The Issue

The limitation of the deductibility of interest

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

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”.

Research Questions

- Are comprehensive interest barriers in line with standard international and European tax law and principles?
- What are the tax policy justifications and/or principles underlying comprehensive interest barriers?
- Are there other fair and neutral solutions to reform the way that interest is deducted and taxed in the international tax framework?

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

Tax reform of the treatment of cross-border interest:

Partial tax reform: - Interest box? - Defiscalization of interest? - Interest apportionment?

Radical tax reform: - Global apportionment? - Comprehensive Business Income Tax (CBIT)?

Preliminary Findings

The deductibility of genuine and arm’s length interest expenses incurred to earn business income is disallowed in accordance with domestic standards determined by comprehensive interest barriers.

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

In a cross-border scenario, these rules create economic double taxation. This problem is not likely to be solved by the creditor state (i.e. the tax base of the recipient of interest income will not be reduced by the amount of non-deductible interest).

Potential partial solution of the economic double taxation of interest between related parties through the EU Interest and Royalties Directive.