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

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The Issue

The deductibility of interest

Traditional thin capitalization rules between related parties

Comprehensive interest barriers

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

Deduction of interest – Debtor state

Non-deductible interest = Excess interest

Deductible interest

Taxation of interest – Creditor state

Total amount of interest paid

Partial tax reform:
- Interest box?
- Defiscalization of interest?
- Partial solution of the economic double taxation of interest between related parties through the EU Interest and Royalties Directive.

Radical tax reform:
- Global apportionment?
- Taxation of interest – Creditor state

Methodology

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

Compatibility with basic tax principles:
- Ability-to-pay principle
- Net-income principle
- Benefit principle
- Arm’s length principle

Nature of comprehensive interest barriers

Investigation of possible solutions to solve international double taxation of interest:
- OECD Income and Capital MC
- European Union law
- Unilateral measures

Research Questions

Are there other fair and neutral solutions to reform the way that interest is deducted and taxed in the international tax framework?

Introduction

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

Preliminary Findings

The deductibility of genuine interest expenses incurred to earn business income, as well as of arm’s length interest payments paid to independent third parties, is disallowed under comprehensive interest barriers.

In an international context, these rules result in economic double taxation as the creditor state is not likely to exclude the non-deductible interest, determined in accordance with a purely domestic standard, from its tax base.

Potential use of the new Article 7 OECD MC to establish an international consensus for the capital structure of a company.