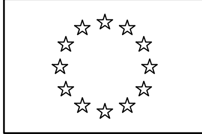

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SECRETARIAT'S DISCUSSION PAPER ON THIN CAPITALIZATION

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Thin capitalization and the Arbitration Convention

This paper has been prepared to aid the Forum in its deliberations on thin capitalization (thin cap) and the Arbitration Convention (AC). Business is very keen that instances of double taxation arising from thin cap cases are capable of being resolved under the AC and, in particular, are capable of being adjudicated by the arbitration panel if the Competent Authorities cannot agree how to remove the double taxation within the normal two year period. The Secretariat notes that it is much better for taxpayers if thin cap cases can be resolved by the AC. A questionnaire on thin cap and the AC was circulated to the tax administration members of the Forum; the overwhelming majority of tax administrations who have replied have indicated that they will admit thin cap cases, of no matter what kind, into the AC. This paper analyses the AC itself and sets out the reasons why instances of double taxation arising from thin cap cases should be resolved under the AC

By "thin capitalization" tax administrations typically mean looking at the rate of interest charged between associated persons or the amount of the debt on which interest is charged. When considering the amount of the debt, tax administrations look at the amount which could have existed at arm's length (borrowing capacity) and also some tax administrations look at the amount of debt which would have existed (borrowing capacity and attitude to debt and/or risk).

Different tax administrations have different rules used to look at debt arrangements between associated persons. In some countries, "normal" transfer pricing rules apply. In other countries, there are special rules. Some countries have both. But all rules tend to consider the problem in a similar fashion: the outcome must be that the debt arrangements reflect those which would have existed between third parties. Most tax administrations treat taxpayers on a case by case basis, looking at the facts that apply in that case but some tax administrations apply ratios for allowable debt for all taxpayers.

Principles underlying the AC

Article 4 sets out the principles which govern the application of the AC. Where conditions are made or imposed between enterprises under direct or indirect control that differ from those that would be made between independent enterprises, any profits which would have been enjoyed but for those conditions can be assessed accordingly. This is in essence the arm's length principle. Article 4 is not however a charging provision – that is a matter for domestic legal codes – but defines the framework under which profits are taxed and any double taxation created is to be resolved by the AC.

Article 4 also sets out the situations where the conditions between the associated persons can give rise to profits as they would have arisen between independent persons. Commercial transactions are included, which under normal circumstances would arguably include the provision of debt finance. However, financial transactions are also specifically mentioned, which, given the nature of debt finance, must include loans (and would also specifically include loan arrangements not on commercial terms which might otherwise not be considered as "commercial" if one was to follow a somewhat restrictive interpretation of the word commercial).

So it seems clear from Article 4 that thin cap – which concerns debt finance - should be included in the AC. And that this requires an adjustment of some sort in the hands of the second taxpayer involved.

Furthermore, it is implicit in Article 4 that where profits are taxed on an arm's length basis in one country, the same should apply in the second country concerned. Hence a corresponding adjustment is necessary to ensure this is the case and to avoid double taxation. This is made clear at the end of Article 5: "If after such information has been given the two enterprises and the other Contracting State agree to the adjustment…" then no further action is necessary – the other enterprise in the other state, and the state itself, have agreed to adjust their profits accordingly. However, if the other taxpayer and the other state do not agree at this stage, the double taxation is only subsequently removed by a corresponding adjustment to the profits of the other associated enterprise, or an agreement between the Competent Authorities as to what other amount will be assessed and relieved, or a decision of the Arbitration panel. This necessitates articles 6 and possibly 7 being applied.

In a wider context, the language in Article 4 of the AC mirrors the language in Article 9 of the OECD model treaty – the associated enterprises article. It is this language that effectively imports the idea of the arm's length principle into the AC. Since thin cap adjustments always affect associated enterprises, it is logical to conclude that the adjustments should be viewed as adjustments carried out to reflect the arm's length principle itself.

From the above, it is easy to see why many tax administrations do allow thin cap cases to be resolved under the AC.

In the past, two arguments have been advanced for not eliminating under the AC double tax caused by thin cap: thin cap is not transfer pricing and an adjustment has to be made by a tax administration for the AC to apply. But an analysis of the AC itself does not support these arguments.

Is thin cap transfer pricing?

The very title of the AC makes it clear that it should apply to cases of double taxation: "Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises." Transfer pricing is not mentioned expressly, only profits between associated enterprises. So it seems irrelevant whether thin cap legislation is part of the transfer pricing legislation of a country or a separate part of the code. Transfer pricing is not mentioned expressly in Articles 4, 5, 6 or 7 of the AC, nor indeed anywhere else in the Convention.

Article 1 of the AC mentions the principles set out in Article 4 (essentially concerning the arm's length principle) being applied in the corresponding provisions of the state's own law. But Article 1 does not expressly mention the transfer pricing code - the language makes it clear that any part of the laws of the state which affect the profits of associated enterprises are within the AC ("on the grounds that the principles set out in Article 4 and applied either directly or in corresponding provisions of the law of the State concerned have not been observed.")

Hence it seems irrelevant for the purposes of the AC whether thin cap is considered to be transfer pricing since thin cap undeniably affects the profits that arise between associated enterprises.

In the same way, where thin cap is viewed as some sort of "anti-abuse" measure, it must be seen as a protection against abusive arrangements between associated enterprises. Otherwise what type of abuse is thin cap a protection against? Again it is evident that arrangements between associated enterprises that are not considered to be arm's length are in point and therefore use of thin cap legislation, which affects associated enterprises, should be included in the AC.

<u>For the AC to apply to thin cap, is it necessary for a tax administration to have made an adjustment?</u>

It is not possible to find anywhere in the AC the rule that a tax administration has to have expressly made an adjustment before the AC can apply. Article 5 mentions a tax administration making an adjustment but only in the context of that tax administration informing the second administration of its action or intended action. It is Article 6 which allows for the initiation of the actual AC procedure and here the word adjustment is not mentioned – rather it is the existence of double taxation, contrary to Article 4, which is the causal factor necessary for the AC procedure. And the procedure is initiated by the taxpayer.

The argument for a tax administration adjustment being necessary seems to be made most strongly in contexts where some sort of clearance system is in place whereby thin cap rules apply before a tax return is submitted, where ratios exist in law to limit interest deductions or in other cases where the dynamic is very different from the usual position of an audit giving rise to an adjustment to the tax return of a company. Perhaps where a taxpayer has, after a negotiation with a tax administration, altered the amount claimed for interest from the amount it originally intended to claim.

The title of the AC states it is concerned with the elimination of double taxation arising from the adjustment of profits of associated enterprises but does not state that it is a tax administration which has to make the adjustment. Taxpayers can also make an adjustment.

Nor is it stated anywhere in the AC what form the adjustment has to take or indeed what has to be adjusted – tax returns, formal accounts, management accounts etc could all be adjusted by one taxpayer when the other taxpayer

concerned has already declared a different amount of interest as income or a deduction. This would lead to double taxation that would need to be resolved. Equally, a voluntary adjustment to comply with a tax administration's publicly stated position or legally expressed thin cap ratio is still an adjustment which can lead to double taxation.

Obviously the situation is not completely open-ended in the favour of taxpayers. Double taxation only arises where there is an asymmetry of interest spent or received between associated debtor and creditor. If, pre tax returns being made, a taxpayer agrees with a tax administration what interest is deductible and the other taxpayer receiving the interest is able to credit the same amount then double taxation as normally defined has not occurred. There is nothing which needs to be resolved. (Traditionally, the smaller number of thin cap cases under MAP compared to the number of mainstream transfer pricing cases has been explained by the ability of taxpayers to agree a tax treatment for interest before the tax returns of both parties are submitted.) Where, however, one taxpayer has adjusted an amount claimed as an interest deduction and the other taxpayer receiving the interest has not made a corresponding adjustment itself then there is double taxation which needs to be resolved. It is double taxation that arises from the financial relations between associated persons.

ECJ Case law

The recent ECJ case "Test claimants in the Thin Cap Group litigation v Commissioners of Inland Revenue" of course was not about whether thin cap should be in the AC. This is not the place for a discussion of this case. However, the judgement in the case does link thin cap rules to the arm's length principle. *In particular, the judgement notes that thin cap rules which limit an interest deduction are only permitted in an EU context to the degree that any interest is not "arm's length." Thus the arm's length principle is specifically mentioned by the Court.*

Given this, it is clear that as the AC covers adjustments based on the arm's length principle – as outlined above – then thin cap should be covered by the AC.

Conclusion

From the above analysis it seems clear that double taxation arising from thin cap cases should be resolved under the AC:

Debt and interest are part of the commercial and financial relations between associated persons. Taxpayers face double taxation arising from these transactions if there is a difference in the amount of interest charged to tax in one MS and the amount of interest allowed as a deduction in the other MS concerned. The AC is clearly designed to resolve issues of double taxation between associated persons which arise from profits being included in the profits of one associated person without an appropriate corresponding adjustment and there is nothing in the AC which states that cases of thin cap should be excluded. Indeed the phase "commercial or financial transactions" expressly apply to debt finance; what else could the words apply to?

Notwithstanding spheres of domestic competence, the AC is an international, multilateral instrument. There is an obvious benefit if all signatories interpret the instrument in the same way.

Considering the answers provided to the questionnaire on thin cap and the arguments included in the present document does the Forum consider that instances of double taxation arising from thin cap cases are covered by the AC?

Relevant articles of the AC:

Article 1
1. This Convention shall apply where, for the purposes of taxation, profits which are included in the profits of an enterprise of a Contracting State are also included or are also likely to be included in the profits of an enterprise of another Contracting State on the grounds that the principles set out in Article 4 and applied either directly or in corresponding provisions of the law of the State concerned have not been observed.
2. For the purposes of this Convention, the permanent establishment of an enterprise of an Contracting State situated in another Contracting State shall be deemed to be an enterprise of the State in which it is situated.
3. Paragraph 1 shall also apply where any of the enterprises concerned have made losses rather than profits.

Article 4
The following principles shall be observed in the application of this Convention:
1. Where:
(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of another Contracting State, or
(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one Contracting State and an enterprise of another Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ form those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
2. Where an enterprise of a Contracting State carries on business in another Contracting State through a permanent establishment situated therein, there shall be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
Article 5
Where a Contracting State intends to adjust the profits of an enterprise in accordance with the principles set out in Article 4, it shall inform the enterprise of the intended action in due time and give it the opportunity to inform the other enterprise so as to give that other enterprise the opportunity to inform in turn the other Contracting State.
However, the Contracting State providing such information shall not be prevented from making the proposed adjustment.
If after such information has been given the two enterprises and the other Contracting State agree to the adjustment, Articles 6 and 7 shall not apply.
Section 3

Mutual agreement and arbitration procedure

Article 6

1. Where an enterprise considers that, in any case to which this Convention applies, the principles set out in Article 4 have not been observed, it may, irrespective of the remedies provided by the domestic law of the Contracting States concerned, present its case to the competent authority of the Contracting State of which it is an enterprise or in which its permanent establishment is situated. The case must be presented within three years of the first notification of the action which results or is likely to result in double taxation within the meaning of Article 1.

The enterprise shall at the same time notify the competent authority if other Contracting States may be concerned in the case. The competent authority shall then without delay notify the competent authorities of those other Contracting States.

2. If the complaint appears to it to be well-founded and if it is not itself able to arrive at a satisfactory solution, the competent authority shall endeavour to resolve the case by mutual agreement with the competent authority of any other Contracting State concerned, with a view to the elimination of double taxation on the basis of the principles set out in Article 4. Any mutual agreement reached shall be implemented irrespective of any time limits prescribed by the domestic laws of the Contracting States concerned.

Article 7

1. If the competent authorities concerned fail to reach an agreement that eliminates the double taxation referred to in Article 6 within two years of the date on which the case was first submitted to one of the competent authorities in accordance with Article 6 (1), they shall set up an advisory commission charged with delivering its opinion on the elimination of the double taxation in question. Enterprises may have recourse to the remedies available to them under the domestic law of the Contracting States concerned; however, where the case has so been submitted to a court or tribunal, the term of two years referred to in the first subparagraph shall be computed from the date on which the judgment of the final court of appeal was given.

2. The submission of the case to the advisory commission shall not prevent a Contracting State from initiating or continuing judicial proceedings or proceedings for administrative penalties in relation to the same matters.

3. Where the domestic law of a Contracting State does not permit the competent authorities of that State to derogate from the decisions of their judicial bodies, paragraph 1 shall not apply unless the associated enterprise of that State has allowed the time provided for appeal to expire, or has withdrawn any such appeal before a decision has been delivered. This provision shall not affect the appeal if and in so far as it relates to matters other than those referred to in Article 6.

4. The competent authorities may by mutual agreement and with the agreement of the associated enterprises concerned waive the time limits referred to in paragraph 1.

5. In so far as the provisions of paragraphs 1 to 4 are not applied, the rights of each of the associated enterprises, as laid down in Article 6, shall be unaffected.