Thin Capitalisation

(adopted by the OECD Council on 26 November 1986)

Table of contents

I. THE PROBLEM STATED

A. *Options in corporate financing*

1. The methods by which companies are provided with their capital affect the taxation of corporate income. This arises because the calculation of the taxable income of the company and also that of the persons providing the capital are both affected by the way in which that capital is provided. It is also the case that in countries which levy a tax on net wealth or capital, the way in which a company is financed may have a direct effect on the taxable capital of the company, since debt is usually deductible in arriving at the taxable amount. This report, however, deals only with the taxation of corporate income and profits.

2. There are broadly two ways in which a company may be financed. One is by the issue of shares in the equity of the company and the other is by borrowing. This report is mainly concerned with the taxation problems which may arise from the balance between these two methods of financing. These problems are sometimes referred to, though rather loosely, as problems of "thin capitalisation".

3. The differences between loan capital and equity capital may seem obvious but it is nevertheless pertinent to spell them out briefly. First, there are legal differences. The owner of shares is normally entitled to a proportion of the profits of the company. He is not normally entitled to recover his original investment except on the dissolution of the company and the risks he undertakes are normally limited to the amount of equity capital which he has subscribed or has undertaken to subscribe. He would usually however be able to sell his shares and thus recover the current value of his investment, which might be more or less than the amount he originally invested. The provider of loan capital, on the other hand, is normally entitled to a periodical amount of fixed interest on the amount lent, regardless of what profit, if any, is made by the company. He is normally entitled to recover his investment after a certain period. He may in some circumstances be able to make an earlier sale of his rights to another person, at which point, as with shares, he may recover either more or less than his original investment, although the factors affecting the sale value of a bond may well be different from those affecting the sale value of a share. The provider of a loan risks, as does the shareholder, the loss of his entire investment.

4. Second, there is an economic difference. The fact that loan creditors can look to a periodic fixed reward for the use of their loan capital, and to the return of that capital itself at the end of the loan period, while the subscribers of equity capital (or those who purchase their shares) can be expected to wait for their reward, within reason, until the directors of the company decide that

profits can be spared for distribution rather than reinvestment, means that a company which is mainly financed by equity capital can operate in a very different way from one which is mainly financed by loans. For example it may be able to wait longer for the expected profits to materialise and may have a better prospect of receiving trade credits from suppliers, etc.

5. Perhaps the most important difference from the tax point of view is the fact that equity investment is designed to produce a return for the investor in the form of a distribution of taxable profits while the return on a loan investment is, for the payer, an expense which has to be met before the profits can be established.

B. The choice of financing and the implications for taxation

6. In practice companies are frequently financed partly by equity contributions and partly by loans. The proportion of a company's capital which is financed by each method may well be determined by considerations which arise from economic or commercial necessity or desirability and have nothing to do with tax, and, on this basis, tax authorities have generally tended, in the absence of contrary indications, to regard the way in which a company is financed, as primarily a matter for the judgement of the parties concerned.

7. As a consequence of the fundamental difference between loan and equity capital, however, the tax treatment of a company and the contributors of its capital also necessarily differs fundamentally according to whether the capital is equity or loan capital. As already pointed out, this may obviously be the case where the company's capital is itself the subject of taxation. With respect to the taxation of its income or profits, the basic difference is that the shareholder's reward – the distribution to him of profits, usually in the form of a dividend – is not deducted in arriving at the taxable profit of the company. Indeed, this follows from the fact that what the shareholder receives is a distribution of the profits themselves. Interest on a loan, however, is usually allowed as a deductible expense in computing the taxable profits of the company paying it (being effectively if not specifically regarded as an expense of earning those profits).

8. Thus, in the national context, the rewards of equity financing are first taxed in the hands of the company as profit as well as being subsequently taxed in the hands of the shareholders as dividends, though the economic double taxation may be mitigated (most commonly by giving a credit or some other relief to the shareholder in respect of the company's tax). In the international context, the company's profits are similarly likely to be subjected to tax in the country of source while shareholders also suffer source country tax on the dividend. In both the national and the international

context, the shareholder's tax is likely to be withheld by the payer but, in the international context, the amount withheld is more likely to represent the shareholder's final tax liability to the tax of the source country on that income (though rate of the withholding tax may be limited under the equivalent in a bilateral treaty of Article 10 of the 1977 OECD Model Double Taxation Convention – hereinafter referred to as the "OECD Model", or "the Model"). In the case of loan financing on the other hand the payments of interest (except for excessive interest treated as constructive dividends) would effectively be free of corporate income tax. In both the national and the international contexts the lender is the only person likely to suffer tax on interest payments. In the international context, interest payments, like dividends, are often subjected to a withholding tax, though the rates of such taxes may, under tax treaties, be reduced (often to rates lower than those which would be charged on dividends) or the payments may be exempted from tax altogether.

9. In the international context further complications may arise, for both dividends and interest, by the tax treatment of the payments in the country of residence of the recipient, including the application of any provisions for relieving double taxation. Although some countries generally relieve double taxation by exempting income and others generally relieve it by crediting foreign tax against their own tax, this difference is not always important in the case of interest and dividends because most countries use the credit method in relation to both types of income. However, the distinction between interest and dividends is important in this context in some circumstances for two reasons: first, the rate of foreign tax creditable may differ according to whether the income is of the one or the other kind; second, a special relief is often given to a parent company which receives dividends from a subsidiary under what is sometimes described as a "parent/subsidiary regime", and this kind of relief is not given in the case of interest received by a parent company. Thus, while credit for the tax of the country of source in relation to interest is always limited to the tax charged on the interest itself, credit for source country tax in respect of dividends may sometimes extend under a "parent/subsidiary regime" to a part of the tax charged on the appropriate proportion of the underlying profits out of which the dividend was paid – credit for underlying tax, or "indirect credit". Similarly, countries which ordinarily operate the exemption method will generally, under a "parent/subsidiary regime", simply exempt a dividend rather than relieve its double taxation by way of credit. For a discussion of "parent/subsidiary regime" – see paragraph 42.

10. The broad effect of these two different tax treatments is that it may sometimes, from the tax point of view, be more advantageous to a particular combination of company and contributor to arrange the financing of the company by way of loans rather than by way of equity contributions. Less

frequently it may happen that in particular cases a tax advantage arises from transferring funds as a distribution of profits rather than as a payment of interest. However, tax authorities, for the most part, have been more concerned hitherto about the tax advantages deriving from the use of loan capital rather than equity capital and the fact that these may induce the parties concerned to provide what is essentially equity capital in the form of a loan (sometimes described as "hidden capitalisation"). Tax motives – it is worth repeating – may not be the only factor leading to the decision of a multinational enterprise to use loan capital rather than equity capital in any particular case. The motive may be to preserve the mobility of funds: it may well be easier to repay a sizeable loan than to pay an equivalent amount in dividends, and such flexibility may seem desirable even where the underlying intention is to provide long term capital; there may be a need to ensure that capital is not unnecessarily tied up in one country if for example there is a possibility that, at some not too distant period, it can be more profitably used elsewhere or may be needed to meet an urgent and unexpected demand for funds. Other factors may also be relevant. Nevertheless, the desire to benefit from tax advantages may be the sole or most important motive in this context and tax authorities must therefore consider, in any particular set of circumstances, whether or not this should influence the way they regard the use of a particular method of financing.

11. "Hidden capitalisation" (more strictly perhaps "hidden equity capitalisation") may manifest itself in different ways. One such manifestation may be in the form of what is sometimes described as "hybrid financing". It is necessary at this stage to explain briefly what is meant by this term. It derives from the fact that the broad distinction between debt financing and equity financing, which is mentioned in paragraphs 2 to 4 above, may sometimes be blurred since, for example, creditors may at some stage be able to convert their debt into a participation in the equity of the company, or the interest which they are entitled to receive may be closely dependent on the profits made by the company. In such situations it is not always easy to classify the financing as purely debt finance or purely equity finance. As a result, what is essentially equity capital may possibly be disguised as debt. But the use of a hybrid type of financing does not inevitably mean that hidden equity capital is present. Nor is hybrid financing the only form which hidden capitalisation can take.

12. A description of various indications that hidden capitalisation may be present is contained in paragraphs 75 and 76 below. One of these should be mentioned at this stage however since the way in which it is very often described – *i.e.* as "thin capitalisation" – is often loosely used to describe the whole range of forms of hidden equity capitalisation, and is indeed, for brevity, so used in the title and frequently in the remainder of the body of this report. An indication of the possible presence of hidden equity capitalisation

is a high proportion of debt to equity as a feature of the company's capital structure. In such a case the company is sometimes said to have a "high debt/equity ratio". It is not at all clear what relationship between debt and equity should be taken as the norm in deciding in any particular instance whether a company's debt is high in relation to its equity capital, but a high debt/equity ratio may be an indication of an effort to achieve tax advantages by a disproportionate use of debt. On the other hand, it may well be the consequence of decisions taken for purely commercial or economic reasons and not to obtain tax advantages. It constitutes therefore merely an indication, not proof, of hidden capitalisation.

13. Because the expression "thin capitalisation" is commonly used in its loose sense it has been so used in this report – *i.e.* to describe the whole range of hidden equity capitalisation. Where the text refers only to the specific phenomenon of a high debt/equity ratio or a high proportion of debt to equity, it uses these words and does not use the term "thin capitalisation".

14. The possibility that tax considerations have been the main factor in influencing the capital structure of a company is perhaps more obvious where the capital is provided by majority shareholders or associated companies in a Group, but there could in some circumstances also be tax advantages for unconnected parties in contributing capital by way of a loan rather than as an equity participation.

15. The mechanism of hidden equity capitalisation may be exploited in a variety of ways by a multinational group. The basic advantage is that, other things being equal, a group consisting of a parent company in one country and a subsidiary in another may pay less tax in total if the profits of the subsidiary are transferred to the parent in the form of interest which is deductible in calculating the subsidiary's taxable profits than they would if the profits were transferred as a non-deductible dividend. The insertion into the group of an intervening holding company in a tax haven may combine this advantage with the deferral, perhaps indefinite, of any liability to tax on the income in the hands of the parent company. Alternatively, the insertion into the parent/subsidiary group of one or more holding companies in a country or series of countries linked by suitable tax treaties may enable the funds available to be transferred as tax free interest to the country where, for the group's purposes, they can be most usefully employed. If it should at some stage become more advantageous for the original profits to be transferred as a dividend, the capital structure may well permit the payment of a very large dividend (notwithstanding that the basic equity capital is very small) and it may be possible for interest payments to be waived at the same time. The mechanism of hidden equity capitalisation can thus be exploited to achieve a maximum of flexibility in the movement of funds within a multinational enterprise at a minimum tax cost to the enterprise as a whole. The tax cost of the various

manoeuvres which are possible will however depend on the way in which the domestic tax and other laws of the countries concerned impinge upon them, and the presence or absence of appropriate relieving provisions in any tax treaties between them. Moreover, if for example the country of the parent exempts dividends from relevant foreign subsidiaries or gives the parent companies credit for underlying tax, it may be more advantageous for the subsidiary's profits to be transferred as a dividend.

16. The transfer of profits in the form of interest may also be achieved by the use of abnormal or excessive rates of interest on funds which have unchallengeably been provided as loans, and this may also be a problem for tax authorities. It is sometimes dealt with by domestic law and also by provisions in tax treaties.

C. Tax policy aspects

17. Faced with the fact that the use of loan financing rather than equity financing may have consequences for tax revenue, those concerned with tax policy may have to consider a variety of factors in deciding what, if any, action should be taken in relation to particular cases of the use of loan financing. Some of these factors are detailed briefly below. It is not however the purpose of this description to indicate what importance should be given to each factor or what action should be taken in relation to them. At present, it is clear that they will be given different weights in different countries, and that there is no generally accepted international view about their relative importance or on the approach which should be adopted to the various problems involved:

These factors are as follows:

i) The possibility that some investors may obtain tax advantages by artificially using loan finance rather than equity finance (for example the deduction of dividends in the form of artificial interest payments in the calculation of taxable profits, or the avoidance in full or in part of economic double taxation) whilst others may not have the same opportunity to obtain such advantages may make it necessary to consider whether the relevant law is adequately equitable between taxpayers or neutral between the choices of action available to them;

ii) The possibility that fiscal advantages gained by such artificial loan financing are increased if an associated lender is subject to tax at lower than normal rates or is exempt from tax (for example, by virtue of being a charity or a superannuation fund in some countries) or is able to offset the tax by reliefs (for example because of unused tax credits) or has no taxable profits (for example, because of the carry forward of losses) may make it necessary to consider whether

the income is adequately taxed in total, taking the payer and recipient together;

iii) The possibility that foreign investors may obtain tax advantages in the country of source by artificially using loan rather than equity financing for associated enterprises may pose questions, for that country, about the adequacy of the total tax charged on the payment (taking into account any tax charged in the recipient's country of residence) and the adequacy of the share of that total tax received by the country of source. A wide variety of situations is possible, even, in the extreme case, double exemption (where for example the country of source exempts the payment from tax completely and for some reason no tax is charged in the country of residence of the recipient). Depending on whether the tax advantages in the source country derive from its domestic law or from a tax treaty, consideration may have to be given in that country to the introduction of amending legislation in the one case or the renegotiation of the treaty in the other;

iv) The possibility that tax advantages gained in the source country by a foreign investor from the artificial use of loan financing may be received through a base company situated in a tax haven may raise similar questions but in a possibly more acute form;

v) In any case where a payment is treated as interest for tax purposes instead of as a dividend as a result of an artificial use of loan finance, and this reduces the share of the total tax which is received by the country of source, that country may legitimately consider whether it is receiving an adequate share of the total tax;

vi) The possibility that the artificial use of loan finance rather than equity finance may benefit a foreign enterprise operating through a subsidiary while it does not benefit such an enterprise operating through a branch or other permanent establishment (because interest paid to another company is deductible while interest paid to the head office of the same enterprise is not deductible except in special cases such as banks) may raise the question whether the law in this context is adequately neutral between subsidiaries and branches;

vii) It is also possible to consider, from the viewpoint of neutrality, whether a foreign parent company which is unable to benefit from an imputation system because the tax credit is confined to domestic shareholders, may not try, by the artificial use of loan finance, to obtain an advantage equivalent to that provided by the operation of an imputation system to a domestic parent company;

viii) The possibility that the capacity to derive tax advantages from the artificial use of loan capital may overbalance the scales against equity capital, and may even in consequence worsen the position of trade creditors in general or undermine the stability of national or international investment, may also need to be taken into consideration by the country concerned.

18. Where foreign investment is concerned, the action, if any, which is taken in the light of these or other relevant considerations by the source country of any relevant payment, may affect the tax revenue of the country of residence of the recipient of the payment. It is appropriate therefore to consider the ways in which tax treaties may be involved.

D. Scope of the report

19. The 1979 Report on "Transfer Pricing and Multinational Enterprises" dealt briefly with thin and hidden capitalisation in paragraphs 183 to 191 inclusive but it dealt with them only briefly because they were not central to the issues with which that section of the Report was primarily concerned. In that section the main problem for consideration was how interest payments should be dealt with – *i.e.* the transfer pricing of loans. Thin or hidden capitalisation rules deal however with a preliminary question – *i.e.* whether or not the payment concerned derives from a loan. This preliminary question was left for possible detailed treatment at some later date. The purpose of this report is to clarify some of the main issues involved. It does not seek to define for international purposes acceptable proportions of debt to equity capital. Still less does it seek to harmonise the domestic laws of OECD member countries in the context of thin or hidden capitalisation. Its purpose is simply to consider the elements of these phenomena, to study the international effects of the varying national approaches to them, to note how the relevant national legislation may be affected by tax treaties (in particular those adopting the provisions of the OECD Model Convention) and to study how far unjustifiable juridical or economic double taxation may be relieved, and how bilateral treaties might be drafted so as to avoid such double taxation.

II. COUNTRY PRACTICES

20. This section examines briefly the ways in which the domestic legislation of member countries deals with the problems arising from thin or hidden capitalisation or other situations facilitating the transfer of profit under the guise of interest. Few countries, however, have a comprehensive set of rules or practices in this field.

21. As already indicated, in normal circumstances there is usually no difficulty about accepting that a payment which is ostensibly interest is in fact

what it claims to be. But in some circumstances tax authorities feel obliged to question whether the form of the payment reflects its true nature. In some countries therefore there are specific rules either to deem certain interest to be a distribution of profit or to deem the relevant capital to be an equity contribution and not a loan. These rules normally apply only or mainly in the context of enterprises making payments to foreign associated enterprises.

A. Excessive payments of interest

22. Where a payment between associated enterprises is unchallengeably interest but the rate of interest charged is higher than the arm's length rate, the question of thin capitalisation does not in strictness arise but the situation is one in which it may be possible to regard the excess interest as effectively a transfer of profit (see Article 9 and Article 11(6) of the Model). Some countries therefore, in addition to refusing a deduction for the excess interest in such cases, would also treat it as a dividend. But this is not a universal practice.

B. Hybrid financing

23. Where the nature of the financing is, on the face of it, not clearly either debt or equity, rules may be necessary to decide the issue. Such cases of "hybrid financing" may include participating loans (*i.e.* loans where the interest payable depends in whole or in part on the profits of the borrowing enterprise) or convertible loans (*i.e.* loans which can at some stage entitle the lender to exchange his right to interest for a right to a share in profits) or in some cases sleeping partnerships, or securities where either the right of ownership or the rights attaching to the securities themselves are closely connected with the ownership of shares in the same company. Country practice is not uniform. Participating loans are sometimes, but not usually, treated as equity contributions. Convertible bonds are usually treated as loan capital until they are actually converted but in some cases are automatically treated as equity. Sleeping partners may or may not be treated as shareholders.

24. Rules which have been introduced to treat interest arising from hybrid financing as a distribution of profit have, moreover, sometimes themselves been artificially exploited to give either debtor or creditor a tax advantage, creating a necessity for additional, often complex legislation.[1]

C. Approaches to the treatment of interest as a distribution of profit

25. Where the nature of the financing is ostensibly debt and even where the rate of interest is not excessive and the nature of the financing is not hybrid, the laws in some countries, however, treat interest paid as a distribution of profit for tax purposes, under certain conditions, as a consequence of

approaching the matter in one or other of a variety of ways. In the use of these approaches the emphasis on different factors or combinations of factors often varies from country to country.

i) *General anti-abuse approach – arm's length principle*

The basis of many of these approaches is to look at the terms and nature of the contribution and the circumstances in which it has been made and to decide, in the light of all the facts and circumstances, whether the real nature of the contribution is debt or equity. Some countries apply particular rules in this connection. Others would use more general rules if these are available, such as general anti-avoidance legislation, provisions against "abuse of law", provisions allowing the substitution of substance for form, or enabling abnormal acts of management to be disregarded. Another example of this kind of approach may be described as an arm's length approach. Under this the decision is based on the size of the loan which would have been made in the arm's length situation. The underlying thought is that if the loan exceeds what would have been lent in the arm's length situation then the lender must be taken to have an interest in the profitability of the enterprise and his loan, or at any rate the excess of it over the arm's length amount, must be taken to be effectively designed to procure a share in the profits. Some countries in fact employ this particular kind of approach. Others think that it could be used in appropriate circumstances. A high debt/equity ratio would clearly be one factor to be taken into account in using any of these approaches but would not necessarily be the deciding factor. It does not appear that such approaches have been used very extensively in practice as a basis for treating interest as a distribution for tax purposes. The main difficulty in using any of these approaches is the absence of any clear guidelines as to what are the practices adopted by independent parties, and thus the difficulty of devising any consistent practice (where the parties to a suspected artificial use of loan rather than equity capital are in fact at arm's length, then evidence as to what is normal between other parties at arm's length may carry little weight in any case);

ii) *Fixed ratio approach*

In an effort presumably to overcome these difficulties some countries have adopted what may perhaps be described as a "fixed ratio" approach. Under this, if the debtor company's total debt exceeds a certain proportion of its equity capital, then the interest on the loan or the interest on the excess of the loan over the approved proportion is automatically disallowed or treated as a dividend. A few countries

employ such a fixed ratio in relation to associated enterprises, usually in fairly restricted circumstances, as the sole determinant of the issue. Others use it as a safe haven rule, giving the taxpayer the option of showing that the relevant company's own debt/equity ratio is an arm's length ratio or is otherwise acceptable.

III. RELEVANCE OF TAX TREATIES

A. *The problems stated*

General

26. When, in seeking to counter any tax advantages which the taxpayer may derive from thin or hidden capitalisation, or to protect the revenue against tax loss from these phenomena, tax law or practice treats a *prima facie* payment of interest as a dividend, the consequence of this treatment is usually to deprive the payer of a deduction for the payment and possibly also to apply, in connection with the payment, the rules which deal with dividends instead of those which deal with interest. Where the payment is to a non-resident the question then arises of how this adjustment is affected by any relevant tax treaty. Whether any particular bilateral tax treaty affects the issue will of course depend on the terms of that treaty. In the following paragraphs this report considers the questions which arise under treaties using the provisions of the 1977 OECD Model, with occasional reference to provisions which, though not in the Model, may in fact appear in a number of bilateral treaties. A number of articles of the Model may be of relevance and each of them is considered in turn.

Article 9 of the Model – arm's length principle

27. Article 9(1), in the case of associated companies where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises" allows "any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions have not so accrued" to be "included in the profits of that enterprise and taxed accordingly". The relevance and application of Article 9 in this context raises a number of complex issues. There are four main questions.

28. The first is whether Article 9 itself provides any rules to decide whether a payment which is *prima facie* interest should be treated as a distribution of profit, *i.e.* whether under this Article it is possible to deem the nature of the payment to be something other than interest. The Article is concerned with

the adjustment of profits which have ostensibly arisen to one person but which, in the arm's length situation, would have arisen to another. It is not in terms concerned with the adjustment of distributions of those profits, or the definition of interest and distributions. The basic question seems to be therefore whether, in the arm's length situation, the interest which is deemed to have been a distribution of profit would have been a profit of the ostensible debtor, and, if so, whether Article 9 is apt to allow it to be attributed to him. Article 9 is clearly applicable in deciding the amount of any payment which should be regarded as deductible in arriving at the profits of one or other associated person, and thus in deciding the rate of interest which should be allowed in calculating the amount of the relevant deduction for the payment in arriving at the debtor's taxable profits. The question is whether part or all of the payment can be disallowed as a deduction under Article 9 on the grounds that, in the arm's length situation, it would have been a distribution of profit and thus not a deductible expense. An extension of this question is whether the disallowed payment can then be treated in all other respects as a distribution.

29. On the assumption that Article 9(1) does apply there is a further question as to how it applies – *i.e.* does it limit any adjustment made under domestic thin capitalisation rules to the amount necessary to bring the relevant taxable profits to the "arm's length" profit. In this context it is relevant to consider whether Article 9(1) is:

a) Restrictive or limitative in its scope (in the sense that it prohibits adjustments of profits in circumstances which are not strictly in accordance with the conditions which it enumerates – *e.g.* prohibits the adjustment of profits to an amount exceeding the arm's length amount); or is

b) Illustrative or exemplary (in the sense that it tends only to provide a "conventional" or "treaty" framework for adjustment of profits, and would not prevent a country from making, in accordance with its domestic law, an adjustment to the taxable profit which would bring it to an amount exceeding that which would correspond with the arm's length profit).

30. The "illustrative" interpretation would, it has been suggested, enable a country to make adjustments to profits on the basis of its domestic legislation without having to demonstrate that the conditions of Article 9 were being complied with, provided that it was clearly understood that the country would adjust only the profits of its residents and that the adjustments would not be contrary to any other express provision of the relevant tax treaty.

31. If, in principle, a deduction can be refused under Article 9(1) on the grounds that the payment would be a distribution if in similar circumstances

it was paid to a person at arm's length, there is nevertheless a third question. This is whether, in applying Article 9, the tax authority

a) has to be governed in deciding on the nature of the payment by other definitions of dividends and interest contained in the Model, *i.e.* those in Articles 10 and 11 respectively; or

b) may, under Article 3(2) of the Model apply its own domestic rules. (Article 3(2) provides that "As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies").

32. The fourth question in relation to Article 9 is, assuming that the Article does apply, what practical guidelines or standards are available to assist in the application of whatever interpretation of Article 9 is accepted.

Articles 10 and 11 of the Model

33. The Model defines "dividends" and "interest" in Articles 10 and 11 respectively. A basic question is therefore whether those definitions require payments which are *prima facie* interest to be treated as interest even if the domestic thin capitalisation rules of the country of source treat them as dividends.

34. These definitions are specific to the particular Articles – *i.e.* the term "dividends" is defined by Article 10 as it is used in Article 10 and the term "interest" is defined in Article 11 as it is used in Article 11. A preliminary question is therefore whether the definitions apply outside the Articles in which they appear.

35. The term "dividends" as used in Article 10 is defined by Article 10(3) as "income from shares, 'jouissance' shares or 'jouissance' rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident". The phrase "not being debt-claims" has raised the question whether income from something which purports to be a debt claim is precluded by Article 10 from being treated as a dividend. If it is not, a further question arises, *viz.* whether the income arises from a "corporate right".

36. The Commentary on Article 10 envisages, however, it has been argued, that disguised distributions of profit which are treated as dividends by the State of which the paying company is a resident, may be included as dividends (see paragraph 27 of the Commentary which says explicitly that payments

which are regarded as dividends may include, *inter alia,* disguised distributions of profits). The Commentary also, it has been argued, recognises (in paragraph 15 d) – which, however, is concerned with the meaning of the term "capital" rather than with what is meant by any particular type of capital) that interest may be treated as a dividend. Paragraph 15 d) says that "when a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when, on the basis of internal law or practice ('thin capitalisation' or assimilation of a loan to share capital) the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as 'capital' within the meaning of subparagraph 2 *a*) of the Article".

37. The term "interest" as used in Article 11 is defined in Article 11(3) as "income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures". It has been argued that the phrase "whether or not carrying a right to participate in the debtor's profits" prevents the interest on participating bonds and other interest closely related to the company's profitability from being treated as a dividend under the Convention even though it may be treated as a dividend under the domestic thin capitalisation rules of the country of source.

38. The Commentary on Article 11 elaborates this phrase as follows: "Debt claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest. In the contrary case, where the participation in profits rests upon the provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan and Article 11 does not apply".

39. Article 10 and Article 11 are, however, mainly concerned with the tax treatment of recipients of dividends or interest by the country of source. They do not, directly at any rate, deal with the question of deductibility [which is explicitly dealt with in Article 24(5)]. They do, nevertheless, where interest is treated as a dividend in the source country for the purpose of calculating the paying company's profits, pose two questions. One is how the payment should be treated in the source country for the purposes of that country's tax on the recipient – some countries would treat it in all respects as a dividend for this purpose; others might merely disallow it as a deduction while continuing to treat it in every other way as interest. The other is whether the recipient's country of residence is obliged to accept the treatment as a dividend and give relief accordingly, *e.g.* by way of credit for the dividend rate of withholding tax, or by way of relief under a special "parent/subsidiary regime".

R (4)

40. Paragraph 6 of Article 11 provides that "Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed :upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention". This paragraph therefore raises the question of whether or to what extent it coincides or conflicts with Article 9 of the Model where interest is paid between associated persons, and especially in cases affected by rules dealing with thin capitalisation.

Article 23 of the Model (with particular reference to parent companies and other substantial shareholders)

41. It may be important in applying under a bilateral treaty the equivalent of Article 23 of the Model, to decide whether or not a payment of interest which has been disallowed as a deduction and perhaps treated in all other respects as a dividend by the source country is to be regarded as interest or as a dividend by the country of residence of the recipient. As mentioned earlier, this could be important for one of two reasons – either because the rate of source country withholding tax which is creditable may differ according to whether the payment is treated as interest or as a dividend, or because of the possibility that, as a dividend, the payment may attract relief under a "parent/subsidiary regime". Article 23 of the Model does not provide any guidance in the matter.

42. Article 23 of the Model in fact does not provide for any special relief for dividends paid by a subsidiary company to its parent company. But paragraphs 49 to 54 inclusive of the Commentary on that Article indicate that Contracting States are free to choose their own methods of providing such a relief, and many do, either unilaterally or in accordance with bilateral treaties. The relief may take the form of credit for underlying tax (indirect credit) or it may take the form of complete exemption of the dividend (where in the case of other dividends credit would be given for tax deducted from it). The first form is likely to be used by countries generally operating the credit system of relief for double taxation while the second is likely to be used by countries generally operating the exemption system for this purpose. A third form is to assimilate the treatment of a dividend from a foreign subsidiary to that of a dividend from a domestic subsidiary. In countries where dividends from domestic subsidiaries are exempted this may, in effect, be indistinguishable from the

second form. What constitutes a "parent/subsidiary relationship" for this purpose may however vary from country to country.

Article 24 of the Model (non-discrimination)

43. A further question is whether the non-discrimination Article (Article 24) may prevent the treatment of interest as a distribution of profit under thin capitalisation or hidden capitalisation rules if the treatment applies only in respect of payments to non-residents. Paragraphs 5 and 6 of Article 24 may be of relevance in answering this question.

44. Paragraph 5 of Article 24 provides that "Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State". If paragraph 1 of Article 9 applies to enable interest to be treated as a dividend under thin capitalisation rules, this paragraph accordingly appears not to prevent it.

45. Paragraph 6 of Article 11 allows an excessive payment of interest to be reduced for the purposes of the Article in certain circumstances to the amount which would have been paid if the parties to the transaction had been at arm's length. (The relationship between this arm's length provision in Article 11(6) and the main arm's length rule in Article 9 is discussed in a later paragraph of this report). The excess amount of the interest remains taxable according to the laws of the two Contracting States "due regard being had to the other provisions of the Convention". It has been argued that some, if not all, of an interest payment treated as a dividend under thin capitalisation rules could thus remain liable to be so treated notwithstanding paragraph 5 of Article 24. The Commentary on this paragraph does not, however, throw any further light on this aspect.

46. Paragraph 6 of Article 24 provides that "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected". On the face of it this provision might, it has been argued, prevent the operation of rules which disallow the deduction of interest paid to non-resident shareholders of companies controlled by non-residents if under similar circumstances, the interest would

be deductible for a company which was not controlled by non-residents. The Commentary on this paragraph does not deal with the point.

Article 25 of the Model (mutual agreement procedure)

47. If one country treats an interest payment as a dividend and the treaty partner country continues to regard it as interest, the question arises of whether it may be possible to arrive at a solution to any consequent problems of double taxation under Article 25 (mutual agreement between tax authorities).

B. *Consideration of the effect of tax treaties*

Article 9 of the Model – Impact in general

48. It was generally accepted by the Committee that Article 9 of the Model is relevant to the question of thin capitalisation. It was accepted that the Article itself did not draw a clear line in positive terms between what was interest and what was a distribution of profit. It was agreed however that the Article is relevant not only in determining whether the rate of the interest concerned is an arm's length rate but also in determining whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment (depending on whether or to what extent the funds would have been contributed as a loan in the arm's length situation).

49. The basis for this view is as follows. Article 9(1) allows the tax authority of a Contracting State to adjust the taxable profit of an enterprise of that State to include profits which have not accrued to it in its accounts but which would have accrued to it in the arm's length situation. Thus, if profits have not accrued to the enterprise in its accounts because it has paid what it has described as interest to an associated enterprise and this payment has been deducted in arriving at the profits shown in the accounts but, in the arm's length situation, the payment would not have been deductible, then, in adjusting the taxable profits of the enterprise to include the payment, the tax authority would be acting in conformity with Article 9(1). Provided therefore that the re-categorisation of interest as a distribution of profit under domestic thin capitalisation rules has the effect of including in the profits of a domestic enterprise only profit which would have accrued to it in the arm's length situation there is nothing in Article 9 to prevent operation of those rules.

Article 9 – Whether restrictive or illustrative?

50. If however the effect of such re-categorisation goes beyond this and includes more than the arm's length profit in the taxable profit of the domestic enterprise, the answer to the question whether Article 9 may inhibit

the operation of the relevant thin capitalisation rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this. One group of countries takes the view that where a provision similar to Article 9(1) is included in the convention, it simply prohibits an adjustment of the profits of the resident company to any amount exceeding the arm's length profit. Another group of countries takes the view that while Article 9(1) permits the adjustment of profits up to the arm's length amount it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. A third group, while accepting that there is an absence of such a prohibition in the language used, nevertheless takes the view that the practical effect of Article 9 must often be to impose such a restraint. They point out that the other Contracting State is not obliged to accept an adjustment which is not in conformity with the arm's length principle and would be entitled to include, in its own tax charge on the profits of its own resident associated entity, the portion of the adjustment in the paying country which exceeds the arm's length profit in that country. It may do this in order to bring the profits of its own entity up to the arm's length profit in its own country, with the result that, under Article 9(2), the associated company in the other country whose profits were adjusted in the first place would be able to initiate a claim to a corresponding adjustment to reduce its profits for tax purposes to the arm's length amount. The Committee generally agreed that, in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit, that this principle should be followed in applying existing tax treaties, in particular in the operation of the mutual agreement procedure under the equivalent of Article 25 of the Model, and that it should also be followed in the negotiation of bilateral treaties in the future.

Article 9 – Whether definitions in Articles 10 and 11 apply

51. If, in seeking to apply Article 9, it was thought necessary to decide whether a payment should be regarded as a dividend or as interest, the fact that Article 9 does not itself provide a definition of either term raises the question whether it would be appropriate to apply the definitions in Articles 10 and 11, with the result that, for example, a payment which was clearly interest as defined in Article 11(3) would have to be treated as interest for the purposes of Article 9, notwithstanding that domestic thin capitalisation rules treated it as a distribution of profit. The fact that these Articles specifically define "dividends" as the term is used in Article 10 and "interest" as the term is used in Article 11 may be thought to imply that the definition in each of these two Articles does not apply in relation to any other Article of the Model. However, under the legal practice of some countries this would not prevent

the definitions from being used in relation to other Articles if definitions were required for the purpose of interpreting those other Articles. Under such legal systems, indeed, the definitions in Articles 10 and 11 might well be preferred to other definitions, on the basis that Articles 10 and 11, being Articles of the treaty in question, provided definitions in the closest relevant context. It may be important in consequence to consider these definitions, in thin capitalisation cases, where Article 9 is concerned, as well as where Articles 10 or 11 themselves are concerned. The basic question in relation to Article 9 would however be not so much whether an ostensible payment of interest was a dividend as such, but whether it was a part of the arm's length profit of the paying entity.

52. Where the Contracting States would not be obliged under their domestic law to use the definitions in their equivalents of Articles 10 and 11 of the Model in the application of other provisions of their bilateral treaty, it seems that they would be under no obligation to follow such definitions in deciding whether a payment (and the amount of any deduction allowable for it) could be adjusted under Article 9. Indeed it seems likely that the Contracting States would be able to use the definitions of interest and dividends in the relevant provisions of their domestic law and thus, if appropriate, those provided by their rules about thin capitalisation (whether Article 3(2) would help them in this context is not clear: there is no use of the term "interest" in Article 9 of the Model).

53. Where the law of one or other of the Contracting States would regard the definitions in Articles 10 and 11 as valid in deciding whether or not the amount of a deduction for such a payment could be adjusted under Article 9, it may be necessary for the Contracting States to vary the wording of the equivalent of Article 11(3) in their bilateral treaty so as to protect the operation of their thin capitalisation rules, and to ensure, if appropriate, that payments of interest which are treated as dividends under those rules are treated as dividends for the purposes of those corresponding to articles 10 and 11 of the Model and are also treated as dividends for the purposes of other provisions in the treaty such as those corresponding to Articles 9 and 23. Indeed this may be the most satisfactory course for them to follow in the circumstances.

54. On the other hand, the Model does not specifically require that any payment defined as interest must *ipso facto* be deducted in arriving at the taxable profits of the payer. Although the Model does provide [in Article 24(5)] that, in certain circumstances, if interest is deductible when it is paid to a domestic resident it must also be deductible when paid to a resident of the other Contracting State, this leaves open the question whether the interest would be deductible in the first place. The answer to this question should be the same where the interest is paid to a resident as it is where the interest is paid to a non-resident. However, unless the payment is capable of being

regarded as an expense of earning the relevant profits there seems to be no necessary reason why it should be deducted in arriving at the taxable amount of those profits. If in fact the payment is not an expense of earning the profits but is a distribution of profit, it may be arguable therefore that it may be added back to the taxable profits of the paying entity notwithstanding that it is defined as interest and may indeed be treated in the same way as interest under Article 11. In such a case the automatic application of the definitions in Articles 10 and 11 to the remainder of the treaty may not create difficulty where the domestic thin capitalisation rules of the Contracting State are consistent with Article 9 of the Model.

Article 9 – Practical Guidelines

55. The question of what practical guidelines and standards are available to assist in the application of Article 9 is dealt with in more detail in Section IV below.

Articles 10 and 11 of the Model

56. In considering the terms of the definitions of dividends and interest in Articles 10 and 11 of the Model in this context, the following points were made. The majority opinion was that the specific exclusion of income from debt-claims from the definition of "dividends" in Article 10(3) did prohibit the treatment of interest as dividends under thin capitalisation rules, except where the relevant payments could be regarded as "income from other corporate rights which is subjected to the same taxation treatment as income from shares" by the laws of the relevant country. There seem to be two possible but divergent interpretations of this phrase. A narrow interpretation, based on the fact that interest is defined in Article 11(3) as including income from debt-claims of every kind, would exclude income arising from a debtor-creditor relationship as well as income from all other financial relationships not clearly constituting a participation in the membership of a corporate body. On this view the reference in Article 10(3) to "other corporate rights" is to rights which are not themselves debt-claims (rights which are debt-claims having already been excluded, on this view, from the scope of the definition by the reference to shares, etc. "not being debt-claims"). A broader interpretation would include income arising from any financial relationship which is treated as constituting a corporate right under national law. In fact it might be said that the reference to income from such other corporate rights would make no sense if it was limited to income from shares or other corporate rights already covered in other parts of the definition, and it seems clear also (*e.g.* from paragraph 15(d) of the Commentary on Article 10) that the Model was not designed to frustrate domestic rules for the countering of abusive

arrangements such as might be the effect of thin capitalisation. In deciding this question therefore the majority of the Committee felt that it would in certain cases be appropriate to regard as a dividend a payment which had been treated as a dividend under national rules dealing with thin or hidden capitalisation.

57. In seeking to define the circumstances in which it would be appropriate to do this, the Committee was guided by that part of the Commentary on Article 11 which indicates (see para. 37 above) that debt-claims which carry a right to participate in the debtor's profits are regarded as loans if the contract, by its general character, clearly evidences an interest-bearing loan but, where the participation in profits rests on the provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan. The conclusion reached therefore was that Articles 10 and 11 of the Model did not prevent the treatment of interest as dividends under national rules dealing with thin or hidden capitalisation where the contributor of the loan effectively shared the risks of the company's business.

58. The fact that the contributor of the loan does share the risks of the borrowing company's business will normally have to be established by reference to all the relevant circumstances. The absence of any legal obligations to pay other debts of the company will not necessarily dispose of the matter. A strong risk that a major creditor may not be able to recover his loan may, from the economic point of view, mean in certain circumstances that, effectively, he shares just as much in the risks of the debtor's business as if he was a shareholder. An indication that the risks of the business may perhaps be regarded as effectively shared by the creditor in this way may be derived from the fact that the loan very heavily outweighs any other contribution of capital to the debtor company (or replaces a substantial proportion of other capital which has been lost) and is substantially unmatched by redeemable assets. This may not be a sufficient indication under the laws of every country – it might be necessary, for example, to show that the creditor would participate in any profits of the business or that the repayment of the loan was subordinated to claims of other creditors or to the payment of dividends, or that the level or payment of interest would depend on the profits, or that there were no fixed provisions for repayment of the loan by a definite date. However, there could well be other indications that the creditor effectively shared in the risks of the enterprise's business.

59. In the light of the inclusion of income from participating bonds in the definition of interest in Article 11(3), it was also agreed that interest on participating bonds was not normally to be regarded as a dividend, and it was further agreed that interest on convertible bonds was not normally to be regarded as a dividend until such time as the bonds were actually converted into shares.

60. It was agreed, however, that, in order to remove any danger of ambiguity or overlap between the types of income dealt with respectively by Articles 10 and 11, it should be made clear that the term "interest" as used in Article 11 did not include items of income which were dealt with under Article 10. It was also agreed that it would be desirable to remove the possible ambiguity in Article 10(3) which may support the narrow interpretation described in paragraph 56 above.

Article 9(1) and Article 11(6) of the Model

61. It was generally agreed that Article 9(1) and Article 11(6) may both apply in certain circumstances to allow a tax authority to adjust the rate of interest to that which would have been paid between independent parties and that, in this respect, both provisions had the same effect. It was also agreed, however, that Article 11(6) permits only the adjustment of the interest rates and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under Article 11(6) it would be necessary to substitute other words for the phrase "having regard to the debt claim for which it is paid". (Article 11(6) excludes, from the operation of Article 11, interest which "having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon" in the arm's length situation. In some bilateral treaties the Contracting States have, in fact, in order to overcome this difficulty, excluded instead interest which "for whatever reason" exceeds the amount which would have been agreed upon in the arm's length situation). It was agreed, nevertheless, that Article 11(6) could affect not only the recipient but also the payer of excessive interest, and, if the laws of the source country permitted, the excess amount could be disallowed as a deduction, due regard being had to the other provisions of the Convention.

62. As Article 11(6) is drafted in the Model moreover it creates some possibility of conflict with Article 9, even if the more precise definition of interest in Article 11(3) is not regarded as conclusive for the purposes of Article 9 – the amount of interest might be adjusted under Article 9 but it might nevertheless still be argued that the unadjusted amount should be treated as interest for the purposes of withholding tax etc. under Article 11.

Article 23 of the Model (parent/subsidiary regime, etc.)

63. Since Article 23 of the Model gives no guidance as to whether interest treated as a dividend under thin capitalisation rules in the country of source should also be treated as a dividend in the country of residence of the recipient, the problem ordinarily has to be solved by reference to the particular

terms of any relevant bilateral treaty or by the domestic law of the country of receipt.

64. Where a bilateral treaty provides reliefs under an Article equivalent to Article 23 of the Model, the Committee agreed that, in the case of interest treated as a dividend under the partner country's thin capitalisation rules, the country of residence of the lender would, in certain circumstances, clearly be obliged by the treaty to give these reliefs as if the payment was in fact a dividend (*e.g.* credit for withholding tax suffered at the rate applicable to a dividend, and, where the bilateral treaty provides it, relief under a parent/subsidiary regime) if the text of the Article in question gave the reliefs in respect of "income defined as dividends in Article 10" or even as "items of income dealt with in Article 10". This obligation would arise to the extent that the relevant rules conformed to the provisions of Articles 9, 10 and 11 of the Model as interpreted in the previous paragraphs of this Report (*i.e.* if the contributor of the loan effectively shared the risks of the borrowing company's business, and the profit as adjusted in consequence did not exceed the profit which would have been made at arm's length).

65. If the text of the relevant Article simply gave the relief in respect of "dividends" without referring to Article 10, and if there was no generally applicable definition of dividends elsewhere in the relevant bilateral treaty, the meaning of "dividends" for this purpose would depend on the domestic law of the country of residence of the lender, which would not necessarily accept any extended definition of "dividends" provided by the thin capitalisation rules of the country of the paying company. Nevertheless, the Committee felt that the country of the lender ought to give the reliefs due under the relevant Article, if need be by way of the mutual agreement procedure, in three situations where adjustments had been made under thin capitalisation rules: *viz*

a) Where the interest was treated as a dividend in the country of source by the operation of Article 9 – in such a case the country of residence of the recipient would, if it agreed that the original treatment of the payment as a dividend was justified, be obliged under Article 9(2) to make a corresponding adjustment and it would be in accordance with the spirit of this obligation to accept the treatment of the payment as a dividend for the purposes of its own tax. Logically this rule should also apply to payments considered by the source country under Article 11(6) not to be interest (because excessive) and thus treated as a dividend;

b) Where the country of residence of the lender operated similar thin capitalisation rules and would treat the payment as a dividend in a

reciprocal situation, *i.e.* if the payment were made by a company in its territory to a shareholder in the partner country;

c) Where in any other case the country of residence of the lender recognised that it was proper to treat the interest as a dividend.

Article 24 of the Model (non-discrimination)

66. *a)* The Committee agreed that, if interest is treated as a dividend under thin capitalisation rules in conformity with Article 9(1) or Article 11(6), then Article 24(5) does not operate to prohibit that treatment. If, however, the treatment is not in conformity with these rules and at the same time the thin capitalisation rules apply only where the creditor is non-resident, then Article 24(5) would prevent interest being treated as a dividend under the rules;

b) So far as concerns Article 24(6), the Committee took the view that this paragraph is relevant to thin capitalisation but is worded in very general terms and aims broadly at preventing "tax protectionism" – *i.e.* the deterrence by tax measures of investment from outside the country. It had not, the Committee considered, been designed to deal with measures introduced to prevent the transfer of profits in the guise of interest. Because it is in such general terms, the Committee concluded, it must take second place to more specific provisions in the treaty. Thus Article 24(5) [referring to Article 9(1) and Article 11(6)] takes precedence over it in relation to the deduction of interest;

c) The Committee noted that, notwithstanding the provision of Article 24 of the Model, France has in this context, reserved the possibility of applying the provisions in its domestic laws relative to the deduction of interest paid by a French company to a foreign parent company.

Article 25 of the Model (mutual agreement procedure)

67. The Committee agreed that Article 25 provided an appropriate framework for the solution of problems which arose out of the application of measures dealing with thin or hidden capitalisation and which produced taxation contrary to the letter or spirit of the Convention including otherwise unrelievable double taxation, whether juridical or economic.

68. It is necessary, however, to distinguish between the three different categories of cases dealt with by Article 25. Article 25 provides, in brief, as follows:

i) Paragraphs 1 and 2 provide for the elimination, by mutual agreement between the competent tax authorities of the Contracting States, of taxation which is not in accordance with the Convention, such as

double taxation which might arise from different approaches by the two Contracting States to the interpretation of the Convention in particular cases;

ii) Paragraph 3 of the Article provides, in its first sentence, for the resolution by mutual agreement between those competent authorities of general doubts or difficulties arising as to the interpretation of application of the Convention;

iii) Paragraph 3, second sentence, authorises the competent authorities to consult together for the elimination of double taxation in cases not provided for in the Convention.

69. The Committee agreed that:

a) In relation to the first category – taxation in individual cases – the text of Article 25 enabled adjustments to be made by mutual agreement to eliminate double taxation not in accordance with the Convention in the same way where thin capitalisation rules were in point as in other types of cases, provided that the relevant adjustment was based on the application of a substantive provision of the Convention, for example, the application of Article 9, Article 11(6), Article 23, or Article 24(5) of the Model;

b) In relation to the second category – general problems of interpretation or application of the Convention – Article 25 enabled the competent authorities to endeavour to resolve by mutual agreement, for example, the general problem of whether interest which was treated as a dividend under thin capitalisation rules in a country (being the country of source) could qualify for reliefs under a parent/subsidiary regime granted by the other country (being the country of residence of the recipient) when these reliefs were provided by the relevant bilateral treaty;

c) The third category of relief providable under Article 25 (*i.e.* relief for double taxation not otherwise provided by the Convention) offered wide opportunities for the competent authorities to resolve problems arising from the operation of thin capitalisation rules only if the domestic law of the countries concerned (*i.e.* specific legislation, the rules of the constitution or the general principle of the laws) empowered them to relieve double taxation not specifically covered by tax treaties.

IV. PRACTICAL APPLICATION OF ARM'S LENGTH PRINCIPLE IN RELATION TO THIN CAPITALISATION

70. It is clear from what has been said in Section III above that in cases where thin capitalisation rules have international implications it is important that their application should accord with the arm's length principle as delineated in Article 9(1) of the Model Convention. Consideration is therefore given in the following paragraphs to the practical application of this principle in such circumstances. It is recognised however that it is difficult to provide precise guidelines for drafting national legislation on these questions. The comments in the following paragraphs may nevertheless, it is hoped, be helpful in this context.

71. The matter was considered briefly in the 1979 report on "Transfer Pricing and Multinational Enterprises" (paragraphs 183 to 191 inclusive) (referred to hereafter as "the 1979 Report"), and it is pertinent to refer now to what was said then. The 1979 report indicated that thin capitalisation could create problems for tax authorities and described the different ways in which some member countries sought to deal with these problems. It pointed out that the operation of different rules by different countries created a distinct possibility that the same financial transaction could be treated as a loan by one country and as an equity contribution by another. This, it commented, was an unsatisfactory situation which it would be desirable to improve. The report posed the question whether, in time, member countries could move in directions which would achieve such an improvement by effectively harmonising their domestic legislation in this field. But it did not provide any but the most tentative guidelines as to how this might be done. Its Recommendations are contained in paragraph 191 which it is appropriate to quote here in full. The paragraph reads:

> 191. It is generally recommended that a flexible approach should be adopted in which the special conditions of each individual case would be considered, although it is realised that such an approach would call for sufficient qualified staff to carry out a somewhat sophisticated analysis and could, if cases were numerous, thus raise problems for some tax administrations. A hard and fast debt-equity rule would, however, not be appropriate for the solution of problems raised by the determination of the nature of a financial transaction. Financing practices differ too widely from one country to another, and, within a given country, between different categories of enterprises. Most of the countries whose practices are described in the previous paragraphs, therefore, refer to a number of factors which are of significance in distinguishing a loan from an equity contribution. On the same reasoning, it is considered that a

rule based on the fact that the owner of the shares was non-resident would not be appropriate for general adoption either.

72. As has already been pointed out, the arm's length principle is relevant in deciding whether or not a *prima facie* payment of interest derives from a loan or from an equity contribution because, if more than the arm's length profit on the relevant transaction is charged to tax, economic double taxation may arise as a result. This would create a situation in which Article 9(2) or some similar provision might be invoked to secure a reduction of the tax charged in the first country to tax on the arm's length profit there. More generally, however, the Committee takes the view that, at any rate in cases where fraud or abusive avoidance arrangements are not concerned, it would be inconsistent with the spirit of Article 9 of the Model if the arm's length principle which is expressed in that Article was not followed in answering the question whether or not a *prima facie* payment of interest derives from a loan or from an equity contribution.

73. Article 9 may not however be strictly applicable. If the loan which is being treated as an equity contribution is a loan between ostensibly independent persons, and Article 9 therefore does not apply, as may possibly be the case if the thin capitalisation rules attack abusive arrangements designed to conceal the fact that the real parties to the transaction are associated enterprises, then it is very doubtful whether the tax authorities of the paying entity would be able to adjust the payment, but also very doubtful, if they did adjust it, whether they should be obliged to make any special effort to relieve double taxation arising from the operation of such measures.

74. Where Article 9 is, in terms, applicable, *i.e.* broadly, where the relevant transaction is one between associated persons, it is relevant to consider how far the various methods of deciding whether a payment should be treated for tax purposes as interest or as a dividend, are consistent with the Article. As already indicated, these methods generally follow one or other of two main approaches.

75. The first main approach depends very much on the particular facts and circumstances of each case. The authorities would seek to decide what is the real nature of the payment in the light of reason and the general observation of commercial activity. In such an examination a variety of factors would be relevant including evidence of what happens or could reasonably be expected to happen between independent parties. It could thus be relevant, *inter alia*, that the borrowing enterprise was a company which had a high debt/equity ratio either before the loan was granted or as a result of it, that the loan was designed to finance the long term needs of the borrower, that the loan was contributed proportionately to existing shareholdings or as a condition of such shareholdings, that the loan was designed to improve the financial

situation arising from heavy losses, that the interest payable was dependent on the result of the company's business, that the loan was convertible at some stage into a share of the company's equity, or that the interest exceeded a reasonable commercial return on the money lent. Another relevant factor might be that the payment of interest on the loan or the repayment of the amount lent was subordinated to the rights of other creditors, and yet another might be the absence of fixed provisions for repayment of the loan by a definite date or the presence of provisions making repayment dependent upon the level or timing of profits. The presence of any one of such factors by itself would not necessarily be conclusive evidence, though it might be an important indication, of hidden equity capitalisation, but the presence of several such factors would be more indicative and clearly the indications would be stronger the more such factors were present.

76. In considering these factors the question may be asked whether an independent person would have provided such a high proportion of the capital of the enterprise in the form of a loan. In some cases it could perhaps be shown that no independent person would be satisfied with the fixed interest return envisaged in the relevant transaction, bearing in mind the risk involved and the profit potential of the enterprise, but would require a share in the profits as a condition of providing the funds. Or it might perhaps be shown that no independent person, bearing in mind the poor economic condition of the enterprise, would make a loan to it at all. It may be necessary indeed to adopt an approach comparable to that which a banker would adopt, and to ask whether, considering the borrower's financial and economic condition, an independent bank would have provided the funds as a loan on the terms actually agreed between the parties. Too rigid a reliance on this approach may not however be wholly satisfactory since it is possible that a parent company might have a better understanding of the profit potential of its own subsidiary than would a banker looking at the matter from the outside, and it might in consequence be reasonable to accept (if such was in fact the case) that an independent person who was as fully informed as the parent company might lend where a bank would hesitate to do so. Where it is a question of the supply of additional capital by way of loan it may be appropriate to ask – again looking at the subsidiary's economic situation with a banker's eye – whether in the circumstances an independent person would perhaps lend to protect his original investment, or, on the contrary, would decide to cut his losses.

77. There is a considerable amount of evidence about the forms of financing which are in fact used in particular cases in the open market. But it may sometimes be very difficult to discern what adjustment should be made in any particular case of arrangements between associated enterprises in order to bring those arrangements into line for tax purposes with the arrangements which would be made by independent parties in the relevant circumstances.

This is because a wide range of open market forms of financing may be available and appropriate for any particular type of case, depending to a certain extent on varying market conditions. Nevertheless there may be sufficient general evidence of the ratios between equity and loan prevailing in the market place to indicate any very wide divergence from the normal in any particular case.

78. Much would obviously depend, in the operation of such an approach, on the judgement of the tax authorities in the first place and, in the last resort, on the judgement of the courts or tribunals deciding appeals against the decisions of the tax authorities. Nevertheless, methods of deciding questions which follow from such a facts and circumstances approach are clearly consistent, it seems to the Committee, with the arm's length principle to the extent that they use evidence of transactions between independent persons and apply this evidence in a reasonable manner.

79. Another approach is to deem ostensible payments of interest to be distributions of profit if the debt/equity ratio of the paying company exceeds a fixed ratio. Such a ratio is bound to be arbitrary to some degree, even though it might be fixed by reference to the kind of ratio commonly found in the open market. Where however such a ratio is employed merely as a kind of "safe haven" rule, leaving the relevant company the option of showing that the actual ratio of the company's debt to its equity capital is an arm's length ratio (perhaps, for instance, by demonstrating that it corresponds to the ratio which is characteristic of independent companies in the same kind of business in the same country) then this too could be regarded as compatible with the arm's length principle. It is relevant to point out however that the availability of such an option nevertheless imposes on some taxpayers a burden of proof which may be quite heavy. It is important therefore that any safe haven ratio which is adopted by a tax authority should allow as high as possible a proportion of debt to equity or should be otherwise so flexible as to minimise the number of taxpayers who are obliged to make use of the option. Where, on the other hand, a fixed debt/equity ratio is employed by the tax authorities without allowing such an option, then the majority of countries consider that the results would undoubtedly be inconsistent with the arm's length principle. The lower the ratio of debt to equity permitted by such a rule, and the more rigid the practice followed in applying it, the more serious may be the danger of producing a result which is both inconsistent with the arm's length principle and disadvantageous to the taxpayer. Moreover the lower the ratio the greater may be the risk of economic double taxation and the possibility that the tax authorities of the country of the lender will find it difficult to accept the result and give satisfactory relief from double taxation. Similarly the higher the ratio the greater will be the likelihood of producing a result which unduly favours the taxpayer.

80. Where abusive arrangements are relevant in this context and general anti-evasion or anti-avoidance rules (such as those against "abuse of law" or those substituting substance for form) are invoked to deem interest to be a distribution of profit, it is for consideration whether or not the tax law should require the authorities to ensure that taxation arising from the impact of such measures conforms with the arm's length principle. The Committee however makes no comment on the point.

81. The preceding paragraphs deal with questions relating to the taxation of income and profits. It seems to the Committee that where, in accordance with the arm's length principle, a loan is effectively recategorised as an equity contribution for those purposes, it might *prima facie* be similarly recategorised for the purposes of the taxation of the capital of the company.

V. CONCLUSIONS AND SUGGESTIONS

A. *General*

82. The conclusions of paragraph 191 of the 1979 report still represent the view of the Committee. While the Committee in 1979 generally recommended flexible methods of deciding the question whether a *prima facie* payment of interest should be treated for tax purposes as interest or as a distribution of profit and recommended against using hard and fast debt/equity ratios, or rules based on the fact that the shareholder receiving such interest payments was a non-resident, the 1979 report essentially left member countries to devise and implement whatever rules seemed appropriate to each individual country in these matters. In this, paragraph 191 reflected the absence of any firm international consensus on how thin capitalisation problems should be dealt with.

B. *Summary of conclusions concerning the application and interpretation of tax treaties*

83. The Committee has nevertheless now reached conclusions on a number of points concerning the relationship between tax treaties and domestic rules about thin capitalisation. These are summarised below.

84. As regards Article 9 of the Model, the Committee is of the opinion that:

a) The Article is relevant when countries are applying their domestic rules about thin capitalisation (see paragraph 48);

b) The Article is not only relevant in adjusting the rate of interest, but also, in appropriate circumstances, in determining whether what is presented as a loan should be considered as a contribution to equity capital (see also paragraph 48);

c) The Article does not prevent the application of national rules on thin capitalisation insofar (but only insofar) as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation (see paragraph 49).

85. As regards Articles 10 and 11 of the Model, the Committee is of the following opinion:

a) Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company. When interest of this kind is in point Articles 10 and 11 do not prevent the treatment of interest as dividends under the national rules on thin capitalisation of the borrower's country (see paragraph 57);

b) i) In the light of the definition of interest in Article 11(3), interest on participating bonds should not normally be regarded as a dividend,

ii) Interest on convertible bonds should not normally be regarded as a dividend until such time as the bonds are actually converted into shares,

iii) Article 11(6) enables the amount of interest to be corrected but not the recharacterisation of the relevant loan as a contribution to equity capital (see paragraph 59);

c) It is desirable to remove a possible danger of ambiguity or overlap between the types of income dealt with respectively by Articles 10 and 11 (see paragraph 60).

86. As regards Article 23 of the Model and certain additions to that Article which appear in a number of bilateral treaties, the Committee is of the opinion that:

a) When by the application of its national rules about thin capitalisation, the country of the borrower has assimilated a payment of interest to a distribution of profit, the country of the lender would in certain circumstances clearly be obliged under particular bilateral treaties, as the result of a combination of Articles corresponding generally to Articles 10 and 23 of the Model, to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend (such as credit for tax withheld at the source at the rate appropriate to a dividend and, possibly, application of a parent/subsidiary regime) (see paragraph 64);

b) In other cases also (see paragraph 65), the country of the lender ought to give relief for any juridical or economic double taxation of the

interest as if the payment was in fact a dividend, if need be by way of the mutual agreement procedure, in three situations, *viz:*

i) Where the interest has been treated in the country of source as a dividend or distribution of profit under rules which are in accordance with Article 9(1) or Article 11(6) and where the country of the creditor agrees that it has been properly so treated and is prepared to apply a corresponding adjustment as provided for article 9(2),

ii) Where the country of residence of the lender, also having provisions against thin capitalisation, would apply these provisions (*i.e.* would assimilate the payment to a dividend) in a reciprocal situation (*i.e.* when the payment was made in the same circumstances by a company established in its territory to a resident in the other Contracting State),

iii) In all other cases where the country of residence of the lender agrees with the adjustment made by the country of residence of the borrowing company.

87. *a)* As regards Article 24(5) of the Model the Committee came to the conclusion that it follows from the wording of Article 24(5) that the country of the borrower is not prohibited from assimilating interest to dividends under thin capitalisation rules which are consistent with Article 9(1) or Article 11(6). However, if interest is assimilated to dividends under rules which are not consistent with these Articles, and if the rules apply only to non-resident lenders (and not to resident lenders) then Article 24(5) does prohibit such an assimilation [see paragraph 66(a)];

b) As regards Article 24(6) of the Model the Committee came to the conclusion that Article 24(6), though relevant in principle, is worded in such general terms that it must take second place to more specific provisions in the treaty and that Article 24(5) would, in particular, take precedence over it in relation to the deduction of interest [see paragraph 66(b)];

c) France has entered a general reservation on the effect of Article 24 in the context of rules about thin capitalisation [see paragraph 66(c)].

88. As regards Article 25 of the Model, the Committee (see paragraph 69) concluded that:

a) Paragraphs (1) and (2) of Article 25 enable adjustments to be made by mutual agreement in individual cases, to eliminate double taxation not in accordance with the Convention, in the same way where thin capitalisation rules are in point as in other types of cases, provided

that the relevant adjustment is supported by a provision of the Convention corresponding for example to Article 9, Article 11(6), Article 23, or Article 24(5) of the Model;

b) Insofar as paragraph (3) of Article 25 offers the possibility of generally resolving difficulties and doubts encountered in the interpretation or application of the Convention, it enables the Contracting States to endeavour to resolve by mutual agreement the question of whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when such relief is provided by the relevant bilateral treaty);

c) In certain circumstances Article 25, which offers the competent authorities of certain countries the possibility to resolve problems of double taxation not foreseen by the convention, may also provide for the possibility to solve problems arising from the operation of thin capitalisation rules.

C. Final remarks

89. The Committee emphasises that the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to an amount greater than the profit which would have accrued in the arm's length situation, that this principle should be followed in applying existing tax treaties, in particular, for example, in the operation of the mutual agreement procedure under the equivalent of Article 25 of the Model, that it should also be followed in the negotiation of bilateral treaties in the future, and that it should be taken into account in any future revision of the Model. It should be noted, however, that Germany has certain reservations on the way in which the report uses the "arm's length principle" (see note 2).

90. The Committee urges that national thin capitalisation rules should provide sufficient flexibility to allow the relief of any consequent double taxation where such relief is appropriate, and, further, that where double taxation arises because of a conflict of view between tax authorities about the nature of a *prima facie* payment of interest, or the impact of rules about thin capitalisation, the tax authorities concerned should endeavour to resolve the conflict by mutual agreement under the relevant bilateral tax treaty.

91. The Committee also suggests that the considerations set out in the above Report should be taken into account by OECD member countries in the

application of existing bilateral tax treaties and in the negotiation of new such treaties.

Notes and References

1. Thus in the United Kingdom until recently certain companies seeking new finance found it advantageous to borrow from banks in such a way that the interest was treated, under United Kingdom law, as a distribution of profit for tax purposes. This was achieved by giving the lending bank a connected right to a small participation in the company's profits. The companies were induced to make this kind of arrangement because they were unlikely to derive any benefit from a deduction for interest for some years to come and were open to an offer of a substantially reduced rate of interest in return for providing the banks with an advantage. The companies were unlikely to make any taxable profits for some years to come because, quite apart from any possible deductions for interest paid, they were carrying forward heavy losses or massive reliefs for capital investment or large reliefs for inflationary increases in the prices of new stock. The banks could benefit from the receipt of distributions rather than interest because they could use the advance corporation tax (ACT) paid in respect of the "distributions" as a credit against the ACT which they would have to pay on making distributions to their own shareholders, and could effectively pass the distributions directly on to their own shareholders without first including them in the total of their taxable profits. The banks thus paid no tax on the remuneration which they received for making the loans and in consequence were able to make the relevant loans at a lower rate of interest than they would otherwise have felt the need to charge. For the companies the immediate benefit of a lower gross rate of interest outweighed the more or less indefinitely deferred benefit of a possible tax deduction for a larger gross amount even if this might have produced a lower net expenditure.
2. The Federal Republic of Germany welcomes the report as a highly important contribution to understanding problems of thin capitalisation but cannot accept it without a general reservation, essentially with respect to the way it makes use of the "arm's length principle". In this context the Federal Republic of Germany
   - Takes note, that the report is based rather on the notion of an "arm's length profit" rather than on the generally accepted notion of an "arm's length price";
   - Points out that the consensus regarding the actual application of the "arm's length principle" is extremely vague and precarious;
   - Regrets that the report might lead to diminishing the protection provided for under Article 25 of the OECD Model against discrimination, namely where a state's thin capitalisation rules are justified by a one sided claim to stay within the "arm's length principle".

   The Federal Republic of Germany, furthermore, reserves its attitude to the report's interpretation of the dividend definition. It is, however, ready to co-operate in the spirit of the report in order to avoid double taxation by mutual agreement.