The Offshore Tax Planning Review

THIN CAPITALISATION: ICTA 1988 SECTION 209(2)(da) ET AL

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In introducing the thin capitalisation rules contained in Finance Act 1995 s.87, now contained in ICTA 1988 s.209(2)(da) and s.209(8A) to (8E), the draftsman has sent tax advisers into new heights of derangement. The aim of the Inland Revenue in attacking the mischief of equity contribution being disguised as debt is unexceptionable, perhaps even laudable. However, it must be said that I have nothing good to say about these provisions. They are appallingly drafted. They are of the most dubious legality, in terms of both Double Tax Treaties concluded by the UK and the Treaty of Rome. Quite independently of the first two observations, the test which these provisions seek to apply is arguably completely misconceived. Finally, Revenue interpretations of certain of the provisions bear little or no relation to the provisions themselves.

The analysis is in six parts, namely:

1. Context: a brief examination of the concept of thin capitalisation;

2. UK treatment of cross-border interest prior to the enactment of section 209(2)(da) et al;

3. The rationale of anti-thin capitalisation rules and the authority of a Contracting State to introduce such rules in the context of the OECD Model Treaty;

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This Article contains the observations I made in a lecture to the Financial Markets Group at the London School of Economics on 16th October 1995. I am grateful to John Avery-Jones, of Speechley Bircham, and Malcolm Gammie, of Linklaters & Paine, for suggesting that I put my thoughts in writing. At the request of the Revenue, I have sent the International Division an advance copy of this article.

4. The construction of the statutory provisions contained within these new rules;

5. The test propounded by the rules:

6. Grounds of challenge to the legality of the rules[2].

1. Thin Capitalisation: the Phenomenon

To put the new rules in context, it is necessary to revisit familiar territory. The capital structure of a multinational company is likely to favour a high debt to equity ratio for commercial reasons[3], as well as tax reasons[4]. Thus, a particular company resident outside the UK may choose to fund its subsidiary by debt rather than equity for those reasons. So far as the UK tax regime is concerned, funding arrangements seeking to obtain fiscal advantages by using debt rather than equity are attacked as "thin capitalisation". Thin capitalisation is a synonym for disguised equity contribution. In other words, if in the view of the UK Revenue a debt funding arrangement is put in place instead of equity financing merely to obtain tax advantages, interest payments in respect of such loans should properly be categorised as payments in respect of equity rather than debt. The consequence of such recategorisation is that some or all of the interest payment would be disallowed as a deduction and the payments would be taxed as if they were payments of dividends[5].

2. UK Treatment of Cross-Border Interest Payments

Consider Figure 1 below. Prior to the introduction of section 209(2)(da) et al, if the non-UK creditor company was resident in a territory with which the UK had

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[2] Incidentally, the arguments I raise below in respect of the non-discrimination provisions in the OECD Model Treaty (1992 version) and the Treaty of Rome may be adapted to challenge many other provisions, e.g., the equity note provisions contained in ICTA 1988 s.209(2)(e)(vii).

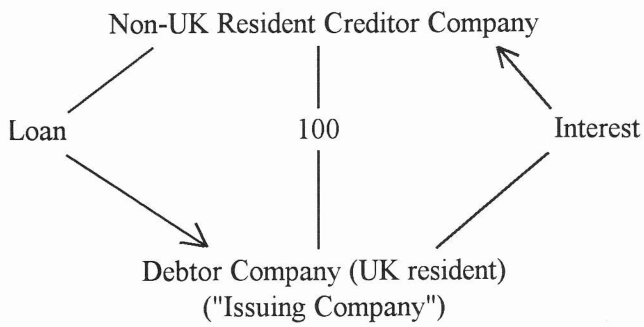
[3] Interest payments may be easier to repatriate cross border than dividends. e.g., because the paying company need not have to consider its distributable reserves.

[4] Interest payments will give rise to a deduction either as a trading expense or a charge on income, while dividends are paid out of taxed income, quite apart from potentially favourable treatment of the interest as equity in the jurisdiction of the recipient.

[5] i.e., in the UK, give rise to a charge to ACT.

no Double Tax Treaty, the interest paid by the Issuing Company would automatically have been a distribution[6].

Figure 1



If the creditor company was resident in a territory with which the UK had a Double Tax Treaty, the treatment of the interest, prior to 14th May 1992[7], would have been exclusively governed by Article 11 (the "Interest Article") of that Treaty.

The genesis of the new thin capitalisation provisions is contained in Article 11 of the OECD Model Treaty, the "interest" Article. Article 11(2) limits taxation of interest in the state of source to a maximum of 10% of the gross amount of interest[8]. Thus interest payments made by the UK debtor company are protected to this extent from UK tax by Article 11.

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[6] ICTA 1988 s.209(2)(e)(iv); this provision only applied if the UK debtor company paid interest to a 75% non-UK resident parent or a 75% non-UK resident fellow subsidiary but *not* to payments from a UK resident parent to its non-UK resident subsidiaries, (unless both were controlled by a non-UK resident company) presumably on the footing that the provision broadly sought to attack illegitimate forms of debt finance that could have taken the form of equity finance (although this rationale breaks down in part where the interest was paid by a UK resident company to a 100% non UK subsidiary, where both were controlled by a non-UK resident company since the interest would have been caught by s.209(2)(e)(iv)).

[7] From which date ICTA 1988 s.808A, introduced by F(No2)A 1992 s.52 applied. I (briefly) consider this provision below.

[8] Under paragraph (1) the State of residence of the recipient may also tax the interest, in which case double taxation will be relieved under Article 23.

However, Article 11(6) of the OECD Model (hereafter "Article 11(6)" refers to that provision in the OECD Model) contains an anti-avoidance arm's length rule. Where by virtue of a "special relationship" between the payer and the payee of interest, the *amount* of interest *exceeds* that which would be payable between the parties at arm's length, the protection of Article 11(2) will only apply to such amount as would have been paid between unrelated parties[9]. To the extent that the interest payment falls outside the scope of that protection, it would be governed by the domestic law of the State of residence of the paying company.

So in Figure 1, if the whole of the interest paid by the UK debtor company was established as having been paid by reason of a "special relationship" between the debtor company and the non-UK creditor company, interest payments paid by the former would not be protected by Article 11 of the Double Tax Treaty and would be subjected to the application of ICTA 1988 s.209(2)(e)(iv). Thus the interest paid by the UK company in Figure 1 would (prior to the enactment of s.209(2)(da)) have suffered recategorisation as a distribution for the purposes of the Corporation Tax Acts.

Clearly Article 11(6) applies where the **rate** of interest is higher than would be agreed between arm's length parties. However, the question arises as to whether it applies where the **amount** of interest is excessive given the debt:equity ratio of the payer. In other words, is the protection of Article 11(6) withdrawn where, although the rate of interest on a loan between parties with a special relationship is commercial, that *particular* loan (whether of a particular amount or at all) would not have been made had the parties had no special relationship, on the basis that *any* interest paid in respect of such a loan is excessive? Following a decision of the Special Commissioners (see (1993) 78B Cahiers DFI at page 699) which concluded that the answer was "no", ICTA 1988 s.808A was introduced to reverse that decision and make it clear that, as a matter of UK domestic law, the debt:equity ratio of the payer is taken into account to consider whether any amount of interest (notwithstanding that the rate may be a commercial rate) is excessive and thus categorised as a distribution, and stripped of the protection of the interest Article of any Double Tax Treaty concluded by the UK. Section 808A, however, was perceived as discriminatory in terms of EC law,[10] which led to the introduction of s.87 of the Finance Act 1995, introducing in turn s.209(2)(da) and 209(8A) to (8E) into ICTA 1988, in an attempt to achieve the ends desired by s.808A.

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9 The test postulated by Article 11(6) is subjective; the question is not whether a third party (whether an institutional lender or not) would have lent to the paying company but whether a particular lender would have lent to a particular borrower in the absence of a special relationship. The significance of a subjective test, which is incorporated into the thin capitalisation rules, is examined below.

10 See below for the application of the relevant principles to the new provisions.

3. The New Rules: Jurisprudence and Authority

It is crucial to note at this stage that the jurisprudence underlying the question posed by the Special Relationship provision in Article 11(6) dealing with excessive rates of interest due to the presence of a Special Relationship and that inherent in the question posed in the Special Commissioner's decision to which I refer above are quite distinct. Orthodoxy decrees thin capitalisation to be a transfer pricing issue[11]. Thus the question which ought to be addressed by the thin capitalisation rules is one of the *adjustment of profit levels*. Put shortly, if thin capitalisation is a transfer price issue, thin capitalisation rules are properly to be price adjusting mechanisms and nothing else. They ought not to recategorise the *status* of payments subjected to them without specific authority.

Article 11(6) permits a Contracting State which has entered into a Double Tax Treaty based on the OECD Model[12] to subject interest paid above an arm's length rate (as between the particular companies involved) to domestic law. So, in the case of the UK, interest paid at an excessive rate would be subject to the provisions of ICTA 1988 s.209(2)(d). In other words, Article 11(6) is indeed merely a price setting mechanism.

However, we have already seen that Article 11(6) does *not* catch interest payments on loans which are paid at a commercial rate of interest, even if the Revenue can establish that the loan was only made due to a Special Relationship[13].

To subject interest payments on this latter type of loan to anti-avoidance provisions, the Revenue effectively categorises the loan as an "unacceptable" loan, in that it would not have been made if the parties had been at arm's length, ignoring the "price" of the loan, i.e., the interest. Given that domestic legislation introduced to either deny a deduction for such interest or recategorise it as a distribution in respect of equity would apply to interest otherwise within the protection of Article 11, the Treaty would be contravened unless provisions which it itself contained permitted such legislation. Quite apart from questions of Treaty

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11 See OECD: Committee on Fiscal Affairs (1987): *Issues in International Taxation (no 2); I "Thin Capitalisation"*, paras 182-191, following a brief discussion of the problem in the Report of the Committee of Fiscal Affairs (1979): *Transfer Pricing and Multinational Companies*

12 I explore the interaction between authority conferred by a Treaty based on the OECD Model and provisions of the Treaty of Rome below.

13 The Revenue cannot argue that the entire interest payment is excluded from the protection of Article 11, on the footing that the loan ought to carry a *higher* rate of interest than that actually charged due to peculiar characteristics of either lender or borrower on the basis of Article 11(6), since the latter provision only applies to *excessive* rates of interest.

override[14] if there were no such authority, the provisions introduced would be subject to the non-discrimination provisions of the Treaty.

Article 9(1) of the OECD Model[15] permits to a Contracting State to recategorise a loan as an equity contribution, quite apart from any questions of the rate of interest charged in respect of the loan, if the loan would not have been made if the parties had been acting at arm's length[16]. Article 9(1)[17] expressly overrides one of the non-discrimination provisions in the OECD Model Treaty[18] but not the other[19]. However, it is crucial to note that in any event the provisions introduced under the authority of Article 9(1) may only *vary the profit level of the enterprise in the State of residence of the Contracting State which has introduced the legislation by reference to hypothetical arm's length "commercial or financial relations" between the two enterprises*[20]. Article 9(1) does *not* permit recategorisation of interest payments caught by legislation enacted under its authority as distributions in respect of capital.

Thus, to return to Figure 1, legislation enacted with the authority of Article 9(1) may adjust the profits of the UK debtor company on the footing that the loan was not made on arm's length terms[21], without falling foul of Article 24(4), but would still be subject to the terms of Article 24(5). Article 9(1) does not, in any circumstances, authorise that such interest be recategorised as a distribution.

Article 10(3) of the OECD Model on the other hand *does* give authority to reclassify interest as a distribution if, *inter alia*, the paying company is thinly capitalised. However, unlike Articles 9(1), 11(6), or 12(4), Article 10(3) does *not*

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14 Discussed below.

15 Which is reproduced in most of the Treaties concluded by the UK.

16 See paragraph 2(b) of the Commentary to Article 9(1).

17 And, indeed, Article 11(6) and Article 12(4) (Special Relationship provision in respect of royalties).

18 Article 24(4).

19 Article 24(5).

20 The imposition of "safe harbour" ratios of debt:equity or income:interest payments is, therefore, arguably outside the scope of Article 9(1) which seeks to put *two particular enterprises* on an arm's length footing (i.e., the Article 9(1) test and its application are subjective) and not to subject those enterprises to some objectively set (indeed perhaps arbitrary) standard.

21 The profits could be adjusted upwards by denying a deduction or downwards *(however unlikely) by imputing an additional interest payment.*

expressly override Article 24(4). Thus any legislation introduced under the authority of Article 10(3) must be always be subject to Article 24(4) and is, in any event, always subject to Article 24(5).

Thus section 209 (2)(da) has the authority of Article 9 (1) to deny a deduction. The denial of deduction overrides Article 24(4) but not Article 24(5). Section 209 (2)(da) has the authority of Article 10(3) to recategorise interest as a distribution but is in this regard subject to the non-discrimination provisions of both Article 24(4) and (5). I explore this question further below. However, it is convenient at this stage to turn to the construction of s.209 (2)(da) et al.

4. Construction and Application of the New Rules

So much for the theory. I now turn to the terms of the thin capitalisation rules themselves.

There are four preliminary conditions under the new section 209(2)(da) which must be satisfied before these new provisions are triggered:-

(1) There must be an issue of "securities" by one "company" (the "issuing company") to another "company". "Securities" bears the definition in ICTA 1988 s.254(1), and thus a simple debt with no documentation is deemed to give rise to an issue of securities. "Company" bears the definition in ICTA 1988 s.832(1), and is thus not restricted to UK bodies corporate.

(2) The issuing company must be a 75% subsidiary of the creditor company, or the issuing company and creditor company must be fellow 75% subsidiaries of a common parent. Bodies corporate held indirectly may constitute 75% subsidiaries for this purpose: ICTA 1988 s.838(1)(b)).

(3) There must be a payment of "interest" or some "other distribution".

(4) The creditor company must **not** be either:

(a) within the charge to UK corporation tax[22], or

(b) an exempt body under ICTA 1988 s.506, 507.

[22] ICTA 1988 s.212(1)(b); put another way, an issuing company paying interest to a creditor company subject to UK corporation tax is exempted from the application of section 209(2)(da). I deal with the significance of this below.

It is crucial to note that, like the test in the Special Relationship provision in Article 11(6) of the Model OECD Treaty, the test posed by s.209(2)(da) is subjective. The test is whether "if the companies had been companies between whom there was (apart from in respect of the securities in question) no relationship, arrangements or other connection (whether formal or informal) [the amount of interest or other distribution would have been paid]". The question posed is **not** whether a third party lender (whether institutional or otherwise) would have lent the money to the issuing company but rather whether *that particular* creditor company would have lent to *that particular issuing company*.

To the extent that the interest or other distribution is viewed as having been paid only by virtue of the relationship etc between the issuing company and the creditor company, that interest is categorised as an income distribution under s.209(2)(da). Section 209(2)(da) refers to "an amount which would not have fallen to be paid". Thus the mere imposition of a commercial rate of interest is not sufficient to escape the application of these new provisions; if the loan would not have been made at all or a loan of the particular amount in question would not have been made but for the relationship between the issuing company and the creditor company, the amount of interest attributable to the relationship (whether at a commercial rate or not) will be categorised as a distribution. The interest payment caught by section 209(2)(da) will therefore (i) not be deductible either as a trading expense or as a charge on income[23] and (ii) give rise to a charge to ACT[24].

Section 209(2)(da) asks two questions:

(1) Is there a relationship etc between the issuing company and the creditor company? Given that the provisions only apply to companies within the 75% relationship specified in section 209(2)(da), the answer to this question will inevitably be "yes", since the share capital will in itself give rise to such a relationship, either direct or indirect.

(2) Would the interest have been paid but for that relationship?

Both of these questions are questions of fact and the burden of proof is on the taxpayer (i.e., the issuing company) to demonstrate that the interest was not paid by virtue of the relationship etc between the issuing company and the creditor company[25].

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23 ICTA 1988 s.337(2), s.338(2)(a).

24 Ibid, section 14.

25 s.808A(3), incorporated into s.209(2)(da) by the new s.209(8A).

The Scheme of the New Provisions

In considering whether or not the interest was paid by virtue of the relationship between the issuing company and the creditor company, "all factors" must be taken into account unless such account is specifically prohibited.[26]

Incidentally, the Inland Revenue have indicated that the major factor to be considered in applying the test in s.209(2)(da) is the debt:equity ratio of the group[27] which contains the issuing company. It may well be that the debt:equity ratio of the commercial group containing the debtor company is a significant factor, perhaps even the prime factor, for an institutional lender. To suggest, however, that this should be the prime factor in applying the test in section 209(2)(da) is nonsensical. We must remember that this test is subjective. The test is not whether an institutional lender would have lent to the issuing company but whether the particular creditor company would have done so, if the parties were acting at arm's length. Thus, factors relevant to institutional lenders may not have the same significance in the context of the transaction entered into by the particular issuing and creditor companies subjected to this test. Group indebtedness may be a factor if there were banking covenants, for example, which required a group indebtedness not to exceed a specified threshold. In the absence of this, the proposition that the debt:equity ratio of the group as a whole is significant, so far as the creditor company is concerned, is quite simply misconceived. The UK Grouping debt:equity ratio is clearly going to be of generally less significance in respect of an intra-group loan (whether or not the creditor company is in the UK Grouping) than in the case of a loan made by a completely unconnected party, even if the parties are acting at arm's length in the intra-group transaction. Section 209(8B)(a) makes it clear that one must always consider the "appropriate level" of indebtedness of the *issuing company*[28] in applying the test in s.209(2)(da).

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26 s.808A(2), as incorporated by s.209(8A).

27 Which presumably means the UK Grouping, as defined in s.209(8D); see below. See Tax Bulletin, No 18, June 1995 218.

28 Or at least, s.209(8A)(b) provides that relationships etc between the issuing company and companies relevantly connected to the issuing company should not be taken into account in the matters specified in s.209(8B)(a)-(c). This implies that one otherwise would take them into account in respect of these questions. Section 209(8B)(b) and (c) effectively pose the same question as the test postulated in s.209(2)(da); see below. Thus to ignore relationships etc specified in s.209(8A)(b) for the purposes of s.209(8B)(b) and (c) is effectively to ignore such relationships etc for the purposes of s.209(2)(da). Incidentally, it is slightly surprising that no indication is given of what an "appropriate level" might be; nor is there any recognition of the fact that the "appropriate" level must vary from industry sector to industry sector, although the question is partly addressed in the Inland Revenue Tax Bulletin, expressing the Revenue view on certain questions concerning the application of the rules: see Tax Bulletin No 18, June 1995 218 at 220.

Nothing is said about the UK Grouping debt:equity ratio. Thus this latter factor is accountable only as one of "all" of the factors referred to in s.808A(2)[29]. The suggestion that the importance of the UK Grouping debt:equity ratio exceeds that ratio of the issuing company itself in importance therefore sits uneasily both with commercial reality and the terms of the provisions of s.209(8A) and (8B) themselves.

The proposition that "all factors" must be accounted for is then qualified by a requirement to undertake the following exercise:

(i) The "UK Grouping" which contains the issuing company is ascertained;

(ii) The companies to which the issuing company is "relevantly connected" are ascertained;

"UK Grouping" and "relevant connection" are elaborately (albeit inelegantly) defined. In answering the question "would an interest payment by the issuing company have been paid but for a relationship etc between it and the creditor company?", all relationships etc between the issuing company and companies "relevantly connected" to it (e.g., guarantees given by such companies of the issuing company's loans, or indeed, guarantees given by the issuing company of loans taken out by a relevantly connected company) are ignored *unless* the company relevantly connected to the issuing company is within the issuing company's UK

Grouping.[30] In other words, relationships etc between the issuing company and a company within its UK Grouping are always taken into account in applying the

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29 As incorporated by section 209(8A).

30 Strictly speaking, the exercise of ignoring relationships etc between the issuing company and a company relevantly connected to it (and outside its UK Grouping) is to be undertaken in respect of those matters referred to in s.209(8B), rather than the basic "but for" test posed in section 209(2)(da). However, the matters referred to in s.209(8B)(b) and (c) are whether "it might have been expected that" the issuing and creditor companies would have entered the loan transaction under scrutiny (whether at all or of a loan of the amount actually lent to the issuing company) and the terms of the loan, including the rate of interest. Thus s.209(8B)(b) and (c) merely restate the basic question posed by s.209(2)(da): would the interest have been paid but for the relationship etc between the issuing company and the creditor company? It follows that if a particular factor is ignored for the purposes of s.209(8B)(b) or (c), it is also ignored for the purposes of s.209(2)(da): i.e., it is ignored for the purposes of the thin capitalisation rules altogether. See footnote 28 supra.

test posed by section 209(2)(da), although, as I demonstrate below, the latter will also be relevantly connected to the issuing company. Relationships etc between the issuing company and companies completely unconnected to it are also always taken into account for the purposes of section 209(2)(da).[31]

Definition of UK grouping

The definition of UK grouping is contained in s.209(8D)(a) to (c):

(a) Where the issuing company has no "effective 51% subsidiaries" and is not "an effective 51% subsidiary" of a UK resident company, the UK grouping is the issuing company alone.

(b) Where the issuing company has one or more "effective 51% subsidiaries" of its own but is not itself an "effective 51% subsidiary" of a UK resident company, the UK grouping is the issuing company and all of its effective 51% subsidiaries.

(c) If the issuing company is itself an "effective 51% subsidiary" of a UK resident company, the UK grouping consists of that UK resident holding company, and all of the effective 51% subsidiaries of the UK holding company[32], including, of course, the issuing company.

What, then, is an "effective 51% subsidiary"? Section 209(8E) incorporates the definition employed by TCGA 1992 s.170(7) (one company is the effective 51% subsidiary of the other if the latter has a beneficial entitlement to more than 50% of its profits and assets on a winding up). It follows that indirectly held subsidiaries cannot, without some extension of the definition of "beneficial entitlement", constitute effective 51% subsidiaries.

However, the Revenue have suggested that TCGA 1992 s.170(8) is incorporated into s.209(8E), along with s.170(7). Section 170(8) incorporates ICTA 1988 Schedule 18, of which paragraph 6 extends the concept of "beneficial entitlement" to indirectly held companies. This latter provision is certainly not expressly incorporated by any of the terms of s.209 ICTA 1988. Furthermore, the terms of TCGA 1992 s.170(8) make it clear that this subsection is not incorporated into

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31 Given that the general rule is that one must account for all factors and there is no qualification to this proposition in respect of completely unconnected companies.

32 "UK holding company" is a defined term which applies for the purposes of s.209(8D)(c) only and appears to be a completely unnecessary piece of jargon inserted by the draftsman.

s.209(8E). Section 170(8) applies "...for the purposes of subsections [170(6) and 170(7)] above...". What are "the purposes" of section 170(7)? A glance at the terms of section 170(7) tells us that it applies for "...the purposes of [section 170] and 171 to 181", that is sections 170 to 181 of *TCGA 1992*. Section 170(8) is not, unsurprisingly, expressed to apply for the purposes of s.209 ICTA 1988. Thus TCGA 1992 s.170(7), as incorporated for the purposes of s.209(8E), applies *without* the extended definitions imported by s.170(8) in the absence of an express provision to the contrary.

Indeed, any such provision extending the definition of beneficial entitlement so as to include indirectly held subsidiaries for the purposes of section 209(8E) could not sensibly incorporate TCGA 1992, s.170(8) for these purposes. To do so would incorporate the *whole* of Schedule 18 of ICTA 1988 (as modified for TCGA ss.171 to 181 purposes by TCGA 1992 s.170(8)), not just paragraph 6 of that Schedule. Schedule 18, as we are all well aware, applies a modified test for ascertaining the rights of "equity holders" to profits by way of dividend and assets on a winding up for the purposes of ICTA 1988, s.413[33] and TCGA 1992 s.170(3)[34].

The extent of a shareholding of a creditor company in the issuing company, once the initial 75% relationship has been ascertained, by reference to rights to dividend profits or rights to assets on a winding up is quite simply of no relevance to the test propounded by s.209(2)(da) as to whether interest would have been paid but for the relationship etc between the issuing company and the creditor company. Indeed, to incorporate the whole of the TCGA 1992 version of Schedule 18 would be to incorporate the provisions of paragraph 4 (limited share rights ignored), which would make the establishment of the required 75% relationship between the issuing and creditor companies more difficult for the Revenue! In any case, why should Schedule 18 apply for s.209(2)(da) purposes in the TCGA form[35], when this Schedule applies in full for all other purposes for which it is applied in ICTA 1988? Furthermore, it is instructive that TCGA 1992 s.170(8) makes certain modifications to paragraph 7 of Schedule 18[36] so that the latter can sensibly apply for TCGA 1992 ss.171 to 181 purposes but that no such carpentry is in place for its application to s.209(2)(da) purposes.

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33 Group and consortium relief.

34 Ascertaining the membership of a group for the purposes of corporation tax on chargeable gains, by reference to the definition of "effective 51% subsidiary".

35 Ignoring certain of the provisions of paragraphs 5(3) and the entirety of paragraphs 5B to 5E.

36 Substituting "section 170(6) and (7)" for "ICTA 1988, section 413(7) to (9)" for the purposes of that paragraph and disapplying paragraph 7(1)(b).

What these observations demonstrate is the absurdity of the proposition that the concept of beneficial entitlement is extended by the implied incorporation of TCGA 1992 s.170(8) for the purposes of ICTA 1988, s.209(8E). My conclusion is unaffected by the fact that it makes certain words of s.209(8D)(c)(i) contemplating that the issuing company might be an effective 51% subsidiary of more than one company difficult to construe. The short answer is that the Revenue may undoubtedly have *sought* to include indirectly held subsidiaries within the definition; however, the draftsman has failed to do so.

Any extension of the notion of beneficial entitlement must be done specifically, perhaps by incorporating the terms of paragraph 6 of Schedule 18 for s.209(8E) purposes. That is a matter for Parliament; given the very specific importation of TCGA 1992 s.170(7) (but no other provisions) for the purposes of s.209(8E), what may be a drafting error cannot be rectified as a matter of statutory construction by the Courts on the current wording of s.209(8E).

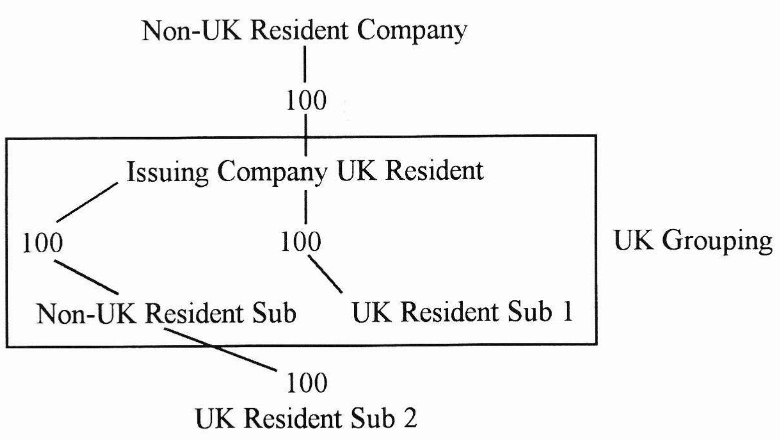
Section 209(8E) makes one modification to the definition of "effective 51% subsidiary" as contained in s.170(7) TCGA 1992, in that the beneficial entitlement of the UK holding company of which the issuing company is an effective 51% subsidiary in non-UK resident companies is ignored. The reason for this will become apparent upon examining the concept of "relevant connection" below.

Incidentally, since an effective 51% subsidiary is defined as a company which is an effective 51% subsidiary of another company within TCGA 1992 s.170(7) and "company" bears the ICTA 1988 s.832 definition, which encompasses non-UK resident companies, it follows that an effective 51% subsidiary can include a non-UK resident company.

It is convenient to illustrate the operation of the UK Grouping definition provisions at this stage.

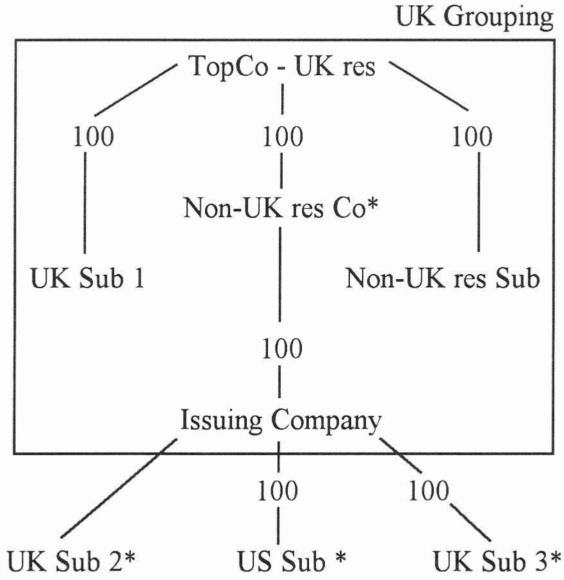
To return to Figure 1, the UK Grouping is the Issuing Company alone.

Figure 2



In Figure 2 the UK Grouping is the Issuing Company and its two directly owned subsidiaries (including UK Resident Sub 1) but **not** UK Resident Sub 2, since this latter company is not an effective 51% subsidiary of the Issuing Company, being indirectly held by the latter.

Figure 3



* Relevantly connected to Issuing Co and outside UK grouping

Finally in Figure 3 the UK Grouping is TopCo, the Issuing Company and UK Sub 1. Section 209(8E) requires TopCo's holding in non-UK resident company to be ignored, thus deeming Issuing Company to be an effective 51% subsidiary of TopCo. Once again, UK Sub 2 and UK Sub 3 and US Sub are not effective 51% subsidiaries of TopCo and thus outside the UK Grouping[37].

Relevant Connection

I now turn to the definition of "relevant connection". Any relationship (or "inference" therefrom) between the issuing company and the company to which it is "relevantly connected" if that latter company is **outside** the UK grouping of the

[37] Contrary to the Revenue view that "effective 51% subsidiary" can include indirectly held subsidiaries.

issuing company is to be ignored (s.209(8A)(b)) for the purposes of section 209(2)(da). The intention appears to be to examine the issuing company within the context of the UK grouping alone. One may legitimately observe that this circumscription is arbitrary; thin capitalisation is, by definition, concerned with cross-border loans; why seek to ignore companies outside the UK grouping in analysing the legitimacy of the funding of the issuing company? Furthermore, the relationships etc of the issuing company with companies **completely** unconnected to it (i.e., outside the UK grouping and not relevantly connected to it) are accounted for!

Definition

There are two alternative definitions of relevant connection:

(a) If the two companies are connected within the meaning of ICTA 1988 s.839, then the two companies are relevantly connected[38];

(b) Alternatively, if one company is "the effective 51% subsidiary" of another (see above for definition of this term), then the two companies are, once again, relevantly connected.[39]

Since any two companies in an effective 51% relationship will inevitably be connected within ICTA 1988 s.839, the provisions referring to effective 51% subsidiaries in the context of a relevant connection are pure surplusage.[40]

Thus, to return to Figure 3, **all** of the companies are relevantly connected to Issuing Company (within ICTA 1988 s.839 imported by s.209(8C)). Thus one ignores, in applying s.209(2)(da), relationships etc between the Issuing Company and, respectively, UK Subs 2 and 3 and US Sub (since those companies are outside the UK grouping). So, for example, if any or all of those companies were cash rich and had guaranteed all debts incurred by the issuing company, those guarantees would be ignored in applying the 'but for' test in s.209(2)(da) and make it far more likely that a loan would be found to have been made (say by TopCo) on non-arm's length terms. The test is thus demonstrably not applied to the real world. Lest it might be said that my criticism of the artificiality of the test is based on a drafting error, in that these guarantees *would* be accounted for if "effective 51% subsidiary" included indirectly held subsidiaries, a guarantee given by any company, which had a greater than 51% holding in TopCo, to the issuing

38 s.209(8C), preamble.

39 Section 209(8C)(a) and (b).

40 See ICTA 1988 ss.839(5) and (6) and s.416(2)(b) and (c).

company (or *vice versa*) would be ignored, if that ultimate parent company were non-UK resident[41], while if such an ultimate parent holding more than 50% of all the shares in TopCo were UK resident, a loan guarantee relationship between the latter and the issuing company would be ignored, whether indirectly held subsidiaries could constitute "effective 51% subsidiaries" or not[42].

Consequences of ignoring a relationship (and inferences from a relationship) between the issuing company and a company which is outside the UK grouping but relevantly connected to the issuing company.

One has to consider what the effect of ignoring such a relationship (and inferences therefrom) would be. In the example of a guarantee, which I have just given, the effect is straightforward; the guarantee is simply ignored in applying the 'but for' test.

What of other relationships etc such as loans? Does one, for example, not only ignore the relationship but also the *consequences* of that relationship? So, to return to Figure 1, the UK Grouping is the issuing company alone. The non-UK parent is therefore relevantly connected to the issuing company but outside the UK Grouping and relationships etc between the issuing company and the non-UK parent are ignored, other than, obviously, the loan subjected to the s.209(2)(da) test[43]. The share capital held by the non-UK creditor company in the issuing company in Figure 1 is clearly a "relationship etc" between those two companies. Therefore one must ignore it. Does this mean that the debt:equity ratio of the issuing company is infinite for s.209(2)(da) purposes and any loan made to the issuing company falls foul of s.209(2)(da)? Surely some mistake, as readers of *Private Eye* would say. I agree. My own view is that while one ignores the relationship, one does not ignore the consequences of that relationship. So, in the example in Figure 1, one does ignore the "relationship" constituted by the share capital held in the issuing company (e.g., voting rights, dividend rights, rights to assets on a winding up) and any "inferences" from that relationship (e.g., that the parent would not permit its 100% subsidiary to default on a loan). However, one

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41 Since it would be relevantly connected to the issuing company but outside the UK Grouping (ICTA 1988 s.209(8D)(c)(i)) *irrespective* of whether "effective 51% subsidiaries" encompassed indirectly held subsidiaries or not.

42 Ibid, s.209(8D)(c)(i); if "effective 51% subsidiaries" could include indirectly held subsidiaries, TopCo would be deemed, under this provision, to be outside the UK Grouping if the ultimate parent which held more than 50% of TopCo was UK resident. However, TopCo would still be relevantly connected to the issuing company and therefore all relationships etc, including the guarantee relationship, between the issuing company and TopCo would be ignored for s.209(2)(da) purposes: s.209(8A)(b).

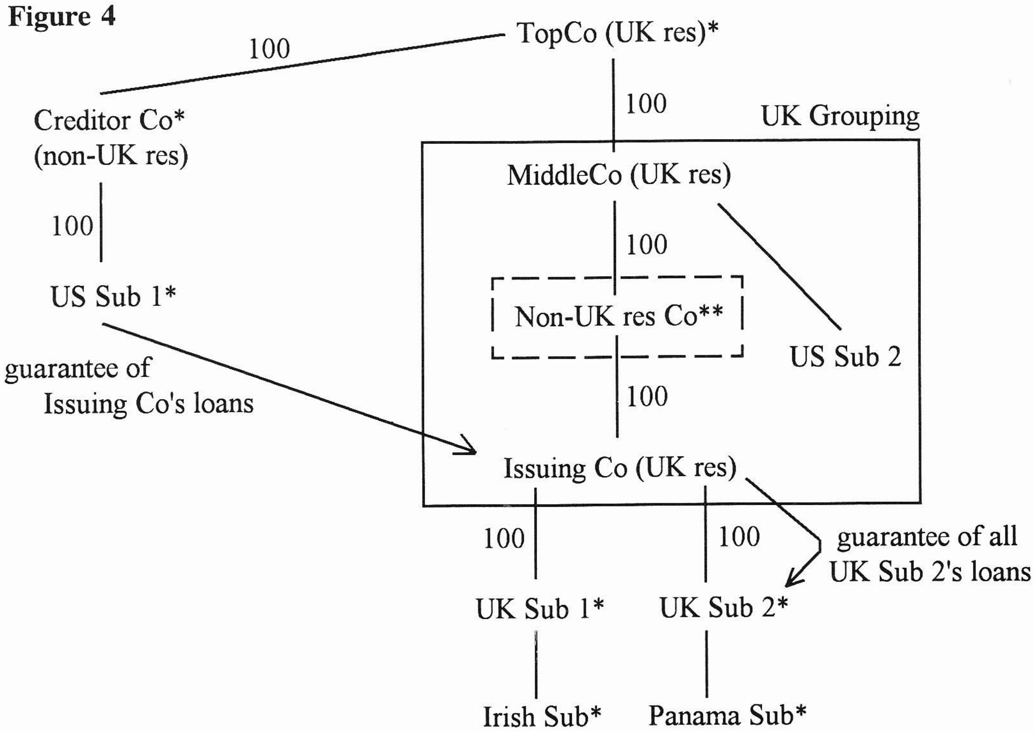
43 The term "other" as used in section 209(8A) is clearly used to contradistinguish the relationship under scrutiny from other relationships etc between the issuing company and other companies (including the creditor company).

would not ignore the consequence of that relationship, viz., the impact of the share capital on the debt:equity ratio of the issuing company. Similarly, if the parent had made a loan to the issuing company prior to making the loan subjected to s.209(2)(da), the "relationship" between the issuing company and the parent as debtor and creditor (giving rise perhaps to rights of lien etc) would be ignored as would any "inference" from the relationship (e.g., the fact that the loan was made shows that the issuing company is credit-worthy). However, the consequence of that loan, the impact on the debt:equity ratio of the issuing company, is accounted for in applying s.209(2)(da) to a subsequent loan to the issuing company.

Any alternative analysis would make the exercise of applying the test in s.209(2)(da) highly artificial which, given that one must consider "all factors", cannot have been the intention of the legislature. There are, of course, relationships which give rise to no independent consequence, such as guarantees, which I have discussed above. If such relationships etc are ignored under section 209(8A)(b), they are ignored entirely.

To take a further example, consider Figure 4.

Figure 4



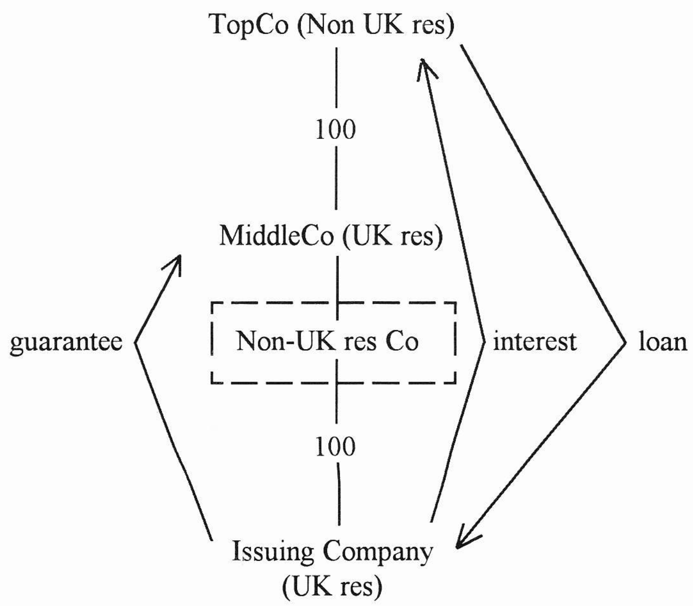
*Relevantly connected but outside UK Grouping
**Outside UK Grouping under section 209 (8E)

Creditor Co has lent to the issuing company. US Sub 1 (which is cash rich) has guaranteed all of the issuing company's loans. The issuing company in turn has guaranteed all of the loans of UK Sub 2, which is highly geared and has little in the way of assets. The UK grouping is MiddleCo, the issuing company and US Sub 2. All of the other companies in Figure 4 are relevantly connected to the issuing company but are outside the UK Grouping.[44]

MiddleCo's holding in Non-UK res Co is ignored under s.209(8E), which deems, therefore, MiddleCo to hold shares in the issuing company directly. The UK Grouping is MiddleCo, the issuing company and US Sub 2 (the last two being the effective 51% subsidiaries of MiddleCo within s.209(8D)(c)). The issuing company guarantee of the loans of UK Sub 2's loans is ignored in applying the s.209(2)(da) test since the latter company is relevantly connected to the issuing company but outside the UK Grouping, while the guarantee of US Sub 1 of the issuing company's loans is ignored for the same reason.

Figure 5 reveals the rationale of s.209(8E) (beneficial entitlement of a UK holding company of which the issuing company is an effective 51% subsidiary in non-UK resident companies ignored).

Figure 5



[44] Since they are all connected within ICTA 1988 s.839(6.)

Assume that the issuing company is thinly capitalised and has also guaranteed the loans of its 100% UK resident direct parent, MiddleCo. MiddleCo and the issuing company are in a UK grouping and one would have to account for this relationship in examining whether another loan to the issuing company by the 100% non-UK resident direct parent of MiddleCo (TopCo) was made only by the reason of a relationship between TopCo and the issuing company. A simple device to circumvent s.209(2)(da) would be to interpose a non-UK resident company between MiddleCo and the issuing company. MiddleCo would not be in a UK grouping with the issuing company (see s.209(8A)(b)(i)) but would be relevantly connected to it (see s.209(8C)) and the relationship between the issuing company and MiddleCo (the guarantee by the issuing company of MiddleCo's loans) would be ignored.

Section 209(8E) counters this device by ignoring the beneficial entitlement of MiddleCo in the interposed non-UK resident company. However, it is the holding of MiddleCo in the non-UK resident company which is ignored, not MiddleCo itself, which is thus properly seen to be in terms of s.209(8E) as being deemed to hold the share capital in the issuing company, thus bringing MiddleCo and the issuing company back together in the same UK grouping[45]. It would follow that the guarantee by the issuing company of MiddleCo's loan would once again have to be accounted for in applying s.209(2)(da) to the loan from TopCo to the issuing company.

Nature of the Business of the Creditor Company to be Ignored

In asking the question "would the loan have been made to the issuing company but for the relationship between the issuing company and the creditor company?", one is expressly directed by s.808A(4), as incorporated, to ignore the fact that it may not be the business of the creditor company to make loans. Note that the converse is not the case; in other words, if it is the business of the creditor company to make loans this is a factor which *may* properly be considered.

In order for *every* intra-group loan not to be caught by s.209(2)(da), the prohibition in s.808A(4) is essential, since *any* non-banking company or a company which is not a financing company making such a loan would almost always be doing so because of the group relationship it has with the borrowing company.

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[45] If MiddleCo was not deemed to hold the share capital of the issuing company by reason of s.209(8E), the UK Grouping would be completely unaffected by that provision and the terms of s.209(8E) would be rendered nugatory.

5. The Test Propounded by Section 209(2)(da): Misconceived in Certain Cases

So much for questions of construction. Let us return for one moment to the "simple" "but for" test posed by s.209(2)(da). This test will only catch that interest paid by the issuing company which is not demonstrated as having been paid on arm's length terms as regards the two particular parties to the transaction. The regime created by section 209(2)(da) et al does not specify the criteria to test the arm's length character of the loan.

However, to my mind, reference may be made to three factors:

- motive (independent of particular circumstances);
- the commercial circumstances surrounding the loan transaction; and
- the terms of the loan themselves.

As regards motive, the motive of the creditor company for making the loan in principle, quite apart from particular commercial circumstances to be considered, is, for s.209(2)(da) purposes, irrelevant. In respect of loans made by any company which is not a banking or financing subsidiary, I have already observed that the motivation underlying any intra-group loan is likely to be predicated on the group relationship. The legislation removes the nature of the creditor company's business from those factors relevant to s.209(2)(da). If the business of the creditor company cannot be accounted for in applying the test, it is difficult to see how the motive of the creditor company to make a loan in principle can be accounted for.

The motive of the issuing company must, however, be accounted for. A loan which is commercially perverse will generally fall foul of s.209(2)(da). To take an example given by the Revenue[46], if the issuing company replaces a loan with interest running at LIBOR + 1% with an intra-group loan with a rate of interest of LIBOR + 1.5% (with all other terms of the second loan being identical to the first), this latter loan will be caught by s.209(2)(da), even if the interest rate of LIBOR + 1.5% is a commercial rate of interest at the time that the second loan is put in place. The issuing company is unlikely to be able to demonstrate a commercial motive to choose to pay a higher rate of interest on the part of the issuing company; the interest is only paid because the issuing company took on the

46 Tax Bulletin, June 1995 218 at 219.

second loan for some wider group purpose, i.e., due to the relationship etc between the issuing and creditor companies,[47] and thus s.209(2)(da) would apply.

The commercial circumstances surrounding the loan transaction are clearly relevant, both in relation to the creditor company and the issuing company. It may be that an intra-group loan is made for a perfectly good commercial reason and that the issuing company is beyond reproach as regards *its* fitness to borrow. However, the *creditor company* is highly geared and would be commercially better advised to invest in equities rather than in a debt instrument issued by the issuing company. Or, perhaps, it can be demonstrated that the creditor company is in no commercial position at all to lend and it is a mere conduit for a loan which in reality emanates from some other company. In both cases, since the test in s.290(2)(da) is subjective, it is possible that the interest payments by the issuing company would be caught by that provision, although the issuing company is one which I have postulated to be commercially suitable to borrow.

It is when the s.209(2)(da) test is applied to the terms of the loan transaction that it appears at best to be difficult to apply and at worst to be entirely misconceived. Assume that the issuing company is indeed highly geared beyond an "appropriate level of indebtedness". Furthermore, let us assume that there are no guarantees of the issuing company's loan in place. In other words, the issuing company is a high risk for any lender. Where does the application of the s.209(2)(da) test take the Revenue? It is **crucial** to remember that, applying the test to a particular creditor company and a particular issuing company, the question is whether **that particular creditor company** would have lent to **that particular issuing company**. It is also crucial to remember that the rules will bite in a situation where the facts are that the creditor company *has in fact lent* to the issuing company.

The Revenue may seek to argue that in fact no one would have lent to such an issuing company, on any terms, if they had been acting at arm's length to it. Such a proposition would be most difficult to sustain in any action before, say, the Special Commissioners. It is, for example, irrelevant that institutional lenders will generally not lend to high risk borrowers even with the compensation of a high interest coupon. The question is whether the creditor company, not a bank, would have lent. Given that the creditor company has *in fact* lent, if the creditor company can, as a matter of fact, demonstrate that some other unconnected

47 *Quaere* whether this reasoning would hold true if the issuing company could demonstrate an unashamedly fiscal reason for wishing to raise the interest coupon it paid (and could further demonstrate that the bank which made the existing loan was quite happy to oblige!); however, rather than refinancing with the bank, the issuing company refinanced with a group company; why should the interest be caught by the "but for" test in section 209(2)(da)?

body[48] would have lent to the issuing company (and that other body could be any sort of entity whatsoever; it is most unlikely that *some* entity could not be found which would be prepared to lend to the issuing company, provided it received adequate compensation for the risk undertaken), the proposition would become unsustainable.

If the Revenue concede that the loan is such that parties acting at arm's length may have entered into it, to apply the s.209(2)(da) test to such a loan to the highly geared, high risk, issuing company would not produce the result that the Revenue would want. If the parties to such a loan had been acting on an arm's length basis, it is certainly arguable that such a loan would only be made if the interest coupon is *raised*. In other words, the one thing that the application of this test cannot do in respect of a loan made at a commercial rate of interest is to demonstrate that the interest payment should not have been paid at all. Quite the contrary. If anything, the interest payment should be higher than a commercial rate to compensate the creditor company for the risks it has undertaken. It is worth repeating that it is no answer for the Revenue to demonstrate that institutional lenders tend to lend at a commercial rate of interest or not at all. This is not the question in issue. The question is, given that this particular creditor company has in fact lent *and the loan is one which could have been made on an arm's length basis*, what would the terms of the loan have been if the creditor company and issuing company had been acting at arm's length? To repeat the answer, to compensate for the risk of default which arises to the creditor company in the circumstances that I have outlined, the answer is an extremely high coupon.

Could the Revenue, if they accepted this argument, argue that because the rate of interest on a particular loan is, commercially, too low (on the footing that an unconnected lender would have demanded a higher coupon than the prevailing commercial rate for the type of issuing company that I describe above) and thus categorise the *whole* of the payment as a distribution? The short answer is "Yes". So, if the arm's length rate of interest for an intra-group cross-border loan to this type of issuing company is 5% above LIBOR but the issuing company is paying only 2% above LIBOR (the latter rate being the prevailing commercial rate for loans by institutions), the entire interest paid at 2% above LIBOR may be categorised as a distribution, on the basis that such a low rate of interest is only paid due to the relationship etc between the Issuing company and the creditor company[49]. However such a contention can easily be resisted by raising the coupon! A high coupon in these circumstances ought not to fall foul of either the Special Relationship provision in Article 11(6), since this test is also subjective, or ICTA 1988 s.209(2)(d), since the rate will be a reasonable commercial return.

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48 On a worldwide basis; we are, after all, dealing with cross-border loans.

49 Since interest paid at arm's length would be 5% above LIBOR.

In short, this deceptively simple question is, in my view, almost impossible to apply to any loan which *could* have been made to the issuing company by an unconnected party[50] to the advantage of the Revenue, given the subjective nature of the test. The test can only be applied in alliance with some sort of "safe harbour ratio" of debt to equity, or income receipts to interest payments[51]. Certainly, in the light of the subjective nature of the test, such safe harbours are *not* permissible other than as bases on which to raise rebuttable presumptions as to what constitutes an arm's length transaction. Despite protestations to the contrary, the Revenue appear to be seeking to employ such safe harbours[52]. Quite apart from the question of whether there is any authority under Article 9 of a Double Tax Treaty based on the OECD Model[53], to impose safe harbours, if the rebuttable presumption is overturned on the footing that a loan could have been made to the issuing company on arm's length terms by an unconnected lender, notwithstanding its debt:equity ratio and income cover, the fact that generally accepted ratios are not met by the issuing company will only serve to demonstrate that the creditor company should be compensated for increased risk by an increased coupon.

Incidentally, the Tax Bulletin also states that gearing and other requirements are necessarily moveable feasts; what is acceptable today may not be acceptable twelve months from now and lenders may require periodic reviews of such requirements.

The Revenue undertake "to reflect such trends".[54]

If this comment is simply a recognition that one test of whether a loan is an arm's length loan might be that the lender may require periodic reviews of gearing requirements etc when the loan is put in place, then it is unexceptionable. It is simply one of many factors which must be taken into account when ascertaining whether a loan is indeed made at arm's length. If, however, the comment is an assertion that while a loan may be demonstrably at arm's length today and thus outside the scope of s.209(2)(da), it may not be so in the future due to a change in commercial circumstances and the interest paid in respect of it may therefore in

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50 Which is a pure question of fact; see above.

51 Which, as I have observed, is very arguably outside the authority of Article 9(1).

52 In the Inland Revenue Tax Bulletin (op. cit.) it is accepted that inflexible debt:equity or income:interest ratios are difficult to apply and indeed appropriate ratios must vary from industry to industry (at 219) but that a debt:equity ratio of 1:1 and income cover of 3:1 is generally acceptable (at 220).

53 See below.

54 At 219.

the future become subject to the terms of s.209(2)(da), the comment is indefensible, at least in relation to fixed term loans. If such a loan is established as having been made at arm's length at its commencement, it must continue to be a loan at arm's length throughout its life. For loans repayable on demand, however, the position may be different. For this latter type of loan, it may be commercially unjustifiable for the creditor company to forbear to call in the loan and relend at a higher interest rate if rates rise dramatically. To continue to allow the issuing company to pay interest at a lower than commercial rate may well categorise the interest as paid by reason of the relationship between the issuing company and the creditor company alone, and in turn subject to s.209(2)(da).

6. Challenges to the Legality of the Thin Capitalisation Provisions

Quite apart from the difficulties in applying the test posed by s.209(2)(da), the legality of the new provisions are vulnerable to attack on three bases:

(i) Intentional Treaty override;

(ii) The non-discrimination provisions of a Double Tax Treaty based on the OECD Model[55];

(iii) Infringement of certain fundamental freedoms in the Treaty of Rome.

It is worth making the point that the following observations are not "mere academic" reflections on the application of esoteric legal provisions.

The bases of challenges to the legality of the thin capitalisation provisions discussed below have been successfully applied in other jurisdictions to defeat the application of various domestic provisions

(i) Intentional Treaty Override

The introduction of s.209(2)(da) et al brought with it the repeal of s.209(2)(e)(iv)[56]. Therefore, interest paid after 28th November 1994[57] to a 75%

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[55] In considering Double Tax Treaty provisions, I shall, for convenience, simply refer to the Articles in the 1992 OECD Model.

[56] Interest paid to a 75% parent or 75% fellow subsidiary automatically a distribution unless protected by a Double Tax Treaty; thus interest paid to a 75% parent resident in a tax haven was always a distribution under section 209(2)(e)(iv).

[57] The date from which the new rules took full effect.

parent resident in a tax haven will no longer automatically be a distribution if the interest is not caught by s.209(2)(da). Equally, however, these provisions will apply to interest payments which were previously protected by Article 11 of the OECD Model and outside the scope of Article 11(6)[58] and may categorise such interest payments as distributions. To that extent, Article 11 of those double tax treaties concluded by the UK is overridden[59].

The authorities supporting the proposition that UK domestic law can override the provisions of a double tax treaty[60] concern *unintentional* treaty override, in the sense that the UK did not have any intention of deliberately flouting the Double Tax Agreements in issue. So far as the thin capitalisation rules are concerned, these rules are a direct result of the Inland Revenue having lost a case before the Special Commissioners[61] because the terms of the special relationship provision in Article 11(6) of the UK/US Treaty did not encompass the payment of interest which the Revenue sought to attack. There can be no clearer example of intentional treaty override. Thus the UK authorities referred to in this article have no bearing on this case.

Furthermore, the terms of s.788(3) of ICTA 1988, which is the current enabling provision under which double tax treaties are enacted in UK law by way of statutory instrument, apply "notwithstanding anything in any enactment". The wording of the enabling provisions dealt with in *Collco* and *Woodend* did not contain any such wording. Thus, as a matter of statutory construction, it appears

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58 The special relationship provision - see supra.

59 It should be noted that Article 11(4) of the UK/Austria Treaty appears to expressly provide that domestic legislation of either Contracting State, *whenever* enacted, **cannot** override the terms of the interest Article of that Treaty (Article 11(1) et seq). There is no express provision in s.209(2)(da) overriding such Double Tax Treaty provisions. Thus in any conflict, the type of Double Tax Treaty provision in Article 11(4) of the UK-Austria Treaty must prevail. So if an interest payment is outside the Special Relationship provision, that interest is outside the scope of s.209(2)(da) et al. The Revenue Tax Bulletin comment that UK-Austrian funding arrangements are affected by the thin capitalisation rules therefore appears to be incorrect (op. cit. at 220). It may well prove to be a useful exercise to ascertain which other Double Tax Treaties concluded by the UK have a similar provision.

60 *IRC v Collco Dealings Ltd* (1961) 39 TC 509 (HL), dealing with the application of F(No 2)A 1955 s.4(2) which subjected Irish residents to UK tax, although the UK/Ireland Double Tax Agreements of 1926 and 1947 exempted Irish residents from UK tax; *Woodend (KV Ceylon) Rubber & Tea Co Ltd v CIR* [1971] AC 321, dealing with the UK/Ceylon Double Tax Agreement of 1950 which was offended by certain provisions of s.53C of the UK Income Tax (Amendment) Act of 1959.

61 See supra at 194.

that UK legislation must be construed so as not to conflict with the provisions of any double tax treaty concluded by the UK under s.788(3) as presently worded. Incidentally, JDB Oliver argues[62] that the words of s.788(3) which I refer to above can only apply to legislation in force at the time that a particular double tax treaty is concluded, in respect of that treaty. This is on the basis that Parliament cannot bind its successors. To my view this argument ought not to succeed in favour of the Revenue. It is true that Parliament cannot bind its successors and may, at any time, repeal the words of s.788(3) which I have referred to. Until then, however, the terms of s.788(3), as presently drafted, must have the force of law and prevail over any conflicting legislation enacted either prior to or subsequent to Double Tax Treaties enacted as statutory instruments under the authority of s.788. After all, there are several provisions in UK fiscal legislation which apply "notwithstanding the application of other provisions"[63]. Until such provisions are repealed, they rule the day.

My conclusion in this context is that it is strongly arguable that the thin capitalisation rules are vulnerable to attack on the footing that they constitute an intentional treaty override which contravene the provisions of s.788(3) and Article 11 of Treaties concluded under its authority. Put another way, these rules should not be construed so as to conflict with any such Treaty. If, then, the Revenue has arguably no authority to levy a charge to tax under s.209(2)(da) in this context, the onus is **on the Revenue** to demonstrate that such a charge arises.

(ii) Non Discrimination Provisions in Article 24 of the OECD Model Treaty

It is important to recall that the terms of ICTA 1988 s.212(1)(b) provide that a interest paid on a loan otherwise caught by s.209(2)(da) is *exempted* from the application of the latter provision, if the interest is paid to a UK creditor company within the charge to UK corporation tax.

I have already observed that, so far as Treaties based on the OECD Model are concerned, the authority for the introduction of the thin capitalisation rules stems either from Article 9(1), which permits an adjustment of profits (by a denial of a deduction or otherwise) but does *not*, on its terms, permit recategorisation of such profits as dividends, or Article 10(3), which does permit such reclassification of

62 'Double Tax Treaties in United Kingdom Tax Law' [1970] BTR 388 at 404; I understand that Mr Oliver has subsequently modified this view.

63 E.g., s.486(1) of ICTA 1988.

interest as distributions if the paying company is thinly capitalised.[64] An adjustment of profits would not be subject to the terms of Article 24(4) but would be subject to Article 24(5).[65] A recategorisation of interest as a distribution is subject to both Article 24(4) and 24(5).

Article 24(4) of the OECD Model Treaty

This Article ensures that, *subject to* the Special Relationship provisions in Article 11(6), 12(4) and the provisions of Article 9(1) (but *not* Article 10(3)), interest and other payments paid by the resident of one Contracting State to a resident of the other should be deductible as if they had been paid to a resident of the same State.

The only sensible comparison is to a hypothetical resident of the enacting State engaged in similar activities, i.e., *not* a recipient of the interest which is outside the charge to corporation tax of that State (that is outside the UK tax net for present purposes). The Special Relationship provision in Article 11(6) is of no import to interest which is attacked by s.209(2)(da) since this provision seeks to attack interest paid at a perfectly commercial rate and therefore not subject to Article 11(6). Article 12(4) is patently irrelevant for present purposes. Thus one compares the treatment of s.209(2)(da) of interest paid to a non-resident creditor company (no deduction even if the interest is outside the scope of Article 11(6); charge to ACT) to a payment of interest *prima facie* caught by s.209(2)(da) but paid to a UK resident creditor company (deduction afforded; no charge to ACT).

The treatment of the two payments is clearly not the same. While an adjustment of profits under Article 9(1) can escape the application of Article 24(4), however, a recategorisation of interest as a distribution cannot. If, therefore, any Treaty concluded by the UK contains provisions corresponding to Article 24(4), the thin

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64 Article 10(3) permits interest to be categorised as a dividend if the lender "shares the risks run by the [borrowing] enterprise", including, inter alia, if the loan very heavily outweighs any other contribution to the capital of the enterprise.

See paragraph 24 and 25 of the Commentary to Article 10(3). Incidentally, the wording of Article 10(3) appears to exclude income from "debt-claims" from its scope; however, the majority of the Committee for Fiscal Affairs considered that reattribution of certain interest as dividends was permitted: see OECD, Committee on Fiscal Affairs : *Issues in International Taxation no 2; I Thin Capitalisation*, paragraphs 56-60. Furthermore, the UK (and Canada) expressly reject that certain categories of interest specified in paragraph 24 of the Commentary to Article 10(3) cannot be reclassified as dividends.

65 See below.

capitalisation rules ought to be defeated by its application[66] and a deduction be given to the paying company. The paramount status of Article 9(1) (which permits an adjustment of profits by the denial of a deduction) is of no consequence, since the thin capitalisation rules seek not only to adjust profits but also to simultaneously recategorise interest as a distribution and are, therefore, outside the compass of those rules which may be enacted within its provenance. Legislation enacted under the authority of Article 10(3) is subject to the provisions of Article 24(4) in all circumstances.

Article 24(5)

Under this Article, enterprises of a Contracting State, the capital of which is held[67] by a resident of the other Contracting State, must not be subjected to any taxation[68] which is "other" or "more burdensome" than the taxation (and connected requirements) to which "similar enterprises" in the former State are subjected. Article 24(5) is *not* subject to Articles 11(6), 12(4) or 9(1) and therefore overrides legislation enacted with the authority of those provisions, as well as any legislation enacted under the authority of Article 10(3).

Paragraph 58 of the Commentary confirms that Article 24(5) is, in principle, relevant to thin capitalisation but that, in the light of the more specific wording of Article 24(4), the latter Article must take precedence in relation to the deduction of interest. It follows that in any Treaty containing provisions corresponding to both Article 24(4) and 24(5), questions relating to the deduction of interest must be governed by the former provision[69]. This of little consequence in the context of the thin capitalisation rules, which do not have the authority of either Article 11(6) or 9(1) but must seek their authority in Article 10(3). If a Treaty contains the equivalent of Article 24(5) only, this would govern the question of deduction of interest alone.

In any event, Article 24(5) exclusively governs the question of the recategorisation of interest as a distribution by s.209(2)(da). Article 24(5) requires that the *paying*

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66 If confirmation of the correctness of this analysis were needed, reference may be had to the reservation of France to Article 24(4), expressly preserving the right to limit the deduction of interest payments (not, one will note, to reclassify the payment as a distribution) by a company within the French tax net, notwithstanding the terms of Article 24(4). The UK has made *no* such reservation.

67 Whether wholly or partly, directly or indirectly.

68 Or other connected requirement.

69 Which, unlike Article 24(5), is specifically subject to Article 11(6) and Article 9(1).

company, in this case the issuing company, does not suffer different or more burdensome taxation than its counterpart paying to a UK resident *parent*.

So far as the thin capitalisation rules are concerned, this is clearly the case. An issuing company paying interest to a UK resident parent within the charge to corporation tax is outside the scope of s.209(2)(da)[70], even if the interest is *prima facie* within the terms of that section. Such an issuing company, subject to the terms of the other provisions of s.209, will obtain a deduction for the interest paid and will not suffer any charge to ACT. An issuing company which pays interest to a non-UK resident parent company in circumstances in which the interest is caught by s.209(2)(da) is denied a deduction and suffers an ACT charge.

To my mind, Article 24(5) ought to apply to remove discrimination arising from the application of s.209(2)(da) in respect of interest paid to a non-UK resident parent.

Furthermore, the fact that the s.209(2)(da) may apply to interest payments from the issuing company to a UK resident company outside the charge to UK tax[71] does not affect the analysis. There are very few *companies*[72] to which this "exclusion to the s.212(1) exclusion" will apply and none of them are likely to be "similar enterprises" to the recipient of the interest from the issuing company. If the term "similar enterprises" is to have any meaning, the correct comparison must be made between the issuing company paying interest to the non-UK creditor company and a hypothetical issuing company paying interest to a hypothetical UK resident company engaged in "similar" activities to the creditor company.

It appears to be the case that the UK Inland Revenue take the view that the phrase "similar enterprises" refers to other "similar" subsidiaries with non-UK resident parents[73]. In relation to s.209(2)(da), the Revenue would no doubt argue that the position of a UK issuing company which was a subsidiary of and had borrowed from a non-UK resident parent should be compared with a UK resident subsidiary of a parent which is either non-UK resident or otherwise exempt from UK corporation tax. If this were correct, there would be no discrimination, since an issuing company which has borrowed from such a parent *would* be subject to the terms of s.209(2)(da). This argument has, however, failed in the context of other

70 ICTA 1988 s.212(1)(b).

71 Provided the recipient is not an exempt body under ICTA 1988 ss.505 and 506.

72 We should recall that s.209(2)(da) et al only applies to inter-company payments.

73 See Oliver, 1989 BTR 141 .

domestic provisions challenged under Article 24(5) in Sweden[74], the Netherlands[75] and Finland[76].

In the light of these decisions in other OECD Member States, it is almost certain that "similar enterprises" bears the meaning I refer to above as being correct.

It follows that interest paid on loans to an issuing company to a direct or indirect *parent* ought to be protected by Article 24(5). However, loans made by a non-UK resident creditor company, which was a fellow 75% subsidiary of the issuing company but with *no* holding (either direct or indirect) in that issuing company, would *not* be so protected, since an issuing company which borrowed from a non-UK resident creditor company which had no direct or indirect 75% holding in the issuing company would be subject to s.209(2)(da) whether it had a UK resident parent or not. To obtain the protection of Article 24(5), therefore, the loan must be made to a creditor company with a direct or indirect 75%[77] holding in the issuing company.

(iii) EC Law and the Treaty of Rome[78]

The first point to make is that, notwithstanding the principle of Subsidiarity[79], the fiscal provisions of each Member State are within the jurisdiction of the ECJ[80].

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74 Decision RA 1987 Reference 158 of 19th November 1987, Regeringsrattens Dom No. 2225-1987, reported at, *inter alia*, (1988) *European Taxation* 401.

75 *Halliburton*, decision of 22nd December 1992, discussed in [1993] *Tax Planning International Review*, 15.

76 Supreme Administrative Court, decisions nos. 536 and 537 18th November 1992, discussed in [1993] 78 B Cahiers DFI, page 410.

77 Section 209(2)(da) would only apply and trigger the application of Article 24(5), so far as interest payments to a *parent* were concerned, if the issuing company was a 75% subsidiary (direct or indirect) of the [parent] creditor company. If the shareholding in the issuing company was less than 75% on the part of the creditor company, section 209(2)(da) would apply *irrespective* of the residence of the issuing company's parent(s) and Article 24(5) is therefore of no assistance.

78 References are to the Treaty of Rome, unless otherwise stated.

79 Article 3b, para 2 of the Treaty of European Union ("The Maastricht Treaty"), under which Community action is only justified if it serves an end which both cannot be satisfactorily achieved at national level and can be better achieved at Community level.

80 *EC Commission v France* [1986] ECR 273; *Biehl v Luxembourg* [1990] ECR I 1779.

It is true that the Parent-Subsidiary Directive[81] cannot apply so as to hinder the application of these rules. Article 7 of that Directive makes it clear that "withholding tax" does not include ACT, within the meaning of Article 5. However, there are other principles enshrined in the Treaty which offer a substantial challenge to the new rules.

State Aid[82]

If the regime imposed by s.209(2)(da) et al constitutes State Aid, I do not perceive any defences to a challenge to its illegality.

State Aid which is granted by, or through the resources of, a Member State, in any form whatsoever, is prohibited under Article 92(1) if that aid distorts (or threatens to distort) competition and affect trade between Member States.

"Aid" in this context includes tax exemptions and advantages[83]. While State aid already in force at the time that a Member State joins the Community is monitored on a progressive basis by the Commission, with a view to eliminating those provisions which offend Article 92(1)[84], any *proposed* aid which offends Article 92(1) to be enacted *after* the Member State has joined **may not be enacted at all until the Commission has been notified and approval been given by the Commission.**[85] Any undertaking prejudiced (or potentially prejudiced) by post-membership State Aid unapproved by the Commission **may request the competent national courts to annul the offending legislation**[86].

The UK Revenue have clearly not obtained Commission approval for s.209(2)(da) et al. The thin capitalisation rules put a non-UK resident creditor [Member State] company lending to a UK subsidiary which is caught by the rules at a financial disadvantage compared to a UK resident company in an identical relationship to a UK subsidiary to which it lends. This must distort competition as regards trade between the UK and other Member States. It follows that there is a most

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81 90/435/EEC OJ 90 L225 (20.8.90).

82 For an analysis of the prohibitions against State Aid in relation to the insurance industry, see Dassesse 1995/96 ECTJ 15.

83 *Banco Exterior de España SA v Ayuntamiento de Valencia* [1994] STC 603.

84 Article 93(1) and (2).

85 Article 93(3).

86 *Saumon v France* Case 354/90 (ECJ).

persuasive argument that a UK issuing company (to revert to s.209(2)(da) terminology) may request the UK courts to strike down these provisions.

Discrimination[87]

Article 6 of the EEC Treaty provides general prohibition against discrimination on the grounds of nationality[88]. This general principle is translated into specific fundamental freedoms contained in Article 48 (Free Movement of Workers), Article 52 (Freedom of Establishment), Article 59 (Freedom to Provide Services) and Article 73 (Free Movement of Capital), all of which preclude a Member State from discriminating in favour of its own residents. An action under Article 6 appears to stand or fall with an action under one of the specific freedoms.[89] If one of the latter Articles is infringed, Article 6 has no application.[90] To my mind, the freedoms relevant to any attack on the thin capitalisation rules are contained in Articles 52, 59 and 73.

The test for discrimination is this: similar situations should not be treated differently unless there is an objective justification for doing so.[91] This proposition is subject to a *de minimis* principle.[92] So the refusal of personal allowances to a non-resident is only prohibited if that non-resident receives all or a substantial part of his taxable income from the State from which he claims those allowances[93].

Furthermore, the theoretical (or actual) application of particular provisions to certain residents of a particular State does not remove the discriminatory nature of those provisions, if they have the *de facto* effect of infringing one of the

87 See Lyons 1Discrimination Against Individuals and Enterprises' 1994 BTR 554 and in 1995/96 ECTJ 27 for a comprehensive analysis of the concept of discrimination and defences to it in the fiscal context.

88 The protection from discrimination is extended to companies and firms by Article 58.

89 *R v IRC, ex parte Commerzbank AG* [1994] 2 WLR 128 (ECJ).

90 *EC v Hellenic Republic* [1989] ECR 1461 at 1476-1477.

91 Case C-280/93 *Germany v Council* [1994] ECR I-4973 (a case not about tax but bananas!).

92 Every difference does not amount to discrimination: *Biehl v Luxembourg* Case C-175/88 [1990] ECR I 1779 at 1785.

93 *Finanzamt v Schumacker* [1995] STC 306 at 317, paragraph 76 of the Advocate General's Opinion.

fundamental freedoms of a non-resident entity. In other words, if there is a risk that the provisions complained of will operate in particular against residents of other Member States, those provisions may be discriminatory, even though they may also apply to certain residents of the enacting State[94]. Indirect discrimination is, in the eyes of the ECJ, as reprehensible as direct discrimination.

Freedom of Establishment (Article 52) and Freedom to provide Services (Article 59)

In considering the freedom of establishment under Article 52, it is the freedom of the parent company to operate cross border which is in issue. It must be able to operate via a subsidiary, subject to the same rules as a UK resident company. Clearly, in the light of the thin capitalisation provisions it cannot do so, if the way it may fund that subsidiary is restricted due to fiscal provisions. In other words, Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and "that freedom of choice must not be limited by discriminatory tax provisions."[95] Clearly the thin capitalisation rules do limit the choice of the non-UK resident parent by means of a discriminatory tax provision. Furthermore, while the application of s.209(2)(da) relates to payments made by the UK subsidiary rather than the non-UK resident parent, this is of no consequence. The non-UK resident parent clearly suffers by the application of the thin capitalisation rules since its subsidiary has had to pay ACT. Even if fully creditable in the country of residence of the parent this represents a timing disadvantage and been refused a deduction.[96] It follows that the new regime is vulnerable to attack on the footing that the freedom of establishment of a non-UK resident entity is infringed by reason of the restrictions on the methods of financing put upon it by s.209(2)(da).

The same issues and arguments apply in relation to the freedom to provide services under Article 59.

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94 *Sotigu v Deutsche Bundepost* [1974] ECR 153; Case C-272/92 *Spotti v Freistaat Bayern* [1993] ECR I- 5185; *Biehl* supra.

95 *EC Commission v France* [1986] ECR 285 at 305 at para 21.

96 See *Halliburton Services BV v Staatssecretaris Van Financien* [1994] STC 655 for an illustration of the willingness of the ECJ to have regard to the indirect harm done to companies resident in one member state by another member state. The representation of the parent may, however, be a factor in choosing the form of litigation against the Revenue. For example, the parent may be represented as an intervener at Judicial Review proceedings in the UK Courts.

Free Movement of Capital

This freedom is governed by Article 73 of the Treaty[97]. I am not aware, as yet, of this Article having been considered by the ECJ. Article 73b prohibits any restrictions on the free movement of capital. It is tolerably clear that payments of interest represent "movements of capital" for Article 73 purposes.

Article 73d qualifies that general prohibition by permitting Member States to enact fiscal provisions which (a) "distinguish taxpayers not in the same situation with regard to their place of residence or with regard to where their capital is invested" and (b) "to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation...".

The permitted distinction in (a) is best read as a statutory expression of the successful defence to a charge of discrimination of the "cohesion of a tax system" in *Bachmann v Belgium*,[98] which I examine below. It cannot be read as a blanket permission to discriminate against non-residents, since to do so would render Articles 6, 48, 52 and 59 nugatory. In other words, the cohesion of a tax system, if successfully established as a legitimate justification for the treating non-residents differently to residents, will prevent a finding of discrimination rather than merely offering a defence to such a finding.[99]

So far as the "Public Interest" provisions in (b) are concerned, measures taken under Article 73d(b) must not be "arbitrary"[100], which demonstrates that Article 73d(b) cannot be sensibly read as authority to discriminate against non-residents, both for the reasons I give above in relation to Article 73d(a) and on the footing that the distinction between residents and non-residents is specifically catered for in Article 73d(a). Article 73d(b) is unlikely to be construed as permitting discrimination so as to make any limitation on the scope of Article 73d(a) redundant. It is likely that any provisions which are discriminatory will be arbitrary.

In any event, any measures taken under the authority of Article 73d must be "proportional" i.e., the provisions must not go beyond what is necessary to achieve

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97 Article 73 was introduced by the Treaty on European Union ("The Maastricht Treaty").

98 In fact there were two judgments of the ECJ: Case C-300/90 *EC Commission v Belgium* and Case C-204/90; *Bachmann v Belgium*.

99 This is the view of Vanistandael: 'The Limits to the New Community Tax Order' 31 1994 CMLR 213.

100 Article 73d(2).

what is specified in Article 73d.[101] In particular, a heavy burden should not be imposed on some persons in order to achieve an objective of only slight significance to others.[102] Thus, even if the thin capitalisation rules are established as being necessary to the cohesion of the UK tax system (which is most debatable; see below) and (if the Revenue plead that they are covered by Article 73d(b)) that they are not arbitrary (which is, if the term is a synonym for "discriminatory", for the reasons I give below, once again debatable) they still only will be permissible if they are "proportional". If they cause significant inconvenience to creditor companies resident in other Member States, with only a marginal impact in preserving the cohesion of the UK tax system (which is likely, since the rules have only recently been introduced and apply to interest hitherto protected by Double Tax Treaties), they will not satisfy the proportionality principle and thus be *prima facie* unlawful.

In the context of the thin capitalisation rules, it is clear that the terms of s.209(2)(da) may operate more onerously in relation to the payment to a non-UK parent than to a UK parent. Thus there is a *prima facie* case of a restriction on the movement of a capital payment resulting in discrimination. It follows that unless the Revenue can establish one of the defences to discrimination I discuss below, an attack on the thin capitalisation rules may be mounted on the back of Article 73.

There is one quirk in taking an action in respect of free movement of capital which needs to be mentioned. It appears that the view of the ECJ is that where a particular set of provisions offends both free movement of capital and another fundamental freedom, discrimination in respect of free movement of capital will effectively be ignored and only the effect of the provisions in question in relation to the latter freedom will be examined.[103] This ought not to cause any practical difficulty since all it means is that the thin capitalisation provisions infringe free movement of capital if they also infringe another fundamental freedom, e.g., freedom of establishment, and any action should be taken on the footing that the rules infringe either Article 52 and/or Article 59 *as well as* Article 73.

Defences to Discrimination

Even if discrimination is established, the UK may nonetheless plead that the discrimination is in some way justified in law. The following defences are amongst those likely to be raised by the Revenue on this basis:

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101 Article 3b, paragraph 3.

102 See, *inter alia*, Case 30/77 *R v Bouchereau* [1977] ECR 1999.

103 *Bachmann* [1994] STC 855 at 880, para 34.

Free Movement of Capital: Article 73d (a) and (b)

I have discussed these provisions above.

Bachmann

Bachmann[104] established that the "cohesion of a tax system" was established as a successful defence to discrimination. The term "cohesion", in the light of *Bachmann*, appears capable of bearing two meanings. Firstly, it may refer to the "logic" of a tax system. Thus the UK may argue that a more favourable regime in respect of UK resident creditor companies is permissible since the UK parent is subject to corporation tax in respect of the interest payment made by the UK subsidiary, for which the latter obtains a deduction. Since a non-UK resident creditor company will not bear tax on an interest payment *prima facie* caught by s.209(2)(da) et al, the UK is justified, in terms of the "logic" of its tax system, to subject a UK issuing company paying interest to such a creditor company to a harsher regime than if the issuing company paid that interest to a UK resident creditor company.

There are several counter-arguments here.

Firstly, there is no tax deduction as such offered by s.209(2)(da) which is offset by the taxation of the interest in the hands of the recipient company. The rules simply attack (by denying a deduction and levying a charge to ACT) interest payments on loans which, even assuming that the relevant test can be sensibly applied, are subjected to the value judgments of the legislature and perceived to be illegitimate.

More importantly, the conclusion of double tax agreements by the UK effectively destroys this type of "coherence" argument, in the sense that the alleged "matching" of deduction and taxability is destroyed by the UK *itself* waiving its right to tax certain payments under a Double Tax Treaty. Indeed, it is the Double Tax Treaty position, under which the UK waives its right to tax interest payments not caught by Article 11(6) of the OECD Model Treaty but which nevertheless, prior to the introduction of s.209(2)(da), gave rise to a deduction in the hands of the paying company, which represents the "cohesion" of the UK tax system. In other words, the UK cannot plead "coherence" of its tax system as a defence of discrimination on the basis of some sort of matching of tax deductions and taxed receipts when it itself has destroyed that coherence by concluding double tax treaties which removed many types of payment from the UK tax net although those payments may in certain cases be deductible from the UK corporation tax profits

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104 Supra.

of the paying company. It was precisely this argument which found favour with the ECJ in *Wielockx v Inspecteur der Directe Belastingen*[105].

In the case of the thin capitalisation rules, these were introduced to *override* the Double Tax Treaty position; the rules are a reaction to a ruling on the scope of Article 11(6). Far from preserving the cohesion of the tax system as represented by the application of Double Tax Treaties based on the OECD Model, the new rules seek to significantly qualify that regime. It follows that a defence to discrimination based on this *Bachmann* version of the cohesion of a tax system should hold few fears for a taxpayer challenging the legality of s.209(2)(da).

Secondly, there is a suggestion in *Bachmann* that the term "coherence" of a tax system is a synonym for the protection of tax receipts. This defence is unlikely to succeed in the context of s.209(2)(da), in this bald form at least, since the thin capitalisation rules do not protect existing receipts. They broaden the tax base of the UK by subjecting interest payments currently protected by a double tax treaty to distribution treatment.

The defences I discuss above are clearly not exhaustive. Defences which have not succeeded include a lack of harmonisation in the industry sector of which the taxpayer is a member,[106] the fact that the discrimination is avoidable, e.g., by setting up a branch rather than a subsidiary (or *vice versa*),[107] the fact that the discrimination is mitigated by a Double Tax Treaty,[108] that the taxpayer may obtain incidental benefits from the application of the discriminatory provisions,[109] and the availability of administrative measures to remedy the discrimination.[110] However, my own view is that the defences I have outlined above to a charge of discrimination by the UK in respect of the thin capitalisation rules are the most likely defences to be forwarded by the Inland Revenue and, at least, *prima facie*, do not offer a complete defence to the Revenue in any such action.

Developments are anxiously awaited.

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105 [1995] STC 876 at para 52 to 55 of the Advocate General's Opinion and para 25 and 26 of the Judgment.

106 *EC Commission v France*, supra.

107 Ibid.

108 Ibid.

109 Ibid; *Biehl*, supra; *Commerzbank*, supra

110 On the footing that administrative procedures (e.g., in the UK governed by Statements of Practice or Concession) are not of automatic application.