

Beyond the Interest Barrier: Harmonizing Thin-Cap Rules to Secure European Investment

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Initiative

This science communication project is part of the "Introduction to Science Communication" lecture series within the Topics in Applied Economics course at Ludwig-Maximilians-Universität München (LMU). The initiative investigates the critical tension between statutory CIT rates and the integrity of national tax bases in a globalized economy.

It aims to provide policymakers and economic stakeholders with a clear, evidence-based framework to address **profit shifting through intra-group debt**. By synthesizing complex fiscal regulations like Germany's *"Interest Barrier"* with international standards such as the OECD BEPS project, this initiative seeks to advocate for coordinated EU-wide "thin-cap" rules that prevent capital flight while ensuring tax fairness.

Executive Summary: Beyond the Debt Loophole

The Problem: A New Race to the Bottom

Multinational Enterprises are increasingly utilizing internal debt as a primary channel for profit shifting, moving capital from high-tax affiliates to low-tax jurisdictions. While unilateral measures—such as Germany's "interest barrier" (Zinsschranke)—have successfully reduced debt ratios, they have also created a double-edged sword: increasing the sensitivity of real investment to tax hikes and risking capital flight to neighbors with laxer rules. This lack of coordination has triggered a "new form of competition" where nations relax thin-cap rules to poach mobile capital, ultimately shifting the tax burden onto less mobile national firms.

The Solution: Strength in Coordination

To stabilize the tax base and end this "leaky bucket" era of revenue loss, we propose the **EU-wide coordination of thin-cap rules**. Economic modeling suggests that when countries jointly restrict the deductibility of internal interest, they effectively dampen the most harmful channel of tax competition. Even if nominal rate competition persists, revenues rise for all participating nations due to a significantly broader MNE tax base. This approach not only resolves the unilateral investment dilemma but also aligns perfectly with OECD BEPS efforts to ensure a level playing field for all enterprises.

The Context: A Global Shell Game

The current international tax landscape is less of a level playing field and more of a global shell game. MNEs leverage complex financial structures (transfer pricing for goods and services, Intra-group debts etc.) to ensure profits "evaporate" where they are earned and reappear where they are barely taxed . This systemic leakage is evidenced by three landmark cases:

- **Starbucks (UK):** Despite generating £3 billion in revenue, the company paid just £8.6 million in tax. It achieved this by reporting consecutive losses through 6% royalty payments and intra-group loans carrying "risk premiums" far above market rates. ^{1,2}
- **Apple (Ireland) - The 0.005% Reality:** Through a special regime, Apple's effective profit tax rate plummeted to an almost invisible 0.005%. This was eventually ruled as unlawful state aid, leading to a mandatory €13 billion repayment. ^{3,4}
- **Google (The 'Double Irish'):** By locating intellectual property (patents) in low-tax jurisdictions, billions in royalties were shifted out of high-tax nations. This strategy, often involving a "Dutch Sandwich" of shell companies, moved over \$23 billion annually to tax havens, highlighting the critical need for coordinated rules on royalties and internal debt. ^{5,6}

The evolution of global capital mobility has shifted international tax competition from explicit rate-cutting to structural profit-shifting mechanisms, primarily through intra-group debt. MNEs frequently utilize internal financial structures to deduct interest payments in high-tax jurisdictions while receiving that income in low-tax affiliates, a strategy that significantly erodes national tax bases . Empirical evidence from cases like Starbucks' use of intra-group loans with high risk premiums and Apple's historically low effective profit tax rates underscores the scale of this revenue leakage.

Unilateral responses to this challenge, such as Germany's 2008 interest barrier, illustrate a critical policy trade-off. While these measures effectively reduce debt ratios, they also heighten the investment sensitivity previously noted, potentially driving mobile capital to jurisdictions with laxer thin-capitalization rules . This dynamic fosters a regulatory race where nations use leniency to poach foreign direct investment, ultimately shifting the tax burden onto less mobile domestic firms.

Company	Financial Data	Shifting Method	Result / Sanction
Starbucks	£ 3 Billion in Revenue / £ 8.6 Million in Taxes	6% royalty payments and intergroup loans with high risk premiums	Very low tax payment
Apple	0.005% Effective Tax Rate	Special Tax Regime (Illegal State Aid)	€13 Billion Reimbursement Decision
Google	\$23 Billion in Annual Transfers	Moving intellectual property to low-tax areas (Dutch Sandwich)	Large-scale base erosion

Table 1.0: Selected Case Studies of Corporate Profit Shifting through Intra-group Transfers.

¹ Reuters (2012). *Special Report: How Starbucks avoids UK taxes.* ² UK House of Commons (2012). *Committee of Public Accounts: Tax avoidance—MNCs.* ³ European Commission (2016). *State aid: Commission decides Ireland gave illegal tax benefits to Apple.* ⁴ The Guardian (2016). *Apple's 0.005% tax rate in Ireland: The EU ruling.* ⁵ Reuters (2019). *Google moved \$23 billion to tax haven Bermuda in 2017.* ⁶ IMF Working Paper (2018). *Piercing the Veil: Tax Haven Activity by Multinational Enterprises.*

Evidence: The German Case and the Cost of Unilateralism

The German Tax Reform of 2008 serves as a pivotal case study for the effects of anti-shifting measures. The reform cut the statutory CIT from 25% to 15%, bringing the average profit tax to approximately 30%. To compensate for this revenue loss, the government introduced the interest barrier, limiting interest deductibility to 30% of EBITDA. ⁷

Empirical data reveals a complex outcome: while debt ratios of affiliates in high-tax Germany were successfully reduced, the restricted profit-shifting opportunities made real investment significantly more sensitive to tax increases. ^{7,8} This creates a policy trade-off: strict anti-shifting rules can deter the very foreign investment they aim to tax fairly. Without international coordination, unilateral measures risk shifting capital to jurisdictions with lax thin-cap rules, as seen in the 2002 policy shift in Ireland.

Criterion	Pre-Reform / Situation	Post-Reformation / Impact
Statutory Corporate Income Tax (CIT)	25%	15%
Average Profit Tax	-	About 30%
Interest Rate Barrier (Zinsschranke)	No restrictions	Limited to 30% of EBITDA.
Positive Impact	-	Successful reduction in affiliates' debt.
Risk / Side Effect	Low tax sensitivity	Increased sensitivity of investments to tax increases.

Table 2.0: The Impact of the 2008 German Tax Reform on Statutory Rates and Interest Deductibility.

⁷ Buslei, H., & Simmler, M. (2012). *The Impact of the German Interest Barrier on Corporate Financial Structure*. DIW Berlin. ⁸ OECD (2023). *Tax Policy Reforms: Germany*. OECD Publishing, Paris.

Key Insight: The Coordination Paradox and Base Integrity

Fix the base to end the race: Strategic coordination is the only antidote to systemic profit shifting.

The fundamental challenge in modern fiscal policy is that multinational capital demand is significantly more tax-elastic than that of domestic firms. When nations act in isolation, they fall into a "regulatory trap": tightening anti-shifting rules unilaterally can inadvertently increase the capital volatility, driving mobile capital toward neighbors with more lenient regimes. This creates a destructive cycle of regulatory poaching where countries use regulatory loopholes rather than just nominal rates to attract investment.

However, economic modeling reveals a strategic solution: **Partial Coordination**. If EU member states jointly restrict the deductibility of internal interest, they effectively secure the collective European tax base. Even if countries continue to compete on nominal tax rates, the resulting broader tax base for all participating nations ensures that total tax revenues rise. Thus, the path to fiscal stability lies not in individual protectionism, but in the strategic synchronization of thin-cap rules to eliminate the profit-shifting channel entirely.

Strategic Recommendation: Harmonized Base-Protection Standard (HBPS)

To effectively neutralize the systemic revenue loss without triggering capital flight, the European Union must transition from the current patchwork of unilateral "interest barriers" toward a **Harmonized Base-Protection Standard**. This approach shifts the focus from competing through regulatory leniency—such as the recent policy shifts in Ireland—toward a unified restriction on internal interest deductibility across all member states. By synchronizing these thin-cap rules, the EU can effectively decouple the integrity of the national tax base from the volatility of nominal rate competition. This recommendation ensures that while nations retain sovereignty over their statutory rates, the most pervasive channel for profit shifting—intra-group debt—is structurally closed, leading to a significantly broader tax base for all participating economies. Ultimately, this collective safeguard levels the playing field, ensuring that multinational enterprises contribute fairly alongside less mobile domestic firms.

Implementation Roadmap: The HBPS Framework

- **Metric Standardization:** Define a uniform 30% EBITDA limit on interest deductibility as the mandatory baseline for all member states, utilizing the German interest barrier as a proven structural model for reducing MNE debt ratios.
- **Regulatory Harmonization:** Mandate the removal of intra-EU exemptions for credit relations to close the loophole that currently allows nations to "poach" mobile capital through regulatory leniency.
- **Global Integration:** Synchronize the HBPS with the OECD BEPS Action Plan to ensure that European base-protection measures remain fully compatible with international transparency standards.

Transitioning from fragmented national defenses to a unified European fiscal shield is essential to halt the "race to the bottom". Securing the integrity of the tax base through coordination is the only way to ensure that the tax burden does not fall disproportionately on less mobile domestic firms while multinational enterprises continue to leverage complex shifting strategies.