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SPECIAL REPORTS

The Implications of the (Reverse) Ban on Interest

by Wolfgang Kessler and Daniel Knörzer

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> Thou shalt not lend upon interest to thy brother; interest of money, interest of victuals, interest of anything that is lent upon interest.
>
> — Deuteronomy 23:19

In the Old Testament, demanding interest from "brother Israelites" is banned. Although most religions overturned this rule long ago, European policymakers have started to establish a new ban on interest. This time, however, it does not refer to demanding interest but, unfairly, to paying it. The rationale behind the changes is a sharply disparate tax treatment of debt and equity. Multinational corporations make use of the widespread bias toward debt by shifting their equity to jurisdictions with low nominal tax rates.[1] To protect their tax base, legislators in countries with a relatively high tax burden have reacted to this kind of international tax planning in two different ways. First, they adopted a tax-cut-cum-base-broadening policy. It comes as no surprise that statutory tax rates have declined, whereas the effective tax burden has remained constant.[2] Second, they introduced thin capitalization rules that set a limit on interest payments to related parties.[3] This article shows that some European legislators have converted their thin cap legislation into a general ban on interest. Moreover, this article elaborates on the interaction between this new class of thin cap rules and treaty law and European Community law.

The New Class of Thin Cap Rules . . .

In the past, all thin capitalization rules in the European Union could be divided into two groups: Either they recharacterized excess interest payments to shareholders into (hidden) profit distributions or they did not. These days, to avoid any interference with the freedom of establishment[4] and to shield their tax bases from a beneficial treatment of outbound related-party loans,[5] an increasing number of member states are changing their thin cap legislation. They prefer a mere cap on the deductibility of interest to the recharacterization of debt into (hidden) equity. A closer examination of the past decade shows an increasing share of EU thin cap rules denying any adjustment to the debtor. (See Figure 1.) During this period, Denmark (in 1999) and the Netherlands (in 2004) introduced thin capitalization rules that do not allow for a favorable

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[1] *See, e.g.,* Desai, Foley, and Hines, "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," 59 *Journal of Finance* 2451, at 2472 (2004).

[2] *See, e.g.,* U.S. Department of Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, pp. 6-9 (2007).

[3] *See, e.g.,* U.S. Department of Treasury, *Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, pp. 10-11 (2007).

[4] *See, e.g.,* Lars-Erik Wenehed, "Thin Capitalization and EC Law," *Tax Notes Int'l*, June 16, 2003, p. 1145, *Doc 2003-14352*, or *2003 WTD 115-8*.

[5] *See* Harold Plewka and Karin Beck, "German Tax Treatment of Interest for Outbound Shareholder Loans," *Tax Notes Int'l*, Nov. 6, 2006, p. 453, *Doc 2006-18823*, or *2006 WTD 218-8*. At least in the case of outbound loans to countries that do not recharacterize excessive interest payments, Germany's dividend treatment of the proceeds was abolished by the new thin cap rule.

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dividend treatment on the shareholder's level.[6] Moreover, France (in 2007) adopted a new thin cap rule that denies any dividend treatment.[7] And finally, nearly all of the new member states in Central and Eastern Europe with thin cap rules restrict deductions for excessive shareholder loans without recharacterizing the payments as dividends.[8]

Since the beginning of 2007, a new group of thin cap rules has started to emerge.

Since the beginning of 2007, however, a new group of thin cap rules has started to emerge. (See Figure 1.) The EU member states stick to the mere restriction on deductibility, while expanding its sphere of application. To protect their tax base, legislators have started to deny deductions for interest paid to both related and unrelated parties. The four most prominent examples are in the Czech Republic, Denmark, Germany, and Italy, although Hungary started doing so in 2001, Latvia began in 2003, and the United Kingdom is at least considering similar changes.[9] Since neither Hungary nor Latvia apply their thin cap rules to loans taken out from financial institutions, the tightening of Czech, Danish, German, and Italian provisions seems to herald a new age in the limitation of interest deduction.

Besides their exceptions for bank loans, Hungary and Latvia retain the traditional way of protecting national tax bases by offering both a safe haven to the debtor and a favorable dividend treatment to the creditor. In contrast, Danish, German, and Italian legislators chose profit based-determinations of artificial capital structures. (See Table 1.) Thereby, the German *Zinsschranke* seems to be the most comprehensive provision because it also applies to partnerships.

. . . and Its Implications

In the new age of limiting interest deductions, both the beneficiary and the debtor are fully assessed on interest payments within the same country. Unlike the former dividend treatment, this leads to widespread double taxation, which might be alleviated by interest carryforwards. But given the time value of money concept, those measures seem to be a mere drop in the bucket. To make things even worse, Germany and Italy enacted strict rules on maintaining such a carryforward. For instance, a 51 percent change in the ownership of a German corporation will result in permanent nondeductibility of all its excess interest.

For international financing structures, double taxation can be avoided only if the debtor's residence country provides for a dividend treatment of the proceeds. Even though its local tax law is not bound by the source country's classification, it seems unlikely that the country of residence will apply its favorable dividend taxation to nondeductible interest payments, because the necessary recharacterization didn't even happen on a regular basis when Germany itself recharacterized related-party loans, and given the German refusal to exempt Italian or Danish third-party interest from taxation, it gets even less likely. For affiliated companies, the debtor's residence country could be obliged to make an appropriate adjustment if the relevant income tax treaty includes a provision similar to article 9(2) OECD model treaty. However, all that reciprocity does not get a double-taxed company anywhere, if the thin cap rule does not refer to arm's-length conditions. Unfortunately, even in the case of an unrelated party that is willing to lend the same amount to the debtor, the (reverse) ban on interest can increase taxable income.[10] Given this departure from arm's-length standards, homeless interest deductions will become a common feature of international tax law.

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[6]*See* Emmeluth, ''Host Country Denmark,'' *TMI Forum*, 2004, p. 13; Schröder, ''Host Country the Netherlands,'' *TMI Forum*, 2004, p. 32.

[7]*See* Michael Collet, ''France to Reform Thin Capitalization Rules,'' *Tax Notes Int'l*, Oct. 10, 2005, p. 119, *Doc 2005-20129*, or *2005 WTD 191-4*.

[8]*See* Vegh and Szúcs, ''Hungary,'' *ET*, 2005, p. 398, at 400 (Hungary); Andrejs Birums, ''Corporate Income Tax Changes Take Effect,'' *Tax Notes Int'l*, Feb. 26, 2007, p. 743, *Doc 2007-4334*, or *2007 WTD 36-2* (Latvia); Degesys, ''Lithuania,'' *ET*, 2005, p. 410, at 412 (Lithuania); Anna Brynska, ''EU Accession Prompts Review of Polish Thin Cap, Transfer Pricing Rules,'' *Tax Notes Int'l*, Nov. 3, 2003, p. 413, *Doc 2003-23208*, or *2003 WTD 207-3* (Poland).

[9]*See* Pavel Fekar, ''Finance Ministry Proposes New Thin Cap Rules,'' *Tax Notes Int'l*, Apr. 23, 2007, p. 345, *Doc 2007-9668*, or *2007 WTD 74-1* (Czech Republic); Anne Becker-Christensen, Maj-Britt Klemp, Anders Oreby Hansen, and Nikolaj Bjørnholm, ''Tax Reform Focuses on Interest Limitations, CFC Rules,'' *Tax Notes Int'l*, Apr. 30, 2007, p. 440, *Doc 2007-10115*, or *2007 WTD 84-3* (Denmark); Wolfgang Kessler and Rolf Eicke, ''New German Thin Cap Rules — Too Thin the Cap,'' *Tax Notes Int'l*, July 16, 2007, p. 263, *Doc 2007-15373*, or *2007 WTD 141-9*; Rolf Schwedhelm and Heinz-Willi Kamps, ''Germany's Corporate Interest Limitation Rule,'' *Tax Notes Int'l*, Dec. 10, 2007, p. 1061, *Doc 2007-24634*, or *2007 WTD 240-9* (Germany); Vegh and Szúcs, *supra* note 8, at 398 (Hungary); Marco Rossi, ''Italy Introduces Broad Corporate Tax Reforms,'' *Tax Notes Int'l*, Jan. 28, 2008, p. 307, *Doc 2008-1046*, or *2008 WTD 14-2* (Italy); Birums, *supra* note 8, at 743 (Latvia); *2007 WTD 124-18* or *Doc 2007-15183* (United Kingdom).

[10]*See* Diana L. Wollman, ''Recent U.S. Earnings Stripping Proposals: Why Were the Doctors Called and Is the Medicine

(Footnote continued on next page.)

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Table 1

Country	Safe Haven	Minimum Deduction	Others
Denmark (2007)	—	80% of EBIT	Minimum deduction reduced to 6.5% of the tax base of the Danish operating assets plus 20% of the value of foreign subsidiaries to the extent net financing expenses are in excess of €2.66 million (asset limitation).
Germany (2008)	—	30% of EBITDA	Exceptions for: • companies not being part of group and without substantial interest payments to related parties (stand-alone clause); • companies with an equity ratio not below that of their group, but without substantial interest payments to related parties (escape clause); and • net interest expenses below €1 million.
Italy (2008)	—	30% of EBITDA	—
Hungary (2001)	3:1	—	Exception for bank loans.
Latvia (2003)	4:1	—	Exception for bank loans.
Czech Republic (2008)	6:1	—	• Stricter rules applicable to related-party financing. • Special transitional provisions. • Unified interest rate.

Violation of Treaty Obligations

The new class of thin cap rules breaches treaty law, concerning both the provisions' fundamental approach and the exact way they work. Regarding the latter issue, the antidiscrimination principle in article 24(5) OECD model treaty is of great importance.[11] This may be illustrated by the group consolidation regime to which the German thin cap rule refers. When other companies from the same unit do not make use of their minimum deduction, Germany allows a company's nondeductible interest to be deducted at the unit level. Given that a foreign company cannot consolidate its tax results with those of its domestic subsidiaries,[12] a German corporation with foreign shareholders is more likely to suffer from homeless interest deductions than its competitors with domestic shareholders. From this perspective, Italy has done well in choosing a limitation on interest deduction that allows foreign companies to be virtual members of its domestic consolidation regime.[13]

Concerning its fundamental approach, the new class of thin cap rules seems to be even less compatible with treaty obligations. Although none of the provisions under scrutiny may apply to permanent establishments, and, thus, in most cases[14] the determination of profits in article 7(3) OECD model treaty can be considered irrelevant, they are not compatible with the spirit and purpose of income tax treaties. Given that all of their treaties restrict severely any source taxation of income from debt claims, the allowance for arm's-length interest would be the least that the Czech Republic, Denmark, Germany, and Italy have to do. Otherwise, all countries are free to undermine treaty law by simply restricting interest deductions. This treaty abuse would prove even more harmful to the movement of capital than imposing withholding taxes, because no foreign tax credit is available for homeless interest deductions.

Worse Than the Disease?'' *Tax Notes Int'l*, May 5, 2003, p. 483, *Doc 2003-11116*, or *2003 WTD 86-16*.

[11]This may also be true if the general thin cap rule denies a deduction for interest payments to related persons; *see* Robert E. Culbertson and Jaime E. King, ''U.S. Rules on Earnings Stripping: Background, Structure, and Treaty Interaction,'' *Tax Notes Int'l*, Mar. 24, 2003, p. 1161, *Doc 2003-7328*, or *2003 WTD 56-14*; and Wollman, *supra* note 10, at 514.

[12]*See* Clemens Philipp Schindler and Christian Wimpissinger, ''Austrian and German Perspectives on *Marks & Spencer* and *Oy AA*,'' *Tax Notes Int'l*, Dec. 11, 2006, p. 853, *Doc 2006-23785*, or *2006 WTD 242-8*.

[13]*See* Galeano and Rhode, ''Italy: 2008 Budget Law reduces corporate tax rate, but expands tax base,'' *TMI Tax Management Portfolio*, 2008, 18, at 19.

[14] Because the German thin cap rule applies to partnerships that are regarded as permanent establishments for treaty purposes, a violation of article 7(3) OECD model treaty could arise.

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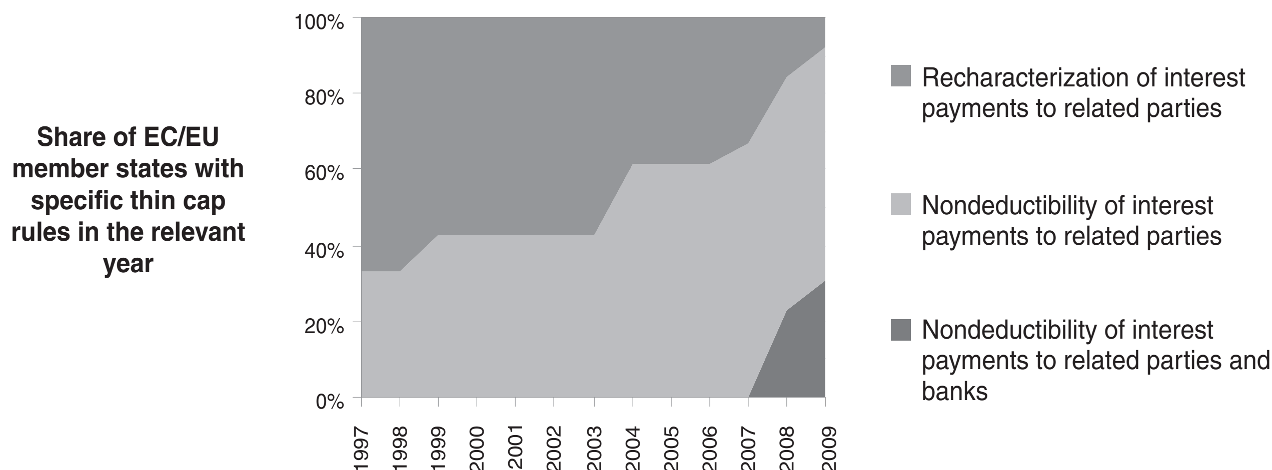

Not only does the ban on interest violate the spirit and purpose of income tax treaties, but it is also in breach of some provisions of the OECD model treaty, most notably article 9(1). Specifically, none of the thin cap rules under scrutiny makes sure that arm's-length interest on intragroup lending is deductible, although those rules "should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit."[15] Because the reduced withholding rate on disallowed interest must be denied under article 11(6) OECD model treaty, if the payment cannot be justified by bona fide business reasons, policymakers provide for additional evidence of restricting arm's-length loans by sticking to favorable source taxation.

Most importantly, however, article 9(1) and 11(6) of the OECD model treaty restrict the adjustment of profits of associated enterprises to the well-defined situation of related-party financing. By the means of an *argumentum e contrario*, this can be regarded as a ban on thin cap rules that apply to bank loans, at least for associated enterprises.

It is up to each country's legal system, however, to determine to what extent treaties are given effect domestically. In Germany treaty overriding was held constitutional if legislative history clearly indicates the intention to violate bilateral agreements.[16] But when tightening the German thin cap rule, both houses of Parliament failed to express this hidden agenda. Hence, the German Supreme Court might step in and rule in favor of international tax law.[17]

Despite constitutional concerns, for all countries the adverse effects of treaty overrides are obvious. Foreign governments are tempted to retaliate by altering their thin cap rules, which will reinforce the trend toward a general ban on interest deductions. There will be a worldwide apportionment of debt and equity that has nothing to do with business needs and global welfare and is purely tax motivated.

Violation of EC Law

Given the European Court of Justice's recent decision in *Columbus Container*, treaty violations by themselves do "not necessarily mean that those provisions constitute a restriction on the freedom of establishment within the meaning of Article 43 EC law."[18] Since this judicial constraint may also apply to the free movement of capital, it must be substantiated independently that the new thin cap rules are in breach of European Community law. Again, it is helpful to distinguish between problems arising from the provisions' fundamental approach and those owed to their details. In the

[15]OECD commentary on article 9(1) model treaty, para. 3.

[16]*See, e.g.,* Federal Tax Court, decision of July 7, 1994, *Federal Tax Bulletin* II (1995), p. 129.

[17]In the special case of German-source interest paid to Austrian creditors, the ECJ might take over the Supreme Court's role, serving as a mandatory arbitral court in accordance with article 25(5) of the relevant income tax treaty.

[18]*Columbus Container Services* (C-298/05), para. 38; for a detailed analysis, see Tom O'Shea, "German CFC Rules Held Compatible With EU Law," *Tax Notes Int'l*, Dec. 24, 2007, p. 1203.

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latter case, the special treatment of domestic tax consolidation groups (Germany) or domestic assets (Denmark) results in a (covert) discrimination of nonresident group members.[19] Since the thin cap rules do not give any competitive edge to foreign companies or assets and since an arm's-length comparison is not available to taxpayers, neither fiscal coherence nor the prevention of abuse justifies the restrictions on the basic freedoms.

For the fundamental approach, secondary Community law, most notably the interest and royalty directive, becomes the focus of attention. Although in the new age of limiting interest deductions, payments to creditors are no longer recharacterized as dividends, the ECJ's interpretation of the parent subsidiary directive is instructive. In *Athinaiki Zythopoiia,* the Court held ''that the nature of a tax, duty or charge must be determined by the Court, under Community law, according to the objective characteristics by which it is levied, irrespective of its classification under national law.''[20] Thus, if legislators start to deny interest deductions for normal bank loans, as is the case now, they run the risk of being overruled by the ECJ on the grounds that they unlawfully withheld taxes.

[19] *See* Kessler and Eicke, *supra* note 9, at 266 (Germany); Becker-Christensen, Klemp, Hansen, and Bjørnholm, *supra* note 9, at 447 (Denmark).

[20] *Athinaiki Zythopoiia* (C-294/99), para. 27.

Summary

This article has identified the reverse ban on interest as a new feature of European tax law. In an attempt to shield their poorly designed tax systems from international competition, the Czech Republic, Denmark, Germany, and Italy have started to establish general limitations on interest deductions. Given that international tax planning is the lawmakers' stated target, it comes as no surprise that many violations of treaty obligations and Community law go hand in hand with this new class of thin cap rules. While unlawful details can be corrected, the fundamental problem of widespread double taxation will remain an ultimate obstacle to conformity with treaty obligations and Community law. To restrict their thin cap rules to abusive capital structures and to thereby restore lawfulness, legislators should amend the rules with an arm's-length comparison and, possibly, an underlying asset safe harbor.[21] In the long run, the allowance for equity — as seen most recently in Belgium[22] — may well be the only way to reconcile fiscal needs with international obligations. ◆

[21] *See* Department of Treasury, ''General Explanation of the Administration's Fiscal Year 2004 Revenue Proposals,'' p. 104; Torrione, ''Switzerland,'' *ET*, 2005, p. 446, at 447.

[22] *See* Marcel Gerard, ''A Closer Look at Belgium's Notional Interest Deduction,'' *Tax Notes Int'l*, Feb. 6, 2006, p. 449, *Doc 2005-24832*, or *2006 WTD 26-14*.

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