Sandra Martinho Fernandes

International Double Taxation of Interest

Assessing Recent Developments in Thin Capitalization Regimes

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International Double Taxation of Interest

Why this book?

The problem dealt with in this book stems 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. Recently, 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 countries and international institutions to introduce or recommend the introduction of new, stricter thin capitalization rules, commonly referred to in this book as "Comprehensive Interest Barriers".

This book, after examining the evolution of the tax treatment of interest and thin capitalization rules, carries out a comparative study of some of the domestic regimes that have adopted this new trend of rules, as well as of the OECD recommended approach under BEPS Action 4 and the interest limitation rule adopted under the Anti-Tax Avoidance Directive. On the basis of the examination of these Comprehensive Interest Barriers, this book concludes that these new rules are not in line with basic international tax principles, namely the net income and ability-to-pay principles, the benefit principle and the arm's length principle. In addition, these new rules create economic double taxation of interest and realign the taxing rights regarding the taxation of cross-border interest from the country of residence of the creditor to the source country. On the basis of these conclusions, this book investigates how to implement a single international standard regarding the adequate (i.e. arm's length) capital structure of an entity by proposing the harmonization of the different capitalization requirements applicable to permanent establishments and subsidiaries (the New Capitalization Standard). By implementing the proposed New Capitalization Standard, an international consensus regarding the amount of capital that should generally be attributed to an entity, as well as the manner in which the said total amount of capital should be split between debt and equity capital, would be crafted, and therefore, a solution to the problem of economic double taxation would also be indirectly achieved. This book also addresses the issue of economic double taxation related to any adjustments to the capital structure.

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Abstract

Traditionally, corporate income tax has evolved on the basis of a different tax treatment of debt and equity. The problem dealt with in this book stems 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. Recently, 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 countries and international institutions to introduce or recommend the introduction of new rules, commonly referred to in this study as "Comprehensive Interest Barriers".

This book consists of a comparative study of the domestic regimes that have adopted this new trend of Comprehensive Interest Barriers, namely New Zealand, Australia, Italy and the United Kingdom, as well as of the OECD recommended approach under BEPS Action 4 and the interest limitation rule adopted under the Anti-Tax Avoidance Directive. On the basis of the examination of these Comprehensive Interest Barriers and the development of a case study, we expect to conclude that these rules are not in line with basic international tax principles, that they create international double taxation and that they realign the taxing powers regarding the taxation of cross-border interest. On the basis of these conclusions, this study will investigate possible solutions to relieve double taxation and to present ways to reform the taxation of cross-border interest, which could entail either a partial or a radical tax reform.

Chapter 1

Introduction

"Contemporary tax systems are therefore the outcome of historical developments, economic and social considerations and administrative possibilities."[1]

1.1. Background

The unequal taxation of interest and dividends has been a common characteristic of the majority of corporate income tax systems for almost a century. While interest is deductible from the taxable income of an enterprise, dividends are non-deductible. The non-deductibility of dividends results in economic double taxation as there is a concurrent taxation of the company's profits in the hands of the company and of the dividends in the hands of the shareholders, whereas, as a general rule, there is no economic double taxation of interest as the interest payment is fully deductible in the hands of the payer and the interest income is fully subject to tax in the hands of the recipient. This problem is the so-called debt-equity distortion.

Against this background of debt-equity distortion, it has been considered that the problem of economic double taxation of dividends should be addressed either by means of applying the exemption or the credit method (i.e. granting an indirect tax credit) in order to tackle the debt bias of the corporate tax systems. Such an approach has indeed been implemented through the introduction of the so-called participation exemption regimes in the domestic tax regimes of different countries, by agreeing on the relief for the economic double taxation of dividends under double tax treaties and at European Union (EU) level through the adoption of the Parent-Subsidiary Directive.[2]

However, even if full relief were granted to solve the issue of economic double taxation of dividends so that both interest and dividends (i.e. the returns on debt and equity capital) would not trigger any economic double taxation, the tax consequences of financing an entity with debt or equity

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1. League of Nations Fiscal Committee (1938), Sec. II, para. 3., p. 4272.
2. Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, as amended.

capital are still not the same. The main reason for this is that the international allocation of taxing rights in relation to the returns on debt and equity capital is not the same. Accordingly, the country that will tax the dividends (i.e. the return on equity capital) is the source country (i.e. dividends are taxable in the hands of the payer and exempt or granted a full indirect tax credit in the hands of the recipient), whereas the country that will tax the interest paid (i.e. the return on debt capital) is the residence country of the recipient (i.e. interest payments are deductible in the hands of the payer and interest income is taxable in the hands of the recipient). In basic terms, everything being equal,[3] in a cross-border scenario asymmetric taxing rights are allocated to the source country or to the residence country depending on the way in which the investor chooses to finance its investment with equity or debt capital.

Indeed, as rightly pointed out by Piltz in 1996 in the IFA General Report:

> [w]ith equity financing, the source country receives the lion's share of the taxes, whereas with debt financing, the bulk of tax revenue goes to the shareholder's country of residence. In this respect, it is of little importance whether a DTC stipulates the credit method or the exemption method for dividends. Debt financing only offers a significant tax advantage for subsidiary companies and shareholders taken together if the shareholder pays no taxes on the income received, e.g. because he benefits from tax exemption, is making losses or is a resident in a non-tax or a low-tax country. *Consequently, thin capitalization regulations are aimed at protecting the tax revenue of the source country* [emphasis added].[4]

It follows from the above that in a cross-border scenario the debt-equity tax distortion and the asymmetric allocation of taxing rights in relation to dividends and interest can clearly influence the decision of, *inter alia*, the shareholder, manager or director to finance the company with debt instead of equity capital. As a result, in order to protect their tax revenues and avoid the erosion of their tax base, the majority of the countries have adopted rules that target thinly capitalized companies, i.e. companies whose financing sources are mainly debt instead of equity financing instruments.

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3. In practice, in a cross-border scenario, there will always be differences between the tax system of the country of the payer and of the recipient of interest or dividends, such as the tax rate, loss carry forward rules, scope of the participation exemption, etc. On the other hand, there may be tax differences between the payer and the recipient as one may be in a profit-making position and the other in a loss-making position (or vice versa), or one may be a fully exempt entity and the other a fully taxable entity. As a result of such differences, i.e. the specific tax features and situation of the payer and recipient, debt financing may become more interesting than equity financing (or the other way round).
4. Piltz (1996), p. 97.

The measures drafted by the different countries against thin capitalization are diverse but operate mainly through general legal rules and principles, *e.g.* general anti-avoidance rules, the substance-over-form principle, or through specific, technical, thin capitalization rules. These rules generally refer to an international standard – the arm's length principle (hereafter referred to as the "ALP") – to determine whether the quantum of loans provided and the interest rate agreed between related parties are consistent with what unrelated parties would have agreed upon under conditions of free and fair competition.

The main purpose of thin capitalization rules is to prevent multinationals ("MNEs"), often on the basis of presumptions, from shifting their profits from one jurisdiction to another by the use of excessive debt financing. Therefore, these rules initially targeted cross-border intra-group financing and not domestic intra-group financing. However, through the Lankhorst-Hohorst[5] decision the Court of Justice of the European Union ("CJEU") prompted a change in the structure of these rules, at least in some Member States of the EU. In fact, the Lankhorst-Hohorst decision brought with it some uncertainty regarding whether anti-avoidance rules only applicable to non-residents, such as thin capitalization rules, would be in breach of the treaty freedoms. Due to that uncertainty, Member States opted either to extend thin capitalization rules to purely domestic situations or to apply such rules only to non-EU residents. As highlighted by AG Geelhoed in the opinion delivered on the Thin Cap Group Litigation, the ambiguity regarding the effects of the Lankhorst-Hohorst decision on the domestic tax laws of the Member States had a negative impact on the efficiency of the internal market.[6] In a subsequent case, the Thin Cap Group Litigation, the CJEU reiterated that Member States could apply thin capitalization rules exclusively to non-residents provided that those rules were proportional, i.e. they specifically targeted "wholly artificial arrangements".[7] In addition, the CJEU went further and held that thin capitalization rules could be compatible with EU law provided two conditions were met. Firstly, thin capitalization rules

5. CJEU, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*. In short, in the Lankhorst-Hohorst case the CJEU held that the German thin capitalization rules covering only cross-border financing by non-resident associated companies, and not by domestic companies, without targeting "wholly artificial arrangements" designed to circumvent national tax rules, constituted an unjustifiable restriction of the freedom of establishment as laid down in Article 49 TFEU (Ex Article 43 EC).

6. UK: Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, para. 68, Case Law IBFD.

7. UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, para. 79, Case Law IBFD.

should be based on an objective factor, such as the ALP, in order to specifically determine the existence of a "wholly artificial arrangement" and had to grant the opportunity to the taxpayer to prove the contrary, without being subject to undue administrative constraints.[8] Secondly, when it is objectively determined that the loan is not at arm's length and no evidence to the contrary is produced, only the return on the excess amount of debt capital (i.e. the portion of debt capital that is not at arm's length and that may be requalified as equity capital) may be requalified as a dividend.[9, 10]

Moreover, in a globalized world the financing of MNEs has become a worldwide problem due to the strong concern that MNEs can plan their worldwide leverage to minimize their overall tax liability. This concern has highlighted the risk of base erosion and has led some countries to re-design their domestic thin capitalization rules and/or to design new interest limitation rules. In that regard, some countries[11] have replaced and/or supplemented traditional thin capitalization rules only applicable to related party lending with new stricter rules that also apply to third party lending. Generally, these new rules limit the interest deductibility of related and unrelated-party debt to a certain percentage of the debtor's assets and/or earnings and/or by reference to the worldwide debt ratio of the group to which the debtor belongs. In some of these countries, these rules are generally applicable both to a permanent establishment ("PE") and to a subsidiary.

Furthermore, as of 2013, the OECD launched its base erosion and profit shifting ("BEPS") action plan (hereafter referred to as the "BEPS Action Plan") comprising 15 actions[12] to change the international tax landscape in order to "restore confidence in the system and ensure that profits

8. Id., paras. 80-82.
9. Id., para. 83.
10. For an overview of the relevant case law of the CJEU regarding thin capitalization, *see* Marres (2016), pp. 10-14) and HJI Panayi (2013a), Chapter 8 and references therein.
11. Australia, Denmark, Germany, Finland, France, Greece, Italy, New Zealand, Portugal, Spain and the United Kingdom.
12. The 15 actions of the BEPS Action Plan are as follows: Action 1 – Address the Tax Challenges of the Digital Economy, Action 2 – Neutralise the Effects of Hybrid Mismatch Arrangements, Action 3 – Strengthen CFC Rules, Action 4 – Limit Base Erosion via Interest Deductions and Other Financial Payments, Action 5 – Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 6 – Prevent Treaty Abuse, Action 7 – Preventing the Artificial Avoidance of PE Status, Actions 8-10 – Assure that Transfer Pricing Outcomes are in Line with Value Creation, Action 11 – Measuring and Monitoring BEPS, Action 12 – Require Taxpayers to Disclose their Aggressive Tax Planning Arrangements, Action 13 – Re-examine Transfer Pricing Documentation, Action 14 – Make Dispute Resolution Mechanisms More Effective and Action 15 – Develop a Multilateral Instrument. The in-depth analysis of all the BEPS

are taxed where economic activities take place and value is created".[13] The first final outcome of the BEPS Action Plan occurred in October 2015 with the release of recommendations in 13 reports, subsequently approved and endorsed by the G20 country governments in November 2015, as well as welcomed by the EU Council in its conclusions of 8 December 2015. The OECD recommendations[14] under the BEPS Action Plan consist of "new or reinforced international standards as well as concrete measures to help countries tackle BEPS",[15] such as measures to tackle BEPS through the deduction of interest and other financial payments.

The BEPS Action Plan identified under its Action 4 the need to limit base erosion via interest deductions and other financial payments, regardless of whether the borrower and the lender are related parties ("BEPS Action 4"). As noted by the OECD in one of the reports released under BEPS Action 4, the latter's aim was to:

> develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.[16]

Pursuant to the 2015 final report on BEPS Action 4 and the updated report thereon released in December 2016, the recommended approach by the OECD regarding the limitation of interest deductions and other financial payments is based on:

> a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA). As a minimum, this

Action Plan is out of the scope of this thesis, which will be reduced to the analysis of the BEPS actions dealing with the deduction of interest and disclosure of information on the capital structure of an MNE, i.e. Action 4 and Action 13.

13. OECD (2015c), p. 4.

14. It is to be noted that in the framework of the OECD/G20 BEPS Project all the OECD recommendations submitted under the BEPS Action Plan were endorsed by the G20. In addition, following the release of the different final reports under the BEPS Action Plan, the G20 has requested their timely implementation and called on the OECD to develop a more inclusive framework with the involvement of interested non-G20 countries and jurisdictions, including developing economies. Further to the G20 request, the OECD established the so-called "Inclusive Framework on BEPS" in January 2016 so that all interested countries and jurisdictions can work together, which by March 2017 included almost 100 members.

15. OECD (2015c), p. 4.

16. OECD (2013a), p. 17.

> should apply to entities in multinational groups. … The approach can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances.[17]

Building on the 2015 OECD recommendations to address BEPS, the European Commission submitted in January 2016 an anti-tax avoidance package, which included a proposal for a Council Directive proposing rules against tax avoidance practices that directly affect the functioning of the internal market.[18] The Anti-Tax Avoidance Directive ("ATAD") proposal included, among other measures to tackle BEPS, an interest limitation rule mirroring the recommended approach under BEPS Action 4. On 12 July 2016, the EU Council approved the proposed ATAD, as amended throughout its legislative process, which basically reflects a part of the aforementioned January 2016 proposals submitted by the European Commission to strengthen the rules against corporate tax avoidance.[19] The ATAD includes a specific provision to deal with the limitation of the tax deductibility of interest and similar financial payments by corporate taxpayers, i.e. Article 4 of the ATAD.

This means that certain countries' domestic rules, the OECD recommended approach under BEPS Action 4 and the interest limitation rule adopted by the ATAD perceive the issue of thin capitalization and risk of base erosion through interest deductions as problematic, and consider that the scope of the rules targeting such practices should include and limit both the related and unrelated party debt of an entity. These new rules adopted by different countries, which has been endorsed as best practice by the OECD under the aforementioned BEPS Action 4 and adopted by the EU under the ATAD, will hereafter be referred to as "Comprehensive Interest Barriers".[20]

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17. OECD (2015a), p. 11 and OECD (2017a), p. 13.
18. *See* COM/2016/026 final - 2016/011 (CNS).
19. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (hereafter referred to as the "ATAD"). The ATAD comprises the following measures against tax avoidance and base erosion practices: the interest limitation rule, exit taxation rules, the general anti-abuse rule, the controlled foreign company rule and rules on hybrid mismatches. Subject to certain exceptions, the Member States will have until 31 December 2018 to transpose the ATAD into domestic law. The investigation of the interest limitation rule proposed by the ATAD will be carried out infra in section 3.2.6.
20. The term "Comprehensive Interest Barriers" will be used throughout this thesis to encompass all the different domestic rules, the OECD recommended approach regarding the deductibility of interest and similar financial payments under BEPS Action 4 and the interest limitation rule adopted by the EU under the ATAD, which despite their different denominations, such as comprehensive thin capitalization rules, interest barriers and interest limitation rules, have a common feature that is to limit the total amount of debt

Under the veil of merely broadening the scope of traditional thin capitalization rules, or of becoming comprehensive, the Comprehensive Interest Barriers in fact represent a conceptual change from traditional thin capitalization rules and seem at first sight to be in conflict with long-established tax principles, such as the net-income and ability-to-pay principles, the benefit principle and the ALP.

On the other hand, in a cross-border context, Comprehensive Interest Barriers create international economic double taxation of interest because the non-deductible interest is taxed in the source country of the interest payment (or country of residence of the borrowing company) and in the country of residence of the recipient of the interest income. It is not expected that the latter will give relief to this economic double taxation of interest, since the amount of interest that is non-deductible at source is not defined in accordance with traditionally accepted international tax practices and principles, but merely derives from new domestic legal standards, which over time have been embraced by the recommended approach to limiting the deductibility of interest under BEPS Action 4 and adopted by the EU under the interest limitation rule provided by the ATAD.

In fact, the Comprehensive Interest Barriers seem to constitute an attempt to address the problem that the tax jurisdiction is exercised on the concept of net income determined on the basis of the separate enterprise method (as opposed to the formulary apportionment method). With respect to interest, this means that in a globalized context the financing method determines the revenue which the jurisdiction can tax, i.e. the decision to locate the lender and the borrower in country A or B will automatically determine the revenue which each jurisdiction can tax. Finally, these new rules also seem to violate the allocation of taxing powers regarding interest, which, in accordance with international standard practice, is allocated to the country of residence of the creditor. As a consequence of the non-deduction of interest payments at source, the source country realigns the taxing powers in its favour and creates international economic double taxation of interest.

In parallel with this evolution towards stricter and broader thin capitalization rules, such as the Comprehensive Interest Barriers, and before the 2015 release of the final report on BEPS Action 4 and on the other actions of the BEPS Action Plan, the Committee on Fiscal Affairs of the OECD also developed and released the new authorized OECD approach (hereafter

(related and unrelated party debt) of an entity by reference to an asset ratio and/or earnings cap and/or by the worldwide debt (asset or earnings) ratio of the group to which the entity belongs.

referred to as the "AOA") regarding the attribution of profits to PEs in its 2010 OECD report (hereafter referred to as the "2010 OECD Report"). Pursuant to the 2010 OECD Report, in order to determine the PE's arm's length amount of profits, one crucial step is to determine the amount of funding, i.e. "free" capital and interest-bearing debt, that a PE requires in order to carry out its functions, and to support its assets and risks.[21]

With respect to the attribution of "free" capital, the 2010 OECD Report clearly states that even where all the operations of the PE were funded by borrowings from third parties, it would still be necessary to disallow part of the interest expense with reference to an amount of "free" capital.[22] This statement is very important because for the first time the OECD observes that the issue of adequate capital structure and thin capitalization should not only restrict related-party debt payments, but also unrelated-party debt payments. The same statement has been reiterated by the OECD within the framework of the OECD work on BEPS Action 4, as well as by the EU under the ATAD.

As a result, it follows from the above that there is a common element between the authorized OECD approaches to attributing "free" capital to PEs and Comprehensive Interest Barriers. Both norms restrict the deductibility of interest payments paid to related parties and to third parties and, as a result, create a problem of economic double taxation of interest in the international tax scenario.[23] Yet, there is one crucial difference between these two norms. The concept of "free" capital is an international norm created by virtue of an international consensus and which works with reference to the long-standing and widely accepted ALP. In contrast, the Comprehensive Interest Barriers are purely protective measures of the domestic taxable base, which were initially adopted by certain countries and which were subsequently endorsed by the OECD pursuant to the issuing of the recommended approach to limiting the deductibility of interest under BEPS Action 4 and adopted by the EU under the interest limitation rule provided

21. OECD (2010b), Part I, paras. 15, 28-32 and 44.
22. However, it should be noted that this adjustment is not mandatory as the host country can opt to tax less than the arm's length amount of profits, *see* OECD (2010b), Part I, paras. 163 and 167. The only binding rule mandated by Article 7 of the 2017 OECD Model Convention is that the host country cannot tax the PE in excess of its arm's length amount of profits.
23. It is worth noting that bearing in mind the importance of the problem of economic double taxation of interest created by virtue of the AOA, one would have expected that this issue would have been properly addressed by the relevant OECD report. However, that was not the case, *see* OECD (2010b), Part I, paras. 167-168.

by the ATAD and which, at first sight, seem to be entirely disconnected from the ALP.

It becomes clear from the above that the determination of the capital structure of an entity and, in particular, the determination of the arm's length amount of debt financing, clearly presents a number of difficult and interesting issues in a cross-border scenario. Despite the work that has been done on determining the arm's length capital structure or on the discussion of the issue of thin capitalization over the years, there is still, as yet, no satisfactory and generally accepted solution to the issues they present.[24] To date, there has been no comprehensive and detailed analysis of all the issues that can arise from the implementation of Comprehensive Interest Barriers, which limit the leverage of an entity to certain fixed and predetermined caps. The impact which recent developments may have on the determination of the capital structure of an entity, such as the new AOA regarding the attribution of profits to PEs, has also not been considered in depth. The intention of this book is therefore to present a comprehensive analysis of issues regarding the aforementioned Comprehensive Interest Barriers in light of the relevant international tax norms and taking into account recent developments in international tax law, with the ultimate aim of identifying a comprehensive solution to the issues that such rules present.

1.2. The research questions

From what has been stated above, the following three normative research questions were generated:

(i) Are the new rules[25] regarding interest deduction and taxation in line with standard international law and principles?

(ii) Are there any economic justifications and/or principles underlying the new rules regarding interest deduction and taxation?

24. It is to be noted that the OECD stated in the 2014 discussion draft issued with respect to BEPS Action 4 that due to the difficulties and burdensome application of the ALP to the issue of thin capitalization, *see* OECD (2014b), Chapter III. A., para. 24, "it was agreed that neither arm's length tests nor withholding taxes should be included as options for a best practice recommendation" and it subsequently recommended the adoption of thin capitalization rules similar to the Comprehensive Interest Barriers, *see* OECD (2015a), pp. 11-13. *See*, for more details, OECD (2014b), Chapter III. A., paras. 10-12 and 24, Chapters VIII-X and Annex 3, B. and C.
25. The reference to new rules in this section should be understood as a reference to the Comprehensive Interest Barriers, as previously defined in section 1.1.

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

The first and second normative research questions are interrelated, this being because the need to answer the second research question depends on the answer to the first research question. Should this investigation conclude definitely that the new rules regarding interest deduction and taxation are not in line with standard international law and principles; this will lead to the scrutiny of the second research question. Conversely, should this investigation conclude that the new rules regarding interest deduction and taxation are consistent with standard international law and principles; there will be no further need to answer the second research question.

While in the analysis of the first normative research question the author will also include references to EU law, this investigation does not examine whether Comprehensive Interest Barriers are in line with EU law, the fundamental freedoms or the principle of proportionality. This investigation will focus instead on international tax law and principles, since even if the Comprehensive Interest Barriers adopted under the ATAD were not in line with EU primary law and the proportionality principle, the recommendation under BEPS Action 4 would still remain valid for all the countries outside the EU.

However, throughout this research the author will also take into account EU law and case law of the CJEU in connection with Comprehensive Interest Barriers in order to reply to the different normative research questions. The reason for that is the fact that, on the one hand, under its secondary law (i.e. ATAD) the EU has also endorsed Comprehensive Interest Barriers and, on the other hand, the CJEU has developed considerable case law regarding thin capitalization rules as well, both of which are relevant for the purposes of this book. In addition, throughout this book the author will make reference to EU law or case law of the CJEU in order to corroborate certain premises or issues, notably regarding the principle of tax neutrality between a PE and a subsidiary.

These three normative research questions imply an in-depth review of the following sub-questions or issues:

- what are the distinctive features between traditional thin capitalization rules and the new rules regarding interest deduction and taxation;
- which countries or international organizations, such as the OECD or the EU, adhere/have adhered to the new rules regarding interest deduction and taxation and can therefore be part of this investigation;

- how are the international tax powers regarding interest currently allocated;
- are these new rules regarding interest deduction and taxation in line with the selected international tax principles and with the allocation of the tax powers regarding interest, i.e. the net-income and ability-to-pay principles, the benefit principle and the ALP;
- how can we resolve the international double taxation created by these new rules;
- a review of the validity of taxation on a net income basis in a globalized world and investigation of new solutions; and
- an investigation of the possible solutions regarding the deduction and taxation of interest arising from a partial and a radical tax reform, and discussion of their effects and implementation problems in an international tax scenario.

1.3. Research method: The comparative method

This investigation will use the comparative analysis method, which is thought to be the most accurate method to conduct this research. This is because the aim of this study is to understand these new rules, i.e. the Comprehensive Interest Barriers which originate from different national tax systems, the OECD final report released under BEPS Action 4 and the interest limitation rule provided under the ATAD, and to compare them with the international and European tax law and principles, to determine their economic justifications and/or principles (if any). Further to the aforementioned analysis, this investigation will draw a conclusion regarding whether these Comprehensive Interest Barriers constitute a good tax policy (or not). In the event that the rules do not represent a good tax policy, the investigation will then depart from the previous conclusions to formulate other solutions thought to constitute a better tax policy regarding interest deduction and taxation.

As mentioned by Thuronyi:

> For tax reform, comparative study can canvass the rules that apply in different countries in the area being considered and can discuss whether these rules represent good policy and how policymakers might go about deciding what rules to apply.[26]

Therefore, comparative analysis will be used to evaluate the Comprehensive Interest Barriers from an international perspective and to consider whether

26. Thuronyi (1999), p. 339.

such rules constitute a real and advisable tax reform in the matter. In the event that these rules do not qualify as a sound tax reform, this investigation will proceed to scrutinize other solutions that could constitute a good tax policy for an upcoming tax reform regarding the deduction and taxation of interest.

The legal systems and historic periods on which this research will focus are certain selected jurisdictions that introduced Comprehensive Interest Barriers in their tax systems, the OECD recommendation on BEPS Action 4 regarding interest deductions and other financial payments and the interest limitation rule adopted under the ATAD, as follows:

– Australia: Period after July 2001 until 31 March 2017, as well as preparatory documents of the law that changed the previous thin capitalization rules.

– Italy: Period after January 2008 until 31 March 2017, as well as preparatory documents of the law that repealed the previous thin capitalization rules and implemented interest limitation rules in 2008.

– EU: Period after the adoption of the ATAD in 12 July 2016 until 31 March 2017, as well as preparatory documents of the ATAD.

– New Zealand: Period after April 1996 until 31 March 2017, as well as preparatory documents of the law that changed the thin capitalization rules in 1996.

– OECD: Period after the release of the 2015 final report and 2016 updated report released by the OECD under BEPS Action 4 until 31 March 2017, as well as preceding discussion documents on the said Action 4 and any other relevant discussion documents or final reports released by the OECD under the BEPS Action Plan framework.

– United Kingdom: Period after the approval of the 2009 Budget until 31 March 2017, as well as preparatory and discussion documents of the 2009 Budget, that repealed the thin capitalization rules and introduced a worldwide debt cap.

With respect to the selection of the legal jurisdictions and international organizations that will be scrutinized in this book, the author would like to note that this selection has mainly been made on the basis of the following factors: availability of in-depth preparatory work documents or reports; identification

and analysis of the first country that has introduced such new rules; availability of solutions to mitigate the problem of economic double taxation of interest and knowledge of the language of the relevant jurisdiction. With respect to the latter criterion, the author would like to note that the Comprehensive Interest Barrier rules introduced in Germany as part of the German corporate tax reform in 2008 were excluded from the scope of this research as the author does not speak German and would therefore not be able to review the German law, case law and literature concerning the relevant rules.

As far as international and European tax laws are concerned, the primary sources used in this investigation to draw a comparison with the new rules will be:

- OECD Income and Capital Model Convention (the "OECD MC") and related OECD Commentary (2017);[27]
- OECD Committee reports and OECD Guidelines in relation to this subject;
- OECD discussion documents and reports issued under the framework of the BEPS Action Plan;
- case law of domestic high courts regarding the interaction between domestic thin capitalization rules and double tax treaties and/or OECD Committee reports;
- the selected tenets of international tax law presented by tax scholars, i.e. the net-income and ability-to-pay principles, the benefit principle and the ALP;
- Treaty on the Functioning of the European Union ("TFEU");
- secondary EU law: Parent-Subsidiary Directive,[28] Interest and Royalties Directive,[29] ATAD[30] and Arbitration Convention;[31] and
- case law of the CJEU.

27. All references to provisions or commentary to the OECD MC, as well as any provisions/articles mentioned without any specific legal reference throughout this book should be understood as a reference to the provisions of and commentary to the 2017 OECD MC unless otherwise specified.

28. Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended (hereafter referred to as the "Parent-Subsidiary Directive").

29. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, as amended (hereafter referred to as the "Interest and Royalties Directive").

30. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

31. Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, as amended (hereafter referred to as the "Arbitration Convention").

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