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Thin Capitalization in the OECD, the EU and  
Sweden:  
policy responses, evaluation and alternatives.

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# Summary

The issue of thin capitalization has risen in importance in recent years, to the point that it warranted international action. That action came in the form of Action 4 of the OECD BEPS Project, of Article 4 of the EU ATAD and of the new interest deduction limitation rules in the national Swedish legislation. The main part of the chosen rule in all these instances disallows interest deduction over 30% of the deducting entity's EBITDA.

The purpose of the rules was to stop interest deductions from being used by BEPS-driven transactions. This requires a qualitative evaluation, where interest deduction for commercially justified loans would be allowed, while deduction for transactions set up to take advantage of tax rules would be disregarded. The chosen rule, on the other hand, includes a quantitative evaluation, where interest deductions, regardless of the nature of the underlying transaction, are allowed up to a specific amount and disallowed over that amount. This reveals an inconsequence between the purpose sought and the rule adopted.

The reason that BEPS through interest deductions is possible in the first place is that there is a difference in the tax treatment of debt and equity finance, which results in a bias towards debt financing. Models better suited to address that difference have been proposed. The reforms such models require may have been too extensive, however, and the global coordination necessary for the effects of these models to be acceptable may have been beyond the reach of multinational consensus. As such, the chosen rule might have been the best measure the international community could agree on at this point.

# Sammanfattning

Underkapitaliseringsfrågan har blivit mer och mer aktuell under den senaste tiden, så att den har krävt internationella åtgärder. Sådana åtgärder kom i form av Action 4 av OECD:s BEPS Project, Artikel 4 av EU ATAD och de nya svenska ränteavdragsbegränsningsreglerna. Huvuddelen av den valda regeln i alla instanser nekar avdrag för räntebetalningar som överstiger 30% av betalarens EBITDA.

Målet med reglerna var att förhindra ränteavdrag från att användas av BEPS-drivna transaktioner. Detta kräver en kvalitativ bedömning, där ränteavdrag för kommersiella skäl skulle godkännas, medan avdrag för skattebaserade transaktioner skulle nekas. Den valda regeln omfattar dock en kvantitativ bedömning, där ränteavdrag, oavsett karaktären av den underliggande transaktionen, godkänns upp till ett visst belopp och nekas över det beloppet. Detta avslöjar en inkonsekvens mellan ändamålet och medlet.

Anledningen till att BEPS genom ränteavdrag har varit möjligt är att det finns en skillnad i skattebehandlingen av investering med eget och lånat kapital. Skillnaden leder till en positiv särbehandling av lånefinansiering i skattehänseende. Det finns lämpligare modeller för att åtgärda denna särbehandling, men de är förmodligen för långtgående och den globala Kooperation som krävs kan ha varit utom räckhåll för de flesta länderna. Med detta sagt är det möjligt att den valda regeln kanske inte är den bästa lösningen överallt, utan den bästa åtgärd som det internationella samhället har lyckats komma överens om vid den tidpunkten.

# Abbreviations

ACE	Allowance for Corporate Equity
ACC	Allowance for Corporate Capital
AGI	Allowance for Growth and Investment
ATAD	Anti-Tax Avoidance Directive
BEPS	Base erosion and profit shifting
CBIT	Comprehensive Business Income Tax
CIT	Corporate Income Tax
COCA	Cost of Capital Allowance
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
EU	European Union
FSK	Företagsskattekommittén
GDP	Gross Domestic Product
HFD	Högsta Förvaltningsdomstolen
IL	Inkomstskattelagen
MNCs	Multinational Companies
OECD	Organisation for Economic Co-operation and Development
PIT	Personal Income Tax
SEK	Swedish krona
SU	Skatteutskottet
TCRs	Thin capitalization rules

ÅRL

Årsredovisningslagen



# 1. Introduction

## 1. 1 In general

Debt financed investments have been facing more favourable tax treatment than equity financed ones in many jurisdictions for a long time. This difference has evolved into an issue demanding attention in the last decades on the following grounds: the facts that the finance market has been deregulated and that currency regulations have been abolished have led to standardized methods to achieve large interest deductions and reduce corporate tax payments, especially regarding multinational groups. One reason is because it has become easier to move income to low-tax jurisdictions, by financing investment in such jurisdictions with equity and providing internal loans to affiliates in high-tax jurisdictions, thereby using the deductible interest payments as means to shift the income where it would be taxed at a lower tax rate.<sup>1</sup>

## 1. 2 The overall aim of the thesis

The current thesis has three distinct aims.

First, to present the issue of thin capitalization and the regulatory responses to that issue at the level of the OECD, of the EU and of the national Swedish legislation. The OECD response was chosen because the BEPS project has been the greatest influence in a worldwide tax reform and Sweden was chosen on the grounds that this thesis is written in the context of the Swedish Diploma in the University of Lund. The EU level was a natural connecting point between the two, as the EU response in the ATAD was inspired by the BEPS project and in turn influenced the Swedish initiative.

Second, to critically evaluate these responses in light of the objective they seek to achieve and highlight the degree to which they manage to achieve said objective.

Third, to present alternative, possibly more appropriate, responses and attempt to reason as to why the chosen rule was selected over those responses.

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<sup>1</sup> Neutral bolagsskatt – för ökad effektivitet och stabilitet, Slutbetänkande av Företagsskattekommittén, Stockholm 2014, SOU 2014:40, p. 58. In the following "Neutral bolagsskatt".

## **1. 3 Demarcations**

The issue of thin capitalization is rather extensive and so are the policy responses to it. However, this thesis focuses on the core of the issue, namely the BEPS caused by interest deductions. This means that it, as a rule, does not enter into the area of the hybrid corporate forms or instruments. It does so in the exceptional case of Sweden because the Swedish section has to do with applied legislation, which is one step forward compared to the level of a suggestion or a proposal, i.e. the BEPS project and the Directive. In the case of Swedish legislation, the aspiration was to give an as complete image as possible of how a country has chosen to counteract the issue of thin capitalization. Doing so at the OECD and the EU level, by analysing the action of the BEPS project as well as the article of the ATAD relevant to hybrids, would shift the focus of the thesis. It has been a challenging choice and I believe the result does justice to the reasoning.

A second demarcation is that interest deduction operates at a different level in the banking sector, a fact that has required special reasoning from the OECD and has been specifically addressed in the literature. In addition to hybrids, the thesis does not deal with that issue either, in order to better focus on the phenomenon of thin capitalization and on the effects of the chosen measure concerning the “normal” corporate sector.

## **1. 4 Method and material**

The thesis uses the legal doctrinal method, studying legal sources, both doctrine and legislation, to define the legal issues around thin capitalization and the legislative responses to it. Be that as it may, the inspiration for the chosen material stems from the financial literature. The reason is that this literature is in the background of the legislative choices leading to the rules studied here. That is because, in the issue of thin capitalization, it is the financial problems caused by the phenomenon that the legal rules come to counteract. I have, therefore, deemed it appropriate to base the research on sources that can highlight the issue and its causes; this allows for a more grounded critique in the relevant section 6. As regards the content of these sources, however, I have made the conscious choice to focus on their formulation of the issues they recognize, the causes they uncover and the results they present from the financial research. This means that I have avoided the finance part itself, while

focusing on the contribution of these sources to the legal issue in question and the effects of the proposed measures.

Moving on to the material, one thing that may stand out is the “other source”, namely the PWC country overview of financing options. This source is used instead of traditional academic sources for the following reason. It provides support for general features of the tax systems, in a way that academic sources, by nature focused on their own national legislations and thus limited by them, cannot. More specifically, a traditional source would allow for the same content in the text but it would require the reservation that the observations are limited to the scope of the study in question. The paragraphs that the PWC source offers support for include elements that are used as examples to clarify the corporate financing through debt vs. equity in general. As they do not refer to a specific tax system, reference to specific legal provisions would offer little for the purposes of the explanation. By using this general source, on the other hand, the content becomes easier for the reader. What is more, the characteristics of these finance forms actually are valid, as any academic source could offer support for them but not refute them.

In this context, Action 4 of the OECD BEPS project is treated as a legal source: even though OECD is not a state organ and thus the Report has no part in any legislative procedure, it nevertheless contains a proposal for legislation with extensive reasoning and explanations; a proposal not only similar to how a national pre-legislative process looks like, but one that has actually been followed in practice, both at international, i.e. the EU, and at national, e.g. the Swedish, level.

Especially regarding the Swedish level, Tjernberg notes that the simple answer that, since the OECD does not constitute a formal authority within national jurisdictions, therefore the OECD sources do not hold any interpretative value within a national legal order is not so simple in practice; the reason being that administrative and judicial organs already apply provisions of the national law through the filter of OECD recommendations and guidelines.<sup>2</sup> Even though OECD sources are not binding and must be implemented in order to have any legal bearing in a domestic context, not the least because of the lack of democratic legitimacy, as the national Parliament has not taken part in the OECD decision-making process, even the Swedish Highest Administrative Court (HFD) has decided in *Shellmålet* (RÅ 1991 ref. 107) that, as long

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<sup>2</sup> Tjernberg Mats, OECD:s dokument, tolkningsvärdet för ren intern rätt, Svensk Skattetidning, 2017, p. 119-130, p. 120.

as the OECD guidelines do not contradict the local legislation and constitute a balanced highlight of the problems in question, they can serve as guidance in the implementation of national law.<sup>3</sup> It is, on these grounds, appropriate to treat the OECD Report in a similar way as a legal source, in the context of the present thesis.

In sections 3, 4 and 5, I have limited the material as close to the official sources as possible. Even though there is literature on the subject, my aim has been to report both the content and the reasoning of the rules according to the authorities that have adopted them.<sup>4</sup> The critique is included in the relevant section 6.

As far as the doctrine is concerned, the literature on the subject is rather extensive, ranging a number of years. This shows both that there are ideas that have withstood the test of time and that the issue is still interesting today – as also evidenced by the recent legislative developments; the Swedish legislation was voted in the Parliament in June 2018 and will enter into force from January 2019. A possible issue was that there were several sources mentioned in the literature but were, unfortunately, inaccessible through the student account. This, however, does not seem to constitute a cause for concern, as the vast majority of the arguments have ample uniform support in the studied sources and it is highly unlikely that the unavailable sources would seriously affect the outcome.

## **1. 5 Disposition**

Section 2 presents the issue of thin capitalization: the tax treatment of debt and equity capital and the bias towards debt financing that enables the BEPS through interest deductions. Sections 3, 4 and 5 deal with the responses to that issue at the level of the OECD, the EU and Sweden respectively, and section 6 evaluates the responses and puts forward alternative measures. Section 7 concludes.

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<sup>3</sup> Tjernberg p. 121-122, 124, 125, 129.

<sup>4</sup> For a latest example of the Swedish literature, see Melz Peter, Nilsson Peter and Norrman Erik, Bolagsskattereformen 2019 – ränteavdragsbegränsningar, Skattenytt 2018 p. 471.

## **2. The issue of Thin Capitalization**

This section starts by presenting the issue of thin capitalization in general terms under 2.1; this is the issue that the OECD, the EU and Sweden are attempting to counteract through the rules analysed in the following sections 3, 4 and 5 respectively. It continues with an explanation of the different forms of corporate finance through equity and debt capital, under 2.2, and proceeds to analyse the different tax treatment of the returns on these two forms under 2.3. The section concludes with a presentation of the problems caused by this different tax treatment under 2.4, problems that have required the intervention at the OECD, the EU and the national Swedish level.

### **2. 1 Thin Capitalization in general**

Companies acquire the funds they need to function from three main sources: they have income from their business activities, they have funds contributed from their owners and they can borrow money from creditors. The funds contributed from the owners form the company's equity capital and a firm is considered to be thinly capitalized when this capital is too low in relation to its balance sheet.<sup>5</sup>

There are many reasons why mostly multinational companies (in the following MNCs) choose to be thinly capitalized. One reason is in order to reduce the group's total tax liability. This is further explained under section 2.3 below. As an overview it can be mentioned here, however, that the main reasoning is as follows: if a profitable company in a group is resident in a high-tax jurisdiction, it is beneficial to finance that company's operations with internal loans. The reason is that the interest payments on these loans are deductible (a more detailed explanation on that follows under section 2.2.2 below) and they can be used to reduce, or even eliminate, the profit of the profitable group company in the high-tax jurisdiction. If, on the other hand, the receiving company is resident in a low-tax jurisdiction, the combination results in a reduction of the group's total tax liability. It is, therefore, beneficial from a tax perspective to thinly capitalize companies resident in high-tax jurisdictions.<sup>6</sup>

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<sup>5</sup> Neutral bolagsskatt, p. 146.

<sup>6</sup> *Id.*, p. 146-147.

## **2. 2 Debt and equity finance**

This section presents the main characteristics of the two forms of corporate finance, equity and debt. Details differ between different countries and there are even specific definitions in double tax treaties. The aim of this section, however, is to give an overview of the main qualities of these two forms, in order to provide a basis to understand the debt bias and the problems it poses as explained in the following sections 2.3 and 2.4; for this reason, specific study of national legislation and tax treaty provisions is avoided.

Section 2.2.1 deals with equity capital and section 2.2.2 explains the function of debt capital.

### **2. 2. 1 Equity capital**

As explained in a country overview provided by PWC, owners provide capital, equity capital, in exchange for some kind of right to percentages of the business profits, the first source of income mentioned above. This way, the owners acquire shares in the company and the shares give them, among other things, right to dividends. Tax-wise, dividends are paid out of the company's taxed income. <sup>7</sup>

A simplified outline, for the purpose of this example, looks like this: the company earns business income, deducts all deductible expenses, pays taxes on the profit (in this context: on the difference between income earned and expenses paid) and may distribute what is left as dividends to its shareholders. For example, if a company has an income of 100 and expenses of 76, this company has made a profit of 24 (100 - 76). At a 25% Corporate Income Tax (in the following: CIT) rate, the company will pay a tax of 6 (25% x 24) and be able to distribute a dividend of 18 (24 - 6) to its shareholders.

### **2. 2. 2 Debt capital**

In the same report as before, one can read the following regarding debt capital. A company gets debt capital from its creditors. Creditors get no shares in exchange for the capital; instead, they have a right to get the invested capital back from the company. In addition, they require a return on their capital, a payment for the time

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<sup>7</sup> PWC, Financing options: Debt versus equity A country overview, 2016, p. 3. In the following "PWC".

that said capital is not at their disposal but, instead, at the disposal of the company. This return is the interest on the loan. From a tax perspective, interest is paid out of the company's pre-tax income and constitutes an expense that the company may deduct, as explained under 2.1.1 above, before calculating its profit to be subsequently taxed.<sup>8</sup>

Assuming that the same company as in the example above, with a speculated profit of 24 (income of 100 minus expenses of 76), was exploring its financing options and it could choose between issuing shares in order to pay 18 to the shareholders in the form of dividends and taking a loan in order to pay the same amount, 18, in the form of interest to its creditors, it could calculate its choice as follows: in this case, the amount of interest would be added to the other expenses before calculating the company profit. This would mean that the company's expenses would increase to 94 (76 + 18), decreasing the income to 6 (100 – 94) and the tax on that income to 1.5 (25% x 6). This way, the company can pay back the same amount to the person who invested the capital and have additional income of 4.5 left, corresponding to the decrease in tax liability, in the examples at hand from 6 to 1.5, compared to equity capital. This is a simple way to demonstrate the tax bias towards debt financing, widely mentioned in literature. <sup>9</sup> The following section 2.3 analyzes this phenomenon in more depth.

## **2. 3 Bias towards debt financing**

It is common ground that the difference in tax treatment as described in the previous section, namely that interest payments are deductible while dividend payments are not, creates a bias towards debt financing.<sup>10</sup> As shown in the PWC report mentioned

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<sup>8</sup> PWC, p. 3.

<sup>9</sup> Bräutigam Rainer, Heckemeyer Jost H., Nicolay Katharina, Spengel Christoph, and Stutzenberger Kathrin, Addressing the Debt-Equity Bias within a Common Consolidated Corporate Tax Base (CCCTB) – Possibilities, Impact on Effective Tax Rates and Revenue Neutrality, World Tax Journal May 2018 p. 165-191, p. 165, 176, 190; de Mooij Ruud and Keen Michael, Debt, Taxes, and Banks, IMF Working Paper, WP/12/48, February 2012, p. 3; de Mooij Ruud A., Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, May 3, 2011, SDN/11/11, p. 8; Desai Mihir A., Foley C. Fritz, Hines Jr. James R., A Multinational Perspective on Capital Structure Choice and Internal Capital Markets, National Bureau of Economic Research, Working Paper 9715, May 2003, p. 3, 12; Dubai Curtis, Taxation of Debt and Equity: Setting the Record Straight, REPORT Taxes, The Heritage Foundation, p. 3.

<sup>10</sup> Bräutigam *et al* p. 165; de Mooij Ruud A., Ederveen Sjeff, Corporate Tax Elasticities A Reader's Guide to Empirical Findings, Oxford University Centre for Business Taxation, WP 08/22, p. 3-4; International Monetary Fund, Achieving more with less, Fiscal Monitor, April 2017, p. 53; de Mooij p. 3-5; de Mooij Ruud and Heckemeyer Jost, Taxation and Corporate Debt: Are Banks any Different? IMF Working Paper, WP/13/221, October 2013, p. 4; Haufler Andreas, Runkel Marco, Firms' financial choices and thin capitalization rules under corporate tax competition, Oxford University Centre for

in the previous sections, in a purely domestic context, this bias should balance itself out, at least to a certain extent: the non-deductible dividend payments are, in certain cases, non-taxable for the recipient, while the deductible interest payments, on the other hand, are included in the recipient's taxable income.<sup>11</sup> In a cross-border context, however, the situation is usually different, as different rates of CIT in different countries allow MNCs to make use of interest payments in the following way: if a company in a low-tax jurisdiction, let us say with a CIT rate of 10%, finances a company belonging in the same group in a high-tax jurisdiction, let us say with a CIT rate of 30%, through a loan, then, each interest payment of 100 has the following tax effects.

First, since the interest is deductible for the paying company in the high-tax jurisdiction, this means that this company realizes a tax saving of:

*Tax saving in the high-tax jurisdiction*

[CIT rate] x payment (in the case of our example this is 30, for a CIT rate of 30% and a payment of 100:  $30\% \times 100 = 30$ ).

Assuming that the company has an income of e.g. 1000, the tax on that income would be 300 with a CIT rate of 30% ( $30\% \times 1000 = 300$ ). Now that the company can deduct the interest payment of 100 from its income, its taxable base becomes 900 ( $1000 - 100$ ) and the tax on that base is 270 ( $30\% \times 900$ ). The difference is 30 ( $300 - 270$ , or  $30\% \times 100$ ), which represents the less taxes that the high-tax jurisdiction receives on the company's income.

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Business Taxation, WP 08/15, September 2008, p. 1; Neutral bolagsskatt p. 160; Södersten Jan, Bolagsbeskattningens Incitamentseffekter, Expertrapport till Företagsskattekommittén, SOU 2014:40, Bilaga 7, p. 831.

<sup>11</sup> PWC p. 3.



Second, assuming that the interest is taxable in the low-tax jurisdiction, the tax that the receiving company will pay on that income is 10 (10% $\times$ 100). Therefore, the tax saving for the group is equal to:

*Group tax saving*

([high-tax CIT rate] – [low-tax CIT rate])  $\times$  payment,

or (30% - 10%)  $\times$  100 = 20, which is the same as the difference between the tax that would have been paid in the high-tax jurisdiction minus the tax that is paid in the low-tax jurisdiction (30 – 10=20).

The aforementioned scenario explains the debt bias, the different tax treatment between debt and equity, as an incentive for “firms ... to finance their operations with debt rather than equity”.<sup>12</sup> The tax savings explained therein are known by the term “debt tax shield”, or “tax savings that are generated by the deductibility of interest payments on debt from the corporate tax base.”<sup>13</sup> This tax shield can be internal, when the tax savings are generated by “internal borrowing from related affiliates”, and external, when “[they] are generated by loans from the external capital market, that is, by borrowing from unrelated, third parties.”<sup>14</sup>

In order to make the most of the debt tax shield, MNCs employ the following structures highlighted in the literature: the general idea is that the companies of the group that are located in high-tax jurisdictions will be financed with debt, while the ones located in low-tax jurisdictions will be financed by equity.<sup>15</sup> More specifically, the goal is to employ a “structure [which] assures that interest earned is taxed at the lowest possible tax rate, while interest paid is deducted from taxable income in affiliates that face a higher tax rate. This reduces the global tax bill.”<sup>16</sup> This is achieved

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<sup>12</sup> Blouin Jennifer, Huizinga Harry, Laeven Luc, and Nicodème Gaëtan, Thin Capitalization Rules and Multinational Firm Capital Structure, IMF Working Paper WP/14/12, p.1. See also PWC, Financing options: Debt versus equity A country overview, 2016, p. 1; de Mooij and Ederveen p. 4; Desai *et al* p. 3; Graetz Michael J., A Multilateral Solution for the Income Tax Treatment of Interest Expenses, Bulletin for International Taxation, Vol. 62, No. 486, 2008, p. 487, 489-491; Haufler and Runkel p. 1; Merlo Valeria, Riedel Nadine, Wamser Georg, The Impact of Thin Capitalization Rules on the Location of Multinational Firms' Foreign Affiliates, Ludwig-Maximilians University's Center for Economic Studies & Ifo Institute Working Paper No. 5449 Category 1: Public Finance, July 2015, p. 7; Møen Jarle, Schindler Dirk, Schjelderup Guttorm, and Tropina Julia, International Debt Shifting: Do Multinationals Shift Internal or External Debt? University of Konstanz Department of Economics, Working Paper Series 2011-40, October 7th, 2011, p. 2; Ruf Martin and Schindler Dirk, Debt Shifting and Thin-Capitalization Rules – German Experience and Alternative Approaches, Nordic Tax Journal 2015; 1:17–33, p. 17.

<sup>13</sup> Ruf and Schindler p. 17.

<sup>14</sup> *Ibid.*

<sup>15</sup> de Mooij and Ederveen p.4; Merlo *et al* p.7.

<sup>16</sup> Møen *et al* p. 3.

in the following manner: in order to maximize the efficiency of the external debt shield, external debt is accumulated in “affiliates generating high net tax savings (i.e. being located in high-tax countries)”.<sup>17</sup> As far as the internal debt shield is concerned, on the other hand, the following structure is employed:

[T]he mechanism at play is to deduct interest in high-tax countries and to earn interest in low-tax countries in such a way that the tax savings in high-tax countries exceed the increased tax liability in low-tax countries. ... [I]t is [therefore] optimal to set up an internal bank in the lowest-taxed affiliate, which provides all other affiliates with internal debt, i.e., with intra-company loans.<sup>18</sup>

The following section 2.4 presents the problems created by the debt bias, as explained above, in the form of distortions, such as resource misallocation, under 2.4.3, competition issues, under 2.4.4, and tax planning costs, under 2.4.5. Before touching on these issues, however, the section explains the increased cost of equity capital as a result of the debt bias, under 2.4.1, and the effects of this increased cost on corporate finance decision making, under 2.4.2. This is important because the aforementioned distortions come as a result of the decisions influenced by the bias.

## **2. 4 Problems**

The bias towards debt financing, as explained under section 2.3 above, has several problematic consequences. One of these is that it increases the cost of equity capital in relation to the cost of debt capital.<sup>19</sup>

### **2.4.1 Increased cost of equity capital**

The cost of capital in general is understood as the lowest pre-tax yield that a company has to demand from its investment projects, so that the after-tax return does not fall below the investors’ expected yield.<sup>20</sup> In that sense, the bias towards debt financing increases the cost of equity capital in relation to the cost of debt capital in the following way: to explain this effect, the same example as under section 2.2 above can be relevant.

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<sup>17</sup> Ruf and Schindler p. 17.

<sup>18</sup> *Ibid.* with further reference.

<sup>19</sup> Neutral bolagsskatt p. 57.

<sup>20</sup> Södersten p. 829.

Assuming that a company with expenses of 76 in a tax jurisdiction with a CIT rate of 25% has equity investors who expect a minimum yield of 18 from their investment, this company needs to demand a pre-tax yield of 100 from its investment projects, as shown in the example under 2.2.1, in order to be able to make a dividend payment of 18. This covers the investment cost and leaves the company with a balance of zero, after expenses (76), taxes (6) and dividends (18) have been paid ( $100 - 76 - 6 - 18 = 0$ ). As explained in the same example under 2.2.2, however, if the company wants to make the same payment of 18 in the form of an interest payment to its debt investors and be in the same situation as after the dividend payment, i.e. with a balance of zero, that company needs to demand a pre-tax yield of 94, as the interest payment itself is deductible ( $94 - 76 - 18 = 0$ ). The difference in the cost of capital in these two instances is 6 ( $100 - 94$ ), which corresponds to the tax liability on the corporate income before the dividend payment is made [ $25\% \times (100 - 76) \rightarrow 25\% \times 24 = 6$ ]. In the case of the interest payment, since it takes place before the corporate profit is calculated and the CIT on that income is paid, no tax liability arises for the paying company.

The aforementioned tax effect on the cost of capital can affect the after-tax return of investment in an unorthodox way. The issue is explained in more detail in section 3.1 in the context of inbound and outbound investment; it can, however, briefly be mentioned here that tax effects, more specifically the interest deduction, can cause “after-tax returns greater than pre-tax returns.”<sup>21</sup> This means that tax considerations alone can turn otherwise unprofitable investments to attractive ones.<sup>22</sup> “Such investments will clearly decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.”<sup>23</sup>

## 2.4.2 Effects on corporate finance decision making

The fact that the bias towards debt financing can affect corporate finance decision making is documented in the literature.<sup>24</sup> More specifically, the corporate choice of a company’s optimal capital structure involves a weighing between, on one hand, “any

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<sup>21</sup> Graetz p. 491.

<sup>22</sup> Melz *et al*, p. 476 with accompanying example.

<sup>23</sup> Graetz p. 491.

<sup>24</sup> Bräutigam *et al* p. 166; Møen *et al* p. 2.

benefits of debt finance, including its tax shield, against any non-tax cost of debt.”<sup>25</sup> Such non-tax costs include bankruptcy, agency and signalling costs.<sup>26</sup>

Bankruptcy costs occur because “[h]igher debt makes firms more vulnerable to shocks and increases the risk of bankruptcy. [Not only] will creditors, [in this case,] demand a higher interest rate, which reflects a private cost”, but such an increased risk also leads to increased costs for bankruptcy management. “Firms thus face a trade-off between the tax shield of debt and the cost of financial distress.”<sup>27</sup>

“Agency costs are a type of internal cost that a principal may incur as a result of the agency problem.”<sup>28</sup>

The agency problem is a conflict of interest inherent in any relationship where one party is expected to act in another's best interests. In corporate finance, the agency problem usually refers to a conflict of interest between a company's management and the company's stockholders. The manager, acting as the agent for the shareholders, or principals, is supposed to make decisions that will maximize shareholder wealth even though it is in the manager's best interest to maximize his own wealth.<sup>29</sup>

In that context, agency costs “include the costs of any inefficiencies that may arise from employing an agent to take on a task, along with the costs associated with managing the principal-agent relationship and resolving differing priorities.”<sup>30</sup> More specifically, as regards the agency costs involved in the issue of corporate finance decision making, these costs reflect the “conflict of interest between managers and shareholders [on one hand, and] between shareholders and debt holders [on the other hand].”<sup>31</sup> Regarding the former conflict, between managers and shareholders, “[i]ssuing debt constrains the use of free cash flow and protects shareholders against [possible] opportunistic behavior of managers. Debt may thus improve managerial decisions.”<sup>32</sup> Regarding the latter conflict, between shareholders and debt holders, the following situation occurs.

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<sup>25</sup> de Mooij p. 11.

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.* See also Melz *et al*, p. 477; Neutral bolagsskatt p. 57.

<sup>28</sup> “Agency problem” on <https://www.investopedia.com/terms/a/agencyproblem.asp> as seen on July 25th, 2018.

<sup>29</sup> “Agency problem” on <https://www.investopedia.com/terms/a/agencyproblem.asp> as seen on July 25th, 2018.

<sup>30</sup> *Ibid.*

<sup>31</sup> de Mooij p. 11 with further reference.

<sup>32</sup> *Ibid.*

By persuading management to take excessive levels of debt, shareholders can shift part of the bankruptcy risk to bondholders. In good times, shareholders incur the profit; in bad times they are only liable for the invested sum and bondholders share in the risk of default.<sup>33</sup>

Signalling costs include the information to outside investors that debt issuance transmits. According to the literature, this information, along with its effects, can be of an ambiguous nature: on one hand, “[it] may be seen as a signal to outside investors that the firm is confident in its ability to service its debt in the future.” The effect in this case will be that “[i]nefficiently high levels of debt will ... be issued”. On the other hand, the following situation may also occur.<sup>34</sup>

[Debt] can be interpreted by investors as a signal of bad health, e.g., due to a lack of liquidity. In that case, firms will be reluctant to engage in external financing [which will cause] adverse selection in debt markets [with resulting] underinvestment and too little borrowing.<sup>35</sup>

Bearing the aforementioned considerations in mind, it is possible that the debt bias towards debt financing will lead companies to make investment decisions for tax instead of business reasons, which can lead to more tax-favoured instead of more productive investments. According to the literature, this can, in turn, contribute to resource misallocation.<sup>36</sup>

### **2.4.3 Resource misallocation**

“[Resource misallocation] is the poor distribution of resources across firms, reducing the total output that can be obtained from existing capital and labor.”<sup>37</sup> The relationship between the bias towards debt financing and resource misallocation is as follows.

The aforementioned bias constitutes a government policy, according to which interest payments are deductible while dividend payments are not. One of the effects of this government policy can be, as explained above, that the tax considerations that this policy reflects can turn otherwise unprofitable investments to attractive ones, as the

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<sup>33</sup> de Mooij p. 11.

<sup>34</sup> *Ibid* with further references.

<sup>35</sup> *Ibid* with further references.

<sup>36</sup> *See* International Monetary Fund, p. xi, 46, 62.

<sup>37</sup> International Monetary Fund p. 47. *See also* Neutral bolagsskatt p. 58.

policy can render them more profitable after-tax than before-tax. A consequence of that effect is that this policy tends to favour investment in assets that are more suitable for debt financing than for equity financing. Indeed, these different financing forms are not equally suitable for all types of investment: “Innovative firms - especially start-ups- tend to rely on equity rather than debt for R&D investments (which have risky, long-horizon payoffs) because there are no collateral requirements and investors share in upside returns.” This essentially “[imposes] a higher marginal tax on research and development investment, which is more dependent on equity compared to other capital spending.”<sup>38</sup>

When a government policy, as outlined above, favours certain types of assets over others, distortions can arise. Distortions are connected to resource misallocation in the following way. As already mentioned, resource misallocation is the poor distribution of resources across firms. This poor distribution differs from a good distribution as explained below.<sup>39</sup>

In a well-functioning economy, it is productivity that decides which businesses shall win market share over time over their competitors. The increased market share will allow these businesses to “[expand] their production, by hiring more labor and acquiring more capital.” Firm size is, in this manner, tied to firm productivity. It follows that, for a firm to be successful in this sense, it has to invest in productive assets, which will lead to an increase in firm productivity, which will in turn lead to an increase in firm size. Capital and labour employed by these firms lead to the optimal output that can be obtained by these resources, in the sense that they are connected to the most productive assets that the firm which employs them has invested in.<sup>40</sup>

When the distortions created by the government policy in question, i.e. the bias towards debt financing, enter into this context, the good distribution explained above is disrupted and threatened by a poor one: by taking advantage of the bias, firms can invest in more tax-favoured assets instead of more productive ones and thus increase in size without necessarily increasing their productivity to a corresponding extent. These firms absorb capital and labour which is used to produce a reduced output, in comparison to the output that could have been produced, had these resources been

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<sup>38</sup> International Monetary Fund p. xi, 53 with further reference. *See also* Neutral bolagsskatt p. 57.

<sup>39</sup> *Id* p. 47.

<sup>40</sup> *Ibid*.

used in more productive assets. This “poor distribution of resources across firms, reducing the total output that can be obtained from existing capital and labor” is the resource misallocation that is caused by the bias towards debt financing.<sup>41</sup>

As follows from the cross-border example under 2.3 above, MNCs can take advantage of the bias in a more efficient manner, a fact that causes competition issues further explained below.

#### **2. 4. 4 Competition issues**

The bias towards debt financing can be exploited by all firms in tax systems which allow interest deduction without a corresponding deduction for dividend payments. MNCs, however, have “opportunities not available to many of their local competitors” “to structure their finances in terms of debt and equity” that offer them “significant advantages” “against companies operating only at a national level.”<sup>42</sup> These advantages correspond to a large extent to “the possibility [available to MNCs] to use internal debt as a means to shift profits from high-tax to low-tax countries.”<sup>43</sup>

#### **2. 4. 5 Tax planning costs**

In order for MNCs to take advantage of the bias towards debt financing as described above, they incur tax planning costs, as the decisions regarding the questions whether or not it would be profitable to shift the profits, how profitable it would be and what it would take to achieve it, among others, are complicated ones, requiring time and energy from the financial and tax advisors, which translate to money for the firm. These costs for the businesses involved are connected with costs for the States concerned, both in the form of costs for the Tax Authorities and in the form of reduced tax revenues. In its turn, the latter reflects a need to make up for the lost revenues by raising other taxes, which generally incurs further socio-economic costs.<sup>44</sup>

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<sup>41</sup> International Monetary Fund, p. 47.

<sup>42</sup> Buettner Thiess, Overesch Michael, Schreiber Ulrich and Wamser Georg, *The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions*, Centre for European Economic Research, Discussion Paper No. 06-068, p. 1-2; Desai *et al* p. 23.

<sup>43</sup> Haufler and Runkel p. 1. *See also* Møen *et al* p. 2 and Buettner *et al* p. 2.

<sup>44</sup> Neutral bolagsskatt, p. 103–104.

As mentioned in the preceding sections, MNCs have increased possibilities to take advantage of the bias towards debt financing by shifting profits from high to low-tax jurisdictions. This behaviour, driven by the asymmetrical tax treatment of equity and debt financing, leads to an erosion of the corporate tax base and even threatens the legitimacy of the tax system.<sup>45</sup> In order to counteract these effects, the OECD, the EU and Sweden have adopted the measures presented in the following sections 3, 4 and 5 respectively in the form, mainly, of interest deduction limitation rules.

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<sup>45</sup> Neutral bolagsskatt p. 58. *See also* de Mooij p. 4.



## 3 The OECD approach

This section analyzes the OECD approach to the issue of thin capitalization, as explained under section 2 above. Section 3. 1 presents the issue according to the OECD, section 3. 2 explains the reasoning behind the proposed rule in the Action 4 of the BEPS Project, and section 3. 3 concludes the section with the rule proposed by the OECD.

### 3. 1 The issue according to the OECD

BEPS action 4 aims to “prevent base erosion through the use of interest expense”.<sup>46</sup> As an example in the cross-border context, the action targets “interest deductions relate[d] to the debt funding of outbound and inbound investment by groups.”<sup>47</sup> Assuming no restrictions in interest deductibility, the issues of outbound and inbound investments are as follows:<sup>48</sup>

In the outbound investment example, company A, resident of a high tax country with 35% CIT rate, borrows funds from a third party bank in order to finance an investment in its subsidiary, company B, located in a low tax country with 15% CIT rate. For the sake of simplicity in the calculation, we assume that the high tax jurisdiction exempts foreign source dividends - in our case, the dividends from B – from taxation. As a first step, we assume that company A borrows 100 at a 10% interest rate and that the investment in B generates a profit of 15. This makes the pre-tax profit of the group equal to 5: 15 (the income from company B) – 10 (the interest expense of company A) = 5. Regarding the post-tax profit of the group, this results from the following calculation: company B has to pay a tax of 2.25 (15% x 15 = 2.25), leaving a profit for the group of 15 – 2.25 = 12.75. Company A has to pay the interest of 10 to the third party bank, but it can deduct that interest from its other income at a rate of 35%, bringing its actual expense to 10 – 3.5 = 6.5. If we deduct that expense from the post-tax profit of company B (12.75), we can see that the result (12.75 – 6.5 = 6.25) is higher than the pre-tax profit of the group. “The group is now subject to a

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<sup>46</sup> OECD (2017), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264268333-enp>. 19. In the following “OECD”.

<sup>47</sup> *Ibid.*

<sup>48</sup> OECD p. 20.

negative effective rate of taxation.”<sup>49</sup> As a point of comparison, if company B had borrowed the funds for the investment itself, it would have deducted the interest expense in its own jurisdiction and have been left with a pre-tax profit of 5 ( $15 - 10 = 5$ ) and a post-tax profit of 4.25 ( $5 \times 15\% = 0.75$ ,  $5 - 0.75 = 4.25$ ).

In the inbound investment example, company A, resident of the high tax country with 35% CIT rate, receives funds for an investment from its parent company B, located in the low tax country with 15% CIT rate. For the purposes of this example, company A has borrowed 100 from a third party bank at an interest rate of 10% and has thus incurred an interest expense of 10. Again for the purposes of our example, company A generates a profit of 15. As a first step, we assume no obligation to pay interest to company B: in this case, company A has a pre-tax profit of 5 ( $15 - 10 = 5$ ) and a post-tax profit of 3.25 ( $5 \times 35\% = 1.75$ ,  $5 - 1.75 = 3.25$ ). In the second step, we assume that company B replaces 50 of its existing equity in company A with a loan of the same amount at the same rate of 10% as the third party bank, in which case company A incurs an additional 5 of expenses ( $50 \times 10\% = 5$ ), making its expenses (10 to the third party bank plus 5 to the parent company B) equal to its profit of 15 and therefore a pre-tax and post-tax profit of nil. Company B, on the other hand has received a pre-tax profit of 5 from company A, which translates to a post-tax profit of 4.25 ( $5 \times 15\% = 0.75$ ,  $5 - 0.75 = 4.25$ ). This way, the effective tax rate of the group has decreased “from 35% to 15% by shifting profit” from the high tax to the low tax jurisdiction.<sup>50</sup> In the final step, company B can choose to replace 100 of its existing equity in company A with a loan. In this case, the pre-tax situation of the group consists of a pre-tax profit of 5: company A has a loss of 5 (15 of profit minus 10 + 10 for the two loans) and company B has a profit of 10 (the interest received from company A). The post-tax situation of the group reaches a result of 5.25: company A can deduct its loss from its other income at the rate of 35%, making its post-tax loss 3.25 ( $5 \times 35\% = 1.75$ ,  $5 - 1.75 = 3.25$ ), and company B is taxed at the rate of 15% ( $10 \times 15\% = 1.50$ ), bringing its profit up to 8.50.  $8.50 - 3.25 = 5.25$ . The group is again “subject to a negative effective rate of taxation.”<sup>51</sup>

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<sup>49</sup> OECD p. 20.

<sup>50</sup> *Ibid.*

<sup>51</sup> OECD p. 21.

The above examples showcase the three basic scenarios in which BEPS risks arise in the area of interest deductions:

1. “Groups placing higher levels of third party debt in high tax countries”, as was the case in the outbound investment example, where company A took the loan from the third party bank instead of company B taking the same loan,
2. “[g]roups using intragroup loans to generate interest deductions in excess of the group’s actual third party interest expense”, as was the case in the inbound investment example, where company B replaced existing equity in company A with a loan, thus generating additional interest expense in excess of company A’s actual interest expense, and
3. “[g]roups using third party or intragroup financing to fund the generation of tax exempt income.” In the outbound investment example, the loan finance generated exempt dividend income for company A.<sup>52</sup>

The core of these issues is the “tax-induced bias, in the cross-border context, towards debt financing”, created by the different tax treatment of debt and equity in most countries. In purely domestic situations, the fact that equity returns are in general non-deductible for the payer and exempt for the payee, while interest payments constitute deductible expenses and taxable income respectively, results in a similar overall tax burden. Internationally, though, the aforementioned bias creates distortions “compounded by tax planning techniques [aiming] to reduce or eliminate tax on interest income in the jurisdiction of the payee.”<sup>53</sup>

Unilateral action by individual states in order to address this bias has been ineffective, “[p]artly ... because the fungibility of money and the flexibility of financial instruments have made it possible for groups to bypass the effect of rules and replicate similar benefits using different tools.” New rules introduced to combat such practices “[create] layers of complexity without addressing the key underlying issues.” An additional point to examine regarding unilateral action is whether such action would actually be desirable from an individual state’s perspective, considering the disadvantages: namely, such action “could adversely impact the attractiveness of the country to international business and the ability of domestic groups to compete globally.”<sup>54</sup>

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<sup>52</sup> OECD p. 13.

<sup>53</sup> *Id* p. 19.

<sup>54</sup> *Id* p. 22.

For these reasons, the OECD reached the conclusion that the most efficient way to address the issue is an international approach, which links, on one hand, “the net interest expense of an entity ... to the overall net interest expense of the group” and, on the other hand, “the distribution of a group’s net interest expense ... to income-producing activities.” A consistent approach between countries would also benefit the groups of companies: it would increase predictability, enable more confident planning, simplify compliance and reduce associated costs, “remove distortions, reduce the risk of unintended double taxation and ... improve fairness and equality between groups.”<sup>55</sup>

What is the risk without such an approach? The solution adopted by the OECD, presented under section 3.3 below, is built around a fixed ratio rule. OECD demonstrates the need for such an approach as follows: “without an agreed best practice approach, there is a risk that competitiveness concerns would drive countries to adopt benchmark fixed ratios at a high level which would allow more interest expense to be deducted and reduce the effectiveness of the rule”.<sup>56</sup> The reasoning behind the adoption of this solution is explained further under section 3.2.

### **3. 2 The reasoning of the OECD**

OECD’s report on action 4 constitutes a best practice approach to address BEPS using interest and economically equivalent payments.<sup>57</sup> The approach itself is analyzed in section 3.3 below. This section presents the reasoning of the OECD, as it can be read in the report, behind the choice of the specific approach.

The report identifies the artificial separation of “taxable income from the underlying activities that drive value creation” as a key cause of BEPS.<sup>58</sup> With that in mind, OECD sets the link between the amount of interest deductions and the level of an entity’s taxable economic activity as one of the aims of the best practice approach.<sup>59</sup> As a starting point, in order to achieve that aim, OECD makes a distinction in the report between debt financing for tax versus non-tax reasons, in the meaning that raising debt for non-tax factors is acceptable and should not be restricted by the best

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<sup>55</sup> OECD p. 22.

<sup>56</sup> *Id* p. 52.

<sup>57</sup> *Id* p. 29.

<sup>58</sup> *Id* p. 41.

<sup>59</sup> *Ibid*.

approach.<sup>60</sup> The balance, therefore, sought by the OECD solution is between, on one hand, effective protection against BEPS involving interest and, on the other hand, allowing “businesses [to raise] the debt finance necessary for their business and commercial investments.”<sup>61</sup> With the aforementioned considerations in mind, the OECD formulated the criteria for the best approach as follows: it should provide an effective solution to BEPS risks and be robust against avoidance mechanisms while at the same time being reasonably straightforward in its application for both groups and tax authorities.<sup>62</sup> The approach chosen by the OECD as one which fulfils these criteria is presented in section 3.3. below.

### **3.3 The rule proposed by the OECD**

This section presents the proposed solution for the thin capitalization problem, proposed by the OECD in the report for BEPS action 4. The section begins by presenting the structure of the rule under section 3.3.1 and the scope of the rule under section 3.3.2, followed by the rule’s nature under section 3.3.3. Section 3.3.4 concludes the presentation by presenting the distinct parts of the proposed solution: the fixed ratio rule in section 3.3.4.1, the group ratio rule in section 3.3.4.2, the carry back/forward rules in section 3.3.4.3 and the targeted rules in section 3.3.4.4.

#### **3.3.1 The structure of the rule**

The basis of the solution represented by the OECD’s best approach is a fixed ratio rule, set at a specific percentage of an entity’s EBITDA.<sup>63</sup> This rule is supplemented by a group ratio rule, allowing an entity to exceed the fixed ratio rule’s limit in certain circumstances.<sup>64</sup> The importance of the fixed ratio rule is underlined in the report: “Whether a country applies the group ratio rule ..., a different group ratio rule, or no group ratio rule, in all cases, a best practice approach must include a fixed ratio rule”.<sup>65</sup> Additional rules may include a *de minimis* threshold, “to remove entities which pose the lowest risk from the scope of a general interest limitation rule”, carry over rules, to reduce the effect of volatility in earnings, and “targeted rules, which protect the integrity of the general interest limitation rules and deal with specific base

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<sup>60</sup> OECD p. 13, 14.

<sup>61</sup> *Id* p. 25.

<sup>62</sup> *Id* p. 29.

<sup>63</sup> *Id* p. 13.

<sup>64</sup> *Ibid*.

<sup>65</sup> OECD p. 62.

erosion and profit shifting risks which remain.”<sup>66</sup> It should be noted that the above rules included in the proposed best practice approach are minimum rules and should not hinder countries from applying stricter rules to either more effectively combat BEPS “or to achieve other tax policy goals.”<sup>67</sup>

### **3. 3. 2 The scope of the rule**

This section deals with the object of the proposed rule and the subjects it applies to. The expression “the object of the rule” is meant to denote the payments the rule applies to, i.e. the specific deductions it is meant to limit, while “the subjects of the rule” means, in this section, the entities which fall within the rule’s field of application.

#### *The object of the rule*

In brief, the best approach applies to “interest on all forms of debt as well as to other financial payments that are economically equivalent to interest.” In order to qualify as such, payments have to fulfil two criteria: first, they have to be “linked to the financing of an entity” and second, they have to be “determined by applying a fixed or variable percentage to an actual or notional principal over time.” The OECD notes, however, that “[the] rule should also apply to other expenses incurred in connection with the raising of finance, including arrangement fees and guarantee fees.”<sup>68</sup>

Based on these criteria, the rule should apply to both third party and intragroup debt, regarding payments “to a lender outside ... or within the same country.” Third party debt includes cases “where one entity or country bears an excessive proportion of the group’s total net third party interest expense”, whereas intragroup debt applies “where a group uses intragroup interest expense to shift taxable income from high tax to low tax countries”. Last, BEPS may arise within a country as a result of structured or back-to-back arrangements.<sup>69</sup>

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<sup>66</sup> OECD p. 30-31.

<sup>67</sup> *Id* p. 31.

<sup>68</sup> *Id* p. 33.

<sup>69</sup> *Id* p. 23.

Examples of payments that the rule should apply to include the following:

- payments under profit participating loans
- imputed interest on instruments such as convertible bonds and zero coupon bonds
- amounts under alternative financing arrangements, such as Islamic finance
- the finance cost element of finance lease payments
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest
- amounts measured by reference to a funding return under transfer pricing rules, where applicable
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
- guarantee fees with respect to financing arrangements
- arrangement fees and similar costs related to the borrowing of funds.<sup>70</sup>

### *The subjects of the rule*

In the report, OECD distinguishes between three categories of entities the rule in the best approach can apply to: entities in MNE groups, entities in domestic groups and standalone entities. “[A]s a minimum, the best practice approach ... should apply to all entities that are part of a multinational group.” Application to domestic groups and/or standalone entities is left to the individual countries.<sup>71</sup>

In addition, in the report it is pointed out that targeted provisions are necessary to ensure the effectiveness of the main rule. These rules should apply to both the entities that the main rule applies, in order to target “specific risks which are not dealt with by the fixed ratio rule”, as well as entities to which the rule does not apply, as, in such a case, the country “will be exposed to [BEPS] risks”.<sup>72</sup>

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<sup>70</sup> OECD p. 34.

<sup>71</sup> *Id* p. 37.

<sup>72</sup> *Id* p. 38.

Last, countries may choose to exclude low risk entities from the scope of the main rules by introducing a *de minimis* threshold, combined with “anti-fragmentation rules to prevent a group avoiding [*sic*] an interest limitation rule by establishing multiple entities, each of which falls below the threshold.” The reasoning behind the adoption of such a threshold lies in reduced administrative and compliance costs and the factors according to which the level of that threshold should be set include “the local economic and interest rate environment, as well as relevant tax or legal considerations.”<sup>73</sup>

### **3. 3. 3 The nature of the rule**

The rule included in the best approach is a direct, net interest limitation rule based on earnings and more specifically EBITDA. These terms are explained in order in the following paragraphs.

A direct interest limitation rule restricts “the amount of interest an entity may deduct for tax purposes”, whereas an indirect rule restricts “the amount of debt with respect to which an entity may claim deductions for interest.” The OECD elected the direct approach on the grounds that it addresses the level of tax deductible expense that drives BEPS, it makes it easier to identify and value interest and economically equivalent payments, and it “give[s] a more accurate picture of the entity’s actual position over the period”, even though it is less predictable than an indirect approach (“[t]he level of debt ... is under the control of the ... management [while] [t]he amount of interest expense may vary reflecting changes in interest rates.”).<sup>74</sup>

A net interest limitation rule applies “to the interest an entity incurs ... after offsetting the interest income it receives.” A gross interest limitation rule does not offset received interest income. OECD’s reasons for choosing the net interest limitation rule were that this rule reduced the risk of double taxation and that it “allow[s] an entity to ... on-lend borrowed funds within its group without [it] incurring a disallowance of part of its gross interest expense.”<sup>75</sup>

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<sup>73</sup> OECD p. 39.

<sup>74</sup> *Id* p. 41–42.

<sup>75</sup> *Id* p. 42.



The fixed and the group ratio rules in the best approach restrict interest expense deductions based on an entity's economic activity. The OECD has chosen earnings values, instead of asset values, to measure that activity, on the grounds that these values offer the following three benefits.<sup>76</sup>

First, measuring economic activity by earnings values offers a connection to one of the goals of the BEPS project, namely "to address practices that artificially separate taxable income from the activities that generate it." The connection is based on the expected "correlation between earnings and taxable income[:] ... measuring economic activity using earnings should be the most effective way to ensure that the ability to deduct net interest expense is matched with the activities that generate taxable income and drive value creation."<sup>77</sup>

Second, the earnings-based approach is more robust against tax planning, as any efforts to increase net interest deductions will have to increase earnings as well. An additional point in this respect is the following.<sup>78</sup>

[A]ny restructuring to move profits out of a country will also reduce net interest deductions in the country. On the assumption that an increase in earnings will also give rise to an increase in taxable income, it is unlikely that the level of earnings will be manipulated in order to increase the interest deductions in a country.<sup>79</sup>

Third, especially regarding the third basic scenario illustrated in section 3.1 above, i.e. the use of interest expense to fund tax exempt income, "the definition of earnings can be adapted to exclude income ... subject to favourable tax treatment."<sup>80</sup>

The main disadvantage of an earnings-based approach, the volatility of earnings, is addressed by the carry over rules to be discussed in detail under section 3.3.4.3 below.<sup>81</sup>

Regarding the definition of earnings used in the proposed approach, the OECD elected to use EBITDA for the following three reasons. First, it "is the most common measure of earnings currently used by countries with earnings-based tests." Second,

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<sup>76</sup> OECD p. 47.

<sup>77</sup> *Ibid.*

<sup>78</sup> *Ibid.*

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid.*

<sup>81</sup> OECD p. 47-48.

it “is a guide to the ability of an entity to meet its obligations to pay interest.” This is because, as opposed to the other possible option, EBIT, it “excludes the two major non-cash costs in a typical income statement (depreciation of fixed assets and amortisation of intangible assets).” Third, it “is often used by lenders in deciding how much interest expense an entity can reasonably afford to bear.” In addition, as far as the definition of of earnings is concerned, the OECD notes the following.<sup>82</sup>

[N]on-taxable income such as branch profits or dividend income that benefit from a participation exemption should not be included in the calculation of earnings. Appropriate adjustments should also be made for taxable branch profits and dividend income to the extent that they are shielded from tax by foreign tax credits, in order to address the base erosion and profit shifting issues which are the subject of this report.<sup>83</sup>

### **3. 3. 4 The elements of the rule**

This section deals with the different elements that comprise the best approach the OECD proposes in the report. Section 3.3.4.1 presents the basis of the approach, the fixed ratio rule; section 3.3.4.2 explains the group ratio rule that complements the fixed ratio rule; section 3.3.4.3 analyzes the carry over rules and section 3.3.4.4 concludes with the targeted rules.

#### **3. 3. 4. 1 Fixed ratio rule**

This section presents the basis of the best approach, the fixed ratio rule. The section is structured as follows: in the beginning, the reasoning and general function of the rule are presented. Subsequently, the section highlights certain advantages and disadvantages of the fixed ratio rule, followed by the process of the rule’s application. The section concludes with a best practice range or “corridor” within which countries are recommended to set their benchmark fixed ratio, explaining the factors that affect the choice of percentage within that corridor.

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<sup>82</sup> OECD p. 48.

<sup>83</sup> *Ibid.*

### *Reasoning and general function*

The reasoning behind the fixed ratio rule is that it should ensure “that a portion of an entity’s profit remains in a country.” Its general function is that it sets a fixed ratio in the form of a specified proportion of an entity’s EBITDA, disallowing “any interest which takes the entity’s ratio above this benchmark”.<sup>84</sup>

### *Advantages and disadvantages*

According to the report, the fixed ratio rule offers the following advantages.

First, it is simple and easy to apply.<sup>85</sup> Second, it “link[s] the level of interest expense to a measure of an entity’s economic activity.”<sup>86</sup> Third, a rule based on earnings instead of assets “is a better tool to combat [BEPS].”<sup>87</sup> Last, the fixed ratio rule fulfils two of the three criteria for the best approach as demonstrated under section 3.2 above: namely, it is robust against tax planning and reasonably straightforward to apply.<sup>88</sup> Regarding the other criterion, constituting an effective solution for the countries, OECD notes the following.

A fixed ration rule provides a country with a level of protection against base erosion and profit shifting, but it is a blunt tool which does not take into account the fact that groups operating in different sectors may require different amounts of leverage [or that] even within a sector some groups are more highly leveraged for non-tax reasons. If a benchmark fixed ratio is set at a level appropriate to tackle base erosion and profit shifting, it could lead to double taxation for groups which are leveraged above this level. Therefore, countries are encouraged to combine a robust and effective fixed ratio rule with a group ratio rule.<sup>89</sup>

The different leverage requirements for groups in different sectors lead to the disadvantage of the fixed ratio rule, in the sense that it does not take that requirement into account.

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<sup>84</sup> OECD p. 51.

<sup>85</sup> *Id* p. 25, 51.

<sup>86</sup> *Id* p. 25. The aim of the best approach, see under section 3.2 above.

<sup>87</sup> *Ibid*.

<sup>88</sup> OECD p. 30.

<sup>89</sup> *Ibid*.

Applying a fixed ratio rule differently to groups in different sectors would inevitably make a rule more complex to administer. ... However, in general, a country should apply the fixed ratio rule consistently, using the same benchmark fixed ratio, to groups in all sectors.<sup>90</sup>

Apparently, the OECD does not consider the increased complexity enough of a disadvantage to hinder the consistent application of the rule.

### *Application*

According to the report, fixed ratio rules operate in the following way: they “apply a predetermined benchmark fixed ratio to the earnings of an entity or a local group to calculate the maximum deductible interest expense.”<sup>91</sup> The effect of such an operation is that the interest expenses that fall within the amount determined by the application of the predetermined benchmark fixed ratio to the entity’s earnings are deductible, while the exceeding interest expenses are disallowed.

It is a three step process to calculate the amount of any interest expense disallowance: first, one calculates the appropriate measure of EBITDA. That is done by adding net interest expenses and equivalent payments as well as depreciation and amortization back to the taxable income. Second, one applies the statutory benchmark ratio to the EBITDA to determine the maximum deductible interest expense; third, one compares the maximum expense calculated according to the second step with the actual expense and disallows any deduction of the excessive part.<sup>92</sup>

### *Best practice range/“Corridor”*

The proposal of the OECD is that countries “set their benchmark fixed ratio within a corridor of 10% to 30%.”<sup>93</sup> The principle is that “[most] groups with positive EBITDA should ... be able to deduct all of their net third party interest expense” within that corridor.<sup>94</sup> Entities posing low BEPS risks can deduct even more net interest expense according to the group ratio rule and entities whose interest expense is low enough can benefit from the de minimis threshold.<sup>95</sup> The role of the proposed best practice range is to address BEPS risks while at the same time reducing “the risk that

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<sup>90</sup> OECD p. 51.

<sup>91</sup> *Ibid.*

<sup>92</sup> OECD p. 52.

<sup>93</sup> *Id* p. 53.

<sup>94</sup> *Id* p. 54.

<sup>95</sup> *Ibid.*

countries will be driven to apply a ratio at a level which is too high to address [such] risks”.<sup>96</sup> The report states the following two aims of the best practice range:

- i) [to allow] the majority of groups to deduct an amount equivalent to their net third party interest expense (assuming net interest expense is spread around the group in accordance with accounting EBITDA)
- ii) [to limit] the extent to which groups can use intragroup interest expense to claim total net interest deductions in excess of their net third party interest expense.<sup>97</sup>

Whether the fixed ratio rule is appropriate to achieve these goals is the subject of section 6.

OECD chose the upper limit of the best practice range with the reasoning that “[once] a benchmark fixed ratio exceeds 30%, the rate at which more groups are able to deduct all of their net third party interest expense increases more slowly.”<sup>98</sup> There are, however, certain factors that can allow a country to apply a higher ratio; especially relevant for EU member states, the obligation according to EU law for equal treatment of entities posing different risk levels is one of them.<sup>99</sup>

### **3. 3. 4. 2 Group ratio rule**

This section examines the group ratio rule proposed in the report. The section starts with the problem of the fixed ratio rule mentioned under “Advantages and disadvantages” in the preceding section, namely that it does not take into account the different leverage requirements of groups in different sectors, and proceeds to explain the characteristics and the application of the group ratio rule. The section concludes with the presentation of cases of loss-making entities that justify certain limitations on the rule’s application.

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<sup>96</sup> OECD p. 53.

<sup>97</sup> *Ibid.*

<sup>98</sup> *Ibid.*

<sup>99</sup> OECD p. 54.

### *Disadvantage of the fixed ratio rule*

As mentioned in the preceding section 3.3.4.1 under *Advantages and disadvantages*, a disadvantage of the fixed ratio rule is that it does not consider the different leverage requirements of groups in different sectors. This disadvantage can result to groups with higher third party net interest expenses than the fixed ratio rule's limits, in which case they would not be able to deduct all of them. As was also mentioned in section 3.3.4.1 above, under *Best practice range/“Corridor”*, allowing net third party interest expense deductions is one of the aims of the fixed ratio rule's corridor. The OECD recommends, therefore, that countries adopt a group ratio rule along with the fixed ratio rule, in order to allow exceeding net interest expense deductions “based on a relevant financial ratio of the worldwide group.” An added advantage of this approach is that it allows for a low benchmark fixed ratio, which is more effective to combat BEPS, while the group ratio rule “compensates for the blunt operation” of such a low ratio.<sup>100</sup>

### *Characteristics of the group ratio rule*

The aim of the group ratio rule is to “allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.” The reasoning behind setting that aim, as it can be read between the lines in the report, is that entities should be able to deduct net interest expense which, on one hand, corresponds to third party debt and on the other hand is undertaken for non-tax reasons. “[A]n uplift of up to 10%” is also available for countries “to prevent double taxation.”<sup>101</sup>

Regarding the rule's form, OECD remarks that it “may be introduced as a separate additional provision, or as an integral part of an overall rule including a fixed ratio rule.” The group ratio rule's function would be to disallow “[o]nly net interest expense which exceeds both the benchmark fixed ratio and the ratio of [the relevant entity's] group”.<sup>102</sup>

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<sup>100</sup> OECD p. 61.

<sup>101</sup> *Id* p. 13.

<sup>102</sup> *Id* p. 61.

### *Application*

A general requirement for the group ratio rule is that it must be “reasonably simple to apply by groups and tax authorities.” This is challenging because, as “[t]he group ratio rule requires an entity to be able to determine the net third party interest/EBITDA ratio of its worldwide group ... [it] must obtain information on its group which can be audited by its local tax authority”. It should be noted, here, that “[w]here an entity is unable to obtain information on its group necessary to apply the group ratio rule, it can still apply the fixed ratio rule and deduct interest up to the benchmark fixed ratio.”<sup>103</sup>

With the aforementioned considerations in mind, OECD developed the following two stage test in order to “[determine] the amount of net interest expense deductible under a group ratio rule”. First, one has to determine the group ratio according to the following formula: “Net third party interest expense/Group EBITDA = Group ratio”. Then, one “[applies] the group’s ratio to an entity’s EBITDA” as follows: “Group ratio x Entity EBITDA = Limit on net interest deductions”.<sup>104</sup>

In a single step, one can find out the limit of an entity’s net interest deductions according to the following calculation: Limit = Group’s net third party interest expense x Entity EBITDA / Group EBITDA.

### *Limitations*

The report highlights two scenarios where it is deemed appropriate to limit the function of the group ratio rule. Both scenarios include “the presence of loss-making entities within a group”.<sup>105</sup>

The first scenario considers the presence of a loss-making entity, whose results lower the group’s EBITDA, thereby increasing the group ratio to be applied to the profit-making individual entities’ EBITDA (see the formula under *Application* above: the group’s EBITDA is in the denominator of the formula and as the denominator decreases the result increases proportionally, assuming the rest of the figures stay the same). The risk in this case is that the increase of the deduction capabilities of the profit-making entities could exceed “the actual net interest expense of the entire group.” The proposed solution in this case is to impose “an upper limit ..., equal to the

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<sup>103</sup> OECD p. 62.

<sup>104</sup> *Id* p. 64.

<sup>105</sup> *Id* p. 69.

net third party interest expense of the entire group.” This limit should, however, not reduce the deduction limit of the profit-making entities to a level lower than that where it would have been, “had the group EBITDA not been reduced by losses.” Although this limit “does not remove the risk that the total ... deductions ... could exceed the group’s actual net third party interest expense ... it should prevent an individual entity [from using] a very high level of interest capacity ... for [BEPS] purposes.”<sup>106</sup>

“The second scenario concerns ... profitable entities” in a group with negative EBITDA. In this case, the negative group EBITDA does not allow for a meaningful calculation of a group ratio, as the negative number would be in the denominator of the relevant formula (see under *Application* above). As the OECD believes, however, that the profitable entity’s positive contribution to the group’s results should be recognized, it is proposed in the report that such an entity “receive interest capacity equal to the lower of the entity’s actual net interest expense and the net third party interest expense of the group. ... [T]his is the most straightforward way of linking an entity’s interest deductibility to the position of its group.”<sup>107</sup>

The above scenarios would not be necessary if it would be possible “to exclude loss-making entities from the calculation of a group’s EBITDA.” Difficulties for the tax authorities in obtaining and controlling the accuracy of such information, however, leads to a preference for the two scenarios in the report.<sup>108</sup>

Last, the OECD notes that the group ratio rule is not a necessary element for the best practice approach. In the case of countries who do not apply such a rule, the report highlights the importance of consistent application of the fixed ratio rule, in order to avoid improper discrimination between domestic and multinational groups.<sup>109</sup>

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<sup>106</sup> OECD p. 69.

<sup>107</sup> *Ibid.*

<sup>108</sup> *Ibid.*

<sup>109</sup> OECD p. 62.



### 3.3.4.3 The carry over rules

#### *The issue*

An entity may be unable to deduct its net interest expense under the fixed and the group ratio rules for reasons unrelated to BEPS and/or outside its control, for example because of “earnings volatility or mismatches in the timing of interest expense and EBITDA”.<sup>110</sup> In these circumstances, the limits of the fixed and the group ratio rules will most likely result in either interest disallowance or unused interest capacity.<sup>111</sup> While a permanent disallowance is deemed appropriate in the case of BEPS, the OECD has decided that other cases should be treated differently.<sup>112</sup> In the case of timing mismatches, for example, or in the case of volatility elsewhere in the group, which can impact “the amount of net interest expense an entity can deduct”, where the group ratio rule would be applicable, such disallowance can lead to uncertainty for long term planning and to risk of double taxation, where “the lender is taxed on the interest income.”<sup>113</sup> In order to address these concerns, the report contains the following solutions.

#### *Solutions*

The proposed solutions in the report include averaging EBITDA and carry over rules. In this sense, “averaging” means that an entity can be allowed to apply the benchmark ratio to the average of EBITDA in a certain period including the current and previous years. The disadvantages of averaging include that it can, on one hand, provide protection against short term, but not long term volatility and, on the other hand, increase complexity in the context of the application of the group ratio rule, “as it would need to be used in calculating the EBITDA of the group as well as of each entity [which] would give rise to additional issues”. However, since it can “help address volatility ... [it] is an option that countries may choose to apply under the best practice approach.”<sup>114</sup>

Bearing the above considerations regarding averaging in mind, the preferred solution in the report consists of the carry over rules. The reason is that these rules offer advantages both for entities and for the countries concerned: entities run a reduced “risk of a permanent disallowance of interest expense where interest expense and

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<sup>110</sup> OECD p. 71.

<sup>111</sup> *Id* p. 72.

<sup>112</sup> *Ibid.*

<sup>113</sup> *Ibid.*

<sup>114</sup> OECD p. 71.

EBITDA arise in different periods” and countries achieve a link between “an entity’s net interest deductions [and] its level of earnings over time.”<sup>115</sup>

### *Risks*

Even though the carry over rules constitute the preferred option for the best approach, they are, nevertheless, tied to significant risks. Namely, “a long or unlimited carry forward [or carry back] could give rise to a sizeable tax asset”. This asset could function as an incentive to the entity or entities concerned, which would be contrary to the aim of a rule against BEPS: more specifically, the only ways to realize such an asset would be to “either [increase] the level of the entity’s net interest expense, or [reduce] the level of EBITDA in a future period”.<sup>116</sup>

In order to address these risks, the OECD proposes in the report that countries consider “imposing limits in terms of time [that the disallowed interest expense or unused interest capacity may be carried back or forward] and/or value [of a carry forward or carry back]”.<sup>117</sup>

As a final remark, the OECD makes a distinction between the relationship of the carry over rules to the fixed and the group ratio rules on one hand and the relationship of the carry over rules to the targeted rules on the other. In particular, the carry over rules should apply to amounts disallowed by the first but should not be available for amounts disallowed by the second.<sup>118</sup> The reasoning behind that distinction is that “[i]nterest expense disallowed under targeted rules will generally relate to transactions or arrangements which give rise to specific [BEPS] risks”.<sup>119</sup> The targeted rules are explained in section 3.3.4.4 below.

### **3. 3. 4. 4 Targeted rules**

This section presents the concept of the targeted rules mentioned in the report.

“Targeted interest limitation rules include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements.”<sup>120</sup> The section begins by laying down the issues with the fixed and the group ratio rules that the targeted rules are meant to address and continues with the

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<sup>115</sup> OECD p. 72.

<sup>116</sup> *Id* p. 73.

<sup>117</sup> *Ibid*.

<sup>118</sup> OECD p. 72.

<sup>119</sup> *Ibid*.

<sup>120</sup> OECD p. 75.

context, in which the targeted rules are meant to function in the context of the best practice approach, and the form of such rules. The section concludes by presenting the benefits and the drawbacks of the targeted rules.

### *The issue*

Both the fixed and the group ratio rules leave certain BEPS risks that need targeted rules in order to be addressed.<sup>121</sup> Such risks include, among others, the following interest payments: payments on “artificial loans”, i.e. loans “where no new funding is raised by the entity or its group”, payments under “structured arrangement[s], [e.g.] back-to-back arrangement[s]”, payments “used to finance the production of tax exempt income” and payments “subject to no or low taxation in the corresponding interest income.”<sup>122</sup>

### *The context*

According to the reasoning in the report, the targeted rules are supposed to supplement the general rule: in this case, as “general interest limitation rules” are meant the fixed and the group ratio rule. This should “provide countries with the comfort that the main risks posed by base erosion and profit shifting are addressed, while ensuring that groups are able to obtain relief for their real net third party interest expense.” The interesting thing about this remark is that, in this sentence, it is the targeted rules that are supposed to address the main BEPS risks, while the general rule is there to “[ensure] that groups are able to obtain relief for their real net third party interest expense.” The discussion will return to this point in Section 6.<sup>123</sup>

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<sup>121</sup> OECD p. 38, 39, 64, 76.

<sup>122</sup> *Id* p. 77. As back-to-back arrangements are understood arrangements where an entity in the group provides a loan to another entity in the same group via an external financing source. For example, when entity A lends capital to a financing company X which, in turn, provides a loan to entity B in the same group, the interest paid by B is “in form” an external interest payment, but the terms of the loan provided by X do not necessarily have to be market terms, as the capital is already secured by the loan from entity A. In that case, X is merely forwarding the “in essence” internal interest payments from B to A.

<sup>123</sup> OECD p. 75.

### *The form*

According to the report, the targeted rules can take the form of separate rules or even be incorporated in other tax rules, even the fixed and the group ratio rule. In any case, they should be applicable to all entities the general rules apply.<sup>124</sup>

### *Benefits and drawbacks*

An approach that relies solely on targeted rules presents significant benefits:

it reduces the risk that a rule could negatively impact on entities which are already appropriately capitalised and also avoids any incentive for groups to increase the level of net interest expense of local entities up to the level allowed under a fixed ratio rule.<sup>125</sup>

Additionally, it “allows countries to address specific areas of concern, potentially minimising compliance costs for entities, in particular those which do not engage in base erosion or profit shifting.”<sup>126</sup>

However, this approach comes with certain drawbacks as well: it constitutes a reactive response requiring active application. The latter means that “meaning the tax administration must be able to recognise situations where a rule could apply, often as part of a complex transaction, and then engage with a group to determine the correct result.” In addition, the “large number of rules ... will increase complexity, as well as ... compliance and administrative costs.” Last, there is the risk that “[i]f the rules are not comprehensive ... they are unlikely to deal with all [BEPS] risks.”<sup>127</sup>

For these reasons, the OECD regarded a combined approach most appropriate and therefore proposed a best approach consisting of both general and targeted rules. The following sections present the approach followed by the EU, as included in the ATAD, and the one chosen by Sweden in the recently voted amendments to the IL.

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<sup>124</sup> OECD p. 76.

<sup>125</sup> *Id* p. 75.

<sup>126</sup> *Ibid.*

<sup>127</sup> *Ibid.*

## 4 The EU approach

Almost three years following the adoption of the 15-point Action Plan against BEPS, the Council of the European Union adopted the Directive 2016/1164 “laying down rules against tax avoidance practices that directly affect the functioning of the internal market”. The relevant measures against, as the Council puts it, “excessive interest payments”, are included in article 4 of the Directive.<sup>128</sup>

This section presents the provisions of the ATAD against exceeding borrowing costs. Section 4.1 presents the reasoning behind the adoption of rule in Article 4, as such reasoning is expressed in the Preamble of the Directive, and section 4.2 concludes with a presentation of the specific provisions that constitute the measure the Council elected to adopt to tackle the issue of exceeding borrowing costs.

### 4. 1 The reasoning behind the EU approach

The general reasoning is that it is necessary to set rules to counter BEPS in the internal market. The balance that needs to be found here is between countering tax avoidance and avoiding the creation of obstacles in the internal market, for example in the form of double taxation.<sup>129</sup>

In the case of thin capitalization, the problem of BEPS takes the form of excessive interest payments. To address this issue, the Council adopts, in the Directive, an interest limitation rule based on EBITDA along with optional targeted rules against intra-group financing. The aim of these rules is that “[t]ax exempt revenues should not be set off against deductible borrowing costs.”<sup>130</sup>

### 4. 2 The rule in the EU approach

This section explains the main parts of the interest limitation rule included in Article 4 of the Directive. The first part involves a fixed ratio rule, presented under section 4.2.1; this is followed by a group ratio rule, under section 4.2.2; section 4.3.3 concludes with the article’s carry over provisions.

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<sup>128</sup> COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, preambles 6 and 8. In the following “ATAD”.

<sup>129</sup> ATAD preamble 5.

<sup>130</sup> ATAD preamble 6.

## 4. 2. 1 The fixed ratio rule

In the context of the fixed ratio rule, the section presents the safe harbour rule as well as the grandfathering clause. The reason is that both of these provisions are formulated in the Directive as possible exceptions to the provision of paragraph 1, namely the fixed ratio rule.

### *The fixed ratio rule*

The fixed ratio rule the Council adopted in the Directive sets the limit of deductibility of exceeding borrowing costs for the relevant tax period to 30% of the taxpayer's EBITDA. Taxpayers, in the meaning of the article, include the following entities:

[both entities] permitted or required to apply the rules on behalf of a group, ...  
[as well as entities] in a group ... which does not consolidate the results of its members for tax purposes. In such circumstances, exceeding borrowing costs and the EBITDA may be calculated at the level of the group and comprise the results of all its members (Art. 4, par.1)

The calculation of the EBITDA follows the same reasoning as in the report of the OECD.<sup>131</sup> Namely, “the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortisation” shall be added back to the taxable income and “tax exempt income shall be excluded”. (Art 4 par. 2).

### *The safe harbour rule*

Furthermore, the ATAD includes a safe harbour rule, stating that the taxpayer may be given the right to deduct up to 3 million Euros of exceeding borrowing costs or 100% of such costs, in the case of standalone entities. (Art. 4 par. 3)<sup>132</sup> The aim of this rule is “[t]o reduce the administrative and compliance burden of the rules without significantly diminishing their tax effect”.<sup>133</sup>

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<sup>131</sup> See under sections 3.3.3 and 3.3.4.1 *Application* above.

<sup>132</sup> In the meaning of the paragraph, “a standalone entity means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment.”

<sup>133</sup> ATAD preamble 8.

The reasoning behind it is as follows.

Since BEPS in principle takes place through excessive interest payments among entities which are associated enterprises, it is appropriate and necessary to allow the possible exclusion of standalone entities from the scope of the interest limitation rule given the limited risks of tax avoidance.<sup>134</sup>

Based on the same reasoning of limited BEPS risks, “Member States could also exclude exceeding borrowing costs incurred on loans used to fund long-term public infrastructure projects.”<sup>135</sup> (Art. 4 par. 4.b) It is important to note that this exception should still respect the function of the State aid rules.<sup>136</sup>

#### *The grandfathering clause*

Last, “in order to facilitate the transition to the new [regime],” Member States can avail themselves of a grandfathering clause, providing for the possibility to exclude “loans which were concluded before 17 June 2016,” according to the terms they had at that time, from the application of the interest limitation rule.<sup>137</sup> (Art. 4 par. 4.a)

## **4. 2. 2 The group ratio rule**

Entities can exceed the limit of the fixed ratio rule in two ways, according to the group ratio rule adopted in the Directive. The first way is to have an equity over total assets ratio of up to two percentage points lower than the equivalent ratio of the group. The second way is similar to the group ratio rule proposed by the OECD, namely to calculate the group ratio and apply it to the entity’s EBITDA.<sup>138</sup> (Art. 4 par. 5)

The first way refers to what is known as “the shareholder equity ratio”; it essentially “determines how much shareholders would receive in the event of a company-wide liquidation ... and it represents the amount of assets on which shareholders have a residual claim.”<sup>139</sup> If the relevant entity’s ratio is not lower than two percentage points lower than the equivalent ratio of the group and the evaluation is according to

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<sup>134</sup> ATAD preamble 8.

<sup>135</sup> *Ibid.*

<sup>136</sup> *Ibid.*

<sup>137</sup> *Ibid.*

<sup>138</sup> See under section 3.3.4.2 *Application* above.

<sup>139</sup> Shareholder equity ratio: <https://www.investopedia.com/terms/s/shareholderequityratio.asp>. as seen on 2018-07-31.

paragraph 8 of article 4 of the Directive, then the entity in question can deduct 100% of its exceeding borrowing costs. (Art. 4 par. 5.a)

The second way follows the OECD recommendation and calculated the deductibility of exceeding borrowing costs in two steps: first, one determines the group ratio “by dividing the [external] exceeding borrowing costs of the group ... over the EBITDA of the group” and then multiplies that ratio by the relevant entity’s EBITDA. This way does not allow for a full deduction but is applicable if it increases the limit of the fixed ratio rule. (Art 4 par. 5.b).

### **4. 2. 3 The carry over provisions**

Last, the interest limitation rule in Article 4 of the Directive provides for optional carry over provisions available to the Member States. More specifically, there are three alternatives of increasing leniency. The common factor in all alternatives is that they all include an unlimited carry forward option. While the first alternative consists exclusively of that option, the other two alternatives also include carry back provisions: alternative (b) “for a maximum of three years” and alternative (c) “for a maximum of five years”. (Art. 6) It can be noted, here, that the common unlimited carry forward factor is against the OECD’s warning of the risks related to such an approach.<sup>140</sup>

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<sup>140</sup> See under section 3.3.4.3 *Risks* above.



## 5 The Swedish approach

This section presents the Swedish approach to the issue of thin capitalization.

Section 5.1 explains the reasoning behind the choices of the amendments to the relevant provisions of Swedish tax law. The section is based on the report of the Tax Committee (Skatteutskottet, in the following SU), on the Swedish Government's proposition, and on the proposal of the Corporate Tax Committee (Företagsskattekommittén, in the following FSK). Section 5.2 outlines the details of the structure that Sweden has chosen to counteract the problems caused by interest deduction.

### 5. 1 The reasoning behind the Swedish approach

The Swedish story behind the initiative to reform the rules governing interest deduction stems from the consideration that, according to the report of the Tax Committee, growth and job creation require a competitive and dynamic corporate climate. Such a climate exhibits the following characteristics: it is internationally competitive, it promotes investment, it exists in a foreseeable regulatory framework and it supports a healthy competition. One condition for such a climate is that the tax system should, as a rule, not discriminate between finance forms, investments or sectors; it should influence the choice of finance only to a limited extent.<sup>141</sup>

Regarding the latter, the tax system's influence on the choice of how to finance investment, SU highlights the following asymmetry: there is a non-uniform treatment of different finance forms, namely the deduction for the cost of debt, i.e. interest, does not correspond to a similar deduction for the cost of equity capital, i.e. dividend payments. This asymmetry results to a heavier tax burden on equity than on debt investment. This unequal tax burden constitutes an incentive for corporate debt finance, which gives rise to several problems, including lower solidity and bigger vulnerability for high leveraged firms, as well as misallocation of resources within the economy, e.g. more investment in debt financed assets than, for example, research and development, which tends to be equity financed.<sup>142</sup>

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<sup>141</sup> Skatteutskottets betänkande 2017/18:SkU25, p. 19. In the following SUB.

<sup>142</sup> SUB p. 19, 20.

The beginning of the story dates back to 2011, when the Swedish Government decided to establish a committee, the FSK, with the central assignment to submit a proposal to reduce the difference in tax treatment between debt and equity finance.<sup>143</sup>

#### *The reasoning behind the proposals*

FSK ended up submitting two proposals, a main and an alternative proposal to be discussed further on in this section. The reasoning behind these proposals is as follows.

On one hand, there are no socio-economic reasons to discriminate between certain finance forms, investments or sectors. On the contrary, there are good reasons to treat these phenomena in a tax neutral way. In conclusion, tax neutrality between debt and equity finance should increase.<sup>144</sup>

On the other hand, as mentioned above, tax legislation should influence finance choices to a limited extent. This means, in this context, that investments profitable before tax should also be profitable after tax. At the same time, the other side of that coin reads that investments unprofitable before tax should remain unprofitable after tax.<sup>145</sup>

#### *The goal with the proposals*

The goal with FSK's proposals was to increase neutrality between debt and equity finance, and to counteract tax planning through interest deductions. FSK reasoned that a general limitation of interest deduction would increase neutrality in the tax system: how investments are financed would be less decisive for how they are taxed. This, in turn, would lead to a reallocation of tax liability: high leveraged companies, with low yielding investments, will pay more tax compared to the current framework, while low leveraged companies, with high yielding investments, will pay less in corporate income tax compared to how much they currently pay.<sup>146</sup>

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<sup>143</sup> Regeringens proposition 2017/18:245 Nya skatteregler för företagssektorn, p. 57. In the following Proposition.

<sup>144</sup> Proposition p. 58.

<sup>145</sup> *Ibid.*

<sup>146</sup> *Ibid.*

### *The main and the alternative proposal*

FSK's main proposal consisted of a finance deduction. According to this proposal, negative net interest income is not deductible. Deductibility is abolished, and debt and equity capital receive neutral tax treatment.<sup>147</sup>

FSK's alternative proposal was an EBIT-rule. According to this rule, entities can deduct negative interest income up to 20% of their EBIT. Interest deductibility decreases and neutrality between debt and equity finance increases.<sup>148</sup>

FSK deemed that both proposals increase neutrality between debt and equity finance and counteract international tax planning through interest deduction. However, as an overall assessment, FSK recommended the main proposal.<sup>149</sup>

### *Reactions to the proposals*

Be that as it may, even though all reviewing bodies were positive to increasing neutrality between debt and equity capital and counteracting tax planning through interest deduction, none of FSK's proposals were adopted. The main proposal, the one that would equalize the tax treatment between debt and equity was deemed too extensive a limitation on interest deduction. Furthermore, it was seen as negative that this proposal has no international equivalence. Regarding the alternative proposal, a solution based on EBITDA was preferred, as it is more commonly occurring internationally and it favours capital-intensive investments.<sup>150</sup>

More specifically, the Swedish Government's reasoning behind choosing EBITDA instead of EBIT as basis for interest deduction limit, as evidenced in the Proposition, is as follows. Bearing in mind that both approaches are possible according to the OECD's BEPS project and the ATAD, the difference is that EBITDA offers a bigger deduction basis. According to the Finance Department's evaluation, it is true that EBIT is more suited to increase tax neutrality between debt and equity; however, it is too restrictive for capital intensive businesses. EBITDA, on the other hand, may require more complicated legislation and may be less appropriate for the goal of tax neutrality but it offers foreseeability and is more commonly occurring internationally.

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<sup>147</sup> Proposition p. 58.

<sup>148</sup> *Id* p. 58-59.

<sup>149</sup> *Id* p. 59-60.

<sup>150</sup> *Id* p. 60.

On these grounds, the Finance Department proposed the EBITDA rule that has been ultimately adopted by the Parliament.<sup>151</sup>

The main elements of the rule are presented in the following Section 5.2.

## **5. 2 The rule of the Swedish approach**

As mentioned in more detail in the previous section, too beneficial rules for interest deduction were deemed liable to lead to BEPS. In order to reduce that risk as well as to increase the tax neutrality between debt and equity finance, Sweden has decided to introduce an interest deduction limitation rule. In short, that rule consists of a limitation on the deduction of an entity's negative net interest income up to 30% of its EBITDA, as well as a simplification rule ("safe harbour" or "*de minimis*" rule in the context of the OECD or the EU, as mentioned in the previous sections 3 and 4), according to which the entity can choose to deduct the amount of 5 million SEK instead of 30% of its EBITDA. If the entity is part of a group, the amount of 5 million SEK applies to the whole group, as defined according to 1:4 of the Annual Reporting Law (Årsredovisningslagen, in the following ÅRL).<sup>152</sup>

The rule is explained in more detail in the following sections 5.2.1-3.

The system that Sweden has decided to adopt to counteract thin capitalization consists mainly of three parts. There is the aforementioned rule that limits the deduction of negative net interest income to 30% of an entity's EBITDA or 5 million SEK; there is a rule that limits interest deductions in situations hybrid mismatches between associated companies; last, there is a modified version of the "old" rules, i.e. the existing rules before the adoption of the new measures, that regulate the right of interest deduction in payments between, mainly, associated companies. It should be noted, here, that the definition of "associated companies" differs between the latter two sets of rules.

These three parts are analysed in turn in the following paragraphs. The references to the articles of the Income Tax Law (Inkomstskattelagen, in the following IL) are made to the new provisions, in force from January 1<sup>st</sup>, 2019.

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<sup>151</sup> Proposition, p. 92-94.

<sup>152</sup> SUB p. 6 and Proposition p. 1.

## **5. 2. 1 The EBITDA rule**

The interest deduction limitation rule is in article 24:24 IL. Furthermore, the carry forward rule can be found in article 24:26 IL and the right to group deduction is regulated in article 24:28 IL. These provisions are explained in turn below.

### *The main rule: article 24:24 par. 1 IL*

In the first paragraph of article 24:24 IL, the law states that a company can deduct a negative net interest income up to 30% of its deduction basis. The deduction basis is explained in article 25:25 IL as, essentially, the EBITDA. The definition of the negative net interest income is provided in the first paragraph of article 24:23 IL as the difference between deductible interest expenses and taxable interest profits, provided that the interest expenses exceed the interest profits.

### *The simplification rule: article 24:24 par. 2 IL*

In the second paragraph of article 24:24 IL, there is the simplification provision, stating that a company may, instead of using the limit of paragraph one, deduct up to five million Swedish crowns. If the company is part of a group, the total deduction within the group may not exceed five million Swedish crowns.

The definition of the group, for the purposes of article 24:24 IL, is provided in article 24:22 IL and it should be noted that this definition is different from the one provided for the purposes of the article 24:15c IL, which deals with the hybrid situations. The latter is explained in section 5.2 below. The former, article 24:22 IL, includes companies that belong in a group as described in article 1:4 ÅRL. This means companies where one company controls either more than 50% of the voting power in the other company, directly or indirectly, or any number of shares combined with the right to either appoint or remove more than half of the board members or otherwise exercise controlling influence on the other company. This includes all Swedish and foreign partnerships in which a company in the group owns shares, directly or indirectly.

### *The carry forward rule: article 24:26 IL*

Article 24:26 IL provides for a right to deduct previous years' negative net interest income, to the extent that the entity has not been able to deduct it in the year it occurred because of the application of the interest deduction limitation rule. The right goes back six years.

According to article 24:27 IL, the aforementioned right expires in the case of ownership changes, where a company acquires controlling influence over the company with the unused interest deduction capacity. According to paragraph 2 of article 24:27 IL, a company is deemed to have such a controlling influence over another company if the companies, after the ownership change, form a group in the meaning of article 1:4 ÅRL, as explained under the simplification rule above. This means that the restriction does not apply when the companies were already members of the same group already before the ownership change, as mentioned in paragraph 3 of article 24:27 IL.

#### *The group deduction rule: articles 24:28-29 IL*

According to article 24:28 IL, a company with a positive net interest income may deduct another company's negative net interest income, limited to its own positive net interest income, to the extent that the other company's negative net interest income has not been deducted in any other way. It should be noted that this right does not allow the deducting company to deduct carried forward negative net interest income. The deduction reduces the negative net interest income at the other company by the corresponding amount. The definition of the positive net interest income is provided in the second paragraph of article 24:23 IL and it mirrors the definition of the negative net interest income mentioned under "*The main rule: article 24:24 par. 1 IL*" above. Namely, the positive net interest income is defined as the difference between the taxable interest profits and the deductible interest expenses.

Regarding the conditions for a company to have such a right to deduct another company's negative net interest income, article 24:29 IL states that the companies must be able to make group contributions to each other with a corresponding right to deduct. The question of deductible group contributions is regulated in chapter 35 of IL, which is not affected by the new provisions. According to articles 35:3-4 IL, this right exists between wholly owned mother-daughter and sister companies.

## **5. 2. 2 The rule about hybrid mismatches**

Interest deduction limitations in the case of associated companies are dealt with in articles 24:15c-e. They cover the issues of double deduction and of deduction in combination with non-inclusion.

The situations where companies are “associated”, for the purpose of these articles, is clarified in article 24:15a IL. According to this article, companies are associated under any of the three following conditions: either when they belong in the same group, as such is stated in article 1:4 ÅRL, explained under “*The simplification rule: article 24:24 par. 2 IL*” in section 5.2.1 above; or when a company, directly or indirectly, owns at least 25% of the capital, votes or rights to the other company’s profit; or, last, when the same person owns at least 25% of the votes or capital of each of the companies in question. In these cases, the rules explained below limit the companies’ right to deduct interest payments.

### *Double deduction*

The issue of double deduction has to do with an entity’s legal classification in different tax regimes: when the entity is treated as transparent in one jurisdiction and as non-transparent in the other, the following situation can occur. An example structure can be of use in order to illustrate the issue.<sup>153</sup>

This example structure assumes a company, situated in state A, owing an entity, situated in state B, which entity, in turn, owns a company situated in state B. The interesting part of the scenario is that the intermediate entity can be a “hybrid” entity; for the sake of this illustration, this hybrid entity can be transparent for the legislation of country A and non-transparent for the legislation of country B. If this hybrid entity borrows money from a third party and pays interest for that loan, the situation from the perspective of either country looks as follows.

Country A, disregarding the hybrid entity, will grant the deduction for the interest payment to company A and allocate the interest expense to that company. Country B, on the other hand, will grant the deduction to the hybrid entity, which will result in the same amount being deducted twice in two different jurisdictions. In this case, article 24:15c IL forbids a company from deducting the same interest expenses as a foreign associated company may deduct, as long as these expenses are paid either by the foreign associated company or by the company claiming the deduction and the same deduction is not denied in the other state. This prohibition does not apply where both companies declare the same income in both states.

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<sup>153</sup> The structure and the explanation come from OECD *Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues*, March 2012, p. 8.

It should be noted here that, in order for the companies to be “associated” for the application of article 24:15c IL, the percentages of 25% mentioned in article 24:15a and explained in the beginning of the current section 5.2.2 should be 50%, as stated in the last paragraph of article 24:15a IL.

### *Deduction/non-inclusion*

The issue of deduction/non-inclusion arises both in the case of hybrid entities, as was the situation in double deduction above, and also in the case of hybrid payments. The following structure can help illustrate the issue.<sup>154</sup>

Starting with the case of hybrid entities, the example structure assumes a company in country A owning an entity in country B. If country B treats the entity as non-transparent, while country A treats it as transparent, and the entity in country B makes a deductible payment to the company in country A, the following interesting situation occurs: country B will offer the deduction to the hybrid entity, whilst country A will disregard the payment for tax purposes. That way, a deductible payment will not be included in the taxable income of the receiving company. That is the issue.

Continuing with the issue of hybrid instruments, the example structure assumes a company in country A funding a company in country B with an instrument that country A qualifies as equity, while country B qualifies it as debt. If the company in country B makes payments on that instrument, then country B will deduct the payments from the company’s income, while country A will exempt them as equity payments. Again, the issue is that a deductible payment is not included in the taxable income of the receiving company.

The cases of deduction/non-inclusion are regulated in articles 24:15d-e IL. Article 24:15d IL regulates the issue of hybrid entities, while article 24:15e IL regulates the issue of hybrid financial instruments. Both articles forbid the deduction of interest payments to foreign associated companies, in cases where the corresponding amount is not taxed in the foreign jurisdiction. Article 24:15d IL is applicable where this occurs because of differences in the legal classification of entities, while article 24:15e IL is applicable where this occurs because of differences in the legal classification of the financial instrument or payment.

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<sup>154</sup> The structure and the explanation come from OECD Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues, March 2012, p. 8-9.



Other differences between the two articles are the following: regarding article 24:15d IL, where the mismatch occurs because of differences in the legal classification of entities, in order for the companies to be “associated”, the percentages of 25% mentioned in article 24:15a and explained in the beginning of the current section 5.2.2 should be 50%, as stated in the last paragraph of article 24:15a IL. These are the same percentages that apply in the case of double deduction. Regarding article 24:15e IL, where the mismatch occurs because of differences in the legal classification of the financial instrument or payment, the income will be deemed as taxed even if that happens within twelve months from the expiration of the tax year of the relevant interest expenses. This is stated in the second paragraph of article 24:15e IL.

### **5. 2. 3 The rule about associated companies**

This rule, in article 24:18 IL, allows a company to deduct an interest payment to an associated company only if the receiving company is resident within EEA or in a country that has a double taxation agreement with Sweden or would have been taxed for the interest income at a rate of at least 10% in its own state, if it would only have that income. The right to deduct does not exist when the underlying debt has arisen exclusively or virtually exclusively so that the association would get an essential tax benefit.

According to article 24:16 IL, companies are considered to be associated where one of them, directly or indirectly, has an essential influence on the other or when they are under substantially common management.

Last, article 24:20 IL regulates the issue of back-to-back loan arrangements. This article states that the rule in 24:18 IL applies to debts to non-associated companies as well, to the extent that such debts bear a connection to a claim one of the associated companies has to the non-associated company or to a company associated with the latter.

## **5. 3 The effects of the rule in the Swedish approach**

The rules mentioned above are expected to have the following effects, as stated in the report of the Tax Committee. One side of the coin reads that, since the cost of debt will increase, as a consequence, the return of corporate debt financed investment will

decrease and so will the extent of such investment. It should be noted, here, that the profitability of debt financed investment will remain the same within the limits of the EBITDA rule. The other side of the coin reads that the return of equity financed investment will increase and therefore the cost of equity will decrease. This is thought to have long term positive effects on corporate investment, as debt capital will, to some extent, be replaced by equity capital. This last development is expected to decrease the risks for the economy by reducing debt incentives.<sup>155</sup>

## **6 Critique and alternatives**

As shown in the previous sections 3, 4 and 5, the OECD, the EU and Sweden respectively are proposing or implementing, as the case may be, measures to counteract tax planning with the help of interest deductions. Regarding the aforementioned measures, this section serves a double purpose. On one hand it examines the degree to which the measures proposed or implemented are appropriate for achieving the goal they are meant to achieve; on the other hand, it presents alternative proposals which may offer higher chances of achieving the same goal.

The sections below are organized as follows: section 6.1 includes the examination of the degree to which the chosen measures are appropriate for achieving the goal behind their proposal or adoption; section 6.2 considers whether the debt bias is justified, before section 6.3 proceeds with alternative measures that may be better suited for achieving the same goal. Finally, section 6.4 attempts to uncover a reasoning as to an explanation regarding the reasons for which a possibly more appropriate measure was not selected.

### **6.1 Critique of the selected measure**

As shown in the discussion in the previous sections 3, 4 and 5, OECD's BEPS action 4, article 4 of the ATAD and the recently adopted Swedish rules have been selected to counteract profit shifting due to tax planning that takes advantage of the interest deduction. The main rule in all three regimes consists of an interest deduction limitation to the level of 30% of the deducting entity's EBITDA. As has been explained by the OECD and can be reasonably assumed to be valid in the context of the EU and Sweden as well, this limit is set to curb the interest deductions that cannot be justified from a business perspective but have been set in place by companies purely or mainly to take advantage of tax rules. The reasoning behind it seems to be that interest paid on loans for commercial reasons is legitimate and should not be limited, while interest paid in the context of transactions without commercial justification should be disallowed as a deduction from the paying company's taxable income. The combination of the selected measure with the aforementioned reasoning can be problematic for the following reasons.

The underlying goal seems to require a qualitative evaluation, i.e. an evaluation of the nature of the underlying transaction which gives rise to the interest payment that the paying entity wishes to deduct. This means that each transaction should be examined regarding its reasons and that the deduction of each payment should be allowed or denied depending on the findings of that examination: valid commercial reasons should lead to allowed interest deduction, while tax planning considerations, leading to the conclusion that the transaction constitutes profit shifting which causes tax base erosion, should lead to a denied interest deduction. The assets, the equity or the earnings of the paying company, the amount of the interest paid, its rate or the corporate income tax rates of the companies involved should not, on their own, be decisive of whether or not the payment would be deductible or non-deductible; they should, by all means, constitute indications pointing to the reasoning of the parties, but they should not, as standalone factors, influence the decision whether the interest payment in question should be deductible or not. In the cases at hand, it is a measure of the paying company's earnings, as expressed by the EBITDA figure, that is decisive of whether interest payments will be deductible or not.

Coming to the selected measure, on the other hand, one can see that it constitutes a quantitative restriction: interest payments up to the chosen limit are deductible, regardless of their nature, and payments beyond that limit are non-deductible, again, regardless of their nature. This means that interest payments that constitute profit shifting for tax considerations can be deducted -unless they are caught by targeted rules, that is- up to the chosen limit, while genuine interest payments made for commercial reasons will be non-deductible if they are above the chosen limit. This effect of the selected measure is inconsistent with the aim that the measure is supposed to achieve, i.e. restrict the deduction of interest payments on qualitative grounds.

The following section 6.2 discusses whether the different tax treatment of debt and equity capital, which is the driving force behind the tax planning with interest deductions that the OECD, the EU and the Swedish measures are trying to counteract, is justified or not. The reason that the answer to this question is important is that most of the measures presented in section 6.3 are trying to achieve the goal of counteracting the profit shifting that takes advantage of interest deductions by eliminating that advantage: namely, by bringing about a greater degree of neutrality in the tax treatment of these two finance forms. Here lies the importance

of the question of justification: if the bias towards debt financing is justified, then tax neutrality between finance forms should not be pursued; if it is not, then it should.

## 6.2 Justification of the debt bias

As FSK notes in its final report, in the area of corporate taxation, the principle of neutrality means, among other things, that the tax system will not distort the companies' investment and finance decisions. The tax discrimination between equity and debt capital violates that principle. This section examines whether that violation is justified.<sup>156</sup>

In its final report, FSK highlights three reasons why a tax bias towards a specific finance form could be justified: if the chosen form had positive externalities, if the form discriminated against had negative externalities, or if the chosen form could lead to a reduction of the total finance costs, including state costs.<sup>157</sup>

The chosen form, in this case debt finance, would have positive externalities, if there would be advantages associated with this form that would benefit neither the investors or the financed company but someone else. That would constitute a positive external effect.<sup>158</sup>

The form discriminated against, in this case equity finance, would have negative externalities, if there would be costs associated with this finance form that would be borne by some other party than the investors and the financed company. These costs would constitute negative external effects.<sup>159</sup>

FSK found no reasons to support the different tax treatment between the two forms of corporate finance.<sup>160</sup> Rather, it found that there are good reasons to pursue neutrality in the tax treatment between debt and equity.<sup>161</sup> The lack of compelling grounds "for giving tax preferences to debt based on legal, administrative or economic considerations" is supported in the literature as well.<sup>162</sup> The argument for allowing debt but not equity deduction is presented as follows: "interest is a cost of doing business [while] equity returns reflect business income"; this idea is deemed to

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<sup>156</sup> Neutral bolagsskatt p. 57.

<sup>157</sup> *Id* p. 101-102.

<sup>158</sup> *Id* p. 102.

<sup>159</sup> *Ibid.*

<sup>160</sup> Neutral bolagsskatt p. 23, 58, 62, 102.

<sup>161</sup> *Id* p. 23.

<sup>162</sup> de Mooij p. 3; Ruf and Schindler p. 30 with further reference.

make no economic sense.<sup>163</sup> Rather, “[i]n economic terms, both payments represent a return to capital and there is no a priori reason to tax one differently from the other.”<sup>164</sup>

## **6.3 Alternative solutions**

Since the bias towards debt financing cannot be justified, as shown above, plus it is harmful, as follows both from the presentation under section 2 as well as from the background of the OECD, the EU and the Swedish provisions under sections 3, 4 and 5 respectively, it will be a positive development if it can be mitigated. There are two general directions available in order to mitigate the debt bias: one is in the direction of interest, examined under section 6.3.1 below, the other is in the direction of equity, analysed under section 6.3.2.

### **6.3.1 The direction of interest**

A development in the direction of interest would involve a regulatory framework that restricts or abolishes interest deductions. The path chosen by the OECD, the EU and Sweden falls into the first category that restrict interest deductions. As analyzed in sections 3, 4 and 5 above, the selected criterion for this restriction is a percentage of the deducting entity’s EBITDA.

These rules are commented on under the following section 6.3.1.1. Section 6.3.1.2 presents rules that disallow interest deductions: the Comprehensive Business Income Tax or CBIT and the finance deduction, which was the main proposal of FSK and essentially constitutes a less extensive variant of the CBIT model.<sup>165</sup>

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<sup>163</sup> de Mooij p. 10.

<sup>164</sup> *Ibid.*

<sup>165</sup> Neutral bolagsskatt p. 146.

### 6.3.1.1 The direction of interest: restrictions

Rules that restrict the deductibility of interest form the category of thin capitalization rules (in the following TCRs).<sup>166</sup> In certain sources there appears a distinction between thin capitalization and earnings stripping rules: the former category seems to include rules that restrict interest deductibility in relation to an entity's assets, whilst, in the case of the latter, the restriction is based on a percentage of the entity's earnings.<sup>167</sup> In other instances, the same sets of rules are referred to as old/safe haven rules, that restrict interest deductibility based on capital structure, and new rules, that achieve the same result based on the company's profits.<sup>168</sup> The distinction is, in any case, not consistent and seems not to affect the practical application of the rules in question.<sup>169</sup> For this reason, for the purposes of this section, TCRs include all the rules that restrict interest deductibility.

Although effective, TCRs have been criticized in the literature:

[even though they] have had some effect on debt ratios, [they] create new complexities and problems. ... these rules are only imperfect solutions to the problem of debt bias and come along with other costs. In fact, they are usually ad-hoc, not well targeted, and are often avoided by firms that can exploit hybrid instruments and international differences in definitions of debt and equity.

Closing loopholes generally leads to refinements and complexities of tax laws.<sup>170</sup>

FSK has expressed a mixed view on the subject. On one hand, it states that TCRs are insufficient and too easy to circumvent; the EBIT/DA model, however, is deemed at its core difficult to circumvent or manipulate.<sup>171</sup> The apparent inconsistency can be attributed to the distinction between thin capitalization and earnings stripping rules mentioned above. On the other hand, it highlights that the EBIT/DA model is the most usually occurring internationally.<sup>172</sup> This quality constitutes an important

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<sup>166</sup> Blouin *et al* p. 1, 3, 7-8; Buettner *et al* p. 2, 4; Buslei Hermann and Simmler Martin, The impact of introducing an interest barrier - Evidence from the German corporation tax reform 2008, DIW Berlin, German Institute for Economic Research, June 11, 2012, p. 1; Haufler and Runkel p. 1; Merlo *et al* p. 7; Ruf and Schindler p. 19; Neutral bolagsskatt p. 147; Ruf and Schindler p. 18; Weichenrieder Alfons J., Windischbauer Helen, Thin-Capitalization Rules and Company Responses Experience from German Legislation, CESIFO Working Paper No. 2456 Category 1: Public Finance, November 2008, p. 2.

<sup>167</sup> Buettner *et al* p. 4; Graetz p. 486; Neutral bolagsskatt p. 148; PWC p. 4.

<sup>168</sup> Buslei and Simmler p. 1; Ruf and Schindler p. 19.

<sup>169</sup> Ruf and Schindler p. 18.

<sup>170</sup> de Mooij p. 14.

<sup>171</sup> Neutral bolagsskatt p. 150, 156.

<sup>172</sup> *Id* p. 156.

factor, because “coordinated policy [in the implementation of] a uniform TCR would ... be ... welfare increasing [and] come at a lower cost than [alternative systems]”.<sup>173</sup>

Last, FSK states that the EBIT/DA model is different from other models in the sense that its interest deduction limitation does not always apply.<sup>174</sup> Namely, as argued under 6.1 above, companies can use interest deduction unhindered by the rule, within the rule’s limit. Partly for this reason there have been proposals for systems that lead to increased neutrality between debt and equity finance: either through denying interest deductions or through allowing deductions for equity.

### **6.3.1.2 The direction of interest: abolition**

The idea to abolish interest deduction altogether, even though it would lead to the neutrality of tax treatment between debt and equity finance, has also been criticized in the literature: “it would also introduce new distortions into investment, and implementing it would be very difficult. For these reasons, no country has moved toward eliminating the deduction.”<sup>175</sup> It can be noted here that the last observation, that no country has moved towards eliminating the deduction, constitutes a significant difference between rules that abolish interest deduction and the EBIT/DA model, as FSK pointed out in the preceding paragraph. Not only, as noted above, is international coordination an important feature for the application of any proposal, but, what is more, the lack of international equivalence was among the reasons that FSK’s main proposal was rejected, as mentioned under section 5.1. Mainly on these grounds, more weight has been put on solutions that move towards the direction of equity. These solutions are explored under the following section 6.3.2. The rest of the current section will present the proposals comprising the rules that disallow interest deduction: the CBIT model and FSK’s finance deduction.

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<sup>173</sup> Haufler and Runkel p. 21; Merlo *et al* p. 4.

<sup>174</sup> Neutral bolagsskatt p. 167.

<sup>175</sup> de Mooij p. 3.



## *CBIT*

The CBIT model achieves full neutrality between debt and equity finance.<sup>176</sup> The way it achieves that is by disallowing deduction of interest expenses.<sup>177</sup>

[An application of the CBIT model is] consistent with a broad, source-based tax on capital income, withheld at the level of the firm. Since all capital income is taxed at the firm level, CBIT can be accompanied by an abolition of PIT [personal income tax] on interest, dividends, and capital gains.<sup>178</sup>

What this essentially means is a “levelling-up” of the effective tax liability for debt finance to equal that of equity finance.<sup>179</sup>

The main advantage of such a system is, of course, that the tax neutrality between debt and equity finance removes the incentive for tax planning in the form of interest deduction. Additionally, the CBIT model broadens the tax base.<sup>180</sup> This can lead to increased tax revenue or it can allow for a reduction of the CIT rate, in the context of a neutral tax reform.<sup>181</sup> Either way, the reduced tax burden on equity can attract multinational equity investment.<sup>182</sup>

On the other hand, there are also disadvantages associated with the CBIT model. Since it raises the cost of debt capital, it can discourage debt-financed investment and thereby, unless the adoption of the system is part of global coordination, reduce the adopting state’s attractiveness for such investment.<sup>183</sup> Furthermore, “it may cause double taxation if countries deny foreign tax credits or exemptions for interest from CBIT countries.”<sup>184</sup> An additional disadvantage is the following.

[I]mplementation [of the CBIT model] will meet practical obstacles and transitional difficulties. For instance, ... in dealing with pre-existing debt. Hence, it can only be implemented gradually over a fairly long time horizon. In the short run, CBIT also risks amplifying financial distress.<sup>185</sup>

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<sup>176</sup> de Mooij p. 15; Bräutigam *et al* p. 168, 179; Neutral bolagsskatt p. 59, 146; Ruf and Schindler p. 30.

<sup>177</sup> de Mooij p. 14; Neutral bolagsskatt p. 59; Bräutigam *et al* p. 168, 179; Ruf and Schindler p. 30.

<sup>178</sup> de Mooij p. 15. *See also* Bräutigam *et al* p. 168.

<sup>179</sup> Bräutigam *et al* p. 179.

<sup>180</sup> Bräutigam *et al* p. 179; de Mooij p. 15; Neutral bolagsskatt p. 59.

<sup>181</sup> de Mooij p. 15; Neutral bolagsskatt p. 59.

<sup>182</sup> *Ibid.*

<sup>183</sup> Bräutigam *et al* p. 180; de Mooij p. 15.

<sup>184</sup> de Mooij p. 16.

<sup>185</sup> *Ibid.*

In any case, “[t]here are no real-world examples of CBIT systems”.<sup>186</sup> As mentioned under section 5.1, the lack of international correspondence was also one of the reasons that FSK’s main proposal was rejected as a base for the Swedish legislation. FSK’s finance deduction is further commented on below.

### *Finance deduction*

FSK’s model, like CBIT, also achieves neutrality in the tax treatment between debt and equity finance.<sup>187</sup> The way it achieves that is by disallowing deduction for negative net interest income.<sup>188</sup> The reason that net income is chosen is in order to avoid chain taxation within groups: this could be the case where a company in a group took an external loan and loaned the money forward to other companies within the group; if both companies were denied deduction for their interest payments but were tax liable for their interest income, then chain taxation would occur.<sup>189</sup>

FSK had reported several advantages with the finance deduction. The most important of those was that it is hard to manipulate or circumvent: the model is, on one hand, independent of size of the interest to be deducted, therefore there would be no incentive to increase a firm’s leverage in order to increase the deduction; what is more, there is neither an incentive to report an inaccurately high profit, as the tax on the increased profit would be higher than the value of the deduction.<sup>190</sup> What is more, the finance deduction would contribute to a simplification of the tax system, as the current rules would be rendered redundant and could be abolished.<sup>191</sup>

Be that as it may, FSK notes that the model has no international equivalence and admits that the CBIT model, on which the finance deduction is based, is too extensive to constitute an appropriate alternative.<sup>192</sup> FSK considered that the difference between its proposal and the CBIT, namely that the finance deduction allows deduction for the interest expenses that are balanced by interest income, made the finance deduction worth examining.<sup>193</sup> The proposal was, however, criticized and finally rejected on these exact grounds, as explained under section 5.1.

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<sup>186</sup> de Mooij p. 16.

<sup>187</sup> Neutral bolagsskatt p. 154, 156.

<sup>188</sup> *Id* p. 154.

<sup>189</sup> *Id* p. 61-62.

<sup>190</sup> Neutral bolagsskatt p. 154.

<sup>191</sup> *Id* p. 154, 156.

<sup>192</sup> *Ibid.*

<sup>193</sup> Neutral bolagsskatt p. 156.

The following section discusses alternative solutions that seek to achieve greater neutrality in the tax treatment of debt and equity finance in the direction of equity. These consist of the ACE (Allowance for Corporate Equity), the ACC (Allowance for Corporate Capital), the COCA (Cost Of Capital Allowance) and the AGI (Allowance for Growth and Investment) models.

### **6.3.2 The direction of equity**

A development in the direction of equity would involve a rule which allows for equity deductions in the same or similar way as interest deductions. The following four models that attempt to achieve a greater degree of neutrality in the tax treatment of debt and equity finance all offer some degree of equity allowance. The most widely proposed and accepted of these is the ACE model, presented in section 6.3.2.1 below.

#### **6.3.2.1 ACE: Allowance for Corporate Equity**

ACE allows a deduction for a notional return on corporate equity.<sup>194</sup> It should be noted here that it is not the actual equity returns that may be deducted according to ACE, but the return of the corporate capital calculated according to a specific pre-determined rate of return. This makes “the determination of the underlying notional interest rate [t]he decisive element of an ACE.”<sup>195</sup> The two parts of the calculation are thus the capital basis and the notional rate.

The basis is calculated yearly. Changes from one year to the next should correspond to changes in equity capital, including both new contributions and retained earnings turned into equity, with a deduction for return on equity capital. The rate should correspond to the risk-free rate for medium term state bonds.<sup>196</sup>

The ACE model does not achieve full neutrality between debt and equity finance for the reason explained above, that the deduction for interest “applies to true interest payments while the equity allowance applies to a notional return.”<sup>197</sup> For this reason, one can be at least a little sceptical when FSK lists tax neutrality among the financial

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<sup>194</sup> Bräutigam *et al* p. 168; de Mooij p. 16; Neutral bolagsskatt p. 144.

<sup>195</sup> Bräutigam *et al* p. 168.

<sup>196</sup> Neutral bolagsskatt p. 144 with further reference.

<sup>197</sup> de Mooij p. 17. *See also* Bräutigam *et al* p. 176.

features of the ACE model, as it mentions the calculation of the notional interest for the equity allowance in the paragraph preceding the comment about tax neutrality.<sup>198</sup>

In the context of a neutral tax reform, since ACE results in a reduction of the tax base and thereby in a reduction in corporate tax revenues, its implementation would require an increase of either the CIT or another tax.<sup>199</sup> More specifically, the “direct estimated revenue cost [of the tax base narrowing through ACE is] approximately 15 percent of CIT revenue, or 0.5 percent of GDP, but this cost can be reduced significantly by accompanying measures.”<sup>200</sup> There are different ways to reduce ACE-related costs in the short and in the long term: “in the short run by restricting the allowance to new investment alone. The long-run fiscal costs would be lower to the extent that the allowance induces favorable behavioral responses, leading to higher investment and employment.”<sup>201</sup>

The ACE model has been praised as “[t]he most promising reform” and “theoretically the best option”.<sup>202</sup> One has, again, a reason to be sceptical, though, as the same literature mentions, as one of the reasons for said praise, that ACE “does not affect the attractiveness of a country as a location for investments in the case of a revenue-neutral implementation”, whereas ACE can lead, as highlighted above, to an increase of CIT or other tax rates, on the grounds of the reduction of the tax base it entails.<sup>203</sup>

Be that as it may, the ACE model has the unique advantage of constituting the only alternative model that has been tested in practice.<sup>204</sup> Not only that, but it has been effective as well: “Evaluations suggest that these ACE reforms have actually been associated with reduced debt-equity ratios”.<sup>205</sup>

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<sup>198</sup> Neutral bolagsskatt p. 144.

<sup>199</sup> *Id* p. 145; Ruf and Schindler p. 30.

<sup>200</sup> de Mooij p. 16.

<sup>201</sup> *Id* p. 19.

<sup>202</sup> *Ibid*; Bräutigam *et al* p. 190.

<sup>203</sup> Bräutigam *et al* p. 191.

<sup>204</sup> Bräutigam *et al* p. 176, 191; de Mooij p. 17.

<sup>205</sup> de Mooij p. 17 with further reference.

### *ACE and CBIT: a comparative evaluation*

The main difference between the ACE and the CBIT model is the following.

The CBIT leads to a “levelling up” to the effective tax levels under equity financing [by increasing the relative cost of debt financing, as shown under 6.3.1.2 above, while] [u]nder the ACE, the cost of capital for equity-financed investments is “levelled down” to that under debt financing.<sup>206</sup>

The aforementioned difference can lead to the following effects regarding these two models: on one hand, the possible increase of the CIT rate that can result from an implementation of ACE can lead to increased BEPS, as the incentive for profit shifting and company relocation will become greater. On the other hand, CBIT could be especially beneficial for countries with a big industrial sector with highly refined and qualified exports of both products and services, like Sweden.<sup>207</sup>

The differences mentioned above notwithstanding, the fact remains that, as explained in the beginning of this section, it is ACE that has been more acclaimed in the literature as well as implemented in practice. In the end, both models are deemed to discourage debt shifting by removing the incentive of debt bias and constitute very attractive alternatives to TC rules.<sup>208</sup>

The following model, the ACC, moves further than ACE in the direction of neutrality in the tax treatment between debt and equity finance and “can be seen as a combination of the properties of the ACE and [the] CBIT [models].”<sup>209</sup>

#### **6.3.2.2 ACC: Allowance for Corporate Capital**

The reason why ACC goes further than ACE in the direction of neutrality is that, as the name suggests, it “allows for the deductibility of a notional return on all capital at the corporate level, which results in a single notional interest deduction for debt and equity.”<sup>210</sup> Here lies the combination of the ACE and the CBIT models: like CBIT, ACC “disallows the deduction of any actual interest payments”.<sup>211</sup> At the same time, like ACE, it allows the deduction of a notional equity return.<sup>212</sup> The new thing about

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<sup>206</sup> Bräutigam *et al* p. 189.

<sup>207</sup> Neutral bolagsskatt p. 154.

<sup>208</sup> Ruf and Schindler p. 31.

<sup>209</sup> Bräutigam *et al* p. 169. *See also* de Mooij p. 17.

<sup>210</sup> Bräutigam *et al* p. 169.

<sup>211</sup> *Ibid.* *See also* de Mooij p. 17.

<sup>212</sup> Bräutigam *et al* p. 169; de Mooij p. 17.

ACC is that it introduces the same notional return on interest as well.<sup>213</sup> In practice, this means that “[a] presumed return on equity can be deducted while interest deductibility is limited to the notional amount.”<sup>214</sup>

The following model, “COCA is a concept similar to the ACC and differs only with regard to the taxation of income at the shareholder level.”<sup>215</sup>

### **6.3.2.3 COCA: Cost Of Capital Allowance**

The COCA model is different from ACE regarding “the tax treatment of dividends and interest income at the investors’ level”. Like ACE, “the tax deductibility of interest expenses is [removed and] replaced by a uniform deduction on both equity and debt invested in the business ... even if the actual dividend or interest payments exceed the amount of the COCA deduction.” The additional element of the COCA model at investor level is as follows.<sup>216</sup>

[I]nvestors are subject to tax with a return on their investments calculated at the same COCA rate as applied by the corporation, regardless of whether they actually receive that return in cash. Payments beyond the anticipated return are not included in the taxable income and thus, in principle, are exempt from taxation.<sup>217</sup>

Another model very close to the ACE is the AGI, explained in the following section.

### **6.3.2.4 AGI: Allowance for Growth and Investment**

As with the ACE model, the AGI also provides for an equity allowance. What is different from ACE is the base on which the allowance is calculated: while, in ACE, “the equity allowance is based on the total amount of equity”, “AGI provides an equity allowance for the incremental changes in equity compared to a reference year.”<sup>218</sup>

Bearing in mind that there are several models aiming to achieve greater neutrality in the tax treatment between debt and equity finance, thus eliminating or, as the case may be, reducing the bias towards debt financing, the following section 6.4 considers

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<sup>213</sup> Bräutigam *et al* p. 169; de Mooij p. 17.

<sup>214</sup> Bräutigam *et al* p. 169.

<sup>215</sup> *Ibid.*

<sup>216</sup> *Ibid* with further reference.

<sup>217</sup> *Ibid.*

<sup>218</sup> Bräutigam *et al* p. 169.

the question why the EBITDA-based TCR was chosen over all of these systems in all levels, the OECD, the EU and also in Sweden.

## **6.4 Interest deduction limitation over tax neutrality: why?**

As mentioned in sections 3-5, the main purpose of the interest deduction limitation rule is to counteract BEPS through interest deductions. Considering that what makes the problematic tactic possible is the different tax treatment between debt and equity finance, one could reasonably expect that the counteracting measure would attempt to address that difference. One reason why this was not the case may have to do with the reasons for which FSK's proposal was rejected in Sweden, namely the lack of international occurrence and the too extensive character of the measure.

The line of this reasoning starts with the argument presented under section 6.3.1.2 about the CBIT model: for an extensive reform, global coordination would be required, as the consequences of such a reform can be negative for a country, or for certain countries, if only it or they reform their tax system in a way that renders them less attractive for international investment. The next step has to do with the observation that, as explained under section 6.3.2.1, in the comparison between the ACE and the CBIT models, different models can be suitable for different countries. The combination of these two arguments leads to the following conclusion: a reform which could lead to greater neutrality in the tax treatment between debt and equity finance may have required a consensus that could not be reached, based on the fact that such a reform would be too extensive as well as the fact that, since it is not common internationally, the number of countries that would have to agree to change their tax regimes in such an extensive manner was too high. This might mean that the chosen interest deduction limitation rule was not selected because it constitutes objectively the best option to counteract the phenomenon of BEPS through interest deductions; maybe it was the best option that the international community could agree on at the time. This opens up the possibility that experience with the interest deduction limitation rule may constitute a step in the direction of greater neutrality in the tax treatment of debt and equity.

## 7 Conclusion

BEPS through interest deduction limitation has led to action from the OECD in the form of Action 4 of the BEPS Project, from the EU in the form of article 4 of the ATAD, and from Sweden in the form of the tax reform including the interest deduction limitation rule proposed by the EU and the OECD. The purpose of the action has been to counteract BEPS-driven transactions, while allowing firms to acquire the debt capital they need for commercial reasons; it requires a qualitative evaluation of the transactions that give rise to interest deductions. The chosen rule, however, sets a quantitative boundary, allowing interest deductions up to 30% of an entity's EBITDA, regardless if said deductions arise from BEPS-related transactions or not, and disallows deductions above that limit, again, regardless of the nature of the underlying transactions.

Bearing in mind that the issue in question, namely the BEPS through interest deductions, is made possible by the different tax treatment of debt and equity finance, one would reasonably expect a measure that would deal with the underlying cause and address this difference. There are, indeed, several models that increase the tax neutrality between these two finance forms. Such measures, however, can have adverse effects for the implementing jurisdictions if the implementation is not globally coordinated. It is thus possible that the chosen interest deduction limitation rule was not selected as the best possible option but rather as the best option on which consensus could be reached at the time. In that case, experience with the rule's application, in combination with further research on the other available models and their effects, may lead to a different, more appropriate measure in the future.



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