European Union

BEPS Action 4: Policy Considerations and Implementation Status

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This article addresses BEPS Action 4. The authors provide a historical perspective of the relevant BEPS and EU measures, explain the highlights of BEPS Action 4, discuss the overlap between the different Actions, update readers on country-specific implementation of BEPS Action 4, summarize existing case law in the area, present practical examples dealing with the impact of Action 4 on certain structures and, finally, provide concluding remarks.

1. Executive Summary and Policy Considerations

As part of the Final Report issued by the OECD on BEPS Action 4, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments",[1] the OECD proposed a new approach to tackling excessive debt financing that puts debt and equity instruments on the same level for tax purposes. The OECD's approach consists of three aspects: (1) a fixed ratio rule based on a benchmark net interest/EBITDA ratio; (2) a group ratio rule that allows an entity to deduct more interest in certain circumstances based on the position of its worldwide group; and (3) targeted rules to address specific risks. Although detailed guidance on identifying instances that lead to excessive interest deduction is contained in the Final Report on Action 4, additional assistance in tackling such structures is provided by other BEPS Action Plans. The following lists how intercompany interest charges on intercompany loans become restricted through a series of BEPS and/or domestic measures:

(1) hybrid instrument and/or entities being used by MNEs – BEPS Action 2;

(2) CFC measures that target interest income in an MNE structure – BEPS Action 3;

(3) excess debt-to-equity ratio and/or interest levels relative to market – BEPS Action 4;

(4) preferential tax regime providing "low/no tax rates" to the treasury hub or cash boxes used by MNEs – BEPS Action 5;

(5) group affiliates used as "flow stream entities" to obtain a benefit from "tax treaties" – BEPS Action 6; and

(6) instances when the group entity acting as a lender does not actively manage the financial risks – BEPS Actions 8-10. These Actions take a different perspective in such scenarios, i.e. the maximum interest rate the lender can charge the other group entity is limited to a "risk-free interest rate".

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1. OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (5 Oct. 2015), International Organizations' Documentation IBFD.

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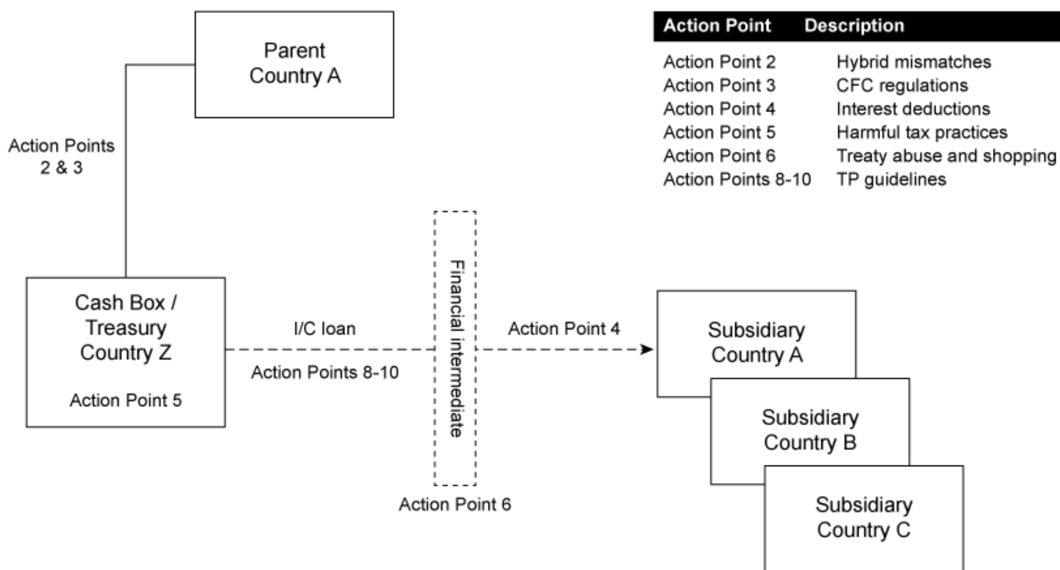
The above points 1-6 are reflected in Diagram 1, which portrays the different segments of a company that these points impact.

Diagram 1: Interaction between the BEPS Action Points



The European Union approved the Anti-Tax Avoidance Directive (2016/1164) (ATAD)[2] on 21 June 2016, which addresses common tax avoidance practices allegedly used by major multinational corporations. It seeks to ensure a consistent and uniform implementation of BEPS recommendations across the European Union. The Directive specifically covers points 1-4 and contains a general anti-abuse rule to widen its scope. The ATAD is being presented by the European Commission as a means to facilitate implementation of the BEPS measures, in particular how and when this should be done. Most of the ATAD's measures should ultimately be implemented in the domestic laws of the EU Member States by 31 December 2018 and become effective as from 1 January 2019.

While efforts are being made by the European Union to harmonize its tax system based on BEPS recommendations, in order to effectively bring about any change at a global level, the governments of (all) countries need to assess how to implement measures to tackle cases listed under points 1-6 above without disrupting their country's attractiveness to domestic and international investors. The following policy considerations and challenges appear to be hurdles in effecting such implementation:

(1) each country has different policies designed to keep the investment climate attractive, therefore, each country's level and timing of implementation of points 1-6 will differ;

(2) the cumulative impact of points 1-6 could easily lead to more than double taxation. Section 4. of this article provides an illustration of this possibility;

(3) the interplay between BEPS Actions Plans is complex to understand and implementation, from a purely tax/technical perspective, becomes even more complex when governments or regions, such as the European Union, blend their own political preferences into the implementation steps;

(4) various tax-related measures initiated by different countries/regions may limit and interfere with other prevailing principles, such as the four fundamental freedoms within the EU internal market; and

(5) the OECD has not issued/recommended a road map for synchronizing the new measures with the complex and sporadic network of existing bilateral tax treaties.

This article begins by providing a historical perspective of the BEPS and EU measures (section 2.). Section 3. compliments this overview by explaining the highlights of BEPS Action 4. As outlined in section 1., the key messages of Action 4 overlap with Actions 2, 3, 5, 6 and 8-10; therefore, section 4. explains this overlap/relationship by providing some "tax neutral", as well as "multiple taxation", scenarios that result from such interplay. Section 5. then indicates the country-specific implementation status of BEPS Action 4. Section 6 summarizes existing case law in an attempt to explain the countries' current approaches to tackling excessive interest deduction, as well as "debt versus non-debt classification". Section 7. presents some practical examples dealing with the impact of Action 4 on various types of structures. Section 8. provides the authors' concluding remarks and observations.

2. Council Directive 2016/1164 of 12 July 2016 Laying Down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193/1 (2016), EU Law IBFD.

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2. History of the BEPS and EU Measures

The OECD published its Action Plan on Base Erosion and Profit Shifting on 19 July 2013 (the Report).[3] The Report recognizes key pressure areas including, amongst others, "the tax treatment of related-party debt-financing, captive insurance and other intra-group financial transactions". The Report further explains that "BEPS opportunities are created through leverage, i.e. the differential treatment of debt versus equity both within and across countries that creates an incentive for debt-financing".[4] Action 4 of the BEPS Action Plan focuses on best practices in the design of rules to prevent base erosion and profit shifting using interest and other financial payments economically equivalent to interest and reads as follows:[5]

> Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.

As a follow-up to the initial Report, a Discussion Draft on Action 4 was published on 18 December 2014.[6] The Discussion Draft stressed the need to address base erosion and profit shifting using deductible payments, such as interest, that can give rise to double non-taxation in both inbound and outbound investment scenarios. It provided a survey of existing approaches to tackling the main issues and set out different options to develop best practices. Furthermore, the Discussion Draft also identified specific questions where input was required to advance practical solutions. A request to comment on the contents was met by an overwhelming response, after which a public consultation meeting was organized at the OECD Conference Centre on 17 February 2015. The following issues and questions were discussed in the Discussion Draft:

- What is interest and what are "payments economically equivalent to interest"?
- Who should a potential rule apply to?
- Should a potential rule apply at the level of debt or interest expense and should it target gross or net income?
- Should a small entity exception or threshold apply?
- Should interest deductions be limited with reference to the position of the entity's group?
- Should interest deductions be limited with reference to a fixed ratio?
- Should a combined approach be applied?
- The role of targeted rules.
- The treatment of non-deductible interest expense and double taxation.
- Considerations for groups in specific sectors.
- The interaction of Action 4 with other areas of the BEPS Action Plan.

The OECD paid attention to these comments and issued its Final Report on Action 4 as part of the package presented on 5 October 2015 (Final Report).[7] Based on the Final Report, many countries have started incorporating changes into their domestic law to reflect the principles outlined in the BEPS reports. One of the main actions in this respect was taken by the European Union, which, in January 2016, published the proposed ATAD (2016/1164). Limitation of interest deduction as part of a tax avoidance scheme is one of the major issues covered by the Directive. The Directive was based on the *Action Plan for Fair and Efficient Corporate Taxation*, presented by the European Commission on 17 June 2015.[8]

According to the Explanatory Memorandum to the Proposal, the Directive addresses the concern that unilateral and divergent implementation of BEPS Final Reports by each Member State could fragment the Single Market by creating national policy clashes,

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3. OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), International Organizations' Documentation IBFD.
4. Id., at 43.
5. Id., at 31.
6. OECD, *Public Discussion Draft – BEPS Action 4: Interest Deductions and Other Financial Payments* (OECD Publishing 2014), International Organizations' Documentation IBFD.
7. OECD, Action 4 Final Report, *supra* n. 1.
8. Communication from the Commission to the European Parliament and the Council. A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM(2015) 302 final (17 June 2015), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf.

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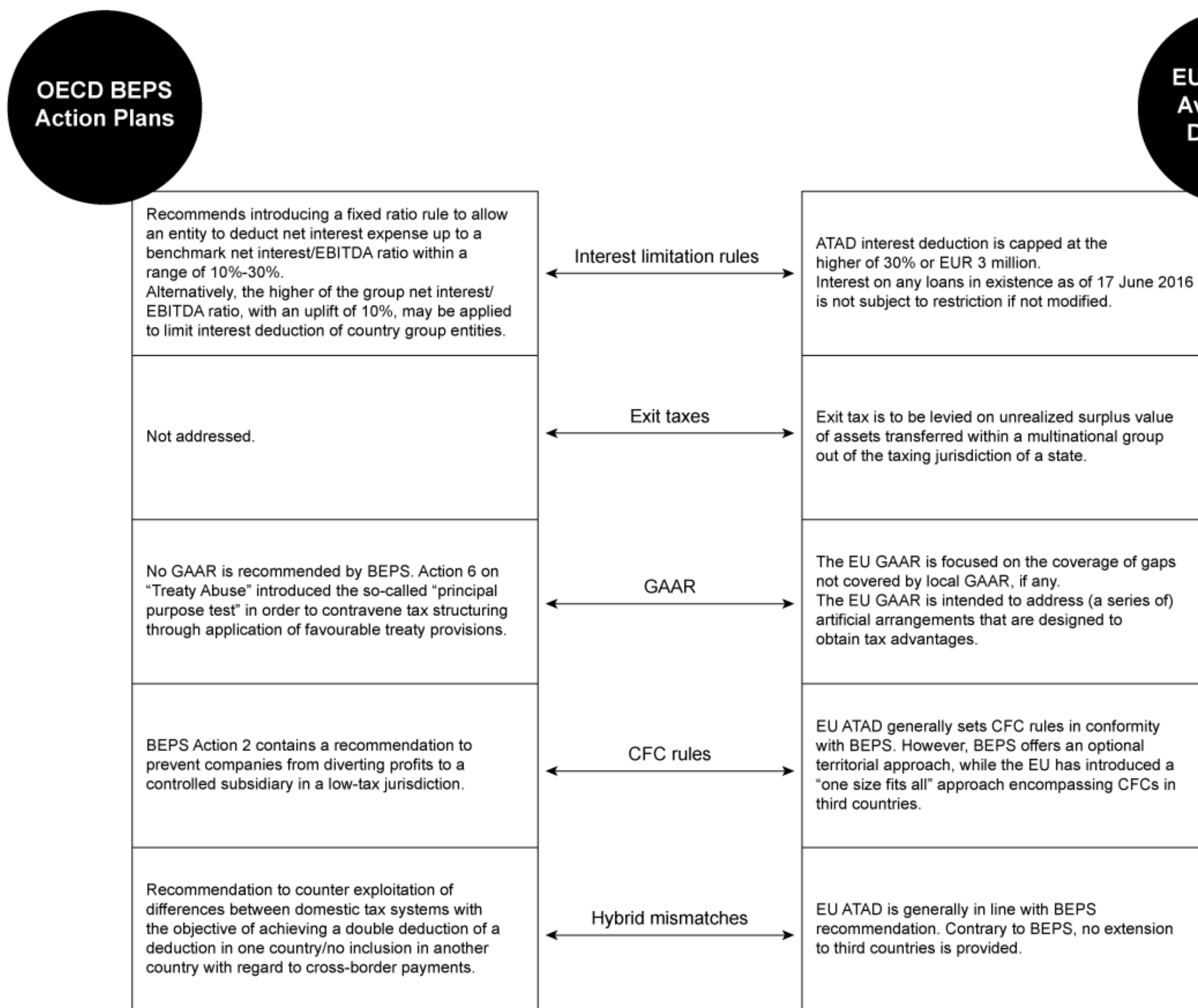
distortions and tax obstacles for business in the European Union. Further, it noted that the Commission would relaunch its Proposal for a Common Consolidated Corporate Tax Base as a holistic solution to creating fairer and more efficient taxation.[9]

The EU Economic and Financial Affairs Council (ECOFIN), in discussing the ATAD (2016/1164) during its meeting on 25 May 2016, confirmed the basic proposition regarding the limitation of interest deduction. As the members of ECOFIN disagreed on several measures included in the Directive, however, it remained uncertain when rules on interest deduction would be published. Ultimately, on 21 June 2016, the Council of the European Union agreed on a draft directive addressing tax avoidance practices commonly used by large companies.[10]

Diagram 2 presents the relationship between the ATAD (2016/1164) and the BEPS Action Plans.

Diagram 2: Comparison between the BEPS Action Plan and the ATAD



9. For further developments in this respect, *see* European Commission Press Release IP/16/3471, Commission proposes major corporate tax reform for the EU (25 Oct. 2016), available at http://europa.eu/rapid/press-release_IP-16-3471_en.htm.
10. European Commission Press Release IP/16/1886, Fair Taxation: Commission welcomes agreement reached by Member States on new rules to tackle tax avoidance (21 June 2016), available at http://europa.eu/rapid/press-release_IP-16-1886_en.htm.

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3. Action 4: The Outline

3.1. In general

The Executive Summary of the Final Report on BEPS Action 4 declares that BEPS risks in the area of interest or economically equivalent payments may arise in three basic scenarios:

- groups placing high levels of third-party debt in high-tax countries;
- groups using intra-group loans to generate interest deductions in excess of the group's actual third-party interest expense; and
- groups using third-party or intra-group financing to fund the generation of tax-exempt income.

In order to address these risks, the Final Report recommends an approach that encourages groups to adopt funding structures pursuant to which (1) the net interest expense of an entity is linked to the overall net interest expense of the group and (2) the distribution of a group's net interest expense is linked to income-producing activities. A best practice approach to tackling these issues should apply to all forms of interest and payments equivalent to interest payments.

Chapter 1 of the Final Report formulates the following recommendations for a best practice approach:

(1) An optional de minimis monetary threshold to remove low-risk entities, based on the net interest expense of the local group, should be established.

(2) Each group entity should be allowed to deduct net interest expense up to a benchmark net interest/EBITDA ratio preferably within a range of 10%-30%, i.e. a "fixed ratio rule".

(3) Each group entity should be allowed to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio. In addition, each country should have the option of applying uplift to a group's net third-party interest expense of up to 10%. Countries are entitled to apply different ratios or no ratio at all. This is known as the "group ratio rule".

(4) Each country should have the option of providing for carry-forward of disallowed interest/unused interest capacity and/or carry-back of disallowed interest.

(5) Targeted rules to support general interest limitation rules and address specific categories of risk should be adopted.

(6) Specific rules should apply to address issues raised by the banking and insurance sectors.

Chapter 2 delineates the boundaries for recognition of interest, as well as economically equivalent forms of remuneration in the financial domain.

Chapter 3 deals with specific parties to which the best practice recommendations would apply. In this connection, the chapter recognizes three scenarios that lead to BEPS, i.e. BEPS can arise through entities that are part of a multinational group, entities that are part of a domestic group and standalone entities. Further, BEPS can arise through financing operations with related parties outside a group and through the use of structured arrangements with third parties.

Chapter 4 of the Final Report discusses the relationship between the best practice approach and the level of interest expense or, alternatively, the level of debt. It concludes, based on a number of arguments, that the instrument to combat BEPS should be linked to interest instead of debt. It also includes the option to exclude certain public-benefit projects.

Chapter 5 of the Final Report contains arguments to measure economic activity using earnings or asset value. Although the main benefit of an asset-based approach is relative stability over time as compared with the earnings-based approach, the latter is more appropriate to the realization of the BEPS objectives.

Chapter 6 of the Final Report provides a more detailed treatment of the fixed ratio rule. Different ways of benchmarking fixed ratios are discussed, including factors that could influence the ultimate outcome of the application of such ratios.

Chapter 7 of the Final Report outlines various issues arising in applying the group ratio rule. In particular, the operation of the group ratio rule is explained through the execution of a two-stage test, i.e. (a) determine the group's net third-party interest/EBITDA ratio and then (b) apply the group's ratio to an entity's EBITDA.

Chapter 8 of the Final Report addresses the topics of volatility and double taxation over multi-year periods. Issues addressed include the carry-forward period and other limitations thereof.

Chapter 9 of the Final Report describes targeted rules in the form of provisions that restrict interest deductions on payments made in respect of specific transactions or arrangements. These transactions could include converting interest expense into a different form of deductible expense, entering into an arrangement with a related or third party to increase the level of net third-party interest expense under the group ratio rule or restructuring a group into two groups so as to manipulate the application of fixed or group ratio rules.

Chapter 10 of the Final Report relates to the application of the best practice approach to banking and insurance groups.

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Chapter 11 of the Final Report deals with various general tax issues and interference with other BEPS Actions, as well as the group taxation systems of different countries.

Four annexes are then added in order of sequence:

- Annex A: European Union Law issues;
- Annex B: Data on companies affected by a benchmark fixed ratio at different levels;
- Annex C: The equity escape rule (equity/total assets ratio equivalent to or higher than equivalent group ratio); and
- Annex D: Examples.

3.2. Summary/issues of importance

BEPS Action 4 highlights that the existing approaches to counteracting base erosion and profit shifting using interest expense schemes are not sufficient to deal with the issue of base erosion and profit shifting, as (1) current fixed ratios are considered too high to be an effective tool in addressing base erosion, (2) targeted anti-avoidance rules can never catch up to expanding profit shifting opportunities and (3) withholding tax on interest payments, in practice, is often reduced (even to zero) under tax treaties. Consequently, the OECD issued a recommendation, via BEPS Action 4, to design domestic rules aimed at preventing base erosion and profit shifting through interest deduction or other financial payments equivalent to interest payments.

In addition to requiring countries to implement targeted rules to support general interest limitation rules and address specific risks raised by the banking and insurance sectors, BEPS Action 4 introduces two optional approaches:

(1) a de minimis monetary threshold rule that will act as a safe harbour for low-risk entities; and

(2) a carry-forward and/or carry-back of disallowed interest.

Keeping in mind that these rules will be implemented either through unilateral actions by individual countries (which, in itself, could lead to a distortion of the results produced by each individual country), or through a multilateral instrument (which may require extensive negotiations), BEPS Action 4 will certainly impact the operations of venture capitalists with equity levels varying from 0% to 20%, as well as listed companies with an equity level below 20%.

The main issues of concern will be:

(1) how to deal with debt capacity;

(2) whether to centralize a company's business model and profit;

(3) how to get from the current leveraged structure to a new one more quickly and in a less costly manner;

(4) how to prevent leakage through deemed dividends; and

(5) how to avoid non-deductibility.

4. Interaction with Other BEPS Action Plans

4.1. Introductory remarks

As described in section 3., Action 4 does not, on its own, cover all situations that deal with intercompany loans and interest costs. In fact, a few other BEPS Action plans also assist in addressing these situations, leading to multiple levels of taxation of the same income. As a result, whereas under the pre-BEPS scenario it was possible for the tax result of an MNE in the context of interest payments to be "0" or even negative, it is most likely that the cumulative impact of the BEPS Actions will lead to excessive taxation of the same MNE income.

The following examples illustrate pre-BEPS scenarios regarding interest payments, as well as the impact of additional taxation resulting from implementation of the relevant BEPS Actions. This case scenario assumes the following:

- A loan of EUR 1,000 is provided by the "Parent" via a "Cash Box Structure" and a "Financial Intermediary" to its subsidiaries.
- This loan is provided at an interest rate of 10%.
- The corporate income tax (CIT) rate in all countries (except the country of the cash box, where CIT is assumed to be 0%) is 25%.
- The withholding tax (WHT) rate in all countries is assumed to be 8%.

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4.1.1. Pre-BEPS Scenarios

4.1.1.1. Scenario A: "0" game

Interest income of 100 is taxed at 25% (= 25 in tax) in the country of the subsidiary and the combined deduction received by the group is 25, i.e. tax = 0%.

4.1.1.2. Scenario B: "negative tax" game

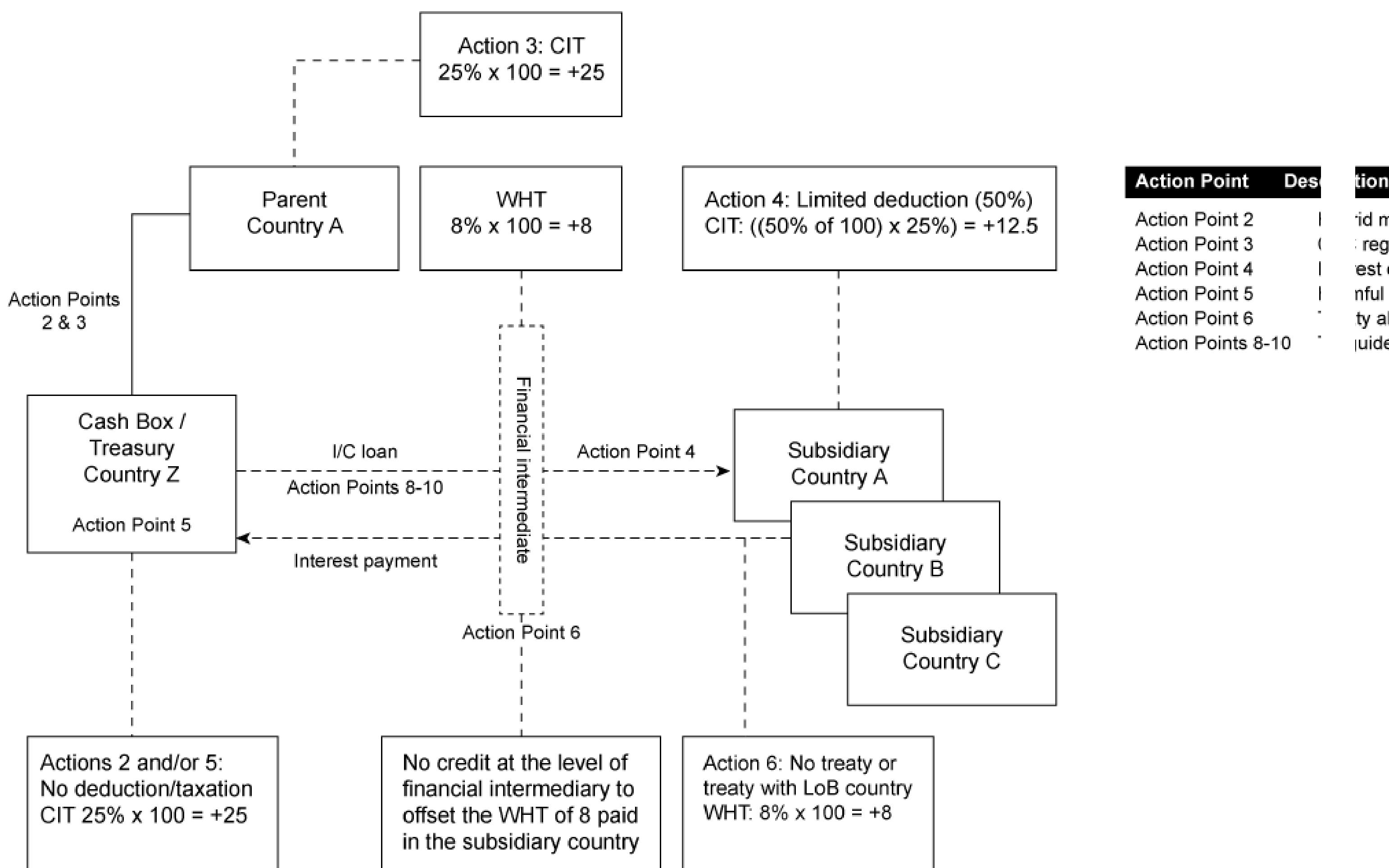
Interest income of 100 is taxed at 5% (= 5 in tax), whereas the combined deduction received by the group is 25, i.e. tax = -20.

4.1.2. Post-BEPS Scenarios

4.1.2.1. Scenario C: multiple taxation

The possibility for multiple taxation is illustrated in Diagram 3.

Diagram 3: Cumulative effects of the various BEPS Action Points



Thus, in Scenario C, the combined impact of the BEPS Actions leads to an additional tax burden as outlined in Table 1.

Table 1: Additional tax burden resulting from BEPS implementation

Action Point	Additional tax
Action 3	25
Action 4	12.5 and 8
Action 2 and/or 5	25

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Action Point	Additional tax
Action 6	8
Total additional tax:	78.5

5. Implementation of Action 4

5.1. Introductory remarks

Table 2 provides a survey of the status of implementation of BEPS Action 4 by various countries. Subsequently, certain countries that have implemented rules in respect of BEPS Action 4 are discussed in further detail.

Table 2: Interest barrier rules in selected countries

Country	Regulation	(Expected) date of implementation	Entities/transactions covered
Australia	Strengthened its thin capitalization rules in 2014	2014	Changes made to debt-to-equity ratio (previously 3:1; now 1.5:1)
Chile	New thin cap rules introduced in 2015 apply not only to interest but also to commission fees, financial expenses and other disbursements related to loans. The "excess of indebtedness tax" at 35% applies to the Chilean debtor and WHT at 4% is creditable to the debtor	1 Jan. 2016	Interest, commission fees, financial expenses and other disbursements related to loans
China	Interest in respect of companies where the debt-to-equity ratio exceeds 5:1 (financial industry) and 2:1 (non-financial industry) not deductible	2009	Excessive debt financing structures
Italy	A fixed ratio rule already applies in Italy with regard to computing the maximum amount of deductible interest (30% of EBITDA)		Excessive debt financing structures
Japan	Earnings stripping rules prevent deduction of interest where it exceeds 50% of taxable income	1 Apr. 2013	Excessive debt financing structures
Korea (Rep.)	Changed the debt-to-equity ratio requirement in 2015 from 3:1 to 2:1	1 Jan. 2015	Excessive debt financing structures
Norway	A fixed ratio rule applies in Norway from 2016 onwards with respect to computing the maximum amount of deductible interest (25% of EBITDA)	1 Jan. 2016	Excessive debt financing structures
South Africa	EBITDA consisting of the sum of (1) the interest received or accrued to the debtor and (2) a percentage of adjusted taxable income (but not exceeding 60%); and reduced by interest incurred in respect of outstanding debts Percentage calculated by formula: A = B x C/D B = 40 C= average rate + 400 basic points D = 10	1 Jan. 2015	Excessive debt financing structures. Before, a 3:1 ratio was applied
United Kingdom	Consultation undergoing since October 2015 on proposed changes	Apr. 2017	Unknown
United States	A fixed ratio rule applies to interest deduction for foreign owned corporations (50% of taxable income)	Existing	Excessive debt financing structures

5.2. Netherlands implementation of Action 4

The Netherlands corporate tax system contains several interest limitation provisions.[11] These provisions are intended to target specific anti-avoidance risks under Netherlands law. Roughly speaking, these provisions fall under the following categories:

- loan granted under conditions that justify recharacterization as equity;
- interest paid to related parties for the financing of specific transactions, unless a business purpose can be demonstrated and/or the interest is effectively taxed in the hands of the recipient;
- interest paid by conduit finance companies lacking sufficient equity to cover risks;
- non-arm's length interest rate for a period exceeding 10 years or for an indefinite period of time;

11. NL: Corporate Income Tax Act, arts.10-1-d, 10a, 10b, 10c, 13l and 15ad, respectively, National Legislation IBFD.

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- interest incurred in connection with the acquisition of subsidiaries; and
- interest incurred by Netherlands-based intermediate holding entities in connection with the acquisition of other Netherlands-based entities and consequent debt push-down within the resulting Netherlands fiscal unity.

Until 1 January 2013, thin capitalization rules were in existence limiting excessive debt financing to related parties according to a 3:1 debt-to-equity ratio.

Apart from these categories, interest deduction might be limited through the general arm's length principle.[12] In 2013, the Netherlands tax administration issued a decree assessing and clarifying key transfer pricing-related topics in light of Netherlands policy guidelines and case law.[13] "Financing transactions" is one of these key topics and although, in principle, this topic is not aligned with earnings/asset ratios, it may still run parallel, having regard to the approach of the Netherlands tax administration.

The preliminary statement of the Netherlands tax administration relates to the usual yardstick, i.e. pricing conditions must be measured against the behaviour of independent parties. If it is not possible to make the loan arm's length by way of a price adjustment, other non-pricing-related conditions must be evaluated. Such an appraisal boils down to the allocation of significant risks. More specifically, this means that an independent lender "is more willing to grant a loan to an independent borrower whose creditworthiness, after the financial transaction has been entered into, does not fall below a certain level".[14] The Netherlands tax administration concludes that "an associated lender that grants a loan to a borrowing group company with a poor credit rating (after the loan, the credit rating is <BBB-) must convincingly demonstrate that the loan was entered into under arm's length conditions".[15] A borrower whose creditworthiness falls below BBB- fails the "investment grade" test.

In a notorious Netherlands case,[16] the Supreme Court provided a considered opinion regarding the issue of the extent to which write-down of an intra-group loan is permitted. This case focused on the notion of a "non-business-like loan". The respective loan amount of EUR 5.3 million resulted from the automatic dissolution of a Netherlands fiscal unity between the related parties as a consequence of the conversion of a second-tier fiscal unity member into an investment vehicle. What was at issue before the Court was the 5% interest on the relevant loan. Given the weak creditworthiness of the borrowing company, the lender company decided to impute a write-off amounting to EUR 1.2 million. The loan was classified as "non-arm's length" on the following grounds:

- no profit-generating activities;
- insufficient equity;
- no guarantee;
- no redemption scheme;
- insufficient income from shares to pay 5% interest; and
- loan and interest non-repayable.

According to the Supreme Court, under the circumstances:[17]

> […] the lending company assumes a bad debt risk on its loan that a third party would not have accepted. In that case –special circumstances excepted – it must be assumed that the lending group company accepted this risk with the objective of serving the interests of the associated company in a shareholder or sister/subsidiary capacity. The Supreme Court regards this as a non-business motivated loan. Any write-down loss on such a loan cannot be deducted from the lender's taxable profit.

The Supreme Court stipulated the following rule of thumb:[18]

> The interest rate on a non-business motivated loan should be set at the interest rate that the borrowing group company would have had to pay had it borrowed from a third party under the same conditions and in the same circumstances and with the lending company acting as guarantor.

Hence, the interest level on a non-business-like loan should be determined having due regard to the credit rating of the lending company, acting as the guarantor company. The Netherlands tax administration, however, considers the deemed guarantee to be meaningless in a

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12. Further work on the transfer pricing aspects of financial transactions will be undertaken in 2016 and 2017. *See supra* n. 1, at 13.
13. Decree of 14 Nov. 2013, No. IFZ 2013/184M.
14. Id., at 28.
15. Id., at 29.
16. NL: SC, 25 Nov. 2011, Case 08/05323, *X BV v. the Tax Administration*.
17. Case 08/05323 (25 Nov. 2011), para. 3.3.3.
18. Id., at para. 30.

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situation in which the credit rating of the lending group company is no different from that of the borrowing group company. In that scenario, only the risk-free interest on the loan should be taken into account.[19]

5.3. German implementation of Action 4

The German interest barrier rule, introduced by the Tax Reform Act 2008, is included in section 4h(1)(1) of the Income Tax Act[20] and section 8a of the Corporate Income Tax Act.[21] It applies to fiscal years commencing on or after 25 May 2007.

5.3.1. Scope of the interest barrier rule

The interest barrier rule applies to all legal forms of partnerships, as well as corporations, regardless of whether the shareholders or partners are resident or non-resident. What is decisive is if the company or partnership derives income from trade, agriculture, forestry or the provision of services, i.e. business income.

Furthermore, all interest-bearing debt is taken into account in calculating the barrier. In this respect, it is irrelevant whether the debt instrument is owned by a shareholder or partner or by a related or unrelated party. Clarifications concerning the application of the barrier were included in an interpretation letter published by the Ministry of Finance on 4 July 2008.[22]

5.3.2. Qualifying debt

The Ministry of Finance letter indicates that the definition of qualifying debt includes:

- fixed and non-fixed interest-bearing loans;
- profit participation loans;
- typical silent partnerships; and
- jouissance rights.

5.3.3. Qualifying interest

The letter indicates that an interest expense represents remuneration for debt capital that has reduced the entity’s profits, while interest from financial assets results in a profit increase.

In addition, the letter indicates that relevant interest expenses or income includes:

- an original issue discount;
- a loan discount;
- an early termination fee; and
- fees payable to the seller of the debt (creditor).

Relevant interest expenses and income do not include:

- dividends;
- interest paid on late payment of taxes;
- cash discounts paid;
- cash discounts received; and
- bonuses.

5.3.4. Calculation of the interest barrier

Under the barrier, net interest expenses, i.e. the difference between interest paid and interest received, are deductible. Up to 30% of the relevant earnings before interest, taxes depreciation and amortization (EBITDA) are deductible. A carry-forward applies to any interest that cannot be deducted in a particular year. EBITDA that is not used in a particular year can be carried forward for a period of five years.

Furthermore, the law provides for three escape clauses pursuant to which the interest is fully deductible. The escape clauses apply where:

(1) the excess interest does not exceed EUR 3 million;

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19. Id., at 30.
20. DE: Income Tax Act (*Einkommensteuergesetz*), National Legislation IBFD.
21. DE: Corporate Income Tax Act (*Körperschaftsteuergesetz*), National Legislation IBFD.
22. Ministry of Finance, Letter of 4 July 2008 No. IV C 7 – S 2742-a/07/10001.

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(2) the enterprise (business) only belongs to a group of companies (group) on a pro rata share stand-alone basis (non-membership in a group); and

(3) the business belongs to a group and its equity ratio as of the closing date of the preceding balance sheet equalled or exceeded that of the group. An equity ratio deficiency of up to two percentage points is not harmful (group escape ratio).

The above escape clauses do not apply in the event of a hidden profit distribution to a substantial shareholder owning a participation of at least 25% in a company.

The term "equity ratio" in this context means the ratio between equity and the balance sheet total. The equity ratio must be determined, on the one hand, in accordance with the consolidated group financial statements that include the business, as well as in accordance with the entity's stand-alone financial statements (annual financial statements or individual financial statements).

Any goodwill increases the company's equity, as reported in the consolidated financial statements, as well as 50% of special items of an accrual nature (*Sonderposten mit Rücklageanteil*). The company's equity is decreased by the book value of shareholdings in other group companies and by capital contributions made in the six months preceding the balance sheet date insofar as they correspond to withdrawals or distributions made in the six months after the balance sheet date and by participations that do not confer voting rights, with the exception of preferred shares.

With regard to a partnership, the relevant EBITDA is calculated as follows:

Taxable income prior to application of section 4h of the Income Tax Act – interest income + interest expense + amortization = EBITDA

With regard to companies, the relevant EBITDA is calculated as follows:

Taxable income prior to application of article 8(1) of the Corporate Income Tax Act – interest income + interest expense + amortization as specified herein + loss deduction (loss carry-back and carry-forward) + deduction of donations = EBITDA

A shortfall of up to 2% does not trigger the application of the limitation rule. Despite these clauses, the interest deduction limitation rule is applicable if more than 10% of the interest expense is related to debts to related parties, i.e. shareholders with interests of 25% or more.

5.3.4.1. Calculation example

Profit before interest expense, taxes, depreciation and amortization (EBITDA)	EUR 12 million
Amortization	EUR 2 million
Finance costs	EUR 4 million
Profit after deductions	EUR 6 million
Deductible interest 30% of EBITDA = EUR 3.6 million. This means that EUR 0.4 million is not deductible and has to be carried forward	EUR 0.4 million (carried forward)
Taxable profit (EUR 6 million + 0.4 million non-deductible interest)	EUR 6.4 million
Municipal trade tax add-back 25% x (EUR 6 million – EUR 0.4 million) = EUR 1.4 million	EUR 1.4 million
Municipal trade tax base (EUR 6.4 million + EUR 1.4 million) = EUR 7.8 million	EUR 7.8 million
Municipal trade tax 3.5 x 200% municipal multiplier of EUR 7.8 million	EUR 0.55 million
Corporate income tax + solidarity surcharge of 15.83% of EUR 6.4 million	EUR 1.01 million (rounded off)
Profit after tax EUR 6 million - EUR 0.55 million - EUR 1.01 million)	EUR 4.35 million
Tax rate (EUR 1.65 million of EUR 6 million)	27.5%

5.3.5. Constitutional problems concerning the interest barrier rule

In Case I R 20/15 (14 October 2015),[23] the Federal Financial Court (*Bundesfinanzhof*) held that the interest deduction limitation rule is unconstitutional.

The Court decided that a limitation on the deductibility of such expenses constitutes an infringement of the ability-to-pay principle as derived from article 3 of the German Constitution. It decided to stay the proceedings and refer the matter to the Federal Constitutional Court (*Bundesverfassungsgericht*).

In the case at hand, a German resident corporate entity formed part of a domestic group of companies operating in the real estate sector. In the relevant tax year, the taxpayer was subject to the interest deduction limitation rule. The amount of non-deductible interest expense could not be carried forward to subsequent tax years due to a corporate restructuring.

The taxpayer appealed the decision of the tax authorities to apply the interest deduction limitation rule, as well as the subsequent decision (7 K 680/12 (6 March 2015))[24] of the Financial Court of Munich (*Finanzgericht München*).[25]

23. DE: BFH, 14 Oct. 2015, Case I R 20/15, *GmbH A v. Finanzamt München*.
24. DE: FG Munich, 6 Mar. 2016, 7 K 680/12, *GmbH A v. Finanzamt München* .

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The German Constitution generally gives broad discretionary powers to legislators regarding the determination of tax rates and the tax base.[26]

A leading principle of the German constitution is the equality principle, which is included in article 3(1) of the Constitution. It places limits on this discretionary leeway. The provision obliges legislators to treat things that are substantially alike similarly and treat things that are substantially not alike differently.[27]

Consequently, article 3(1) of the Constitution limits the ability of the state to impose taxes, constraining the state's leeway both concerning the application of the law and its freedom to enact legislation.

Therefore, taxpayers with the same ability to pay have to be taxed at the same tax rates and the tax burden has to be equally distributed.

In addition, the German interest barrier infringes the net taxation principle under which expenses that are incurred in securing the taxpayer's income should not be taken into account in calculating the tax assessment basis. The Court held that the fact that an unlimited carry-forward applies with regard to non-deductible interest does not save this infringement because this rule does not always guarantee full deductibility of the interest.

The Court also held that a violation of this principle cannot be justified. The Court rejected the argument of the need to control economic policy with the aim of strengthening the equity capital base. This goal is not equally realized because the interest barrier does not apply to SMEs.

The Court also did not accept the argument that investment incentives for direct investment include the use of an interest carry-forward because this does not impact the non-deductibility of the interest.

Also, the aim of securing the German tax base was not accepted as a proper justification because it cannot be invoked in purely domestic situations.

The need to cover the state's financial needs cannot be invoked because the German interest barrier does not result in an equal and just distribution of the tax burden.

Finally, the interest barrier cannot be justified based on abuse. In the first place, the Court regard the restriction as disproportionate because it also applies to purely domestic situations. Moreover, not all abuse situations are combated because the restriction does not apply to abusive situations below the exemption limit and the rule also does not apply if the difference between interest paid and interest received is positive.

5.4. The implementation of Action 4 in other countries

A commonly used instrument with regard to implementation of BEPS Action 4 is thin capitalization rules. The term "thin capitalization" indicates that an entity is thinly capitalized with equity, being funded instead with a substantial amount of debt. This is done because interest, in contrast to dividends, is deductible. Sometimes, thin capitalization is covered by transfer pricing rules. If such rules are triggered, an investigation may be initiated into whether a debt agreement and the interest charged is at arm's length.

Concerning restrictions on the deductibility of interest, various systems can be distinguished and some countries have introduced a combination of these systems.

5.4.1. Stand-alone approach

The first approach is the stand-alone approach. Under this approach, what is investigated is how much money a subsidiary could borrow and at what interest rate, assuming that it would borrow from a third party as a separate (stand-alone) entity instead of from a group member. If the debt is higher than the debt calculated under the stand-alone approach, the interest on the excess debt is not tax deductible. At the same time, any interest in excess of an arm's length interest is not tax deductible. This method is used in the United Kingdom, where thin capitalization became part of the transfer pricing rules effective 1 April 2004.

5.4.2. Worldwide ratio approach

Under the worldwide ratio approach, the total amount of a multinational's debt towards third parties is compared with its equity (the group's worldwide debt-to-equity ratio).

This ratio is subsequently compared with the debt-to-equity ratios of the group members. Under this approach, interest is tax deductible only to the extent that the ratio does not exceed the group ratio. Sometimes, the tax-deductible interest is based on an allocation of the total amount of interest paid by the group to external lenders or an average interest rate derived from the group's average third-party interest rate, disregarding the actual intra-group interest amounts.

25. For commentary, *see* S. Lampert, T. Meickmann & M. Reinert, *Article 4 of the EU Anti Tax Avoidance Directive in Light of the Questionable Constitutionality of the German "Interest Barrier" Rule*, 56 Eur. Taxn. 8 (2016), Journals IBFD.
26. *See* DE: BVerfG, 4 Feb. 2009, 1 BvL 8/05, para. C.II.1.a and DE: BVerfG, 18 July 2012, 1 BvL 16/11, para. B.I.2.a.
27. *See* DE: BVerfG, 15 Jan. 2008, 1 BvL 2/04, para. C.I.2.a aa; and DE: BVerfG, 8 May 2013, 1 BvL 1/08, para. C.II.1

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This method is used in France, where group companies can avoid a restriction on the deductibility of interest if they prove that the debt-to-equity ratio of the group to which they belong is higher than their own debt-to-equity ratio computed on a stand-alone basis.

Denmark also applies a consolidation rule under which the debt-to-equity ratio is calculated jointly for the Danish debtor and other controlled Danish entities, including any foreign subsidiary covered by Danish group taxation. The consolidation rule only applies to Danish companies and their foreign subsidiaries that can be considered part of the same group.

New Zealand also applies a group system under which excessive debt is deemed to exist where a taxpayer's "New Zealand group debt percentage" exceeds both a safe harbour ratio of 60% and 110% of the controlling non-resident groups' worldwide debt percentage. In such a scenario, the interest deductions must be apportioned.

A system that is commonly applied is the debt-to-equity safe harbour approach, which is based on a fixed debt-to-equity ratio, for instance 3:1. This approach means that if a company has equity of 100, the maximum amount of debt should be 300 and any interest on a debt amount in excess of this threshold is non-deductible.

This system is applicable in many countries, such as Argentina (2:1 ratio), Australia (1.5:1 ratio), Belgium (5:1 ratio for intra-group loans), Czech Republic (4:1 ratio), Luxembourg (85:15 ratio), Poland (3:1 ratio), Romania (3:1 ratio) and South Africa (3:1 ratio).

France applies the following three cumulative tests under this method:

(1) the overall indebtedness in respect of loans granted by the related parties (i.e. all receivables, except trade receivables) may not exceed 1.5 times the net equity of the borrower (including share premiums, retained earnings), i.e. a debt-to-equity ratio of 1.5:1;

(2) the amount of the interest paid to the related companies may not exceed 25% of adjusted operating profits plus the tax, interest paid to related parties, depreciation and amortization and certain lease payments realized by the borrower, resulting in an interest-to-profit ratio of 1:4; and

(3) the amount of interest paid to related parties must exceed the amount of interest received from affiliated companies, i.e. a ratio of 1:1 applies.

A newer method to restrict the deduction of interest is an interest-to-profit ratio. This system is also known as an interest limitation, interest barrier or earnings stripping rule. In this scenario, the interest expense is tax deductible only to the extent that it does not exceed a prescribed percentage of EBITDA.

This system is applied in Germany (interest expenses in excess of 30% of EBITDA are not tax deductible), Greece (interest expenses in excess of 40% of EBITDA are not tax deductible) and Ukraine (interest expenses in excess of 50% of EBITDA are not tax deductible.

5.4.3. Hybrid approach

Some countries apply a hybrid approach under which a debt-to-equity ratio or an interest-to-profit ratio is combined with an arm's length interest rate. In this scenario, companies can show that the interest paid is still at arm's length and should be deductible if the debt-to-equity ratio is regarded as too severe. Another example of a hybrid approach is to allow companies to demonstrate that the debt-to-equity ratio of the group is higher than the debt-to-equity ratio specified in the thin capitalization rule. If so, they can apply that higher group ratio instead of the (lower) fixed ratio under the law.

Australia is one country that applies a hybrid system. If the safe harbour test is failed, interest in Australia is still deductible if the entity can demonstrate that the debt amount is at arm's length, i.e. an independent party would be able to raise the same amount of debt under the same terms and conditions. Furthermore, taxpayers can avoid the application of the thin capitalization provisions by satisfying the worldwide gearing test, which requires that the average value of their Australian assets be at least 100% of their worldwide assets.

5.4.4. Thin cap list

Table 3 outlines the current debt-to-equity ratios of various countries.

Table 3: Debt-to-equity ratios

Country	EBITDA	Safe harbour rule	Group escape clause	Exemption
Argentina	No	2:1	No	No threshold applies to exclude SMEs
Australia	No	1.5:1 (15:1 financial institutions)	Worldwide gearing test	Thin cap does not apply to companies whose annual debt deductions do not exceed AUD 2 million
Austria	No	No, but adequate equity test developed in case law	No	No threshold applies to exclude SMEs
Belgium	No	1:1 (individual directors, shareholders and non-resident corporate directors)	5:1 loans received from another group company	A general exemption for SMEs does not apply. The rules do not

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Country	EBITDA	Safe harbour rule	Group escape clause	Exemption
		5:1 for creditors that are exempt or taxed at a reduced rate		apply, however, to (1) financial companies engaged in the leasing of movable assets and/or real estate and factoring to the extent that the loans are effectively used for those activities and (2) companies carrying out a project under public/ private cooperation obtained from the government through a tender
Brazil	30% of equity for low-tax jurisdictions	2:1 of equity of investor 2:1 of equity of related companies	No	No threshold applies to exclude SMEs
Bulgaria	Difference between the (regulated interest expenses less interest income) and 75% of the accounting profit/ loss before interest (EBIT)	No	No	Threshold 75% of EBIT
Canada	No	1.5:1	No	No threshold applies to exclude SMEs
Chile	No	3:1	No	No threshold applies to exclude SMEs
China	No	5:1 (financial enterprises) 2:1	No	No threshold applies to exclude SMEs
Colombia	No	3:1	No	No threshold applies to exclude SMEs
Croatia	No	4:1	No	No threshold applies to exclude SMEs, but the rules do not apply to financial institutions
Cyprus	No	No	No	No
Czech Republic	No	4:1	No	No threshold applies to exclude SMEs
Denmark	No	4:1 Max. 80% of profits and 3.4% of value of company's business assets	No	Interest of less than DKK 21.3 million always deductible. With regard to controlled debts, loans of up to DKK 10 million not taken into account
Egypt	No	4:1	No	No threshold applies to exclude SMEs
Estonia	No	No	No	No
Finland	25%	No	No	Safe harbour EUR 500,000
France	25% of earnings before taxation	1.5:1 Amount of interest paid to associated companies does not exceed the amount of interest received from those companies	Worldwide ratio	Safe harbour EUR 150,000
Germany	30%	No	No	No threshold applies to exclude SMEs
Greece	40%	No	No	Safe harbour EUR 3 million
Hong Kong	No	No, but subject to tax test	No	No
Hungary	No	3:1	No	No threshold applies to exclude SMEs, but debts to financial institutions excluded
India	No	No	No	No
Ireland	No	No	No	No
Italy	30%	No	No	No threshold applies to exclude SMEs, but interest on loans guaranteed by mortgage excluded
Japan	No	Earnings stripping rules prevent deduction of interest where it exceeds 50% of taxable income	No	No threshold applies to exclude SMEs
Korea (Rep.)	No	Not more than 200% of equity (600% in respect of financial institutions)	No	No threshold applies to exclude SMEs. The rules do not apply, however, if the total loans that would otherwise be subject to these restrictions can be shown to be

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Country	EBITDA	Safe harbour rule	Group escape clause	Exemption
				similar, in terms of interest payable and amount borrowed, to the terms of borrowing available from an independent lender or the debt-to-equity ratio is less than that of a comparable Korean company
Latvia	No	4:1	No	No threshold applies to exclude SMEs
Lithuania	No	4:1	No	No threshold applies to exclude SMEs
Luxembourg	No	85:15	No	No threshold applies to exclude SMEs
Malta	No	No	No	No
Mauritius	No	No	No	No
Mexico	No	3:1	No	No threshold applies to exclude SMEs
Netherlands	No	No, but various targeted rules	No	No
New Zealand	No	No	60% or 110% of group debt to asset ratio 50% or 100% of net interest expense to net income if the worldwide debt of the multinational group is more than 75% of its worldwide assets (excluding any recognized goodwill), at least 80% of the worldwide group's debt is from lenders not associated with a member of the group and the New Zealand part of the multinational group and the worldwide group both have net income and net interest expenses	No threshold applies to exclude SMEs
Philippines	No	No tax administration determines reasonableness of debt-to-equity ratio	No	No
Poland	No	1:1 Alternatively, amount not exceeding the tax value of assets (excluding intangible assets) multiplied by the reference rate of the National Bank of Poland on the last day of the preceding tax year and increased by 1.25%	No	No threshold applies to exclude SMEs
Portugal	30%	No	No	Safe harbour EUR 1 million
Romania	No	3:1	No	Interest related to loans taken out for business purposes generally deductible
Russia	No	3:1	No	No threshold applies to exclude SMEs
Singapore	No	No	No	No
Slovak Republic	25%	No	No	Thin capitalization rules not applicable to banks, insurance and reinsurance companies, leasing companies and collective investment companies
Slovenia	No	4:1	No	No threshold applies to exclude SMEs Thin capitalization rules do not, however, apply if the taxpayer demonstrates that he could raise the surplus of loans from the lender who is a non-related person
South Africa	Yes	EBITDA consisting of the sum of (1) the interest received or accruing to the debtor and (2) a	No	No threshold applies to exclude SMEs

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Country	EBITDA	Safe harbour rule	Group escape clause	Exemption
		percentage of adjusted taxable income (but not exceeding 60%); and reduced by interest incurred in respect of debts owed Percentage calculated by formula: A = B x C/D B = 40 C = average rate + 400 base points D = 10		
Spain	30% of adjusted equity	No	No	Safe harbour EUR 1 million
Sweden	No	No Interest paid to related company not taxed unless a subject to tax test is met	No	No
Switzerland	No	70% of value of shareholdings 70% or 80% for immovable property 6:1 ratio applies to financial companies	No	No
United Kingdom	No	No (arm's length rule)	No	No
United States	No	Earnings stripping rule ratio 1.5:1 and not more than 50% of adjusted taxable income	No	No

6. Court Cases on Intercompany Interest Dealings

6.1. Australia

On 23 October 2015, the Federal Court delivered its transfer pricing decision in the *Chevron Australia Holdings* (23 Oct. 2015) case.[28]

6.1.1. Facts

The case concerned an oil and gas exploration and production (E&P) multinational, Chevron, the parent company of which is resident and listed in the United States. In 2000, Chevron acquired the Texaco group, whereafter its Australian business unit was restructured to refinance existing debt and increase the debt level of the Australian operations to a 47% debt-to-equity ratio.

In 2003, a Credit Facility Agreement was entered into between the parent of the Australian group, CAHPL, which was resident in Australia, and its wholly owned subsidiary, CFC, which was resident in the United States. The aim of the US company was to raise USD 2.5 billion in the US commercial paper market.

The financing was carried out in such a manner that the interest withholding tax exemption in Australia would apply. A private binding ruling was obtained from the ATO stating that this exemption would apply. The required funds were raised by CFC in USD and put at the disposal of CAHPL for a period of five years in return for a promise to repay the AUD equivalent amount with interest at the Australian LIBOR rate plus 4.14%.

CAHPL did not provide security or financial or operational covenants. The US parent company did not guarantee that CAHPL would have disposal of the funds, but did guarantee the USD borrowing by CFC.

CFC did not hedge the AUD/USD currency risk. CAHPL was free to repay the loan at any time. The USD funds were raised by CFC at an interest rate of approximately 2% and lent on to CAHPL in AUD at an interest rate of approximately 9%.

The profits of CFC were distributed to CAHPL in the form of a dividend. This dividend was received tax free. CAHPL, in return, distributed a substantial amount of dividends to its US parent during the period of the loan.

CFC was not taxable in the United States on the interest. The reason for the exemption was not given. CAHPL claimed deductions for the interest paid to CFC with regard to the five-year term of the loan.

The Australian tax administration (ATO), however, denied a substantial part of the interest deduction. For the assessments issued in 2010 and 2012, the denial was based on Division 13 of the 1936 Income Tax Assessment Act concerning international agreements and the determination of source of certain income (hereinafter Division 13), on Subdivision 815-A of the Income Tax Assessment Act 1997 (cross-border transfer pricing) for some of the years and on the associated enterprises article of the Australia-United States Income Tax Treaty (1982).[29] The ATO imposed a 25% penalty on the basis that CAHPL entered into the facility for the sole or dominant purpose of obtaining a "scheme benefit".

28. AU: FC, 23 Oct. 2015, [2015] FCA 1092, NSD 569-578 of 2012 and NSD 151-440 of 2013, *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation* (No. 4), Tax Treaty Case Law IBFD.
29. *Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (6 Aug. 1982) (as amended through 2001), Treaties IBFD.

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6.1.2. Evidence

Evidence concerning the transactions was provided by a number of (former) employees of the Chevron group. A substantial part of the evidence concerned advice received from investment banks on the amount that CAHPL could borrow and at what interest rate.

Judge Robertson only accepted evidence from one of the executives involved in the deal. From this evidence, it followed that the higher the interest rate paid by CAHPL, the higher the cash benefit CAHPL would receive as corresponding tax-free dividend payments from CFC to CAHPL.

In addition, the Court held that the agreed terms for the borrowings were only negotiated as such because of the dividend flows from CFC. Consequently, the terms adopted would not have been agreed between independent parties, as there would be no dividend distributions between them.

Finally, the fact that CAHPL did not grant security or give covenants and no parent guarantee was provided for CAHPL's borrowing tended to increase the interest rate charged for the loans.

The taxpayer called various experts to provide evidence. Two experienced commercial lenders and a former bank regulation official gave evidence on how such lenders would price the loan. Another expert explained how a credit rating agency would determine the credit rating of the loan/lender.

Two experts provided insight into the borrowing practices of oil and gas companies and another expert dealt with the issue of whether the terms of the loan should be expressed in USD rather than in AUD.

Furthermore, the taxpayer called an expert on transfer pricing, a former OECD official, who gave evidence on the interpretation of the OECD Transfer Pricing Guidelines, as well as an economist, who gave evidence on whether there was a natural hedge for the exchange rate risk and one accounting expert. Lastly, experts on US tax law and a former US treaty negotiator dealt with the issue of whether the associated enterprises article of tax treaties conferred an independent assessment power.

The ATO obtained support from an oil and gas industry expert, a banking industry expert, a transfer pricing economist, three ratings experts and an accounting expert.

The Court did not, however, attach much weight to the evidence of these wide-ranging experts, although it drew some important conclusions from a combination of some of their evidence.

6.1.3. Decision

The Court began by referring to the relevant part of Division 13, which looked to the following two criteria:

(1) whether a taxpayer acquired property under an international agreement; and

(2) whether the taxpayer paid or agreed to pay consideration in respect of the acquisition and the amount of that consideration exceeded arm's length consideration in respect of the acquisition.

The Court rejected the taxpayer's reasoning that the property acquired included the sums actually lent to it. He held that the Division 13 hypothesis requires depersonalizing the agreement, i.e. making it a hypothetical agreement between independent parties dealing at arm's length, without altering the property acquired. Furthermore, he took the actual characteristics of the borrower into consideration in determining an arm's length interest rate.

With regard to the issue of consideration he held, inter alia, that, in respect of a loan, contrary to the taxpayer's reasoning, the consideration provided by the borrower is not limited to the interest rate paid.

As CAHPL did not provide security and operational and financial covenants as independent parties dealing at arm's length would have done, the Court held that the arm's length consideration determined by the ATO was not excessive. The Court pointed out that this fact contributed to the higher interest rate actually paid.

Thereafter, the Court addressed the financing issues. In determining an arm's length interest rate, the ATO approach and expert evidence was that first the credit rating of CAHPL and the loan itself had to be determined. Thereafter, an arm's length interest rate or credit spread based on market rates for similarly rated comparable debt arrangements had to found as a benchmark.

In this context, the Court noted that the rating assigned to the borrower or loan needs to reflect an arm's length "consideration" under Division 13 or arm's length "conditions" under Subdivision 815-A.

He opined that the starting point for a correct approach to determining the borrower's creditworthiness is a commercial lender. Reference should not, therefore, be made to how an external credit ratings agency would rate the borrower.

The Court accepted that, as part of their internal credit risk analysis, relevant lending institutions do not necessarily follow the same approach as credit rating agencies and do not rely on credit agency ratings in deciding whether to lend and at what price.

In the Court's view, one of the key differences in terms of risk rating by banks and by rating agencies is the degree to which the rating reflects a company's stand-alone credit profile versus the credit profile of the parent company. What is particularly relevant is the financial

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support that a bank would presume the parent entity to provide to the subsidiary during periods of distress in the absence of an explicit guarantee.

The Court also noted that rating agencies observe caution by issuing ratings ranging from a non-investment grade rating (S&P BB+ and below) to an investment grade rating (S&P BBB- and above). This observation was based on the weight given to an investment grade rating by the marketplace.

The Court continued by addressing the issue of the influence of the interest rate of the parental affiliation on the creditworthiness of the borrower. In this context, the ATO argued that parental affiliation can have a material impact on and significantly improve the creditworthiness of the borrower. CAHPL argued that the parental affiliation concept had no application, taking the view that the statutory test involved determining the appropriateness of the pricing based on a hypothetical transaction between two separate and independent entities. This meant that the borrower could not have any parental affiliation. In contrast, the ATO reasoned that the affiliation between the party being tested and its group was fundamental in interpreting and applying the arm's length principle.

The Court concluded that independent enterprises dealing wholly independently with each other may still be subsidiaries and may still have subsidiaries even if the enterprises are independent of each other. Consequently, the Court accepted that the affiliation between a hypothesized party to a transaction and other members of that party's group of companies could not be ignored. He acknowledged that, while implicit support may be relevant in determining a borrower's credit rating, its value is fact dependent.

The Court accepted Chevron's argument that, in the absence of a legally binding parental guarantee, implicit credit support had very little impact on pricing by a commercial lender.

An important and fundamental issue in the case concerned the currency of the Credit Facility Agreement. The ATO reasoned that CAHPL borrowed funds in USD, while the taxpayer held that it borrowed in AUD. This point was particularly relevant because the prevailing base USD interest rates in 2003 were much lower than AUD interest rates. The ATO held that the CFC had, in fact, transferred USD 2.5 billion, rather than its AUD equivalent. In response, CAHPL gave evidence (through both its own staff as well as experts) that the borrowing was denominated in AUD, notwithstanding the fact that CAHPL actually received funds in USD.

CAHPL, inter alia, mentioned that there were concerns in 2003 about the tax implications of foreign exchange gains and losses upon realization of a USD borrowing. The ATO essentially argued that it did not make sense for CAHPL to borrow in AUD, particularly because its sales income would be USD denominated. In addition, the ATO observed that CFC had borrowed in USD and passed on those funds to CAHPL.

The Court accepted the taxpayer's argument that borrowing in AUD would avoid or limit foreign currency gains and losses and held that the Credit Facility was in AUD.

The Court then found that if that credit facility had been acquired under an agreement between independent parties dealing at arm's length with each other, the borrower would have given security and operational and financial covenants as a result of which the interest rate would have been lower.

The Court decided that such rewriting of the terms of the Credit Facility Agreement did not constitute an impermissible recharacterization.

The taxpayer had contended that any such approach constituted a recharacterization or reconstruction of the agreement. The taxpayer pointed to a number of factors, such as the OECD Transfer Pricing Guidelines and the reconstruction power in the more recent Subdivision 815-B, in support of its proposition that it was impermissible to rewrite the terms of the loan. Rather, in CAHPL's submission, it was necessary to keep the terms as they were and just determine the interest rate.

The case also highlighted the very high standards of comparability expected by courts, at least as far as the benchmarking of interest rates is concerned, in applying the comparable uncontrolled transactions (CUT) or comparable uncontrolled price (CUP) method.

As the agreement was drafted in a manner that would not be common between independent parties, the Court decided that it would always be a challenge in such a case to benchmark the interest rate using the traditional CUT/CUP approach. This was so even though two investment banks were consulted as to pricing by the taxpayer prior to entering into the loan.

Because no reasonably accurate CUTs/CUPs could be identified due to the manner in which the CAHPL/CFC loan was drafted, the conclusion reached by the Court was that Chevron had not "shown that the consideration in the Credit Facility Agreement was the arm's length consideration or less than the arm's length consideration nor proved that the amended assessments were excessive".

A final interesting point regarding the decision is that it was held that treaties do not provide an independent transfer pricing adjustment power. Firstly, the judge noted that tax treaties assign taxing rights between states and those rights must be exercised by states under their domestic law.

Secondly, the Court opined that tax treaties are exclusively of a relieving nature. Finally, he referred to expert evidence that the United States does not regard article 9 of a treaty as imposing tax and that the same should apply on the Australian side.

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7. Cases on the Compatibility of Thin Capitalization Rules with the Domestic Constitution

7.1. Belgium

With effect from 1 July 2012, article 198(11) of the Income Tax Code (ITC)[30] provides that interest is not deductible in excess of a 5:1 debt-to-equity ratio if the recipient of the interest is tax exempt or taxed at a reduced rate. In addition, the scope of article 198(11) of the ITC has been broadened. The 5:1 debt-to-equity ratio also applies to intra-group loans. In defining the term "group", the legislator refers to the definition of "associated enterprises" in article 11 of the Belgian Company Code, i.e. companies that are in a direct and indirect affiliation relationship. The thin capitalization rules apply if the recipient of the interest is established in a tax haven where he is exempt or subject to income tax at a reduced rate.

On 9 July 2013, the Belgian Constitutional Court, in *Liga van Belastingplichtigen v. Belgische Staat* (No. 104/2013)[31] had to address the compatibility of this provision with articles 10 and 11 (non-discrimination) and article 172 (legality principle) of the Belgian Constitution.

The Court first observed that the aim of the amendment was to combat tax avoidance through increased undercapitalization by means of group loans. Thereafter, the Court considered that the distinction regarding the deductibility of interest is based on an objective criterion, i.e. the capacity of the granter of the loan and his relationship with the debtor company. Due to the character of intra-group loans, the legislator could take the view that, with regard to group loans, a higher risk of abuse exists. In this context, the Court observed that group companies can set up structures that cannot be used in respect of loans financed through a public call on savings or loans received from a bank or independent credit institution.

As the amendments were aimed at avoiding the above risk, the Court held that a reasonable justification for the distinction exists. This conclusion is not altered by the fact that intra-group loans might also have a different aim. The Court held that with regard to such technical matters, the legislator may decide to use a simple distinction, without determining cases where a financial structure is aimed at something other than reducing the tax base.

In addition, the Court held that the measure was not disproportionate because an undercapitalized company may still obtain group loans – it is just that the interest deduction is restricted if debts exceed five times the amount of equity – while interest on loans obtained through a call on public savings are fully deductible. Therefore, the Court held that the legislator had maintained a reasonable balance between the correct collection of taxes, the need for groups of companies to be able to make autonomous financing decisions and the need for undercapitalized companies to have access to the credit market under preferential conditions.

The Court pointed out that interest on loans received from shareholders and third companies is tax deductible if those interest recipients are not taxed at a reduced rate that is substantially more favourable than the Belgian rate.

The Court further held that no discrimination exists with regard to the calculation of the debt-to-equity ratio. The Court held that group loans or loans from a foreign financial institution are not always included in the debt-to-equity ratio, but only if the recipient of the interest is tax exempt or taxed at a reduced rate that is substantially more favourable than the Belgian rate.

In this context, the Court observed that the 5:1 ratio is a deduction limit that can easily be determined for fiscal and accounting purposes, which avoids abuse and problems concerning the determination of the deductible interest.

Moreover, the Court held that the exclusion of certain loans from the debt-to-equity ratio is justified because it can be presumed that such loans are not entered into mainly to reduce the tax base.

The Court held that the distinction between financial institutions that are preferentially taxed and those that are not is also justified, due to the wide margin of interpretation that the legislator has.

Finally, the Court held that interest on group loans is also deductible if the 5:1 debt-to-equity ratio is exceeded, provided the loans partially consist of loans that are not included in the debt-to-equity ratio because they are received from public savings. The Court decided that this possibility makes the amendments even less disproportionate.

7.2. Colombia

In Columbia, interest is only deductible under the thin capitalization rules if the debt-to-equity ratio does not exceed 3:1. In Ruling C-622 (30 September 2015),[32] the Constitutional Court decided that article 109 of Law 1607 of 2012 on the introduction of thin capitalization rules is in accordance with the Constitution. The Court held that the provision complies with the principles of equality and equity because public service infrastructure and housing projects have a social purpose and need to be financed. With regard to the principle of legal certainty, the Court concluded that the provision is not contrary to such a principle simply because, in exceptional cases, there could be a risk of conflict between articles 109 and 121 of the Taxation Statute,[33] which also deals with the deductibility of interest for income tax purposes.

30. BE: Income Tax Code 1992, National Legislation IBFD.
31. DE: CC, 9 July 2013, Case No. 104/2013, *Liga van Belastingplichtigen v. Belgische Staat* and A. Peeters & K. Willoque, *De nieuwe thin cap-regeling: Het bos door de bomen*, AFT 6-7, pp. 23-49 (2013).
32. CO: CC, 30 Sept. 2015, Ruling C-622 of 2015, *M.P. Luis Guillermo Guerrero Pérez.*
33. CO: Tax Statute, National Legislation IBFD.

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In 2014, the Court came to the same decision in Ruling C-665 (10 September 2014).[34] It held that the thin capitalization regime complies with the principle of equality because it applies to all taxpayers, regardless of whether or not they are financed fully or partially by way of loans. Furthermore, the regime is in accordance with progressive taxation because it does not affect taxpayers with low economic capacity who are parties to bank loans. Finally, thin capitalization rules are not incompatible with the freedom to conduct a business because they do not seek to promote or endorse any particular financial instrument or investment measure within the economy.

7.3. Germany

The German Federal Finance Court (*Bundesfinanzhof*) took a different approach in I B 85/13 (18 December 2013),[35] wherein it expressed doubts concerning the constitutionality of the interest deduction limitation rule. The Court expressed its concerns in light of the general principle of equality contained in article 3 of the German Constitution. The interest deduction limitation rule deviates from the general concept that business expenses are deductible in the tax period in which they were incurred and in which they constituted a burden for the taxpayer. The Court, therefore, considered that the interest deduction rule is incompatible with the objective net principle. The Court further doubted that such a deviation from the objective net principle in the form of the interest deduction limitation rule could be justified. It could, however, be generally justified on the basis that it is needed to finance another benefit, such as a reduction in tax rates. In 2008, the legislator reduced the corporate income tax rate (from 25% to 15%), as well as the basic municipal business tax rate (from 5% to 3.5%). The Court, however, noted that the legislator did not finance the reduction in the tax rates by generally broadening the tax base, as the interest deduction limitation rule is only applicable to a small group of taxpayers. The Court further considered that the interest deduction limitation rule cannot be justified due to a qualified fiscal purpose based on the need to avoid unpredictable losses in tax revenue.

The Court also doubted that the interest deduction limitation rule could be justified as an anti-abuse measure. In the explanatory notes to the 2008 Corporate Tax Reform Bill, the legislator stated that the rule in question must serve to protect the domestic tax base, as well as the need to avoid abusive tax planning structures. The rules must, however, also comply with the principle of proportionality. The Court opined that the wording of the interest deduction limitation rule is not precise enough to fulfil its purpose as an anti-abuse measure. On the one hand, the rule does not apply to wholly artificial arrangements in cases where the restrictive exceptions to the general rule apply, for example, if the net interest expenses do not exceed a certain threshold. On the other hand, the rule might apply to rather common debt financing arrangements, which may result in irreparable damage to companies in financial difficulty.

In view of the serious doubts regarding the constitutionality of the interest deduction limitation rule in light of the general principle of equality contained in article 3 of the Constitution, the Court did not consider any possible infringement of the guarantee of property contained in article 14 of the Constitution.

The Court, finally, noted that serious concerns regarding the constitutionality of the rule in question are sufficient to justify a suspension of the execution of the assessment. Generally, a suspension may only be granted in extraordinary cases where the enforcement of the tax charges would result in irreparable damages, such as an insolvency procedure. A suspension may also be granted, however, where the taxpayer's burden is comparably lower, if the danger to management of the public budget is also comparably lower, which is the case regarding the interest deduction limitation rule. The Court thus noted that, in the underlying case, the taxpayer's interest in a suspension of execution outweighs public interest in the execution of the assessment.

8. Cases on the Compatibility of Thin Capitalization Rules with Tax Treaties

8.1. Czech Republic

On 10 February 2005, the Czech Supreme Administrative Court gave its decision in Case No. 2Afs 108/2004–106[36] on the application of thin capitalization rules under the Czech Republic-United States (1993)[37] and Czech Republic-Netherlands (1974)[38] Income and Capital Tax Treaties. The Supreme Court did not consider the excessive interest to be income from other corporate rights and thus subject to article 10 of the respective treaties, despite the fact that the payment of interest was subject to the profitability of the debtor.

Furthermore, the Supreme Court did not accept an argument based on the Commentary on the OECD Model (2010).[39] In its view, the Commentary is not part of the context of these treaties in the sense of article 31(3) of the Vienna Convention on the Law of Treaties (1969)[40] because the tax administration did not prove that the Commentary is a "subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions, nor a subsequent practice in the application of the treaty" that establishes the agreement of the parties regarding its interpretation.

34. CO: CC, 10 Sept. 2014, Ruling C-665, *M. P. Gabriel Eduardo Mendoza Martelo*.
35. DE: BFH, 18 Dec. 2013, I B 85/13,
36. CZ: SAC, 10 Feb. 2005, Case No. 2Afs 108/2004–106.
37. *Convention between the United States of America and the Czech Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (16 Sept. 1993), Treaties IBFD.
38. *Convention between the Kingdom of the Netherlands and the Czechoslovak Socialist Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (4 Mar. 1974), Treaties IBFD.
39. *OECD Model Tax Convention on Income and on Capital: Commentary* (22 July 2010), Models IBFD.
40. *Vienna Convention on the Law of Treaties* (23 May 1969), Treaties IBFD.

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The Court considered the Commentary as a supplementary means of interpretation, but did not consider the relevant provisions. In its view, the meaning of the terms "dividend" and "interest" was not left ambiguous or obscure in the respective tax treaties. Consequently, the Court reclassified the excessive interest as dividends.

8.2. Netherlands

On 21 September 2012, the Netherlands Supreme Court (*Hoge Raad*) gave its decision in *X BV v. the Tax Administration* (Case No. 10/05268)[41] on the compatibility of the Netherlands thin capitalization rules with EU law and article 9 of the Netherlands-France (1973),[42] Netherlands-Germany (1959)[43] and Netherlands-Portugal (1999)[44] Income and Capital Tax Treaties.

The Supreme Court rejected the taxpayer's argument that the thin capitalization rules are incompatible with the Treaty on the Functioning of the European Union (TFEU) (2007).[45] In the taxpayer's view, this is because the rules apply if a Netherlands company is more than 95% owned by a foreign company, which means that in such a scenario, mainly foreign companies are affected. The Court based its decision on an earlier decision in LJN BN 3537 (24 June 2011)[46] in which it was held that domestic and foreign holding companies are not in a comparable situation.

Referring to the decision of the European Court of Justice (ECJ) of 21 July 2011 in *Scheuten* (Case C-397/09),[47] the Court also held that the thin capitalization rules are not incompatible with the Interest and Royalties Directive (2003/49)[48] because that Directive deals with the position of the creditor and not with that of the debtor.

The Court also rejected the argument based on article 25(5) (non-discrimination) under the France-Netherlands Income and Capital Tax Treaty (1973) because the taxpayer is not being treated differently from another company that is not part of a group and is not comparable with a group company.

Thereafter, the Court decided that the provision at issue is also not incompatible with the arm's length provisions under article 9 of the France-Netherlands Income and Capital Tax Treaty (1973) and article 9 of the Germany-Netherlands Income and Capital Tax Treaty (1959) because those provisions only provide for a corresponding adjustment in respect of contracts and financial relations between related parties that are not at arm's length, while the Netherlands thin capitalization rules concern the entire financing structure of a company.

Finally, the thin capitalization rules are also not incompatible with article 9 of the Netherlands-Portugal Income and Capital Tax Treaty (1999) because article X of the Protocol specifically allows the Member States to apply their domestic thin capitalization rules. Those rules may only not be applied if related companies prove that their agreements are at arm's length based on their activities or their specific economic circumstances.

Because the term "thin capitalization" is not defined in the Netherlands-Portugal Income and Capital Tax Treaty (1999), the term must be interpreted by means of article 31(1) of the Vienna Convention (1969), which means that the meaning of the term must be determined in good faith based on the subject and purpose of the Treaty. Based on the thin capitalization rules applicable in Portugal at the time the Treaty was signed, the Court held that the term refers to interest deduction restrictions concerning interest paid on loans to related companies. This is in line with article 9 of that Treaty, which aims to determine whether the conditions in a concrete legal case are at arm's length. Therefore, the Court held that the term "thin capitalization" in the Treaty with Portugal only concerns certain loans and not a general thin capitalization rule regarding the total financing structure of a company.

8.3. Russia

On 2 September 2014, the Federal Arbitration Court of the Moscow Circuit (FAC) decided, in Case A41-21630/2013,[49] that the thin capitalization rules were applicable to the taxpayer because the relevant tax treaty does not contain any restrictions on deductibility rules. The Court began by referring to the Protocol to the Russia-Germany Income and Capital Tax Treaty (1996),[50] which provides that interest paid by a company that is a resident of Russia and in which a resident of Germany participates will be deductible in Russia without any limitations, irrespective of whether or not the interest is paid to a bank or another person and irrespective of the term of the loan. This deduction cannot, however, exceed the amount that would have been agreed upon by independent enterprises under similar circumstances.

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41. NL: HR, 21 Sept. 2012, Case No. 10/05268, *X BV v. the Tax Administration*.
42. *Convention between the Republic of France and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* [unofficial translation] (16 Mar. 1973) (as amended through 2004), Treaties IBFD.
43. *Convention between the Federal Republic of Germany and the Kingdom of the Netherlands for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital and Various Other Taxes, and for the Regulation of Other Questions Relating to Taxation* (unofficial translation) (16 June 1959), Treaties IBFD.
44. *Convention between the Kingdom of the Netherlands and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (20 Sept. 1999), Treaties IBFD.
45. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.
46. NL: Supreme Court (*Hoge Raad der Nederlanden)*, 24 June 2011, LJN BN 3537, *X BV. v. the Tax Administration*.
47. DE: ECJ, 21 July 2011, Case C-397/09, *Scheuten Solar Technology GmbH v. Finanzamt Gelsenkirchen-Süd*, ECJ Case Law IBFD.
48. Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies of Different Member States, OJ L157 (2003), EU Law IBFD.
49. RU: FAC – Moscow Circuit, 2 Sept. 2014, Case A41-21630/2013, Aluplast RUS LLC**.**
50. *Convention between the Federal Republic of Germany and the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* [unofficial translation] (29 May 1996) (as amended through 2007), Treaties IBFD.

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The FAC continued by observing that tax treaties should apply in scenarios where domestic law conflicts with international law. The FAC clarified, however, that the provisions of the Protocol providing for unlimited interest deduction do not prevent the application of thin capitalization rules because that provision only states that interest should be deductible, but does not specify the amount and the computation rules regarding deductibility.

8.4. Spain

The Spanish Supreme Court, in its decision in Appeal No. 5871/2006 (17 March 2011)[51] held that domestic thin capitalization rules are inapplicable to loans from a related company in Switzerland, as such rules are contrary to the non-discrimination article (article 24(1) of the Spain-Switzerland Income and Capital Tax Treaty (1996)).[52] The Supreme Court decided that the thin capitalization regime established under the Spanish CIT was incompatible with the non-discrimination article of that Treaty.

The Court held that the incompatibility between the domestic rules and the Treaty should be resolved by applying the speciality principle, under which domestic rules apply only where there is no tax treaty with a non-discrimination provision.

Therefore, interest paid to the Swiss parent company should be deductible for CIT purposes, as if paid to a Spanish company, because the thin capitalization rules do not apply in such a scenario.

9. Compatibility of Thin Capitalization Rules with EU Law

9.1. Netherlands

An important decision on the compatibility of thin capitalization rules with EU law was given by the Netherlands Supreme Court (*Hoge Raad der Nederlanden*) in Case No. 12/05498 (29 November 2013).[53] In this case, the Court had to decide whether or not the former thin capitalization rules, which were abolished with effect from 1 January 2013, were compatible with EU law and the Denmark-Netherlands Income and Capital Tax Treaty (1996).[54]

In this case, a Netherlands limited liability company had borrowed a substantial amount of money from a Danish parent company.

The Court firstly observed that a restriction of the freedom of establishment exists only if similar cases are treated differently. Regarding the attribution of debt, the Court stated that a PE is not in a similar situation as a subsidiary.

If the Danish company had chosen to undertake its Netherlands activities through a PE, the loan, under the same circumstances, would have been attributable to the PE. This is comparable to a subsidiary that borrows money from a third party. In both these situations, the Court considered that the thin capitalization rules would not apply.

The Court held that the situation of the taxpayer is similar to that of a Netherlands PE the acquisitions of which are financed through a loan agreement with a company related to the Danish parent company. In this situation, the thin capitalization rules would, however, have the same effect as in the case before the Court. Consequently, the Court decided that there was no difference in treatment of similar cases.

With regard to the Treaty, article 9 allows for the adjustment of profits in situations in which, in the course of trade or financial relations, related companies agree on transaction terms that are not at arm's length.

The Court stated, however, that thin capitalization rules only apply to the (entire) financial structure of a company. The fact that the loan agreements between the parent company and the Netherlands subsidiary might be the only transactions that form the basis for the application of thin capitalization rules is not relevant in this context because thin capitalization rules do not cover transactions; they only address the financial structure of a company.

In addition, the Court noted that paragraph 3 of the Commentary on Article 9 of the OECD Model (2014)[55] does not provide sufficient grounds for a different interpretation of the issue.

10. Examples

On 11 July 2016, the OECD published a Discussion Draft consultation on the elements and design of group ratio rules for the deduction of interest.[56] The Draft suggests the following three means of determining a group ratio:

(1) the use of income and expense figures taken from the consolidated income statement without adjustment. This may result in substantial differences between groups because it depends on the group policy;

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51. ES: SC, 17 Mar. 2011, Appeal number 5871/2006, *HERO ESPAÑA, S.A.*
52. *Convention between Spain and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital* [unofficial translation] (26 Apr. 1966) (as amended through 2011), Treaties IBFD.
53. NL: HR, 29 Nov. 2013, Case No. 12/05498.
54. *Convention between the Kingdom of the Netherlands and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (1 July 1996), Treaties IBFD.
55. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 9(3)* (26 July 2014), Models IBFD.
56. OECD, Discussion Draft on the Design and Operation of the Group Ratio Rule under BEPS Action 4 (11 July 2016), available at www.oecd.org/tax/beps/oecd-releases-discussion-draft-on-the-design-and-operation-of-the-group-ratio-rule-under-beps-action-4.htm.

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(2) the use of income and expense figures taken from the consolidated income statement without adjustment, whereafter these figures are adjusted for items included in the definition of interest that are regarded as economically equivalent to interest; and

(3) the identification of a group's items of income or expenses falling within the definition of interest and payments economically similar to interest and determining how these items are treated in the consolidated financial statements of the group.

The effects of the proposals are shown by means of several examples.

Example 1: Application of a 10% uplift with regard to third-party expense

Presume company A Co has an EBITDA of EUR 30 million. B Co has an EBITDA of EUR 100 million. The group EBITDA is, therefore, EUR 130 million.

The net interest of A Co is EUR 5 million and of B Co, EUR 27.5 million. The group net interest is, therefore, EUR 32.5 million. After a 10% uplift, this amount is increased to EUR 35.75 million.

The group net third-party interest EBITDA ratio is 27.5%. The interest capacity of A Co is EUR 8.25 million and of B Co, EUR 27.5 million. This means that the interest paid by both A and B Co is fully deductible.

Moreover, this also means that A Co has an unused interest deduction capacity of EUR 3.25 million (i.e. EUR 8.25 million - EUR 5 million).

Example 2: Excluding net related-party interest expense from the net third-party interest expense

Both A Co and B Co have an EBITDA of EUR 50 million. The group EBITDA is, therefore, EUR 100 million. A Co and B Co both have a net third-party interest in respect of related parties of EUR 25 million. The group net interest expense in respect of related parties is, therefore, EUR 50 million.

The other net interest expense of both A Co and B Co is EUR 12.5 million. The group net interest is EUR 25 million and the total net interest expense, EUR 75 million (i.e. EUR 50 million + EUR 25 million).

The group net third-party interest expense/EBITDA ratio of A Co is 75% and that of B Co, 25%.

This means that the interest capacity of A Co is EUR 37.5 million and that of B Co, EUR 12.5 million.

Consequently, the interest paid by A Co of EUR 37.5 million is fully deductible. From the interest paid by B Co of EUR 37.5 million, only EUR 12.5 million is deductible.

Example 3: Including the net interest paid to related parties in the adjustment for interest income and expenses when calculating the group EBITDA

Both A Co and B Co have an EBITDA of EUR 50 million. The group EBITDA is, therefore, EUR 100 million. A Co, as well as B Co, has a net interest expense in respect of related parties of EUR 25 million. The group net interest expense in respect of related parties is, therefore, EUR 50 million.

The other net interest expense of both A Co and B Co is EUR 12.5 million. The group net interest is EUR 25 million and the total net interest expense, EUR 75 million (i.e. EUR 50 million plus EUR 25 million).

If the related-party interest is included in the calculation, the group EBITDA is EUR 100 million, while it is EUR 50 million when the related-party interest is not included.

If the net related-party interest is included, the group net third-party interest expense/EBITDA ratio is 25%, while it is 50% when the net related-party interest is not included.

If the net related-party interest is included, the deductible interest of A Co and B Co is EUR 12.5 million. If the net related-party interest is excluded, the deductible interest is EUR 25 million.

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As a result, the non-deductible interest is, for both A Co and B Co, EUR 25 million (i.e. EUR 37.5 million - EUR 12.5 million) if the net related-party interest is included and EUR 12.5 million (i.e. EUR 50 million - EUR 37.5 million) if not included.

Example 4: Including taxable dividends in the Group EBITDA

Presume A Co obtains EUR 25 million of dividends, while B Co does not obtain any dividend. The group dividends are EUR 50 million. The other taxable EBITDA of A Co is EUR 25 million and that of B Co, EUR 50 million. The group EBITDA is EUR 75 million.

The EBITDA of both A Co and B Co is EUR 25 million. The group total is EUR 100 million. The net interest expense of both A Co and B Co is EUR 12.5 million. The group total is EUR 25 million. The group net third-party interest/EBITDA ratio is 25%.

The taxable entity EBITDA of both A Co and B Co is EUR 50 million. The deductible interest capacity of both A Co and B Co is 25% of EUR 50 million, i.e. EUR 12.5 million. Because this amount is equal to the amount of interest paid by both A Co and B Co, the interest is fully deductible.

Example 5: Removing taxable dividends from the group EBITDA

Presume A Co obtains EUR 25 million of dividends, while B Co does not obtain any dividends. The group dividends are EUR 50 million. The other taxable EBITDA of A Co is EUR 25 million and that of B Co, 50 million. The group EBITDA is EUR 75 million.

After removing the dividends from the group EBITDA, the group EBITDA becomes EUR 50 million. The taxable entity EBITDA of both A Co and B Co is EUR 50 million. The net interest expense of both A Co and B Co is EUR 12.5 million. The group total is EUR 25 million. The group net third-party interest/EBITDA ratio after exclusion of the dividends is 33%.

The taxable entity EBITDA of both A Co and B Co is EUR 50 million. The deductible interest capacity of both A Co and B Co is 33.3% of EUR 50 million, i.e. EUR 16.65 million. Because this amount of interest paid by both A Co and B Co is EUR 12.5 million, the interest is fully deductible.

Furthermore, both A Co and B Co have an unused interest capacity of EUR 4.15 (i.e. EUR 16.65 - EUR 12.5 million).

Example 6: The impact of losses on the operation of a group ratio rule

Presume A Co, B Co and C Co have an EBITDA of EUR 50 million, EUR 5 million and minus EUR 50 million, respectively. The group EBITDA is EUR 5 million (i.e. EUR 50 million + EUR 5 million - EUR 50 million).

The net third-party interest paid by A Co and B Co is EUR 10 million and EUR 1 million, respectively, while C Co received interest of EUR 5 million. The group net interest is EUR 6 million (i.e. EUR 10 million + EUR 1 million - EUR 5 million).

The group net third-party interest expense/EBITDA ratio is 120%.

The deductible interest capacity of both A Co and B Co is EUR 60 million and EUR 6 million, respectively). The interest paid by both A Co and B Co is fully deductible.

In addition, A Co has an unused interest capacity of EUR 50 million (i.e. EUR 60 million - EUR 10 million), while B Co has an unused interest capacity of EUR 5 million (i.e. EUR 6 million - EUR 1 million).

11. Conclusion

Based on the authors' analysis of BEPS Action 4, its implementation by multiple countries, existing legislation and the case law of multiple countries, it can be concluded that:

- BEPS Action 4 cannot be examined in isolation if its intended result is to be achieved, as explained in the example contained in section 4.1.2.1., unless a mechanism for ranking BEPS Actions is introduced. The final result could be as high as 50%-70% in additional tax payments for an MNE impacted by all Actions simultaneously;
- political influence (varying from country to country) creates a distortion regarding global implementation of the key solutions proposed by the BEPS Action Plan. As explained in section 2., the ATAD implements the BEPS Actions at an EU level, however, a comparison of the measures suggested by both approaches reveals that there are mismatches, as well as overlap between the proposed Action

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Points. For example, the EU politicians intend to close all loopholes with tax avoidance potential via the ATAD without taking into account any of the side effects as explained herein;

- a lack of harmonization of the tax systems of various countries has always existed, which has allowed MNEs to structure their operations in a tax efficient manner. The proposal of BEPS measures at a global level, while leaving implementation to individual countries, will not address the problem of a lack of harmonization of tax systems across the globe;
- last, but not least, in light of the unilateral measures being proposed left and right to implement the BEPS proposals, there is indeed a grave danger of over-taxation of many MNEs. Implementation of BEPS measures should not, however, be cited as a justification to override a country's sovereignty to decide on its tax policy, which is what is occurring. The European Commission has, in fact, threatened to impeach/alienate Member States of the European Union on the charge of non-compliance with the ATAD proposal. This extends beyond the powers of the Commission, as direct tax policy is a matter that has always been 100% under the Member States' sovereignty.

This raises a pertinent question: Keeping in mind the intention to bring back profits to the appropriate place of taxation, is the (unsupervised) implementation of the BEPS Project leading to excessive and unjustified taxation of companies and is it overriding the sovereignty of Member States?

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