankruptcy Costs: Some Evidence"*, The Journal of Finance, Volume 32, Issue 2, Papers and Proceedings of the Thirty-Fifth Annual Meeting of the American Finance Association, Atlantic City, New Jersey, May,1977, pp. 337-347.

[22] Ross, *"The Determination of Financial Structure: The Incentive-Signalling Approach",* The Bell Journal of Economics, vol. 8, No. 1, 1977, pp. 23-40.

According to the authors, the issue of shares is the less preferred means to inject capital into the company because when managers who, as a general rule, are more informed about the real conditions of the company than the shareholders, issue shares, investors will assume that the company is overvalued and that managers are taking advantage of that. Under this theory, the asymmetric information between shareholders and managers may induce firms to use more debt than equity.[23]

Also, the information asymmetry between debt and equity markets may originate differences in their international mobility by making debt more mobile than equity and, thus, more difficult to tax at source. Foreign investors may feel reluctant in acquiring a company in another country as they might be overcharged by domestic owners who have more information about the future expectations of the company.[24] According to Tirole, "outsiders cannot observe the insiders' carefulness in selecting projects, the riskiness of investments, or the effort they exert to make the firm profitable".[25]

Another relevant issue is the fact that credit constraints may be more applied to companies in growth than to mature companies. This is especially because lenders may be more reluctant to supply credit when they cannot verify certain behaviour by debtors. Thus, companies with relatively few assets and large investment opportunities, may not benefit from the general deduction for interest as much as companies that already have access to external borrowing. Consequently, this can lead to excessive investment by robust companies and too little investment by start-ups and growing companies. In this sense, the debt bias might decrease firm dynamics and foster long-term economic growth.[26]

Deduction for debt is only allowed based on the premise that interest is the cost of doing business whereas equity returns reflect business income. However, this rationale may raise some questions in economic terms and more neutrality in the taxation of debt and equity might be desirable. The above mentioned considerations do not provide convincing reasons for a recurrent favouritism towards debt but the asymmetric tax treatment given to these

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[23]Myers and Majiuf, *"Corporate Financing and Investment Decisions When Firms Have Information the Investors do Not Have",* NBER working paper series, working paper No. 1396, July1984.

[24] Gordon and Bovenberg, *"Why is Capital so Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation"*, National Bureau of Economic Research, working paper No. 4796, July 1994.

[25] Tirole, *"The Theory of Corporate Finance"*, Princeton University Press, 2006, p.2.

[26] Keuschnigg and Ribi, *"Business Taxation, Corporate Finance and Economic Performance"*, Discussion Paper no. 2010-04, January 2010.

means of financing investment may motivate companies to strongly rely on debt finance.[27] In addition, debt financing has been used as a vehicle for aggressive tax planning through profit-shifting to jurisdictions that apply lower tax rates.

[27] Haufler and Runkle, *"Firms" Financial Choices and Thin Capitalization Rules under Corporate Tax Competition"*, CESifo working paper, October 2008.

2. Agressive tax planning and financial policies

Tax planning, as a means of reducing or deferring the tax burden, is a practice that has accompanied the taxation over the centuries, being, therefore, something intrinsic to the existence of tax regimes. Tax planning is commonly defined as the set of acts which, under the law, are intended to reduce or minimize the tax burden of the taxpayer.

While tax avoidance comprises the use of legal methods, tax evasion is a practice not only objectionable from an ethical point of view but also illegal and punishable under the terms defined by tax codes. Many consider tax planning a practice only accessible to a small group of taxpayers who use complex mechanisms in order to reduce or eliminate taxation, that is, tax planning is seen as a distant reality and only at the service of those who have the knowledge and the financial resources needed for this purpose. On this subject, it is relevant to note that tax planning is not an elitist practice but rather the application of the knowledge of the law to a specific tax situation.[28] More than that, tax planning is a right of taxpayers.

In the wise words of Saldanha Sanches, tax planning plays an indispensable role in a tax system where it is up to the taxpayer to interpret and apply the law and to determine and quantify its tax obligations.[29]

Taxpayers have, on the one hand, a fundamental duty to pay their taxes, thereby contributing to the economic and social sustainability of the society in which they operate and, on the other, the freedom to fiscally plan their activities and their income in order to delimit the amount of their tax obligations. However, the distinction between legitimate and illegitimate tax planning is becoming more tenuous and may depend on the interpretation and discretion of the tax administration.[30]

Furthermore, the analysis and discussion of the main mechanisms of tax planning, as well as, remedies or measures adopted by the tax authorities to combat some types of aggressive tax planning may lead us to the traditional image of the cat and mouse game where the state defines the rules and taxpayers rapidly try to find ways to circumvent them and avoid taxation. Additionally, in the permanent tension between states and taxpayers, the state is not only a passive actor of tax planning, but also the main author of several tax planning

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[28] Silva, in *"O direito dos contribuintes ao planeamento fiscal"*, TOC 104, November 2008.

[29] Sanches, *"As Duas Constituições- Nos Dez Anos da Cláusula Geral Anti-Abuso"*, in "Reestruturação de Empresas e Limites do Planeamento Fiscal", Coimbra Editora, 2009.

[30] Russo, *"Fundamentals of International Tax Planning"*, IBFD, Amsterdam, 2007, pp. 49-61.

mechanisms and policies aiming at increasing tax competition in the country against third parties and achieving certain economic goals.

The issue of tax planning begins to be truly discussed, however, when the behaviour of taxpayers deviates from the tax planning possibilities that the law, itself, deliberately allows and when taxpayers take advantage of legal forms and the letter of the law to achieve results that they would not get if they acted within the normal use of rules and business.

Aggressive tax planning comprises the practice of lawful acts but whose results may not be accepted by the law because they are contrary to the principles underlying the tax system. In this case, the acts and practices of taxpayers are, per se, lawful but the tax authorities may consider these concrete acts illegitimate to the extent that they only seek to obtain the elimination or reduction of taxes.

Multinational companies make important decisions in which taxation is a crucial factor. Such decisions may include where to locate a foreign operation, which legal form these operations should take and how these operations are to be financed. Companies can adopt different aggressive tax planning strategies to reduce their taxes by structuring their transactions and operations so that they result in the smallest tax burden possible.[31]

In order to reduce its tax burden, a multinational corporation has various ways to structure its activities.This tax planning may involve conventional decisions to structure companies in a way which is tax efficient, for instance, by using debt instead of equity financing. However, there are also less conventional practices that take advantage of the specific characteristics of multinational enterprises. Particularly, tax planning makes use of profit-shifting strategies which merely entail the adjustment or adaptation of the internal structure of the multinational company.

Although there are various ways to shift profits, one prominent technique comprises the use of internal loans by borrowing from affiliates situated in low-tax jurisdictions and lending to affiliates situated in high-tax countries. This will result in the reduction of profits throught the deduction of interest payments in high-tax countries. These profits will then be taxed as earnings in the low-tax jurisdiction.

When multinational companies analyse their investment strategies, which include finding the best possible way to pay less taxes, they tend to adopt a profit-migration technique meaning the moving of profits from a high-tax jurisdiction to a lower-tax one.

[31] Holtzblatt, Jermakowicz and Epstein, *"Tax Heavens: Methods and Tactics for Corporate Profit Shifting"*, International Tax Journal, 2015.

Legislators have been trying to combat this phenomenon by creating anti-abuse measures. However, experience has shown that the innovations created by taxpayers are very advanced compared to the reaction means available to the legislator and the tax authorities.[32] Some of the problems faced by this common mission of enforcing the tax laws are the increasing globalization, the liberalization of capital markets and the technological innovation, leading to the emergence of corporate structures that may challenge the current tax rules and mechanisms that may facilitate the failure of national tax obligations.

The use of offshore accounts, the movement of assets between companies in the same group and the use of different existing tax systems were some of the mechanisms highlighted in the Seoul conference, which took place in September 2006 and brought together leaders of the tax administrations of 35 countries.[33] The conference also brought to light concerns with the role of legal and financial consultancy firms, investment banks and other institutions in promoting schemes aimed at obtaining abusive tax gains.

Tax avoidance can be a lucrative global industry and it can be assumed that there are professionals who ensure that, even though the letter of the law is respected, creative and immoral ways of perverting the spirit of the law can be found in order to avoid tax.[34]

Regardless of the variety of channels used by multinational companies to shift their profts, there exits evidence that the use of financial policies[35] plays an important role in this process, specifically debt-shifting between multinational enterprises and hybrid financial instruments.

3. Profit-shifting via debt-fiancing

The amount of debt in a group entity may be altered by multinational groups via intra-group financing and advantageous tax results can be achieved as a result. Academic studies

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[32] Sousa, *"O planeamento fiscal abusivo. O Decreto-lei 29/2008 de 25 de Fevereiro e os esquemas de planeamento fiscal abusivo.",* Working papers TributariUM, June 2012.

[33] OECD, Third Meeting of the OECD Forum on Tax Administration, Final Seoul Declaration, 14-15 September 2006, Centre for Tax Policy and Administration.

[34] Sikka and Hampton, *"The Role of Accountancy Firms in Tax Avoidance: Some Evidence and Issues"*, Accounting Forum, Academic Journal, September 2005.

[35] In what concerns financial policy, there are two key choices that companies usually make: how much of their capital structure should be supported by debt instead of equity, and how much of their earnings should be retained for internal equity finance, instead of paying dividends and issuing new equity in the market.

have considered the impact of tax rules on the location of debt and it has been acknowledged that groups are able to multiply the level of debt at the level of individual group entities by way of intra-group financing.[36]

In accordance with Action 4 of the BEPS project, base erosion and profit shifting risks may appear in three possible situations: "(i) groups placing higher levels of third party debt in high tax jurisdictions; (ii) groups using intra-group loans to generate interest deductions in excess of the group's actual third party interest expense; and (iii) groups using third party or intra-group financing to fund the generation of tax exempt income."[37]

When these possibilities are exploited by multinational groups, competitive distortions may occur between groups operating at an international level and those performing in the domestic market. This may negatively impact capital ownership neutrality, establishing a tax preference for assets to be held by multinational groups rather than by domestic ones.

Research shows that groups tend to leverage more debt in subsidiaries situated in high tax-jurisdictions[38] and that debt shifting does not only affect developed countries but also developing ones, which, may end up more exposed to these risks[39], partially because in these countries production costs are usually lower but the tax on business income is generally high, so that makes up for finance subsidiaries located in jurisdictions with high tax rates through debt, making use of the interest deductions to relieve the tax burden.

Studies have also shown that thin capitalization is firmly related to multinational groups and that foreign companies use more debt when compared to domestically-owned ones.[40] Additional debt may be provided through both intra-group and third party debt, with intra-group loans typically used in cases where the borrowing costs on third party debt are high.[41]

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[36] Desai, Foley, and Hines, *"A Multinational Perspective on Capital Structure Choice and Internal Capital Markets"*, The Journal of Finance, vol. 59, Issue 6, December 2004, pp.2451-2487.

[37] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, p.11.

[38] Huizinga, Laeven, and Nicodeme, *"Capital Structure and International Debt-Shifting"*, Journal of Financial Economics, vol.88, Elsevier, Amsterdam, pp.80-118; Mintz and Weichenrieder, *"Taxation and the Financial Structure of German Outbound FDI"*, CESifo working paper no. 1612.

[39] Fuest, Hebous and Riedel, *"International Debt Shifting and Multinational Firms in Developing Economies"*, Economic Letters, vol. 113, Issue 2, November 2011, pp. 135-138.

[40] Taylor and Richardson, *"The Determinants of Thinly Capitalized Tax Avoidance Structures: Evidence from Australian Firms"*, Journal of International Accounting, Auditing and Taxation, vol. 22, Elsevier, Amsterdam, pp. 12-25.

[41] Buettner, et al., *"The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions"*, ZEW Discussion Paper No. 06-068, 2006.

In chapter II, this research will show how countries are responding to this phenomenon and will look at the OECD work on BEPS through interest deduction, specifically at Action 4.

4. How hybrid financial instruments can affect tax planning

International capital markets have been facing the emergence of new financial instruments and techniques. Globalization and technological changes have played a leading role, making the global securities market closer. As markets become less distinct and more mixed, capital-raising exercises are increasingly seen on an international basis rather than on a merely domestic one.

New financing techniques for both debt and equity are growing unexpectedly fast in an attempt to meet the needs of sophisticated investors. Investors are now provided with a more complex package, which usually entails the merging of the more conventional features of debt and equity.

A hybrid financial instrument can be defined as a security including two elements, equity and debt, which could be described as either a bond with equity characteristics or a share with debt features.[42] These instruments may have the typical legal features of the one category but the economic features of the other or they can allow for the possibility of converting the investment from one form to another.[43] When investing in hybrid instruments, investors may either get a fixed or floating rate of return and payment returns may come in the form of interest or dividends.

Within the range of hybrid financial products[44], convertible bonds and convertible preferred shares are relevant examples due to its extensive use. Convertible bonds usually can be converted by the holder into a predetermined number of shares in the issuing company. When first issued, they usually function like common bonds but with a relatively lower

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[42] Gallo, *"Drawing the Borderline between Debt and Equity in Tax Treaty Law (Hybrid Finance)"*, in International Group Financing and Taxes, Wien: Linde, 2012 vol. 74, pp.463-485.

[43] Eberhartinger and Six, *"Taxation of Cross border Hybrid Finance. A legal Analysis"*, Discussion Papers SFB International Tax Coordination, 27 and SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna, 2007.

[44] Jouissance rights, silent partnerships, participation bonds, convertible bonds, warrant bonds, profit participation loans and preference shares.

interest rate.[45] The decision to convert is generally influenced by the performance of the common stock. The investor may be also stuck with the bond's initial return- which is usually below the return that a non-convertible would get[46] if the underlying company has a poor performance.

Preferred convertible shares may pay dividends at a fixed or floating rate before common stock dividends are paid, and can be exchanged for common shares of the company in question. In this case, investors may either hold debt-like preferred equity or have the option of converting into common equity.[47] The decision to convert preference shares into common ones is usually dependent on the performance of the common shares- investors will be interested in the conversion when they can gain from a rise in the price of the common shares.

Although preference shares may not come together with the right to vote, they usually involve other advantages which may include the fact that preferred shareholders receive dividends before common shareholders; in case of insolvency the preference shareholders receive priority of payment in relation to common shareholders; and, while preferred shareholders usually receive dividends on a regular basis, common shareholders only receive dividends when the board of directors decides to issue them.[48]

Since preferred shares are less volatile than the regular ones, they tend to have certain similarities with fixed-income securities. Convertibles may offer more income potential than regular bonds, however there is still the possibility that they lose value if the underlying company has a poor performance.

In spite of the fact that hybrid instruments can be issued for various reasons, which may not be tax related, taxation issues usually carry a significant weight on management's finance decisions considering hybrid instruments. This is mainly due to the fact that hybrid instruments, in most countries, can only be treated as equity or debt, which means that the yield is either treated as profit distribution or as interest. This classification is relevant

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[45] Brennan and Schwartz, *"Analysing Convertible Bonds"*, The Journal of Financial and Quantitative Analysis, vol. 15, Issue 4, Proceedings of 15th Annual Conference of the Western Finance Association, California, November 1980, p. 907.

[46] Kinga and Mauer, *"Determinants of Corporate Call Policy for Convertible Bonds"*, Journal of Corporate Finance, Volume 24, February 2014, pp. 112–134.

[47] Kaplan and Stromberg, *"Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts"*, Review of Economic Studies, 2002, pp. 1–35.

[48] Arcot, *"Participating Convertible Preferred Stock in Venture Capital Exits"*, Journal of Business Venturing, Elsevier, 2013.

because it will determine if the issuer can treat the yield as tax-deductible and it will define, in some cases, if the received payments from the respective instrument are exempt from tax.[49]

In cross border activities, income from hybrid instruments may be regarded as debt in the source state and as equity in the country of residence of the shareholder and the contrary is also possible.[50] In this case, the source state would allow for a deduction of the return on the investment, and the state of residence of the shareholder would confer a tax exemption on the same return.

On the contrary, that is, when a hybrid is treated as equity in the source state and as debt in the shareholder's state of residence, its return will be treated in the source state as a non-deductible profit distribution, whereas in the country of the shareholder's residence, the return will be treated as a taxable interest payment. Presuming that anti-avoidance rules are not considered, situations of double non-taxation or double taxation may occur as a result.

Hybrid mismatch arrangements aim at exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries and they have been confronted by tax administrations in many states. In terms of their results, these hybrid mismatch arrangements may originate "double non-taxation" that may not be intended by either country, or may rather give rise to a tax deferral which if maintained over various years is economically equivalent to double non-taxation. Concerns in relation to distortions caused by double taxation are as important as concerns respecting unintended double non-taxation.[51]

Hybrid mismatch arrangements usually aim at achieving one of the following results: "*(i) the multiple deduction of the same expense in different countries, (ii) the deduction of a payment in the country of the payer without a corresponding inclusion in the country of the payee and (iii) multiple tax credits for a single amount of foreign tax paid"*.[52] In this way, hybrid mismatch arrangements may considerably reduce the overall tax for taxpayers and raise several tax policy issues, affecting, for example, tax revenue, competition, economic efficiency, transparency and fairness.

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[49] Gelder and Niels, *"Tax Treatment of Hybrid Finance Instruments"*, Derivatives & Financial Instruments, July/August 2013, IBFD, pp.140-148.

[50] Duncan, General Report, *"Tax treatment of Hybrid Financial Instruments in Cross-Border Transactions"*, Cahiers de droit fiscal international, vol. 85a, Kluwer Law International, 2000, pp.21-34.

[51] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[52] OECD, Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues (2012), p. 11.

5. Hybrid Finance in the OECD-MC: Articles 10 (dividends) and 11(interest)

International tax treaties have played a fundamental role in providing relief from double taxation. Hence, their main objective is to improve cross-border activities through the elimination of double taxation. A double tax treaty may also serve other purposes as preventing tax avoidance and evasion, avoiding cases of double non-taxation and preventing discrimination.

When negotiating tax treaties, countries usually rely on two model treaties: one prepared by the OECD: the Model Tax Convention on Income and on Capital; and the other by the United Nations: the UN Model Double Taxation Convention. Both models divide taxing rights on cross-border investment and business activities. The OECD treaty shifts more taxing powers to capital exporting countries whereas the UN treaty reserves more for capital importing countries.[53] Tax treaties following the OECD model convention severely limit the exercise of source jurisdiction.

This research analyses the treatment of hybrid instruments in light of the standards envisaged in the OECD MC, essentially because this model forms the basis of the majority of double tax treaties currently in force.[54]

In most cases, the income from hybrid instruments either qualifies as dividends or as interest in accordance with the OECD MC. In this way, the focus lies in articles 10 (dividends) and 11 (interest) of the MC.

The OECD reduces the right of the source state to charge withholding tax, limiting the amount that the source state can levy. Accordingly, article 10 limits the withholding tax to 5% if the concerned entities are related and 15% in other cases; and article 11 limits the withholding tax to 10%.

Article 10 (3) of the OECD-MC defines the term dividends in the following manner:

"The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights not being debt-claims, participating in profits, as well as income from other corporate rights, which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."

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[53] Klaus Vogel, "Double Tax Treaties and Their Interpretation", Berkeley Journal of International Law, vol. 4, 1986.

[54] Palma, *"The Paradox of Gross Taxation at Source"*, 38 Intertax, Issue 12, 2010 pp. 624–642.

In its last sentence, article 10 (3) makes reference to the national law of the source state and, thus, this law becomes part of the treaty between the two contracting states. It may be debated whether this reference to national law comprises the entire definition of dividends or if it only includes income from other corporate rights as mentioned in the second part of the article.

According to the wording of article 10, this reference to national law does not include the types of income listed in the first part of the definition, that is, "income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights not being debt-claims, participating in profits" have to be interpreted autonomously from the national law of the source state. As a result, one may assume that only income from other corporate rights is influenced by reference to the law of the source state.[55] The term corporate right as used in the treaty should be interpreted independently from the national law of the source state.

An investment is usually considered to include a corporate right when the investor recognizes the possible risk of the loss of the investment in a way comparable to the risk that is supported by a common shareholder.[56] In accordance with the leading German doctrine, only when the investment involves a participation in the profits as well as a participation in the liquidation proceeds of the issuing company, does it constitute a corporate right.[57]

Furthermore, the use of the term "other" corporate rights may indicate that all income items listed in article 10 (3) constitute corporate rights. Subsequently, the income from a hybrid instrument, whether included in the first or second part of the definition, will only be classified as dividend if the hybrid instrument in question comprises a corporate right under the Convention.[58]

Art 11 (3) of the OECD-MC provides the definition of the term interest. It reads as follows:

"The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate

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[55] Helminen and Marjaana, *"International - Classification of Cross-Border Payments on Hybrid Instruments",* Bulletin for International Fiscal Documentation, IBFD, Amsterdam, vol. 58, 2004, pp. 56-61.

[56] Cf. Para. 25 OECD Model: Commentary on Art. 10; Para. 19 OECD Model: Commentary on Art. 11.

[57] Barsch, *"Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform"*, Springer, 2012.

[58] *Id*.

in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

Article 11 (3) makes no reference to the national law of either contracting state and, as such, it may be assumed as a final and universal definition of interest, which has to be interpreted independently of the national law of the contracting states.[59]

The term "income from debt-claims of every kind" is an essential element of the interest definition established in article 11 (3). However, the term is not expressly defined either in the oecd-mc or in the oecd-com, but only complemented by a list of examples of certain types of debt-claims (government securities and income from bonds or debentures).

In this way, article 11 (3) has a broad character and does not include restrictions to the term interest. However, what the leading doctrine considers is that interest reflects the cost of doing business by making capital available. Regarding hybrid finance, a problem may arise because on the one hand dividends, in accordance with article 10, also constitute remunerations in response to an injection of capital and, on the other, debt claims which involve the "right to participate in the debtors profits" are specifically included in the interest definition of article 11 (3).

Accordingly, articles 10 (3) and 11 (3) may be related but under paragraph 19 of the OECD commentary on article 11 any income that integrates article 10 (3) cannot be included in article 11 (3), which may end up partially clarifying the concept of interest.[60] Thus, according to the prevailing doctrine, mutual exclusivity is given to the terms income from corporate rights and income from debt-claims, in the sense that dividends cannot fall under article 11 (3) even if they were qualified as interest.

From a double tax convention perspective, hybrid instruments that include a profit-participation right or the right to participate in the liquidation proceeds of the issuing company, do not normally constitute interest in terms of article 11(3), but they are rather considered a corporate right under article 10(3). In the same way, hybrid instruments that encompass a participation in the entrepreneurial risk only through a profit participating right-

[59] *Ibid*.

[60] OECD, Commentaries on the Articles of the Model Tax Convention, 2010, p.212.

for instance, if the payment on a debt claim is dependent on profits being made- do not usually qualify as dividend but rather as interest in line with article 11(3).[61]

The fundamental criterion to distinguish article 10 from article 11 is, thus, the presence of a corporate right.[62] However, these criteria are not clearly defined by the OECD. Concerning hybrid instruments and their multitude of features with respect to participation in the entrepreneurial risk, they can lead to situations where the contracting states may not agree on the characteristics to qualify a particular hybrid instrument as a corporate right and, therefore, as dividends.

The trend is that countries first follow the income classification provided for in their national laws which, in certain cases, may not correspond to the classification of the other contracting state. This can put the taxpayer in a situation where one state applies Article 10 whereas the other employs article 11, which, depending on the national laws and double taxation treaties, can lead to double taxation or non-double taxation of the income concerned.

Even in the presence of a tax treaty, double taxation may occur if the contracting state interprets a provision of the treaty in a different manner or qualifies the same income in a different way. The Mutual Agreement Procedure, which is established in article 25 of the OECD-MC, is an instrument provided by tax treaties which seeks to solve disputes involving the application and interpretation of tax treaties. Accordingly, when states that have signed a treaty interpret a term written in it in a different way, as may happen in the case of hybrid instruments, the MAP procedure can possibly lead to a solution.[63]

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[61] Gallo, *"Drawing the Borderline between Debt and Equity in Tax Treaty Law (Hybrid Finance)"*, in International Group Financing and Taxes, Wien: Linde, vol. 74, pp.463-485.

[62] Giuliani, *"Article 10(3) of the OECD Model and Borderline Cases of Corporate Distributions"*, Bulletin of International Taxation 2002, pp. 11-14.

[63] Lombardo*, "The Mutual Agreement Procedure (Art. 25 OECD MC) - A tool to overcome interpretation problems?"* in Fundamental Issues and Practical Problems in Tax Treaty Interpretation, Linde 2008, p.490.

6. Cross Border Hybrid Finance within the European Union: Parent and Subsidiary Directive (PSD) and Interest and Royalties Directive (IRD)

In the history of the European Union, directives have been an important tool used by the Council in aligning the national laws of the member states with the requirements of a common internal market within the EU.Regarding the taxation of cross-border hybrid finance, the PSD[64] and the IRD[65] are the most relevant of these directives: the first one deals with the payment of dividends and the second involves the payment of interest and royalties between related companies. These directives have been implemented by most member states.

The PSD determines that the residence state of the parent company shall refrain from taxing distributed profits (article 4 (1)) and that the profits that the subsidiary distributes to the parent company should be exempt from withholding tax. The PSD, however, does not include a definition of the term profits but merely determines that the member state shall apply this directive to distributions of profits (article 1 (1), 90/435/ECC).

The Council of the European Union, in the introduction to the PSD, establishes that the purpose of the directive is to "exempt dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes and to eliminate double taxation of such income at the level of the parent company". Distributive profits, in which dividends are included, have a broader scope and can be interpreted to cover any payment arising from the company-shareholder relationship or association between companies.[66] It seems that the directive leaves it to the member states and their national laws to decide what profits integrate the scope of the national implementation of the directive.

In the context of hybrid financing, the main goal of the PSD is to eliminate double taxation regarding the relationship between parent companies and their subsidiaries and, thus, it seems reasonable to assume that the PSD should be applied in these situations. The return from hybrid instruments that classifies as equity investment is generally subject to the benefits conferred by the directive. This means that the benefits of the PSD should be applied to payments from hybrid instruments at national level if the member state in question treats these payments as dividends in accordance with its national tax law.

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[64] Cf. Council Directive, 90/435/EEC: 6, as lastly amended by Council Directive, 2003/123/EC: 41.

[65] Cf. Council Directive, 2003/49/EC: 49.

[66] Cf. Para. 25 OECD Model: Commentary on Art. 10; Para. 19 OECD Model: Commentary on Art. 11.

Regarding the state of residence of the parent company, it may be questioned if it has to confer the benefits provided in the directive symmetrically with the source state, thus accepting the classification made by the latter.[67] If the state of residence of the parent company does not confer the benefits of the PSD, either because it adopts a different interpretation of the term profit distribution or because it classifies income as interest (classification conflict), it is possible that the recipient state will levy tax on profits distributed by the subsidiary, although the source state may choose to apply the PSD. It is widely accepted that it cannot be required to the state of residence of the parent company to accept the classification made by the source state[68] and, because of that, the possibility of double taxation may remain despite the directive.

The term interest in the IRD is defined as in article 11(3) of the OECD-MC. The IRS includes a broad definition of the term interest ("*income from debt -claims of any kind*"), which may end up comprising almost any type of hybrid instrument (participation bonds, profit-participating loans, warrant bonds, preference shares as well as forms of jouissance rights and silent partnerships). At the same time, the IRD allows member states not to confer the benefits of the Directive in four cases established in article 4, enabling them to narrow the application of the directive. For this analysis, articles 4 (a) and 4 (b) are of particular relevance.

Article 4 (a) of the IRD allows the source state to deny the benefits of the directive on payments that are treated as a distribution of profits or as a repayment of capital in accordance with its national law. With regard to hybrid finance, this provision may be particularly relevant given that it is unclear whether such payments fall within the scope of application of the PSD. If the option of article 4(a) is executed and provided the other requirements are met, these payments should fall under the scope of application of the PSD.

Assuming that all payments that are classified as a profit distribution under the tax law of the source state integrate the scope of the PSD, the question that may arise is what happens if the source state does not apply the option of article 4 (a) of the IRD and if these payments are covered by the scope of both directives. This would not be a relevant issue given that both

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[67] Barsch, *"Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform"*, Springer, 2012, pp.114-118.

[68] *Id*.

directives provide an exemption from any withholding tax on payments and, therefore, the impact on the tax burden would be the same. [69]

Article 4 (b) allows the "exemption of debt-claims which carry the right to participate in the debtor's profits." In this way, the source state has the option to exclude many of the hybrid instruments from the application scope of the IRD (participation bonds, profit-participating loans, warrant bonds, preference shares as well as forms of jouissance rights and silent partnerships). It is possible that the source state may exempt certain hybrid instruments from the benefits of both directives by first qualifying them as debt on a national level, thus exempting them from the benefits of the PSD, and then using the option in article 4 (b) to exempt them from the benefits of the IRD.

Eberhartinger and Six, argue that article 4 (b) should only apply to situations where the treatment given under the national tax law corresponds to the general definition of interest present in article 2 (1) of the Directive.[70] In this case, member states may decide to deny the benefits of the directive on payments of certain financial products, while still qualifying these same payments as interest under their national tax laws. Thus, article 4 may frustrate the overall IRD objective of elimination of double taxation on the interest payments.

According to Distaso and Russo, it is possible that the intention behind these provisions is to give an instrument for member states to eliminate situations of double non-taxation, excluding instruments that create a tax deduction on the source state at the same time that they give rise to a taxation exemption of the respective income because, for example, the state of residence of the parent company treats the income as dividends and applies the PSD.[71]

Assuming that this may be the reasoning of the article, this provision may not be entirely appropriate given that the directive affects not only payments between a pair of member states but all payments within the scope of its application, and that article 4 does not contain reference to the treatment that is given to payments in the recipient country.[72]As a result, the source state may exclude payments from the scope of the directive which are treated as interest in the two states, thus leading to situations of double taxation.

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[69] Eberhartinger and Six, *"Taxation of Cross border Hybrid Finance. A legal Analysis",* Discussion Papers SFB International Tax Coordination, 27 and SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna, 2007.

[70] Eberhartinger, Six, *"National Tax Policy, the Directives and Hybrid Finance"*, in National Tax Policy in Europe, 2007, pp. 213-236.

[71] Distaso and Russo, *"The EC Interest and Royalties Directive – A Comment"*, IBFD European Taxation, 2004, pp. 143-154.

[72] *Id*.

From this analysis it is possible to conclude that both directives allow for the possibility of member states to exclude some hybrid instruments from the benefits conferred by both directives and that these directives, as they presently stand, fail to assure single taxation.

Although the directives deal with cross border intra-group finance, the fact is that EU tax law has not been able to entirely cover hybrid financing in a manner that guarantees single taxation. The main reason for this is that the correlation between the two directives is not always straightforward. Therefore, a clear-cut delimitation between dividends and interest appears as a proper response to this problem. Despite the fact that different measures are applied in order to avoid double taxation and to ensure single taxation, cases of double taxation and double non- taxation are still possible.

The tax treatment of a certain hybrid instrument is widely dependent on the classification and interpretation made by the two countries involved. Therefore, taxpayers face significant legal uncertainty with respect to the fiscal consequences deriving from the use of hybrid instruments in cross border intra group finance.

7. Interim conclusions

Although governments try to create tax systems that, on the one hand, provide the best environment for companies and, on the other, ensure the sustainability of the welfare state, almost none of them ensure that the principle of fiscal neutrality is incorporated in practice. The different tax treatment of debt and equity is a striking example of this failure.

Financing decisions seek to optimize costs and, in the case of taxes, the deductibility of interest is a crucial factor in giving preference to debt over equity. So long as there is a tax benefit to prefer one form of finance over the other, firms will feel motivated to use it.

However, this tax-bias towards debt financing may pose some risks such as distortions in the capital structure of companies and profit-shifting via transfer of debt. In order to preserve their tax bases, countries have been adopting measures to mitigate this problem. The following chapter will address policy responses to correct the debt bias problem evidenced in current tax systems.

Part II- Policy options to correct the debt bias

1. Thin Capitalization

Thin capitalization can be defined as a phenomenon that is evidenced by the existence of a marked disproportion between a company's equity capital and its level of debt towards capital holders or with other companies with which there are special relations.[73] A company is considered to be "thinly capitalized" when it has a high proportion of debt compared to its equity capital. The amount of loans that a company would be able to obtain from independent entities is a comparative standard often used.

Thin capitalization rules establish a limitation on the tax deductibility of interest expenses that are considered excessive. In this way, these rules seek to limit the achievement of tax advantages through debt financing and can exist in different forms. There are several mechanisms that are used to implement thin capitalization rules, such as fixed-debt ratios; earnings stripping rules; safe haven rules combined with the possibility of taxpayers demonstrating that another debt-equity ratio is adequate in a specific case; and application of the arm's length principle to define the debt-equity ratio that is allowed.[74]

The purpose of such rules is to prevent improper shifting of income to the jurisdiction of the creditor, and the deduction of interest expenses as regards borrowings that are granted in better conditions than those granted to non-related parties. Basically, these rules are intended to prevent the erosion of the tax base that can lead to revenue losses.

There exists evidence that international groups use third party and related party interest as a profit-shifting technique misaligning interest deductions with taxable economic activity. Thin capitalization has been a popular tax planning method used by international groups especially due to the tax treatment differences that apply to debt and equity in most countries.

Despite the fact the that their form may vary from country to country, a general feature of thin capitalization rules is that the interest deduction is denied for loans from foreign affiliates if the debt- equity ratio is above the threshold established.

The context of these rules may differ from the perspective of the debt-to-equity ratio or the safe haven; the consequences of the application of the thin capitalization rules, that is, if

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[73] Prazeres, *"As Regras Fiscais sobre a Subcapitalização"*, CTF, Nº383, Ministério das Finanças, 1996, Lisboa, p.14.

[74] Wijnen, *"Thin capitalization rules and Tax Treaty Law",* in International Group Financing and Taxes, Wien: Linde, vol. 74, pp. 83-118.

the tax system only denies the deduction of excessive interest expenses or if it also recharacterizes the excess amount as dividends and tax it accordingly; and the type of loans that may be considered to define the application of the general interest limitation rule (some EU member states restrict the application of the provision to loans granted by shareholders or related parties, whereas others extend its application to all types of loans regardless of whether there is a relation between the debtor and the creditor or not.[75]

Studies have suggested that thin capitalization is, in fact, an important phenomenon at the international level. [76] In 2003, Altshuler and Grubert, based on data available from the USA, observed that an increase of 1% in the tax rate of foreign subsidiaries of US multinational groups leads to an increase of 0.4% in the debt-to-equity ratio of those subsidiaries.[77]Desai, Foley, and Hines also concluded that a 10% higher tax rate can give rise to an increase of 3 to 5% in the debt-to-equity ratio.[78]

In 2006, Huizinga, Laeven and Nicodeme, taking into account data collected from more than 90,000 affiliates across thirty-one European countries, concluded that a 0.06% higher effective tax rate in the country of the subsidiary company raises its debt/equity ratio by 1.4%.[79]

A previous survey conducted by Weichenrieder in 1996, established that in the early 1990s (before thin capitalization rules were introduced in Germany), over three quarters of German inbound foreign direct investment included loans, while the German investment abroad mainly comprised equity financing.[80]

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[75] Bravo, *"Thin Capitalization Rules and EU Law/Fundamental Freedoms"*, in International Group Financing and Taxes, Wien: Linde, vol. 74, pp. 119-143.

[76] Mooij, *"Will Corporate Income Taxation Survive?"* De Economist 153(3), 277-301, 2005, p. 292.

[77] Altshuler and Grubert, *"Taxes, repatriation strategies and multinational financial policy"* Journal of Public Economics 87, 2003, pp. 73-107.

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

[79] Huizinga, Laeven, and Nicodeme, *"Capital Structure and International Debt-Shifting"*, Journal of Financial Economics, vol.88, issue 1, Elsevier, 2008.

[80] Weichenrieder, *"Fighting international tax avoidance: the case of Germany"* Fiscal Studies, vol. 17, no. 1, 1996, pp. 37-58.

The studies mentioned above suggest that this general phenomenon entails negative consequences in respect of collected revenue and, as a result, the introduction of thin capitalization rules is rising within the EU and among OECD countries.[81]

There are various policy options to mitigate the debt-bias problem, some of which have already (intentionally or unintentionally) been put in practice. For instance, a decrease in the corporate tax rates reduces the value of the tax shield for debt. The most common option has been the adoption of thin capitalization rules and their use has developed dramatically since the 1990s. A similar instrument, for example, is an earnings-stripping rule which seeks to limit the interest deductibility when the net interest expenses exceed a defined percentage of the EBITDA.

[81] T. Buettner, et. al, observed that while 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, p. 2.

2. The OECD treatment of intra-group financing: BEPS Action 4

The BEPS project comprises the involvement of more than 80 countries, including 34 OECD members, all members of the G20 and over 40 developing countries. The main purpose of their work is to find coherent and consistent solutions to fill the gaps in international tax rules that allow companies to legally but artificially shift their profits to low or no taxation jurisdictions. These instruments are developed and agreed upon by the governments of participating countries and constitute soft law instruments. They seek to treat cases of double non-taxation and also to improve the mechanisms to deal with cases of double taxation.[82] Once these instruments are agreed upon, all participating countries can, in accordance with their legal and constitutional systems, implement them.

In the sequence of the report "Addressing Base Erosion and Profit Shifting" in February 2013, countries of the OECD and the G20 adopted a 15-point Action Plan to tackle beps in September 2013. The Action Plan includes 15 actions based on 3 fundamental pillars which include introducing coherence in the national provisions that impact cross-border activities, strengthening substance requirements in the existing international rules, and promoting certainty and transparency.

This research will address Action 4 of BEPS which involves recommendations on best practices in the design of rules to avoid base erosion and profit shifting through the use of interest and payments economically equivalent to interest.

Most countries treat interest as a deductible expense for tax purposes, but each country uses its own approach to define which expenses integrate the concept of interest and that are, therefore, deductible for tax purposes. Action 4 does not intend to propose a definition of interest to be applied by all countries, recognizing that there will remain differences between countries in relation to the items that are treated as deductible expenditure, and that countries will continue to apply their own definition of interest for other tax aims, for example, for withholding taxes. Action 4 suggests that there are benefits to countries in adopting a broader approach to the items that should be covered by these general interest limitation rules.

According to Action 4, the best practice approach prescribes a fixed ratio rule which aims to limit interest deductions of an entity to a fixed percentage of its profit, which is measured through the use of earnings before taxes, interest, depreciation and amortization

[82] OECD, Explanatory Statement, Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, 2015.

(EBITDA) and taking into account tax numbers.[83] The EBITDA approach aims to ensure that a portion of the entity's profit is subject to taxation in the country.

EBITDA is the recommended measure of earnings to be applied, however the best practice gives countries the possibility to adopt earnings-based rules before interest and taxes (EBIT) and, in exceptional cases, allows countries to employ a fixed ratio rule based on asset values instead of earnings.

The fixed ratio rule is assumed by the OECD as a direct and relatively simple to apply rule aimed at ensuring that the interest deduction by an entity directly corresponds to its economic activity. This rule also relates these deductions with the taxable income of the entity, making it an efficient tool against tax planning.

An efficient fixed ratio rule requires countries to establish the benchmark fixed ratio rule to a level that is adequate to combat beps but also taking into account the differences between countries in terms of their legal framework and economic environment. According to the OECD, it is recommended that countries establish their benchmark fixed ratio rule within a corridor of 10% to 30% considering certain factors.

Action 4 recognizes that the fixed ratio rule may be a blind instrument in the sense that it does not consider the fact that groups that operate in different sectors may require different levels of leverage, and even within the same sector certain groups may be more leveraged due to non-tax reasons. If the benchmark fixed ratio rule is established at a level effective enough to combat beps, it can cause double taxation for groups that are leveraged above this level.[84]

In this way, the best practice approach gives countries the possibility to combine a fixed ratio rule with a group ratio rule that, in certain cases, allows an entity to deduct more interest expense. This group ratio rule can be established separately or as an integral part of a general provision, comprising both fixed ratio and group ratio rules.

According to the group ratio rule, an entity exceeding the benchmark fixed ratio can deduct interest expenses up to the net the third party interest / EBITDA ratio of its group, when this is superior. Consequently, only the deduction of interest expenses that are above the levels provided by the fixed ratio rule or the group ratio rule will not be permitted.

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[83] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, pp.47-54.

[84] Deloitte, *"OECD Tax Alert: BEPS Action 4: Interest Deductions and Other Financial Payments, International Tax"*, October 2015.

Different group ratio rules, such as those using asset-based ratios can be applied as long as they only allow an entity to exceed the benchmark fixed ratio when it is possible to prove that a certain financial ratio is in conformity with that of its group.

A country may also choose to use a fixed ratio rule alone and, when a country does not apply the group ratio rule, it should employ, without discrimination, the fixed ratio rule to entities in both multinational and domestic groups. The best practice approach suggests that countries should apply the fixed ratio rule by making use of a benchmark ratio which is low enough to tackle beps.

With the objective of excluding entities that represent the lowest risk from the scope of the general interest limitation rule, the best practice approach suggests that a country may apply a de minimis threshold centered on the monetary value of the interest expense of all entities in the local goup. In this case, no restrictions apply to the deduction of interest of entities that are below this limit. For groups that have more than one entity in the country, this limit should consider the total interest expense of the entire local group, covering all entities in that country. When a rule is applied to the level of an individual entity, it is recommended that a country should adopt anti-fragmentation rules to restrict a group's ability to avoid the application of the interest limitation rule by establishing various entities, each one falling below the limit defined by the rule.[85]

The rules that relate interest deduction to EBITDA may raise questions when the interest expense of an entity and earnings arise in different periods. This may be a consequence of the volatility of earnings which comprises the ability of an entity to deduct interest changes from year to year, or because the entity has incurred interest expense to finance an investment that will only give rise to gains in a subsequent period.[86] To alleviate the impact of these issues, a country may allow entities to carry forward disallowed interest expense or interest unused capacity.

The application of carry forward and carry back provisions may result in clear benefits for entities by mitigating the risk of a permanent denial of interest expense in cases where interest expense and EBITDA emerge in distinct periods. However, it is recommended that countries include limits on the application of these carry forwards and carry backs to tackle beps risks.

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[85] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, p.35.

[86] OECD, BEPS Action 4, 2015 Final Report, pp.67-70.

The fixed ratio rule and the group ratio rule should be complemented by targeted rules aimed at protecting the integrity of the general interest limitation rule and addressing specific beps risks that may remain.[87]

The fixed ratio rule and the group ratio rule may not be efficient rules to tackle beps involving interest in the banking and insurance sectors due to the particular characteristics surrounding these industries.

Regarding the recipients of these rules, Action 4 determines that the best practice approach, as a minimum, should be applied to all entities forming part of a multinational group. A wider application is also possible including entities of a domestic group and / or standalone entities that are not part of a group.[88]

An entity is considered to be part of a group, if it is directly or indirectly controlled by another company or if the entity constitutes a company that directly or indirectly controls one or more other entities. For a group to be considered multinational it has to operate in more than one jurisdiction, including through a permanent establishment.

Entities integrating multinational groups represent a higher risk as regards base erosion and profit shifting. Nevertheless, a country can opt for the application of a broader fixed ratio rule in order to also include entities operating in domestic groups. This may be part of a wide approach to address BEPS in all entity types or may be in order to satisfy other policy objectives, such as to prevent competition issues between national and multinational groups, to reduce the tax bias in favour of debt financing, or to meet constitutional obligations with respect to the equal treatment of taxpayers. Particularly, countries that are EU member states will have to take EU legislation into account when implementing their national rules.

A standalone entity refers to any entity not forming part of a group. Many of times, they are small entities which belong directly to an individual where there are no other entities under common control. In such cases, as a result of the small size of the entity and the absence of related parties, the beps risk concerning interest is expected to be comparatively low. There are cases, however, where these standalone entities can be robust entities held under complex holding structures involving trusts or partnerships, where there are a number of entities under the control of the same investors. In these situations, the beps risks may be similar to those represented by a group structure.

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[87] OECD, BEPS Action 4, 2015 Final Report, pp.71-74.

[88] OECD, BEPS Action 4, 2015 Final Report, pp.33-35.

Countries are free to implement stricter standards than those proposed by the OECD for the purpose of combating beps or to achieve other fiscal policy objectives. Thus, the best practice approach can be complemented by general or specific interest limitation rules that a country considers adequate to mitigate the risks it may face. A country may adopt interest limitation rules that include broader fiscal policies such as reducing the tax bias towards debt financing.[89]

Each country, in the implementation of the best practice approach, will need to consider the obligations in light of its constitution and the specific features of its general tax system.

In summary, the OECD is committed to reducing the opportunities for tax avoidance by multinational companies that make use of internal financial structures to artificially reduce their taxes through inflated deduction of interest from taxable profits. Accordingly, it is recommended that countries introduce a limit on such interest deductions. The OECD suggests that the deduction of interest should be related to the profits made by the firm (EBITDA) in order to ensure that the deductibility of interest effectively corresponds to the economic activity of the company. It seems to me that the OECD recommendations are a strong contribution in addressing problems of double non-taxation or harmful competition. However, I think that these reccomendations should be made in a way that does not establish burdensome rules for financial transactions which are actually genuine and they should be consistently justified from an operational point of view.

3. Thin Capitalization Rules and tax treaty law: the arm's length approach

Thin capitalization and earnings stripping rules bring about some complex questions respecting tax treaty law. A fundamental question remains as to whether "rigid" thin capitalization approaches or earnings-stripping rules clash with the arm's length principle (article 9 OECD MC).

The arm's length approach requires a fundamental question that needsto be answered, that being whether an independent entity would also have granted an identical volume and price for loans to the company. If the answer is affirmative, the enterprise meets the arm's length criteria and is not deemed thinly capitalized. If not, the interest would be regarded as

[89] OECD, BEPS Action 4, 2015 Final Report, p.82.

excessive and not reflecting real market conditions and would, in most cases, be treated as dividend, making it a non-deductible item in calculating taxable income and, consequently, increasing the tax liability.[90]

The UK, for example, exclusively applies an arm's length approach to regulate financing structures which are excessively leveraged. Accordingly, it denies interest deductions exceeding a firm's arm's length debt capacity. However, if the UK company fulfils the arm's length criteria, no profit adjustment is made. In general, countries applying such an approach are not infringing article 9.

However, things might be slightly different with respect to debt-equity ratios and earnings stripping rules.

Under the fixed ratio approach, the borrower's debt-to-equity ratio is tested against a pre-established specified fixed ratio determined by the country of the debtor which, in some cases, may have been settled arbitrarily.[91] These rules substantially differ among countries that have applied such an approach. Some of these rules merely affect intra-group debt financing, whereas others also take independent third-party loans into consideration. Moreover, the ratios may vary significantly between countries. US, Belgium, Spain and Denmark are examples of countries which apply debt-to-equity ratios.

This fixed ratio approach may be rigid and may give rise to double taxation if the country of the lender does not grant relief for the corporate taxes paid on the non-deductible interest in the country of the borrower. In addition, the compatibility of such a rule with article 9 may be debatable.

Like the fixed ratio rule, the safe harbour approach relies on a pre-established debt-to-equity ratio with the difference that it gives an additional possibility to the debtor to explain the arm's length nature of the debt when it exceeds the fixed debt-to-equity ratio. The borrower company may escape from the rigor of thin capitalization rules and its adverse consequences if it is successful in demonstrating that the arm's length criteria is satisfied even if the interest deduction exceeds the debt-to-equity ratios. The safe harbour mechanism differs

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[90] Hanlon, *"Thin Capitalisation Legislation and the Australia/United States Double Tax Convention: Can They Work Together?"*, Journal of Australian Taxation (2000), p.12.

[91] Fross, *"Debt-equity Ratios, Earnings Stripping Rules and The Arm's Length Principle*", in International Group Financing and Taxes, Volume 74, Wien: Linde, 2012.

from the strict fixed-ratio rule in the sense that this mechanism is more flexible since it is related to the arm's length principle and, normally in line with article 9.

The fixed ratio rule and the safe harbour approach represent tradicional thin capitalization rules which imply a balance sheet test (testing the debt-to-equity ratio). Some countries have recently moved from those traditional rules to earnings stripping rules, which rely on the company's income ratio. Such rules limit the interest deduction to a percentage of the EBITDA or similar criteria. Given that earnings stripping rules relate the deduction of interest to EBITDA, they are based on an income test instead of a balance sheet test. This approach is in line with the OECD recommendations provided for in BEPS Action 4. Germany, Portugal and Italy represent examples of countries that shifted to earnings stripping rules.

Article 9 of the OECD-MC provides the basis for tax treaty provisions concerning transfer pricing and establishes the use of the arm's length principle to treat the transactions between associated companies as if they were conducted between unrelated parties.

Article 9 (1) determines that the profits made by a company with its associated enterprises can be adjusted to the same level as it would have earned if it dealt with an independent company at arm's length. Contrarily, no profit adjustment of related enterprises is justified where the transactions between such enterprises have occured under normal open market commercial conditions, for example, on an arm's length basis.

An adequate profit adjustment may be made in the debtor's state in conformity with article 9 when the transaction between associated companies is not in accordance with the arm's length principle. In this way, article 9(1) allows for amounts not in line with the arm's length principle to be included in a company's profit. Article 9 (2) acknowledges a corresponding adjustment in the creditor's state of residence for the purpose of preventing double taxation.

Under the arm's length principle, as a rule, interest is deductible, however, non-arm's length interest is normally not deductible and may receive a range of different treatments. In this context, three types of rules may be applied at a national level: it is possible to establish an interest rate adjustment, according to which only a disallowance of the deduction is applied; to establish an interest-rate adjustment according to which the adjusted interest

payment is reclassified as a distribution of dividends; or to establish a reclassification of the loan as an equity contribution.[92]

The next question to be addressed is if article 9(1) as it stands is relevant to decide whether a firm's debt may be reclassified as equity for tax purposes. The OECD Thin Capitalization Report answers this question in the affirmative by stating that article 9 is relevant for the thin capitalization issue.[93]

According to the OECD Commentary on article 9, article 9 (1) is relevant not only to test the arm's length nature of the interest rate, but also to assess whether a loan can, at first glance, be considered as equity for tax purposes.[94] Thus, the OECD has considered that article 9 (1) is also pertinent for the volume of the loan.

Academic literature has criticized this suggestion of the OECD. It is accepted that article 9 (1) allows the tax authorities of the borrower's state to adjust the profits if the interest rate is not at arm's length. However, what is not accepted by the opposing view is that the article allows the reclassification of debt into equity.[95]

This argument is based on textual interpretation. It is argued that Article 9 (1) refers to "conditions (...) made or imposed between two enterprises in their (...) financial relationships." In accordance with the opposing view, the word "condition" involves a narrow scope and relates to the terms of a contract (for example, interest rates, payment terms, etc.).In this way, the wording of article 9 (1) would not allow the consideration of the implied financial relations (i.e. the volume of debt financing) and therefore would not allow the tax authorities to question if an independent company under comparable conditions would incur in such a loan and, thus, to reclassify the loan as equity.[96]

The historical background of the article is an argument which is also mentioned to sustain this position. After some linguistic clarification, article 5 of the League of Nations Model Convention of 1933 became article 9 of the OECD Model in 1963. It is argued that at this time the original drafters did not take into account the issue of thin capitalization. For

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[92]Wijnen, *"Thin capitalization rules and Tax Treaty Law"*, in International Group Financing and Taxes, Wien: Linde, Volume 74, pp. 83-118.

[93] OECD, Thin Capitalisation Report 1986, R (4)-22.

[94] *See* para.3 of the Commentary on Article 9 of the OECD Model.

[95] Fross, *"Debt-equity Ratios, Earnings Stripping Rules and The Arm's Length Principle"*, in International Group Financing and Taxes, Wien: Linde, vol. 74, pp. 33-53.

[96]*Id.*, pp. 44-46.

these reasons, many scholars have disagreed with the OECD position in relation to such loan recharacterization.[97]

The followers of the OECD position, however, do not embrace such a restrictive textual interpretation. De Broe, for example, asserts that the choice between debt and equity financing is encompassed in the term "conditions made or imposed in their financial relations." Also, article 9 (1) allows profit adjustments for "any profits which would have accrued, but have not by reason of those conditions."[98]

According to this interpretation, the authors of the provision did not have a restrictive intention in mind and, therefore, a flexible interpretation is required. While it may be true that the original drafters did not consider the issue of thin capitalization (since at that time it was not deemed an important question), the interpreting scope should not be restricted to the specific profit-shifting techniques that the authors had in mind.

Moreover, the principle of effectiveness prescribes that a treaty shall be interpreted in a practical way over time in order to allow new phenomena to be included in the treaty. This may include software, new financial instruments, e-commerce, etc. A restrictive interpretation would not be enough to include new phenomena that may appear in the future and could also lead to double taxation. Thus, article 9 (1) should be interpreted broadly.

Furthermore, since it is widely accepted that tax treaties do not create tax responsibility, a legal base in the national laws is necessary in order to make profit adjustments among associated enterprises.[99] The legal basis in national law as regards thin capitalization rules can give rise to difficulties when, for example, a state makes a profit adjustment that is in conformity with the tax treaty and domestic law, but another state lacks national rules to make the corresponding adjustment. This situation could lead to double taxation.

From this analysis we may conclude that article 9 functions as the general basis for the application of transfer pricing throughout tax treaties. Other provisions relating to transfer pricing and the application of the arm's length principle rely on the authoritative statements of article 9. Therefore, the article can be regarded as a lex generalis. The next question to be dealt with is its relation with article 11(6) of the OECD MC.

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[97] De Broe, "International Tax Planning and Prevention of Abuse", vol. 14 in the Doctoral Series, August 2008 pp-504-505.

[98] *Id*., pp-505-506.

[99] Lang, *"Introduction to the Law of Double Taxation Conventions"*, Wien: Linde Verlag, 2010, p. 32.

As mentioned before in this research, article 11 of the OECD MC allocates the right to levy taxes on interest payments. Under article 11(6) it is possible to make a rate adjustment in cases where interest is deemed excessive. However, article 11 (6) only applies where such excessive interest is paid due to a special relationship between the debtor and the creditor and only with respect to interest payments that exceed an arm's length payment.[100]

Article 11 (6) constitutes a lex specialis with respect to article 9 in the sense that article 11 (6) is a special rule which limits the application of article 11[101]. The intention of article 11 (6) can be acknowledged in the Introductory Report of the Draft OECD MC of 1963, which describes the provision as a safeguard clause dealing with excessive interest payments.[102]

The goal of article 11 (6) is related to the extensive treaty definition of interest contained in article 11 (3). Within this broad definition and in the absence of article 11 (6), states would not have the possibility to refuse the classification of an excessive interest payment as an interest payment even if it exceeded the arm's length payment of interest. If article 11 (6) was not included in a tax treaty this would mean that states would have to continue to treat excessive interest payment as an interest payment, since it would be covered by the definition provided by article 11 (3).[103]

In the context of tax treaty law, the definitions of dividend and interest have proven to be relevant for the application of other provisions of the treaty. With respect to tax treaty law and national thin capitalization rules, the OECD's view is that article 10 (3) does not preclude a reclassification of interest due to thin capitalization rules.[104] However, the reclassification is allowed only to the extent that the lender effectively shares the risks incurred by the debtor company on a particular loan. Considering that this criterion is fulfilled, the reclassified payment may be treated as income from "other corporate rights", falling under article 10 (3).

The debtor state which applies thin capitalization rules can consider the excessive amount as dividend for all treaty purposes or it may simply not allow the deduction of excessive interest and continue to treat the payment as interest. Regarding the creditor state, it

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[100] Para.33 of the Commentary to Article 11 OECD MC.

[101] Vogel, *"Double Taxation Conventions",* London: Kluwer Law International, 1996, pp. 518-519 and 758.

[102] Introductory Report to the OECD Draft double taxation convention on income and capital 1963, General remarks and brief analysis of the Convention, para.19.

[103]Valencia, *"Tax Treatment of Intra-Group Interest in the Context of Art. 11 OECDMC"*, in International Group Financing and Taxes, Wien: Linde, vol. 74, pp. 409-435.

[104] Wijnen, *"Thin capitalization rules and Tax Treaty Law"*, in International Group Financing and Taxes, Wien: Linde, vol.74, pp. 83-118.

may either agree with the disallowed interest deduction or reclassified interest payment made by the debtor state providing relief from double taxation, or it can refuse the adjustment or reclassification and, in this case, double taxation may persist.[105]

In cases where a debtor state does not allow an interest deduction for an amount that is not in accordance with the arm's length, the treaty provisions lead to an acceptable adjustment considering the limits provided for in article 10 (3). In this way, the disallowed interest deduction can then be treated as a dividend for purposes of the treaty. On the contrary, when an interest deduction does not allow for an amount that is in line with the arm's length principle, it continues to be treated as interest for treaty purposes.

The criterion to determine if the treaty definition of dividend referred to in article 10 (3) includes a reclassification also requires the creditor state, in principle, to accept the national thin capitalization rules of the debtor's state when the creditor shares the risks incurred by the debtor company.

This position and the subsequent treatment that should be given by the lender State is included in the OECD Commentary which states that, when the condition of sharing the risks is met, the reclassified amount may be taxed by the debtor state as a distribution of dividends and the amount is included in the taxable profits of the debtor.[106] Accordingly, the lender state has to provide relief from double taxation as if the reclassified amount were in fact a dividend distribution. The structure of the treaty therefore allows adjustments and reclassifications respecting the limits of the arm's length principle and expects that the creditor state will accept those in a similar manner.

The vision of the OECD as regards the acceptance by the creditor state of the adjustments made by the debtor state based on national thin capitalization rules is not embraced by all creditor states. Research has shown that lender states generally do not feel bound by the reclassification made by the debtor state and, as such, continue to treat the payment as interest for national tax purposes.[107]

This position of creditor states may give rise to double taxation, although, here the issue of double taxation is not considered to be very significant. Many states do not reclassify

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[105] Schon, "General Report", in IFA, *"The tax treatment of interest in international economic transactions"*, Cahiers de droit fiscal international, 1982, vol. 67a.

[106] Paras. 67 and 68 of the Commentary to Article 23 A and B of the OECD MC.

[107] Hinny, "General Report", in IFA, *"New tendencies in tax treatment of cross-border interest of corporations"*, Cahiers de droit fiscal international, 2008, vol. 93b, p.43.

the non-arm’s length interest payments; instead they do not allow a deduction from the debtor's profits. In the EU, for example, reclassified interest payments are not subject to dividend tax withholding as a result of the Parent and Subsidiary Directive.

4. Thin Capitalization Rules and EU Law

This section will analyse the compatibility of some national thin capitalization provisions with the EU Law, especially with the EU fundamental freedoms.

The TFEU contemplates five fundamental freedoms, which include the free movement of goods (article 28 et seq.), the free movement of workers (article 45), the freedom of establishment (article 49), the free movement of services (article 56), and the free movement of capital (article 63), in order to meet the target of a common internal market.[108]The fundamental freedoms which are likely to be associated with thin capitalization rules are the freedom of establishment and the free movement of capital.

The CJEU has interpreted the freedom of establishment as to apply in cases where the shareholder or investor exerts a significant influence on the decisions of an enterprise allowing him to define the activities of the company.[109] In the context of the free movement of capital, the CJEU has interpreted it as applicable in situations where an investor, through a shareholding or the acquisition of securities on the capital market, has a direct investment that takes the form of participation in a company.[110]

The TFEU does not determine in which way these freedoms should interact with each other in situations where a national law breaches more than one freedom at the same time. In this context, The CJEU has accepted two different approaches to deal with cases where the freedom of establishment and the free movement of capital may be exposed to a restriction: the priority or hierarchy approach[111], which establishes that the free movement of capital should only be considered in cases where the freedom of establishment is not applicable; and the parallel approach[112] which includes the concurrent application of both freedoms. The application of both freedoms in parallel is particularly relevant in the case of the free movement of capital given that it is the only freedom that comprises an external dimension.[113]

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[108] Consolidated Version of the Treaty on the Functioning of the European Union of 26 October 2012, Official Journal of the European Union, C 326/47.

[109] ECJ, 13 April 2000, Case C-251/98 Baars [2000] I-2787, para.22.

[110] ECJ, 13 May 2003, Case C-98/01 Comission v United Kingdom [2001] I-4641, para.39. See, also, ECJ, 16 March, 1999, Case C-222/97 Trummer and Mayer [1999], I-1661, paras. 20-21 and ECJ, 2 June 2005, Case C-174/04 Commission v Italy [2005] I-4933, para.27.

[111] ECJ, 21 November 202, Case C-436/00 X and Y [2002] I-10829, paras. 66-68.

[112] ECJ, 27 May 2007, C-157/05 Holböck [2007] I- I-04051, paras.27-31.

[113] Basalykas, *"The Free Movement of Capital and the Freedom of Establishment in the Association and Partnership Agreements"*, in Heidenbauer and Stürzlinger (eds.), The EU's External Dimension in Direct Tax Matters, Viena: Linde, pp.447-454.

With regard to intra-EU cases, the application of the priority approach may not entail any consequences given that shareholders will always be protected against thin capitalization rules which involve restrictions or discrimination, regardless of the fundamental freedom that the CJEU may apply. However, the consequences are not the same with respect to non-EU countries because only the free movement of capital comprises an external dimension and, as such, if this freedom does not apply, but only the freedom of establishment, third countries are not protected against any restriction, which might result from the application of the thin capitalization rules.

Due to the possible application in the future of the parallel approach by the CJEU to the analysis of these issues, parent companies which are resident in third countries should be protected against any type of restriction that may appear as a result of the application of thin capitalization rules, through the free movement of capital, when such rules are neither justified nor proportional. In this context, it is relevant to note that the application of thin capitalization rules that are not justified or proportional to companies of third countries may deter them from financing their subsidiaries situated in the EU by way of debt, even in cases where there is not a wholly artificial arrangement, but a transaction with real substance. Because of this, protection may be needed.

The CJEU has issued some decisions with regard to national thin capitalization rules that have been adopted by member states. In these cases, the CJEU has examined the possible infringement of the fundamental freedoms envisaged in the TFEU, the presence of discrimination or restrictions as a consequence of the application of national thin capitalization rules, the existence of justifications for the use of such provisions, and the proportionality of the measures established by national legislation.

The first decision of the CJEU to address the question of the compatibility of domestic thin capitalization rules with EU law was issued in the *Lankhorst-Hohorst* case and influenced equivalent rules in other EU Member States.

In the *Lankhorst-Hohorst* judgment of 12 December 2002, the CJEU held that the initial German thin capitalization provisions were inconsistent with the freedom of establishment in accordance with article 49 of the TFEU. Especially, the CJEU found that the German thin capitalization rules gave rise to a different treatment between resident subsidiaries depending on whether their parent company had its seats in Germany or not, and that this represented a barrier to the freedom of establishment. The German rule provided that the important requirement in order to reclassify the payment of interest as a profit distribution

was if the shareholder who received the repayment of the loan was allowed to a corporate tax credit or not, and, as a rule, resident parent companies were entitled to a tax credit, while non-resident parent companies were not.[114]

In this way, the interest paid to a non-resident parent company was always taxed at a 30% rate, while the interest paid on loans provided by a resident parent company was considered as an expense.[115] This represented a restriction to the freedom of establishment by making it less appealing for companies based on other Member States to establish a subsidiary in Germany.[116]

The CJEU rejected the argument that this different treatment was justified by the risk of tax evasion, given that the provision did not pursue the specific objective of avoiding artificial arrangements, but it was rather applicable to all cases involving parent companies whose residence was not in Germany. The Court added that this situation did not pose a risk of tax evasion since the parent company that was not domiciled in Germany would still be taxed in its country of residence. [117] Moreover, the ECJ rejected the above mentioned justification because no evasion had been proven.

In this case, the CJEU refused the arguments used by the German government that the thin capitalization rules did not give rise to discrimination on the grounds of nationality, that they were created to deter tax evasion, and that they were legitimized by the need to guarantee the coherence of the tax system and the efficiency of fiscal supervision.

On the basis of the criteria followed by the CJEU in the *Lankhorst-Hohorst* case, various groups of resident subsidiaries in the United Kingdom claimed restitution and compensation for the tax disadvantages that have arisen as a result of the application of the UK thin capitalization rules. One factor that these cases had in common was that each group of companies included a resident company in the UK which was at least 75% owned, directly or indirectly, by a non-resident parent company and had been provided a loan either by that parent company or by another non-resident company which was at least 75% owned, directly or indirectly, by the same parent company.[118]

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[114] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, paras. 28 and 4.

[115] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, para. 29.

[116] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, para. 32.

[117] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, para. 37.

[118] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I- 02107, para.17.

The High Court of Justice of England and Wales questioned if national rules which limit the capacity of a company resident in a MS to deduct interest on loans provided by a direct or indirect parent company resident in another MS, in circumstances in which the debtor company would not be exposed to such restrictions if the parent company was resident in that same state, constituted an infringement to the freedom of establishment, the free movement of services and/or the free movement of capital.

In the *Thin Cap Group Litigation* judgement of 2007, the CJEU held that the freedom that was mainly affected was the right of establishment as all the cases were linked to companies in which at least 75% of the shares were held by a non-resident parent company[119] and, as such, the creditor exerted decisive control over the debtor. The Court added that any limitation to the free movement of services and capital was an inevitable result of the restriction on the freedom of establishment, which did not justify a separate analysis of these freedoms.[120]

The CJEU in this case also found that the difference in treatment between resident subsidiaries according to the place where their parent company had its headquarters represented a restriction to the freedom of establishment, as it made it less appealing for companies based on other MS to exercise their freedom of establishment.[121]

In this judgment, the CJEU accepted for the first time the justification for thin capitalization rules to prevent and fight tax avoidance, considering the arm's length principle as a proper and equitable test of artifice.

The CJEU also considered the proportionality of the provisions relating to thin capitalization, that is, if they do not go further than what is needed to prevent abuse, suggesting that they are regarded as such when they allow taxpayers to demonstrate the economic substance of the operations, and when the only amount that is recharacterized as dividends is the one that does not correspond to the interest that would have been paid under the arm's length principle.[122]

In the *Lasertec* judgement, the German company challenged the assessment of the tax authorities and, as a result, the competent Finance Court asked for a preliminary ruling from the CJEU, questioning if the reclassification as profit distribution of interest paid by a resident

[119] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I- 02107, paras. 32-33.

[120] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I- 02107, paras. 34-35.

[121] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I- 02107, para. 36.

[122] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I- 02107, paras. 78-83.

corporation to a lender and substantial shareholder that is resident in a non-EU country comprised a restriction or discrimination to the free movement of capital between a EU member state and the third country.

In this case, the CJEU adopted the criteria established in previous judgments and held that national rules relating to shareholders who exert decisive influence over the company's decisions fall under the scope of the freedom of the establishment.[123] Since in this case the Swiss shareholder held 75% of the capital of Lasertec, the case fell solely under the freedom of establishment. [124] The CJEU indicated that that the freedom of establishment only involves an internal dimension and, as a result, it does not apply to third countries and, therefore, it does not apply to cases like the one in question.[125]

In the *NV Lammers & Van Cleef* case, the CJEU stated that the Belgian legislation provided a different tax treatment to the interest paid by a resident company according to whether or not its director is a resident in Belgium. The Belgian legislation allowed the reclassification of interest as a profit distribution and taxed it as such only in cases where the director is a non-resident company and the interest is deemed excessive under the limits provided for in the Tax Code. Conversely, when the director is a resident company, the interest is not reclassified as a distribution of profits, even if it is regarded as excessive. In this way, non-resident companies that are directors of a Belgian company face a less favourable tax treatment.[126]

In this case, the CJEU concluded that the difference in treatment between resident and non-resident directors of a Belgian corporation constituted a restriction to the freedom of establishment and held that such limitation went beyond what was required to meet the goal of preventing abusive practices, given that it could impact operations which cannot be regarded as artificial.

In the *Itelcar* case, the CJEU considered the Portuguese thin capitalization rules applied between resident companies and companies from third (non-EU) countries, which are regarded as related parties, as contrary to the free movement of capital.[127] The CJEU ruled

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[123] ECJ, 10 May 2007, Case C-492/04 Lasertec [2007] I- 3775, para. 20.

[124] ECJ, 10 May 2007, Case C-492/04 Lasertec [2007] I- 3775, paras. 21-24.

[125] ECJ, 10 May 2007, Case C-492/04 Lasertec [2007] I- 3775, paras.26-28.

[126] ECJ, 17 January 2008, Case C-105/07 NV Lammers [2008] I- 00173, paras. 20-24.

[127] Global Tax Alert EU Competency Group, "The CJEU finds Portuguese thin capitalization rules contrary to free movement of capital", 10 October 2013.

that the Portuguese provisions intended to prevent a resident company from obtaining credit in a way deemed excessive from a company resident in a third country. The CJEU accepted the argument of the Portuguese Government on the need of the rule to deter tax avoidance and evasion, however, the Court indicated that the rule went beyond what is necessary to achieve this goal and for that reason considered it inconsistent with EU law.[128]

Some countries like Denmark, Germany, Italy, Portugal, Spain and the United Kingdom have adapted their thin capitalization rules in order to be in line with the decisions issued by CJEU.[129] A member state which has not yet adjusted its thin capitalization rules to be in accordance with the CJEU's criteria should do it in order to avoid any consequences, such as the filing of complaints against the MS and the resulting obligation to refund the taxes paid as a result of the application of thin capitalization provisions that are incompatible with the fundamental freedoms of the EU.

Following the CJEU decision in the *Lankhorst-Hohorst* judgement, various Member States amended their provisions on thin capitalization rules. The approach followed by the member states in order to conform to EU legislation was essentially to broaden the scope of thin capitalization rules so as to include the loans that were signed between resident corporations- Denmark and the Netherlands opted for this approach; or to exclude intra-EU loans from the scope of thin capitalization provisions- Spain until 2012 and Portugal chose this approach.

Within these changes, the rules introduced in Germany, Portugal and UK will deserve special attention. Germany adopted earnings stripping rules, under which the deductibility of interest expenses on loans with related and unrelated parties is limited to up 30% before EBITDA and applies to both resident and non-resident creditors.[130]Any interest expenses which exceed this limit are not deductible, however they can be carried forward and deducted in subsequent years, when they will again be subject to interest barrier rules.

So far, there is no certainty as to whether this new rule is in line with EU law. In fact, the new rule does not confer a different treatment to resident and non-resident parent companies, however, there are still some provisions in the German legislation that may result in hidden discrimination.

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[128] ECJ, 3 October 2013, Case C- 282/12 Itelcar [2013], paras. 36-40

[129] Terra and Wattel, "*European Tax Law"*, 5th edition, Alphen aan den Rijn: Kluwer Law International, 2008, p. 585.

[130] However, the earnings stripping rule is not applicable either to smaller sized businesses that incur net expenses below the amount of EUR 1,000,000, or to a business that does not belong totally or partially to a group.

In particular, thin capitalization rules do not apply in cases where companies constitute an integrated fiscal unit, which is considered as a single "business" for German tax purposes under section 4h of the GITA (German Investment Tax Act). The question is that, under section 14 (1) of the GCITA (German Corporate Income Tax Act), only resident companies can qualify as an integrated fiscal unit and the provision does not include a cross-border dimension. Thus, a German fiscal unit with a non-resident parent company or a German parent company with non-resident subsidiaries is unable to take advantage of the opportunity to avoid triggering interest limitation rules, which may infringe the freedom of establishment. [131]

Currently, Portuguese thin capitalization rules are very similar to the ones adopted in Germany. Before the 2013 reform, the Portuguese Corporate Income Tax Code (CIRC-Código do Imposto sobre o Rendimento das Pessoas Colectivas) adopted a fixed ratio rule, according to which excessive debt was considered to occur when the value of debt in relation to each of the entities was more than twice the value of the corresponding shareholding in the taxpayer's equity (2:1 debt-to-equity ratio). In this way, when the amount of debt of a Portuguese taxpayer in relation to a non-resident entity in Portugal or in an EU country with whom special relations existed was deemed excessive, the interest paid in relation to the part of the debt considered excessive would not be deductible for the purposes of assessing taxable income.

After the 2013 reform, Portuguese thin capitalitalization rules were tightened. Particularly, under article 67º of the Portuguese Corporate Income Tax Code the deductibility of net financial expenses is limited to the higher of the following: EUR 1 million; or 30% of EBITDA, and it applies to both resident and non-resident creditors. The arm's length principle is included in article 63º of the Portuguese Corporate Income Tax Code with respect to transfer pricing. Accordingly, any commercial transactions, including transactions or a series of transactions related to goods, rights, services or financial arrangements between a taxpayer and another entity with which it has special relations must be conducted as if they were independent entities carrying out comparable transactions. Hence, Portuguese thin capitalization rules appear to combine features of an earnings stripping rule and an arm's length approach.

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[131] Soshnikov, *"Structure and Elements of National Thin Capitalization Rules"*, in International Group Financing and Taxes, Wien: Linde, 2012, p. 64.

The UK, following an entirely different approach, chose to revoke its thin capitalization rules and alternatively applied, to transactions that fell within their scope, transfer pricing rules, with the result that taxpayers are no longer required to have their debt-to-equity in a ratio established by a national thin capitalization rule, but rather to carry out all their operations at arm's length considering that only the amount of interest that is not in accordance with this principle is treated as not deductible.[132]

This system is applicable to transactions which relate to both resident and non-resident creditors and seems to comply with EU law and the CJEU decisions, as was stated by Advocate General Geelhoed in the Thin Cap Group Litigation judgment.[133]

Despite the fact that member states follow different thin capitalization approaches, one thing that they have in common is that their legislation has to be in conformity with EU law. However, the fact that thin capitalization rules considerably differ among member states may entail undesirable effects (like uncoordinated tax effects) and that's why some authors have drawn attention to the need to harmonize thin capitalization rules within the EU.

[132] Green, *"U.K. Thin Capitalisation: After the Renovations"*, BNA International's Tax Planning International Transfer Pricing, September 2004.

[133] Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04 Thin Cap Group Litigation [2007] I- 02107, point 44.

5. Thin Capitalization Rules: need of harmonization?

The Common Consolidated Corporate Tax Base (CCCTB) proposal covers one single set of rules for the corporate tax base which aims to eliminate some of the main tax barriers and market distortions that hinder the effective functioning of the single market. In particular, in order to calculate its taxable income, a company or group of companies would have to follow just one EU system instead of applying different rules in each Member State that it operates. Furthermore, according to the CCCTB and under a "one-stop-shop" approach, companies which operate in more than one EU member state would only have to file a singular tax return for the overall of their activity within the EU.[134]

The CCCTB include multiple objectives: it is designed to considerably decrease the administrative burden, compliance costs and legal ambiguity in the EU caused by the concurrence of 28 different corporate tax systems; to enable enterprises to treat the Union as a single market for corporate tax purposes; to give the possibility of offsetting losses of one entity against profits in another jurisdiction permitting the consolidation of profits and losses at EU level; and to turn the EU into a more competitive and attractive place for international investments.[135]

Assuming that debt and equity will continue to be subject to different tax treatments, some authors have suggested the introduction of a common thin capitalization rule within the context of the CCCTB.[136] As mentioned before in this research, national thin capitalization rules considerably differ between member states. Some countries do not apply thin capitalization rules and between those that apply, there are evident differences in their specific design, especially as regards their scope and effect.

In terms of the CCCTB, the introduction of thin capitalization rules has beneficial results due to their capacity to mitigate this type of international tax planning. This assumption is based on two central aspects: first, the introduction of these rules will protect the tax base and, therefore, revenue, which would otherwise be exposed to erosion; and

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[134] McLure, *"Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications"*, July 2008, Tax Policy and the Economy, vol. 22.

[135] Kocaer, *"Disallowance of Interest Deductions in Article 81 of the CCCTB Draft Proposal"*, in: International Group Financing and Taxes, Wien: Linde, 2012, pp. 147-168.

[136] See, for example, Dourado and la Feria, *"Thin Capitalization Rules in the Context of the CCCTB"*, Oxford University Centre for Business Taxation, 2008.

second, the non-inclusion of those rules could, in itself, lead to more serious economic distortions.

Not including a common thin capitalization rule in the context of the CCCTB could mean that Member States continue to apply their individual provisions and the resultant application of different national rules is considered to facilitate tax planning.

The difference in treatment that is given by Member States to thin capitalization provisions may also cause some difficulties as regards double taxation and high administrative costs. Thus, some commentators have suggested the harmonization of the provisions relating to thin capitalization as an adequate solution.[137]

The CCCTB proposal, under its article 81, entails a limitation to the deduction of interest when specific conditions are met but the Commission did not provide either an EBITDA test or a fixed debt-to-equity ratio in the proposal. It presented the general interest limitation rules as applicable to non-cooperative countries and third countries with low corporate income tax rates.[138]

In this way, article 81 will only apply when three cumulative requirements are satisfied: interest is paid to an associated party, the associated company is resident in a third country in which the applicable corporate tax rate is low, and there is no exchange of information on request up to the standard of the Mutual Assistance Directive.[139]

There are some practical concerns regarding the application of the CCCTB since it implies a high level of cooperation and coordination between countries. According to the CCCTB, after the company's tax base is computed it will be apportioned to all Member States in which the company is active on the basis of a fixed apportionment formula which should be based on economic factors such as labour, capital and sales and which will determine the tax base of each individual taxpayer.[140] Naturally, each country would try to have the most advantageous weighting in the formula which might lead to some difficulties.

The application of the formula apportionment presupposes the integration of an economic area and a strong cooperation between States and it is questionable whether the

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[137] 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"*, Intertax 32(3), 2004, pp.126-137.

[138] Kocaer, *"Disallowance of Interest Deductions in Article 81 of the CCCTB Draft Proposal"* In: International Group Financing and Taxes, Wien: Linde, 2012, pp. 147-168.

[139] *Id*.

[140] Spengel and Wendt, *"A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some Issues and Options"*, Oxford University Centre for Business Taxation, June 2007.

European Union has already accomplished the level of integration needed. It seems to me that it is unlikely that all member states will join the CCCTB and also that the CCCTB will be adopted via the normal EU procedure, that is, unanimous voting in the Council.[141]

Besides the CCCTB proposal, the European Comission, at the beginning of 2016, published a proposal for a directive (the Anti-Tax Avoidance Directive) which is intended to deal with tax avoidance and to harmonize measures that can affect the adequate function of the internal market.

6. Anti-BEPS Directive

The European Commission, on 28 January 2016, published its proposal for a Council directive to deal with tax avoidance in the EU - the so-called Anti-Tax Avoidance Directive (ATA)[142]. The proposal is a product of the influences of the (so far) failed 2011 CCCTB proposal and the BEPS project of the OECD.

The aim of the Directive is to improve the resilience of the single market as a whole against cross-border tax avoidance. For this purpose, the directive intends to reach cases where taxpayers act against the real purpose of the law, exploiting the differences between national systems to decrease their tax burden.

The Commission resorts to article 115 of the TFEU which comprises the general rule for harmonization measures that affects the proper functioning of the single market. The reason for this is that if each member state adopts unilateral and uncoordinated measures to tackle tax avoidance, specifically by following divergent approaches to the implementation of the BEPS recommendations, the single market would face more fragmentation and barriers as regards cross-border activity.

The ATA directive in its article 4 includes an interest limitation rule. According to the plain wording of article 4(2): *"exceeding borrowing costs shall be deductible in the tax year in which they are incurred only up to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA) or up to an amount of EUR 1 000 000, whichever is higher. The EBITDA shall be calculated by adding back to taxable income the*

[141] European Business Initiative on Taxation (EBIT) Contribution to EC Consultation on CCCTB, November 2006, pp. 1-8.

[142] COM(2016) 26 final, Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, 28 January 2016.

tax-adjusted amounts for net interest expenses and other costs equivalent to interest as well as the tax-adjusted amounts for depreciation and amortisation". Article 4(3) adds that the taxpayer may have the opportunity to deduct excessive interest in full if the taxpayer is able to show that the ratio of its equity over its total assets is equal to or more than the equivalent ratio of the group.

By reading article 4 of the ATA directive it is possible to conclude that this interest limitation rule closely resembles the German and Portuguese interest barrier rules, which also limit the deduction of interest expense up to 30% of the EBITDA.

In this context, it is worth noting that just two weeks after the release of the ATA directive proposal, on 10 February 2016, the German Federal Tax Court (Bundesfinanzhof, BFH) made a decision regarding the German interest limitation rule (Zinsschranke). Given that both rules are very similar, one may question if the findings of the BFH may be, to some extent, also valid for the interest barrier rule suggested in the ATA-Directive proposal.

In this case, the taxpayer, a German company claimed that, at least in a purely national situation, the German earnings stripping rule infringes the principle of equal treatment, as provided for in Article 3 of the German Constitution. The BFH supported the view of the taxpayer and referred the matter to the German Constitutional Court (Bundesverfassungsgericht, BVerfG) to obtain a judgment about the compatibility of this rule with Article 3 of the German Constitution.[143]

Considering the BVerfG previous case law, the court has interpreted the equal treatment as a principle which includes the ability to pay doctrine. In other words, taxpayers should be taxed equally but taking into consideration their financial capacity to pay taxes. As regards corporate taxpayers, the BVerfG has established the objective net principle, meaning that companies should be taxed based on their net profits and including the fact that business costs, as a rule, must be deductible from the taxable base.[144]

In accordance with the BFH, the German interest barrier provision has infringed the objective net principle since it limits the deduction of interest, which is to be qualified as business costs. The possibility of reporting the interest for future years does not change that, because in an annual periodic tax system, the costs should be deductible in the year they are incurred. Moreover, the deduction of interest which is carried forward in subsequent years is

[143] Breuer, *"Anti-Tax Avoidance Directive: A Violation of the German Constitution?"*, 2 March 2016, in Kluwer International Tax Blog.

[144] Breuer, *"Anti-Tax Avoidance Directive: A Violation of the German Constitution?",* 2 March 2016, in Kluwer International Tax Blog.

also subject to 30% -EBITDA-rule, which makes the use of the interest carry-forward practically impossible for companies that face a period of stagnation.[145]

Furthermore, according to the BFH, the infringement of the objective net principle cannot be justified by the premise that the interest carry-forward possibly allows for a full deduction of interest considering the entire period of existence of a company. The justification is that the German legislation decided to apply an annual periodical tax system. A multi-tax-period approach is accepted in relation to losses, but not with regard to business expenses that can be reported to a particular fiscal year. Hence, the BFH considers that the cases of loss carry-forward and interest carry-forward are not analogous nor worthy of comparison.[146]

Due to the similarities of the German earnings stripping rule with the interest barrier rule proposed by the ATA directive, particularly their application to both domestic and cross-border situations, the very high threshold to limit its scope to only a small group of taxpayers, and the violation of the objective net principle, it is possible that the BFH may consider the interest barrier rule proposed in the ATA directive contrary to the principle of equality provided for in the German constitution.

It is interesting to see a national provision which strongly resembles the one established in the directive proposal being challenged internally.

7. Interim conclusions

This chapter was devoted to addressing how states are responding to this debt bias issue and has also analysed the effort made by the OECD and the EU in combating base erosion and profit shifting through the use of inflated interest deduction. We saw that the most common response has been the adoption of thin capitalization and earnings stripping rules. They have seemed to be effective in curtailing this kind of aggressive tax planning. However, as we are going to see in the following chapter, their application may also entail some adverse effects. For this reason, some authors have been suggesting that the real solution to prevent the erosion of the tax base is to eliminate the different treatment applied to debt and equity and that the application of a neutral tax treatment to debt and equity financing would alleviate the need to create tax schemes to obtain tax advantages from the use of debt financing.

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[145] *Id*.

[146] *Ibid*.

Part III - Towards more neutrality between debt and equity

1. Potencial negative impact of thin capitalization rules on levels of investment

In terms of their effectiveness, thin capitalization rules, in fact, appear to have decreased debt ratios.[147] However, there are some economic surveys which establish that the imposition of constraints on particular forms of international tax planning may result in unfavourable consequences with respect to investment made by international groups in countries which apply high tax rates.[148]

In this context, it is pertinent to consider the cases of foreign subsidiaries that finance their operations with internal debt usually granted by low-tax related parties and, as a result, enjoy a comparatively low tax burden. When a thin capitalization rule is introduced, companies that strongly rely on debt finance will face a situation of excessive debt, that is, debt that exceeds the threshold determined by the debt/equity ratio. Consequently, a part of the interest deduction will be disallowed, and there will be an increase in the tax burden as a result. This may have the effect of decelerating foreign direct investment.[149] Also, even if companies opted to reduce their internal debt finance levels, the tax burden would also increase, given that companies would be applying less tax-efficient financing.

In the presence of a thin capitalization provision, when there is an increase in the tax rate, the tax shield from internal debt financing is less efficient for companies with limited deductibility of interest. As a result, there will be an increase in the tax burden and the tax sensitivity of foreign direct investment may increase when a thin-capitalization rule is introduced. Such policies are also considered to possibly enhance tax competition.[150]

Companies that do not use much internal debt are usually below the debt/equity ratio and any deduction of interest is, in principle, not denied. In, this way, the introduction of thin-capitalization rules would not affect those companies. However, studies seem to suggest that it is more likely to find companies that are subject to limitation of interest deduction in countries that apply higher tax rates. Accordingly, some authors have considered that the

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[147] Overesch and Wamser, *"Corporate Tax Planning and Thin-Capitalization Rules: Evidence from a Quasi Experiment"*, Applied Economics, 2008.

[148] Peralta et al, *"Should countries control international profit shifting?"* Journal of International Economics 68, 2006, pp. 24-27.

[149] Buettner, Overesch and Wamser, *"Anti Profit-Shifting Rules and Foreign Direct Investment"*, CESifo working paper no. 4710, March 2014.

[150] *See*, Peralta et al, *"Should countries control international profit shifting?"* (2006) Journal of International Economics 68, 24-27.

introduction of thin capitalization rules may have negative effects on foreign direct investment, especially in countries that apply high statutory tax rates.[151]

Despite the fact that some preoccupation has arisen over the impact of thin capitalization rules on levels of investment, recent studies have not succeeded in establishing, in pragmatic terms, a direct correlation between thin capitalization rules and investment levels.[152] However, some concerns remain over an eventual decrease of tax sensitivity resulting from the introduction of thin capitalization rules. There has been a tendency among OECD countries to reduce their corporate tax rates while introducing anti profit-shifting rules. Assuming that thin capitalization rules, in fact, reduce tax sensitivity, the economic impact of potential corporate tax reductions would be limited. As a result, the ability of governments to stimulate foreign investment through the introduction of those reductions would also be limited. In this way, the decrease of tax sensitivity should be taken into consideration when introducing thin capitalization rules.

2. Possible solutions to achieve more neutrality

The fact that many member states confer a different tax treatment to interest and dividends constitutes the main reason why some multinational groups opt to finance their affiliates by means of debt rather than equity capital. This led to the need to create thin capitalization rules. Against this background, some authors have argued that the best solution to prevent the erosion of the MS's tax base is to give a neutral treatment to both debt and equity financing, meaning that the need to adopt tax schemes in order to obtain tax advantages will no longer exist and, consequently, it will not be necessary to design anti aggressive tax planning rules to address this matter. This would also mean that concerns regarding the compatibility of such rules with EU law would cease.[153]

Two alternatives are suggested regarding the design of corporate tax systems in order to remove the distortion caused by the different treatment that is given to debt and equity financing by dealing with both sources of funding in the same manner- an Allowance for

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[151] Buettner, Overesch, Schreiber and Wamser, *"The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions"*, CESifo working paper no. 1817, October 2006.

[152] Dourado and la Feria, *"Thin Capitalization Rules in the Context of the CCCTB",* Oxford University Centre for Business Taxation, 2008.

[153] Bravo, *"Thin Capitalization Rules and EU Law/Fundamental Freedoms"*, in International Group Financing and Taxes, Wien: Linde, vol. 74, pp. 119-143.

Corporate Equity (ACE) or a comprehensive business income tax (CBIT). The ACE would allow for a deduction for return on equity (as in the case of interest payments) and would consequently mitigate or eliminate the tax benefits of debt finance. The CBIT system, in turn, would deny the deduction of interest for corporate income tax purposes. The common factor in these systems is that they are both intended to counteract the distortionary impact of corporate taxes on the financial structure of companies.

Recently, the CBIT and the ACE have raised interest in the EU policy debates as a possible path to readjust corporate tax systems.[154] Some countries have experienced or implemented changes in their tax laws with characteristics similar to the ACE system. The majority of countries have established limits on the deduction of interest which further resembles the CBIT.[155]

2.1 CBIT

The CBIT aims to remove the advantageous tax treatment that is given to investment that is financed with debt, by proposing the disallowance of the deduction of interest payments. In 1992, the US Treasury suggested the CBIT and its proposal comprised an important distinction between CBIT entities and non-CBIT entities.[156]

In principle, most companies will classify as CBIT entities (only small companies will not) which are not allowed to interest deductions. This would also be applicable to financial firms, including banks. In order to prevent double taxation of interest, it should be given a tax exemption or credit to interest received by companies or banks from other CBIT entities. However, if the interest payment comes from a non-CBIT entity, it will be exposed to tax. Interest that is received from abroad, in principle, will be subject to tax, however, if the interest received comes from a CBIT entity it should be tax exempted or credited.[157]

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[154] Mooij and Devereux, *"Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms"*, Oxford University Centre for Business Taxation, 2008.

[155] *See*, for example, Mooij and Devereux, *"An Applied Analysis of ACE and CBIT Reforms in the EU"*, International Tax and Public Finance, February 2011, vol. 18, Issue 1, pp. 93-120, Published online: 3 June 2010.

[156] "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Once," Jan. 1992.

[157] Hubbard, *"Corporate Tax Integration: A View from the Treasury Department"*, Journal of Economic Perspectives, Volume 7, Number 1, 1993, pp. 115–13.

The CBIT has the effect of increasing the cost of capital for a debt financed investment because the interest paid is no longer deductible when calculating the tax base.[158]Despite the fact that this reform leads to an increase in the capital cost, it might be recommended for a country to apply it if, at the same time, the country adopts a lower corporate tax rate since the tax base is now broader.

Therefore, the CBIT deals with debt as present CIT systems deal with equity financing. It is compatible with a wide, source-based tax on investment income which is retained at the enterprise level. As all capital income is taxed at the company level, the CBIT may be combined with the elimination of personal income tax on interest, dividends and capital gains.[159]

The CBIT removes distortions in the financial structure of companies, but increases the cost of capital when investments are financed by debt. The latter may have the result of reducing investment but, at the same time, since the CIT base will be broader, it will allow a reduction in the CIT rate as part of a revenue-neutral reform. Hence, the tax burden on profitable equity financing will be reduced. Additionally, a decrease in the corporate income tax rate will also make a country more appealing for foreign direct investment.

In 2007, Sorensen found that, in general, the effect of the CBIT is unclear: on one hand, the cost of capital for low-income debt financed investments is likely to rise, which may represent a decrease in investments; on the other, highly profitable equity financed investments will be less taxed so these investments will probably expand.[160] Following Bond (2000), the advantages arising from lower tax rates under CBIT will presumably compensate for the costs incurred due to a higher cost of capital.[161]

Until now, there are no practical examples of the CBIT system and according to Mooij, its implementation can possibly result in transitional problems and practical adversities, as for example, difficulties in treating pre-existing debt.[162] In this way, the

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[158] Graham, *"Do Corporate Taxes (and Interest Deductibility) affect Corporate Decisions"*, Presentation at IMF Technical Workshop on Tax-Induced Debt Bias, 4 March 2011, Washington DC.

[159] Mooij, *"Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions"*, IMF, 3 May 2011.

[160] Sørensen, *"Can capital incomes taxes survive? And should they?"*, CESifo Economic Studies 53, pp. 172-228.

[161] Bond, *"Levelling Up or Levelling Down? Some Reflections on the ACE and CBIT Proposals, and the Future of the Corporate Tax Base"*, in S. Cnossen (ed.), Taxing Capital Income in the European Union, Oxford University Press, Oxford, 2000.

[162] Shaviro, *"The 2008 Financial Crisis: Implications for Income Tax Reform"*. Forthcoming in J. Alworth and G. Arachi (editors), Taxation Policy and the Financial Crisis, Oxford University Press, 2011.

implementation of such a system should be gradual and take place over a long period of time. The CBIT system, in a short-term, may also pose some risks with respect to financial distress.

A partial application of the CBIT to intra-group debt financing may be effective in reducing the levels of debt shifting by multinational companies, although it implies coordination between countries. Hence, states would consider all intra-group financial flows as equity and tax their returns accordingly. Therefore, international groups would no longer be able to shift their profits through debt across jurisdictions.

Nevertheless, if the CBIT system is unilaterally applied, this could aggravate international debt shifting as companies would stop financing their investments with debt in countries that apply this system (since the deductibility of interest is not allowed) and would rather finance their investments in the countries that do not apply the CBIT with debt which derived from countries that apply the system (given that interest payments are usually not taxed.)[163] In addition to this, it may give rise to double taxation in cases where countries do not allow foreign tax credits or exemptions for interest payments arising from CBIT countries.

2.2 ACE

The ACE system was initially suggested by the Capital Taxes Committee of the Institute for Fiscal Studies in 1991. The system rests on an earlier idea developed by Boadway and Bruce in 1984, who proposed an allowance for corporate capital (ACC).[164] The authors' suggestion was to eliminate the deduction of actual interest payments and to substitute it with an allowance of the normal return, applied to the book value of all the company's capital according to the tax accounts.

The ACE lightly differs from the ACC as it continues to allow the deduction of interest payments. In addition to the deduction of interest, a notional return on equity would also be deductible against companies' profits. (Bond and Devereux, 1995).

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[163] Mooij and Devereux, *"Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms"*, Oxford University Centre for Business Taxation, 2008.

[164] Boadway and Bruce, *"A General Proposition on the Design of a Neutral Business Tax"*, Journal of Public Economics, 1984, pp.231-239.

The ACE is perceived to have some appealing characteristics. One important feature is that it achieves neutrality between debt and equity financing. Therefore, the ACE renders thin capitalization rules inessential.[165]

Another feature of this system is its neutrality on the subject of marginal investment decisions. Since the ACE allows a deduction for both interest and the normal rate of return on equity, it is not intended to tax capital income. In this sense, the system is intended to only tax economic rents and no tax would be levied on investments whose return corresponds to the cost of capital.[166]

Despite the fact that the ACE is more neutral than present corporate tax regimes with respect to investment and its financial structure, it also includes some disadvantages. In particular, the ACE has the effect of narrowing the tax base (since deduction on equity is now allowed) which would imply a decrease in corporate tax revenue collected by states.[167] As a result, states would probably apply higher taxes elsewhere in order to compensate this revenue loss and to balance the government budget. One possible option would be to increase the corporate tax rate.

In this context, the ACE would transfer the tax burden from marginal return to capital to economic rents. If one considers a closed economy, which is characterized by a perfect capital market, the tax system would not be distortionary. However, inasmuch as the economies are open, rents can be mobile. For example, specific rents of companies related to brands or patents may be shifted across countries. Hence, the move from capital to rents would influence the production location.[168]

The ACE system also seems to impact investment decisions when companies encounter credit constraints. In particular, these restrictions are applicable to new and innovative companies which still do not have a reputation. Assuming that these companies cannot get credit from banks or investors, they will depend on retained earnings as a way to finance their new projects. Hence, an increase in the corporate tax rate would not benefit such

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[165] Klemm, *"Allowances for Corporate Equity in Practice"*, IMF working paper, Fiscal Affairs Department, November 2006.

[166] Mooij and Devereux, *"Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms"*, Oxford University Centre for Business Taxation, 2008.

[167] Fatica, Hemmelgarn and, Nicodème, *"The Debt-Equity Tax Bias: Consequences and Solutions"*, working paper N.33 – 2012, July 2012.

[168] Bond, *"Levelling Up or Levelling Down? Some Reflections on the ACE and CBIT Proposals, and the Future of the Corporate Tax Base"*, in S. Cnossen (ed.), Taxing Capital Income in the European Union, Oxford University Press, 2000. Oxford. *See*, also, Devereux and Griffith, *"Taxes and the Location of Production: Evidence from a Panel of U.S. Multinationals"*, Journal of Public Economics 63, pp. 335–367.

companies since it will decrease cash flow and liquidity of companies.[169] This allows them to finance more investment from retained earnings. A lower corporate tax rate allows companies to finance more projects with retained earnings.

The ACE might be considered undesirable with respect to international profit shifting. There are several options which are made available for multinational groups to shift profits across jurisdictions. The fact that countries apply different statutory tax rates is the main reason why international profit shifting techniques are exploited by states. Since an ACE is only advantageous for states' revenue when accompanied by an increase in statutory tax rates, the government is likely to lose revenue through the application profit shifting strategies towards other countries.[170]

It is important to note that the ACE system does not necessarily imply an increase in the corporate tax rate. An increase in the tax on consumption, for instance, may be another candidate to make up for the revenue costs of the ACE. In this way, the economic consequences of an ACE system may be different if this alternative way to balance the government budget is applied.

International tax planning by means of intra-group loans might also change given that debt and equity would receive a more neutral treatment according to the ACE system. In this way, if all countries adopted this system, multinational companies would no longer feel motivated to adapt their intra-group debt-to-equity ratios. Conversely, if the ACE system is adopted by only one country, international groups may have an incentive to locate their equity in that country since equity returns would not be fully taxed.[171] If the distribution of dividends is exempted in the country of the parent company, it makes it appealing for multinationals to channel equity to the ACE country and decrease their overall tax burden.

Various countries have experienced some variants of the ACE system. Croatia, Austria and Italy implemented variants of the ACE but they were subsequently brought to an end. However, according to Keen and King (2002), this was not due to administrative or technical difficulties.[172] The abolition of the ACE was rather part of a reform directed at decreasing the corporate income tax rates. Klemm (2007) indicates that these ACE reforms

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[169] Mooij, *"Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions",* IMF, 3 May 2011.

[170] Mooij and Devereux, *"Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms"*, Oxford University Centre for Business Taxation, 2008.

[171] *Id*.

[172] Keen and King, *"The Croatian Profit Tax: An ACE in Practice",* Fiscal Studies 23, 2002, pp. 401–18.

have been linked to a reduction in debt/equity ratios.[173] At present, Brazil, Latvia and Belgium apply some variations of the ACE.

Brazil has introduced the concept of "interest on net equity" ("INE") into its corporate income tax system. Shareholders may be remunerated either through the payment of dividends, which are not deductible for corporate income tax purposes, or through the INE. INE paid to shareholders is deductible for purposes of corporate income tax, subject to the following limits: "(a) the official long-term interest rate times accounting net equity, and (b) 50 per cent of taxable income, before the deduction of INE.[174]

In 2006, Belgium adopted the notional interest deduction (NID), which establishes an interest deduction with respect to equity financing, regardless of whether dividends are paid. The deduction corresponds to the interest rate on 10-year Belgian state bonds multiplied by the amount of the company's net assets. Although the goal of the NID is to narrow the different treatment of debt and equity financing, such differences persist due to differences in the treatment of interest and dividends received by investors.[175]

The economic implications of ACE reforms remain slightly unclear. Not only is there insufficient information provided but it is also difficult to assess the ACE individually since in most cases it was part of a multiple reform.[176]

2.3 ACE and CBIT combinations

In theory, there can be a combination of the ACE and CBIT systems. For example, Italy and Austria in their experiments did not exempt normal economic profits from taxation, but rather applied a lower tax rate on such profits than on economic rents.[177] Hence, these systems can be typified as partial ACE systems. In the same way, reforms which establish restrictions on the deduction of interest, such as thin capitalization rules or earnings stripping rules, can be seen as partial CBIT reforms.

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[173] Klemm, *"Allowances for Corporate Equity in Practice"*, CESifo Economic Studies 53, 2007, pp. 229-262.

[174] Brown, General Report, IFA cahier, vol.2, 2012, p.39.

[175] *Id*.

[176] *See*, for example, Mooij and Devereux, *"An Applied Analysis of ACE and CBIT Reforms in the EU"*, International Tax and Public Finance, February 2011, vol. 18, Issue 1, pp. 93-120, Published online: 3 June 2010.

[177] *Id*.

The discrimination between debt and equity can be reduced by a combined reform of a partial ACE and a partial CBIT.[178]Simultaneously, the implications for corporate tax revenue should be counterbalanced. Consequently, the optimal combination would include a reform package of a partial ACE and partial CBIT which is revenue neutral for the states and even more neutral in relation to the companies' financial structures.

It is rather difficult to determine an ideal combination of ACE and CBIT. In order to achieve optimality, not only financial distortions would have to be reduced, but also distortions of the corporate income tax, including location distortions, investment distortions, and aggressive tax planning via profit shifting.[179] Different countries have different levels of distortions. Therefore, optimality rules will differ accordingly.

Furthermore, these distortions depend on how countries draft their systems. They could do so unilaterally or multilaterally. An economic perspective regarding optimality conditions may indicate that some countries will consider that it is optimal to shift the tax burden to other tax bases. For example, an ACE can be financed by a raise in labour or consumption taxes. Countries may rather reduce their corporate tax rates and cut back transfers, achieving effectiveness in this way.

It is, however, not only a question of effectiveness. Equity issues have to be taken into account when questioning if such policies are socially advantageous or even alluring. To reach optimality, it is necessary to get a full assessment of key trade-offs between equity, efficiency, and administrative feasibility.

In my opinion, a reform in the tax system with the objective of eliminating the existing discrimination between the two financing forms appears to be an attractive and reasonable idea. Nonetheless, I believe that a more thorough analysis remains to be made on this subject in order to more clearly assess the implications arising from a reform which combines a partial ACE and a partial CBIT.

Even if countries choose to make reforms towards more neutrality, I think that it will always be effective for them to have rules in their tax systems which limit the deductibility of interest so that governments may have the necessary tools to prevent the erosion of the tax base.

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[178] Fatica, Hemmelgarn and, Nicodème, *"The Debt-Equity Tax Bias: Consequences and Solutions"*, working paper N.33 – 2012, July 2012.

[179] Mooij and Devereux, *"An Applied Analysis of ACE and CBIT Reforms in the EU"*, International Tax and Public Finance, February 2011, vol. 18, Issue 1, pp. 93-120, published online: 3 June 2010.

I consider that the amount of equity return that corresponds to the cost of capital may also be regarded as the cost of doing business and, as such, like interest, it should also be deductible up to a pre-determined threshold. Moreover, although the approximation between the treatment of debt and equity is likely to lead to a decrease in the adoption of tax schemes aimed at gaining tax advantages, this does not make interest limitation rules unnecessary.

A reform which allows the deductibility of equity returns that correspond to the cost of capital is likely to result in a decrease in the states' tax bases since new deductions are now allowed. In this way, it is important to counterbalance the effects of such a reform, that is, if in an overall framework this reform is desirable to the economic and social sustainability of the welfare state. If so, deducting equity returns levelling the cost of financing appear an interesting idea. At the same time, interest would still be deductible but with limits.

3. Conclusions

The different tax treatment between equity and debt finance gives multinational companies opportunities for tax arbitrage on an international level. Tax arbitrage is essentially the process of taking advantage of the differences in the tax rates applied by countries and is only achieved because the country of the lender applies a more advantageous tax rate than the country of the borrower. If this is the case, international groups naturally opt for debt-financing rather than equity financing so as to decrease the group's general tax burden by shifting income from high-tax jurisdictions to low-tax ones via debt-financing.

This has the result of eroding the corporate tax base of the borrower's country and, because of this, thin capitalization rules and earnings stripping rules are generally considered to be effective measures to combat financial structures which are excessively leveraged. In order to counter the debt bias problem, the most popular reaction has been the adoption of thin capitalization rules not only within the EU, but also among OECD countries. The OECD has done extensive work on the matter of international tax avoidance especially through the BEPS project whose Action 4 recommendations assumed particular importance for this research.

In the EU context, some of the thin capitalization rules adopted by MS were considered to be incompatible with the EU fundamental freedoms and, as a result, a number of member states have adapted their thin capitalization rules in order to be in conformity with the EU law.

The fact that thin capitalization rules considerably differ among member states may lead to uncoordinated tax effects deriving from their application, mainly in relation to third countries. An appropriate solution would be to create common thin capitalization rules in the EU context. This could be done in the context of the secondary law that has already been created and adopted by MS in relation to dividends or interest, or in the context of the CCCTB or ATA Directives. Assuming that debt and equity will remain subject to different tax treatments, it seems reasonable to introduce a common thin capitalization rule among member states.

Although some studies suggest that the adoption of thin capitalization rules may have a potential negative impact on investment in high-tax jurisdictions, introducing these rules has positive effects in curtailing international tax planning through debt financing. Their implementation will protect the tax base, and consequently the revenue. Also, not to include

rules that put a limitation on the interest deduction could give rise to many more economic distortions.

However, what some authors have been suggesting is that the real solution to prevent the erosion of the tax base is to eliminate the different treatment applied to interest and dividends. The application of a neutral tax treatment to debt and equity financing would alleviate the need to create tax schemes to obtain tax advantages from the use of debt financing.

With the aim of neutralizing the divergent treatment that is given to debt and equity, two more radical solutions were suggested- the ACE and the CBIT systems The ACE would allow for a deduction for return on equity (as in the case of interest payments) and would, consequently, mitigate or eliminate the tax benefits of debt finance. The CBIT system, in turn, would deny the deduction of interest for corporate income tax purposes.

These systems appear to have some appealing features but there are also some drawbacks associated with them. These should be counterbalanced to assess the effectiveness of the systems. A possible combination between a partial ACE system and a partial CBIT system appears to be an attractive idea, but there is still research that remains to be done on this subject.

A reform in the tax systems aimed at ending with the discrimination between the two sources of financing seems an interesting and feasible idea but more direct evidence on its plausibility should be provided since some implications are liable to derive from this reform. Given the present context and the universal effort made in the direction of thin capitalization rules, their adoption seems to be the most pragmatic solution in the short run. Furthermore, it seems to me that they are, in fact, effective in reducing debt-to-equity ratios and tax avoidance and that their life expectancy is still long. Despite the fact that countries may undertake reforms towards more neutrality, I believe that it will always be convenient for them to have rules that limit the deduction of interest, that is, rules that help governments to prevent the erosion of the tax base.

In the same way that interest is the cost of doing business, so is the injection of capital in a company until the moment that the capital cost is recovered. In my view, the amount of equity return that corresponds to the cost of capital or cost of financing should also be considered as the cost of doing business and, as such, this amount (like interest) could be deductible up to a pre-established threshold.

The question remains whether this discrimination between the two forms of financing is justified and why an investment financed via debt should receive a more favourable tax treatment than one that has been financed with equity capital.

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