

Legal Risks and Regulating Suggestions on Cross-border Tax Avoidance: Using Thin Capitalization As a Starting Point

Mingmin Kong^{1, *}

¹ School of Humanity and Law, Shanghai Business School, 201400, Shanghai, China

* Corresponding Author Email: 20454040116@stu.sbs.edu.cn

Abstract. With the integration of the global economy and the rising volume of international transactions, tax avoidance by MNCs poses a huge challenge to the global economy. Thin capitalization by MNCs creates serious tax base erosion and profit shifting for host countries and is a tax avoidance tool that cannot be ignored. This paper focuses on the present legal risks of thin capitalization and thus proposes recommendations for improving the legal regulation of tax avoidance by MNCs. Firstly, this paper introduces the concept of thin capitalization and analyses the impact of capital weakening by MNCs as a tax avoidance tool on the host country, revealing that thin capitalization by MNCs can have significant adverse effects on the host country. Secondly, the paper then looks at international law and the tax laws of China, the UK and Germany. The analysis concludes that international tax treaties are effective in regulating thin capitalization by MNCs. This paper analyses the advantages of international tax treaties and shows their importance. Finally, this paper makes suggestions for improving international tax cooperation based on the importance of international tax treaties as analyzed in the previous section. This paper proposes that the improvement of the BEPS MLI may start with setting a time limit on treaty reservations, strengthening the tax administration systems of economically underdeveloped countries and regions, and encouraging developing countries to actively participate in international tax cooperation.

Keywords: Tax avoidance; Thin capitalization; BEPS MLI; Multinational corporations.

1. Introduction

With the increasingly frequent international transactions, the role multinational corporations played in driving international economic development becomes more and more prominent. Meanwhile, a wide range of tax avoidance practices in multinational corporations have brought great challenges for tax authorities in each country. Among various tax avoidance practices, thin capitalization is relatively serious.

In the study of international tax law, there are two academically recognized regulative objects. One is international tax allocation relationships, the other is the taxation relationship between national tax authorities and foreign taxable entities. Therefore, this paper considers two former regulative objective and gives respective analyses. OECD report on base erosion and profit shifting contributes to the first regulative object, which is international tax allocation relationships. In terms of the second regulative object, here are two factors conflicting. One factor is that the tax authorities in each of the countries spare no effort to prevent tax losses. Another factor is that multinational corporations possess foreign characteristic, hence they are subject to both a country's domestic tax law and international tax agreements. Multinational corporations' tax avoidance inevitably occurs when conflicting law in international tax agreements refers to foreign tax laws. Companies are all profit-driven, by comparing high and low tax rates between different countries, they will use international tax agreement to avoid tax.

This paper is divided into 5 sections. Section 2 examines how multinational corporations use thin capitalization to implement tax avoidance and several anti-tax avoidance rules introduced by many countries. In order to close the legal loopholes of current tax law, section 3 also compares China's tax law to other countries' tax laws, such as UK and German. Finally, this paper comes up with some reasonable suggestions on regulation of tax avoidance by multinational corporations in section 4. Those analyses and suggestions may have positive and important significance for both global and China's anti-tax avoidance.

2. An Overview of Thin Capitalization

2.1. The Concept of Thin Capitalization

Thin capitalization is a type of tax avoidance that multinational corporations purposefully lower the capital ratio and increase the debt ratio. In this way, they reduce the proportion of capital financing and increase the proportion of debt. Due to the tax law, the interest generated according to the debt can be deducted before tax, so as to achieve the purpose of tax avoidance by multinational corporations. If multinational corporations finance their capital legally, the dividends are not considered as interest. Therefore, the dividends have to be taxed twice, respectively taxed by Corporation Income Tax Law and Individual Income Tax Law. Take China's tax law as an example, a multinational corporation shall pay enterprise tax on its' dividends at a rate of 25 per cent according to the Law of the PRC on Enterprise Income Tax [1]. Then the taxed dividends shall be taxed again according to the Individual Income Tax Law of the PRC (Revised in 2018) at a rate between 5 to 45 per cent [2]. If shareholders of that multinational corporation funding their business instead of financing capital, they save 25 per cent of tax.

2.2. The Impact on Host Countries

Firstly, it is clear that thin capitalization would result in a significant loss of tax revenues in host country. For multinational corporations, through the form of debt capital repayment and interest payment, most of the profits of the subsidiaries of multinational corporations in the host country are transferred overseas, and this part of the interest cannot be taxed by the tax authorities of the host country, so this part of the interest can only go abroad. In the long run, multinational corporations will maliciously avoid more and more taxes in the host country, and it is well known that in modern society, taxation is one of the main sources of fiscal revenue of any country. Multinational corporations often have strong financial resources, and as the host country lacks this tax, it will bring great harm to the host country's economy.

Secondly, if the host country fails to effectively regulate the thin capitalization of multinational corporations, it will not only infringe the legitimate rights and interests of third-party creditors, but also discourage foreign investment in host country. Since multinational corporations that have adopted thin capitalization tax avoidance have set a bad example, multinational corporations that have not adopted thin capitalization will wait, and once they found that the tax authorities of the host country cannot effectively regulate thin capitalization, then the multinational corporations have not adopted thin capitalization will inevitably imitate and adopt thin capital tax avoidance. As multinational corporations become increasingly indebted and replenished capital levels are declining, they are likely to become an empty shell to the detriment of other third-party creditors.

Thirdly, once the behavior of thin capitalization of multinational corporations is rampant, it will cause serious harm to the market order of the host country. Due to the proliferation of thin capitalization, the tax authorities of the host country will certainly crack down on thin capitalization, such as adopting the fixed proportion method. Although that method can limit the real dilution behavior to a certain extent, it also cracks down on multinational corporations that have a debt-to-capital ratio exceeding the tax law of the host country due to other business reasons. Crackdown on such multinational corporations that take the behavior of thin capitalization without purpose is also very harmful to the normal market order.

2.3. Ways of Regulating Thin Capitalization

This paper lists two main ways of regulating thin capitalization.

The first one is fixed proportion method. The fixed ratio method is to limit the ratio of debt capital to equity capital in taxation, if the ratio of corporate debt to equity capital exceeds the fixed ratio stipulated by the tax law, the interest on debt exceeding the fixed ratio is not allowed to be deducted before tax, and the excess debt interest is treated as dividends and subject to income tax. This method

is known as a safe harbor in tax law terms, and it means that it is safe and tax-free inside the port before tax deduction, and it is unsafe and taxable outside the port.

The other one is arm's length principle. This method aims to judge whether the related party has the same condition as the non-related party when multinational corporations face a loan or offer fund. If there exists a discrepancy, the loan of the related party may be regarded as a hidden offering, and interest shall be taxed in accordance with the relevant laws and regulations.

3. The Law of Thin Capitalization at the International Level

3.1. International Agreements

For the international supervision of tax avoidance by multinational companies, emphasis should be placed on tax treaties as a legal basis. The obligation to exchange tax information is assumed by the States parties to the tax treaties. Tax treaties are also an important means of cooperation between national tax authorities to prevent and restrain tax avoidance by multinational corporations [3].

The *Model Convention with Respect to Taxes on Income and on Capital* of OECD (the Model Tax Convention) is an important international agreement that guides the exchange of the collection of tax revenues around the world. The main features of the Model Tax Convention include: progressively remove the technical barriers to the exchange of information in order to facilitate a wider and more effective exchange of tax information on a global basis; Clarify the exceptions, the limitations on tax information exchange, and the scope and use of the Model Convention to prevent abuse of these exceptions; make the exchange of tax information become more proactive and automatic; increase the attention paid to the protection of taxpayers' rights, etc [4]. In addition to the Model Tax Convention, tax treaties which involve the exchange of tax information also have The *UN Model Double Taxation Convention between Developed and Developing Countries* (the UN Model), *United States Model Income Tax Convention*.

At the St. Petersburg summit in September 2013, G20 leaders agreed to implement Base Erosion and Profit Shifting (the BEPS Project). They commissioned OECD to lead BEPS Project. The fifteenth BEPS Action Plan proposes the development of multilateral instruments to revise existing bilateral tax treaties. To this end, the OECD set up a special working group to draft *The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the BEPS MLI). To date, 100 countries and jurisdictions have joined the BEPS MLI [5]. The BEPS MLI entered into force for China on September 1, 2022, it has been used to amend the 47 bilateral tax treaties China has signed and has significantly affected the implementation and interpretation of tax treaties and the negotiation of new tax treaties [6].

In order to safeguard the interests of developing countries or economically underdeveloped areas and to reduce the risk of conflicts of interest between countries, the BEPS project established an ad hoc Group, this ad hoc Group is open to any country or region and responsible for formulating the BEPS MLI [7]. The ad hoc Group has placed several explicit restrictions on the scope of the provisions of the BEPS MLI that may be reserved and applied by the contracting parties, thereby attempting to limit to some extent the freedom owned by the Parties. Firstly, the BEPS MIL does not allow for universal treaty reservations, the second is that only limitations on scope of reservations are allowed [8]. To be specific, not all provisions are reservable, and the BEPS MLI is clear about those that are. Besides, the BEPS MLI allows the contracting parties to withdraw reservations or reduce the scope of reservations at any time and prohibit the parties from extending the scope and extent of reservations.

3.2. China's Domestic Tax Law

The emergence of thin capitalization regulation in China was relatively late, and there was no relevant legal regulation specifically designed to regulate thin capitalization until the *Enterprise Income Tax Law*. There are two reasons for this: on the one hand, our legislative techniques for taxation are still inadequate. On the other hand, due to the rapid development of our economy until

some years ago, the number of multinational companies has proliferated and the danger of thin capitalization for national tax revenues has become increasingly prominent, so that until now there was no direct and specific legislation to regulate thin capitalization.

The legal regulations relating to China's tax law are rather fragmented. They are mainly distributed in *Law of the PRC on Enterprise Income Tax*, *Regulations on the Implementation of Enterprise Income Tax Law of PRC*, *Standard for Pre-tax Deduction of Interest Expenses of Related Parties of Enterprises Notice on Tax Policy Issues*, *Individual Income Tax Law of the PRC* and *Law of the PRC on the Administration of Tax Collection*.

Some scholars have divided China's legal regulatory rules on capital weakness into two categories: indirect regulatory rules and direct regulatory rules [9]. The criterion for classification is whether the rule is intentional: if it is a rule specifically created for thin capitalization, then it is a direct regulatory rule; if it is an indirect regulatory rule, then it is the rule that inadvertently restrains to thin capitalization.

China has set up thin capitalization regulation provisions in the *Enterprise Income Tax Law* firstly.

In accordance with the legislative aims of *Law of the PRC on the Administration of Tax Collection*, this law has been formulated to strengthen the administration and supervision of tax collection, guarantee the tax revenue of the country and protect the legitimate rights of taxpayers.

3.3. UK's Tax Law

The scope of the UK thin capitalization rules has been part of the UK transfer pricing rules since 1 April 2004 [10]. The UK does not have safe harbour rules relating to the amount of debt or interest (or equivalent). Therefore, HM Revenue & Customs (HMRC)'s assessment of a company's use of thin capitalization as a tax avoidance technique must be based on the company's specific circumstances [11]. HMRC is taking a closer look at the arm's-length nature of interest rates applied when taxpayers lend and borrow [12]. HMRC requires taxpayers to assess for themselves whether they are complying with the the arm's-length principle [11].

3.4. Germany Tax Law

The legal regulation of thin capitalization was introduced earlier in Germany, the first explicit rule of thin capitalization was legislated in 1993 and came into force in January 1994 [13]. At first, the thin capitalization rules were only aimed at internal debt in MNCs. But after a large tax reform in 2008, the thin capitalization rules may apply to the use of external debt [14]. The German thin capitalization rules use a combination of the safe harbour rules and the arm's-length principle.

4. Suggestions for Regulating Thin Capitalization

Since it is well known that the exchange of information on tax collection is essential for the tax authorities of each country, this paper includes emphasizing the improvement of multilateral cooperation and the tax collection and administration system. The paper also recommends the strengthening of the overall skills of tax officials. In addition, this paper is trying to find out whether it is appropriate to increase tax transparency or not.

4.1. Improvement of the BEPS MLI

Firstly, the BEPS MLI should serve as a substantive tool of multilateralism, and it is generally agreed that the creation of the tool should focus on achieving the goal of "multilateralism" [8]. Although the BEPS MLI is innovative in its scope of subject, not only states but also non-state jurisdictions, such as Hong Kong, China and Macao, China, can become parties. However, in order to comply with the principle of the sovereign independence of national taxation, states remain the main actor in global tax management, they have a crucial role to play in their participation in global tax governance. Therefore, the BEPS project can only contribute to the widespread and universal nature of its governance if it is recognized and accepted by as many countries as possible [8].

Secondly, due to the BEPS MLI adopts a treaty-reservable regime, which makes a difference to the rules that each country chooses to apply to the BEPS MLI, the result is the existence of various bilateral agreements between contracting countries. So the undermining of the integrity of the BEPS MLI has greatly increased the difficulty of implementing the BEPS project [8]. For this reason, there are also many countries or regions that are hesitant to become party to the BEPS MLI and have not yet done so. In addition, multinational corporations are able to avoid tax through thin capitalization by avail themselves of the loopholes in tax treaties. So if the BEPS MLI allows for treaty reservations, there will still be many different bilateral treaties that will continue to allow multinationals to avoid tax [15]. But there is no denying that conflicts of interest between countries are a constant dilemma and this is a challenge for the BEPS MLI.

To address the above shortcomings, this paper comes up with the following suggestion. Although it was mentioned earlier that the ad hoc Group has defined the scope of reservations to treaties and limitations on scope of reservations. In the long-term interests, the parties to the BEPS MLI should gradually reduce the number of provisions reserved over time, rather than giving contracting parties the right to retain provisions for a long period. It is certainly unrealistic to suddenly prohibit the retention of provisions that would lead to tax confusion and harm the tax revenues of some countries or multinational corporations. But if it is a question of giving contracting parties some time to adjust their own tax administration within their countries or regions. The BEPS MLI may facilitate the process of allowing the contracting parties to reduce the scope of the reservation clause. In this way, the integrity of the BEPS MLI Treaty can be slowly restored.

4.2. Promotion of Tax Collection and Management System in Developing Countries and Undeveloped Areas

As conflicts of interest between countries are a constant dilemma, developing countries and economically underdeveloped areas may be reluctant to enter into tax agreements for fear that their interests will be captured by developed countries. This makes it all the more important to promote a national consensus that countries, especially developing countries should improve tax collection and management system, and developed countries may help train tax officials from developing countries. Because of the complexity of the areas involved in thin capitalization, developed and developing countries should be encouraged to build a platform for exchange and dialogue to teach anti-avoidance of capital weakening. Those who are taught the relevant knowledge are then passed on to university students, creating a fully trained pool of professionals specializing in multinational tax avoidance.

The reporting obligations of MNCs is also essential for improving tax collection and management system. Increasing tax transparency has been controversial in both academic and practical circles. This paper recommends increasing the tax transparency of multinational corporations' reporting obligations. Because tax transparency is the price to pay for improving international tax cooperation [16]. But there's an academic point out its drawbacks, increased disclosure by tax authorities inevitably leads to audit pressure and increased compliance costs for multinational corporations, so this proposal remains to be seen [17].

5. Summary

By investigating relevant international tax agreements of thin capitalization, this paper summarizes and analyzes the legal risks of tax agreements in detail. This paper starts with an overview of thin capitalization, introduces the concept of thin capitalization, how it operates to avoid tax This paper lists and analyzes China's anti-tax avoidance laws in depth, and also compares the differences with those of UK and German. This paper also reveals the current level of international anti-tax avoidance development by researching international regulations, such as the *Model Tax Convention* and the BEPS MLI, the author discusses the difficulties and problems encountered in the implementation of anti-tax avoidance.

Based on the above analysis, this paper raises the difficulty in the face of multilateral tax treaties that the reservable treaty regime undermines the integrity of the BEPS MLI, as the reservable treaty regime results in different bilateral agreements remaining between contracting countries, which may still allow multinational corporations to achieve thin capitalization and ultimately avoid tax. This paper comes up with several suggestions from different perspectives such as strengthen international anti-tax avoidance cooperation by improving the BEPS MLI and promote tax collection and management system in developing countries and undeveloped areas. A more concrete approach would be to attach deadlines to “treaty reservations”, to gradually reduce the scope of the treaties to which the contracting parties have reservations, and to increase the number of countries joining the BEPS MLI by improving the overall quality of tax practitioners in developing countries.

This paper has not sufficiently discussed the forms of thin capitalization used by MNCs and only combed through the tax laws of three countries, this paper didn’t compare the laws. Future research may focus on strengthening international tax cooperation and improving tax information exchange platforms. This paper suggests exploring more and better ways to promote active participation in international tax agreements by more countries.

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