A debate concerning thin capitalisation started with the judgement from the European Court of Justice (ECJ) in the Lankhorst Hohorst Case (C-324/00). The main issue in this judgement is that the ECJ found the thin capitalisation legislation in Germany to be in breach of the freedom of establishment in the EC Treaty. The reason behind the discrimination was that the German legislation was only applicable when the lending company was a non-resident company.

The purpose of thin capitalisation legislation is to keep the tax revenue within the borders of a country. Interest payments on cross-border transactions transfer the taxing rights across the border to the recipient’s country of residence, consequently, thin capitalisation legislation focus on non-resident parent companies.

In this article, we discuss and analyse thin capitalisation legislation in the light of the ECJ judgement. The starting point is three different ways to amend existing legislation to be in accordance with the judgement. The different solutions are found in three countries, Germany, the United Kingdom and Spain. Germany has extended their thin capitalisation legislation to also include domestic shareholders. The United Kingdom has abolished their legislation and instead included thin capitalisation provisions in their transfer pricing legislation, and extended the legislation to also cover domestic relations. Finally, Spain no longer applies their thin capitalisation provisions on shareholders resident within the European Union.

We do not include Sweden in our article since Sweden is one out of two countries in the European Union that does not have any thin capitalisation rules. Finland is the other country. This seems very odd and strange since most developed and sophisticated economics have adopted this kind of anti-avoidance rules. Even stranger is the fact that thin capitalisation legislation is not a debated topic in Sweden. Sweden does not levy any withholding tax on interest payments and together with the fact that the corporate tax rate is rather low makes Sweden an ideal place to debt financing subsidiaries.

I The Lankhorst Case

On the 12th of December 2002 the European Court of Justice (the ECJ) passed a judgement that widely affected the application of domestic thin capitalisation rules within the European Union. This judgement, Lankhorst-Hohorst GmbH v Finanzamt Steinfurt (the Lankhorst Case) deals with the German thin capitalisation legislation's compatibility with the EC Treaty. The Lankhorst Case has been heavily analysed and discussed since it has influenced the structure of every Member State’s thin capitalisation legislation.

The ECJ found that the German thin capitalisation constituted a restriction on the freedom of establishment according to art. 43 of the EC Treaty. Basically, the ECJ found the reason to its ruling in the mere fact that German subsidiaries to local parent companies got an favourable tax treatment compared to German subsidiaries to foreign parents resident in a Member State.

1.1 Facts of the Case

The company resident in Germany, Lankhorst-Hohorst (Lankhorst), was a fully owned subsidiary to a Dutch company, Lankhorst-Hohorst BV. In its turn, another Dutch company, Lankhorst-Taselaar BV (LTBV), owned Lankhorst-Hohorst BV.

Since Lankhorst for several years was a loss making company LTBV granted a loan to the company in 1996. The DM 3,000,000 loan had variable interest rate that was due at the end of each year. This loan was used by Lankhorst to repay a high-yield bank loan to reduce the total amount of interest expenses. A so called letter of support (Patronatserklärung) saying that LTBV waived its repayment claims if a third party creditor raised claims against Lankhorst accompanied the loan.

The German thin capitalisation rules at the time were to be found in Para 8a of the Körperschaftsteuergesetz (KStG). The debt-to-equity ratio applied under this rule was 3:1 and the interest on the debt exceeding the ratio was reclassified as dividends.

It shall also be mentioned that this legislation only applied when the parent company was not entitled to a tax credit on the dividends received from the German subsidiary. Practically, more or less all German parent companies are entitled to a tax credit. The only German companies that were excluded from the benefit of tax credit were “legal persons governed by public law and those carrying out business in a specific field or performing tasks which should be encouraged”. Consequently, the thin capitalisation rules in para. 8a KStG applied on situations where the parent company was resident in a foreign state and not on German parent companies that benefited from a tax credit.

The question forwarded by the Finanzgericht Münster was as follows: “Is the requirement of freedom of establishment for nationals of a Member State in the territory of another Member State laid down in Article 43 of the Treaty of 10 November 1997 establishing the European Community to be interpreted as precluding the national rule contained in Paragraph 8a of the German Körperschaftsteuergesetz?”.

1.2 The ECJ’s Reasoning

Even though the competence of the ECJ was not questioned by the parties it started by stating that “although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law and in particular, avoid discrimination on
The anti-abuse argument

The anti-abuse argument was initially considered by the ECJ when examining the thin capitalisation rules, which are intended to prevent tax evasion. The ECJ has clarified that these rules are not automatically incompatible with the principle of freedom of establishment. However, they must be justified under the rule of reason test. This test requires that the measure in question be compatible with the principle of freedom of establishment and not discriminate between domestic and foreign entities.

The restriction on the right of establishment does not have to be permanent, and in some cases, it can be justified if it is necessary to achieve a legitimate objective, such as the prevention of tax evasion. The ECJ has found that the German thin capitalisation rules were justified under this test when applied to resident parent companies.

The anti-abuse argument was put forward by the German Government to justify the thin capitalisation rules. The argument was based on the principle that tax evasion is a serious concern that needs to be addressed. However, the ECJ found that the rules were not applied in a discriminatory manner and did not interfere with the right of establishment.

In the Lankhorst case, the anti-abuse argument was also dismissed as it was considered to be a legitimate tax measure. The ECJ concluded that the thin capitalisation rules were justified under the rule of reason test and did not discriminate between domestic and foreign entities.

The anti-abuse argument was also considered in the Gebhard judgement, where the ECJ found that the thin capitalisation rules were justified under the rule of reason test. The argument was based on the principle that tax evasion is a serious concern that needs to be addressed. However, the ECJ found that the rules were not applied in a discriminatory manner and did not interfere with the right of establishment.

In conclusion, the anti-abuse argument was dismissed by the ECJ as it was considered to be a legitimate tax measure. The thin capitalisation rules were justified under the rule of reason test and did not discriminate between domestic and foreign entities.
1.2.2.2 The fiscal cohesion argument

The second argument presented by the Governments, the coherence argument, was also dismissed by the ECJ. The Court refers to the Bachmann\textsuperscript{29} case in which it accepted the cohesion argument.

Hans Martin Bachmann was a German that temporarily moved to Belgium. Mr. Bachmann had taken out sickness, invalidity, and life insurances from German insurance companies. These kind of insurance contributions were tax deductible under the Belgian law if paid to resident insurance companies. Consequently, the later repatriated benefit to the insured was taxable income. Contrary, if the contribution was not deducted when paid to the insurance company the benefit was tax exempt. This, however, was not to any relief for Mr. Bachmann since he would be back in Germany at the time for the repatriation of the benefits. The ECJ found the Belgian provisions discriminating workers from other Member States and that it restricted insurance companies resident in other Member States.

Nevertheless, the ECJ accepted the justification, fiscal cohesion for the national tax system, presented by the Belgian Government. There existed a direct link between the deductibility of contributions and the tax burden of the later received benefits. If the contribution was deducted, the benefit was taxable and if the contribution was not deducted, then the benefit was tax exempt. The Belgian Government argued that accepting deductions of contributions to foreign insurance companies would disrupt the cohesion since they would not be able to levy a withholding tax on the benefit repatriated by these foreign insurance companies. Furthermore, it would not be possible to tax the benefit in the hands of Mr. Bachmann since he would not live in Belgium when receiving the benefits. The ECJ accepted this argumentation and concluded that the Belgian provision was a necessity to ensure the fiscal coherence.

However, the scope of the justification of cohesion has been clarified and also downsized in later cases\textsuperscript{30}. In the more recent cases, Baars\textsuperscript{31} and Verkooijen\textsuperscript{32} the ECJ is very clear in this matter. In the latter of these cases, the ECJ says, “In Bachmann and Commission v. Belgium, a direct link existed, in the case of one and the same tax payer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related to the same tax.”\textsuperscript{29}

The ECJ applies its “direct link” principle on the circumstances in the Lankhorst Case. The difference between the Bachmann decision and the case at hand is that in the Bachmann case it was the same person who paid the tax and who benefited from the deductibility of the pension contributions. However, in the Lankhorst case the ECJ clarified that the coherence of the tax systems did not justify the thin capitalisation legislation since the subsidiary was not compensated for the disadvantage taxation imposed by the German legislation.\textsuperscript{30} By this statement the ECJ clarifies that a group i.e. a company and its shareholders cannot be seen as an entity when it comes to coherence of the tax systems. Personal identity is required for cohesion since it must be the same company that suffers from a disadvantage that also benefit from any relieving compensation.\textsuperscript{31}

1.2.2.3 The fiscal supervision argument

The Government of the United Kingdom presented the third and last argument. Relying on the Futura Participation and Singer\textsuperscript{33} case the Government argued that the German legislation could be justified “to ensure the effectiveness of fiscal supervision”.\textsuperscript{33} The ECJ only briefly commented this argument. The argument was dismissed since no proof was presented on how this legislation could improve the tax administration’s supervision.\textsuperscript{34} The legislation did not concern fiscal supervision. If it really would have had this effect it could be discussed whether the legislation was not in disproportion to reach the desirable supervision or not.\textsuperscript{35} The ECJ always refers the Member States to the Mutual Assistance Directive\textsuperscript{36} when it is argued that a restrictive measure on cross-border is justified for supervision purposes.\textsuperscript{37}

Finally, after having dismissed the last argument the court concluded its reasoning by saying that art 43 EC was preventing the German thin capitalisation rules\textsuperscript{38}.

2 After the Lankhorst Case

The abolishing of withholding taxes on interest payments together with the ECJ judgement in the Lankhorst Case have made it more urgent and at the same time difficult to apply anti-avoidance rules on thinly capitalised companies. The loss in tax revenue for the borrowing company’s country of residence is even larger since no withholding tax is applicable within the European Union when the requirements in the Interest and Royalties Directive (2003/49/EC) are fulfilled. On top of that, thin capitalisation rules are considered discriminatory within the Union when only targeting non-resident parent companies. Resident parent companies are very seldom covered by the rules since no tax revenue is lost when the lending and the borrowing company are resident in the same country. However, the ECJ judgement made it obvious that loss in tax revenue is no justification of the discrimination of the fundamental freedoms. Loss in tax revenue in one Member State means only that the tax revenue is increased in another Member State when the loan is within the Union.

So, how will the problem with thinly capitalised companies be dealt with within the European Member States in the future? We are going to describe and analyse three different ways to tackle the problem in three different countries. The chapter starts with Germany, which had to change its legislation after the judgement. Thereafter we continue with the United Kingdom and its way to deal with the problem. Finally, we end up with Spain, which had a legislation, at the time of the Lankhorst case, that was almost identical to the German legislation.

2.1 Germany

The thin capitalisation legislation in Germany was found discriminatory since it was incompatible with the principle of freedom of establishment provided by art. 43 of the EC Treaty by the European Court of Justice. The discrimination depended on the legislations application only to companies with a non-resident parent company. The legislation did actually not exclude resident companies from its application.
There were no such restrictions in the German legislation. However, in reality the outcome of the legislation made it applicable only on non-resident parent companies. The legislation was only applicable when the parent company was not entitled to a tax credit on dividends received from a German subsidiary. Non-resident companies were only in rare situations entitled to this credit. A vast majority of the resident German companies were entitled to a tax credit. The only exceptions are German-resident shareholders exempt from corporate income tax such as legal entities of public law and tax-exempt corporations and organisations.

The applicability of the German thin capitalisation rules was restricted as an immediate response to the judgement. During a transitional period, the rules were no longer applicable if the non-resident company was entitled to benefit from freedom of establishment under Art. 43 of the EC Treaty. The Federal Ministry of Finance was working on a follow-up provision to the German thin capitalisation legislation in 2003. In December 2003, the Federal Parliament adopted the new thin capitalisation legislation that was effective for financial years starting after 31 December 2003. In accordance with the new legislation, the rules apply to resident as well as non-resident shareholders of corporations that are subject to unlimited or limited tax liability in Germany. However, the rules do not apply if the total interest paid does not exceed EUR 250,000 per year.

The effect of the German thin capitalisation legislation is that an excessive interest payment is reclassified as a dividend payment. With effect from 2004, this will occur independently of the nationality of the lending company. Currently there is a great degree of uncertainty on how to apply the new legislation from the taxpayer’s point of view. The tax administration will publish a clarification letter on the application of the legislation in the beginning of the summer of 2004. As the legislation reads today there is no limitation to only German subsidiaries. In theory, an interest payment from a subsidiary incorporated in a jurisdiction without any thin capitalisation legislation, e.g. Sweden, can fall under the German thin capitalisation legislation. It the Swedish subsidiary would be considered thinly capitalised according to the German legislation the income could be treated as a hidden profit distribution and taxed as a dividend income when received by the German parent company. This would lead to a non-taxation situation since Sweden does not levy any withholding tax on interest and Germany exempts foreign sourced dividends. This situation is probably not desired by the legislator. It is without doubts that the legislation is in need of some clarifications from the legislator.

2.1.1 A Lankhorst analysis on the German Legislation

The first question to be answered is if the legislation restricts the right of free establishment in art. 43 of the EC treaty? The only objective with the new legislation is to comply with the Lankhorst Case and not restricting the right of free establishment. The tool that Germany is relying on the extension of the thin capitalisation rules. Today the rules do not only cover non-resident parent companies but also resident parent companies. This seems to be in accordance with the Lankhorst Case since the tax treatment of a company is not depending on the nationality of its parent company. However, first of all small and medium sized companies will in many cases be excluded from the legislation since it has a threshold for its applicability. The threshold to be met is that the total amount of interest paid by the company must exceed EUR 250,000 per annum. Could this threshold constitute a situation of discrimination or restriction?

2.1.1.1 Justification of the potential restriction

The first justification argument is the anti-abuse argument. The change of the German legislation was the geographical scope i.e. that the legislation also covers resident parent companies, and that only a subject form is applied when deciding if the company is thinly capitalised or not. The ECJ could find the legislation justified by the anti-abuse argument. The rules have been narrowed thanks to the subject form method and could be declared to only combatting wholly artificial arrangements.

The fiscal cohesions argument can never be used for justification of thin capitalisation rules. One of the basic requirements to apply this type of legislation is that a transaction is made between related companies. Consequently, the required direct link, stating that it must be the same company that suffers from a disadvantage that also benefit from a relieving compensation is never met since it is always two separate taxpayers involved.

Finally, the fiscal supervision argument: the situation has not changed for Germany by the new legislation. The rules are still applicable within the European Union and consequently the Mutual Assistance Directive can be used to secure fiscal supervision.

2.2 The United Kingdom

In the Inland Revenue Technical Note from December 2003 it is stated that the judgement from the European Court of Justice created uncertainty on how to apply thin capitalisation as well as transfer pricing rules. As a consequence to this uncertainty, the transfer pricing legislation was amended and the new rules, introduced by Budget 2004, entered into force in April 2004. In an attempt to remove the uncertainty, the Government extended the application of transfer pricing rules to cover also domestic transactions. The transfer pricing rules were in accordance with the thin capitalisation rules applicable only on cross border situations prior to this date. In addition to this change, thin capitalisation rules were abolished and instead transfer pricing rules would be applicable on these situations.

However, the extension of transfer pricing rules on domestic transactions will lead to a huge amount of extra administrative work for businesses. In an attempt to reduce this extra burden, the Government excluded small and medium sized companies from the application of the new rules. Small companies are companies with fewer than 50 employees and either turnover or assets of less than £m. Medium sized companies are defined as companies that are not small but which have fewer than 250 employees and
This exemption for SMES (small and medium-sized companies) does not apply in relation to companies resident in countries with which the United Kingdom does not have a double tax treaty including an appropriate non-discrimination article. A non-discrimination article is an article in which it is stated that residents in one state may not be less favourable treated in the other state than residents of that state under the same circumstances. According to the OECD Model Tax Convention, the information regarding non-discriminating is found in article 24. The Inland Revenue\textsuperscript{42} regards that out of 109 British double tax treaties 97 contains an appropriate non-discriminating article as of 1\textsuperscript{st} April 2004.

The amended transfer pricing rules are applicable to any case of domestic loan financing where the terms differ from those that would have been agreed upon by independent companies. Furthermore, the rules are also applicable when the interest paid by the borrowing company exceeds the amount that an independent borrower would have paid\textsuperscript{43}. An interest payment in breach of the new rule is disallowed as a tax deduction in the borrowing company.

The consequence of triggering transfer pricing rules is the non-deductibility of the interest payment. When the payment is not deductible, tax is levied on the transaction in the paying company. The extension of the transfer pricing rules to cover domestic transactions can lead to double taxation of a transaction within the United Kingdom in situations where the rules are triggered. Cross-border transactions may also be subject to double taxation but treaties and domestic credit rules already cover these situations. However, these credit rules are only applicable on cross-border transactions and consequently, domestic transactions are not covered. To avoid double taxation due to the new extended rules, a corresponding adjustment allowance is introduced. An ordinary interest payment is subject to tax in the receiving company, which in these situations will lead to double taxation of the same payment. However, this drawback is compensated by a corresponding adjustment. A corresponding adjustment is allowed in the recipient company receiving a non-deductible interest payment.

### 2.2.1 A Lankhorst analysis on the UK legislation

As seen above, the new legislation, combating thin capitalisation situations, is included in the transfer pricing rules. These rules have been extended to also cover transactions to resident parent companies as well as non-resident parent companies. Like the German legislation, the UK rules does not restrict the freedom of establishment. The subsidiary to a non-resident parent company is treated similar to a subsidiary to a resident parent company.

### 2.3 The effects of the revised legislations in Germany and the United Kingdom

Since the effect of the revised legislations in Germany and the United Kingdom are similar to each other they will be jointly analysed in this chapter.

#### 2.3.1 Discrimination of non-resident companies

Looking at the legislations it seems it does not discriminate a subsidiary of a foreign parent company. Subsidiaries resident in either Germany or in the United Kingdom will get the same treatment independently of the parent company’s residence since both countries’ legislations have been extended to cover also purely domestic transactions.

To avoid double taxation on domestic relations both the German and the British legislations state that adjustments will be made in the hands of the parent company. In the United Kingdom we have seen that the interest paid by a thinly capitalised company will be non-deductible and taxed at source. Then if the parent company is resident in the United Kingdom the interest received from the British subsidiary will be tax exempt due to the new legislation. A similar situation under the German legislation would lead to a reclassification of the interest as dividend. Consequently, the deemed profit distribution will be taxed at the level of the subsidiary and tax exempt at the level of the German parent company.

In both countries, adjustments of the taxation of the subsidiary will be made in the hands of the resident shareholder. This also means that the taxation of foreign thinly capitalised companies should be accepted and treated similar to domestic thinly capitalised subsidiaries, i.e. accordingly adjustments to the taxation of subsidiaries under foreign thin capitalisation rules shall be made.

Are adjustments regardless of the residence of the subsidiaries made in Germany? This question could be answered by an example. Let us assume that a German company has two subsidiaries, one in Germany, and one in the United Kingdom. Both companies are considered to be thinly capitalised and taxed accordingly. The taxation of the German subsidiary will be made at source as a dividend and then tax exempt when received by the parent company. The interest paid from the British company will be non-deductible in the United Kingdom. Under the previous German legislation, this interest would have been taxed as an ordinary interest income in Germany. Germany earlier stated that they would never accept a non-deductible interest and tax exempt such an interest income. Under these circumstances when the treatment of a company is depending of its residence the German legislation could be argued to be discriminatory and in breach of the EC Treaty.

The Federal Ministry of Finance published on 14 May 2004 a draft letter regarding the interpretation of the new thin capitalisation rules under Sec. 8a of the Corporate Income Tax Law (Körperschaftsteuergesetz). In this draft letter it is clearly pointed out that the interest paid on the loan by the non-resident company would only be reclassified as a hidden profit distribution in the hands of the German parent company to the extent that these payments are not deductible under the thin capitalisation rules of the state of residence of the paying company.

Following this letter from the Federal Ministry of Finance, the interest paid from the company resident in the United Kingdom in our example above, would be treated as a dividend in Germany. Consequently, the interest from the
foreign company will be tax exempt just as the interest from a domestic company. The risk of discriminating foreign entities is in this case avoided.

The example above could also be constructed and applied on the British legislation; a British shareholder has two subsidiaries, one in Germany and one in the United Kingdom. Would the same relief be granted to a foreign thinly capitalised subsidiary as to a domestic thinly capitalised company. It does not seem like the automatic adjustment that the domestic company would be granted, would be granted to a foreign subsidiary. The United Kingdom is not making any adjustments on situations where the interest has been reclassified as a dividend. This means that the reclassified interest from Germany would not get the corresponding adjustment in the United Kingdom. Apparently, foreign companies are not given the same benefit as British companies and this could be argued to be a discrimination of non-resident companies.

2.3.2 Restriction on the free establishment
We have found that the German legislation is not discriminating non-resident companies. The next step is to see whether the legislation could restrict the free establishment in art 43 EC.

The interest paid from a thinly capitalised German company is considered to be a deemed profit distribution. A dividend in Germany is taxed with the corporate tax. The corporate tax consists of a flat rate tax of 25%, a solidarity surcharge of 5.5% and a municipal business tax that varies depending on the municipality. Assuming an average municipal business tax of 20% will lead to a total effective tax rate of 38.6% on the reclassified interest. This will also be the total tax on the interest transaction since it will be tax-exempt income for the German parent company.

Comparatively, an ordinary interest payment is only taxed in the hands of the shareholder. The total tax on the transaction will still be 38.6% if we disregard the possible difference in municipal trade tax.

On the purely domestic relation, as described above, the thin capitalisation has no impact on the tax paid on the interest transaction. With or without the legislation the tax will amount to 38.6%. The reason for this is that the payment will never be double taxed under pure domestic relations. Under the thin capitalisation rules, the German parent company will automatically consider the deemed profit distribution as such and exempt it from further taxation.

If we assume that a Dutch company holds the shares of a German thinly capitalised company, just as it was in the Lankhorst case, the same taxation of the interest payment will take place in Germany, i.e. taxed as a dividend at a corporate tax rate of 38.6%. According to the Netherlands Hoge Raad, the Netherlands is not willing to make a corresponding adjustment and tax the income as a dividend. The income will consequently be treated as an interest income and taxed accordingly. In the Netherlands, interest is taxed with a 34.5% corporate tax net of German taxation. Since no credit relief is granted for the tax paid in Germany the total tax on the transaction is 59.8%.

Under these circumstances the Dutch company will most likely refrain from investing in a German company. Especially if it is a company that is in need of financial support before getting profitable and generating returns on the investment. A similar situation for a German investor would probably not lead to the same decision since the double taxation is avoided due to the internal legislation. Therefore, the fact that foreign investors might refrain from investing in German companies due to its thin capitalisation legislation could be considered to constitute a restriction on the right of free establishment.

If the legislation is found inconsistent with art. 43 EC Treaty, Germany would try to justify the legislation by the rule of reason test.

The German legislation has a subject form method approach when scrutinising a company’s financial status to decide whether a company is considered to be thinly capitalised or not. In this end Germany could argue that the legislation is narrow and that only wholly artificial arrangements are hindered by the rules.

2.3.3 Thin capitalisation rules – an international instrument
The thin capitalisation rule is a national legislation. Initiated, created and implemented by the national law making body. This means that the country that has such legislation forces the country of the lending company to make corresponding adjustments to avoid double taxation.

However, if the countries involved have entered into a double tax agreement and if art. 9, especially art 9.2, follows the OECD Model Convention, the country shall make corresponding adjustments to the taxation in the source state. Nevertheless, there are examples of countries that unilaterally state that they will not make any adjustments and the income will consequently be double taxed.

Normally, a country is not obliged to make sure that their legislation works in an international context, but when it comes to thin capitalisation it could be questioned. The nature of thin capitalisation rules are that they are intended to combat tax evasion by debt financing. The entire idea behind the legislation is to be used on cross border transactions. Therefore, it would be in the interest of the thin capitalisation country to ensure that the rules are only applied on situations when double taxation is avoided by corresponding adjustments in the receiving country.

2.4 Spain
The Spanish thin capitalisation legislation was until 31 December 2003 applicable in situations where a non-resident parent company financed its Spanish subsidiary by debt. As the German legislation, the consequence of excessive debt is that the interest payment is reclassified as a dividend payment. The Spanish reaction to the Lankhorst Case, was to amend its anti avoidance rules concerning thin capitalisation. The Spanish rule has been restricted and not extended to also cover purely domestic situations as the German rule. With effect from 1 January 2004, the Spanish thin capitalisation legislation applies only to parent companies resident in countries outside the European Union. Consequently, within the borders of the European Union,
no thin capitalisation rules apply. The financing of Spanish subsidiaries by companies resident in European Member States can probably be tackled by the general substance over form rule when the loan agreement is obviously fictitious.

However, when the loan agreement is sound and serious but in breach of the debt to equity ratio in Spain, this will not lead to any consequences within the European Union. This amendment seems to be in line with the ECJ judgement. The amended legislation would not be discriminatory and in breach of the fundamental freedoms provided for in Art. 43 of the EC Treaty. On the other hand, the decrease in tax revenue in Spain is the same regardless of where the lending company is resident, i.e. outside or within the European Union.

### 2.4.1 A Lankhorst analysis on the Spanish Legislation

It is obvious that the Spanish legislation cannot restrict or discriminate the right of free establishment since the legislation is not applied when the receiver of the thin capitalisation interest is resident within the European Union. The legislation is only applied on relations with non-EU shareholders. Could this constitute a breach of article 56 EC Treaty? Article 56.1 states that restrictions on movement of capital between a Member State and a third State are prohibited.

We will leave the Lankhorst analysis since the Spanish legislation is not applied within the EU and instead briefly discuss the possibility of a restriction on the free movement of capital.

### 2.4.2 The Spanish legislation and the free movement of capital

Art. 56.1 is prohibiting the use of restrictions “on movement of capital between Member States and between Member States and third countries”. From the wording of the article it could be understood that the restrictions that are prohibited within the European Union shall also be a prohibited restriction in relation to a third country.

First it must be clarified whether this article covers tax legislation or not. First, the aim of the free movement in relation to a third country has a limited scope compared to the free movement within the European Union. Mohamed has argued that the prohibition of restrictions only covers actual movements of capital across the borders. This means that a tax regulation could only in exceptional cases be in conflict with art. 56.1 EC Treaty. Contrary it has been argued that tax regulations could under certain circumstances fall under the prohibition in art. 56.1. Nevertheless, the possibility to justify restrictions that fall under this article is greater than the possibility to justify restrictions that fall under art. 43 EC Treaty.

Since there are more possibilities for a Member State to justify its tax restrictions in relation to a non-member state, compared to an intra-community relation, it is most likely that anti avoidance legislation, such as thin capitalisation, would be justified.

Most likely the Spanish legislation will not only pass the prohibition in art. 43 but also the prohibition to restrict the free movement of capital between a Member State and third countries under art. 56.1.

### 2.5 Conclusions

In this section, we have analysed three different solutions to make thin capitalisations rules comply with the Lankhorst Case. In our opinion they have in many aspects succeeded with their compliance.

We have found that there are different possibilities to still apply thin capitalisation rules after the Lankhorst Case, also within the European Union. However, the Spanish solution to only apply its thin capitalisation rules on relations outside the Union might be the safest way to comply with Community Law. However, even though it is small for the time being, there is a risk that the legislation could be found restrictive on the right of free movement of capital between a Member State and third country according to art 56.1. Today this field is unexplored regarding tax law but as the case law develops this might be found incompatible with the EC Treaty in the future. If a case concerning taxation in relation to a third country would end up before ECJ it would be very interesting to see if there is a greater chance to justify obstacles with art. 56 EC than with art. 43 EC.

The solutions chosen by Germany and the United Kingdom are in many ways similar to each other. The United Kingdom has however repealed their thin capitalisation rules and extended their transfer pricing rules to cover thin capitalisation situations. None of the countries has a fixed debt to equity ratio when deciding whether a company is thinly capitalised or not. Instead, both countries apply a subject form method. Applying the subject form method makes the legislations narrower and targets only wholly artificial arrangements, which is desired by the ECJ if they would find the rules incompatible with the right of free establishment.

Corresponding adjustments are made to avoid double taxation on transactions between a company and a resident shareholder. In the United Kingdom the rules state that the non-deductible interest would be tax exempt in the hands of the resident shareholder. In Germany the interest is reclassified as a dividend under the thin capitalisation rules. The effect is that the taxation takes place at the level of the company and that the income is tax exempt in the hands of the shareholder, in the same way as an ordinary dividend is treated. However, there is one major difference between the German and the British legislation: In Germany, the relief granted on a deemed profit distribution from a resident subsidiary will also be granted on interest payments from non-resident companies. Consequently, a non-deductible interest, received from a company resident in a country with thin capitalisation rules, will be treated as a deemed profit distribution in the hands of the German shareholder.

On the other hand, the United Kingdom does not automatically make the corresponding adjustment on a received non-deductible interest. In this case the treatment of subsidiaries to a British shareholder depends on the company's country of residence. In our opinion, this could be seen as a discriminating provision and incompatible with the EC Treaty.
Helsingborg, juni 2004

Anette Karlqvist, jur. kand.
anette.karlqvist@comtaxit.com

Henrik Spirén, jur. kand.
henrik.spiren@comtaxit.com

Anette Karlqvist och Henrik Spirén är verksamma som skattejurister vid Comtax AB.

Fotnoter
1 Covers only the Member States prior to 1 May 2004.
2 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, C-324/00, 2002, ECJ.
3 Ibid, at para. 32.
5 Körperschaftsteuergesetz, para 8a Gesellschafter-Fremdfinanzierung.
6 Lankhorst-Hohorst, para 28.
7 Ibid, para 25.
8 Ibid, para 26.
10 Lankhorst-Hohorst, para 32.
11 Ibid, para 27.
12 Lankhorst-Hohorst, para 28.
13 Lankhorst, para 32.
14 Terra, Ben, Wattel, Peter, European Tax Law, 2001, p. 41.
15 Reinhard Gebhard v. Consiglio dell’ ordine degli avvocati e procuratori di Milano, C-55/94.
16 Gebhard, C-55/94, para 37.
17 Lankhorst, para. 34.
19 Lankhorst, para 36.
21 Lankhorst, para. 37.
22 Metallgesellschaft and Others, C-397/98 and C-410/98, para. 57
23 See also X and Y, C-436/00, para. 43 and 61.
24 Lankhorst, para 38.
25 Bachmann, C-204/90.
26 Wielockx, C-80/94, Svensson, C-484/93, Baars, C-251/98 and Verkooijen, C-35/98
27 Baars, C-251/98
28 Verkooijen, C-35/98
29 Ibid, para 57. See also Baars, C-251/98, para. 40 and Metallgesellschaft C-397/98 and C-410/98, para. 69.
30 Lankhorst, para. 42.
32 Futura Participation SA and Singer v. Administration des contributions, C-250/95.
33 Lankhorst, para 43.
34 Ibid, para 44.
36 Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ L 336/15.
37 Terra, Ben, Wattel, Peter, European Tax Law, p 77.
38 Lankhorst, para. 45.
39 IBFD, Tax News Service 2003, p. 249
40 Inland Revenue technical note, December 2003, Corporate tax reform: the next steps, para. 1.7.
41 Inland Revenue technical note, para. 1.10.
42 Inland Revenue, Draft Guidance, Small and medium sized enterprises, p. 1
43 Inland Revenue, Draft Guidance, Thin capitalisation, p. 4
45 Source the International Bureau of Fiscal Documentation, Amsterdam.
47 Denmark is an example of a Member State that refuses to make any corresponding adjustments to avoid double taxation.
48 Ståhl, Kristina, Den fria rörligheten för kapital mellan EU och tredje land, Skattenytt, Nr. 9, 2003, p. 589.
50 Ståhl, Kristina, Den fria rörligheten för kapital mellan EU och tredje land, Skattenytt, Nr. 9, 2003, p. 594.