THIN CAPITALISATION LEGISLATION

A BACKGROUND PAPER FOR COUNTRY TAX ADMINISTRATIONS
(Pilot version for comments)

Initial draft - August 2012
THIN CAPITALISATION

Introduction

This paper, which has been prepared by the OECD Secretariat for training purposes, aims to assist country tax administrations that are considering revising their existing thin capitalisation rules, or introducing thin capitalisation rules for the first time.

The paper aims to:
- describe what is meant by thin capitalisation
- explain why many countries take measures to address thin capitalisation in their tax rules
- describe the legislative approaches that countries frequently adopt to such rules
- address some of the issues that frequently arise in the context of thin capitalisation regulations

The paper acknowledges that countries adopt differing approaches to thin capitalisation, and these different approaches are reflected in the “model legislation” included in this paper. Neither the OECD nor the OECD Secretariat recommend any one approach over another.

The paper includes two Annexes:

Annex 1 contains illustrative legislation, intended to illustrate the key elements of country thin capitalisation legislation.

Annex 2 contains a number of examples of country thin capitalisation legislation.
What is a thin capitalisation?

A company is typically financed (or capitalized) through a mixture of debt and equity. “Thin capitalisation” refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as “highly leveraged” or “highly geared”.

Why is thin capitalisation significant?

The way a company is capitalized will often have a significant impact on the amount of profit it reports for tax purposes. Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit. The higher the level of debt in a company, and thus amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity.

<table>
<thead>
<tr>
<th>EQUITY</th>
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<td>Own resources</td>
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<td>Financer (provider of funds)</td>
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<td>→ Payment = equity contribution</td>
<td>→ Payment = loan</td>
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<td>→ Return to financier = dividends or increase in share value</td>
<td>Return to financier = interest Normally a deductible expense in the jurisdiction of the payer</td>
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Multinational groups are often able to structure their financing arrangements to maximise these benefits. Not only are they able to establish a tax-efficient mixture of debt and equity in borrowing countries, they are also able to influence the tax treatment of the lender which receives the interest - for example, the arrangements may be structured in a way that allows the interest to be received in a jurisdiction that either does not tax the interest income, or which subjects such interest to a low tax rate.
The following examples highlight the impact that the level of debt may have on the taxable profit.

**Example 1: Debt to equity investment of 1 to 1.**

Company X, a corporation from Country A, establishes group affiliate Company Y in Country B with an investment of 50 in equity capital and a loan of 50 from Company X at a 10% interest rate.

Company Y generates pre-tax and pre-interest operating income of 15 for year 20XX, and pays interest to Company X at 10% i.e. an interest payment of 5. The post-interest taxable profit of Company Y is 10 and, taxed at a 30% tax rate, generates tax revenue of 3 for Country B.

• Example 1:
Example 2: A debt to equity investment of 9 to 1.

Company X, a corporation from Country A, establishes a group affiliate Company Y in Country B with an investment of 10 in equity capital and a loan of 90 from Company X at a 10% interest rate.

Company Y generates pre-tax and pre-interest income of 15 for year 20XX, and must pay interest to Company X at 10% i.e. a total interest payment of 9. The remaining taxable profit of Company Y is 6 and taxed at a 30% tax rate, which generates tax revenue of 1.8 for Country B.

- Example 2:

The exact effect on tax revenue of increased interest payments will depend on any withholding taxes in point, and the provisions of any tax treaties in force. Countries typically tax interest on a source basis. This means that the recipient of the interest (in this case the non-resident lender) will be taxed in the country in which the interest arises (in this case the country of the borrower). i.e. the non-resident recipient of interest will be liable to tax in the country of the affiliate payer. The interest recipient’s tax liability is normally withheld by the paying affiliate, and then paid to the tax authority of the payer. Bilateral tax treaties, which allocate taxing rights between the source (payer) and residence (recipient) countries, often eliminate or significantly lower withholding tax rates applied to interest paid to a non-resident recipient.
Example 3: A debt to equity investment of 9 to 1 and a withholding tax.

Company X, a corporation from Country A, establishes group affiliate Company Y in Country B with an investment of 10 in equity capital and a loan of 90 from Company X at a 10% interest rate.

Company Y generates pre-tax and pre-interest income of 15 for year 20XX, and must pay interest to Company X at 10% i.e. a total interest payment of 9. The remaining taxable profit of Company Y is 6 and taxed at a 30% tax rate generates tax revenue of 1.8 for Country B.

However, Country B has a withholding tax of 10% for interest payments to non-resident companies. The withholding tax on the interest payment of 9 and generates an additional 0.9 in tax revenue for Country B. Therefore the total tax revenue in Country B is 2.7

- This situation might be balanced by the effect of a withholding tax

Country B might withhold tax on interest paid to non-residents. Ex:
- Withholding tax of 10% of 9 interest
- Withholding tax: 0.9

Total tax revenue: 0.9 + 1.8 = 2.7
What are “thin capitalisation” rules?

As described above, the manner in which a company is capitalised can have a significant effect on the amount of profit it reports, and thus the amount of tax it pays.

For this reason, country tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company’s profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country’s tax base. From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives MNEs an advantage over purely domestic businesses which are unable to gain such tax advantages.

Thin capitalisation rules typically operate by means of one of two approaches:

a) determining a maximum amount of debt on which deductible interest payments are available; and
b) determining a maximum amount of interest that may be deducted by reference to the ratio of interest (paid or payable) to another variable.

These two approaches are discussed below.
a) Limiting the amount of debt on which deductible interest payments may be made

Thin capitalisation rules often operate by limiting, for the purposes of calculating taxable profit, the amount of debt that can give rise to deductible interest expenses. The interest on any amount of debt above that limit (“excessive debt”) will not be deductible for tax purposes.

Countries take different approaches to determining the maximum amount of debt that can give rise to deductible interest payments, but there are generally two broad approaches:

i. The “arm’s length” approach: Under this approach, the maximum amount of “allowable” debt is the amount of debt that an independent lender would be willing to lend to the company i.e. the amount of debt that a borrower could borrow from an arm’s length lender. The arm’s length approach typically considers the specific attributes of the company in determining its “borrowing capacity” (that is, the amount of debt that company would be able to obtain from independent lenders).

The “arm’s length” approach can also encompass a determination of the amount of debt that a borrower would have borrowed if the lender had been an independent enterprise acting at arm’s length. This “would have” approach is discussed in more detail below.

ii. The “ratio” approach: Under this approach, the maximum amount of debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity. The ratio or ratios used may or may not be intended to reflect an arm’s length position.

These two approaches are discussed in more depth below.
i. The “arm’s length” approach

As mentioned above, an arm’s length approach requires the taxpayer company (and tax authority) to establish the amount of debt a third party lender would be willing to lend to it. This involves taking a view on the amount of debt that third party lenders, acting at arm’s length, would be willing to lend to the specific company in question, taking into account the specific attributes of that company. The approach can also take into consideration the amount the lender, acting at arm’s length, would be willing to borrow.

The advantage of the arm’s length approach is that it provides for a much closer approximation of the debt the corporation could borrow at arm’s length and thus removes asymmetrical treatment between companies that are members of multinational enterprises and those that are not. The arm’s length analysis is tailored to the facts and circumstances of each case, and allows a more tailored approach to the determination of deductible debt interest. In contrast, a ratio approach (described below) relies on an often inflexible standard embodied in a ratio.

Depending on the exact wording of the relevant legislation, an arm’s length approach to thin capitalisation may be achieved through a country’s general transfer pricing rules.

An arm’s length approach may also allow elimination of double taxation through the application of a tax treaty, if it is accepted by both treaty partners that the approach represents the application of the arm’s length principle and thus falls within the “associated enterprises” article of the relevant treaty. There is less than full consensus, however, on the extent to which thin capitalisation provisions fall within the scope of tax treaties.

The disadvantage of utilising an arm’s length approach is its large resource and skill requirements. In order to apply the arm’s length approach, the tax auditor needs to understand the processes third party lenders uses to determine the maximum amount they would lend to a specific taxpayer. Tax authorities need to have expertise to step into the role of the third party lender and establish the specific characteristics of the group affiliate to determine an appropriate amount of debt.

In practice this means that, in implementing a pure arm’s length approach:

iii. tax auditors need to gain significant understanding of third party lending practices
iv. …and need to investigate the application of those criteria with regards to specific taxpayers,
v. And, inevitably, this will require a degree of judgment to determine the proper treatment for each factual situation.

In some countries, tax administrations engage in discussions with third party lenders to understand how a third party would determine how much it would be willing to lend. Third party lenders may use criteria based on the free cash flows of the business, and the bank’s perception of the group affiliate’s ability to pay the interest and repay the loan to determine lending amounts. For this lending decision, third party lenders take into account many factors including the forecasted cash flows of the borrower (which they stress test), the quality of the management of
the group affiliate, an economic analysis of the industry sector, the overall health of the economy, the quality of the collateral that can support the loan, and a bank’s own liquidity position.

For example, South Africa engaged in discussion with South African banks to understand their lending criteria and determined that a simple debt to equity ratio is not a key factor for third party lenders in many lending situations. The outcome of the discussion led to a re-evaluation in how excessive debt was calculated by the South African tax authority. The economic and legal environments among countries vary, and tax administrations would benefit from having independent conversations with banks to understand their lending criteria and decision making process.

**Application of the “separate enterprise approach”**

The application of the arm’s length approach involves postulating the borrowing capacity of group affiliates, using a “separate enterprise” approach.

In principle, there are a number of approaches that may be taken to this. Take an example where a company, Company A, is located in Country A, and is a member of a multinational group which has an AAA credit rating. Company A has a number of subsidiaries.

Potential approaches include:

1. Determining the borrowing capacity of Company A on the basis that it has the same credit rating as the multinational group to which it belongs. This approach is widely regarded as not representing an application of the “separate enterprise” approach, and thus the arm’s length principle.
2. Determining the borrowing capacity of Company A on the basis that it is a subsidiary of a group of companies that enjoys an AAA rating. There is less than full consensus on whether this represents an application of the “separate enterprise” approach.
3. Determining the borrowing capacity of Company A on the basis that it is not a member of a wider group of companies, and benefits from no explicit or implicit guarantees from group members, but also on the basis of owning the same subsidiary companies.
4. Determining the borrowing capacity of Company A on the basis that it is not a member of a wider group of companies, and benefits from no explicit or implicit guarantees from group members, and ignoring its ownership of its the subsidiary companies.

The illustrative legislation in Annex 1 below is drafted in accordance with approach 3 above.

**Would-have approach**

The illustrative legislation in Annex 1 is drafted to illustrate the approach described above which determines the amount of debt a company could obtain from an independent lender at arm’s length.
Countries may want to employ an arm’s length approach to include within the scope of the legislation the amount of debt that would have been obtained under arm’s length conditions.

The “would have” approach considers whether the loan would have been entered into by the borrower if it had been dealing with the lender under arm’s length conditions. Under this approach, interest may be disallowed on debt that could have been obtained from an arm’s length lender, but, at arm’s length, would not have been obtained.

As an example, take a company located in a jurisdiction that employs an arm’s length approach and that company is capitalized with a level of debt below an arm’s length amount. In order to maximize the amount of deductible interest available to it decides to increase its debt to achieve a level closer to an arm’s length amount, even though there is no business or commercial need to do so. If the jurisdiction applies a “would have” approach, the tax administration may investigate the extent to which there was a commercial or business need for taking on the additional debt. If it is demonstrated that the additional debt would not have been entered into had the lender been an independent party, then the interest payable on that debt would be disallowed. This might be the case, for example, if the additional debt had been entered into purely to achieve a tax gain – and the tax advantage to the group of companies would not have been available had the lender been an independent party.

Suggested wording to achieve this, if countries wish to do so, is provided in a footnote to the illustrative legislation at Annex 1 below.

Under this approach, tax authorities typically investigate the circumstances under which individual items of debt, or incremental or new debt, has been obtained. They will ask whether there is a business or commercial reason for this debt.
ii. Ratio approaches

Ratio approaches determine the amount of deductible interest expense by reference to a specified ratio, such as the ratio of debt to equity. For example, the rules might allow interest payments on debt of up to two times the total amount of equity invested in the group affiliate. Any additional interest would not be deductible.

Approaches differ among countries. For example, Kenya uses a debt to equity approach and employs a 3 to 1 ratio, while Ghana and Canada, for example, use a 2 to 1 debt to equity ratio. In applying such ratios, some countries use only related-party debt in the equation, whereas others apply this approach using total debt as the basis. It might be expected that a ratio employing total debt as the basis would be lower than a ratio using only related party debt in the equation.

Another type of ratio compares the debt to equity ratio (or other financial indicators) of the entity under consideration to the worldwide group debt (or other financial indicator) to worldwide equity to determine (for the purposes of the thin capitalisation rules) if the group affiliate’s debt level is excessive.

Countries adopt a number of approaches for applying ratio approaches. Some countries aim to determine ratios with the aim of approximating an arm’s length position. Others determine ratios according to other criteria.

Where ratios are determined according to arm’s length criteria, some countries treat the specified ratios as equivalent to a safe harbour. Under this approach, taxpayers will have some certainty that interest that falls within the specified parameters will be considered to be acceptable. Interest that is in excess of the safe harbour may be challenged, however, and potentially disallowed, unless the taxpayer can show that the excess interest represents an arm’s length amount. (China’s legislation, contained in Annex 2, illustrates this approach). Other countries apply the specified ratios more inflexibly.

The advantage of a ratio approach is that it provides a great deal of certainty and reduces compliance costs to companies and taxing authorities. The rule is simple to implement and reduces the resource costs of tax authorities.

The disadvantage of the fixed ratio approach is that it does not necessarily reflect economic reality and may distort behaviour by group affiliates. A fixed ratio approach does not always take into account specific market situations or industries, and may result in inconsistent treatment of members of multinational enterprises in comparisons to independent companies. There is no agreed international standard for the formulation of an appropriate ratio.
Example of the application of a debt:equity approach

Company X, a corporation resident in Country A, establishes group affiliate Company Y in Country B with an investment of 10 in equity capital and a loan of 90 from Company X at a 10% interest rate.

Company Y generates pretax and pre-interest income of 15 for year 20XX, and must pay interest to Company X at 10% i.e. a total interest payment of 9.

Under Country A’s thin capitalisation rules, deductions for payments of interest is limited by reference to a debt:equity ratio of 2:1. That is, interest on any debt that is in excess of 2x the level of equity will not be allowable for tax purposes.

On a simple application of the rules, then, interest on debt in excess of 2x the level of equity will be denied. That is, debt in excess of 20 (2x10). In such case, interest on debt of 70 (90-20) will be disallowed, i.e. 70x10% = 7. This leaves interest of 2 as allowable.

- **Example of ratio 2:1**

  **Country A**
  - Company X1
    - Lender
  **Country B**
  - Company X2
    - Borrower

  **Loan (90)**

  **Repay (90) + 10 % interest (9)**

  **Company X2 is financed by:**
  - 10 Equity / 90 Debt

  **BUT if the ratio is applied → Interest on any debt that is in excess of 2x equity will not be deductible.**
  - Limit on debt: 2x10 = 20
  - Deduction of interest allowed: 10 % of this 20 = 2
  - Post-interest taxable profit: 13
  - Tax rate: 30 %

  **Tax revenue: 3,9**

  **- Pre-tax and pre-interest taxable profit: 15**
  **- Deduction of interest payment: - 9**
  **- Post-interest taxable profit:6**
  **- Tax rate: 30%**
  **- Tax revenue: 1,8**
How are equity and debt defined?

Ratio rules which employ the concepts of debt and equity necessarily need to define these terms.

Third party lenders define debt as anything that is substantively a loan. This includes finance leases, financial derivatives (synthetic loans), certain debt factoring arrangements, certain redeemable preference shares, and overdrafts.

For the purpose of thin capitalisation legislation, debt is not limited to financial instruments classified as debt under accounting standards. The definition of debt used in the suggested legislation (below) avoids the difficulties in determining whether an instrument is effectively equity or debt by focusing on the deductibility of the interest or other finance charges for tax purposes, rather than the principles of accounting or financial standards. That is, in the illustrative legislation below, an instrument is defined as debt for these purposes if it gives rise to interest that is paid or payable that is otherwise deductible in the computation of taxable profit.

As mentioned above, some countries define debt for the purpose of their thin capitalisation legislation as related-party debt only, whereas others apply total debt in the relevant ratios.

### Anti-avoidance (bed and breakfasting)

Another concern specific to the ratio approach is the potential for corporations to attempt to avoid the application of thin capitalisation rules through what is sometimes known as a “bread and breakfast” practice. This refers to a practice under which the group affiliate’s debt level (or another financial indicator) is reduced immediately before a reporting period (financial year, calendar year, monthly, etc.) to avoid triggering scrutiny, but then increased again immediately after the reporting period.

Some countries attempt to counter this practice by using “average level” or “maximum level” of debt (or another financial indicator) during the reporting period.

Most countries define equity in a broad sense, including share capital, capital contributions, retained profits, interest-free loans or revaluation reserves.
Would – have approach

Countries may wish to supplement legislation using a ratio approach with a “would – have” provision similar to that discussed under the arm’s length approach described at i. above.

The “would have” approach considers whether there is a commercial need or justification, from the borrower’s perspective, for all or part of a company’s debt.

As an example, take a company located in a jurisdiction that employs a ratio approach that specifies a 2:1 debt-equity ratio. The company is capitalized on a 1:1 debt-equity basis. In order to maximize the amount of deductible interest available to it, it may decide to increase its debt to achieve a debt-equity ratio closer to 2:1. If the jurisdiction applies a “would have” approach, the tax administration may investigate the extent that there was a commercial or business need for taking on the additional debt. If it is demonstrated that the additional debt was entered into purely to gain a tax advantage, then the interest payable on that debt would be disallowed.

Under this approach, tax authorities thus typically investigate the circumstances under which individual items of debt, or incremental or new debt, has been obtained. They will ask whether there is a business or commercial reason for this debt; or, as a corollary, whether there is a tax motive for entering into new debt. This clearly requires detailed investigation.

b) Limiting amount of interest that may be deducted by reference to its ratio to another variable.

Some countries employ a ratio approach that focuses on the amount of interest paid or payable in relation to the amount of income out which that interest is paid. This is sometimes referred to as an “earnings stripping” approach. The applicable ratio may be by reference, for example, to a ratio of the amount of interest to operating profit or a measure of cash flow (e.g. an interest to EBITDA ratio). Germany and Italy, for example, generally cap the deductibility of interest to 30% of EBITDA.

Example of an earnings-stripping approach

Company X, a corporation resident in Country A, establishes group affiliate Company Y in Country B with an investment of 10 in equity capital and a loan of 90 from Company X, which carries a 10% interest rate. Company Y thus pays interest of 9 (90x10%).

In year 20XX Company Y generates EBITDA of 15, and taxable profit of 6 (15-9). (The example assumes there is no depreciation and amortisation charge in the year.)

Country A has legislation in place that restricts the deduction of interest to 30% EBITDA.

In this case, the deductible interest is limited to 4.5 (30% x 15) and the remaining interest of 4.5
will be disallowed in the computation of taxable profit. The resultant taxable profit of Company Y thus becomes 10.5 (15-4.5)

• Example of limit to interest (30% EBITDA):

How is interest defined?

Third party lenders define interest to include all financing costs, regardless of whether it is legally defined as interest. The definition of interest typically includes premiums for options, discounts, finance lease payments, payments and receipts under interest rate swaps.
Specific issues

a) Relationship between thin capitalisation and transfer pricing rules

The amount of interest that a company pays is determined by two factors:

a) The rate of interest (or similar condition) applied to its loans.

b) The amount of those loans.

Transfer pricing rules unequivocally apply to the rate of interest (or similar condition) applied to its loans. The rate of interest is the price that is paid on a loan, and transfer pricing rules require that such a price conform to the arm’s length principle.

Depending on specific country legislative approaches, transfer pricing rules may or may not apply to determine the amount of the loan. Some countries and commentators take the view that transfer pricing rules that are in line with Article 9 of the OECD Model Tax Convention may be sufficient to disallow interest relating to debt in excess of an arm’s length amount - and thus can be used to enforce an "arm’s length" thin capitalisation regime. However, in order to provide certainty and clarity, many countries typically introduce specific thin capitalisation provisions, even where they adopt a purely arm’s length approach and have existing transfer pricing rules that apply the arm’s length approach.

b) Scope of thin capitalisation rules

Thin capitalisation regulations need to specify the range of financial transactions that fall within their scope. For example:

• whether the rules apply to interest payments paid to domestic resident taxpayers, in addition to those paid to non-resident lenders. Some countries apply their rules to, for example, domestic tax exempt entities, ring fenced domestic tax regimes (e.g. oil sector) or beneficiaries of tax incentives. Where the rules apply to purely domestic transactions, countries may wish to consider whether provisions for “corresponding adjustments” should be made.

• whether the rules apply to loans from third party lenders that are not part of the same multinational group of enterprises. (see box below)

• how to define related parties or associated enterprises for the purposes of the legislation. Typically countries use the same criteria as they employ in their transfer pricing rules.
**Indirect loans (back-to-back and guarantees)**

Multinational enterprises and group affiliates may be able to structure their financing arrangements through third party intermediaries such as banks. The motive for using such intermediaries may be to avoid the application of some thin capitalisation rules, which apply to loans from affiliated lenders only. By arranging for loans to be provided by third party independent lenders, the application of this capitalisation rules may be avoided.

There are typically two ways in which this might be achieved:

- by an affiliate depositing an equivalent and corresponding sum with the lending institution – sometimes called back-to-back arrangements.
- By an affiliate providing a guarantee to the lending institution

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**c) Interaction with Treaties**

Tax treaties do not alone provide a tax authority with the power to enforce thin capitalization provisions – domestic legislation is required to do this.

However, tax treaties typically contain provisions that limit the benefits they accord where excessive interest is paid. See box below for discussion on this.

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**Tax treaties and interest**

Article 11 of the OECD Model Tax Convention determines the tax treatment of interest paid by a taxpayer in one state to a taxpayer in another state, where there is a treaty in place between the two states. Where the treaty applies, the taxing rights of the country of the payer (i.e. the source state) is often limited – typically to a rate of 10%.

Article 11 (6) applies where there the payer of the interest and the beneficial owner of the interest are related, and the amount of interest paid between them exceeds an arm’s length amount. In such cases, the provisions of Article 11 apply only to the arm’s length amount of interest. The result is that the excessive interest (i.e. the amount in excess of the arm’s length amount) will be taxable, without any benefit of the treaty, in both the source state.
and the resident state under the laws of the respective states. In practice this means that withholding tax will apply to the interest at full (non-treaty) rate.

The meaning of “excessive interest” in this case will depend on the exact wording of the relevant treaty. Many treaties will treat interest as excessive only where the rate of interest exceeds an arm’s length amount – in such cases the treaty protection will not be denied if interest is excessive due to the amount of the loan only. Some treaties, however, will treat interest as excessive where the amount of the loan is greater than an arm’s length amount. In such cases, withholding taxes will be applied to the excess interest according to domestic rules, without regards to the treaty.
Contacts

Should you have questions or comments on the attached, please feel free to contact one of the following people at the OECD Centre for Tax Policy and Administration:

Tax and Development Unit:

Colin Clavey, Senior Tax Advisor, Global Relations: colin.clavey@oecd.org
Lee Corrick, Senior Tax Advisor, Global Relations: lee.corrick@oecd.org
ANNEX 1

THIN CAPITALISATION RULES

Drafting Approach

Countries that have introduced thin capitalisation legislation have adopted different approaches. This paper outlines a draft approach to both arm’s length and ratio approaches to thin capitalisation.

The manner in which countries formulate their thin capitalisation rules vary markedly. Some countries adopt very brief “primary legislation” (i.e. in the main body of law), which articulate the main principles, and elaborate on those principles in “secondary legislation” (including regulations, circulars, decrees or similar administrative pronouncements). Other countries have adopted more elaborate and extensive language in primary legislation. The choice of a particular drafting approach will depend on the legal system of the country concerned.

The draft language set out in the attached is intended to be illustrative only, with the main aim of illustrating the key elements most countries adopt in their thin capitalisation rules.

A. Base position - arm’s length approach

1. The legislation applies where:
   • a company, or a permanent establishment of a company ("the borrower"),
   • pays interest (or in the case of a permanent establishment, is attributed interest expense) or similar consideration (including in the form of a discount),
   • that is deductible in the calculation of its taxable income,
   • in respect of any form of debt,
   • issued by a person who is not resident in [Country], or a attributed to a permanent establishment of a person who is resident in [Country]
   • and who is an associated enterprise to the borrower.

2. Where the legislation applies interest shall not be deductible in the computation of taxable profit to the extent that it arises from a non-arm’s amount of debt, as specified in paragraph 3 below.
3. Non-arm’s amount of length debt means the amount of debt that exceeds the amount that the borrower would be able to obtain from a lender that is not associated, and acts at arm’s length. ¹

4. The amount of debt that the borrower would be able to obtain from a lender that is not associated shall be determined on the basis that such a lender takes no account of any guarantees (whether implicit or explicit) provided by an associated enterprise, nor of the borrower’s membership of a group of associated enterprises.

5. Debt means any form of financial instrument on which interest or similar payments are made that are allowable as a deduction in a computation of taxable income.

6. Debt shall be treated as issued by an associated enterprise where it is issued by a lender that is not associated, and either a) an associated enterprise provides an implicit or explicit guarantee to the lender or b) an associated enterprise deposits a corresponding and matching amount of funds with the lender.

B. Base position - Ratio Approach with Debt Factor

1. The legislation applies where:
   - a company, or a permanent establishment of a company (“the borrower”),
   - pays interest (or in the case of a permanent establishment, is attributed interest expense) or similar consideration (including in the form of a discount),
   - that is deductible in its calculation of taxable income,
   - in respect of any form of debt,
   - issued by a person who is not resident in [Country], or attributed to a permanent establishment of a person who is resident in [Country]
   - and who is an associated enterprise to the borrower.

2. Where the legislation applies interest referred to in 1. above shall not be deductible in the computation of taxable profit to the extent that it arises from excessive debt, as specified in paragraph 3 below.

3. Excessive debt means:

¹ If a “would have” approach is to be adopted the wording of paras 3 and 4 above could be adapted to:
3. Non-arm’s amount of length debt means the amount of debt that exceeds the amount that the borrower would obtain from a lender that is not associated, and acts at arm’s length.

4. The amount of debt that the borrower would obtain from a lender that is not associated shall be determined on the basis that such a lender takes no account of any guarantees (whether implicit or explicit) provided by an associated enterprise, nor of the borrower’s membership of a group of associated enterprises.
a. the amount of debt that exceeds the amount of equity in the borrower above a ratio of X:Y, (where X …and Y is….) or

b. the amount of debt that exceeds the amount of EBITDA earned by the borrower in the relevant return period above a ratio of X:Y, (where X is…and Y is….)

Debt means any form of financial instrument on which interest or similar payments is made that are allowable as a deduction in a computation of taxable profit.

4. Equity includes share capital, capital contributions, retained profits, interest-free loans or revaluation reserves.

5. Debt shall be treated as issued by an associated enterprise where it is issued by a lender that is not associated, and either a) an associated enterprise provides an implicit or explicit guarantee to the lender or b) an associated enterprise deposits a corresponding and matching amount of funds with the lender.

C. Base position – “Earnings-stripping approach”

1. The legislation applies where:
   - a company, or a permanent establishment of a company (“the borrower”),
   - pays interest (or in the case of a permanent establishment, is attributed interest expense) or similar consideration, (including in the form of a discount),
   - that is deductible in its calculation of taxable income,
   - in respect of any form of debt,
   - issued by a person who is not resident in [Country], or attributed to a permanent establishment of a person who is resident in [Country]
   - and who is an associated enterprise of the borrower.

2. Where the legislation applies interest shall not be deductible in the computation of taxable profit to the extent that it arises from excessive interest, as specified in paragraph 3 below.

3. Excessive interest means:\(^2\)

   a. the amount of interest that exceeds x % of EBITDA\(^3\) earned by the borrower in the return period,

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\(^2\) A country may choose the ratio or a combination of ratio approaches that best serves them.

\(^3\) Earnings before interest, taxes, depreciation, and amortization
b. [and/or] the amount of interest that exceeds x% of operating profit earned by the borrower in the return period.

4. Debt shall be treated as issued by an associated enterprise where it is issued by a lender that is not associated, and either a) an associated enterprise provides an implicit or explicit guarantee to the lender or b) an associated enterprise deposits a corresponding and matching amount of funds with the lender.

D. Alternative version (Para 1 only) for use in cases where the rules are intended to apply to purely domestic loans in addition to cross-border loans.

1. The legislation applies where:
   - a company, or a permanent establishment of a company ("the borrower"),
   - pays interest (or, in the case of a permanent establishment, is attributed interest expense) or similar consideration (including in the form of a discount),
   - that is deductible in its calculation of taxable income,
   - in respect of any form of debt,
   - issued by a person who is an associated enterprise of the borrower, or attributed to a permanent establishment of person resident in [Country].

Definitions

A. Associated Enterprise

Enterprises are associated where one enterprise directly or indirectly controls the other or where both enterprises are directly or indirectly controlled by a third party.

B. Interest

An amount calculated in reference to the time value of money, or which represents the difference between the financial benefits received and given under a financial instrument, and which, if the provisions of this legislation are ignored, is deductible for tax purposes.

C. Debt

Any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other/finance charges that are deductible in the computation of taxable profit.

D. Financial Instrument
Any instruments on which interest or similar payments are made that are allowable as a deduction in a computation of taxable income.
ANNEX 2

Canada Thin Capitalisation Statute

Limitation re deduction of interest by certain corporations

(4) Notwithstanding any other provision of this Act, in computing the income for a taxation year of a corporation resident in Canada from a business or property, no deduction shall be made in respect of that proportion of any amount otherwise deductible in computing its income for the year in respect of interest paid or payable by it on outstanding debts to specified non-residents that

(a) the amount, if any, by which

(i) the average of all amounts each of which is, in respect of a calendar month that ends in the year, the greatest total amount at any time in the month of the corporation’s outstanding debts to specified non-residents,

exceeds

(ii) two times the total of

(A) the retained earnings of the corporation at the beginning of the year, except to the extent that those earnings include retained earnings of any other corporation,

(B) the average of all amounts each of which is the corporation’s contributed surplus at the beginning of a calendar month that ends in the year, to the extent that it was contributed by a specified non-resident shareholder of the corporation, and

(C) the average of all amounts each of which is the corporation’s paid-up capital at the beginning of a calendar month that ends in the year, excluding the paid-up capital in respect of shares of any class of the capital stock of the corporation owned by a person other than a specified non-resident shareholder of the corporation,

(b) the amount determined under subparagraph 18(4)(a)(i) in respect of the corporation for the year.

Marginal note: Definitions

(5) Notwithstanding any other provision of this Act (other than subsection 18(5.1)), in this subsection and subsections 18(4) to 18(6),

“outstanding debts to specified non-residents”
« dettes impayées envers des non-résidents déterminés »

“outstanding debts to specified non-residents” of a corporation at any particular time in a taxation year means

(a) the total of all amounts each of which is an amount outstanding at that time as or on account of a debt or other obligation to pay an amount.
(i) that was payable by the corporation to a person who was, at any time in the year,

(A) a specified non-resident shareholder of the corporation, or

(B) a non-resident person, or a non-resident-owned investment corporation, who was not dealing at arm’s length with a specified shareholder of the corporation, and

(ii) on which any amount in respect of interest paid or payable by the corporation is or would be, but for subsection 18(4), deductible in computing the corporation’s income for the year,

but does not include

(b) an amount outstanding at the particular time as or on account of a debt or other obligation to pay an amount to

(i) a non-resident insurance corporation to the extent that the obligation was, for the non-resident insurance corporation’s taxation year that included the particular time, designated insurance property in respect of an insurance business carried on in Canada through a permanent establishment as defined by regulation, or

(ii) an authorized foreign bank, if the bank uses or holds the obligation at the particular time in its Canadian banking business;

“specified non-resident shareholder”
« actionnaire non-résident déterminé »

“specified non-resident shareholder” of a corporation at any time means a specified shareholder of the corporation who was at that time a non-resident person or a non-resident-owned investment corporation;

“specified shareholder”
« actionnaire déterminé »

“specified shareholder” of a corporation at any time means a person who at that time, either alone or together with persons with whom that person is not dealing at arm’s length, owns

(a) shares of the capital stock of the corporation that give the holders thereof 25% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation, or

(b) shares of the capital stock of the corporation having a fair market value of 25% or more of the fair market value of all of the issued and outstanding shares of the capital stock of the corporation,

and for the purpose of determining whether a particular person is a specified shareholder of a corporation at any time, where the particular person or a person with whom the particular person is not dealing at arm’s length has at that time a right under a contract, in equity or
otherwise, either immediately or in the future and either absolutely or contingently

(c) to, or to acquire, shares in a corporation or to control the voting rights of shares in a
corporation, or

(d) to cause a corporation to redeem, acquire or cancel any of its shares (other than
shares held by the particular person or a person with whom the particular person is not
dealing at arm’s length),

the particular person or the person with whom the particular person is not dealing at arm’s
length, as the case may be, shall be deemed at that time to own the shares referred to in
paragraph (c) and the corporation referred to in paragraph (d) shall be deemed at that time
to have redeemed, acquired or cancelled the shares referred to in paragraph (d), unless the
right is not exercisable at that time because the exercise thereof is contingent on the death,
bankruptcy or permanent disability of an individual.

Marginal note: Person deemed not to be specified shareholder

(5.1) For the purposes of subsections 18(4) to 18(6), where

(a) a particular person would, but for this subsection, be a specified shareholder of a
corporation at any time,

(b) there was in effect at that time an agreement or arrangement under which, on the
satisfaction of a condition or the occurrence of an event that it is reasonable to expect will be
satisfied or will occur, the particular person will cease to be a specified shareholder, and

(c) the purpose for which the particular person became a specified shareholder was the
safeguarding of rights or interests of the particular person or a person with whom the
particular person is not dealing at arm’s length in respect of any indebtedness owing at any
time to the particular person or a person with whom the particular person is not dealing at
arm’s length,

the particular person shall be deemed not to be a specified shareholder of the corporation at that time.

Marginal note: Loans made on condition

(6) Where any loan (in this subsection referred to as the “first loan”) has been made

(a) by a specified non-resident shareholder of a corporation, or

(b) by a non-resident person, or a non-resident-owned investment corporation, who was not
dealing at arm’s length with a specified shareholder of a corporation,

another person on condition that a loan (in this subsection referred to as the “second loan”) be
made by any person to a particular corporation resident in Canada, for the purposes of subsections
18(4) and 18(5), the lesser of

(c) the amount of the first loan, and

(d) the amount of the second loan
shall be deemed to be a debt incurred by the particular corporation to the person who made the first loan.
South Africa Thin Capitalisation Statute

31. Tax payable in respect of international transactions to be based on arm’s length principle.—(1) For the purposes of this section—

“affected transaction” means any transaction, operation, scheme, agreement or understanding where—

(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—

(i) (aa) a person that is a resident; and

(bb) any other person that is not a resident;

(ii) (aa) a person that is not a resident; and

(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii) (aa) a person that is a resident; and

(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or

(iv) (aa) a person that is not a resident; and

(bb) any other person that is a controlled foreign company in relation to any resident,

and those persons are connected persons in relation to one another; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length;

“financial assistance” includes the provision of any—

(a) loan, advance or debt; or

(b) security or guarantee.
(2) Where—

(a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding—

(i) is a term or condition contemplated in paragraph (b) of the definition of “affected transaction”; and

(ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding.

the taxable income or tax payable by any person contemplated in paragraph (b) (ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length.

(3) To the extent that there is a difference between—

(a) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and

(b) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a),

the amount of that difference must, for purposes of subsection (2), be deemed to be a loan that constitutes an affected transaction.

(4) For the purposes of subsection (2), where any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected as contemplated in that subsection in respect of—

(a) the granting of any financial assistance; or

(b) intellectual property as contemplated in the definition of “intellectual property” in section 231 (1) or knowledge,

“connected person” means a connected person as defined in section 1; Provided that the expression “and no shareholder holds the majority voting rights in the company” in paragraph (d) (v) of that definition must be disregarded.
(5) Where any transaction, operation, scheme, agreement or understanding has been entered into between a headquarter company and—

(a) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of financial assistance by that other person to that headquarter company, this section does not apply to so much of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights; or

(b) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance by that headquarter company to that foreign company, this section does not apply to that financial assistance.
United States Thin Capitalisation Statute

161(j) Limitation on deduction for interest on certain indebtedness

(1) Limitation

(A) In general
If this subsection applies to any corporation for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such corporation during such taxable year. The amount disallowed under the preceding sentence shall not exceed the corporation’s excess interest expense for the taxable year.

(B) Disallowed amount carried to succeeding taxable year
Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year and clause (ii) of paragraph (2)(A) shall not apply for purposes of applying this subsection to the amount so treated.

(2) Corporations to which subsection applies

(A) In general
This subsection shall apply to any corporation for any taxable year if—

(i) such corporation has excess interest expense for such taxable year, and

(ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

(B) Excess interest expense

(i) In general For purposes of this subsection, the term “excess interest expense” means the excess (if any) of—

(I) the corporation’s net interest expense, over

(II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii).

(ii) Excess limitation carryforward If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

(iii) Excess limitation For purposes of clause (ii), the term “excess limitation” means the excess (if any) of—

(I) 50 percent of the adjusted taxable income of the corporation, over

(II) the corporation’s net interest expense.

(C) Ratio of debt to equity
For purposes of this paragraph, the term “ratio of debt to equity” means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence—

(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,
(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof), and
(iii) there shall be such other adjustments as the Secretary may by regulations prescribe.

(3) Disqualified interest
For purposes of this subsection, the term “disqualified interest” means—

(A) any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest,
(B) any interest paid or accrued by the taxpayer with respect to any indebtedness to a person who is not a related person if—

(i) there is a disqualified guarantee of such indebtedness, and
(ii) no gross basis tax is imposed by this subtitle with respect to such interest, and
(C) any interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary (as defined in section 856(l)) of a real estate investment trust to such trust.

(4) Related person
For purposes of this subsection—

(A) In general
Except as provided in subparagraph (B), the term “related person” means any person who is related (within the meaning of section 267 (b) or 707 (b)(1)) to the taxpayer.

(B) Special rule for certain partnerships

(i) In general Any interest paid or accrued to a partnership which (without regard to this subparagraph) is a related person shall not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no tax is imposed by this subtitle on such interest. The preceding sentence shall not apply to any interest allocable to any partner in such partnership who is a related person to the taxpayer.

(ii) Special rule where treaty reduction If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on a partner’s share of any interest paid or accrued to a partnership, such partner’s interests in such partnership shall, for purposes of clause (i), be treated as held in part by a tax-exempt person and in part by a taxable person under rules similar to the rules of paragraph (5)(B).

(5) Special rules for determining whether interest is subject to tax
(A) Treatment of pass-thru entities
In the case of any interest paid or accrued to a partnership, the determination of whether any tax is imposed by this subtitle on such interest shall be made at the partner level. Rules similar to the rules of the preceding sentence shall apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(B) Interest treated as tax-exempt to extent of treaty reduction
If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on any interest paid or accrued by the taxpayer, such interest shall be treated as interest on which no tax is imposed by this subtitle to the extent of the same proportion of such interest as—
  (i) the rate of tax imposed without regard to such treaty, reduced by the rate of tax imposed under the treaty, bears to
  (ii) the rate of tax imposed without regard to the treaty.

(6) Other definitions and special rules
For purposes of this subsection—

(A) Adjusted taxable income
The term “adjusted taxable income” means the taxable income of the taxpayer—
  (i) computed without regard to—
    (I) any deduction allowable under this chapter for the net interest expense,
    (II) the amount of any net operating loss deduction under section 172,
    (III) any deduction allowable under section 199, and
    (IV) any deduction allowable for depreciation, amortization, or depletion, and
  (ii) computed with such other adjustments as the Secretary may by regulations prescribe.

(B) Net interest expense
The term “net interest expense” means the excess (if any) of—
  (i) the interest paid or accrued by the taxpayer during the taxable year, over
  (ii) the amount of interest includible in the gross income of such taxpayer for such taxable year.
The Secretary may by regulations provide for adjustments in determining the amount of net interest expense.

(C) Treatment of affiliated group
All members of the same affiliated group (within the meaning of section 1504 (a)) shall be treated as 1 taxpayer.

(D) Disqualified guarantee
  (i) In general Except as provided in clause (ii), the term “disqualified guarantee” means any guarantee by a related person which is—
    (I) an organization exempt from taxation under this subtitle, or
    (II) a foreign person.
  (ii) Exceptions The term “disqualified guarantee” shall not include a guarantee—
(I) in any circumstances identified by the Secretary by regulation, where the interest on the indebtedness would have been subject to a net basis tax if the interest had been paid to the guarantor, or
(II) if the taxpayer owns a controlling interest in the guarantor.

For purposes of subclause (II), except as provided in regulations, the term “a controlling interest” means direct or indirect ownership of at least 80 percent of the total voting power and value of all classes of stock of a corporation, or 80 percent of the profit and capital interests in any other entity. For purposes of the preceding sentence, the rules of paragraphs (1) and (5) of section 267(c) shall apply; except that such rules shall also apply to interest in entities other than corporations.
(iii) Guarantee Except as provided in regulations, the term “guarantee” includes any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person’s obligation under any indebtedness.

(E) Gross basis and net basis taxation
(i) Gross basis tax The term “gross basis tax” means any tax imposed by this subtitle which is determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by this subtitle.
(ii) Net basis tax The term “net basis tax” means any tax imposed by this subtitle which is not a gross basis tax.

(7) Coordination with passive loss rules, etc.
This subsection shall be applied before sections 465 and 469.

(8) Treatment of corporate partners
Except to the extent provided by regulations, in applying this subsection to a corporation which owns (directly or indirectly) an interest in a partnership—
(A) such corporation’s distributive share of interest income paid or accrued to such partnership shall be treated as interest income paid or accrued to such corporation,
(B) such corporation’s distributive share of interest paid or accrued by such partnership shall be treated as interest paid or accrued by such corporation, and
(C) such corporation’s share of the liabilities of such partnership shall be treated as liabilities of such corporation.

(9) Regulations
The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including—
(A) such regulations as may be appropriate to prevent the avoidance of the purposes of this subsection,
(B) regulations providing such adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of this subsection,
(C) regulations for the coordination of this subsection with section 884, and
(D) regulations providing for the reallocation of shares of partnership indebtedness, or distributive shares of the partnership’s interest income or interest expense.
## Chapter IX Administration of Thin Capitalisation

### Article 85
The interest expenditures which shall not be deducted at the time of computing the amount of taxable income as mentioned in Article 46 of the EITL shall be computed according to the following formula:

Non-deductible interest expenditures = annual actual interest paid to all affiliates \times (1 - \text{standard ratio} / \text{affiliated debt-equity investment ratio})

In the formula above, the term “standard ratio” refers to the ratio as prescribed in the Notice of the Ministry of Finance and the State Administration of Taxation on the Tax Policy Issues concerning the Criteria for Pre-tax Deduction of Interest Expenditures to Affiliates (No. 121 [2008] of the Ministry of Finance).

The term “affiliated debt-equity investment ratio” refers to the ratio of the debt investments received by an enterprise from all of its affiliates (hereinafter referred to as the affiliated debt investments) to the equity investments received by the enterprise (hereinafter referred to as the equity investments) according to Article 46 of the EITL and Article 119 of RIEITL. The affiliated debt investments shall include the debt investments for which the affiliates provide guaranties in various forms.

### Article 86
The affiliated debt-equity investment ratio shall be calculated as follows:

Affiliated debt-equity investment ratio = annual sum of monthly average affiliated debt investments / annual sum of monthly average equity investments

Monthly average affiliated debt investments = (book balance of affiliated debt investments at the beginning of a month + book balance of affiliated debt investments at the end of the month) / 2

Monthly average equity investments = (book balance of equity investments at the beginning of a month + book balance of equity investments at the end of the month) / 2

The equity investments shall be the owner’s equity as shown in the balance sheet of an enterprise. If the owner’s equity is less than the sum of paid-in capital (capital stock) and capital reserves, the equity investments shall be the sum of paid-in capital (capital stock) and capital reserves; if the sum of paid-in capital (capital stock) and capital reserves is less than the paid-in capital (capital stock), the equity investments shall be the paid-in capital (capital stock).

### Article 87
The interest expenditures as mentioned in Article 46 of the EITL shall include the actually paid interest, guarantee fees, mortgage fees and other costs of an interest nature in relation to directly or indirectly affiliated debt investments.

### Article 88
The interest expenditures which shall not be deducted from the taxable income under Article 46 of the EITL shall not be carried forward to the following taxable year. The interest
expenditures shall be allocated among all the affiliates according to the ratio of the actual interest paid to each affiliate and the total interest paid to all the affiliates. For interest that is allocated to a domestic affiliate with an actual tax burden higher than that of the enterprise, a deduction shall be allowed. The actual interest directly or indirectly paid to an overseas affiliate shall be deemed as distributed dividends, and enterprise income tax shall be levied based on the difference between the income tax rates applicable to dividend and interest. If the amount of income tax that has been withheld exceeds the amount of income tax calculated as per dividend, there shall be no tax refund for the excess.

**Article 89** If the affiliated debt-equity investment ratio of an enterprise exceeds the standard ratio and the enterprise intends to deduct the interest expenditures for the excessive part when computing the taxable income, the enterprise shall, in addition to complying with the provisions on Chapter III of these Measures, prepare, keep, and submit as required by the taxation organ the following contemporaneous documentation to prove that the affiliated debt investments comply with the arm’s-length principle in terms of amount, interest rate, term, financing conditions, affiliated debt-equity investment ratio, etc.:

1. An analysis of the solvency and borrowing capacity of the enterprise;
2. An analysis of the borrowing capacity and financing structure of the enterprise group;
3. Descriptions about the changes of equity investments, such as the enterprise’s registered capital;
4. The natures and purposes of affiliated debt investments and the market situations at the time of receiving them;
5. The types of currency, amounts, interest rates and terms of and the financing conditions for affiliated debt investments;
6. The status of collaterals provided by the enterprise and the conditions for the provision thereof;
7. The status of guarantors and the conditions for the provision of guaranties;
8. The information on the interest rate of and financing conditions for a loan of the same type and over the same period;
9. The conversion conditions for convertible corporate bonds; and
10. Other data that may prove compliance with the arm’s-length principle.

**Article 90** If an enterprise fails to prepare, keep and submit as required by the taxation organ the contemporaneous documentation to prove that the affiliated debt investments comply with the arm’s-length principle in terms of amount, interest rate, term, financing conditions, affiliated debt-equity investment ratio, etc., the interest expenditures for the part in excess of the standard ratio shall not be deducted at the time of computing the taxable income.

**Article 91** The term “actual interest paid” as mentioned in this Chapter refers to the interest included by an enterprise in the relevant costs or expenses on an accrual basis.

If there is any transfer pricing issue on the interest actually paid by an enterprise to its affiliates, the taxation organ shall first conduct the transfer pricing investigation and adjustments according to the relevant provisions of Chapter V of these Measures.
152 Arm's length provision where actual provision relates to securities

(1) This section applies where—

   (a) both of the affected persons are companies, and

   (b) the actual provision is provision in relation to a security issued by one of those companies ("the issuing company").

(2) Section 147(1)(d) is to be read as requiring account to be taken of all factors, including—

   (a) the question whether the loan would have been made at all in the absence of the special relationship,

   (b) the amount which the loan would have been in the absence of the special relationship, and

   (c) the rate of interest and other terms which would have been agreed in the absence of the special relationship.

(3) Subsection (2) has effect subject to subsections (4) and (5).

(4) If—

   (a) a company ("L") makes a loan to another company with which it has a special relationship, and

   (b) it is not part of L's business to make loans generally,

       the fact that it is not part of L's business to make loans generally is to be disregarded in applying subsection (2).

(5) Section 147(1)(d) is to be read as requiring that, in the determination of any of the matters mentioned in subsection (6), no account is to be taken of (or of any inference capable of being drawn from) any guarantee provided by a company with which the issuing company has a participatory relationship.

(6) The matters are—

   (a) the appropriate level or extent of the issuing company's overall indebtedness,

   (b) whether it might be expected that the issuing company and a particular person would have become parties to a transaction involving—

       (i) the issue of a security by the issuing company, or
(ii) the making of a loan, or a loan of a particular amount, to the issuing company, and

(c) the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.

**153 Arm's length provision where security issued and guarantee given**

(1) This section applies where the actual provision is made or imposed by means of a series of transactions which include—

(a) the issuing of a security by a company which is one of the affected persons (“the issuing company”), and

(b) the provision of a guarantee by a company which is the other affected person.

(2) Section 147(1)(d) is to be read as requiring account to be taken of all factors, including—

(a) the question whether the guarantee would have been provided at all in the absence of the special relationship,

(b) the amount that would have been guaranteed in the absence of the special relationship, and

(c) the consideration for the guarantee and other terms which would have been agreed in the absence of the special relationship.

(3) Subsection (2) has effect subject to subsections (4) and (5).

(4) If—

(a) a company (“G”) provides a guarantee in respect of another company with which it has a special relationship, and

(b) it is not part of G’s business to provide guarantees generally,

the fact that it is not part of G’s business to provide guarantees generally is to be disregarded in applying subsection (2).

(5) Section 147(1)(d) is to be read as requiring that, in the determination of any of the matters mentioned in subsection (6), no account is to be taken of (or of any inference capable of being drawn from) any guarantee provided by a company with which the issuing company has a participatory relationship.

(6) The matters are—
(a) the appropriate level or extent of the issuing company's overall indebtedness,
(b) whether it might be expected that the issuing company and a particular person would have become parties to a transaction involving—
   (i) the issue of a security by the issuing company, or
   (ii) the making of a loan, or a loan of a particular amount, to the issuing company, and
(c) the rate of interest and other terms that might be expected to be applicable in any particular case to such a transaction.