International double taxation of interest: from arm's length, and thin capitalization to comprehensive interest barriers

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The Issue

The deductibility of interest

Traditional thin capitalization rules between related parties → *"Thinly capitalized"* = high proportion of related-party debt capital in relation to equity capital

These rules limit the interest deductibility by reference to:
I) Arm's length principle
II) Fixed debt-to-equity ratio
III) Safe-harbour approach

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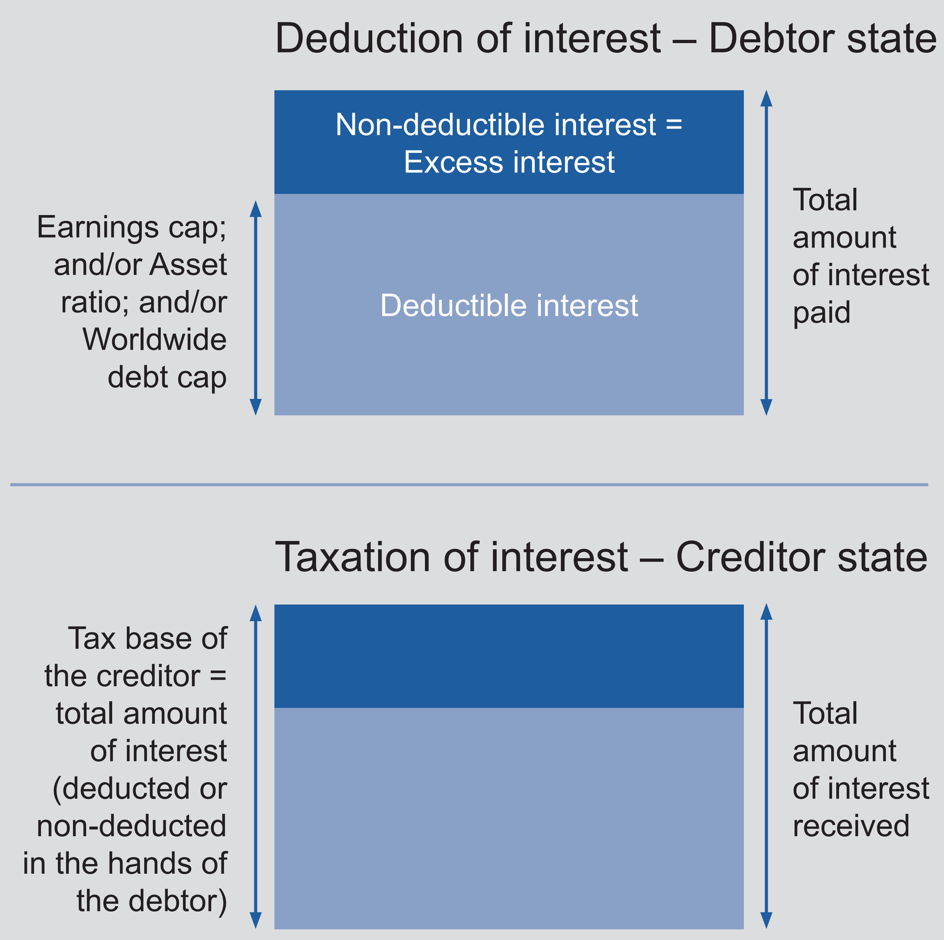
Comprehensive interest barriers (related + unrelated party debt) → Limit the interest deductibility of related and unrelated-party debt to a certain percentage of assets and/or earnings of the debtor and/or by reference to the worldwide debt ratio of the group to which the debtor belongs

Economic double taxation of interest as a result of comprehensive interest barriers



Introduction

This thesis deals with problems stemming from the rule that interest is deductible (and dividends are not) in calculating taxable income, unless the interest is caught by thin capitalization or anti-abuse rules.
ECJ case law has restricted the effectiveness of this traditional approach and new analysis has shown that multinational groups can plan their worldwide leverage to minimize their overall tax liability, highlighting the risk of base erosion.
This has led some states to introduce new rules, commonly called **"comprehensive interest barriers"**.

Research Questions

- Are comprehensive interest barriers in line with standard International and European tax law and principles?
- What are the tax policy justifications and/or principles underlying comprehensive interest barriers?
- Are there other fair and neutral solutions to reform the way that interest is deducted and taxed in the international tax framework?

Methodology

Analysis of the selected domestic comprehensive interest barriers:
Australia, Italy, New Zealand and United Kingdom

↓ to ascertain the

- **Compatibility with basic tax principles:**
  - Ability-to-pay principle
  - Net-income principle
  - Benefit principle
  - Arm's length principle
- **Nature of comprehensive interest barriers**

Investigation of possible solutions to solve international double taxation of interest:

- OECD Income and Capital MC
- European Union law
- Unilateral measures

Tax reform of the treatment of cross-border interest:

Partial tax reform:
- Interest box?
- Defiscalization of interest?
- Interest apportionment?

Radical tax reform:
–Global apportionment?
–Comprehensive Business Income Tax (CBIT)?

Preliminary Findings

- The deductibility of genuine interest expenses incurred to earn business income, as well as of arm's length interest payments paid to independent third parties, is disallowed under comprehensive interest barriers.
- In an international context, these rules result in economic double taxation as the creditor state is not likely to exclude the non-deductible interest, determined in accordance with a purely domestic standard, from its tax base.
- Potential use of the new Article 7 OECD MC to establish an international consensus for the capital structure of a company.
- Partial solution of the economic double taxation of interest between related parties through the EU Interest and Royalties Directive.

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