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Old “thin cap” rule breaches non-discrimination clause of double tax treaty

The Supreme Tax Court has held that the application of the pre-2008 “thin capital” rule to disallow interest on related party finance breaches the discrimination prohibition of double tax treaties.

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Up to 2007, interest paid to a foreign shareholder with at least 25% of the share capital or his related party was disallowed to the extent the “thin capital” rule came into play. This rule required that interest bearing shareholder finance did not exceed initially three times the shareholders’ equity. Later, this debt/equity ratio fell from 3:1 to 1.5:1. In 2010, the Supreme Tax Court held that the debt/equity ratio breached the non-discrimination clause of the Swiss double tax treaty – because it disallowed an expense merely because of the foreign shareholder. The Supreme Tax Court has now confirmed this finding in a second judgment on the loan taken out by a GmbH with an Irish bank in order to finance a local business acquisition. The GmbH and the bank were related parties as they were both wholly-owned by the same US company. The terms of the loan were at arm’s length, although the amount brought the debt/equity ratio well over the allowed limit. However, application of the rule was precluded by the non-discrimination clause in the US double tax treaty. The court emphasised that, in this regard the Swiss and US treaties followed the OECD model treaty, thus giving a clear message that the old “thin capital” would not generally be applicable to companies held from treaty countries.

For 2008, the “thin capital” rule was replaced by the “interest limitation” basically restricting the deductible net interest expense to 30% of EBITDA. However, the interest limitation does not apply in a number of cases (such as where the total net interest cost for the year does not exceed €3 m, the borrower is not part of a group or where at least 90% of the net interest expense is paid to creditors with an equity interest of no more than 25% in the company). The “interest limitation” does not obviously discriminate against foreign owners; however the present case against the “thin capital” rule may well offer support in developing arguments against its successor.

Supreme Tax Court judgment I R 30/12 of January 16, 2014 published on April 9

Schlagwörter

debt/equity ratio, interest limitation, thin cat