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Thin capitalisation- Compatible with EC law?

Master thesis
20 points

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Tax law

2008

Contents

Summary

Thin capitalization means an abnormally high debt-to-equity ratio of a corporation, in a situation where the debt finance comes from a foreign affiliated contributor of capital. The contributor of debt capital is often simultaneously a direct shareholder. Tax revenue from debt is generally realized primarily by the state of residence of the investor whereas the tax revenue from direct investment, equity in particular, is realized by the state of residence of the financed corporation. The use of debt instead of equity distributes tax revenue from the source state to the state of residence of the return on an investment. Therefore, in order to avoid taxation in the source state, a corporation may be financed excessively with debt. The tax advantage gained by debt instead of the use of equity has resulted in various complicated constructions by international companies in order to avoid or at least decrease their taxation.

Within the European Union, the member states have chosen different approaches to measure whether a company is thinly capitalized for tax purposes. Some member states have general tax rules, using a subjective approach or the “arm’s length” approach where the company has to prove that the same loan could be obtained from a third party under the same circumstances and conditions. If the arm’s length principle is not fulfilled the granting of the loan by the shareholder is only motivated by the subsidiary shareholder relationship.

Other member states have enacted particular rules on thin capitalization by specifying an accepted relation between debt and equity, a so-called debt/equity ratio. If the debtor’s debt exceeds a certain proportion of its equity, an adjustment will be made under the country’s thin capitalization rule.

Preface

In this chapter, I would like to show my gratitude to Professor Marjaana Helminen, who introduced me two her two books which have helped me a lot in this thesis.
I would also like to thank my family and my friend Christina Ohlsson for supporting and encouraging me in my work with this thesis, without you the writing process would have been longer and lonelier.
The most important person during this process has however been my supervisor Christina Moëll, she has given me great support and remarks.

Thank you!

Abbreviations

EC	European Community
ECJ	European Court of Justice
EU	European Union
OECD	Organisation for Economic Cooperation and Development

1 Introduction

The profits of a corporate entity are normally taxed only in the entity's state of residence if the entity does not have a permanent establishment in another state and if it does not make a profit distribution. An international enterprise may consist of a group of legally independent companies in different states. Despite the legal independence, the group of companies have a common interest.
The European Union encourages an open market within its territory, thus using its legislative power to set up rules that prohibit any direct or indirect discrimination on grounds of nationality, applying not only to individuals but also to companies established under the laws of an EU Member State with residence, central management or head office in an EU Member State. Tax provisions of the Member States may not treat nationals of two different Member States under the same circumstances differently or under different circumstances similarly with the result, that one is disfavoured over the other.[1]
Because different states have different tax rates, taxpayers may take advantage of this treatment by establishing corporate entities in low tax states and avoid or at least defer taxation. There is a number of what I choose to call "tax constructions" that international companies can use in order to minimize their total tax burden. These "tax constructions" have been noticed by the Member States authorities, creating debate and in some cases legislative measures have been taken. Thus, we find a common ground for CFC, transfer pricing, thin capitalization and thick capitalization; these arrangements include (hidden) profit transfers from one company to another and at the same time from the taxing territory of one state to the territory of another state. If the profits are transferred from a high tax state to a low tax state the tax gain that the companies may benefit from is obvious.
Not only do the Member States different tax rates encourage certain behaviour but also the tax treaty network of different Member States can be exploited with the consequence that no taxes are levied on an item that otherwise would be taxable, i.e. so called treaty shopping.
Within an international enterprise the companies can benefit from tax advantages by taking intra-group transactions that would not have been obtained from a third independent party, transactions that are not within the arm's length principle.[2] The following example is a simple illustration of tax benefits that can be gained by the use of transfer pricing; a company P, situated in State P sells goods to its subsidiary, company S, resident in State S, for a price of 100 (marketing and production is estimated to 50) and the market price for the same goods between non affiliated companies would be 110 (marketing and production is 80), then a profit of 50 would appear in company P and only 10 in company S.[3] Thus, profits are transferred to a State with a lower tax rate, resulting in a tax advantage.

[1] C-279/93 Schumacker, C-307/97 Saint-Gobain.
[2] M. Helminen, Finnish international taxation, 2005, s. 146.
[3] B. J.M, Terra, European tax law, 2005, s. 578.

Thin capitalization means an abnormally high debt-to-equity ratio of a corporation, in a situation where the debt finance comes from a foreign affiliated contributor of capital. The contributor of debt capital is often simultaneously a direct shareholder. Tax revenue from debt is generally realized primarily by the state of residence of the investor whereas the tax revenue from direct investment, equity in particular, is realized by the state of residence of the financed corporation. The use of debt instead of equity distributes tax revenue from the source state to the state of residence of the return on an investment. Therefore, in order to avoid taxation in the source state, a corporation may be financed excessively with debt. The tax advantage gained by debt instead of the use of equity has resulted in various complicated constructions by international companies in order to avoid or at least decrease their taxation.
Thus, it is the aim and purpose of this thesis to evaluate whether thin capitalisation rules are precluded under Community law, how the OECD considers the question and how some Member States have regulated thin capitalisation.

1.1 Purpose and Structure

The aimof this thesis is to evaluate whether thin capitalisation rules are precluded under Community law, how the OECD considers the issue of thin capitalisation and how some Member States have regulated the issue.
The disposition chosen will begin with the OECD Model convention, Community law and national legislation, particularly the Swedish legislation. In the last chapter, analysis and conclusions, I have taken the liberty to express my own view and opinions on the matter.
The application of art. 43 in relation to third countries falls outside the scope of this paper.

1.2 Method and Material

The method used in writing this thesis is a traditional legal dogmatic method. The basis of the thesis consists of primary EC law, such as the EC Treaty and ECJ case law. Articles published in journals and textbooks on the subject of thin capitalisation have been of great help.

2 Thin capitalisation

In corporate financing, shareholders have the choice to finance a subsidiary either by means of equity or by means of loan capital. Return on a debt investment is interest, whereas generally, a return on an equity investment that constitutes a shareholder relationship may be a dividend. Most states treat debt and equity, and interest and dividends differently for tax purposes. The tax treatment of debt and equity is not neutral, even though economically both debt and equity investments in a company have the same function; to enable the company to generate profits. Because the tax treatment of equity finance and debt finance is not neutral, tax implications have a great impact on finance decisions.[4]
The fundamental difference between a pure debt investment and a pure equity investment is that the relationship between a debtor and a creditor is based on a loan contract, whereas the shareholder relationship is based on company law. Another primary difference is the requirement of repayment; a creditor has a right to a refund at the end of a fixed time period whereas a shareholder is not entitled to any refund during the lifetime of the company.[5]
Normally there are few cases where financing of a company is purely made by the use of debt or equity.
An equity investment can have characteristics more similar to a debt investment, the investment may not be perpetual because the shares are redeemable or the investment may not carry any voting rights. Such cases of hybrid financing may include participating loans (loans where the interest payable depends on the profits of the borrowing enterprise), convertible loans (loans that may entitle the lender to exchange his right to interest for a right to a share in profits), sleeping partnership or securities where either the right of ownership or the rights attaching to the securities are closely connected with the ownership of the shares in the company.[6] Therefore, all characteristics of an instrument must be evaluated in order to determine whether an investment is closer to debt or equity in its true nature.
From an economic point of view, there is no reason for a distinction between the tax treatment of debt and equity. Both debt and equity are claims upon the assets of a corporation and both are acquired in exchange for capital. The only difference from an economic point of view between debt and equity is the variability of the returns. The distinction between debt and equity should therefore be to the risk that is involved. A shareholder's intention is to bear the risk of the enterprise, whereas a creditor does not have the intention to assume such risk. In principle, a creditor bears a smaller risk than an equity holder that a return on the investment will not be paid back. Because the return on equity depends on company profits and on a distribution decision and because the remuneration of the investment is

[4] M. Helminen, "The dividend concept in international tax law", 1999, s. 251.
[5] M. Helminen, " The dividend concept in international tax law" 1999, s. 254.
[6] "Thin capitalisation", Issues in international taxation, No 2, 1987, OECD, p. 14.

subordinate to creditors' claims, equity generally bears a higher risk than debt.[7]
The most important difference from the tax point of view is the fact that equity is designed to produce a return for the investor in the form of a distribution of taxable profits while the return on a loan investment is an expense, which has to be met before the profits can be established.[8]

Concentrating on the economic substance instead of the legal form is in line with the principle of tax neutrality. In order for a tax system to be neutral, economically equivalent instruments should be taxed in the same way. The form in which an investment is made should not make a difference in taxation to the extent that the instruments are economically equivalent.

In the following chapters the point of view of the Organisation for European Economic Cooperation (OECD) and the European Union on thin capitalisation will be examined in order to inquire whether consensus have been reached on thin capitalisation.

[7] M. Helminen, "The dividend concept in international tax law", 1999, s. 255.
[8] "Thin capitalisation", Issues in international taxation, No 2, 1987, OECD, p. 9.

3 OECD Model tax convention on income and capital

3.1 Background

International juridical double taxation can be defined as the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods.

Tax treaties between industrialized countries and the structure of those treaties are to a large extent influenced by the work of the Financial Committee and the Fiscal Committee of the League of Nations, which was later continued by the Fiscal Committee of the Organisation for European Economic Cooperation (OECD) and the Fiscal Committee of the OECD, which was formed in 1956.[9] The Committee on Fiscal affairs submitted a series of model treaty articles and a summary report in 1963 to which the complete OECD Model Convention and an official commentary were appended. Since 1963, the Model Convention has been revised several of times with its latest update in 2005.[10]

The main purpose of the OECD model tax convention on income and capital is to clarify, standardize and confirm the fiscal situation of taxpayers in each Member country who are engaged in commercial, industrial, financial or any other activities in other Member countries through the application of a common solution to identical cases of double taxation by all Member countries.[11]
The Model Convention is "soft law", thus it has no legal binding force either at the international level or at national level. However, the Model Convention is used by the OECD Member countries as a basis for negotiating their double taxation conventions.[12]

3.2 Art.9 of the OECD Model tax convention

The authorative statement of the arm's length principle is found in art. 9 of the OECD Model tax convention. It deals with associated enterprises, parent and subsidiary companies and companies under common control, stating that the taxation authorities of a Contracting state may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the

[9] V. Uckmar, "International Tax law", 2006, p.151.
[10] V. Uckmar, "International Tax law", 2006, p.151.
[11] OECD Income and capital Model convention 2005.
[12] V. Uckmar, "International Tax law", 2006, p.152.

true taxable profits arising in that state. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).[13]
In the report "Thin capitalisation" the Committee on fiscal affairs considers that art. 9 is relevant to thin capitalisation and;

- does not prevent the application of national thin capitalisation rules that adjust profits of the borrower to those that would have accured in an arm's length situation,[14]
- that art. 9 also is relevant not only in determining whether the rate is at arm's length but also whether the loan should be regarded as some other kind of payment[15]
- Additionally, the result of thin capitalisation rules should not be the increasing of profits of the relevant enterprise to more then the arm's length profit.[16]

A problem with art. 9.1, in practice, is that it is very difficult to say when a loan meets the arm's length standard. Therefore, the arm's length principle leaves great room for different interpretation.[17] Art. 9.1 does not identify which of the income type articles of the OECD Model that should apply to that kind of interest which the interest deduction has been denied.

In art 10.3 the term dividends is described as "*…income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which are subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident"*.

The term interest is defined in art. 11.3 as "*…income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures*".

Thin capitalisation interest may qualify as a dividend under the OECD Model only if it qualifies as a dividend under art. 10.3. According to the commentaries the term interest as used in art.11 does not include items of income which are dealt with under art.10, therefore if interest in a thin capitalisation situation qualifies as a dividend under art. 10, it is a dividend,

[13] Model Tax Convention on income and capital, Report of the committee on fiscal affairs, OECD, Updated as of 1st September 1995, Commentary, p.C 9-1.
[14] "Thin capitalisation" Issues in international taxation, No.2, 1987, OECD, p.21.
[15] "Thin capitalisation" Issues in international taxation, No.2, 1987, OECD, p.21.
[16] "Thin capitalisation" Issues in international taxation, No.2, 1987, OECD, p.22.
[17] M. Helminen, "The dividend concept in international tax law", 1999, p. 336.

even though the interest would also seem to fit under the definition of interest of art. 11.3.[18]

The re-writing of transactions between associated enterprises in the situation described in art. 9.1 may give rise to economic double taxation. If the profits of enterprise A in State A are revised upwards then the enterprise A will be liable to an amount of profit which has already been taxed in the hands of its associated enterprise in State B. Thus, art. 9.2 provides that in these circumstances, State B should make an appropriate adjustment in order to relieve the double taxation.

However, State B does not automatically have to adjust the profits in State A, an adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. Neither does art. 9.2 specify by which method an adjustment is to be made.[19]

[18] Para.19 of the Commentaries to art.11 of the OECD Income and capital Model Convention 2005.
[19] Model Tax Convention on income and capital, Report of the committee on fiscal affairs, OECD, Updated as of 1st September 1995, Commentary, p.C 9-3.

4 EC tax law

The aim and mission of the European Union is to eliminate all obstacles to intra-Community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market.

The four freedoms, free movement of goods, services, persons and capital encompasses two basic rights; a right of cross-border circulation and a prohibition of discrimination on grounds of nationality or origin. Both direct and indirect discrimination on the grounds of nationality is prohibited as well as measures without distinction but still restrictive.[20]

The four freedoms of the EC Internal Market derive from art. 14.2 of the EC Treaty which describes the internal market as " an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty".

Article 43 prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. The freedom of establishment includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies and firms under the conditions laid down for its own nationals by the law of the country where such establishment is effected. Art. 48 extends the application of art. 43 to companies by stating that for the purposes of the freedom of establishment chapter, firms formed in accordance with the laws of a Member State shall be treated in the same way as natural persons who are nationals of Member States.

When applying the non-discrimination principle, one should bear in mind that a comparative analysis is always required as a starting point. According to the ECJ, discrimination can be defined as the application of different rules to comparable situations or the application of the same rules to different situations.[21] When the protection of cross-border economic transactions is at issue, the relevant comparison factor is the hypothetical purely domestic situation, which is equivalent to the cross-border transaction, except for this cross-border element. Thus if a Member State treats a cross-border transaction worse than a similar domestic transaction, discrimination may be at issue if it cannot be justified.[22]

In a situation where a Member State under its domestic law reclassifies interest as a dividend in thin capitalisation situations, this State must also

[20] B. J.M Terra, P.J Wattel, "European tax law", 2005 4th edition, p. 38.
[21] C-279/93 Schumacker, C-307/97 Saint-Gobain.
[22] M. Helminen, Finnish international taxation, 2005, s. 146.

grant the benefits of the Parent-subsidiary Directive[23] if the requirements set out in the Directive are fulfilled. In the next chapter, these requirements will be further examined.

4.1 Parent-subsidiary Directive

An international group of companies may encounter two tax problems when profits of a subsidiary are distributed to its parent company in another Member State:

- The State of residence of the subsidiary may levy a withholding tax on outgoing dividends; and
- The State of the parent company may tax the incoming dividends in the hands of the parent company; this leads to economic double taxation of the profits out of which the dividends were paid.[24]

Double taxation may also occur in thin capitalisation situations where interest is reclassified as distribution, the Parent-Subsidiary Directive seeks to abolish double taxation in cross-border payments of dividends within group of companies. The Directive applies to "distributions of profits", a term which it does not define.
The Parent-Subsidiary Directive stipulates that intra-group cross-border payments of dividends must be exempted from withholding tax by the Member State of the subsidiary[25] and that the Member State of the recipient parent company must either refrain from taxing the incoming dividend altogether or tax it, but then credit, against the parent's corporation tax, the corporation tax already paid by the subsidiary in its Member State[26].
In order to apply the Parent-Subsidiary Directive the following conditions have to bee satisfied according to art. 2.1:

1. The company must be incorporated in one of the legal forms listed in the Annex to the Directive.
2. The company must be resident for tax purposes in a Member State on the basis of the national tax law of that State.
3. The company must be subject to one of the national corporation taxes listed in Art.2c of the Directive.

Once a company or its branch qualifies as a company of a Member State art.3 of the Directive requires it to qualify as a parent or subsidiary. For this two more conditions must be satisfied:

1. The parent company must hold at least 20% of the subsidiary. However, Member States may grant parent and subsidiary status to

[23] Council Directive 90/43/EEC of 23 July 1990 "on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States".
[24] B. J.M. Terra, P. J. Wattel, "European Tax Law, 4th edition 2005, p.491.
[25] Art 5 of Council Directive 90/43/EEC of 23 July 1990.
[26] Art 4 of Council Directive 90/43/EEC of 23 July 1990.

companies affiliated by smaller shareholdings and Member States may also bilaterally replace the minimum 20% holding by an at least 20% or less voting rights requirement.

2. The second condition is an anti-abuse provision, and stipulates that Member States may deny parent or subsidiary status to companies which are not affiliated by a qualifying shareholding for an uninterrupted period of at least two years. However, Member States may opt for a shorter minimum holding period, some Member States require one year.

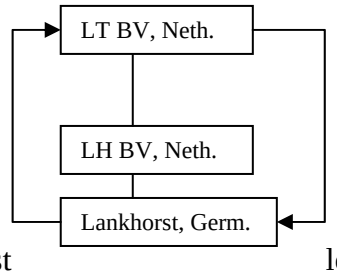
If the State of the subsidiary recharacterizes an interest payment to a foreign parent as a profit distribution, for example because of thin capitalisation and the parent State does not consider it as a profit distribution but interest and therefore does not apply the Parent-Subsidiary Directive, then the problem of double taxation still remains.[27] Unfortunately, the Directive does not address this issue. In the legal literature and debate some consider that the term "distribution" in the Directive also encompasses disguised or constructive dividends whilst other are of a different opinion.[28]
This problem is addressed by Advocate General Mischo in his opinion in the Lankhorst-Hohorst case and will be examined further in the chapter that follows.

4.2 Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt

4.2.1 Background

In the Lankhorst- Hohorst case[29] (hereinafter Lankhorst) the German thin capitalization rules were questioned under art. 43 EC.
Lankhorst, a company situated in Germany was granted a loan accompanied by a letter of support by LT BV, a company registered in the Netherlands, the sole shareholder of LH BV, registered office in Netherlands, who was the sole shareholder of Lankhorst (see the picture below).

[27] B.J.M Terra, P.J Wattel, "European Tax Law, 4th edition 2005, p.514.
[28] B.J.M Terra and P.J Wattel consider that the term distribution should be broadly interpreted whilst L. Brosens in "EC Tax Review 2004/4 p.204" considers otherwise.
[29] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt.



The interest paid by Lankhorst was reclassified to a covert distribution of profits under German legislation and taxed at a rate of 30%.[30] The German legislation applicable at the time stated that repayments in respect of loan capital should be regarded as a covert distribution of profits if a company subject to unlimited taxation had obtained the loan from a shareholder not entitled to corporation tax credit and the total debt/equity ratio exceeded 3:1 unless the taxpayer could demonstrate that the loan capital could have been obtained from a third party under otherwise similar circumstances. These rules applied to non-resident shareholders and corporations governed by German law who were exempt from corporation tax (mainly non-profitable corporations).

The question referred to the ECJ for a preliminary ruling by the Finanzamt Steinfurt was whether the above-mentioned German thin capitalization rules were precluded by art. 43 EC.[31]

4.2.1.1 Judgement of the Court

The ECJ stated that the tax measure in question constituted an obstacle to the freedom of establishment laid down in art. 43 EC and that the German rules made it less attractive for companies established in other Member States to acquire, create or maintain a subsidiary in Germany.[32] The ECJ chose not to compare non-resident shareholders with those German corporations exempted for corporation tax, as argued by the German government since the German companies to which the rules applied were non-profitable driven, whilst Lankhorst was profit driven. The comparison criteria chosen was thus non-resident shareholders and German profit driven shareholders.[33] Establishing that a restriction on the freedom of establishment according to art. 43 was at hand, the ECJ looked for justifications by pressing reasons of public interest.

The German government submitted that the thin capitalization rules were intended to combat tax evasion, since the tax debt could be transferred from

[30] Paragraph 8a of the KStG.
[31] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, p. 25.
[32] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, p. 32.
[33] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, p. 28.

one country to another.[34] By ascertaining that reduction in tax revenue cannot be considered a matter of overriding public interest, the ECJ did not find the German thin capitalisation rules to have a specific aim of preventing wholly artificial arrangements, the rules were applied generally to any situation where the parent company had its seat in another Member State.

As a second justification, the German government argued that the German thin capitalization rules were justified by the need to ensure the cohesion of the tax system and that the rules were in accordance with the arm's length principle, recognised in international law.

According to the ECJ, the requirement for coherence can only constitute a justification if a direct link exists at the level of the same person between the granting of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which must relate to the same tax. In the Lankhorst-Hohorst case, the company and its shareholders are separate taxpayers and cannot be regarded as one in order to apply the cohesion argument.[35]

Thus, by these arguments the ECJ found that the German thin capitalisation rules applicable in the case were precluded by art. 43 EC.[36]

A conflict may arise between the bilateral treaties, the OECD model tax convention and especially the ECJ. The ECJ however has expressed its respect for the OECD (Futura case) and instead has in its judgments made a balance between the two legislations.

4.2.1.2 Interesting opinions of Advocate General Mischo

In this chapter, some opinions of Advocate General Mischo will be briefly examined that were not further commented by the ECJ in the Lankhorst-Hohorst case.

Advocate General Mischo considers the Parent-Subsidiary directive to be applicable in the present case by referring to the Athinaïki Zythopiia case[37], where the ECJ stated that *"… The chargeable event for the taxation at issue in the main proceedings…is the payment of dividends. In addition, the amount of tax is directly related to the size of the distribution"*. The Advocate General continued, by referring to the Athinaïki Zythopiia case that *"… the taxation relates to income which is taxed only in the event of a distribution of dividends and up to the limit of the dividends paid. That is shown by the fact (inter alia) that, as the applicant in the main proceedings*

[34] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, p. 34.
[35] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, p. 42.
[36] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, p. 45.
[37] Case C-294/99 (Athinaïki Zythopiia AE v. Elliniko Dimosio) [2001] ECR I-6797.

and the Commission have pointed out, the increase in the basic taxable amount generated, …by the distribution of profits cannot be offset by the subsidiary using negative income from previous tax years, contrary to the fiscal principle enabling losses to be carried forward which is nevertheless laid down in Greek law".

Advocate General Mischo thus conclude that in the Lankhorst-Hohorst case the payment of dividends and the amount of taxation is directly related to the size of distribution and the company, Lankhorst cannot offset the increase of its taxable amount against losses from previous years.

Advocate General Mischo also commented on the relation between art 43 EC and the rules of the OECD Model Convention, particularly art.9. He states that even if thin capitalisation rules comply with art. 9 of the OECD Model Convention, it does not automatically mean that they comply with art. 43 EC, *"Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same".*[38] He further commented that; *" Art 43 EC does not admittedly, prevent Member States from taxing profits generated in their territories and in that sense does not affect their jurisdiction in relation to fiscal policy. However, it establishes a restriction on that freedom in that it cannot be exercised in a way which gives rise to discrimination. That is an inescapable fact, irrespecitive of anything which the provisions of the OECD model convention may permit".*[39]

4.3 Case C-524/04, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue

4.3.1 Background

Following the Lankhorst-Hohorst case, the United Kingdom's thin capitalisation rules, applicable from 1995-2004 were examined by the ECJ in the Thin Cap Group Litigation case. The UK legislation which was in force between 1988 and 1995 stipulated that where the loan was granted by a non-resident company to a UK-resident subsidiary, all the interest would be treated as a distributed profit, save where there was a provision to contrary effect in a double taxation convention (DTC). The DTCs concluded with a number of countries provided that interest was deductible where the amount of interest did not exceed commercial return. The amount exceeding commercial return was not deductible from the borrowing company's

[38] Opinion of Advocate General Mischo delivered on 26th September 2002, Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, p.80.
[39] Opinion of Advocate General Mischo delivered on 26th September 2002, Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, p.82.

taxable profits and was considered distribution and liable to advance corporation tax.

Between 1995 and 2004, interest paid between the members of the same group of companies was treated as a distributed profit to the extent to which it exceeded the amount that would have been paid at arm's length between the companies. However, those rules did not apply where both companies were subject to corporation tax in the UK.

4.3.1.1 Judgment of the Court

The test cases selected by the ECJ all involved UK-resident companies who had been granted a loan by another company in the same group, and the company granting the loan had been either:

a) Resident in another Member State with the ultimate parent company established in a Member State, or
b) Resident in a Member State, or in a non Member State, or in a Member State but operating through a branch with its residence in a non Member State, but all having their parent company in a non Member State, USA.

A number of questions were referred to the ECJ for a preliminary ruling, the first being whether art 43 EC precluded legislation that restricted the ability of UK companies to deduct interest if the interest was paid to a company in another Member State, and whether such legislation was in accordance with art 43 EC if the aim was to prevent abuse?

ECJ stated, that by treating interest paid to a lending company as distribution, results in an increase of the borrowing company's liability to tax, not only due to the treating of interest as distribution, but also because of the liability to pay advance corporation tax. Thus, thin capitalisation gives rise to difference in treatment between resident borrowing companies and non-resident borrowing companies.

The legislation in force between 1988 and 2004 was considered to impose restrictions on loans granted by non-resident parent companies to UK-resident companies.

Germany and UK submitted that the thin capitalisation rules were in accordance with art 9 of the OECD Model Convention; submitting that it is the right of the borrowing company's State to tax if the transaction is not at arm's length.

ECJ rejected that argumentation by stating that "… *even if, in some cases, the application of the provisions at issue in the main proceedings did no more than implement criteria laid down in DCTs, the fact remains that, in exercising the power of taxation allocated under them, the Member States are obliged to comply with the rules of Community law*".

In the second place the UK Government and the German Government argued that the legislation in force between 1988 and 2004 did not constitute a direct and certain obstacle to the exercise of freedom of establishment since it does not make it less attractive for companies established in other Member States to exercise freedom of establishment in the UK, the legislation merely distinguishes between situations which are not comparable. It is only in a multinational context that a group of companies may organise transfer of profits to another State where the profits will be subject to a lower tax.

The ECJ agreed that there is a risk that within a multinational company profits can be shifted to low tax States, however even these rules can constitute a restriction on the freedom of establishment of the companies concerned.

A restriction on the freedom of establishment is permissible if it's justified by overriding reasons of public interest and that it is appropriate and does not go beyond what is necessary. The UK Government argued that the legislation at force was justified by the need to ensure the cohesion of the national tax system by ensuring that covert dividend payments were taxed once in the appropriate tax jurisdiction and that any increase in taxable profits in the UK would be offset by a corresponding reduction through the DTCs (in the State in which the lending company was a resident). Moreover, it argued that the legislation prevented tax avoidance.

The ECJ rejected the argument that any tax disadvantage inflicted on a group of companies by thin capitalisation rules at issue was matched by a corresponding advantage to the lending company, as a result of DTCs concluded by the UK. Accordingly, the restrictions were not justified by the need to ensure cohesion of the UK tax system.

As regards the aim of preventing tax avoidance the Court reminded of the Cadbury Schweppes Case, where the ECJ stated that "*…the objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory*".

The Court recognised the aim of preventing tax avoidance and adopted two criteria to determine whether the restrictions imposed by thin capitalisation rules were proportionate:

1. The national legislation must provide for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement entered into for tax reasons only. The taxpayer must be afforded an opportunity, without being subject to undue administrative constrains, to provide evidence of any commercial justification that there may have been for that arrangement.

2. Where the consideration of those elements leads to the conclusion that the transaction in question represents a purely artificial arrangement without any underlying commercial justification, the treatment of interest as being non-deductible is limited to the proportion of that interest which exceeds what would have been paid had the relationship between the parties or between those parties and a third party been one at arm's length. [40]

The ECJ thus considers that the legislation in force between 1988 and 1995, does not satisfy the above mentioned criteria where a DTC was not applicable. However, in those cases where a DTC is applicable and the legislation between 1995 to 2004 the second criterion is satisfied. In that context, it is for the national court to determine whether the UK legislation satisfies the first condition by allowing the companies concerned to provide evidence of the commercial reasons for the transactions concerned.

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5 Thin capitalisation rules in Member States

Within the European Union, the member states have chosen different approaches to measure whether a company is thinly capitalized for tax purposes. Some member states have general tax rules, using a subjective approach or the "arm's length" approach where the company has to prove that the same loan could be obtained from a third party under the same circumstances and conditions. If the arm's length principle is not fulfilled the granting of the loan by the shareholder is only motivated by the subsidiary shareholder relationship.
In order to determine whether the loan is within the arm's length principle member states look at different criterions such as the interest rate, the extent to which the lender and borrower are related, comparison of debt/equity ratio in the branch concerned and whether the loan is subordinated to the rights of other creditors.

Other member states have enacted particular rules on thin capitalization by specifying an accepted relation between debt and equity, a so-called debt/ equity ratio. If the debtor's debt exceeds a certain proportion of its equity, an adjustment will be made under the country's thin capitalization rule, rules which vary considerably amongst countries not only in regard to the debt/equity ratio but also with regard to the terminology used.[41]

In response to the ECJ's decision in the Lankhorst- Hohorst case, many Member States revised their thin capitalisation rules[42] and as a direct result of the judgment in the Lankhorst-Hohorst case Germany extended its thin capitalisation rules to apply to both domestic and cross-border loans.[43]

Below, the legislation, or lack of thin capitalisation rules in Sweden and Finland will be examined. However I would like to briefly describe the thin capitalisation rules in United Kingdom and Germany, which are quite different.

In the UK thin capitalisation is a part of the country's transfer pricing rules and the rules apply to all transactions within the UK. Due to the documentation requirements, it has been decided that small and medium sized companies should be exempted from the requirement of documentation. In determining whether the conditions of a loan differ from the arm's length conditions, the amount of the loan, the question whether the loan would have been granted from a third, non-related party and the interest rate should be taken into account.

[41] L. Brossens, "Thin capitalization rules and EU law", EC Tax Review, 2004/4, p.190
[42] Denmark, Spain and United Kingdom.
[43] BGB1. I 2003, 2840, Dr. O.Thoemmes, R. Stricof, K. Nakhai, "Thin capitalization rules and non-discrimination principles", Intertax, Volume 32, issue 3, p. 127.

In Germany interest paid on long-term loans by resident companies to their resident or non-resident shareholders, holding a substantial interest is treated as a hidden profit distribution if the interest is paid on excessive debt financing. By substantial interest is at hand if the shareholder, directly or indirectly holds more than 25% of the nominal capital of the company. Generally interest is treated as a hidden profit distribution if the interest payments exceed 250,000 EUR/year.
Debts are deemed to be excessive if they exceed the prescribed debt-equity ratios. The debt-equity ratios depend on the nature of the debt financing. A distinction is made between two kinds of debt:

1. for debt on which fixed interest is paid, a debt-equity ratio (safe haven) of 1.5:1 is accepted. Interest on excessive debt is not deductible and is treated as a hidden profit distribution; unless the third-party test is met (the taxpayer must demonstrate that an unrelated person would also have granted the loan). Fixed interest is interest calculated as a percentage of the principal, which is not dependent on the debtor's profit or turnover; and

2. variable interest is not deductible. This type of interest includes payments on profit-participating loans, participations or contributions by silent partners and other liabilities with respect to which the interest is not calculated exclusively as a percentage of the principal. The tax authorities include fixed interest-bearing liabilities in the variable interest category if the loan contract stipulates that interest need not be paid in a loss situation.[44]

5.1 Sweden

The corporate tax rate in Sweden is imposed at a flat rate of 28% and the same rate applies to capital gains. Resident companies are taxable on their worldwide income and all income of a company is categorized as business income with the exemption of inter-company dividends and capital contributions by shareholders. All business expenses incurred in obtaining or safeguarding income subject to taxation are deductible and also royalties and interests. Group contributions, losses of one company may be set off against profits of another company in the same group, are allowed if the following conditions are fulfilled:

- both the paying and the recipient company are resident in an EEA state and are subject to tax in Sweden
- the contribution received is taxable as income from a business carried on in Sweden and is not exempt by a tax treaty
- the parent holds more than 90 % of the shares of the subsidiary for the entire tax year

[44] http://ip-online2.ibfd.org.ludwig.lub.lu.se/supps/, visited 17 January 2007

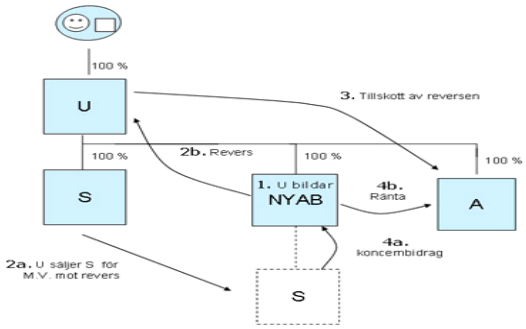
- both companies report the contribution openly during the same year; and
- neither company is an investment company.

There are no specific thin capitalisation rules in Sweden. There is however the so called Skatteflyktslagen, a general anti avoidance legislation according to which a transaction may be deemed an act of tax avoidance, and the transaction may be disregarded for tax purposes if the following requirements are met:

- the transaction, alone or in conjunction with another transaction, results in a significant tax benefit for the taxpayer;
- the taxpayer is, directly or indirectly, a part of the transaction;
- such a tax benefit is assumed to have been the predominant reason for the transaction; and
- taxation on the basis of the transaction would be in violation of the purpose of law.

The arm's length principle is stipulated in 14:19 Inkomstskattelagen. However, the Swedish Supreme Administrative Court, Regeringsrätten, does not consider the rule applicable in thin capitalisation situations (Mobil Oil).The decision concerned whether the arm's length principle could be applied in order to reclassify a loan as equity in a thin capitalisation situation for the purpose of denying interest deduction. The court held that the deductibility of interest could not be denied even though the debt-to-equity ratio was high. There was no proof that in an arm's length situation the debt to equity ratio would have been any different. A reason why the arm's length principle was not viewed as applying to thin capitalisation situations was that an independent actor would not have financed the company by resorting to equity at all. The conclusion of the case is that the arm's length principle may only be applied in situations when there is an abnormally high or low interest on a loan but not in situations where there is an abnormally high debt-to-equity ratio.

The Swedish tax agency, Skatteverket, has decided to further investigate a construction which it refers to as "interest spins" and which they consider that groups of companies are using in order to decrease their tax liability in Sweden. The complex construction is exemplified by a foreign company (U) creating a new Swedish company (NY AB), transferring its Swedish subsidiary (SAB) to NYAB by granting the newly created Swedish company (NYAB) a loan. The loan is then transferred from the new Swedish company (NYAB) to its foreign subsidiary (A) as equity. The interest on the loan from the foreign company (U) to the Swedish company (NYAB) is financed by tax free group contributions from company S to the new Swedish company(NYAB).



The interest that NYAB pays to SAB is deductible, the Swedish tax agency wants to, through the application of the general anti-avoidance legislation deny interest deduction. As mentioned above there are no thin capitalisation rules in Sweden, but an application of Skatteflyktslagen in this specific case would lead to the result that the interest deductions are denied, and they are only denied in cases where the interest is paid to a non-Swedish resident company.
The Swedish Supreme Administrative Court, Regeringsrätten has recently decided that Skatteflyktslagen is not applicable on a similar structure in which an investment company made similar transactions.[45] Due to this ruling, the Swedish tax agency has withdrawn its investigation on "interest spins".

5.2 Finland

The problem of thin capitalisation has been recognised in Finland and several working groups have considered whether thin capitalisation rules should be introduced but no legislative action has been taken, thus Finland has no special thin capitalisation rules.

Interest received by a Finnish resident taxpayer is subject to tax in Finland, in the case of individuals at a rate of 28% and in the case of a domestic corporate entity at a rate of 26%. An interest received by a non-resident taxpayer is in most situations tax exempt, however, there is a special rule stating that an interest paid to a non-resident taxpayer is not tax exempt if the loan is to be regarded as an equity investment. If that is the case, a withholding tax of 28% may be levied on the interest and in the case of a foreign corporate entity with a permanent establishment in Finland, a withholding tax of 26%. This special rule is not triggered by thin capitalisation alone; it may come into play in a thin capitalisation situation in the case of a hybrid loan having more than just one equity characteristic. Based on the general principles of tax law, it is possible to classify a financial instrument and the return on it by its economic substance for tax purposes. In principle, it would be possible to deny tax deductibility of a thin capitalisation interest and to treat it as a dividend according to the Finnish domestic law Act on the Taxing Procedures. However thin

[45] Regeringsrättens dom den 6 november 2007, mål nr 6699-04, 6701-04 och 6703-04

capitalisation alone has not lead to the denial of the interest deduction or the dividend classification.

6 Analysis and Conclusions

Thin capitalisation can be used by a group of companies to reduce or defer taxation. By the use of debt instead of equity tax revenues are distributed from the source state to the state of residence of the return of an investment. Thus, if the state of residence has a lower tax rate the result is decreased tax.

However, when choosing how to finance a subsidiary more reason than just tax reasons are considered. The ECJ correctly pointed out in the Thin cap group litigation case that national legislation must provide for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement that is entered into for tax reasons only. These reasons can be commercial as well as reasons considering labour legislation.

Thin capitalisation rules may not go beyond what is necessary and tax avoidance may not be assumed just because the parent company has its seat abroad. The true purpose of thin capitalisation may not just be the loss of tax revenues, since the use of debt instead of equity as a financing mechanism is not in it self prohibited.

To be acceptable under Community law, national rules must be formed in such a way that they only intervene against wholly artificial arrangements that have the purpose of circumventing national tax laws. Thus, thin capitalisation rules with fixed debt/equity ratio will never be accepted since the rules apply automatically when the debt/equity ratio is exceeded. It is also legally and economically impossible to identify a debt/equity ratio where financing shareholders with the use of debt become abusive.

It also seems that thin capitalisation rules, in order to be compatible with Community law, must not re-classify interest as dividend. This is due to the fact that double taxation may occur, even if the Parent-Subsidiary Directive is applicable since it is not clear whether the parent State has to accept the re-classification of the subsidiary State.
In addition, not all situations are covered by the Parent-Subsidiary Directive since it requires that the parent company holds at least 20%.
The application of Community law and the Parent-Subsidiary Directive in relation to third countries falls outside the scope of this thesis but it is obvious that double taxation may occur when third countries are involved. This double taxation might still create an obstacle under art. 56 EC.

On other hand one can understand governments worrying about erosion of their tax bases, especially within the European Union where the goal is to create an open market without any obstacles, enabling companies and persons to move freely within the union. The same internal market that governments of different European countries have been so eager to create has resulted in competition between some Member States to attract

companies to establish themselves in that country by offering a lower tax rate or by the lack of certain legislation, such a transfer pricing, thin capitalisation, CFC etc…
An example is Sweden. Although not known as a tax paradise there are some tax reasons to why companies should choose Sweden as country of establishment. The Swedish corporate tax is 28%, group contributions are allowed, interest is deductible and there are no thin capitalisation rules.
As long as there is no common European tax rate there will always be incentives from a tax point of view for companies to establish themselves in Member States with more beneficial tax rules, in this example disregarding other reasons.

I find it strange that the Swedish Supreme Administrative Court did not consider the Swedish arm's length rule to be applicable in a thin capitalisation situation; this point of view is not in accordance with art.9 of the OECD Model where the arm's length principle is in fact applicable in thin capitalisation situations. As mentioned above UK has extended its transfer pricing rules to include thin capitalisation, thus using an arm's length approach. This is in accordance with the OECD Model but still the problem of actually determining what the arm's length interest would be remains. One should not also forget the administrative burden that the transfer pricing documentation requirements put on both companies and fiscal authorities.
The "UK solution" however, seems to bee the most bullet-proof legislation from a Community perspective.

The Swedish tax agency made an attempt to address the issue of thin capitalisation by questioning the construction of "interest spins" by using the general anti tax avoidance legislation but once again, the Swedish Supreme Administrative Court considered the legislation not to be applicable. By doing so I believe that the Court is sending out a clear message that Sweden, if it wants to combat the problem of thin capitalisation, has to take legislative action. However, I think that the Swedish legislator is afraid to do so, or at least prefers to await a clarification from the ECJ.

In the Lankhorst-Hohorst case the German thin capitalisation rules were considered to not be in accordance with art 43 EC, a decision which I consider correct. After the case, many Member States changed their thin capitalisation rules in order to conform with the judgment.
In the Thin cap group litigation case however, I believe that the ECJ adopted a more "soft" line than in the Lankhorst-Hohorts case and gave some hope to Member States who have thin capitalisation rules. Further, I don't think that the Thin cap group litigation case made the issue of whether thin capitalisation rules are permitted or not any more clear. What the case did was to clarify *how* thin capitalisation rules must be formed in order not to be considered incompatible with art. 43 EC. The conditions pointed out are in accordance with the arm's length principle as stated in the OECD Model which in their turn are not particularly clear. Thus, according to the GLO

case thin capitalisation rules are allowed if they are constructed in a certain way, how they should be constructed is not answered in detail and once again Community law is unclear regarding thin capitalisation.

Finally it seems that dividends and interest should be treated exactly in the same way in order to discourage thin capitalisation. If the tax treatment would be the same the choice of providing capital by way of equity or loan becomes a decision that is made by other business reason than tax reasons.

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