ARM'S LENGTH PRINCIPLE AND THE ISSUE OF THIN CAPITALIZATION

SANDRA FERNANDES

Principal in the tax department of Charles Russell Speechlys Luxembourg. LL.M. degree cum laude in European and International Taxation at the European Tax College (KU Leuven/Tilburg University). PhD candidate at the KU Leuven.

I. INTRODUCTION

The computation of the income and expenses of a company or of a permanent establishment (**PE**) belonging to a multinational enterprise (**MNE**), is crucial to determine the portion of the business profits of the MNE which originates economically in each of the states in which its business activities are carried out.[1] For the purposes of such computation, a PE should prepare separate accounts and be treated as a hypothetical separate and independent enterprise[2,3], whereas a subsidiary should produce its own accounts (just like any domestic company) and be treated as an independent enterprise (i.e. application of the "independent" enterprise criterion or arm's length rule) .

1 See OECD (2010a, Preface, Para. 12).

2 As of the 2010 update to the OECD Model Convention, the new Art. 7(2) provides that the PE should be treated as a "separate and independent enterprise", whereas the old version of Art. 7(2) provided that the PE should be treated as a "distinct and separate enterprise".

3 Unless otherwise noted, any legal provisions referred to in this paper are from the 2010 OECD Model Convention.

However, problems may arise with the "independent" enterprise criterion and the separate accounting rules whenever the different entities of the MNE do not act as independent parties would do when interacting with each other. In other words, there is a risk that related parties dealing with each other do not abide to conditions of free and fair competition or to the market forces (i.e. do not act at arm's length). In such a case, the items of income and expenses included in the separate accounts of the relevant entities of the MNE may be distorted and, as a consequence, the taxable income of each company in the host country may also be distorted. It is precisely to counteract this problematic that states agreed to resort to the application of the arm's length principle (the **ALP**).[4]

The profit adjustments of PEs or associated enterprises of a MNE by reference to the ALP might appear to be contrary to the independent enterprise criterion, to the separate accounting method or to the net income principle, but in fact they are consistent because those profit adjustments are allowed only insofar as the accounts and the profits were misrepresented by the related parties. In fact, as explained by the OECD, one of the reasons why the OECD member states adopted the ALP is because it provides a level playing field between members of a MNE and independent enterprises. By ensuring an equal treatment of those entities, competition is not distorted and international trade and investment is promoted as well.[5]

As a result, the ALP is the "fair" share standard endorsed by the international tax community to serve the: dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment.[6]

With regard to the OECD Model Convention, the legal provisions that deal with the taxation of a MNE and which are based on the ALP are Art. 7, dealing with the taxation of PEs, and Art. 9, dealing with the taxation of profits of associated enterprises.[7]

Traditionally, corporate income tax has evolved on the basis of a different tax treatment of debt and equity. As a result of the differential treatment between debt and equity for tax purposes, the decision of financing a company by debt or equity can clearly be induced. In particular, associated enterprises may opt for a debt capital structure instead of an equity capital structure to take advantage of the beneficial tax treatment of debt. In addition, associated enterprises can also fix an excessive interest rate on intra-group loans to operate a shift of profits from the borrowing to the lending country. These anti-abuse rules basically target thin capitalized companies, i.e. companies whose financing sources are mainly debt instruments instead of equity instruments. Nonetheless, it should be noted that the fact that a capital structure of an associated enterprise is unbalanced in favour of intra-group debt should constitute a mere indication, and not a definite conclusion, of hidden equity capitalization.

4 The application of the ALP may entail adjustments to the taxable profits, see OECD (2010a, Para. 1.3).

5 OECD (1995, Para. 1.7) and OECD (2010a, Para. 1.8). For the sake of completeness, it should be added that the 1979 OECD Transfer Pricing Guidelines did not refer to this justification as a basis for the application of the ALP.

6 OECD (2010a, Preface, Para. 7).

7 OECD Commentary to Art. 7, Para. 3 and OECD Commentary to Art. 9, Para. 1-2.

Moreover, in a globalized world the financing of a MNE became a worldwide problem due to the strong concern that a MNE might be able to plan its worldwide leverage to minimize its overall tax liability. This concern highlighted the risk of base erosion and led some states to re-design their domestic thin capitalization rules and/or to design new interest limitation rules. Generally, these new rules limit the interest deductibility of related and unrelated-party debt to a certain percentage of the debtor's assets and/or earnings and/or by reference to the worldwide debt ratio of the group to which the debtor belongs (hereafter referred to as "**Comprehensive Interest Barriers**"). In some of these countries, these rules are generally applicable both to a permanent establishment and to a subsidiary

In parallel with this evolution towards stricter and broader thin capitalization rules, the OECD[8] Committee on Fiscal Affairs developed and released the authorized OECD approach (the **AOA**) regarding the attribution of profits to PEs. With regard to the AOA, it is generally considered that it presents an important innovation concerning the issue of capitalization of a PE by introducing the concept of "free" capital.

With regard to the interaction between the ALP and thin capitalization rules and/or Comprehensive Interest Barriers, the question still remains whether the profit adjustments prompted by such rules are (or should be somewhat) limited by the ALP as well. That brings us to the key research question of this paper: **does the issue of thin capitalization fall within the scope of the ALP**.[9]

To address this research question, the next section of this paper (**section 2.**) will provide an extensive investigation of the application of the ALP to the issue of thin capitalization. Section 2. will start by providing a detailed historical analysis of both Arts. 7 and 9 (**Section 2.1.**)[10], is then followed by an in-depth interpretation of Art. 9, including the scrutiny of the respective OECD Commentary, relevant OECD Reports and case law (**Section 2.2.**) and is then wrapped up with some concluding remarks (**Section 2.3.**). Finally, this paper will close by drawing some concluding remarks on whether the ALP should be applied to thin capitalization rules. (**Section 3.**).

8 Organisation for Economic Co-operation and Development (OECD).

9 It is worth noting that in the literature the answer to this question still remains controversial. See, concurring with the author, Nitikman (2000, p. 26, note 21) and Vleggeert (2009, pp. 142-143). See opposing, i.e. considering that in 1933 thin capitalization was not considered to be an issue, De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, p. 233), Michielse (1996, p. 463), Michielse (1997, p. 568), and Sommerhalder (1996, p. 92). In a somewhat borderline position, Bullen (2011, Part. 5.1.4.) suggests that the thin capitalization phenomenon was known at that time, but that Carroll did not clarify whether thin capitalization adjustments were admitted by the separate accounting method.

10 It is worth noting that even though the analysis of Art. 7 and the capitalization of a PE, as such, fall outside of the scope of this paper, the historical analysis of Art. 9 will be done in parallel with the historical analysis of Art. 7 as both dispositions are based on and inspired by the ALP.

II. APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO THE ISSUE OF THIN CAPITALIZATION

2.1. Historical analysis of Articles 7 and 9 of the OECD Model Convention

2.1.1 The Carroll Report

It was not until the Carroll Report that the ALP and the issue of adequate capitalization were dealt with. The Carroll Report was based on a thorough enquiry into the taxation of foreign and national enterprises in several countries carried out by Mitchell Carroll (**Carrol**l) himself. The Carroll Report identified three different methods of allocation.[11] The first one was the method of separate accounting, which corresponds to the ALP.[12] The second one was the empirical method, which consisted of a comparison with the profits of local entities engaged in a similar business.[13] The third method was that of fractional apportionment, which loosely corresponds to global formulary apportionment.[14]

Even though at that time, as mentioned by Carroll, the method of fractional apportionment was the prevailing method under domestic tax law,[15,16] the separate accounting method was considered to be the preferred method to decide the allocation of income to the various countries in which an enterprise had a PE or a subsidiary.[17]

In essence, the separate accounting method assesses the local branch or subsidiary on the basis of their separate accounts.[18] However, the accounts may be verified and eventually rectified if they do not reflect the true taxable profits that should have been attributed to the relevant PE or subsidiary. In any case, as Carroll remarked, this task of control and supervision of the accounts by the tax administration will be easier and will not entail any adjustment:

11 Carroll (1933, Para. 120 and 671-674).

12 Carroll (1933, Para. 120 and 671-672).

13 Carroll (1933, Para. 121 and 673).

14 Carroll (1933, Para. 122 and 674).

15 This conclusion can be found in the Carroll Report, as well as in a subsequent article written by the same author. Accordingly, Carroll (1933, Para. 674) clearly mentioned that the method of fractional apportionment is "employed by certain administrations as a normal procedure and by others when the method of separate accounting fails". Subsequently, in an article published in 1934, Carroll reiterated the same idea by noting that, cfr. Carroll (1934, p. 1, note 4):

> Although the method of fractional apportionment has been relegated to the place of a last-resort measure in the international sphere, it is at present the prevailing method in domestic state legislation. Separate accounting still holds a modest place in the panoply of fiscal usages, although various court decisions tend to favour its more general application.

16 However, it is worth noting that in a previous study from 1930 on this subject based on an enquiry into the different domestic practices, Professor Adams had suggested that the opposite was true, by stating that the method of separate accounting (instead of the method of fractional apportionment) was the prevailing method in the domestic tax legislation at that time, see League of Nations Fiscal Committee (1930, Appendix II, p. 11).

17 See Carroll (1933, Para. 293-310, 671 and 674).

18 E.g. Carroll (1933, Para. 120).

> if the local establishment is virtually self-contained or is an autonomous unit which is treated as such by the foreign enterprise, or if the foreign enterprise has dealt with each establishment at arm's length as if it were an independent enterprise.[19]

For the purposes of this study, the crucial question to ask here is whether one of the adjustments that a tax administration can make under the arm's length umbrella is the attribution of capital. The reason for this is that the manipulation of the amount of capital (i.e. excessive debt capital or excessive equity capital) has an effect on the taxable profits of the MNE and may therefore be used to shift profits between countries. A detailed and in-depth analysis of the Carroll Report reveals four main reasons on the basis of which the aforementioned question should be answered in the affirmative.

First, Carroll clearly stated that the arm's length adjustments promoted by the tax administration could entail:

> in some cases, **allotting to it the capital normally required to carry on its activities** [author's emphasis], and, in every case, billing to it or making charges at the same rates as it would to an outsider.[20]

Secondly, Carroll also noted that a domestic subsidiary of a foreign enterprise "must ordinarily have an adequate capital"[21] just like an independent domestic enterprise.

Thirdly, Carroll also dealt with the issue of capitalization of a PE in an in-depth manner. Accordingly, the author after presenting the two main allocation criteria to determine the income attributable to a PE, namely (i) "the remuneration for services criterion" and (ii) "the sale between independents criterion", recommended the application of "the remuneration for services criterion".[22] The main reasons submitted by Carroll to justify the preference for the application of "the remuneration for services criterion" were to avoid both the use of fictions in the allocation of income to a PE and the difficulties of allotting capital to a branch.[23] In addition, Carroll also discussed the issue of allocation of capital to a PE of foreign banking and financial enterprises and considered that even though the equal treatment of a branch and an independent bank would imply the allotment of the same amount of capital to a PE as if it were an independent bank, it would in fact not be desirable to allot such an amount of capital to a PE.[24] From the perspective of this author, that solution was justified because allotting free capital to a PE would constitute a major hindrance to one of the main advantages of using a branch, which is the free flow of

[19] Carroll (1933, Para. 6). See also Carroll (1933, Para. 384-385) discussing the interaction between dealing at arm's length and the adjustment of the accounts.

[20] Carroll (1933, Para. 6).

[21] Carroll (1933, Para. 627).

[22] Carroll (1933, Para. 676-680).

[23] Carroll (1933, Para. 679-680, and 715).

[24] Carroll (1933, Para. 718).

funds between the head office and the PE.[25] Nonetheless, Carroll also acknowledged that the other criterion should be used, i.e. "the sale between independents criterion", and that the adequate capital should be allotted whenever the PE is sufficiently autonomous to justify it.[26]

Fourthly, Carroll also remarked that interest payments on debt capital directly borrowed from a third party by a PE should be deductible in the hands of the PE as long as the relevant amount of debt capital would not be excessive.[27] The amount of debt capital would not be excessive when it "corresponds in amount with what would reasonably be required by an independent enterprise under similar circumstances"[28].

Thus, it follows from the above that the Carroll Report clearly considered that the issue of adequate capitalization (and any eventual necessary adjustments related thereto) regarding both a subsidiary and a PE was included within the scope of the separate accounting method and the ALP. As a general rule, both entities (i.e. a PE and a subsidiary) should have an adequate amount of capital, i.e. the same amount of capital as would be required by an independent enterprise under similar circumstances. Mutatis mutandis, and perhaps even more remarkable, is the fact that the amount of debt capital granted by a third party to a PE (and, for the same reasons, the same conclusions should be valid regarding a subsidiary) may be scrutinized under the arm's length test i.e. interest payments on debt capital granted by third parties may be denied because the amount of debt capital exceeds what a similar independent enterprise would normally be required to have.[29]

2.1.2. 1933 and 1935 Draft Conventions on Profit Allocation

Further to the Carroll Report, the League of Nations adopted in 1933 a Draft Convention on the allocation of business income between states for the purposes of taxation (the "**1933 Draft Convention**")[30]. The allocation method embraced by the 1933 Draft Convention was the separate accounting method and the ALP. This Draft Convention was slightly revised in 1935 (the "**1935 Draft Convention**")[31], but the provisions that will be scrutinized below in this paper remain generally unchanged.

25 Carroll (1933, Para. 718).

26 Carroll (1933, Para. 680 and 715).

27 Carroll (1933, Para. 681).

28 Carroll (1933, Para. 681).

29 The same general idea, i.e. that in accordance with the ALP a PE should have an amount of debt capital, either provided by related or unrelated parties, which is commensurate with its functions, assets and risks, is currently expressed by the OECD, cfr. OECD (2010b, Part I, Para. 167). However, the same idea is not yet avowed by the OECD in relation to a subsidiary, cfr. OECD (1987, Para. 14 and 73).

30 1933 Draft Convention can be found in League of Nations Fiscal Committee (1933, Annex, pp. 3-6).

31 1935 Draft Convention can be found in League of Nations Fiscal Committee (1935, Annex I, pp. 5-7).

(a) Permanent establishments (PEs)

The allocation of profits to PEs was regulated under Art. 3 of the 1933 Draft Convention and Art. III of the 1935 Draft Convention. These provisions are the precursor to the current Art. 7 of the OECD Model Convention. In accordance with the second paragraph of those legal provisions, the tax authorities could, if necessary:

> rectify the accounts produced [by the PE], notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.

For the purposes of this study, it is important to highlight that the Commentary to the aforementioned legal provision specifically discussed some of the consequences of the application of the ALP to the issue of adequate capitalization of a PE. With regard to that, the Commentary clarified that interest payments on debt capital borrowed (directly or indirectly through the general enterprise) by the PE from third parties may be attributed to the PE insofar as the amount of debt capital so-attributed corresponds to the amount of debt capital that an independent similar enterprise would normally have needed.[32]

In addition to that, the issue of the allotment of capital was also briefly and indirectly discussed regarding PEs of banking and financial enterprises in Art. 4 of those Draft Conventions.[33] Accordingly, the relevant legal provisions[34], as well as its commentary, clarified that in the computation of the net income of banking and financial enterprises the deduction of interest on sums advanced to a PE in lieu of capital was not allowed.[35] Moreover, it was added that this rule could also be applicable in general to a PE of any enterprise.[36]

Thus, the 1933 and 1935 Draft Conventions on profit allocation shed some light on the impact of the ALP on the issue of adequate capitalization of a PE. On the one hand, the amount of debt capital (both from related and unrelated parties) attributed to a PE has to be in line with the amount of debt capital that a similar independent enterprise would need in order to carry out its business activities. On the other hand, it was also acknowledged that any PE might be allotted a certain amount of capital by the enterprise and that interest on the allotted capital should not be tax-deductible for the PE.

32 The wording of the Commentary to Art. 3 reads as follows, cfr. League of Nations Fiscal Committee (1933, Annex, Ad. Art. 3, p. 6):

> [...] interest will not be attributed to an establishment unless it refers to debts contracted by the permanent establishment itself commensurately with its own needs as an independent enterprise [author's emphasis]. In the case of debts contracted by the international enterprise, a portion of the interest may be deducted [...] provided [...] that the amount corresponds to what would have reasonably been required by an independent enterprise [author's emphasis].

33 I.e. Art. 4 of the 1933 Draft Convention and Art. IV of the 1935 Draft Convention.

34 Art. 4(b)(2) of the 1933 Draft Convention and Art. IV(2)(b) of the 1935 Draft Convention.

35 League of Nations Fiscal Committee (1933, Annex, Ad. Art. 4, p. 7).

36 League of Nations Fiscal Committee (1933, Annex, Ad. Art. 4, p. 7).

(b) Subsidiaries

The adjustment of profits of associated enterprises in accordance with the ALP was regulated for the first time under Art. 5 of the 1933 Draft Convention and Art. VI of the 1935 Draft Convention. Those legal provisions were identically drafted and provided that:

> When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.

These legal provisions are obviously the forerunner to the current Art. 9 of the OECD Model Convention, albeit with some differences.[37] Notably, this provision is based on the so-called "diversion criterion" whereas the current Art. 9 is based on the "have-not-so-accrued criterion".[38] The Commentary to Art. 5 of the 1933 Draft Convention did not identify any particular type of adjustment, such as a thin capitalization adjustment, which would be allowed in accordance with the ALP. Instead, the Commentary to that provision generically provides that if the relations of the associated enterprises were not carried at arm's length, with the result that profits (or losses) were diverted from the local subsidiary to the foreign parent, the tax administration was authorized to "make the necessary adjustments in the balance-sheets"[39].

It follows from the above that even though thin capitalization adjustments were not clearly mentioned in relation to subsidiaries, there is also no indication that the ALP should not apply to the issue of thin capitalization. On the contrary, taking into account Art. 3 of the 1933 Draft Convention and its relevant commentary in which it is clearly suggested that the ALP plays a role in the capitalization of a PE, one should not hesitate to conclude that the ALP should also play a role to deal with the issue of adequate capitalization of subsidiaries.

37 For the sake of completeness, it is worth noting that before 1933 some countries already included under their domestic tax law a comprehensive arm's length provision and that also some double tax treaties signed before that date included a comprehensive arm's length provision, such as Art. IV of the France-United States Double Tax Treaty signed in 1932, see Avery Jones [et al.] (2006, pp. 243-244), Bullen (2011, Para. 5.1.3.) and Hamaekers (2001, pp. 32-34).

38 For an analysis of the genesis and justifications of these two different criteria, as well as their practical consequences, see Bullen (2011, Par. 6.1.1.6.3.).

39 League of Nations Fiscal Committee (1933, Annex, Ad. Art. 5, p. 7).

2.1.3. London and Mexico Model Tax Conventions

(a) Permanent establishments (PEs)

Similarly to the Draft Conventions on profit allocation referred to above, the Mexico and London Model Tax Conventions also did not elaborate on the attribution of capital to a PE. The issue of the capital structure was, once more, only indirectly touched upon within the discussion of the deductibility of interest and the allotment of capital to banking and financial enterprises.[40] With regard to that, the Commentary to Art. 3 of the Mexico and London Model Conventions clarified that:

the interest on the permanent capital allotted to a branch cannot be deducted from the income of that branch in the country where it is situated even if the capital takes the form of an advance, loan, overdraft or deposit.[41,42]

Conversely, interest payments on debt capital (which is not deemed to be permanent capital) can be deducted from the taxable income by the debtor and treated as income by the creditor or recipient of that interest income.[43]

(b) Subsidiaries

The Mexico and London Model Conventions continued to adhere to the principle pursuant to which a subsidiary constitutes a distinct legal entity and should therefore be taxed separately.[44] The provision dealing with the mutual relations between parent and subsidiary companies was Art. VII of the Protocol to the Mexico and London Model Conventions, which was drafted in an identical manner to that of Art. 5 of the 1933 Draft Convention and Art. VI of the 1935 Draft Convention. Thus, these Conventions reiterated that the relations between associated enterprises should be checked and supervised to prevent the concealment of profits (or losses) or their diversion from one company to the other by reference to the ALP.[45] The Commentary to those Conventions did not provide any additional explanation or further exemplification. However, that being said, no guidance was given regarding the scope of such arm's length adjustments, in particular it was not addressed whether the capital structure of the subsidiary should be considered as one of the items that should be checked to avoid the concealment or diversion of profits.

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[40] The relevant provision is Paragraph 3 of Art. VI of the Protocol to the Mexico and London Model Tax Conventions which was drafted on the basis of Art. 4(b)(2) of the 1933 Draft Convention and Art. IV(2)(b) of the 1935 Draft Convention.

[41] League of Nations Fiscal Committee (1946, p. 21).

[42] The Commentary also added that the objective of the Protocol in this matter was to "state explicitly certain corollaries of the method of separate accounting as applied to banking and financial enterprises", cfr. League of Nations Fiscal Committee (1946, p. 21).

[43] League of Nations Fiscal Committee (1946, p. 21).

[44] League of Nations Fiscal Committee (1946, p. 17).

[45] League of Nations Fiscal Committee (1946, p. 17).

2.1.4. Concluding remarks

The historical analysis of Arts. 7 and 9 has provided evidence that the issue of adequate capitalization of both a PE and a subsidiary was already known and perceived as a problem from the very early stage of development of international tax law. This means that the issue of adequate capitalization was identified from the very early stages as one way in which the profits of a MNE could be concealed or diverted from one country to another.

As a result, the aforementioned historical analysis clearly suggests that the state in which a PE or a subsidiary is located may apply the ALP to recapture profits which may have been diverted because of thin capitalization or excessive debt-to-equity ratios of those entities. Nevertheless, the scrutiny of the relevant historical documents has also revealed that those documents failed to address in an in-depth and detailed manner how exactly the adequate capital structure should be determined and how any eventual adjustments should be made. That being said, it should be added that in relation to PEs the relevant historical documents offer a little more guidance by determining that a PE should be capitalized in accordance with the amount of capital that a similar independent enterprise would need to carry on such business activities. Even though the historical documents do not provide such guidance for subsidiaries, from the perspective of the author the same kind of guidance should be applied mutatis mutandis to deal with the issue of capitalization of a subsidiary. In particular, the application of the same kind of guidance to PEs and subsidiaries should be admitted because those two types of entities should be treated neutrally for tax purposes. By doing so, the capital structure of both a PE and a subsidiary would be subject to the arm's length standard. This would mean that no adjustment would be allowed where such capital structure would mirror the capital structure that a similar independent enterprise would need to have to carry out the same business activities under the same relevant circumstances. Conversely, if a PE or a subsidiary did not have an arm's length capital structure, the relevant tax administration could promote an arm's length adjustment to their capital structure.

2.2. Article 9 of the OECD Model Convention

2.2.1. The inclusion of the thin capitalization issue

Art. 9 (1) governs the attribution of profits between associated enterprises and establishes the arm's length norm as its underpinning principle by providing that:

> **1. Where**
>
> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

While there is no doubt that within the scope of Art. 9 (1) falls the assessment of whether the interest rate agreed between associated enterprises is at arm's length, the same cannot be said about the assessment of whether the total amount of loans or debt-to-equity ratios are at arm's length. In other words, the issue of whether thin capitalization rules have to conform to the ALP stipulated under Art. 9 (1) is a disputed one. As from the 1987 OECD Thin Capitalization Report, the OECD Commentary to Art. 9 (1) provides that thin capitalization rules may be applied under domestic law, but that their application has to be consistent with the ALP as provided by Art. 9 (1).[46] However, some commentators do not agree with the position stated by the OECD.[47] Similarly, domestic courts, inter alia, in France and in Canada have also ruled that Art. 9 (1) does not apply to thin capitalization rules.[48] From the perspective of the author, the ALP does apply to thin capitalization rules and therefore thin capitalization rules have to be consistent with the ALP.[49,50] Thus, this means that the author agrees with the position expressed by the OECD on this matter and considers the argumentation against that position brought by some commentators and domestic courts unconvincing. While on that subject, it is now time to analyze the underlying reasons for the position submitted by the author.

46 OECD (1987, Para. 48-49) and OECD Commentary to Art. 9, Para. 3.

47 Against the OECD interpretation regarding the application of the ALP to thin capitalization by considering that the arm's length test only concerns the appraisal of whether the interest rate is reasonable, but not whether indebtedness (i.e. amount or quantum of the loan) is also excessive, see Becker (1990, p. 52), De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, pp. 232-233), Michielse (1996, p. 463), Michielse (1997, pp. 567-568), Pacitto (1996, pp. 518-519), Sommerhalder (1996, p. 92), Vleggeert (2009, pp.139-163), Wittendorff (2009, pp. 119-120) and Wittendorff (2010, pp. 161-166).

48 Cfr. Decision No. 233894, SA Andritz of 30 December 2003 of the French Supreme Administrative Court (Conseil d'Etat) and the decision of the Canadian Tax Court in Specialty Manufacturing Ltd. v. The Queen, 97 DTC 1511 (T.C.C.), 99 DTC 5222 (F.C.A.).

49 Concurring with the author and with the OECD interpretation regarding the application and relevance of the ALP to thin capitalization rules, see Avery Jones [et al.] (1991, pp. 343-344), De Broe (2008, pp. 501-510), Lüthi (1991, p. 451), Nitikman (2000, pp. 20-55 and 62-63) and Piltz (1996, pp. 128-130).

50 The position of the different states regarding whether the ALP applies and limits the domestic thin capitalization rules also diverges sharply. For an overview of the different domestic interpretations in this matter, see Hinny (2008, pp. 37-40), Piltz (1996, pp. 129-130) and Van Weeghel (2010, pp. 32-33). By contrast, with regard to the attribution of capital to a PE in accordance with the OECD, "there is an international consensus amongst governments and business on the principle that a PE should have sufficient "free" capital to support the functions, assets and risks it assumes", cfr. OECD (2010b, Part I, Para. 147).

2.2.1.1. Arguments against: critical assessment

Generally speaking, the commentators have provided two main sets of arguments to support their position against the application of the ALP to thin capitalization rules. One is the historical argument and the other one is the need to interpret restrictively the term "conditions" inserted in the relevant legal provision.[51] In a somewhat vicious circle, one of the arguments submitted to support the restrictive interpretation of the term "conditions" is also the historical argument.[52]

(a) Historical argument

The commentators use the historical argument to suggest that thin capitalization, as such, was not considered to be an issue at the time that the original provision was drafted.[53] Similarly, the Canadian Court in the case Specialty Manufacturing Ltd.[54] used the same historical argument to rule that the 1942 and 1980 Canada-United Stated Double Tax Treaty did not apply to thin capitalization cases.[55,56]

While perhaps superficially appealing, the historical argument for the reasons exposed above (see supra Section 2.1.) does not stand up to closer scrutiny. As a general rule, the commentators simply refer to a paragraph of the Carroll Report[57] to argue that thin capitalization or excessive debt financing was not provided as an example of an arm's length adjustment, whereas interest-free loans and excessive interest rates were.[58] However, the conclusions of the preceding discussion of the Carroll Report (see supra Section 2.1.1.), which will not be repeated again here, has clearly revealed that the excessive debt financing was already at that time identified as a manner by which profits could be diverted from one country to another.[59] Therefore, a thorough analysis of this historical argument offers in fact a plea for the opposite interpretation, i.e. that Art. 9 (1) does apply to thin capitalization rules.

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51 See Becker (1990, p. 52), De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, pp. 232-233), Michielse (1996, p. 463), Michielse (1997, pp. 567-568), Sommerhalder (1996, p. 92), Vleggeert (2009, pp.139-163), Wittendorff (2009, pp. 107-120) and Wittendorff (2010, pp. 161-166).

52 E.g. Michielse (1994, p. 233) and Michielse (1997, p. 568).

53 The historical argument basically claims that Art. 9 was not drafted with the issue of thin capitalization in mind, see De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, p. 233), Michielse (1996, p. 463), Michielse (1997, p. 568), Sommerhalder (1996, p. 92), Wittendorff (2009, p. 116), and Wittendorff (2010, p. 162). However, in the literature the historical argument is a controversial issue. See against, Nitikman (2000, p. 26, note 21) and Vleggeert (2009, pp. 142-143) expressing the view that Art. 9 was already drafted with the thin capitalization issue in mind. In a somewhat borderline position, Bullen (2011, Part. 5.1.4.) suggests that the thin capitalization phenomenon was known at the time that the precursor of the current Art. 9 was drafted, but that it was not clarified whether thin capitalization adjustments were admitted by the separate accounting method.

54 The central question in the case Specialty Manufacturing Ltd. concerned the compatibility of thin capitalization rules with Arts. IX (i.e. associated enterprises provision) of the 1942 and 1980 Canada-United Stated Double Tax Treaty.

55 The Canadian Tax Court, after noting that there was no evidence that at the time of the 1942 Canada-United States Tax Treaty the treaty partners addressed the concept of thin capitalization, concluded by saying that (cfr. Specialty Manufacturing Ltd. v. The Queen, 97 DTC 1511 (T.C.C.) at pp. 1519-1520):

> Thin capitalization had not been contemplated during the drafting of the 1942 Treaty. The concept was subsequently addressed by subsection 18(4) of the Act and Article XXV(8)(a) of the 1980 Treaty which took into account the existence of subsection 18(4).

56 Against this decision from the Canadian Tax Court, see Nitikman (2000, pp. 20-64) who after a comprehensive historical analysis of the provision of the relevant Tax Treaty concludes that "history shows that internationally the arm's length rule has always been the guiding standard", cfr. Nitikman (2000, p. 62).

57 The paragraph cited from the Carroll Report (1933) is the paragraph 385 which basically provides several examples of arm's length adjustments, none of which corresponds to thin capitalization adjustments.

58 See De Hosson and Michielse (1989, p. 481), Michielse (1994, p. 233), Michielse (1996, p. 463), Michielse (1997, p. 568) and Sommerhalder (1996, p. 92).

59 See, in particular, Carroll (1933, Para. 6, 621, 680, 681, and 715).

(b) The restrictive interpretation of the term "conditions"

On the other hand, the second set of arguments submitted by the commentators to support their position against the application of the ALP to thin capitalization rules is that the term "conditions" included in Art. 9(1) should be interpreted in a restrictive manner.[60]

The commentators' standpoint rests or depends almost entirely on the following four premises:

(i) general understanding that the term "conditions" has a restrictive meaning;

(ii) the amount of debt cannot be assimilated to "conditions" imposed in a financial relation;

(iii) Art. 9 only allows adjustments of "conditions", not of "commercial or financial relations"; and

(iv) the historical background of the relevant provision also calls for a more restrictive interpretation.

Hereafter, the author will try to show why this line of argumentation is somewhat weak or unconvincing.

(i) Does the term "conditions" have a restrictive meaning?

In accordance with the interpretation suggested by some commentators, Art. 9 (1) only concerns and allows an adjustment of the interest rate agreed between the associated enterprises, but not of the quantum (i.e. total amount) of the loan.[61] Similarly, in the Andritz Case,[62] the French Supreme Administrative Court (Conseil d'État) was of the view that Art. 9 (1) did not allow the tax authorities to impose a thin capitalization adjustment.[63] Thus, that French Court decision has considered that only the interest rate, but not the debt-to-equity ratio, chosen by the related parties can be challenged and eventually adjusted (i.e. if not at arm's length) under Art. 9 (1).[64]

60 See Becker (1990, p. 52), De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, pp. 232-233), Michielse (1996, p. 463), Michielse (1997, p. 568), Sommerhalder (1996, p. 92), Vleggeert (2009, pp. 149-163), Wittendorff (2009, pp. 116 and 119-120) and Wittendorff (2010, pp. 161-166).

61 See Becker (1990, p. 52), De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, pp. 232-233), Michielse (1997, p. 568), Sommerhalder (1996, p. 92), Vleggeert (2009, pp. 150-155), Wittendorff (2009, pp. 119-120), and Wittendorff (2010, pp. 163-165).

62 Decision No. 233894, SA Andritz of 30 December 2003 of the French Supreme Administrative Court (Conseil d'Etat).

63 Baker (2004, pp. 211-212).

64 Baker (2004, pp. 211-212).

At the outset it should be mentioned that there is nothing in Art. 9 (1) that suggests that the term "conditions" should be interpreted somewhat restrictively. Instead, the relevant provision is drafted in general terms. The relevant factor is the causal relationship between the "conditions made or imposed between the two enterprises in their commercial or financial relations" and the increase of profits of one of the enterprises because of those conditions. Thus, all this says is that the conditions imposed between the related parties have to have an impact or to be mirrored in the taxable profits of one of the enterprises. For the purposes of interpreting and applying the relevant provision, all the conditions that may cause or be apt to cause a shift of profits between related enterprises have to be taken into account. Doing otherwise would not be in line with the legal provision at hand. If only some of the conditions with a potential impact on the taxable profits of the related enterprises should be taken into account, such as the prices agreed, then the legal provision should have specifically indicated the relevant conditions and, by doing so, would have narrowed down its scope of application. In other words, a broad interpretation of the term "conditions" is not only plainly allowed by the legal provision at hand, but it is also in line with its wording and its basic aim of protecting the arm's length allocation of profits.[65]

Likewise, the OECD in the 2010 OECD Transfer Pricing Guidelines also pointed out that Art. 9 is the basis for a comparability analysis which requires a "comparison between conditions (including prices, but not only prices)".[66]

By way of comparison, one can also still refer to the other two specific arm's length provisions included in the OECD Model Convention, Arts. 11 (6) and 12 (4), which are construed in a more restrictive manner. Accordingly, Arts. 11 (6) and 12 (4) only allow an adjustment of the "amount" (and not of the "conditions") of the interest or royalty payments by reference to the debt claim in respect of which the payments are made, or to the use, right or information for which the payments are made, respectively. Hence, the different and broader terminology used by the legislator in Art. 9 (1) in comparison with the narrow terminology used in Arts. 11 (6) and 12 (4) clearly suggests that Art. 9 (1) should be interpreted in a different and wider manner than Arts. 11 (6) and 12 (4).[67,68]

65 See Vogel (1997, p. 527, Para. 30) stating that "the term conditions should be given a wide interpretation" and Bullen (2011, Par. 6.1.1.2.) avowing that "the term "conditions", according to its ordinary meaning, is not restricted to certain types of conditions such as price conditions or the accidentalia negotii, but rather includes all types of conditions made or imposed by associated enterprises".

66 OECD (2010a, Par. 1.7.).

67 The same idea is expressed by the OECD Fiscal Committee at OECD (1987, Para. 61).

68 In contrast, Wittendorff (2009, p. 116) takes the view that Art. 9 (1) only concerns transfer pricing adjustments because "there is no evidence indicating that the arm's length principle in the special rules and in Art. 9 (1) should be different".

Moreover, as underlined by the OECD, if the states would like to broaden the scope of those provisions, i.e. Arts. 11 (6) and 12 (4), in order to cover the reclassification of payments, they may do so by deleting the aforementioned restrictive phrase and, if necessary for clarity purposes, "a phrase such as 'for whatever reason' might be added after 'exceeds'".[69] In that respect, it is worth noting that the UK tax treaties normally adopt this double approach to cover the reclassification of payments by deleting the restrictive phrase and adding the aforementioned clarifying phrase.[70] Finally, it should also be mentioned that in the European tax law framework, a similar provision to Arts. 11 (6) and 12 (4) is included in the Interest and Royalty Directive under Art. 4 (2). However, the provision of that Directive was worded differently and does not include the restrictive phrase included in the relevant provisions of the OECD Model Convention. Consequently, it should be considered that Art. 4 (2) of the Interest and Royalty Directive admits the reclassification of interest or royalty payments as a contribution to equity capital.[71]

From the preceding discussion it is clear that the term "conditions" included in Art. 9 (1) should be interpreted in a broad manner. In other words, this provision cannot be so narrowly interpreted as to include only prices of transactions, and not their reclassification. Thus, this means that under Art. 9 (1) not only the interest rate agreed between the associated enterprises, but also the quantum of the loan itself may be tested against the ALP.

(ii) Can the amount of debt be assimilated to "conditions" imposed in financial relations?

Once it has been settled that the term "conditions" should be interpreted in a broad sense, the next question that needs to be addressed is whether the use of excessive debt financing can be qualified as a "condition made or imposed between the two enterprises in their [...] financial relations" which can have an impact on the profits of the enterprise. To answer this question two separate issues have to be scrutinized. The first issue is whether the term "financial relations" should be understood as including the different methods that associated enterprises can use to finance each other: i.e. debt and equity capital. The second issue is whether the amount of debt can qualify as a "condition" for these purposes because it may cause a shift of profits between related enterprises.

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69 OECD Commentary to Art. 11, Para. 35 and OECD Commentary to Art. 12, Para. 22.

70 E.g. UK tax treaties with Belgium, Germany, India, Japan, Lithuania, New Zealand, Norway, Malaysia, Oman and the United States.

71 For more details on the interpretation of Art. 4 (2) of the Interest and Royalty Directive, see Martinho Fernandes (2011, p. 455).

Thus, the first issue that needs to be addressed concerns the interpretation of the term "financial relations". The Oxford English Dictionary defines the term "financial" as "pertaining, or relating to finance or money matters". Consequently, "financial relations" between associated enterprises concerns the dealings involving finance or money matters of enterprises. This means that the term "financial relations" relates to the methods that a company can use to raise the funds needed to run its business operations. In that regard, it is commonly accepted that there are two different ways for companies to be financed: i.e. through debt and equity capital.[72] Thus, there can be little doubt that the term "financial relations" comprehends the funding of associated enterprises by means of equity and/or debt capital. In the same vein, Vogel also notes that:

> Financial relations are primarily relationships existing between associates and evolving from company law and extending to cover situations like payment of constructive dividends and concealed equity contributions.[73]

After showing that the term "financial relations" includes any dealing involving the financing of associated enterprises through equity and/or debt capital, the next issue to be considered is whether the amount of debt should be considered as a "condition" imposed on a financial relation which may prompt a diversion of profits between related enterprises.

There can be little doubt that the total amount of debt financing, i.e. the total amount of loans provided, as well as the rate of interest charged, constitutes a condition imposed between associated enterprises in their financial relations. Moreover, considering that, as a general rule, interest payments are tax-deductible in the hands of the debtor company, by imposing an excessive total amount of loans (i.e. debt financing) related enterprises produce an effect on the allocation of their own profits. This does not mean, however, that only excessive debt financing can cause a shift of profits between countries or that excessive debt financing can be analyzed in an isolated manner. The use of excessive equity capital may also cause a diversion of profits from one country to another.[74,75,76]

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72 See, for example, the 2010 OECD Report on the attribution of profits to PEs noting that to fund their business activities enterprises require capital and that such capital comprises both debt and equity capital, cfr. OECD (2010b, Part I, Par. 105).

73 Vogel (1997, p. 526, Par. 28).

74 By way of example, one of the underlying intentions for capitalizing a subsidiary with excessive capital may be that the associated enterprises prefer to benefit from the dividend exemption on foreign dividends received in country A and which were distributed by a company established in a country B with a very low corporation tax, instead of being taxed on interest income in country A and taking the interest deductions in country B.

75 Unfortunately, by dealing exclusively with the issue of thin capitalization, the 1987 OECD Thin Capitalization Report failed to address the complete picture of the relationship between the ALP and intra-group financing, which covers both situations of thin capitalization and situations of fat capitalization. The same criticism is made by De Hosson and Michielse (1989, p. 482). The issue of fat capitalization is incidentally mentioned in the 1987 OECD Thin Capitalization Report and even though it is acknowledged that such an arrangement may also concede tax advantages the issue does not deserve further attention, cfr. OECD (1987, Par. 10). On the basis of the relevant OECD report, the justification for that seems to be the fact that the tax administrations have been more concerned with the problem of thin capitalization, which might explain why it was perhaps understood that such an issue did not require any detailed analysis. After all, what does not represent a concern for the different states does not require any detailed analysis or guidance by the OECD.

76 An interesting and in-depth analysis of the application and relevance of the ALP in Belgium to both thin and fat capitalization situations is made by the Belgian national reporter to the 1996 IFA Congress, see Wyntin (1996, pp. 345-358 and 360-363).

In fact, generally speaking, the only difference between the two arrangements that associated enterprises may use to shift profits, i.e. use of excessive debt or equity capital, is the country in which there is a loss or an increase of tax revenue. It can either be the country of residence of the parent company or the country of residence of the subsidiary company.

The discussion above clearly demonstrates that the choice to finance an associated enterprise with a certain debt-to-equity financing ratio may have an effect on the amount of taxable profits of the associated enterprises. Consequently, if the associated enterprises agree on total amounts of debt or equity financing on other than arm's length terms, on the basis of the ALP such amounts of debt or equity financing should be adjusted to the amounts of debt and equity financing that unrelated parties would have agreed upon. Doing otherwise would mean that associated enterprises would be allowed to manipulate their capital structure in order to shift income between the two relevant countries without the risk of any adjustment to such taxable profits on the basis of the ALP.

Thus, the income shifting caused by excessive debt financing, as well as by equity financing, just like with any other transfer pricing case, arises from the manipulation of the determination of the income and expenses that should be attributed to each of the associated enterprises. If the issues of thin and fat capitalization are considered together from the arm's length spectrum, one easily sees that is not the deductibility of interest payments or the non-deductibility of dividend payments, as such, that is the origin of the transfer of profits, but the fact that the associated enterprises did not determine correctly, i.e. at arm's length, the income and expenses of each relevant enterprise.[77]

In addition, since the financing of an enterprise is composed of the debt-equity binary, this also means that the total amount of debt, as well as the total amount of equity capital are interrelated and that they have to be analyzed in light of the total amount of financing of the enterprise, i.e. its capital structure. Thus, one of the conditions of the financial relations of related enterprises is exactly the choice between equity and debt financing. In other words, if in a first moment the MNE makes a choice between financing an associated enterprise with a certain amount of debt or equity capital and then subsequently an arm's length analysis shows that such amounts of debt or equity capital diverge from the financing conditions that would have been imposed between independent parties, then not only do the amounts of debt or equity capital have to be adjusted, but it also means that the proportion of debt and equity capital would also indirectly be adjusted.

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[77] Conversely, see Wittendorff (2009, p. 119) and Wittendorff (2010, p. 163) arguing that the income shifting in a thin capitalization case is due to the form of the transaction and the substantial tax treatment of debt financing whose return, i.e. interest payments, is generally deductible for tax purposes. The same argumentation, i.e. that it is the domestic tax treatment of the interest payments that prompts the diversion of profits and not the amount of the loans provided, was applied by the Canadian Court in the Specialty Manufacturing Ltd. case to reject the application of the ALP to solve a thin capitalization case.
The full decision is available in the IBFD Tax Treaty Case Law Database, at http://online2.ibfd.org/cl/ (last visited on 23 June 2013). For a discussion of the arguments of the case, see Wittendorff (2010, pp. 163-164).

Therefore, for the purpose of applying Art. 9, it is irrelevant whether thin capitalization rules, fat capitalization rules, or comprehensive interest barrier recharacterize the excessive amounts from debt payouts into equity payouts (or vice-versa). The reason for that is the tacit assumption on the basis of which both thin capitalization rules and Comprehensive Interest Barriers work: an enterprise is excessively debt financed insofar as it has a disproportionate amount of debt to equity capital. Thus, this means that the total amount of debt is "excessive" in relation to something else, i.e. the other part of the capital structure, the equity capital. To put it otherwise, none of those rules questions the capital structure of the associated enterprises, i.e. the capital structure as such is assumed to be at arm's length. What is questioned is the choice made by the associated enterprises to allocate a greater amount of debt than equity capital in the case of thin capitalization rules and Comprehensive Interest Barriers, or a greater amount of equity than debt capital in the case of fat capitalization rules.[78] It is the choice between capitalizing an associated enterprise with a certain total amount of debt or equity capital that is challenged by the arm's length test, and not so much the deductibility of one kind of payment and not of the other one.

To illustrate this statement, let us consider that the capital structure of an enterprise is 100, the total amount of debt is 80 and the total amount of equity is 20. Thus, the whole capital structure of 100 corresponds to the sum of 80 of debt capital and 20 of equity capital. In a situation where thin capitalization rules or Comprehensive Interest Barriers kick in, such rules simply determine that 80 is an excessive amount of debt capital, but what those rules do not question is whether the total amount of financing that the enterprise requires to run its business is 100. In other words, the amount of 100 is assumed or deemed to be at arm's length because it would have been contributed by a third party, but what a third party would not have done was to contribute the amount of 80 out of 100 as debt capital.

It follows from the above that Art. 9 (1) should be applicable both to: (1) thin capitalization rules (or Comprehensive Interest Barriers) that simply deny the deductibility of interest payments attributable to the excessive amount of debt but maintain the qualification of the payment as interest unchanged; and to (2) thin capitalization rules that deny the deductibility of interest payments attributable to the excessive amount of debt and requalify the excessive debt into equity and the interest into a hidden profit distribution. From the perspective of the author, the underlying reason for such a conclusion is quite simple: both rules concern the arm's length allocation of taxable profits and aim to prevent the shifting of profits from one country to another resulting from a non-arm's length or non-commercial agreement between associated enterprises regarding the total amount of debt capital.[79]

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78 However, that does not amount to saying that the capital structure as such could not be challenged by reference to the ALP. In that regard, it is important to note that the AOA applicable to PEs not only questions how the related parties have decided to determine the capital structure of the PE, but also proposes one approach to attributing "free" capital (i.e. thin capitalization approach) which autonomously determines a total arm's length capital structure consistent with the risks, assets and functions attributed to such a PE, see OECD (2010b, Part I, Para. 129-134).

79 Against the author's conclusion, see primarily Michielse arguing that for different reasons Art. 9 (1) does not apply regarding any type of thin capitalization rules. Michielse takes the view that thin capitalization rules that simply deny the deductibility of interest payments attributable to the excessive amount of debt (i.e. type (1) described above) fall out of the scope of Art. 9 (1) because those "domestic provisions are part of the internal rules which determine the taxable profit", cfr. Michielse (1994, p. 232) and Michielse (1997, p. 568). On the other hand, the second type of thin capitalization rules described above which requalify the amount of excessive interest payments into a hidden profit distribution is not covered by the umbrella of Art. 9 (1) because the text of that provision does not allow a broad interpretation of the term "conditions", cfr. Michielse (1994, pp. 232-233) and Michielse (1997, p. 568). Basically, Michielse qualifies thin capitalization rules that merely

(iii) Is it true that Article 9 (1) only allows adjustments of "conditions", but not adjustments of "commercial or financial relations"?

The basic argument submitted by the commentators is that Art. 9 (1) only allows adjustments to the conditions of the financial relations but not of the financial relations themselves.[80] Thus, as argued by those commentators, "the existing financial relations are the starting point rather than the subject of the provisions"[81].

Accepting this view would mean that one could make an adjustment to the "conditions" of a financial relation without causing any impact or indirect adjustment of the financial relation itself. This view cannot be accepted.[82] As highlighted above, there is a continuum between the adjustment to the total amount of loan financing (or of an adjustment to the total amount of equity financing) and the adjustment of the financial relations themselves, i.e. adjusting the arm's length proportions of debt and capital of the associated enterprises.

Thus, this means that an adjustment to any "condition" of the financial relations will necessarily have an impact, i.e. cause an adjustment, to a greater or lesser extent, of the financial relations themselves.[83]

Therefore, as rightly pointed out by Bullen, accepting the argument submitted by the commentators constitutes a paradox because:

> if Art. 9 (1) is interpreted as only authorizing the adjustment of "conditions" but not of "relations", domestic tax administrations would be unable to do what they are authorized to do (i.e. adjust "conditions") without simultaneously doing what they are not authorized to do (i.e. adjust "relations").[84]

disallow interest deductions as a rule concerning the computation of taxable profits, whereas thin capitalization rules that recharacterize interest as dividends are qualified as an allocation of profits rule. For the reasons expressed above, the author does not agree with this distinction. Concurring with the author, see Nitikman (2000, p. 49) and Vleggeert (2009, pp. 150-151).

80 See Becker (1990, p. 52), De Hosson and Michielse (1989, p. 480), Michielse (1996, p. 463), Michielse (1997, p. 568), Sommerhalder (1996, p. 92), Wittendorff (2009, pp. 116 and 119) and Wittendorff (2010, p. 163).

81 De Hosson and Michielse (1989, p. 480).

82 See Bullen (2011, Par. 6.1.1.4.) refusing the validity of this argument in the context of a general restructuring of controlled transactions by tax administrations.

83 See Bullen (2011, Par. 6.1.1.4.).

84 Bullen (2011, Par. 6.1.1.4.).

From the perspective of the author, the argumentation above shows that some commentators have failed to take into account the fact that there is an integration, instead of a separation, between the adjustment to the "conditions" of the financial relations and the adjustment of the "financial relations" themselves. As a result, the argument that Art. 9 (1) only allows adjustments of "conditions", but not adjustments of "commercial or financial relations" cannot be accepted as a basis to prevent the application of Art. 9 (1) to any kind of thin capitalization rules, notably the kind of thin capitalization rules which formally requalify the excessive amount of loans as equity and the corresponding excessive amount of interest payments as dividends.

(iv) Does the historical background of the relevant provision also call for a restrictive interpretation?

As shown above, see supra Section 2.1., the historical background of Art. 9 (1) was written with all the financing arrangements that could cause a diversion of profits from one country to another in mind, including the diversion of profits by means of manipulation of the total amount of debt financing (i.e. thin capitalization). Therefore, any argument for a restrictive interpretation of Art. 9 (1) cannot be extracted from the historical background of the provision. Instead, as illustrated in Section 2.1. of this paper, such a restrictive interpretation is, in fact, at odds with its historical background.

2.2.1.2. Arguments in favour

Until now, this investigation has been focussed on showing that the arguments against the application of the ALP to thin capitalization rules were not convincing. Now, it is time to turn to the scrutiny of the arguments supporting the application of the ALP to thin capitalization rules.

(a) The arm's length test as a crucial and global test to delimit the profits of the associated enterprises

Art. 9 (1) is a broad rule on the determination of taxable profits of associated enterprises, which uses the ALP as the yardstick for delimiting the profits that are economically connected with the country where the relevant associated enterprise is established. Consequently, any deviation from this benchmark on the determination of taxable profits will lead the relevant country to tax either above or below the amount of taxable profits of the enterprise that are economically related to that country.[85] Thus, the aim of the ALP is to ensure that each country effectively obtains its fair share of the income of a MNE carrying out business activities in that country either through a PE or a subsidiary. To achieve that aim, the ALP corrects any eventual diversion of profits by reallocating the income (and expenses) as they should have been originally allocated between the associated enterprises. However, that is not tantamount to saying that the tax administration can correct the accounts as it so wishes or to arbitrarily correct the accounts of associated enterprises. As noted by the OECD Commentary to Art. 9 (1):

> 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 (on an arm's length basis)."[86]

Thus, with regard to thin capitalization rules, the non-application of the ALP would mean that the different states could freely enforce thin capitalization rules without any reference to the ALP benchmark. Consequently, under such circumstances, the accounts of the associated enterprises could arguably be re-written even in a situation where the associated enterprises would have dealt with each other on arm's length terms.

The discretionary (i.e. without any reference to the ALP) determination of the level of excessive debt financing of associated enterprises may entail the disallowance of the deductibility of arm's length interest payments and, as a result, unduly allocate taxing rights to the country applying them. Consequently, by enacting thin capitalization rules which are not grounded in the ALP, the taxable profits of associated enterprises would admittedly no longer be computed on an arm's length basis. Moreover, as rightly pointed out by Piltz:

> **excessive thin capitalization regulations create an artificial source of revenue** [author's emphasis] for the country concerned and not only – as should be the case – taxation which corresponds to the economically appropriate conditions.[87]

85 It is quite clear that if a country is taxing an amount lower than the arm's length amount of profits, an international tax problem will not arise, but instead an eventual national budgetary problem will, because such a country is raising lower tax revenues than it could (fairly) raise. Conversely, if a country is taxing above the arm's length amount of profits it poses an international tax problem, namely the economic double taxation of the same item of income in the hands of two different persons.

86 OECD Commentary to Art. 9, Para. 2.

87 Piltz (1996, p. 138).

On the other hand, such deviation from the ALP by thin capitalization rules will also necessarily lead to unsolved economic double taxation. The initial adjustment made to the taxable profits of the associated enterprise, which was imposed by thin capitalization rules (or Comprehensive Interest Barriers), was not made on the basis of the ALP. In other words, that state imposed taxes beyond the international agreed standard for the allocation of taxing rights. As a result, the other state would be under no obligation to make a downward adjustment of the taxable profits of the affiliated company.

It follows from the above discussion that accepting that the ALP should constitute the yardstick or the benchmark strictly applied by thin capitalization rules constitutes a crucial piece of the international tax puzzle. By applying the ALP to the issue of thin capitalization, besides ensuring that each state gets its fair share of tax of a MNE, it is also guaranteed that the problem of economic double taxation of income can, at least in principle, be solved. Conversely, accepting the argument that thin capitalization rules do not have to meet any arm's length test indirectly implies accepting that the tax legislator may, on a discretionary basis, introduce excessive thin capitalization rules which create an artificial source of revenue (i.e. taxation of business profits of the enterprise which are not economically related to that country). It is quite clear that such an argument should not be upheld because it is against the basic aim of Art. 9 (as well as of Art. 7), which essentially says that "business profits should be taxed in the State in which they originate economically"[88]

(b) The OECD position under Articles 7 and 9 of the OECD Model Convention

The position of the OECD is that Art. 9 (1) authorizes any kind of domestic thin capitalization rules but only insofar as any upward adjustments made to the taxable profits of the relevant domestic enterprise do not exceed the amount of taxable profits that would have accrued to the same enterprise had there been an arm's-length relationship between the associated enterprises concerned.[89]

In practical terms, this means that the increase of the taxable profits of the borrowing enterprise operated by thin capitalization rules, either through disallowing the deductibility of the deemed excessive interest or by requalifying the disallowed interest as (non-deductible) dividends, cannot exceed the taxable profits which would have accrued to the borrowing enterprise had the lending and the borrowing enterprises been operating at arm's length.

Hence, thin capitalization rules may only regard a certain investment made in an associated enterprise as equity capital, and not as debt capital as qualified by the parties, if a third party under the same circumstances would not have structured the relevant financial relation as debt capital. It is exactly the fact that a third party would not have structured that investment as debt, but instead as equity capital, that gives evidence that the associated enterprises did not act at arm's length.

88 Vogel (1997, p. 518, Para. 10).

89 OECD (1987, Para. 49) and OECD Commentary to Art. 9, Para. 3(a) and (c).

The application of the ALP to the issue of thin capitalization, as well as the OECD guidance in this respect is also followed by the Commentary to the UN 2011 Model Convention.[90]On the other hand, with regard to Art. 7 the OECD position is somewhat different. Accordingly, the OECD reiterates the need to comply with the ALP, but also sets out the ways in which the arm's length capital structure of the PE should be determined. Indeed, further to the introduction of the AOA, the OECD has formally recognized that the attribution of an arm's length capital structure to the PE (i.e. a capital structure compatible with the assets, risks and functions allocated to the PE) plays a pivotal role in the determination of the arm's length profits of the PE.[91] Thus it follows from the AOA that the ALP applies to the issue of thin capitalization of a PE. In addition, the AOA laid down the four (4) authorized approaches to attributing "free" capital to a PE.[92] Those approaches are construed according to two different criteria as follows:

(i) the actual structure of the enterprise of which the PE is a part (i.e. the capital allocation approach and the economic capital allocation approach); or

(ii) the capital structures of comparable independent enterprises (i.e. the thin capitalization approach and safe harbour approach – quasi thin capitalization / regulatory minimum capital approach).

Hence, it follows from the above that the OECD takes the view that thin capitalization rules should be compliant with the arm's length principle. However, that being said, it is worth noting that the OECD does not provide the same kind of guidance in relation to the interaction between thin capitalization rules and the ALP under Arts. 7 and 9. From the perspective of the author such position is quite odd as Arts. 7 and 9 basically incorporate an "arm's length test for delimiting [the] profits" of a foreign enterprise operating in another country[93]. Despite the interest of this issue, it is out of the scope of this paper to discuss the different guidance provided by the OECD to deal with the issue of adequate capitalization of PEs and subsidiaries.

90 See the UN Commentary to the United Nations Model Double Taxation Convention between Developed and Developing Countries (2011) to Art. 9, Para. 5-7. For a discussion of the issue of thin capitalization, see Art. 1, Para. 64-70.

91 See OECD (2010b, Part I, Para. 32) and OECD Commentary to Art. 7, Para. 21.

92 See OECD (2010b, Para. 121-138).

93 Vogel (1997, p. 522, Para. 17).

2.2.1.3. Concluding remarks

The discussion above clearly demonstrates that despite the reservations submitted by some commentators, as well by some states and domestic courts, the arguments in favour of the application of the ALP to thin capitalization rules outweigh the arguments against its application.

In particular, it should be emphasized that the historical argument, which is one of the main reasons used by the commentators (and domestic courts) against the application of the ALP to thin capitalization rules,[94] should be interpreted differently. The reason for that is that a thorough and in-depth analysis of the historical background of Art. 9, notably of the Carroll Report and the 1933 and 1935 Draft Conventions on Profit Allocation, shows a plea in favour of the application of the ALP to thin capitalization rules.

As a result, the arm's length test provided by Art. 9 (just like the arm's length test provided by Art. 7) comprises both a scrutiny of the amount (or quantum) of the loan, as well as of its interest rate.

To sum up: considering that the capitalization of a MNE has an effect on the taxable profits of the associated enterprises and that, in particular, the manipulation of the amount of debt capital may be used to shift profits between countries, there can be no doubt that the ALP should intervene to delimit the amount of profits that might have been so diverted.

94 See De Hosson and Michielse (1989, pp. 480-481), Michielse (1994, p. 233), Michielse (1996, p. 463), Michielse (1997, p. 568), Sommerhalder (1996, p. 92), Wittendorff (2009, p. 116) and Wittendorff (2010, p. 162). See also supra Section 2.2.1.1.

III. CONCLUSIONS

This paper has dealt with the issue of whether the problem of thin capitalization falls within the scope of the ALP. The analysis carried out in this paper has provided sufficient evidence that the ALP is the standard or norm which is used to delimit the proper amount of profits of both a PE and a subsidiary. In particular, the history and the aims of Art. 9 (as well as the history of Art. 7) have shown that the ALP is the internationally accepted guiding standard regarding the allocation of profits and that any deviation from this principle cannot be accepted because it would promote arbitrariness and it would also be contrary to the taxation of the taxable profits in the country in which they originate economically.

With regard to the application of the ALP to the problem of thin capitalization, the basic conclusion of this paper is that the capitalization of subsidiaries and PEs has an effect on their profits and that any eventual manipulation of the capital structure through the use of excessive debt financing may be used to shift profits between countries. Hence, the ALP may apply in order to correct the commercial accounts of the relevant entity by adjusting its taxable profits insofar as the amount of debt financing provided would exceed the amount that an independent party would have provided under the same relevant facts and circumstances. Conversely, when it is not objectively shown that the amount of debt capital is excessive, i.e. that an independent party would not have provided such an amount of debt capital, the capital structure of the relevant entity should be respected and the deductibility of such arm's length interest payments should not be restricted.

Therefore, interest limitation rules, either designed as traditional thin capitalization rules or as Comprehensive Interest Barriers, which try to prevent an improper reduction of the domestic taxable income of the relevant subsidiary (or PE), have to conform to the ALP, i.e. either apply criteria which are compatible with the ALP or apply rules which work directly by reference to the ALP.

Thus, while it is true that the capitalization of subsidiaries (as well as of PEs) has an effect on their taxable profits and that the manipulation of the capital structure may be used to shift profits across countries, any eventual decrease of the taxable profits have to be shown in light of the ALP i.e. by reference to the arm's length amount of taxable profits that would have arisen in an arm's length situation. The restriction of the debt financing of a subsidiary (or of a PE) by domestic arbitrary formulas (i.e. other than the arm's length standard) would be in breach of Art. 9 (and of Art, 7 in the case of PEs). To state it differently, admitting the use of domestic arbitrary formulas to determine the accurate (or maximum) amount of debt financing of a subsidiary is tantamount to admitting that the profits that should be attributed to a subsidiary may be determined by reference to a domestic apportionment mechanic formula disconnected from its net income as determined on the basis of its commercial accounts.

Yet, an issue that remains open and that needs further research is how to determine that the financial relations agreed between the associated enterprises (i.e. their capital structure) do not correspond to or deviate from the financial relations that would have been agreed between independent enterprises under the same or comparable circumstances.

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