Applying Articles 9 and 24 of the OECD Model To Thin Capitalization Rules

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In this article, the author examines domestic laws that prevent base erosion through thin capitalization and considers the applicability of articles 9 and 24 of the OECD model convention to these provisions.

The interplay of domestic tax laws and bilateral and multilateral tax treaties is complex and gives rise to countless debates. Countries may find that even efforts to adjust their domestic law to account for international commitments, including the OECD's base erosion and profit-shifting action plans, can be problematic when read in conjunction with treaty provisions. In some cases, there's even a challenge that precedes the difficult task of reading domestic and international rules together: identifying which treaty obligations are relevant to the interpretation and application of a given domestic law.

This article focuses on thin capitalization rules and asks which provisions of the OECD model tax treaty might apply to these domestic laws, specifically focusing on the arm's-length rule in article 9 and the nondiscrimination principles of article 24.

Domestic Thin Capitalization Laws

Thin capitalization occurs when an entity is financed using a relatively high amount of debt compared with equity. This is also referred to as being highly geared or highly leveraged. It is concerning because maintaining an optimal balance of debt and equity in a company's capital structure is critical if the entity wishes to provide a strong return on capital to its shareholders.

The thin capitalization rules used in practice include both safe harbor and earnings-stripping provisions. Safe harbor rules restrict the amount of interest on debt that is tax deductible based on a defined debt-equity ratio. If the entity exceeds this ratio, the interest paid on the excess debt is not tax deductible. Earnings-stripping rules limit the tax-deductible share of debt interest to pretax earnings. To some degree, thin capitalization rules are designed to prevent hidden capitalization — that is, the use of debt financing disguised as equity capital.

Action 4 of the OECD's BEPS project focuses on designing rules to prevent base erosion through interest expense and similar financial payments. The targeted activities include 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 the use of other financial payments that are economically equivalent to interest payments. The OECD's recommended approach for discouraging these activities 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. Specifically, the OECD recommends limiting interest deductions using a fixed ratio between 10 and 30 percent of EBITDA. The OECD offers a

range "to ensure that countries apply a fixed ratio low enough to tackle BEPS, while recognizing that not all countries are in the same position."

While thin capitalization rules already existed in the domestic tax law of several countries (including Canada, China, South Africa, the United Kingdom, and the United States), several other countries introduced some form of thin capitalization rules in accordance with action 4. For example, the Finance Bill, 2017, brought interest deduction limitation rules into India's Income Tax Act, 1961. Thus, India now restricts the deduction of interest expenses for interest paid or payable by a company to nonresident associated enterprises to 30 percent of EBITDA.

The connection between domestic thin capitalization laws and tax treaties depends on many different factors. These include: how the thin capitalization rules operate; how the nondiscrimination article in a tax treaty is framed; and how, constitutionally, domestic antiavoidance rules integrate with public international law obligations such as those created by a tax treaty.

Further, there has been considerable debate regarding which provision of the OECD model income tax treaty should apply to the thin capitalization rules:

- article 9, which discusses when domestic measures comply with the arm's-length standard and when a contracting state must make a corresponding adjustment; or
- article 24, which provides that a domestic measure may not discriminate between domestic and cross-border payments.

Relevant Principles in Article 9

Article 9(1) of the OECD model convention regulates transfer pricing, seeks to prevent (economic) double taxation, and sets the arm's-length principle as the governing standard. Although the wording of article 9(1) ("may be included") might suggest otherwise, the provision must be read as restrictive instead of illustrative — that is, the arm's-length standard is obligatory.

Article 9(1) does, in a way, regulate interest payments to associated enterprises — that is, by evaluating whether they meet the arm's-length standard. However, it cannot correct a skewed capital structure. For example, these provisions will evaluate the propriety of the interest paid on the debt-equity ratio of 50 to 1 but will not correct the debt-equity ratio to the optimal level of 2 to 1.

Article 9(2) of the OECD model convention aims to avoid economic double taxation. When one contracting state makes a profit adjustment, it requires the other state to make an appropriate corresponding adjustment. That noted, the material scope of article 9(2) is confined to cases in which a profit adjustment is made because the conditions made or imposed differ from those to which independent enterprises would agree.

Relevant Principles in Article 24

Article 24 of the OECD model convention, often referred to as the nondiscrimination article, prevents discrimination between payments made to residents and nonresidents of a contracting state. When the nondiscrimination article applies, residents and nonresidents must be treated equally.

Paragraphs 4 and 5 of article 24 could potentially address nondiscrimination in the context of thin capitalization rules. The text of article 24(4) actually leaves open the question of whether interest is deductible in the first place. Rather than answer that question, paragraph 4 simply examines the residency of the lender and ensures that if interest paid to a resident is deductible in that state, interest paid to a nonresident is also deductible.

Article 24(5) precludes a contracting state from imposing less favorable treatment on an enterprise when the capital of that enterprise is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other contracting state.

Thin Capitalization and the OECD Model

View 1: Article 9 Applies

There are several arguments that support the view that article 9 of the OECD model convention should apply to thin capitalization rules.

The commentary to article 9(1) seems to suggest that the provision may cover thin capitalization. Article 9(1) refers to "conditions . . . made or imposed," phrasing that can accommodate an entity's choice between debt and equity.

Reliance in this regard can be placed on the commentary on article 9(1). As Philip Baker noted:

> The commentary, at paragraph 3, makes reference to the Committee on Fiscal Affairs Thin Capitalisation Report. The paragraph notes that the national rules on thin capitalisation are compatible with the Model Article in so far as they seek to determine the arm's length profit, and that Article is relevant not only to the level of interest on a loan but also to the correct characterisation of the contribution of capital as a loan.[1]

However, this should be read with a caveat that thin capitalization rules would need to exist under the domestic tax laws of the country before they could infringe on the arm's-length price envisaged under article 9(1) of the model convention.

Notably, article 24(4) on deduction nondiscrimination contains an exception stating that it shall not apply to article 9(1), article 11(6), and article 12(4). The listed paragraphs are all concerned with ascertaining the profits on an arm's-length basis. Unless one of the listed paragraphs applies, thin capitalization rules must not discriminate between domestic and cross-border payments — that is, they must apply regardless of the place of the lender's residence. If article 9 applies, national measures must be tested against the arm's-length principle only. If it doesn't apply, they must be tested against article 24. Resident enterprises cannot rely on a nondiscrimination argument to seek immunity from the disallowance of an expenditure in excess of an arm's-length price because the host country's domestic laws do not apply transfer pricing norms to disallow payments made to associated tax-resident enterprises.[2]

View 2: Article 24(4) Applies

There are also arguments in favor of applying article 24(4) to thin capitalization rules that merit consideration. It is worth noting that in some treaties the nondiscrimination article is expressly subject to the thin capitalization rules.

Article 9 does not apply to all situations of income shifting. It only applies when profit shifting is caused by the pricing of a transaction (here, the amount of interest), not by its form (that is, debt instead of equity). Also, article 9 does not address the tax treatment (or the deductibility) of a transaction. It only focuses on adjusting the price (the interest) and recharacterizing the excess (here, into a dividend), not recharacterizing the transaction.

Article 9(1) only covers cases in which a transaction is not at arm's length. Hence, if a transaction is at arm's length, no adjustment is warranted. As the commentary on article 9(1) indicates: "No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms."

This suggests that article 9 does not govern thin capitalization rules because they do not require any corresponding adjustments. Also, thin capitalization rules prevent transfer of profits disguised as interest up to an arm's-length level. Beyond the arm's-length amount, thin capitalization rules are providing tax protectionism — which is discriminatory.

Conclusion

There is some overlap between article 9 and article 24 of the OECD model convention when it comes to domestic antiabuse provisions, but the overlap is only partial. It remains to be seen whether the OECD will clarify the interplay of thin capitalization rules with article 9 and article 24 in the future. ■

[1] Philip Baker, *Double Taxation Conventions — A Manual on the OECD Model Tax Convention on Income and on Capital* (1994), at para. 9B.11.

[2] *See* Rahul Krishna Mitra, "OECD's Public Discussion Draft on Non-Discrimination: A Critical Analysis," *Tax Pla. Int'l Review* (June 2007).