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Dichotomy on the Applicability of Articles 9(1) and 24(4) of the Model Convention to the Thin Capitalization Rules

By Nupur Jalan[*]

Abstract: There has been much debate on the extent to which Articles 9(1)[1] and 24(4)[2] of the tax treaty[3] may interact with the domestic thin capitalization rules. The debate gives rise to several questions, such as: Does Article 9(1) offer protection to thin capitalization? What is the degree of potential overlap between Articles 9(1) and 24(4) in the application of domestic thin capitalization rules? Are domestic thin capitalization rules discriminatory, and should this be covered by Article 24(4) of the tax treaty? Answers to these questions may vary on a case-to-case basis depending on the way rules are drafted in the domestic tax laws of various countries and the wordings of respective tax treaties.

Considering the above background, this column discusses the ongoing debate in part I and then briefly discusses Articles 9(1) and 24(4) in part II. In part III, the piece delves into the interplay of these articles with the domestic thin capitalization rules. Part IV and V further analyzes domestic thin capitalization of some countries and checks their compatibility with Articles 9(1) and 24(4) of the tax treaties to identify the illustrative list of factors and indicators that may make these articles applicable in relation to these rules. Furthermore, the public consultation document[4] on the proposed changes to the Commentaries in the OECD Model Tax Convention for Article 9 and related changes to other articles has also been considered, and certain comments to the public consultation document have also been integrated.

I. SETTING UP THE SCENE

This capitalization means situations where the capital structure of a company consists of a relatively higher proportion of the debt when compared to the equity. Thin capitalization[5] rules include all measures that aim to restrict the tax deductibility of interest on debt, irrespective of whether they focus on internal or total debt, or whether they base thresholds on a debt-to-equity ratio or relative to an earnings measure. While thin capitalization rules existed initially only in the domestic tax law of specific countries such as

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[*] Ms. Nupur Jalan is a tax professional specializing in corporate tax, international tax and transfer pricing and is an interdisciplinary researcher. She can be contacted at jalannupur@outlook.com.

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[1] In these scenarios, thin capitalization rules comply with the "arm's-length" standard. Other states, in principle, make a corresponding adjustment.

[2] In these scenarios, thin capitalization rules may not discriminate between resident and non-residents in terms of interest deductibility.

[3] Most tax treaties have Article 9 dealing with associated enterprises and Article 24 dealing with the non-discrimination clause; hence these articles will be referenced interchangeably as being in the OECD MC or in tax treaties for the purpose of this article.

[4] OECD (2021), Public Consultation Document, Proposed Changes to Commentaries in the OECD Model Tax Convention on Article 9 and on Related Articles (hereinafter "OECD 2021 Public Consultation Document").

[5] Thin capitalization refers to a situation in which a company is financed through a relatively high level of debt compared to equity.

Canada,[6] South Africa, the United States, China, United Kingdom, after BEPS Action Plan 4,[7] several other countries across the globe introduced some form of thin capitalization rules (mainly adopting the alternatives prescribed in Action Plan 4, i.e., interest deduction limitation rules or interest deduction limitation rules in combination with group ratio rules).

Among the topics of discussion is whether to apply Article 9 (associated enterprise (AE) article) or Article 24 (non-discrimination article) (mainly, Article 24(4) — deduction non-discrimination and Article 24(5)[8] — ownership non-discrimination) of the tax treaty to the thin capitalization rules. For this column, the interplay of thin capitalization rules and interest limitation deduction rules with only Articles 9(1) and 24(4) has been analyzed. A brief discussion of these articles is provided in II.C., below.

It is important to mention that some countries have inserted an exception/exclusion in their tax treaties to specifically state that the treaties shall not hinder the application of any of the thin capitalization rules concluded by the contracting States (mainly, such provisions are found in the tax treaty protocols; however, some treaties do specify the exception/exclusion only for the non-discrimination article or sub-clauses of the article). There is no issue of overlap between thin capitalization rules and tax treaty articles where the tax treaty entirely contains an exception/exclusion for the application of the thin capitalization rules. In such situations, thin capitalization rules are applicable as if there were no tax treaty. In some cases, they are subject to other articles of the tax treaties (for example, Artile 9) exception/exclusion of thin capitalization rules is provided only in Article 24 of the tax treaty.

Further, because thin capitalization rules aim to cover in most cases non-residents' enterprises (though in some countries, rules apply to both residents and non-residents), these questions of interplay especially arise in cross-border situations. The main reason for this may be that hidden capitalization is generally a problem in cross-border cases. In cases where investors and companies which receive funding are in the same jurisdiction, the deduction for interest expense is symmetrical (from the standpoint of the country's revenue base) to the interest income that the investor shall earn. Only the tax rate that applies to the two taxpayers (the company and the investor) may differ, leaving less tax arbitrage.

The OECD's public consultation document (PCD) on proposed changes to Article 9 states that the Working Party has "*undertaken work to amend the Commentary on Article 9 to clarify its application, especially as it relates to domestic laws on interest deductibility, such as those recommended in the final report on BEPS Action 4, where some commentators have questioned the interaction of Article 9 with those rules*."[9] From reading the PCD, it appears that the OECD is likewise trying to fix the issue of the amount of interest deduction that will be covered by Article 9(1). However, it remains to be seen how this matter will unfold over time and whether the proposed changes would be sufficient to resolve the dichotomy of the interaction of Article 9, and other articles, with thin capitalization rules. The proposed changes in the PCD are unclear, and more detailed explanations for the proposed changes are required.

II. A BRIEF DISCUSSION OF THE PREVALENT FORMS/VARIANTS OF THIN CAPITALIZATION/INTEREST LIMITATION RULES AND ARTICLES 9(1) AND 24(4)

A. Variants of the Thin Capitalization and Interest Limitation Rules

The manner in which these rules are implemented by different countries varies, some of which are discussed below.

Under the **fixed debt-to-equity ratio approach**, deductible interest is limited within the frame of a specified amount of debt compared to equity.[10] Countries might treat non-deductible interests as dividend payments or leave it as it is (i.e., the excess amount is non-deductible or is allowed to be carried forward). In practice, these ratios may be fixed on an arbitrary basis and vary considerably from country to country. For

[6] Canada was at the forefront, introducing thin capitalization rules in 1971; Australia and the United States followed after quite some time in 1987 and 1989, respectively. The implementation of thin capitalization rules took off between the mid-'90s and 2005.

[7] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (hereinafter "OECD BEPS 2015 Final Report on Action 4").

[8] Commentaries provide that thin capitalization rules should be tested under Article 24(5) if tested for resident entities whose capital is owned or controlled by non-residents. Further, they indicate that in such situations, the carve-outs provided in Article 24(4) for Article 9(1) should also apply to Article 24(5) as those provisions (i.e., the carve-outs) form part of the context in which Article 24(5) must be read. Thus, in principle, both provisions may apply to these rules; however, Article 24(4) may take precedence on the argument that it is more specific (also, considering the argument that it deals more specifically with the characteristics of the thin capitalization rules).

[9] OECD 2021 Public Consultation Document.

[10] Chloe Burnett, *Intra-Group Debt at the Crossroads: Stand-Alone Versus Worldwide Approach*, 6 World Tax J. (2014), p. 53–54.

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example, they may range from 1.5:1 in the United States to 4:1 in Denmark or even higher.[11]

Under the **interest limitation rules approach**, the tax deductible interest portion is calculated based on a certain percentage of pre-tax earnings interest to EBITDA (earnings before interest, taxes, depreciation, and amortization). This ratio mainly focuses on the amount of interest paid or payable in relation to the amount of income out of which that interest is paid.[12] For example, some countries allow for interest deduction up to the limit of 30% of EBITDA in a fiscal year — accordingly, in such cases, interest expense that can be deducted in calculating the taxable income for that fiscal year cannot exceed 30% of the reported EBITDA of that year. These rules are sometimes referred to as earning stripping rules.

Under the **fixed ratio with arm's-length debt test approach**, arm's-length conditions and a fixed ratio of debt to equity are to be met. The arm's-length approach alone (which was advocated by the OECD earlier) is not very popular and is not widely used in practice — mainly because it has a subjective element that may give rise to uncertainty for non-residents.

B. Recommended Approach by the OECD as per Action Plan 4

Action Plan 4[13] (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments) called for recommendations regarding best practices in designing rules to prevent the excessive deduction of interest expenses and other financial payments.[14] It aims to limit the entity's net deductions for interest and payments economically similar to the interest based on the percentage of its EBITDA. Specifically, the OECD recommends limiting interest deductions using a fixed ratio between 10% and 30% of EBITDA, thus connecting interest limitation with the economic activity of an entity. There is also an option for countries to introduce a group ratio rule (either alone or combined with a specific percentage of the EBITDA rule). In such cases, the entity will be allowed to deduct its net interest expense up to its group's net interest/EBITDA level.

C. Brief Discussion on the Relevant Articles of the Model Convention

1. Article 9(1) of the OECD Model Convention

Article 9(1) of the Model Convention (MC) states that the arm's-length price (ALP) applies to commercial and financial relations between AEs and sets the ALP as the allocation norm. As a result, Article 9 should potentially apply to payments of interest on outstanding debt beyond the amount of an ALP between AEs.[15]

Much of the interplay of Article 9(1) with other tax treaty articles and other provisions depends on whether Article 9(1) should be considered restrictive or illustrative. Paragraph 4 of the OECD MC Commentary on Article 9 asserts that there is no consensus among OECD countries regarding whether Article 9(1) is restrictive or illustrative.[16] Some countries view Article 9 as only precluding an adjustment of the profits to any amount exceeding the arm's-length profit. Hence, it backstops the applicability of domestic allocation rules to the effect that it can only work within the scope defined by Article 9(1) of the OECD MC. Other countries' view is that while Article 9(1) allows 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.[17] The arguments for both sides (i.e., whether Article 9(1) is illustrative or restrictive) are analyzed in the Appendix.

Prima facie, it seems that an illustrative interpretation may make Article 9(1) superfluous, thereby making it redundant. This view may not be consistent with the primary purposes of Article 9. This view was also supported in the General Report for the IFA Congress 1992,[18] wherein it was agreed that Article 9(1) should not be construed as merely illustrative. This also appears to be the prevailing opinion in the General Report for the IFA Congress 1996.[19] In the author's

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[11] A. Storck, *The Financing of Multinational Companies and Taxes: An overview of the Issues and Suggestions for Solutions and Improvements*, 65 Bull. for Int'l Tax'n 1 (2011) p. 36.

[12] OECD, *Thin Capitalization Legislation: A Background Paper for Country Tax Administrations (Pilot Version for Comments)* p. 15.

[13] OECD BEPS 2015 Final Report on Action Plan 4, p. 11.

[14] For example, 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.

[15] OECD MC Commentary (2017), Commentary on Article 9, ¶3 p. 225–226; and UN Model Double Taxation Convention (2017), Commentary on Article 9, ¶6, p. 252–253.

[16] OECD, Thin Capitalization Report, adopted by the OECD Council on 26 Nov. 1986 (OECD 1986), published in Issues in International Taxation, No. 2, Thin Capitalization; Taxation of Entertainers, Artistes and Sportsmen (OECD 1987) (hereinafter ''OECD Thin Cap Report'').

[17] Reference can be placed to Craig Elliffe, *Interest Deductibility: Evaluating the Advantage of Earnings Stripping Regimes in Preventing Thin Capitalization*, New Zealand L. Rev. (2017), p. 281–282.

[18] Guglielmo Maisto, *Transfer Pricing in the Absence of Comparable Market Prices: General Report*, Int'l Fiscal Ass'n Cahiers de Droit Fiscal Int'l, vol. 77a (1992), p. 60–61.

[19] Detlef J. Paltz, *International Aspects of Thin Capitalization:*

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view, the proposed changes in the PCD[20] also try to highlight the restrictive nature of Article 9(1).

Also, Article 1(3), i.e., the saving clause[21] in its current form in OECD MC 2017 does not have any exclusion in relation to its applicability for Article 9(1). With Article 1(3) in the tax treaties, it is yet to be seen whether Article 9(1) may be considered restrictive.

2. Article 24(4) of the OECD MC

Article 24 on non-discrimination mainly aims at ensuring that nationals or residents of two states are treated in similar manner in similar situations. Article 24(4) deals will deduction non-discrimination and aims at ensuring that there is no discrimination in regard to the deductibility of payments (like interest, royalties and other disbursements) based on the recipient's residential status. Thus, paragraph (4) simply examines if interest paid to a resident of the same state is deductible in that state, interest paid to a resident of the other contracting state should also be deductible under the same conditions, subject to exceptions for payments that are covered in Article 9(1), 11(6), or 12(4). These exceptions/exclusions seem to be mere confirmation that paragraph (4) will apply when a payment is not in breach of the arm's-length requirements of Article 9(1). However, the commentary in paragraph (4) does not explain why this arm's-length override exists.[22]

III. THE DEBATE ON THE INTERPLAY BETWEEN THIN CAPITALIZATION RULES AND ARTICLES 9(1)/24(4)

There can be views on either side, i.e., some may believe that only Article 9(1) applies to thin capitalization rules, while others may believe that for the amount over and above the amount of interest (i.e., interest amount above the ALP) getting covered in Article 9(1), deduction non-discrimination rules (i.e., Article 24(4)) may apply. However, this would also depend on the wording of Article 24(4) in the tax treaties (discussed in IV., below). Before forming any conclusion, arguments of relevant paragraphs from commentaries and other sources are presented below:

A. Article 9(1) May Apply in Case of Thin Capitalization Rules

Certain points which can denote that Article 9(1) is applicable in the case of thin capitalization rules, are discussed below.

It may be claimed that usage of the phrase "conditions made or imposed"[23] for transactional adjustment in Article 9(1) can accommodate a choice between debt and equity. This is based on the argument that Article 9(1) allows for-profit adjustments for "any profits which would have accrued but have not because 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."[24] Also, the Thin Capitalization Report was added in 1992 in the OECD MC Commentary without any change to the wording of Article 9(1). This indicates that the Thin Cap Report is relevant to the interpretation and application of Article 9 (discussed below). Though the proposed PCD strips this out from Commentary to Article 9(1) with its new phrasing,[25] the general and broader intent remains unchanged. Interest paid to non-resident related parties still needs to be tested under Article 9(1) for arm's-length conditions.

The OECD approach on arm's-length price concerning thin capitalization rules in the context of Article 9 is summarized in the OECD Thin Cap. Report, which states that the article is relevant when countries apply their domestic rules about thin capitalization.[26] Reference in this regard can also be placed on paragraph 3(c) of the Commentary on Article 9 of the OECD MC,[27] which states: "The application of rules designed to deal with thin capitalization should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm' s length profit, and that this principle should be followed in applying existing tax treaties." However, the proposed changes in PCD are very clear in stating that Article 9 does not deal with the issue of whether expenses are deductible when computing the taxable income of either enterprise. The conditions for

General Report, Int'l Fiscal Ass'n Cahiers de Droit Fiscal Int'l, vol. 81b (1996), p. 69.

[20] OECD 2021 Public Consultation Document.

[21] A saving clause preserves the right of the country to tax its own residents irrespective of the tax treaty provision. Article 1(3) of OECD MC includes an exception for certain tax treaty articles to which the saving clause cannot apply.

[22] More information on the role of these arm's-length provisions and non-discrimination are contained in the Commentary at paragraph 79, but the most illuminating discussion is contained in the OECD Thin Cap Report.

[23] The term "conditions" is not defined in the OECD MC Commentary or in the OECD Transfer Pricing Guidelines, but these publications interpret the term rather broadly. (*see* ¶3 of the OECD Model Commentary on Article 9 (2017) and ¶1.65 of the OECD Transfer Pricing Guidelines).

[24] *See* Otto Marres, *Interest Deduction Limitations: When to Apply Articles 9 and 24(4) of the OECD Model*, 56 European Tax'n (2016), p. 2. *See also* Luc De Broe, *International Tax Planning and Prevention of Abuse* (IBFD 2007), p. 505.

[25] OECD 2021 Public Consultation Document.

[26] OECD Thin Cap. Report; OECD MC commentary (2017), commentary on Article 9(1) Para 3, p. 226–227.

[27] OECD MC Commentary (2017), Commentary on Article 9, 3(c), p. 227.

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the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 4 of Article 24.[28] It appears from these proposed changes that the intention is to put more importance on the characteristics of the loan and to determine the arm's-length interest along with the confirmation that the question of deductibility (e.g., of interest on a loan) is a matter to be determined by domestic legislation.

Separately, as per Article 24(4) on deduction non-discrimination, there is an exception that shall not apply to Articles 9(1), 11(6), and 12(4) as per the OECD MC.[29] This indicates that the payments covered by Article 9(1) will not fall in thepurview of Article 24(4). It is important to note that Article 24(4) was introduced into the OECD MC in 1977. Since that time, it has remained unchanged, highlighting that the intentions were never to remove this exception of Article 9(1) from Article 24(4). This would mean that in case where Article 9(1) is applicable on interest payments, both Articles 9(1) and 24(4) should not apply on the same amount of interest payments.

B. View 2: Article 24(4) May Apply in Case of Thin Capitalization Rules[30]

Certain points which can denote that Article 24(4) is applicable in the case of thin capitalization rules are discussed below.

Article 24(4) of the MC prohibits disallowance of a deduction for interest paid to a non-resident lender, which otherwise would have been allowed had the interest been paid to a resident creditor subject to meeting arm's-length requirement of Articles 9(1), 11(6), and 12(4). Once the payment is outside the said exception, i.e., arm's-length requirement, Article 24(4) may apply. Further, the role of Article 9(1) is limited to the adjustment of profits in the event that a special relationship between parties influences the company's true profits. No adjustment is warranted under Article 9(1) if a transaction is at arm's length. However, thin capitalization rules apply irrespective of whether interest payment is at arm's length or whether excessive payment of interest is made based on a special relationship, which is dealt with by Article 11(6). Hence, Article 24(4) should at least apply to thin capitalization rules in situations/amounts where Article 9(1) does not apply.

The other argument for the applicability of Article 24 to thin capitalization rules can be thin capitalization rules are not governed by Article 9 since this does not require any corresponding adjustments. Hence, it should not fall under the purview of Article 9(1) because for most adjustments made in Article 9(1), Article 9(2) dealing with corresponding adjustments are applicable. In addition to the state of residence refusing a deduction for the interest obtained in the source country, in cases where such interest is reclassified as dividends, the state of residence could also refuse to adjust to such categorization. For these reasons, some argue that applying Article 9(1) of the MC is not appropriate to thin capitalization situations.[31] As stated earlier, the proposed changes in the PCD also scraps the paragraph on thin capitalization that is included currently in the commentary to Article 9(1).[32]

The OECD Thin Cap Report[33] identified that Article 24 might prevent the application of the thin capitalization rules if those rules apply only in respect of payments to non-residents (in contrast to residents) or if the rules disallow the deduction of interest in circumstances where a company is controlled by non-residents but allow the deduction if the company is controlled by residents. The Working Group noted that paragraph 56 of the OECD MC Commentary (2005) already deals with the application of paragraph 4 with respect to thin capitalization rules.[34] Currently, a similar provision is found in paragraph 74 in Commentary to Article 24 of the OECD MC Commentary, 2017.

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[28] OECD 2021 Public Consultation Document .

[29] Relevant paragraph from Article 24 of the commentary:

> 74. Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalization in so far as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, suppose such treatment results from rules that are not compatible with the said Articles and only apply to non-resident creditors (to exclude resident creditors). In that case, such treatment is prohibited by paragraph 4.

[30] There are treaties in which the non-discrimination article is expressly subject to the exception for thin capitalization rules. Some countries prefer to keep such exception in the protocol to tax treaty (i.e., an express provision in the protocol whereby the provisions of applicable tax treaty do not prevent the application of thin capitalization rules under domestic law.

[31] G.M.M. Michielse, *Treaty Aspects of Thin Capitalisation*, 51 Bull. for Int'l Fiscal Documentation 12 (1997), p. 565; J. Wittendorff, The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations, 17 Int'l Transfer Pricing J. 3 (2010), p. 203.

[32] OECD 2021 Public Consultation Document.

[33] ¶10.

[34] OECD, Model Tax Convention on Income and on Capital: Condensed Version 2005, para 56 reads:

> 56. Paragraph 4 does not prohibit the country of the borrower from treating interest as a dividend under its domestic rules on thin capitalization insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the

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However, the manner in which this dichotomy may be solved after the proposed changes of PCD,[35] which aim to revise some paragraphs, is yet to be seen. Nevertheless, there is a question to ponder: If this dichotomy always existed, why did the OECD propose these changes in the year 2021 rather than earlier?

As per the author's view, both these articles must be treated complimentarily, i.e., interest should be tested under Article 9(1) for arm's-length conditions. Furthermore, for any amount over and beyond those covered in Article 9(1), Article 24(4) can be invoked where the treatment of interest deductibility between residents and non-residents is discriminatory.

IV. ANALYSIS OF DIVERSE COUNTRY PRACTICES FOR THIN CAPITALIZATION RULES AND APPLICABILITY OF ARTICLES 9(1) AND 24(4) TO THEM

The countries discussed in this part have some distinct features in terms of their practice and implementation of thin capitalization rules/interest limitation rules. For example:

- Canada's thin capitalization rules specify a fixed debt-to-equity ratio, while in its treaty network, most of the treaties exclude the applicability of Article 24(4) to thin capitalization rules.
- India has interest limitation rules, which effectively limit interest deduction to 30% in relation to interest paid to AEs.
- Australia's thin capitalization rules provide a couple of options/tests to check the maximum amount of debt allowable, like the safe harbor test, arm's-length debt test, separate worldwide gearing test in domestic legislation. In its tax treaty network, most of its treaties contain exclusions for the applicability of Article 24(4) to the thin capitalization rules.
- New Zealand's thin capitalization rules limit a company's deductible debt based on a debt/asset ratio and cover both inbound and outbound transactions. In its tax treaty network, most of the treaty is having exclusion for the applicability of Article 24(4) to the thin capitalization rules.
- Denmark's thin capitalization rules are based on the safe harbor for total debt to equity of 4:1. However, more debt (i.e., above 4:1) is allowed if it is proved that it is at arm's length. Furthermore, the thin capitalization rules mainly aim at covering related-party transactions.
- South Africa's thin capitalization rules are integrated with its general transfer pricing (TP) rules.

These country-specific rules and regulations, along with their compatibility with Articles 9(1) and 24(4), are discussed in detail below.

A. Canada[36]

Treatment of interest as per domestic law.[37]: Interest deduction is made based on the hypothesis that interest is not a deductible capital expense.[38] It is also provided that the interest deduction is allowed only on borrowed money or on the unpaid purchase price of the property used to earn income from a business or property.[39] However, restrictions for certain specified categories of interest do exist.[40] Further, excessive interest rates are addressed by including a condition of reasonableness[41] along with the other conditions for deductibility of interest.

Thin capitalization rules.[42] Canada was at the forefront in introducing thin capitalization rules in 1971. The rule uses a fixed 1.5:1 debt-to-equity ratio.[43] Further, tracing principles (a method that aims to check whether borrowed funds are used for a qualifying income-earning purpose) are applied to allocate interest expenses. Where tracing is not possible, other methods such as positive ordering or apportionment may be used.

Applicability.[44] The rules apply in the computation of the income of a corporation or trust from a business or property (except for the Canadian banking business of authorized foreign banks). The rules also

exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

[35] OECD 2021 Public Consultation Document.

[36] Reference has been placed on B.P. Dwyer, *Canada — Corporate Taxation*, Country Tax Guides, IBFD; *Interest Deductibility: The Implementation of BEPS Action 4*, 104 Cahiers de Droit Fisc. Int'l (2019), p. 191–210.

[37] Government of Canada, Income Tax Folio S3-F6-C1, Interest Deductibility.

[38] Income Tax Act, 1985, §18(1)(b) (p. 176).

[39] Income Tax Act, 1985, §20(1)(c) (p. 242).

[40] *See, e.g.*, Income Tax Act, 1985, §§18(2), 18(3.1), 18(11), 18(9) (pp. 181, 185, 210, and 200, respectively).

[41] Income Tax Act, 1985, §4(1)(a)–(b) (p. 3), indicates that a non-resident's income from business carried on in Canada is determined as if the non-resident had no other income and was entitled to any deductions reasonably applicable in whole or in part to that business.

[42] Income Tax Act, 1985, §§18(4), 18(5) (pp. 188–198).

[43] Income Tax Act, 1985, §18(4)(a)(ii) (p. 188).

[44] Income Tax Act, 1985, §§18(4) and 18(5) (pp. 188–198).

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apply in the case of both resident/non-resident corporations and trusts. However, they apply only to deductible interest paid/payable for the outstanding debts owed to "specified non-residents." A specified non-resident is defined as a person who was, at any time in the year —

> (a) a specified non-resident shareholder of a corporation, being a shareholder of the corporation who at that time, either alone or together with non-arm's-length parties, owned 25% or more of the issued shares of any class of the capital stock of the corporation (a "specified shareholder") and who was at that time a non-resident person or a non-resident-owned investment corporation, or
>
> (b) a non-resident person, or a non-resident-owned investment corporation as defined by paragraph 133(8)(d), who was not dealing at arm's length with a specified shareholder of the corporation.[45]

Further, thin capitalization rules do not apply in situations where:

- interest is paid or payable to Canadian-resident beneficiaries of a trust; or
- Canadian residents are shareholders of a corporation.

The coverage of thin capitalization rules increases because of the applicability of anti-back-to-back[46] rules (which envisage that specific amounts that an intermediary owes to a specified non-resident are deemed to be owed to the specified non-resident by the Canadian corporation or trust if there is some linkage between the amount owed by the Canadian corporation or trust to the intermediary and the amount owed by the intermediary to the specified non-resident). The anti-back-to-back rules aim to determine whether the treatment of interest on such loans would be the same if thin capitalization rules were applied directly. Thus, Canada's thin capitalization rules mainly focus on interest paid to substantial non-resident shareholders of Canadian companies or substantial non-resident beneficiaries of Canadian trusts beneficiaries, unlike most of the other countries where the rules are applicable mainly in situations of interest or similar payments made to related/associated non-residents or any of the non-residents.

Reclassifying interest as dividend. Thin capitalization rules deem the portion of the disallowed interest deduction to be a dividend subject to Canadian withholding tax.[47] There are no formal criteria for the recharacterization of debt to equity. It only provides for disallowance of interest expense for the amount/claims that are unreasonable.

Applicability of Articles 9(1) and 24(4) on thin capitalization rules. The rules may not be compatible with Article 9(1) because it cannot be presumed that the ratio of 1.5:1 will always meet the arm's-length condition. Hence Article 9(1) would apply.

Per se, Article 24(4) should apply as the rules are applicable only in situations where interest is paid to substantial non-resident shareholders of Canadian-resident corporations and non-resident beneficiaries of Canadian-resident trusts and concerning specific Canadian tax rules dealing with deduction of interest by non-residents in computing their Canada-sourced income.[48]

However, based on the design of Canadian tax treaties with various countries, Article 24(4) either is not found or is found with an exception/caveat in relation to thin capitalization rules. Some variants of Canada's tax treaties:

- Do not have any non-discrimination article;[49]
- Do not have provisions of Article 24(4) and 24(5) in the non-discrimination article as present in the OECD MC;[50].
- Do not have Article 24(4), but provisions similar to Article 24(5) of the OECD MC are present but limited to the "most-favored-nation' treatment;[51]
- Have provisions of Article 24(4) similar to OECD MC, with the exception of restrictions on the deduction of interest;[52] and
- Provisions of Article 24(5) that are identical to the OECD MC but limited to the "most-favored-nation" treatment.

Hence, where Article 24(4) is not present in the tax treat or there are specific exclusion for thin capitalization rules, Article 24(4) should not apply in such a situation, and thin capitalization rules should be compatible with the tax treaty's Article 24(4).

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[45] Archives, Interest on Debts Owing to Specified Non-Residents (Thin Capitalization), Canadian Income Tax Act, 1985, Clause 18(5)(a)(i)(A).

[46] Income Tax Act, 1985, §18(6) (p. 196).

[47] Income Tax Act, 1985, §214(16) (p. 2856).

[48] Brian J. Arnold, *The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax Treaties*, 67 Canadian Tax J. 4, 1053 (2019).

[49] For example: tax treaties with Australia, Ivory Coast, Kuwait, New Zealand, Oman, and Papua New Guinea.

[50] For example, tax treaties with Austria, Finland, France, Jordan, Malaysia, Moldova, Russia, Singapore, Ukraine, United Kingdom, and Venezuela.

[51] More than 50 treaties have this type of provision.

[52] For example, tax treaties with Romania, Sweden, Portugal, etc.

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B. India

Treatment of interest.[53] Certain criteria need to be satisfied for claiming interest payments as deductible expenses, for example, interest expense in relation to the capital borrowed, if the capital borrowed for the acquisition of a capital asset is not allowed as a deduction and must be capitalized and added to the cost of such asset if the interest pertains to the period until the asset is put to use. Also, the deduction is to be allowed if it is a prudent expenditure. Furthermore, no deduction is permissible for interest expenses incurred by a taxpayer for earning exempt income.

Interest limitation rules. Interest limitation rules were introduced in Finance Act, 2017 to align the tax laws as per the recommended practices suggested by Action Plan 4.

Applicability.[54] The rules provide for a one crore (INR 10 million) limitation on payment of interest by a borrowing Indian company or permanent establishment (PE) of a foreign company to an AE.The amount is deductible in computing the income chargeable under profit and gains from business as per the lesser of:

- 30% of EBITDA; or
- Interest paid or payable to AE.

The rules are aimed at covering situations of both direct and indirect lending.[55]

- An AE lends directly to Indian company or PE;
- Debt is issued by a lender who is not an AE, but an AE provides an implicit/explicit guarantee to such lender or deposits a corresponding/matching amount of funds with a lender — such debt is deemed to be issued by AE.

The above rule does not apply to banking or insurance companies. Carry-forward of interest is allowed for the non-deductible portion in the relevant years for eight succeeding years starting from the assessment year subsequent to the year in which excess interest was disallowed.

Applicability of Articles 9(1) and 24(4) on thin capitalization rules. Prima facie, since the deduction is based on a fixed percentage, it may not satisfy the arm's-length condition; accordingly, may not be compatible with Article 9(1).

TP provisions apply for Indian companies/permanent establishments to determine the reasonableness of interest expenditure paid by the debt borrower. However, interest limitation rules are also applicable for interest expenses that meet the ALP test.

Hence, it can be well said that interest limitation rules shall apply irrespective of the application of TP provisions. This may also be because the interest limitation rule in domestic law starts with a non-obstante clause, overriding even the rules of TP in domestic laws.

As to the compatibility of Article 24(4) with interest deduction rules, views exist on both sides (i.e., Article 24(4) is compatible or incompatible with thin capitalization rules)[56] (analyzed below). Though, there are some tax treaties, for example India Australia tax treaty, where there is an exclusion on the applicability of the non-discrimination clause to the thin capitalization rules.

View 1: Article 24(4) is not compatible with interest limitation rules, and Article 24(4) would apply. Some of the arguments are as follows.

- Thin capitalization rules, in a way, provide for a deferral mechanism (excessive interest for which deduction is not allowed can be carried forward for eight years). However, there could be situations, for example, where no deduction could be claimed for eight years. This situation could lead to discrimination in terms of the amount of interest deduction allowed to residents vis-à-vis non-residents.
- The non-discrimination clause aims to cover indirect discrimination on non-residents by allowing deduction in the hands of the resident who is the payer of interest to a non-resident. In the specific India example, the following situation may arise:
  - Interest paid to a non-resident, non-AE: The entire interest can be claimed as a deduction if payments are made to a non-resident non-AE, like the treatment provided in case of payments to a resident payee. Hence, there is no discrimination, and the non-discrimination clause should not come into play.
  - Interest paid to an associated non-resident enterprise: Where payments are made to a non-resident AE, interest limitation rules are applicable, and excess interest (over and above 30% of EBITDA) will be disallowed and allowed to be carried forward. However, where payment was to be made to a resident AE, then the entire interest would have been allowed as a deduction. Hence, it may be argued there is discrimination in this situation

[53] Indian Income Tax Act, 1961, §§36(1)(iii) and 37.

[54] Indian Income Tax Act, 1961, at §94B.

[55] Jitendra Jain, *Interest Limitation Rules — A Tryst with Non-Discrimination Clause in Tax Treaties*, taxsutra.com (2017).

[56] Bhaumik Goda and Saumya Sheth, Bombay Chartered Accountants' Society, Interest Limitation Provisions Under Section 94B.

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for payments made to non-resident AEs, and hence, the non-discrimination clause may come into play.

View 2: Article 24(4) is compatible with interest limitation rules, and Article 24(4) would not apply. Some of the arguments are as follows.

- Discrimination in Article 24(4) is restricted to a provision in domestic law that operates based on the situs of the recipient, i.e., based on the recipient being resident/non-resident. However, interest limitation rules also depend on whether or not the recipient is an AE, i.e., the rules are based not only on the recipient's situs but also goes a step further to check whether the recipient is an AE or non-AE. Thus, interest limitation rules, in a sense, only covers interest payments to AEs or entities of the same group. Hence, there is no discrimination beyond the group level.

- Interest limitation rules only defer the deductibility of a certain portion of interest, rather than completely disallowing the interest, because the non-deductible interest can be carried forward for eight succeeding years and subject to specified conditions, where possible, a deduction could be claimed in the succeeding eight years.

C. Australia[57]

Taxation of interest. The concept of ''interest'' is not defined in the Australian tax law for general deduction purposes, and the question of deductibility will ordinarily be determined based on whether an expense, in its particular circumstances, meets the criteria of the available deduction provision.[57]

Thin capitalization rules.[58] Thin capitalization laws, first introduced in 2001.[59] deny excessive ''debt deductions' relating to Australian business operations. However, the rules were changed afterwards. Significant consequences of the changes include the following:[60]

- The rules aim to cover inward and outward investors;

- The limitation on interest deduction was based on the total debt of the Australian operations and only on the foreign debt; and

- A de minimis rule was included (rules not applicable if companies together with associates have interest deduction less than AUD 2 million per annum or outward investing entities with 90% or more of their average asset value consisting of Australian assets).

The rules apply to both Australian and foreign multinationals. Either of the following tests determines the computation mechanism of allowable debt.[61]

- *Safe harbor test.*[62] It allows the level of debt to equity in the ratio of 1.5:1. The adjusted average debt is calculated by applying a prescribed formula considering that ratio. If the adjusted average debt exceeds the safe harbor amount, the entity does not satisfy the 1.5:1 debt-to-equity requirement. Disallowance of debt deductions will occur unless the entity can demonstrate that its debt level satisfies the other tests. The information required to fulfil the safe harbor is generally readily available, and the calculation is relatively easy.

- *Arm's-length debt test.*[63] It allows calculation of the level of debt (i.e., the maximum quantity of the debt that an entity can reasonably borrow from commercial lending institutions). An entity is in compliance with this test if, having regard to its relevant financial and economic circumstances, its adjusted average debt is not greater than an amount of debt it is reasonably expected to have and would reasonably expect to be provided by an independent commercial lender on arm's-length terms. The arm's-length debt amount is prescriptive but involves subjective analysis, requiring the taxpayer to consider certain factual assumptions.[64] The Australian Tax Office has released guidance[65] on applying the Division 820 arm's-length debt amount.

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[57] Reference has been placed on J.R. Gadwood, *Interest Deductibility: The Implementation of BEPS Action 4*, Int'l Fiscal Ass'n Cahiers de Droit Fiscal International (2019) vol. 104 — Australia, p. 87–108; and T. Toryanik, *Australia — Corporate Taxation*, Country Tax Guides IBFD.

[57] The general deduction provision is s. 8-1 Income Tax Assessment Act 1997; refer to Judge Hill's opinion in *Macquarie Fin. Ltd. v Comr. of Tax'n*, [2004] FCA 1170 at [47].

[58] Australia's thin capitalization rules in Division 820 of the Income Tax Assessment Act 1997 represent a key limitation on the deductibility of interest-based on the funding circumstances of the borrower.

[59] New Business Tax System (Thin Capitalisation) Bill 2001.

[60] Anton Joseph, *Discussion Paper on Arm's Length Debt Test*, Int'l Transfer Pricing J. (2014), p. 177.

[61] Income Tax Assessment Act 1997, §820–90.

[62] Income Tax Assessment Act 1997, §820-95, 820-100.

[63] Income Tax Assessment Act 1997, §820-105.

[64] Jean Paul Donga and Paul Korganow, *Safe Harbour Not So Safe?*, IBFD Asia-Pacific Tax Bulletin, (2010), p. 285.

[65] Taxation Ruling (TR) 2003/1 — Australia.

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- *Separate worldwide gearing test.*[66] Through this test, the allowable debt is calculated by applying the gearing ratio of the worldwide parent (based on the audited consolidated financial statements) to the average value of Australian net assets. However, this test does not work for determining maximum allowable debt when the entity's Australian assets represent more than 50% of the consolidated group's worldwide assets. Thus, the test would not be appropriate if Australian operations were to drive the worldwide gearing levels of the group.

Applicability of Articles 9(1) and 24(4) on thin capitalization rules. While the exercise of determining the arm's-length debt amount is not a matter of pricing (and this distinguishes it from the arm's-length TP provisions), the test seems similar to that of the other arm's-length tests. The TP provisions would operate to adjust interest where loan interest is not on arm's-length terms.[67] The arm's-length terms and conditions established will be used when conducting the arm's-length debt analysis under these rules. However, it is difficult to establish how they would be compatible with Article 9(1) in instances where the safe harbor test or the worldwide gearing test is applied.

Australia, a capital-importing country, was earlier reluctant to include non-discrimination provisions in the tax treaties.[68] However, the situation has changed over time and, currently, many treaties have a non-discrimination clause, but they also have an exception/exclusion for the applicability of thin capitalization rules.[69] Even for treaties where there may be provision similar to Article 24(4) of the MC, it may be possible to argue that the provision applies both to inward and outward investments (i.e., rule impacts both Australian and foreign entities), and there is no discrimination, so it should be compatible with Article 24(4). Hence, Article 24(4) may not apply in such situations.

D. New-Zealand[71]

Taxation of interest.[70] Interest is deductible if the expenditure is incurred by deriving assessable income or carrying on a business.[71] In practice, the criteria of ''to what use were the borrowed funds put'' is used on the deductibility of interest. If funds are used to buy or improve an income-producing asset or as part of the working capital of a business, interest will be deductible.

Thin capitalization rules.[72] New Zealand's thin capitalization rules were enacted in 1995 to prevent non-residents from allocating excessive interest expenses against their New Zealand taxable income. These rules have been strengthened numerous times. In 2011, the safe harbor percentage was reduced from 75% to 60%, and in 2015 the rules were expanded to apply to New Zealand firms controlled by non-residents acting in concert.

Furthermore, the interest limitation rule (the ''restricted transfer pricing rule'') was introduced via the Taxation (Neutralizing Base Erosion and Profit Shifting) Act 2018 (effective from July 1, 2018). These rules required inbound related-party loans greater than NZD 10 million to be priced as plain vanilla senior debt with a rebuttable presumption of parental support unless the foreign parent has substantial third-party debt also, that includes those terms. The most important reforms were a unique restricted transfer pricing rule to limit the interest rate charged on cross-border related-party loans. The restricted transfer pricing rules usually apply when a person or group holds more than 50% of the voting interest in an New Zealand company. Hence, this ends up covering not only situations where the borrower and the lender are associated parties but also situations where:

- a person or a group of persons hold an ownership interest of 50% or more (measured under thin capitalization rules for measuring ownership tests) in each of the lender and borrower; and
- the lender is a member of a non-resident owning body or group of non-residents who act in concert, and this body or group has total own-

[66] Income Tax Assessment Act, 1997, §§820-110 and 820-111. In the case of worldwide gearing debt test, Australian entities are allowed to claim deductions on the debt portion equivalent to the level as its global group. This may highlight a policy intent of the thin capitalization rules (i.e., prevent disproportionate allocation of debt to Australia for the tax purposes).

[67] Anton Joseph, *Discussion Paper on Arm's Length Debt Test*, Int'l Transfer Pricing J. (2014), pp. 178–179.

[68] Guglielmo Maisto, *Taxation of Intercompany Dividends Under Tax Treaties and EU Law*, IBFD (2012), p. 277

[69] For example: Australia's treaties with Chile, Finland, Japan, Switzerland.

[71] Reference was made to K.J. (Kevin) Holmes, *New Zealand — Corporate Taxation*, Country Tax Guides, IBFD.

[70] DB 7 of New Zealand Income Tax Act 2007.

[71] Case law has confirmed that the business category permits a wider range of deductions than the income category: see *Europa Oil (NZ) Ltd v. CIR* (No. 2) (1974) 1 NZTC 61,169 (CA); and *NZ Co-operative Dairy Company Ltd v. CIR* (1990) 12 NZTC 7,128 (CA). The taxpayer may satisfy either test in the alternative and is not required to satisfy both; see also Income Tax Act 2007, Sections DA 1 and DA 2.

[72] *See* Officials' Report on the Taxation (Neutralising Base Erosion and Profit Shifting) Bill, March 2018.

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ership interests of 50% or more in the borrower.[73]

Similar to Australia, New Zealand's thin capitalization regime limits a company's deductible debt based on a debt/assets ratio and covers both inbound and outbound transactions. Deductible interest needs to be apportioned under the thin capitalization rules where the debt percentage (calculated as the total group interest-bearing debt/total group assets net of non-debt liabilities of a New Zealand entity or group) exceeds both:[74]

- 60% (for ''inbound'' thin capitalization) or 75% (for ''outbound' thin capitalization); and
- 110% of the worldwide group's debt percentage.

Applicability of Articles 9(1) and 24(4) on thin capitalization rules. When it comes to analyzing the compatibility of Article 9(1) with thin capitalization rules, the following question must be answered:

- Can an arbitrarily fixed ratio based on the debt/assets ratio be consistent with an arm's-length principle?[75]
- Will the statistical evidence show that 60–75% of the debt-to-total assets is the same ratio as the arm's-length standard?

Similar questions arise in relation to New Zealand's other safe harbor test (worldwide group's debt percentage), i.e., whether the indebtedness of the New Zealand entity is greater than 110% of the debt percentage of the worldwide group.

Is this test a valid proxy for the arm's-length principle? In the past, OECD has stated that such a fixed ratio could be compatible with the arm's-length principle but only in certain specific circumstances (i.e. in a situation where the ratio is used as a safe haven rule and where the taxpayer has the option of showing that the actual ratio of the company's debt-to-equity is an arm's-length ratio).[76] However, New Zealand's thin capitalization rules do not provide entities an option to establish that their actual debt-to-asset ratio is consistent with that of independent companies in a similar business. Hence, this ratio may not be compatible with Article 9(1).

However, in situations where restricted transfer pricing provisions apply, the issue of compatibility with Article 9(1) should not arise, and the rules should be compatible with ALP.

Regarding Article 24(4), New Zealand's tax treaty policy appears not to include a non-discrimination article in tax treaties.[77] Despite this, New Zealand has agreed to various forms of non-discrimination articles in many of its tax treaties (including some recently negotiated agreements).

In many of New Zealand's tax treaty networks, an exception/exclusion for a thin capitalization regime is explicitly stated in Article 24(4). Regardless, some recent treaties have been negotiated without such carve-outs. Hence, depending on how the non-discrimination clause is worded in the tax treaty, the rules may or may not be compatible with thin capitalization rules. Accordingly, Article 24(4) may or may not apply depending on the specific tax treaty.

E. Others

A brief summary of Denmark and South Africa rules is presented in the table below. These countries are additionally briefly mentioned because of the unique features in their thin capitalization rules.

[73] Policy and Strategy, Inland Revenue, *Interest Limitation Rules: Restricted Transfer Pricing for Cross-Border Related Borrowing* (Special Report, 2018). https://taxpolicy.ird.govt.nz/sites/default/files/2018-sr-beps-interest-limitation.pdf.

[74] *See* FE 6 of New Zealand Income Tax Act 2007.

[75] Craig Elliffe, *Trans-Tasman Thin Capitalization Rules and Treaties: Implications for New Zealand and Australia on Tighter Thin Capitalization Ratios*, 18 Australian Tax Forum (2013), p. 612.

[76] Tax & Development, Thin Capitalisation Legislation: A Background Paper for Country Tax Administrations (pilot version for comments) (initial draft, Aug. 2012).

[77] New Zealand lodged a Reservation to the Model Convention in 1977.

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Country	Thin Capitalization Rule Features	Applicability of Articles 9(1) and 24(4)
Denmark[78]	Thin capitalization rules are based on the safe harbor for total debt-to-equity ratio of 4:1. Other conditions: • More debt (i.e., above 4:1) is allowed if it is proved to be at ALP • De minimis threshold for internal debt below DKK10m. Also, only firms with net interest expenses above DKK 21.3m fall under the rule. Further, the thin capitalization rules apply in situations of: • loans entered into between related corporations (including PEs) • loans from third parties if guaranteed directly or indirectly by a related corporation.	Article 9(1): As per the rule, where debt exceeds ratio of 4:1, it must be proven to meet the ALP test. In such situations, the rule should be compatible with Article 9(1) in such situations. However, when the ratio of 4:1 is applied, it cannot be presumed that such ratio would be compatible with arm's-length conditions. Hence, Article 9(1) may apply. Article 24(4): Since the rule generally aims to cover only related-party transactions, it may not be compatible with non-discrimination. However, similar to the arguments in the Indian example earlier, it may be arguable that as interest payments to only a related party are covered, there is no discrimination beyond the group level. Hence, Article 24(4) should not apply.

Country	Thin Capitalization Rule Features	Applicability of Articles 9(1) and 24(4)
South Africa[79]	Thin capitalization rules are integrated with the general TP rules. This aims at limiting the quantum of the interest deduction for corporations on debt given by a non-resident connected person in relation to the South African borrower or a non-resident connected person entitled to participate, directly or indirectly, in no less than 20% of the company's equity. For thin capitalization purposes, commercial terms, and conditions of an agreement between independent parties, compared to the terms and conditions concluded between a South African taxpayer and non-resident connected person, are checked.	Article 9(1): Since thin capitalization rules are based on the general transfer pricing test and consider checking commercial terms and conditions (i.e., these should be similar to those of transactions between independent parties), they should be compatible with Article 9(1). Article 24(4): As the rules apply in relation to debt connected with the non-resident person directly or indirectly only, these rules may be incompatible with Article 24(4) of the tax treaty. In such situations, Article 24(4) may apply.

V. IDENTIFIABLE FACTORS/ FEATURES THAT MAY MAKE ARTICLE 9(1) OR 24(4) APPLY TO THE THIN CAPITALIZATION RULES

Having discussed the many ways in which thin capitalization rules may operate, the following part presents the factors identified in previous discussions (specifically the country-specific examples) that may make the rules compatible or non-compatible with Articles 9(1) and 24(4) of the tax treaty.

Factors Identified From Domestic Thin Capitalization Laws of Various Countries:	Refer to the following country discussion(s) in IV., above:
Fixed debt-equity ratio or fixed debt/ total asset ratio	Canada, Denmark
Applicability to both residents and non-residents either for specific categories of items or for all categories of payments on loans	Australia, New-Zealand
Applicability to only associated non-resident enterprises	India
Applicability of restricted transfer pricing rules	New Zealand

[78] Reference has been drawn from PwC's world tax summaries online tool. *See also* Corporate Tax Act, §11.

[79] South Africa Income Tax Act No. 58 of 1962, §31(3). http://sars.mylexisnexis.co.za/# Reference has been also drawn from ''Deloitte Tax guides and highlights'' https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-southafricaliahighlights-2020.pdf?nc=1.

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Factors Identified From Domestic Thin Capitalization Laws of Various Countries:	Refer to the following country discussion(s) in IV., above:
Presence of non-obstante clause in thin capitalization rules/interest limitation rules in domestic law.	India
Presence of group ratio criteria/ worldwide gearing test	Australia
Deduction limited to a certain percentage of EBITDA	India
Presence of carry-forward provisions for disallowed interest	India
Presence of rules as part of the general transfer pricing provision	South Africa

Factors Identified From Tax Treaties of Various Countries:	Refer to the following country discussion(s) in IV., above:
Treaty that excludes applicaticability of Article 24(4) of tax treaties to thin capitalization rules	Canada, Australia, New Zealand
Tax treaty does not have a non-discrimination article (i.e., Article similar to OECD MC 24) altogether or does not have a deduction non-discrimination clause ((i.e., clause similar to OECD MC 24(4))	Canada
Treaty with an exception/exclusion for application of entire tax treaty for thin capitalization rules	No direct exampless thta come from previous discussion herein, but reference can be made to France and Austria tax treaty (1993)

Note: Though the above list may not be exhaustive, it may provide a reference point.

VI. CONCLUSION

Thin capitalization rules differ widely across countries in terms of the features present in the rules, restrictions on tax deductibility of interest on debt, and the alternative tax treatment of company interest if full interest deductibility is denied. Hence, in the author's view, for analyzing the applicability of Articles 9(1) and 24(4) on thin capitalization rules, a case-by-case analysis of the rules is required. This would entail analyzing the various country-specific features: whether the rules are based on a fixed ratio approach, the presence of safe haven rules or an escape clause, restricted transfer pricing rules, arm's-length debt test, the applicability of rules only to non-residents or non-resident AEs — and so forth. Also, courts of different jurisdictions may take varied positions, so it would not be possible to give a conclusive and general view on the issue under analysis. As an example: The jurisprudence of one country might treat Article 9(1) as restrictive while others may consider it as illustrative; one country might treat Articles 9(1) and 24(4) as complementary while others may not agree.

Prima facie, domestic thin capitalization rules shall be compatible with Article 9(1); if either the amount of loan or interest thereof is at arm's length (for example, in situations involving the arm's-length debt test or restricted transfer pricing provision in thin capitalization rules, or where the option is given to demonstrate that the thin capitalization rules meet arm's-length requirements).

On the other hand, different viewpoints often arise about whether domestic rules can go farther than just reducing the loan interest to ALP or whether the taxable profit of the enterprise can be increased to an amount greater than ALP. There are arguments that state if the rules go beyond ALP, Article 24(4) precludes them from being applied extensively to non-residents (except where thin capitalization rules are carved out from the applicability of Article 24(4)). However, a lot depends on how Article 9(1) is considered — restrictive or illustrative — in a particular jurisdiction. Also to be seen is how a saving clause in the tax treaties (if present in the tax treaty under analysis) will affect the argument of Article 9(1) being of restrictive or illustrative nature.[80]

On the other hand, the critical aspects of the rules to examine their relationship with non-discrimination are whether the rules apply only to non-residents or to both residents and non-residents. These may entail finding answers to some questions: Are the rules applicable only in cross-border situations, or domestic as well? Do the rules apply only in cases of intragroup financing, or also to third-party loans, etc.? Furthermore, because of the exception in Article 24(4) for payments covered in Article 9(1), profit adjustments that conform to the arm's-length standard should not be made further subject to Article 24(4). It is important to note that many countries do not include any provisions corresponding to Article 24(4) of the OECD model treaty in their Double Tax Convention or have an exclusion for thin capitalization rules in Article 24(4).

Consequently, the question of compatibility for Article 24(4) will not arise in these cases. It is yet to be seen how this conflict is resolved once there is more clarity in relation to the PCD, as requested by many stakeholders in public comments to the PCD.[81] However, the proposed changes in the PCD may not completely resolve the ambiguities arising from the interactive application of domestic laws and tax treaties for determining the deductibility of certain expenses.

Further, considering the diverse practices in tax laws and tax treaty practices of various countries,

[80] Savings clause (as included in OECD MC 2017) has exclusion for Article 24 but there is not exception for Article 9(1).

[81] OECD 2021, Public Consultation Document.

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apart from various factors that are considered by countries while drafting the thin capitalization rules (like efficiency and growth, equity and fairness, revenue integrity, fiscal cost, compliance and administration cost and coherence), it is essential for the countries to see how these rules will interact with various provisions of the tax treaty, to avoid any interpretational conflicts and to provide more certainty.

Appendix[82]

a. Article 9(1) Is Restrictive

Article 9(1) is to be treated as restrictive in nature as it intends to cover only TP adjustments and not transactional adjustments. For example, it prohibits adjustments to the profits of an enterprise in excess of an arm's length (by either denying/limiting the deduction of interest paid by a resident to an associated non-resident).[83] In this regard, Prof. Klaus Vogel also suggested that the ''treaty provision will act only as a safeguard so that any adjustments made will not go beyond the arm's-length standard.''[84] Hence, any adjustments for an amount over and above ALP should not be allowed. The recent PCD proposed changes also do not materially change this position when it states that ''. . .The provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises and, therefore, the provisions would not apply to the rewriting of the accounts of AEs if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's-length basis).[85] In order to ensure the elimination of double taxation, the arm's-length principle and the guidance on its interpretation in the OECD Transfer Pricing Guidelines should be followed in any re-writing of accounts.''

In the comments submitted in response to PCD, Tremonti, Romagnoli, Piccardi E Associati. also stated that ''re-writing of the accounts should be done following the arm's-length principle, although this should be limited to well-justified circumstances. In any case, (i) the burden of proof regarding the legitimacy of the rewriting of the accounts should fall on the tax authorities, and (ii) the same tax authorities should carry out and document the most accurate functional analysis of the counterparties to give appropriate evidence that the re-writing of the (local) accounts is indeed inevitable.''[86]

Separately, even Article 25 of the MC requires the satisfaction of the condition ''taxation not according to the provision of this convention'' for its application. Suppose, if Article 9(1) is not read as restrictive, then how would a primary adjustment beyond arm's length ''not be in accordance with the provision of this convention''? However, the PCD proposed changes to Article 25 adds more clarity by stating:

> 12.1 More generally, the economic double taxation that may result from a primary adjustment consisting of the inclusion of profits of AEs in an amount not justified by reference to the arm's length standard would result in taxation not in accordance with one of the objects and purposes of the Convention to eliminate double taxation. . . .[87]

Also, it would be difficult for Article 7 to restrict the authority of a country in which a permanent establishment (PE) is located, to tax an excess amount of the ALP attributable to the PE, but not for Article 9 to do so with respect to AEs; if provisions of Article 9 are not restrictive.[88] Wittendorff clarifies that Article 7(2) requires the contracting state to comply with the arm's-length principle; the legal effect of Article 9(1) must be the same.[89]

b. Article 9(1) Is Illustrative

The counter-argument to the discussion in point (a) above could be Article 9(1) does not preclude a country from taxation of profits of its resident entities for the excess amount beyond the arm's length — it only provides for a non-binding statement concerning the arm's-length principle and an outline for the adjustment of profits.[90] There are certain clear indications in the OECD MC to this effect. It does not intend to bar

[82] Content for the Appendix is taken from the author's earlier paper, *The Future of Arm's Length Principle — Is There a Need to Revisit the Principle?*, Foundation for International Taxation and blog, ''Whether Article 9(1) is Illustrative or Restrictive!''.

[83] Brian J. Arnold, *The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax Treaties*, 67 Canadian Tax J. 4 (2019), p. 1072.

[84] Reference in this regard can be placed on Prof. Klaus Vogel, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice* (3d ed., Kluwer), ¶7, Commentary on Article 9, p. 517.

[85] OECD 2021 Public Consultation Document.

[86] Public comments received on proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles.

[87] OECD 2021 Public Consultation Document.

[88] Johannes Becker, Ekkehart Reimer, and A Rust, *Klaus Vogel on Double Taxation Conventions* (Kluwer Law Int'l (2015), p. 603.

[89] J. Wittendorff, *The Transactional Ghost of Article 9(1) of the OECD Model*, 63 Bull. for Int'l Tax'n 3 (2009), p. 112.

[90] Brian J. Arnold, *The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax*

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a profit adjustment under the nationals under different conditions.[91] Also, the proposed changes suggested in the PCD try to clarify this when it states:

> In considering whether an interest payment can be regarded as an arm's-length amount, a State will typically examine the terms and conditions of the loan as the rate of interest. It may also need to examine, based on the facts and circumstances, whether a purported loan should be regarded as a loan or as another kind of transaction, in particular a contribution to equity capital. The State making a determination as to the extent to which the purported loan is regarded as a loan will do so, taking into account factors discussed in its domestic laws (including judicial doctrine) or in the OECD Transfer Pricing Guidelines.[92]

Also, it clearly states that:

> Article 9 does not deal with the issue of whether expenses are deductible when computing the taxable income of either enterprise. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 4 of Article 24,[93]

highlighting that Article 9(1) may not be treated as illustrative in the coming times.

Various stakeholders like ICC, EY, Deloitte and BIAC have also expressed concerns that the proposed changes leave the matter of deductibility (e.g., of interest on a loan) to domestic law. However, stakeholders highlighted the need to bring more clarity — for example, Tremonti Romagnoli Piccardi E Associati mentioned that ''the amendment in question should be seen as an opportunity to help in clarifying the priority of application among (i) the OECD TP Guidelines, (ii) the domestic transfer pricing rules (that most of the times mirror the OECD TP Guidelines) and/or (iii) other provisions of the tax law dealing with that matter (such as thin capitalization rule, etc.).''[94]

Also, commentary on Article 9(2) recognizes that countries might tax more than the arm's-length profits of an enterprise. It further indicates that in such situations, the other country might not be obliged to provide for a corresponding adjustment.[95] The draft PCD also confirms this when it states that ''. . .any mismatch in this domestic law treatment does not in itself result in economic double taxation for the purposes of paragraph 2, and there is thus no obligation on State B to make a corresponding adjustment in these circumstances.'' Also, Article 9(1) uses the word ''may'' instead of ''shall''[96] in Article 9(1). It is generally understood that ''may'' is not restrictive, thus, it may be illustrative. Importantly, Article 9 is different from the other distributive rules of the treaty in that it deals with the allocation of taxing rights among two residence countries. In contrast, the other rules deal with allocating taxing rights between the source and residence countries.

Nevertheless, it might not be congruent to the notion that a tax treaty does not restrict a country's rights to tax its own residents unless it does so explicitly if Article 9 were to be interpreted in a restrictive manner.[97] This is also pertinent in regard to the wording of Article 1(3) (wherever Article 1(3) is present), i.e., the saving clause of the OECD MC 2017 — Article 1(3) does not have an exclusion for Article 9(1).[98]

Treaties, 67 Canadian Tax J. 4 (2019), p. 1072.

[91] OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Commentary on Article 9, ¶4.

[92] OECD 2021 Public Consultation Document, p. 5.

[93] OECD 2021 Public Consultation Document, p. 6.

[94] Public comments received on proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles.

[95] Reference in this regard can be placed on OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, Commentary on Article 9, ¶6., p. 227.

[96] Georg Koffler and Isabel Verline, *Unlimited Adjustments — Some Reflections on Transfer Pricing, General Anti-Avoidance and Controlled Foreign Company Rules, and the Saving Clause*, 74 Bulletin for Int'l Tax'n (2020), p. 275.

[97] Reference in this regard can be placed on OECD (2017), *Model Tax Convention on Income and on Capital (Condensed version) Commentary on Article 1*, ¶18, p. 59.

[98] Patricia A. Brown, *Come on in, the Water's. . .Choppy: The Expansion of Saving Clause Beyond the United States*, Canadian Tax Fnd. (2018), p. 59.

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