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Non-Discrimination in Tax Treaties: Selected Issues from a Global Perspective

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International Tax Law: New Challenges to and from Constitutional and Legal Pluralism

Why this book?
While the principle of non-discrimination's core concept remains stable, its importance in tax matters keeps growing. As its implications, regional dimensions and topical applications very frequently change around the world, constant monitoring and updating is essential to seize its current essence. Non-Discrimination in Tax Treaties: Selected Issues from a Global Perspective aims to find a global dimension of the non-discrimination principle in tax law through the analysis of issues with theoretical and practical importance. The editors have selected the following issues, which nine leading European and international tax law experts address in the framework of related topical studies:

- Nationality non-discrimination and article 24 of the OECD Model Tax Convention
- Non-discrimination on the basis of nationality in international investment agreements from a Latin American tax perspective
- Interest deduction limitations and when to apply articles 9 and 24(4) of the OECD Model Tax Convention
- Revisiting the application of the capital ownership non-discrimination provision in tax treaties
- Non-discrimination in tax treaties and article 24(4) and (5) of the OECD Model Tax Convention: a Russian approach to tax treaty interpretation in connection with domestic thin capitalization rules
- Non-discrimination under WTO law and article 24 of the OECD Model: how policy considerations influence comparability and whether less favourable treatment of tax havens and hybrid mismatch arrangements constitutes unjustified discrimination
- Can the European Union learn from the OECD Model Tax Convention and vice versa?
- Non-discrimination à la Cour: the ECJ's (lack of) comparability analysis in direct tax cases
- Discriminatory taxation and the European Convention on Human Rights

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Preface

The non-discrimination principle is an evergreen of international law and tax treaties in particular. While the core concept of non-discrimination remains stable, the principle's importance in tax matters keeps growing. As its implications, regional dimensions and topical applications can be seen to change very frequently around the world, constant monitoring is required.

This book is not a comprehensive study of the non-discrimination principle in tax matters, but rather the search for a global dimension of non-discrimination in European and international tax law through the analysis of a reasoned selection of issues with theoretical and practical importance.

We conceived this book as the first example of research-based teaching supplements written specifically for the students of the Advanced LLM on International Tax Law [http://als.uva.nl/programmes/advanced-masters-programmes/content/international-tax-law/international-tax-law.html], which the University of Amsterdam (UvA) co-organizes with the International Bureau of Fiscal Documentation (IBFD). Accordingly, this book combines the flavours of principles, policy and practice in the framework of scientific duets that contribute to the overall mission by enriching the European legal dimension with different legal and geographical scenarios.

We trust that our Advanced LLM students and all other categories of readers of this book – particularly scholars and practitioners – will enjoy linking up its various chapters with a view to extracting the common elements and divergences that are connected with the global dimension of non-discrimination in tax matters.

There are basically two ways in which to read this book. The first is the more traditional approach, i.e. to go through the book systematically, chapter by chapter. However, we would also like to suggest a second and new way of enjoying its content, namely by going through its overt and covert duets.

A good example of an overt duet is formed by the topical studies authored by Catalina Hoyos Jiménez and Werner Haslehner, since both of them focus on nationality-based discrimination. Hoyos combines the Latin American geographical view with the requirements of non-discrimination under international investment agreements. Where Hoyos' chapter shares some relevant elements with the one drafted by Kasper Dziurdz on the WTO dimension of non-discrimination, this creates a covert duet. The chapter by Dziurdz, in turn, interacts with several other chapters.

The other author in the above-mentioned overt duet, Haslehner, looks at nationality-based non-discrimination from an OECD perspective, thereby providing an interesting analysis of the traditional issues in the context of recent trends and new approaches. This chapter can be linked up with three more studies – authored by Frans Vanistendael, Otto Marres, and Bruno da Silva – which address the other facets of article 24 in the OECD Model Convention. In addition, our readers may find it interesting to learn from the chapter authored by Danil Vinnitskiy how Russian tax treaty practice differently interprets non-discrimination clauses whose wording resembles the OECD Model Convention.

Another interesting duet, namely the one resulting from juxtaposing the chapters drafted by Peter Wattel and Frans Vanistendael, presents a purely European scope and gives a more concrete dimension to the boundaries of non-discrimination in supranational law of the European Union. Such chapters are further enriched by the study of Robert Attard, who addresses non-discrimination from the perspective of human rights. The growing relevance of the Charter of Fundamental Rights of the European Union and its structural link with the European Convention of Human Rights is in our view expected to strengthen this dimension of non-discrimination in the near future.

We trust that our readers will enjoy this book and appreciate the underlying concept, which we regard as a thought-provoking experiment to get the international tax community to reflect upon the nature of its most traditional categories – a nature, we feel, is a dynamic one – at a time when global tax law is evolving.

Pasquale Pistone and Dennis Weber
Amsterdam, 19 January 2016

Chapter 3

Interest Deduction Limitations: When To Apply Articles 9 and 24(4) of the OECD Model?*

Otto Marres

3.1. Introduction

The purpose of tax treaties is primarily the avoidance of international double taxation. The means to achieve this objective is the allocation of taxing rights. Computation of the tax base is a different matter, as it is, in principle, at the discretion of each state. In the Commentary on the OECD Model (2014)[1] it is acknowledged that articles 6 to 22 of the OECD Model do not interfere with the computation of the tax base.[2] There is no rule in the OECD Model providing for the deduction of interest income. This was acknowledged in the OECD's Thin Cap Report, wherein it is stated that "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."[3] With reference to article 24(4)[4] the OECD stated that this provision "leaves open the question whether the interest would be deductible in the first place". This is at the discretion of the contracting states. But there are constraints in the OECD Model that the legislature has to comply with. One of these is article 9(1), which prohibits transfer pricing adjustments that do not comply with the arm's length standard. A second restraint is article 24, in particular paragraph 4, which provides that interest paid to a resident of the other state is deductible under the same conditions as interest paid to a

* This chapter reproduces an article by the author first published in 56 European Taxation 1 (2016), pp. 2-14.

1. *OECD Model Tax Convention on Income and on Capital: Commentary* (15 July 2014), Models IBFD.

2. *See* para. 8 *OECD Model: Commentary on Article 23 A* (22 July 2010), Models IBFD: "Articles 6 to 22 also lay down rules attributing the right to tax in respect of the various types of income or capital without dealing, as a rule, with the determination of taxable income or capital, deductions, rate of tax, etc.…" *See* paras. 7 and 55 *OECD Model: Commentary on Article 7* (17 July 2008), Models IBFD; para. 30 *OECD Model: Commentary on Article 7* (2010); para. 4 *OECD Model: Commentary on Article 6* (2010) and para. 10 *OECD Model: Commentary on Article 17* (2010).

3. OECD Report, *Thin Capitalisation*, adopted by the OECD Council on 26 November 1986, published in *Issues in International Taxation, No. 2, Thin Capitalisation; Taxation of entertainers, artistes and sportsmen*, para. 54 (OECD 1987) (hereinafter "Thin Cap Report").

4. Until 1992: article 24(5).

resident. Although both articles 9(1) and 24(4) may apply to interest deduction restrictions, such as thin capitalization rules, they cannot apply simultaneously in view of the carve-out in article 24(4) for adjustments based on article 9(1). The reason for this may be that the type of tax base erosion that is dealt with in article 9(1) is a phenomenon that typically arises in an international context. Tax base protection is therefore typically targeted at loss import or profit shifting in a cross-border context and will, in many instances, result in discriminatory treatment of cross-border situations. The question, therefore, which is addressed in this contribution, is when to apply article 9 (i.e., in which scenarios must the domestic measures comply with the arm's length standard and the other state, in principle, make a corresponding adjustment), and when to apply article 24(4) (in which event the domestic measure may not discriminate between domestic and cross-border payments). Furthermore, the author briefly discusses article 24(5) of the OECD Model. The article then compares the solution in the OECD Model with the solution chosen by the Court of Justice of the European Union (ECJ) on the issue of whether discriminatory transfer pricing and thin capitalization provisions are contrary to the fundamental freedoms of the Treaty on the Functioning of the European Union (TFEU) (2007).[5]

3.2. The arm's length standard

3.2.1. Article 9 of the OECD Model

3.2.1.1. Illustrative or restrictive?

Transfer pricing rules serve to allocate income earned by multinational enterprises among those jurisdictions in which these enterprises have a taxable presence. Article 9 of the OECD Model (2014) sets the arm's length principle as the allocation norm. Although the wording of article 9(1) ("may be included") might suggest otherwise, the provision must be understood as restrictive instead of illustrative: the arm's length standard is obligatory. This is also stated in the Commentary: "No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis);"[6] although it must be admitted that there is conflicting evidence in the Commentary, in particular reference to a number of countries

5. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.
6. Para. 2 *OECD Model: Commentary on Article 9* (2010).

that interpret the article such that it does not bar a profit adjustment under national law under different conditions.[7] The majority view in the literature is that the provision must be understood as restrictive.[8] Wittendorff (2010) convincingly argues that the purpose of article 9(1), preventing (economic) double taxation resulting from different allocation norms, and the need for the provision to be meaningful (i.e. not superfluous), require the provision to be considered restrictive.[9]

3.2.1.2. Corresponding adjustments

Article 9(2) of the OECD Model (2014) aims to avoid economic double taxation in respect of a profit adjustment by a contracting state (State A) in conformity with paragraph 1, by requiring the other state (State B) to make an appropriate adjustment.[10] According to the Commentary, State B is committed to making an adjustment "only if it considers that the adjustment made in State A is justified both in principle and as regards the amount".[11] If there is a dispute, the solution should be found in the mutual agreement procedure under article 25 of the OECD Model (2014).[12] Whether the associated enterprises deliberately entered into a transaction under article 9(1), i.e. whether they intended to shift profits through transfer pricing, is irrelevant for the purposes of either paragraph of article 9. The various reservations on article 9(2) indicate that, for some countries, the anti-abuse character outweighs the allocation character of the provision: the Czech Republic and Hungary reserve the right not to insert paragraph 2 in their tax treaties, but are prepared to accept it if a third paragraph is added, limiting the potential corresponding adjustment to bona fide cases.[13] Other states are only willing

7. Para. 4 *OECD Model: Commentary on Article 9* (2010). *See also* Thin Cap Report, *supra* n. 3, at para. 50 (p. 22).
8. E.g. G. Kofler, in *Klaus Vogel on Double Taxation Conventions* 4th ed., article 9 at mns. 6, 11-15 and 34 (E. Reimer & A. Rust eds., Kluwer 2015); J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* pp. 196-199 (Wolters Kluwer 2010) (with reference to other authors); and N. Bammens, *Articles 24(4) and 24(5) of the OECD Model Applied to Domestic Thin Capitalization Rules*, 5 World Tax J. 2, sec. 2.1. (2013), Journals IBFD.
9. Wittendorff, id., at pp. 196-197.
10. *See also* Thin Cap Report, *supra* n. 3, para. 72 (p. 30) concerning the application of article 9(2) of the OECD Model in the context of thin capitalization.
11. Para. 6 *OECD Model: Commentary on Article 9* (2010).
12. Para. 11 *OECD Model: Commentary on Article 9* (2010).
13. *See* para. 16 *OECD Model: Commentary on Article 9* (2014). *See also* the position of the non-member countries Ivory Coast, Morocco and Tunisia: these states reserve the right not to insert paragraph 2 in their tax treaties unless the commitment to make an adjustment does not apply in the case of fraud, wilful default or neglect.

to accept insertion of paragraph 2 in their tax treaties to the extent that they agree with the adjustment,[14] or not at all.[15]

3.2.1.3. Scope

According to a literal interpretation, article 9(1) only applies if "conditions are made or imposed … which differ from those which would be made between independent enterprises." This would mean – again, according to a literal interpretation – that the provision would not apply (and there would not be a restriction on making an adjustment) if, in the case at hand, the conditions are at arm's length. Obviously, this interpretation would not make any sense, bearing in mind that the provision is restrictive rather than illustrative (*see* section 3.2.1.1.). This may be illustrated by the following example. Country A applies transfer pricing rules. On the basis of these rules, an amount of interest is not allowed as a deduction, whereas the transactions are in fact at arm's length. If article 9 did not apply, states would be free to adjust profits where this is clearly not intended by the drafters of the OECD Model, since there is no artificial profit shifting and since this would lead to economic double taxation. Under a sensible interpretation (in the author's view), article 9 not only applies if these non-arm's length conditions actually exist, but also if domestic provisions targeted at non-arm's length conditions are applied, even if – in the end – these conditions are actually at arm's length.

An interesting question is whether article 9 might also apply to measures that are not, in particular, targeted at non-arm's length situations. This may be illustrated by the following example. Country A applies earnings stripping rules that limit the deduction of interest to 30% of the fiscal EBITDA, in so far as the excess is payable to non-resident lenders. No distinction is made between group interest and third-party interest. In the example, the amount of interest is 100, whereas the arm's length amount would be 80, and the non-deductible amount is 25 (under the earnings stripping rules). In the author's view, the adjustment of 25 is not in violation of article 9, since the adjustment clearly is not aimed at making the profits of the enterprise conform to arm's length profits (which is evidenced by the fact that the measure also applies to transactions between third parties), and cannot therefore be considered a transfer pricing adjustment. This example is discussed further in section 3.3.2.3. in the context of article 24(4) of the OECD Model (2014).

14. E.g. Germany (para. 17), Italy (para. 17.1), Slovenia (para. 19). *See* for non-member countries the positions of Bulgaria, Lithuania, Malaysia, Russia, Serbia and South Africa.
15. *See* the positions of the non-member countries Brazil, Russia, Thailand and Vietnam.

The author submits that the material scope of article 9 is confined to cases where a profit adjustment is made for the reason that conditions are made or imposed that differ from conditions agreed to between independent enterprises. If so, the domestic measure is a profit allocation rule that must meet the arm's length standard and that in principle gives rise to a corresponding adjustment. If not, the domestic measure is a tax base computation rule that in principle must be applied without discrimination as to the state of residence of the payee (*see* section 3.3.2.). Examples of the first category (profit allocation) are rules that apply where transactions are not at arm's length *casu quo* where there is a rebuttal rule that says that the rule does not apply where the taxpayer proves that the conditions are in fact at arm's length. In the author's view, it is not decisive that the excess payment is recharacterized as a hidden profit distribution or capital contribution; rules that merely limit deductibility may also serve as an allocation rule if the purpose of these rules is to ensure that the profits of the taxpayer reflect an amount corresponding to the profits that would have accrued in an arm's length situation.

3.2.1.4. The meaning of the term "conditions"; transactional adjustments

Article 9 of the OECD Model (2014) applies to (measures targeted at) non-arm's length "conditions". The term "conditions" is not defined in the Commentary on the OECD Model or in the OECD Transfer Pricing Guidelines,[16] but these publications seem to interpret the term rather broadly.[17,18] The interpretation of the term has given rise to quite a lot of debate in the literature, in particular, regarding whether the reference to "conditions" in article 9 means that only adjustments of the conditions of a transaction fall within the scope of the article or also transactional adjustments. In other words: does article 9 of the OECD Model (2014) address non-arm's length conditions only or also situations in which the parties dealing at arm's length would not have concluded the transactions (as a result of which the conditions for these transactions would of course also

16. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010).

17. *See* para. 3 *OECD Model: Commentary on Article 9* (2014) (*see also* sections 3.2.2.1. and 3.2.2.2.) and para. 1.65 of the OECD Transfer Pricing Guidelines, *supra* n. 16, where recharacterization is considered as "adjusting conditions".

18. *See*, for another broad interpretation, UK: Commissioners for Her Majesty's Revenue and Customs, 31 Mar. 2009, [2009] UKFTT 31 (TC), *DSG Retail*, where Special Commissioner Avery Jones argued that "[t]here seems … to be nothing in the model which indicates that 'condition' should be restricted to formal or enforceable arrangements."

not exist). As regards situations in which the parties dealing at arm's length would not have concluded the transactions, the author does not refer to dealings that typically only exist within a group, but transactions that would not have been entered into because of the expected result, e.g. because one party assumes risks that it would not be prepared to take in arm's length situations. This question is addressed in more detail in section 3.2.2.1. in the context of thin cap rules.

3.2.2. Article 9 and thin capitalization (and other interest deduction restrictions)

3.2.2.1. Thin capitalization as "non-arm's length conditions"

The OECD's position that thin cap provisions are to be considered as transfer pricing adjustments under article 9(1) of the OECD Model has given rise to much debate in the literature. One of the proponents of the OECD's point of view – according to which article 9 is relevant to thin capitalization adjustments – is De Broe (2007), who argues that the expression "conditions made or imposed" can also accommodate a choice between debt and equity that is imposed by participants in both enterprises, that article 9(1) allows for profit adjustments for "any profits which would have accrued but have not by reason of those conditions" and that the drafters of the League of Nations Model already intended "to strike down profit shifting regardless of by which method profit is transferred."[19] Another school of thought submits – in short – that article 9 does not apply to all situations of income shifting, but only profit shifting caused by the pricing of a transaction (in this context: the amount of interest) and not by its form (i.e. debt instead of equity) and that article 9 does not address the tax treatment of a transaction (e.g. deductibility), but only the adjustment of the price (in this context: the interest) and a recharacterization of the excess (e.g. into a dividend), but not the transaction.[20]

In the author's view, the point of departure should be that article 9 is not relevant to the issue of whether elements of the profits of a company are taxable or deductible, but only to the issue of whether these elements are indeed attributable to the company. This is supported by the requirement

19. L. de Broe, *International Tax Planning and Prevention of Abuse* p. 505 (IBFD 2007).
20. *See also* the authors referred to by Wittendorff, *supra* n. 8, at p. 164, n. 460. *See* Wittendorff, id., at p. 163 et seq. *See also* other authors referred to by De Broe, id., at p. 623 and Wittendorff, id., at p. 164, n. 459.

for the other contracting state to make a corresponding adjustment: the idea of article 9 is that the total profit of a group of associated companies is attributed to these companies in conformity with the arm's length standard while avoiding economic double taxation. In principle, interest deduction restrictions are not governed by article 9 since they are not made due to the fact that the interest expenses are not attributable to the taxpayer and do not require a corresponding adjustment. This may, however, be different for deduction restrictions that are targeted at profit shifting between associated companies through non-arm's length dealings. And yes, this means that transactional adjustments may also come within the scope of article 9. In the author's view, the wording of article 9(1) of the OECD Model (2014) can accommodate such an interpretation (if parties dealing at arm's length would not have concluded the transactions, the conditions with regard to these transactions, including the requirement to pay interest, would also not exist; *see* section 3.2.1.4.), and such an interpretation is also in conformity with the object and purpose of the provision. The reason for this would not be that article 9 is intended "to strike down profit shifting", but to subject legislation with that purpose to the arm's length standard.[21]

The author therefore submits that article 9(1) of the OECD Model can also apply to thin cap provisions if the aim of these provisions is, as the Commentary reads, "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* section 3.2.2.2.). The logic of such provisions, in the author's view, would require that the non-deductible interest be recharacterized (i.e. as a profit distribution if paid to a parent or sister company). For the issue of whether thin cap legislation falls under article 9 of the OECD Model, however, the technicalities of the adjustment (i.e. through a recharacterization or a mere deduction restriction) should not be decisive. What should be decisive is whether the rules intend to assimilate the profits to an amount corresponding to the profits in an arm's length situation. In the author's view, this is not the situation in respect of thin cap rules or earning stripping rules that also apply to payments to third parties,[22] nor for the rules proposed in the Public Discussion Draft for BEPS Action 4 (Interest Deductions and

21. Should, for example, thin cap legislation not fall within the scope of article 9, there would be nothing in the OECD Model to prevent the deduction restriction save for article 24.

22. *See* A. Linn, *Germany*, IFA Cahiers de droit fiscal international, vol. 95a, *Tax treaties and tax avoidance: application of anti-avoidance provisions* p. 345 (Sdu Fiscale & Financiële Uitgevers 2010), Online Books IBFD, as well as S. van Weeghel, *General Report*, id., at p. 32.

Other Financial Payments).[23] It is not, however, necessarily the case for rules that only apply to related-party interest. For example, although a high debt/equity ratio may be an indication of non-arm's length dealing, thin cap rules that only determine the non-deductibility through a standard debt/equity ratio test do not seem to assimilate the profits to an amount corresponding to what the profits would be in an arm's length situation.

If one accepts that the domestic legislation serves to redress a non-arm's length profit shift, it should meet the arm's length standard (and not the non-discrimination standard of article 24(4) of the OECD Model (2014)) and a corresponding adjustment should in principle be made,[24] if need be via a mutual agreement procedure in accordance with article 25 of the OECD Model. Such a corresponding adjustment would not necessarily result in a reduction of the taxable profit of the recipient of the income, since the interest may, for example, be recharacterized as taxable dividend income; this would not go against the object and purpose of the OECD Model, which in principle serves to avoid juridical double taxation and not all kinds of economic double taxation (and, in any event, not the taxation of distributed and already taxed profits).

3.2.2.2. OECD (Thin Cap Report; Commentary)

According to paragraph 3 of the Commentary on Article 9(1) of the OECD Model (2014), article 9 does not prevent thin cap rules in so far as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits that would have accrued in an arm's length situation. It also states that the article is relevant both in respect of the interest rate and whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular, a contribution to equity capital, and that thin cap rules should not normally have the effect of increasing the taxable profits to more than arm's length profits.[25,26] The question that remains is which rules should be considered thin cap rules as mentioned in the Commentary, since the term is not defined therein. The term, however,

23. OECD, *Public Discussion Draft – BEPS Action 4: Interest Deductions and Other Financial Payments* p. 14 (OECD Publishing 2014).
24. *See* Thin Cap Report, *supra* n. 3, at paras. 50 (p. 22) and 65a (p. 26).
25. These statements are in conformity with the Thin Cap Report, *supra* n. 3, at paras. 48-49 (pp. 21-22) and 84 (p. 33).
26. The only observation in this respect is made by the United States, which observes that "there may be reasonable ways to address cases of thin capitalisation other than changing the character of the financial instrument from debt to equity and the character of the payment from interest to a dividend."

is defined in paragraphs 12 and 13 of the OECD's Thin Cap Report, as "the whole range of hidden equity capitalisation", including hybrid financing and a high debt/equity ratio. In the Thin Cap Report it is stated that here … a fixed debt/equity is employed by the tax authorities without allowing "[w] such an option, then the majority of countries consider that the results would undoubtedly be inconsistent with the arm's length principle."[27] One may consider this as a laudable position of the majority, since they are committing themselves to subjecting their (existing or future) thin cap rules to the arm's length standard; however, it could also be regarded as an attempt to protect them from scrutiny of their discriminatory thin cap rules under article 24 (*see* section 3.3.2.).[28]

3.2.2.3. EU Arbitration Convention (90/436) and thin capitalization

According to the Revised Code of Conduct for the effective implementation of the EU Arbitration Convention:[29]

> The Arbitration Convention makes clear reference to profits arising from commercial and financial relations but does not seek to differentiate between these specific profit types. Therefore, profit adjustments arising from financial relations, including a loan and its terms, and based on the arm's length principle are to be considered within the scope of the Arbitration Convention.

This does not, however, shed much light on the matter, since the position only relates to adjustments based on the arm's length principle and not the question of when thin cap measures do so.

3.2.2.4. Case law

Two well-known cases about the relevance of treaty provisions drafted in accordance with article 9 of the OECD Model to thin cap provisions are *Specialty Manufacturing Ltd* (18 May 1999)[30] and *Andritz Sprout Bauer*

27. Thin Cap Report, *supra* n. 3, para. 79 (p. 31).
28. *See also* Wittendorff, *supra* n. 8, at pp. 165-166.
29. Revised Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 30 Dec. 2009 (2009/C 322/01), para. 1.2.
30. CA: FCA, 18 May 1999, A-659-97, *Specialty Manufacturing Ltd. v. Her Majesty the Queen*, Tax Treaty Case Law IBFD, on appeal from CA: TC, 25 Aug. 1997, 97 DTC 1511 (T.C.C.), *Specialty Manufacturing Ltd. v. Her Majesty the Queen*, Tax Treaty Case Law IBFD.

(30 December 2003).[31] Two more recent decisions of the Supreme Court of the Netherlands deserve at least the same level of attention.

In the *Specialty Manufacturing Ltd* case, Specialty Manufacturing claimed that the disallowance of interest under the Canadian thin cap rules was not permitted under the terms of the Canada-United States Income (and Capital) Tax Treaty in force in the relevant years (i.e. article IV of the treaty concluded in 1942[32] and article IX of the treaty concluded in 1980).[33] The Tax Court dismissed the appeal on the grounds that neither of these treaties limited the application of the Canadian thin cap rules. The Federal Court of Appeal, however, did not find it necessary to deal with Specialty Manufacturing's arguments given the facts of the case.[34] Therefore, this decision does not seem to be conclusive as regards the relevance of article 9 to thin cap provisions.

In the *Andritz Sprout Bauer* case, the compatibility of the French thin cap rules with the ownership non-discrimination clause of the Austria-France Income and Capital Tax and Succession Duty Treaty (1959)[35] was at stake. The *Conseil d'État* held that article 6(5) of that treaty (which was similar to article 9(1) of the OECD Model (2014)) did not authorize the tax administration to apply its thin capitalization rules. As regards the paragraphs in the OECD Commentary on thin cap provisions, it held that these could not be referred to for purposes of interpretation of the 1959 tax treaty since these Commentaries came into existence subsequent to the conclusion of the tax treaty.[36]

In 2012 and 2013, the Supreme Court of the Netherlands also dealt with the same issue with regard to the (now abolished) Netherlands thin cap rules.[37] According to these rules, interest paid to related parties could not be deducted to the extent that the debt/equity ratio exceeded 3:1, without

31. FR: CE, 30 Dec. 2003, no. 233894, *Andritz Sprout Bauer*.
32. *Convention between the United States of America and Canada Relating to the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes* (4 Mar. 1942), Treaties IBFD.
33. *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* (26 Sept. 1980) (as amended through 2007), Treaties IBFD.
34. *Specialty Manufacturing Ltd.* (18 May 1999), paras. 20-27.
35. *Convention between the Republic of Austria and the French Republic for the Avoidance of Double Taxation and the Provision of Mutual Assistance with Respect to Taxes on Income and Capital as Well as Succession Duties* (8 Nov. 1959), Treaties IBFD.
36. FR: CE, 30 Dec. 2003, no. 233894, Tax Treaty Case Law IBFD.
37. NL: HR, 21 Sept. 2012, ECLI:NL:HR:2012:BT5858 and NL: HR, 29 Nov. 2013, ECLI:NL:HR:2013:1364.

an exception existing for arm's length situations.[38] The relevant tax treaties were concluded with OECD member countries, i.e. France, Germany and Portugal (2012 decision) and Denmark (2013 decision). Both the treaties with France and Germany were concluded prior to 1992 (and prior to the Thin Cap Report), but the treaties with Portugal and Denmark were concluded in 1999 and 1996, respectively. The Supreme Court of the Netherlands ruled that the Netherlands thin cap rules did not fall within the scope of the treaty provisions regarding transfer pricing because these rules did not apply to specific debt relations, but to the total finance structure of the taxpayer.[39] The Supreme Court expressly argued – without any reasoning – that the Commentary on Article 9 of the OECD Model, as it has read since the 1992 amendments, did not sufficiently support another position.[40]

As submitted in section 3.2.2.1., the material scope of article 9, in the author's view, is confined to cases where a profit adjustment is made for the reason that conditions are made or imposed that differ from conditions between independent enterprises and that are intended to assimilate the profits to an amount corresponding to the profits that would have been earned in an arm's length situation. This does not seem to be the case for the former Netherlands thin cap rules, which employed a standard debt/equity ratio test (3:1), with an alternative test where the commercial debt/equity ratio of the taxpayer was compared to the commercial debt/equity ratio of the group of companies to which the taxpayer belonged. Furthermore, according to the parliamentary notes accompanying the legislation, the provisions were targeted at an unbalanced distribution of financing expenses within a group,[41] which is clearly not the same as an arm's length comparison. It may be that this is also the line of reasoning of the Supreme Court of the Netherlands, although this is uncertain due to the absence of any further explanation.

The 2012 decision was particularly remarkable since the protocol to the Netherlands-Portugal Income and Capital Tax Treaty (1999)[42] provided that

38. There was, however, an alternative test where the commercial debt/equity ratio of the taxpayer was compared to the commercial debt/equity ratio of the group of companies to which the taxpayer belonged.

39. *See* ECLI:NL:HR:2012:BT5858 (21 Sept. 2012), para. 3.6.2 and ECLI:NL:HR:2013:1364 (29 Nov. 2013), para. 3.4.2.

40. *See* ECLI:NL:HR:2013:1364 (29 Nov. 2013), para. 3.4.2.

41. In Dutch: "*een onevenwichtige verdeling van financieringslasten binnen een concern*"; *see* Kamerstukken II 2003/04, 29 210, no. 8, p. 9 and Kamerstukken I 2003/04, 29 210, no. C, p. 16. *See also* NL: HR, 4 Feb. 2011, ECLI:NL:HR:2011:BO2013, para. 3.4.

42. *Convention Between the Kingdom of the Netherlands and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (20 Sept. 1999), Treaties IBFD.

the application by a contracting state of thin capitalization provisions is not precluded:[43]

> [E]xcept in those cases in which the associated enterprises can show that due to the special characteristics of their activities or their specific economic circumstances, the conditions made or imposed between those enterprises are in conformity with the arm's length principle.

According to the Supreme Court, the Netherlands thin cap rules were not thin cap rules within the scope of article 9 of the treaty, notwithstanding the provision in the protocol.[44] The reasoning of the Supreme Court was as follows: the term "thin capitalization" does not have a clear meaning in (legal) usage; at the time the treaty was concluded, Portugal had adopted thin cap rules, but not the Netherlands; these rules refer to specific loans that fall within the character of article 9 of the treaty; as a result the term thin capitalization rules in the Protocol refers to rules that are aimed at specific loans, not at the total capital structure of the company (such as the Netherlands thin cap rules).

Even if one agrees that the Netherlands thin cap provisions are not governed by treaty provisions in conformity with article 9 of the OECD Model, it is hard to accept that these provisions cannot be considered as "thin capitalization provisions" in accordance with the Protocol to the Netherlands-Portugal Income and Capital Tax Treaty (1999). Of course, the Protocol provision must be understood in the context of article 9 of the Netherlands-Portugal Income and Capital Tax Treaty (1999),[45] but this does not mean that the Protocol provision does not influence the scope of the Treaty provision.[46] If the term "thin capitalization provisions", as used in the Protocol only refers to provisions that would clearly fall within the scope of article 9, it would not make any sense: it would only provide that these measures

43. "It is understood that the provisions of the Convention shall not be interpreted so as to prevent the application by a Contracting State of the thin capitalisation provisions provided for in its domestic law, except in those cases in which the associated enterprises can show that due to the special characteristics of their activities or their specific economic circumstances, the conditions made or imposed between those enterprises are in conformity with the arm's length principle."

44. *See* ECLI:NL:HR:2012:BT5858 (21 Sept. 2012), para. 3.6.3.

45. *See* E. Kemmeren, *Netherlands: Thin capitalization rules are not inconsistent with DTCs and EU Law*, in *Tax Treaty Case Law Around the Globe 2013*, p. 143 (M. Lang et al. eds., IBFD 2014).

46. Kemmeren, id., at p. 143 (n. 21), argues that article 9 of the treaty "determines systematically the scope of the protocol provision and not the other way around." The author does not share this view. In the author's view the treaty provision should be interpreted in combination with the protocol provision and the latter indicates what the concluding parties had in mind when they drafted article 9.

should be in accordance with the arm's length standard, which is already provided for in article 9 of the Treaty. And if one accepts that the Protocol provision may influence the scope of the Treaty provision, it is clear that the term "thin capitalization provisions" interpreted in good faith in accordance with the ordinary meaning to be given to that term in its context and in the light of its object and purpose[47] includes rules applying a standard debt/equity ratio test, such as the Netherlands thin cap rules,[48] especially since the treaty was concluded in 1999, after the relevant amendments to the Commentary on the OECD Model in 1992.

3.2.3. Articles 11(6) and 12(4) of the OECD Model

Articles 11(6) and 12(4) of the OECD Model provide that where, by reason of a special relationship between the payer and the beneficial owner,[49] the amount of the interest and royalties exceeds the amount that would have been agreed in the absence of such a relationship (i.e. the arm's length amount),[50] articles 11 and 12 only apply to the lower amount. Whereas article 9 only applies to associated enterprises, articles 11(6) and 12(4) apply to all special relationships that may result in non-arm's length conditions, including a "relationship by blood or marriage and, in general, any community of interests".[51] One could take the position that these provisions are redundant since the excessive amount cannot be regarded as "income from debt claims" (or "consideration for the use of", respectively), but as preferential treatment caused by the special relationship. If so, the excess amount could not be characterized as interest or royalties in the first place. Apparently, this is not the position taken in the Commentary on the OECD Model.

47. *Vienna Convention on the Law of Treaties* (23 May 1969), art. 31(3), Treaties IBFD.
48. E.g. *see* the Thin Cap Report, *supra* n. 3, para. 12 (p. 11); De Broe, *supra* n. 19, at p. 501. *See also* OECD, *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements* p. 68, para. 241 (OECD Publishing 2014), wherein thin capitalization rules are mentioned as an example of non-transaction specific limitations ("any general non-transaction specific limitation such as a thin capitalization rule"). Advocate-General Wattel also concluded in his Opinion in this case that the Dutch thin cap provisions were "thin capitalisation provisions" within the meaning of the protocol (ECLI:NL:PHR:2012:BT5858 (21 Sept. 2012) at paras. 9.23-9.24.
49. Either directly between them or between both of them and some other person. *See also* para. 33 *OECD Model: Commentary on Article 11* (2014) and para. 23 *OECD Model: Commentary on Article 12* (2014).
50. *See also* para. 32 *OECD Model: Commentary on Article 11* (2014) and para. 22 *OECD Model: Commentary on Article 12* (2014).
51. *See* para. 34 *OECD Model: Commentary on Article 11* (2014) and para. 24 *OECD Model: Commentary on Article 12* (2014).

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