The Interest Limitation Rule of the Anti-Tax Avoidance Directive

Cross-Border Elements and Restrictions on the Freedom of Establishment

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### ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>ATAD</td>
<td>Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market</td>
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<td>BEPS</td>
<td>Base Erosion and Profit Shifting</td>
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<td>CFC</td>
<td>Controlled Foreign Company</td>
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<tr>
<td>CJEU</td>
<td>Court of Justice of the European Union</td>
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<tr>
<td>EBC</td>
<td>Exceeding Borrowing Costs, as defined in subparagraphs 1 and 2 of Article 2 of the ATAD (discussed and explained in chapter 4.2.1).</td>
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<tr>
<td>EBIDTA</td>
<td>Earnings Before Interest, Tax, Depreciations and Amortisations (financial performance proxy for companies, discussed and explained in chapter 4.2.3).</td>
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<tr>
<td>EU</td>
<td>The European Union</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>MNE</td>
<td>Multinational Enterprise</td>
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<td>TEU</td>
<td>Treaty on the European Union</td>
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<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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1 Introduction

In July 2016 the Council of the European Union adopted Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the “ATAD”). The ATAD contains four specific anti-abuse measures against common forms of aggressive tax planning, a CFC-rule (Articles 7-8), an exit-taxation rule (Article 5), a rule against hybrid mismatches (Article 9) and a rule that limits interest deduction (Article 4). Furthermore the ATAD contains a general anti-avoidance rule (Article 6). This thesis will discuss and analyse the rule on interest limitation in Article 4. The main objective is to describe the mechanics of the rule and to illustrate its potential effects using made-up examples. Furthermore the thesis will critically analyse important cross-border elements of the rule and if they constitute as a restriction on the freedom of establishment, cf. Article 49 of TFEU.

The thesis will be structured accordingly; in the first section important methodological issues will be discussed, i.e. the hierarchy of norms in EU law (Chapter 2) and how the ATAD shall be transposed into domestic laws of member states (Chapter 3). In the second section the interest limitation rule of Article 4 of the ATAD will be analysed. The rule’s objective will be described and the mechanics of it explained, using a conventional legal method (Chapter 4) followed by a chapter which gives made-up examples on the application of the rule (Chapter 5). In the third section the author will make an attempt at testing the rule against the freedom of establishment, enshrined in Article 49 of TFEU, a principle of primary EU law, while illustrating a hypothetical example of how the rule may work differently in domestic and cross-border situations (Chapter 6). Finally in the third section the main conclusions and critique will be summarised (Chapter 7).

2 Hierarchy of norms in EU law

The treaties of the EU, the TEU, TFEU and the Charter of Rights, sit at the top of the hierarchy of norms in the EU. Accordingly any legislative act must be made pursuant to a treaty Article.¹ The CJEU has the competence to review the legality

¹ Paul Craig and Gráinne de Búrca, EU Law - Text, Cases and Materials (Sixth edition, Oxford University Press 2015) 111.
of legislative acts passed by the institutions of the EU vis-à-vis third parties and jurisdiction in actions brought before it on grounds of infringement of the treaties. This is clearly stipulated in Article 263 of TFEU. Secondary legislative acts can thus be annulled by the CJEU if they are found to be in violation of the treaties, provided that procedural requirements are met. The treaties can be infringed by going against any of their provisions as amended at any time. This notion is furthermore supported by Article 19(1) TEU which charges the CJEU with the task of ensuring that in the interpretation and application of the treaties the law is observed.

The result of the hierarchy between the rules of the treaties and rules of secondary legislative acts is that any rule of a secondary legislative act must both have a legal basis and also may not infringe the rules and general principles of the treaties. Accordingly the rules of the ATAD, as applies to any directive, must substantively abide by the treaties, including the principle of freedom of establishment, both as a consequence of the principle of the hierarchy of norms but also as a function of the constitutionality of the EU’s legal orders. However, the number of cases where the CJEU has declared secondary legislation in breach of the fundamental freedoms is very low. That might be caused by the fact that challenges brought before the CJEU on such grounds are very scarce, and also because EU rules generally apply equally for all traders within the union and are usually intended to replace restrictions. As far as directives are concerned questions of compatibility with fundamental freedoms are more often raised by national courts in preliminary ruling requests asking rather if a national measure implementing a directive is compatible with the relevant fundamental freedoms. Furthermore, in cases where questions of substantive compatibility of secondary EU law with fundamental freedoms have been raised, the CJEU has strived to rather interpret the secondary law provisions in a manner that conforms to the

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2 The access to court for different categories of persons is discussed in detail in: Craig and de Búrca (n 1) 507–533.
3 Cf. Craig and de Búrca (n 1) 544–545.
4 Craig and de Búrca (n 1) 550.
5 Rita Szudoczy, The Sources of EU Law and Their Relationships: Lessons for the Field of Taxation (IBFD 2014) 717.
6 Szudoczy (n 5) 195.
7 Szudoczy (n 5) 195–196.
8 Szudoczy (n 5) 196.
fundamental freedoms to help maintain the secondary act’s validity, rather than declaring it void.\(^9\)

3 Implementation by member states and Direct Effect

Directives adopted under the TFEU need to be implemented into the national legal systems of the member states. Under Article 288 of the TFEU a directive “shall be binding as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods”.\(^{10}\) Directives may thus leave discretionary options for member states and eventual implementation may not be completely uniform, although the aim of the respective directive must be secured in each member state.\(^{11}\)

The ATAD lays down rules to provide a “minimum level of protection” for domestic tax basis, cf. Article 3. However under that same Article it is clear that member states shall maintain discretion to set stricter rules, to achieve a higher level of protection. According to Article 11(1) member states have until 31 December 2018 to adopt the legal measures necessary to comply with the ATAD.

In the absence of proper implementation directives may however have direct legal effect in member states, meaning that individuals should be able to rely on directive provisions.\(^{12}\) However, when directives place burdens on individuals it could be considered rather unlikely that such provisions would be invoked to have direct effect in the absence of proper implementation. However, if a member state does not implement secondary EU legislation it will become subject to enforcement actions by the Commission, as Article 258 of TFEU gives the Commission broad power to bring infringement proceedings against member states before the CJEU.\(^{13}\)

Due to the discretion given to member states to implement different provisions of the ATAD it remains to be seen how exactly the rules of Article 4 on interest limitation will be put in effect. In the subsequent description and analysis of Article 4 any discretionary options left for member states will be discussed, while keeping in mind that the ATAD still gives discretion to member states to have

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\(^9\) Szudoczy (n 5) 720.
\(^{10}\) Craig and de Búrca (n 1) 200–201.
\(^{11}\) Craig and de Búrca (n 1) 201.
\(^{12}\) Craig and de Búrca (n 1) 202–203.
\(^{13}\) Craig and de Búrca (n 1) 429–430.
stricter rules protecting their respective tax bases. When directive provisions grant member states options to either implement a certain provision or not the exercise of such option must comply also with primary EU law, e.g. the fundamental freedoms. In cases where the exercise of the option infringes the freedoms such an infringement would be attributed to the EU if no discretion is left to the member state on how to exercise the option, however, if the member state is afforded discretion to exercise the option in conformity with the freedoms any infringement would be attributed to the respective member state.

4 Article 4 of the ATAD

4.1 The objective of the rule

In Recital 6 to the ATAD it is stated that groups of companies have increasingly shifted profits and eroded tax bases through excessive interest payments and that a rule that limits deductibility of interest payments is therefore necessary to “discourage such practices”. This primary objective of Article 4 of the ATAD matches with the objective of Action 4 of the BEPS-project. Furthermore it is no secret, as it is explicitly stated in the explanatory memorandum that accompanied the initial Commission proposal for the ATAD, that it is a response to the finalisation of the BEPS-project. The main objective is thus to battle tax avoidance through excessive interest payments.

The final report of Action 4 further illustrates the supposed problem of profit shifting through interest payments by enumerating that MNEs have been found to place higher level of third party debt in high-tax countries, generated interest deductions in excess of the group’s actual third party borrowing costs by using intragroup loans and funded generation of tax exempt income by using either third party or intragroup financing. This is a well-known tax planning strategy and has as such been in the limelight of the EU, OECD and different states and

14 Szudoczy (n 5) 385.
15 Szudoczy (n 5) 398.
organisations for some years. The final report of Action 4 accordingly suggests a rule to be adopted in states’ domestic laws that limits the deductibility of interest payments to a certain fixed ratio where the EBIDTA (earnings before interest, taxes, depreciation and amortisation) ratio of the taxpayer is used as the multiplying factor, with some relevant exemptions. As the rule which has now been adopted in the ATAD draws clearly from the best practice approach introduced in the final report of BEPS Action 4 the statements and explanations of said report may shed light on the interpretation and objectives of the corresponding wording of Article 4 of the ATAD.

4.2 The general rule: The 30 percent EBIDTA ratio limit

The opening provision of Article 4(1) of the ATAD reads as follows:

Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 percent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

This lays down the general rule which shall limit the deductibility of interest payments for tax purposes at 30 percent of the taxpayers EBIDTA in each tax period. The rule seems rather straightforward, but some of its terms need further clarification.

4.2.1 Exceeding borrowing costs

Initially the term “exceeding borrowing costs” needs to be defined. This is done explicitly in subparagraphs 1 and 2 of Article 2 of the ATAD. First the term “borrowing costs” is defined in the following manner:

[I]nterest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to, payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with

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18 It is nonetheless important to emphasise that excessive interest payments cannot generally be considered a problem from a BEPS perspective unless those excess interests are indeed being paid cross-border.
19 E.g. a de minimis rule and a group-ratio exemption, as will be discussed below.
20 Will be referred to as ‘EBC’.
the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of fund.

The term is defined in a broad manner and includes any kind of interest, costs which are “economically equivalent to interest” and any expenses incurred in connection with the raising of finance. For the purpose of increased clarity some forms of payments are explicitly mentioned as included in the definition, without limitation. This approach to defining the costs which deductibility is limited is clearly modelled after the proposals put forward as the best practice approach in the final report to BEPS action 4.\(^2\) The reason for this broad approach is that interest may be as such defined in different manners in different legal systems and that will continue to be so. Accordingly the term “borrowing costs” is exclusively defined for the purpose of limiting the deductibility of payments which are interest or economically equivalent to interest, to ensure a coherent approach to tackling the issue at hand. Furthermore the term emphasises economic substance rather than legal definitions of certain payments.\(^2\) The term does not include payments which are not interest or economically equivalent to interest or incurred in connection with the raising of finance, including i) foreign exchange gains on monies note connected with the raising of finance; ii) amounts under derivative instruments which are not related to borrowings, e.g. commodity derivatives; iii) discounts on provisions not related to borrowings; iv) operating lease payments; v) royalties; or vi) accrued interest with respect to a defined pension plan.\(^2\)

The term “exceeding borrowing costs” is defined as follows in subparagraph 2 of Article 2 of the ATAD, with reference to the term “borrowing costs”:

[T]he amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law.

This essentially means that only the deductibility of borrowing costs that cannot be offset by income which constitutes as taxable interest revenues or other economically equivalent taxable received revenues according to national law is limited, i.e. the net borrowing costs of the taxpayer. This approach is also in line with the best practice approach suggested by the final report on BEPS action 4.\(^2\)

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\(^2\) OECD (n 17) 33–35.
\(^2\) OECD (n 17) 33.
\(^2\) OECD (n 17) 34.
\(^2\) OECD (n 17) 42–43.
The reason for suggesting limiting deductibility of net borrowing costs according to the report is that such a rule is better suited to reduce the risk of double taxation, as a “gross rule” could lead to double taxation where each entity would be subject to tax on its full gross interest income while a part of its gross interest expense would be disallowed. Furthermore a “net rule” has no effect on entities which, because of their business, are net interest receivers, e.g. businesses which borrow money to lend on to their customers.

4.2.2 The tax period
According to subparagraph 3 of Article 2 of the ATAD the term “tax period” means a tax year, calendar year or any other appropriate period for tax purposes. Accordingly it may be safely assumed that the determination of a tax period will follow the domestic legislation of each relevant member state, as the case may be.

4.2.3 Determination of the taxpayer’s EBIDTA
EBIDTA is a financial term which stands for “earnings before interest, taxes, depreciation and amortisation”, and is commonly used as an indicator of a company’s financial performance. This indicator strips out the costs of debt capital and taxes by adding interest and taxes back to earnings and neutralises the effects of financing and accounting decisions. As such the EBIDTA is considered a good proxy to measure the profitability of a company. However, as EBIDTA is not a measure recognised by general accepted accounting principles it allows for certain discretion as to what items are included or not included in its calculation.

The choice of EBIDTA to measure the economic activity of the taxpayer is in line with the best practice approach recommended in the final report of BEPS action 4. According to the report there are both benefits and drawbacks in using earnings to measure economic activity. The main benefit being that there should typically be a clear correlation between what a business earns and its taxable income and therefore measuring economic activity by using earnings should be effective to ensure deductibility of net interest expense where the activities which

\[25\] OECD (n 17) 42.
\[26\] OECD (n 17) 43.
\[28\] OECD (n 17) 47–50.
generate taxable income and drive value creation are actually being performed. Also, the report argues that an earnings-based approach makes an interest limitation rule robust against planning, as businesses could only increase their available interest deduction by actually increasing their earnings, which would in turn increase their taxable income.\textsuperscript{29} Among the main drawbacks the report mentions that earnings may be volatile and accordingly it may be hard for a group of companies to anticipate the level of interest expense that may be deducted for tax purposes in a given year. This can make it difficult to determine the actual cost of debt for certain projects and undertakings. Also, when a business is in a loss-making position an earning based rule limiting interest deductions will have the effect that no interest expenses will be deductible.\textsuperscript{30} These drawbacks are however somewhat mitigated in the interest limitation rule of the ATAD by allowing carry-forwards of interest expenses, as will be further discussed in section 4.9.

The ATAD makes certain adjustments and specifications to the EBIDTA parameter for the purposes of setting the benchmark for interest deductibility as precisely as possible and presumably to eliminate some of the discreitional choices that businesses could otherwise make when determining their EBIDTA. In Article 4(2) of the ATAD it is prescribed that the EBIDTA shall be calculated by adding back to the subject-to-tax income of the taxpayer any tax-adjusted amounts for EBC as well as tax-adjusted amounts for depreciation and amortisation. Furthermore tax-exempt income, such as exempt dividend income, shall not be included in the taxpayers EBIDTA calculations. Accordingly the EBIDTA ratio, for the purpose of setting the interest deduction limit, will be determined by measuring the taxpayer’s subject-to-tax income (not including tax-exempt income) and adding back any amounts of EBC, as determined according to the rules discussed in chapter 4.2.1, and also any amounts that might be deducted under applicable tax rules on depreciation and amortisation.

4.2.4 The 30 percent fixed ratio

Article 4(1) of the ATAD prescribes that EBC may be deductible “only up to” 30 percent of the taxpayer’s EBIDTA. It follows this wording, and is supported by clear statements in the Recitals of the ATAD, that member states have the

\textsuperscript{29} OECD (n 17) 47.

\textsuperscript{30} OECD (n 17) 47–48.
discretion to set this ratio even lower if they want to ensure a higher level of protection. Setting the maximum deductibility at 30 percent of EBIDTA is not an arbitrary number, but exactly at the top of the scale recommended in the final report on BEPS Action 4.31

The objective of setting the deductibility of interest payments at a certain proportion of the taxpayer’s EBIDTA is to ensure that a certain portion of his profits actually get taxed where they are generated. According to the OECD, setting the benchmark at a fixed ratio also provides a simple solution both for businesses and tax administrations. The OECD however sees it as a drawback that the fixed ratio approach doesn’t take into account different levels of leverage between business sectors, or different funding strategies which are put in place for non-tax reasons.32

The OECD suggests that each state sets the benchmark fixed ratio at a level appropriate to tackle BEPS, while taking into account that states have different economic and legal environments. While doing this the OECD still recognises that without a consensus on a best practice approach there would be a risk that states would engage in a competitive conduct, raising the fixed ratio level to the point that their interest limitation rule would cease to be effective to counter BEPS.33 Accordingly in the final report on BEPS action 4 the OECD did an economic study designed to identify a benchmark fixed ratio which would i) allow for the majority of groups to deduct an amount equivalent to their net third party interest costs; and ii) limit the extent to which groups can use intragroup financing to claim deductions in excess of their net third party interest costs. The result of the study was to recommend setting the benchmark fixed ratio no higher than at 30 percent, while some states might consider setting the benchmark at a lower level.34 The ATAD follows these recommendations by setting the max fixed ratio level at 30 percent, while leaving leeway for member states to determine a lower benchmark level. In the final report on BEPS action 4 the OECD indicates several factors which may assist states in setting their benchmark fixed ratio somewhere between 10 percent and 30 percent and discusses each of these factors in some

31 Commission (n 16) 7; OECD (n 17) 51–59.
32 OECD (n 17) 51.
33 OECD (n 17) 52.
34 OECD (n 17) 53.
detail. It is however outside the scope of this thesis to discuss these factors any further, although it is worth pointing out that EU member states may employ this methodology when setting their benchmark fixed ratios when implementing the ATAD.

4.2.5 Summary: The application of the general rule

To summarise how the general rule on interest limitation is operated there are three distinctive steps that need to be taken to apply the rule; i) determining the appropriate measure of EBIDTA, in the manner prescribed in Article 4(2) of the ATAD; ii) applying the benchmark fixed ratio to the EBIDTA determined in step 1 to set the maximum of deductible interest payments; and iii) comparing the maximum of deductible interest to the taxpayer’s EBC, as that amount is determined according to subparagraphs 1 and 2 of Article 2 of the ATAD.

4.3 The taxpayer and determination of domestic groups’ deductibility limit

The second subparagraph of Article 4(1) of the ATAD prescribes that member states may choose to treat domestic groups, which are permitted or required to be taxed in unity under domestic tax rules, to be treated as a single taxpayer for the purpose of limiting interest deductions. Member states may also take into consideration a domestic group’s position for the purpose of setting a group. In each of those circumstances the EBIDTA and the EBC, cf. the first paragraph of Article 4(1) of the ATAD, may be calculated at the group level.

At appears as if this rule ultimately would have the effect that any domestic intra-group interest payments would not count towards the interest deductibility limit, as only EBC at the domestic group level do, since any interest expense at the domestic group level would be offset be the corresponding interest income at another group entity. The only comment on this provision in the preface to the ATAD is in Recital 7:

Where a group includes more than one entity in a Member State, the Member State may consider the overall position of all group entities in the same State, including a separate entity taxation system to allow the transfer of profits or interest capacity between entities within a group, when applying rules that limit the deductibility of interest.

This may contradict with another statement earlier in the same Recital:

35 See further in: OECD (n 17) 54–58.
The interest limitation rule should apply in relation to a taxpayer's exceeding borrowing costs without distinction of whether the costs originate in debt taken out nationally, cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group.

Determining the EBITDA and the EBC for the domestic group as a whole, whether the group entities are treated separately or as a consolidated group for tax purposes, effectively neutralises any effect of any domestic intra-group interest payments on the domestic group’s deductibility limit. This certainly appears to give the interest limitation rule a certain cross-border element which will be explored further in chapter 6 of the thesis.

It must be noted that this rule was not included in the initial Commission proposal for the ATAD. It was added via a “Presidency Compromise” sent to the ECOFIN committee of the Council on 17 May 2016, with a view to reaching a compromise at an ECOFIN meeting which was held on 25 May 2016. The rule was from that point in time onwards included in the work of the Council while trying to reach a consensus on the approval of the ATAD and subsequently included in the final version of the adopted ATAD. Any discussions on this addition are however not included in the official documentation of the Council, as far as the author of this thesis can determine. It may however be assumed that member states wanted this addition included to preserve their domestic systems of group taxation and ensure that the interest limitation rule would not affect how businesses choose to organise their company structure on a domestic basis. As will be further discussed in Chapter 6 the addition however might have introduced important cross-border elements to the interest limitation rule which might lead to restrictions on the freedom of establishment, cf. Article 49 of TFEU, which may not be done by secondary EU legislation as was discussed in Chapter 2.

4.4 The de minimis exemption

In subparagraph a of Article 4(3) of the ATAD it is prescribed that the taxpayer may be given the right to deduct EBC up to 3 million EUR. For the purpose of domestic groups, as discussed in chapter 4.3, this amount shall be considered for

that entire group, to prevent a group avoiding the interest limitation by fragmenting interest costs between multiple domestic entities.

This exemption is discussed in Recital 8 to the ATAD saying that the rule leaves it to member states to determine whether they want to reduce this threshold to achieve a higher level of protection against BEPS. According to that same paragraph the exemption is intended to reduce the administrative and compliance burden of the rules, without significantly diminishing their effect. This furthermore corresponds to the best practice approach suggested in the final report to BEPS action 4, which suggests including a de minimis exemption in order to allow the rules to focus on entities which pose material BEPS risks, while reducing compliance costs for other entities.38

The wording of Article 4(1), “[b]y derogation from paragraph 1, the taxpayer may be given the right […] to deduct exceeding borrowing costs up to EUR 3 000 000”, suggests that this exemption should be interpreted in a manner that it allows any taxpayer to deduct the first 3 million EUR without regard to the interest limitation rule, but any EBC in excess of that amount become subject to the interest limitation. Such an interpretation would furthermore ensure equitable treatment between taxpayers and prevent adverse marginal effects.

4.5 The standalone exemption

In subparagraph b of Article 4(3) of the ATAD it is stated that member states may give so-called standalone entities the right to fully deduct EBC. The term “standalone entity” is defined in the last subparagraph of Article 4(3) as “a taxpayer that is not a part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment”. The term is thus defined with reference to the definition of “associated enterprise”, cf. subparagraph 4 of Article 2 of the ATAD, which treats any situation of direct or indirect control or ownership between two companies over 25 percent as an “associated” relationship. The term “permanent establishment” is not defined specifically in the ATAD. However the term “transfer of business carried on by a permanent establishment” is defined in subparagraph 8 of Article 2 of the ATAD, referring to a taxable presence of the taxpayer in a member state. This wording

38 OECD (n 17) 39.
strongly suggests that the term “permanent establishment” should be interpreted in line with the relevant domestic approach to the presence needed for source taxation of business profits of foreign enterprises, in each member state as the case may be.

According to the standalone exemption companies need to fulfil all three criteria for member states to be able to allow them the right to fully deduct their EBC, notwithstanding the general interest limitation rule; i) that they are not a part of a consolidated group for accounting purposes; ii) that they have no associated enterprises as defined by subparagraph 4 of Article 2 of the ATAD; and iii) that they do not have a taxable presence, i.e. a permanent establishment in any other state.

Including a standalone exemption is in line with the best practice approach suggested in the final report of BEPS action 4. There the main argument for the exemption is that the nature and level of BEPS risk posed by a many standalone entity is less than with other entities, both because standalone entities normally are relatively small and because they lack related parties.\(^{39}\)

**4.6 The grandfather exemption**

According to subparagraph b of Article 4(4) of the ATAD member states may exclude from the scope of the general limitation rule any EBC incurred on loans which were concluded before the adoption of the ATAD on 17 June 2016. However the exclusion does not extend to any subsequent modifications of such loans. In Recital 8 to the ATAD it is stated that this grandfather exemption is intended to facilitate the transition to the interest limitation rule, but would not apply to any increase in the amount or duration of the loan and be limited to its original terms. It is furthermore clear, both from the wording of the provision in subparagraph b of Article 4(4) and the comments in Recital 8 to the ATAD, that it is left open for member states to choose whether they include a grandfather clause when implementing the ATAD into their domestic law.

A possibility for a grandfathering exemption is discussed as part of the best practice approach in the final report of BEPS action 4, as it is recognised there that the implementation of an interest limitation rule may involve significant

\(^{39}\) OECD (n 17) 38–39.
additional costs for some entities and accordingly some states would like to give those entities reasonable time to restructure their financing agreements before coming fully under the scope of the interest limitation rules. Accordingly the grandfather exemption promotes both proportionality and foreseeability.

4.7 The public infrastructure exemption
According to subparagraph b of Article 4(4) loans which are used to fund long-term public infrastructure projects, where the operator, borrowing costs, assets and income are all within the EU, may be excluded from the scope of the general interest limitation rule. However, where the rule applies, any income arising from such projects shall also be excluded from the taxpayers EBITDA for the purpose of setting the interest limitation benchmark and any excluded borrowing costs shall not be included in the EBC of the group when applying the group-ratio exemption discussed in Chapter 4.8 of this thesis, cf. the third subparagraph of Article 4(4).

According to Recital 8 to the ATAD this exemption is provided as public infrastructure projects are not considered to present any significant BEPS risks. However member states are required under the rule, according to these comments, to properly demonstrate that the financing of such projects presents special features which justify granting this exception. It is also noted in these comments that this exception is put forward without prejudice to state aid rules.

The final report to BEPS action 4 does not specifically mention an exception like this as part of the best practice approach. However, when discussing how to set the fixed ratio limiting deductibility of interest, the report mentions that a state may set that ratio higher where it applies an economic policy to encourage investment which is not related to BEPS and mentions infrastructure as an example. However such an approach would prima facie probably be considered as being state aid.

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40 OECD (n 17) 83.
41 OECD (n 17) 57.
This exception was not included in the original commission proposal for the ATAD.\(^{42}\) It was added by the European Parliament’s opinion on 1st reading, however without providing any further comments.\(^{43}\)

### 4.8 The equity escape and group-ratio exemptions

Article 4(5) of the ATAD provides for two alternate methods of determining a limit for deductibility of interest costs for companies which are members of consolidated groups for financial accounting purposes.

Firstly taxpayers may be given the right to fully deduct EBC, provided they can demonstrate that their ratio of ‘equity over total assets’ is equal to or higher than the group’s as a whole, c.f. subparagraph a of Article 4(5). This requirement is considered fulfilled even if the taxpayer’s ratio of equity over assets is lower than the group’s as a whole by up to two percentage points, c.f. item (i) of subparagraph a of Article 4(5). Furthermore, according to item (ii) of subparagraph a of Article 4(5), all assets and liabilities of the consolidated group shall be valued using the same method, which shall be in accordance with International Financial Reporting Standards, national financial reporting systems of a member state, or even other accounting standards if given the right by competent authorities, c.f. Article 4(8) of the ATAD. This is the so-called “equity escape” rule.

Secondly taxpayers may be given the right to deduct EBC to a higher limit than permitted under the general rule calculated on the basis of their group’s consolidated EBIDTA, c.f. subparagraph b of Article 4(5). The group ratio shall be determined by dividing the EBC of the group vis-à-vis third parties over the group’s EBIDTA. That ratio shall then be multiplied by the EBIDTA of the respective taxpayer, as determined under the general rule of Article 4(2). This rule is referred to as the “group-ratio” rule.

According to Recital 7 to the ATAD the group-ratio and equity escape exemptions consider the overall indebtedness of the group at worldwide level for the purpose of granting rights to higher deductions of EBC. The “equity escape” exception applies when companies can show that their equity over total assets ratio is broadly equal to or higher than the equivalent group ratio.

\(^{42}\) C.f. Commission (n 16).

4.8.1 Rationale of the equity escape rule

According to the final report on BEPS action 4 an equity escape rule is currently applied by a number of countries, including Germany and Finland. Under the German rule the general fixed-ratio rule does not apply to entities which can demonstrate that their equity over assets ratio is equal to (within a tolerance of two percentage points) or higher than the equivalent group ratio. Where that entity’s equity over assets ratio is lower (by more than two percentage points) than the group’s the general fixed-ratio rule applies. The final report does not however discuss the rationale behind this rule.

It may well be argued that when a group company is not more leveraged than its group, interest payments do not cause any significant BEPS risks. The equity over assets ratio actually determines how much shareholders would receive in the event of company-wide liquidation, i.e. what the result would be if the company would sell all of its assets for cash and use the cash to pay off any liabilities. The residual cash would then represent the actual value of the shareholders’ equity. Any group entity which has an equal or higher ratio than the group as a whole would hardly be considered to be shifting profits. Furthermore, groups which are highly leveraged, perhaps for normal business reasons, would in the absence of an equity escape rule be unreasonably affected by the general fixed-ratio rule without the BEPS rationale really applying. Accordingly the equity escape rule mitigates unwanted effects of the general fixed-ratio rule and promotes proportionality.

4.8.2 Rationale of the group-ratio rule

In the final report to BEPS action 4 it is stated that the fixed-ratio rule does not take into account the fact that different groups in different sectors may be leveraged differently. The group-ratio rule therefore limits the impact of the fixed-ratio rule on more highly leveraged groups than a blunt application of the fixed-ratio rule would, while making sure the fixed-ratio rule is effective in preventing BEPS. Accordingly, the main objective of the group-ratio rule is to make sure that the interest limitation provisions are actually targeted at payments which cause BEPS risks, i.e. to ensure proportionality.

44 OECD (n 17) 95–96.
46 OECD (n 17) 61.
4.9 Carry-forward of unused interest payments

Article 4(6) of the ATAD gives member states three options to include rules which allow for carry-forward of EBC which can’t be utilised in the current tax period; i) to carry forward EBC without time limitations; ii) to carry forward without time limitations and to carry back for a maximum of three years, EBC; and iii) to carry forward EBC without time limitations and unused interest capacity for a maximum of five years.

In Recital 6 to the ATAD the following is stated:

Member States could decrease this ratio or place time limits or restrict the amount of unrelieved borrowing costs that can be carried forward or back to ensure a higher level of protection.

Accordingly it should be considered clear that member states can choose to set stricter time limitations for carry-forward of EBC than is recommended in Article 4(6) of the ATAD. This presumption is further supported by Article 3 of the ATAD, which states that the directive does not preclude the application of more strict domestic measures aimed at safeguarding corporate tax bases, i.e. that the ATAD provides for a minimum level of protection.

The best practice approach in the final report to BEPS action 4 recommends allowing carry-forwards of unusable interest deductions. The main rationale being that some entities might be unduly affected by the interest limitation rules because of timing mismatches, e.g. when an entity incurs interest expenses for investments which will yield profits in future periods, or when an entity’s EBIDTA fluctuates for reasons outside the control of the entity. The absence of a carry-forward allowance would also ultimately lead to double taxation, provided the lender is taxed on the interest income.47

4.10 Exclusion of financial undertakings

According to Article 4(7) of the ATAD member states may exclude financial undertakings from the scope of the interest limitation rule, including financial undertakings which are a part of a group. According to Recital 9 to the ATAD it is acknowledged that financial undertakings, i.e. financial institutions and insurance undertakings, present special features which call for a more tailored approach to limiting interest deductions. Although it is envisaged that such undertakings will

47 OECD (n 17) 72.
become subject to interest limitation rules discussions in this field are not sufficiently conclusive to provide the specific rules needed, and therefore it is recommended that member states exclude such undertakings from the scope of the interest limitation rule.

The final report to BEPS action 4 discusses this dilemma to some extent, but the reasons for the current exclusion of financial undertakings falls outside the scope of this thesis.\(^{48}\)

It should however be mentioned that rules on financial undertakings are highly harmonised within the EU, and it may be presumed that the exception provided for in Article 4(7) of the ATAD applies to financial institutions and insurance undertakings as so defined by the relevant EU law.\(^{49}\)

### 5 Examples of the application of the interest limitation rule

In this section of the thesis some made-up examples will be made to explain the effect of the interest limitation rule.

#### 5.1 Fixed-ratio rule

Company A, resident in member state A, is a manufacturing company and a part of a multinational group. Company A has an EBIDTA of 100 million EUR in year 1. The taxable profits of Company A, notwithstanding EBC, are 50 million EUR. The corporate tax rate in member state A is 20 percent. Member state A has implemented the interest limitation rule of the ATAD fully in line with its recommendations.

Company A pays a total of 40 million EUR in interest in year 1 to several both related and unrelated lenders. All the loan agreements were concluded after 17 June 2016. As no exceptions apply to company A the fixed ratio rule applies.

The interest limitation benchmark for company A is calculated in the following manner, as the *de minimis* threshold is set at 3 million EUR:

\[
EBIDTA \times 30\% + 3M \text{ EUR}
\]

\(^{48}\) OECD (n 17) 79–81.

In the case of company A that benchmark will be set at 33 million EUR in year 1 (100MEUR * 30% + 3MEUR). As the total EBC of company A in year 1 are 40 million EUR, 7 million EUR of these expenses will be disallowed in year 1, but may be carried forward.

In the absence of an interest limitation rule the tax base of company A in year 1 would have been 10 million EUR (50MEUR – 40MEUR), and the total tax burden would have been 2 million EUR (20% * 10MEUR). But since the interest limitation rule now applies the tax base of company A in year 1 will be 17 million EUR (50MEUR – 33MEUR) and the total tax burden will be 3.4 million EUR (20% * 17MEUR).

5.2 Group-ratio rule
If we continue with the example above, but assume that company A is a part of a group which is consolidated for financial accounting purposes, group A. Group A has EBC vis-à-vis third parties to the amount of 500 million EUR. The overall EBITDA of group A is 1000 million EUR. As in the example above company A has an EBITDA of 100 million EUR and EBC of 40 million EUR. We first have to determine the group ratio under item i) of subparagraph b of Article 4(5) of the ATAD, by dividing the group’s EBC over the group’s EBITDA:

\[
\frac{500\text{MEUR}}{1000\text{MEUR}} = 0.5
\]

Then, under the second step prescribed in item ii) of subparagraph b of Article 4(5) of the ATAD, we multiply the EBITDA of the taxpayer by the group ratio:

\[
100\text{MEUR} \times 0.5 = 50\text{MEUR}
\]

Then we have arrived at the benchmark for interest deductions for company A, under the group-ratio rule. As company A only has 40 million EUR in EBC it may deduct it all under the group-ratio rule, while it was only entitled to deduct 33 million EUR under the fixed-ratio rule as described above.

6 Cross-border elements and the freedom of establishment

6.1 Rules limiting interest deductibility and freedom of establishment
One of the main objectives of the EU is to establish an internal market, cf. Article 3(3) of TEU. This entails the elimination of any obstacles to trade within the EU,
in order to merge the national markets into a single market.\textsuperscript{50} Article 26(2) of TFEU states that the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the treaties. The so-called four freedoms (free movement of goods, services, persons and capital) provide two basic rights to all EU resident persons; a right of cross-border circulation (market access) and a prohibition on discrimination on grounds of nationality or origin.\textsuperscript{51} Covert or indirect distinctions on the basis of nationality or origin are just as prohibited as direct discrimination.\textsuperscript{52} This entails generally that if purely domestic situations are treated more favourably by a member state than comparable situations involving other member states the first mentioned state is in breach of the treaties as it restricts market access and/or discriminates on grounds of nationality or origin. However, restrictions and/or discrimination may be justified under the CJEU’s ‘rule of reason’, a doctrine which the CJEU has developed for circumstances where ‘mandatory requirements of public interest’ justify certain restrictions on the fundamental freedoms.\textsuperscript{53}

In December 2002 the CJEU delivered its landmark ruling on rules limiting interest deductions which discriminate between domestic and cross-border situations, in case C-324/00 (Lankhorst-Hohorst).\textsuperscript{54}

Lankhorst-Hohorst GmbH (LHG) was a limited liability company resident in Germany. It was wholly owned by Lankhorst-Hohorst BV (LHB), which in turn was wholly owned by Lanhorst Taselaar BV (LTB). Both LHB and LTB were resident in the Netherlands. The total share capital of LHG was 2 million DEM. In December 1996 LTB granted a 3 billion DEM loan to LHG. The loan was repayable in annual instalments over a period of 10 years with variable interest rate initially set at 4.5 percent. The loan was subordinate, in the meaning that LTB underwrote that the loan would not be repaid if third parties made debt claims against LHG. For the years 1997 and 1998 LHG paid 135,000 DEM and 109,695 DEM in interest to LTB respectively. In both years LHG realised losses and accordingly paid no corporate income tax.

\textsuperscript{51} Terra and Wattel (n 50) 53.
\textsuperscript{52} Terra and Wattel (n 50) 54.
\textsuperscript{53} Terra and Wattel (n 50) 59–64. It is generally outside the scope of this thesis to discuss this doctrine in any detail.
The German tax authorities characterised a part of the interest payments from LHG to LTB in 1997 and 1998 as hidden profit distributions and accordingly disqualified the deductions claimed by LHG on these payments, supported by the then applicable thin-cap rules. The payments were accordingly taxed at the applicable corporate tax rate of 30 percent. LHG challenged this decision and ultimately the question was referred to the CJEU for a preliminary ruling on the compatibility of the applicable German thin-cap rules with EU law.

The Court pointed out that the effect of the domestic rules was that interest payments to a resident parent company were deductible, but similar payments to a foreign parent company were not deductible where deemed as hidden profit distributions. In essence the Court found this to be a restriction on the freedom of establishment. As to possible justifications to this restriction the Court dismissed both arguments about the effectiveness of fiscal supervision and the coherence of the tax system. However, in its discussion on the restriction possibly being justifiable to prevent tax avoidance the Court said in para 37: “[I]t is important to note that the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany. Such a situation does not, of itself, entail a risk of tax evasion, since such a company will in any event be subject to the tax legislation of the State in which it is established.” Accordingly, the court also dismissed the justification of prevention of tax avoidance. The restriction was thus found to be unjustified.

After the ruling in Lankhorst-Hohorst the question arose whether thin-cap rules which placed restrictions on cross-border establishment could be considered to be compatible to EU principles. That question was answered, to some degree at least, in the subsequent case C-524/04 (Thin Cap):55

These proceedings were a part of a group litigation concerning the UK thin-cap rules of certain periods. The applicants brought the case following the ruling in Lankhorst-Hohorst to test the compatibility of the UK rules with the freedom of establishment. In each case there was a UK subsidiary involved, owned directly or indirectly to at least 75 percent by a non-resident parent company. In each case the parent company or another group company had made a loan to the UK subsidiary. The interest payments were also in each case considered non-deductible for the subsidiary under the then applicable thin-cap rules.

In essence the Court found, similarly as in Lankhorst-Hohorst, the applicable thin-cap rules in each case to pose a prima face restriction on the freedom of establishment, as they only applied to interest payments to non-resident parent companies, but not on a purely domestic basis. Furthermore the Court dismissed the justification that the rules were enacted to ensure the cohesion of the UK tax system. However, to clarify its stance as presented in the Lankhorst-Hohorst case, the Court stated in para 74: “In order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the

specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.” The Court continued this argument in para 80: “[L]egislation of a Member State may be justified by the need to combat abusive practices where it provides that interest paid by a resident subsidiary to a non-resident parent company is to be treated as a distribution only if, and in so far as, it exceeds what those companies would have agreed upon on an arm’s-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies.” As regards proportionality, the final essential piece to the Court’s argument, in para 83, is as follows: “In order for such legislation to remain compatible with the principle of proportionality, it is necessary, in the second place, that, where the consideration of those elements leads to the conclusion that the transaction in question represents a purely artificial arrangement without any underlying commercial justification, the re-characterisation of interest paid as a distribution is limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties or between those parties and a third party been one at arm’s length.” Furthermore the Court emphasised that in any case the taxpayer must be given the opportunity to demonstrate any commercial justification for the payments.

The main conclusion of the Thin Cap case is thus that rules which deem interest payments as hidden profit distributions and by doing so limit the deductibility of such payments, and discriminate between domestic and cross-border situations, are only compatible with the freedom of establishment if they are intended to limit tax avoidance insofar as they apply to interest payments in excess of the arm’s length principle, as such payments may be considered wholly artificial and abusive.

The final key puzzle in this picture was provided in case C-311/08 (SGI):56

SGI was a holding company incorporated in Belgium. It owned 65 percent of the shares in Recydem SA, a French company, and was one of the directors of that company. For the tax years 2001 and 2002 the Belgian tax authorities adjusted the taxable income of SGI for notional interest on an interest-free loan granted to Recydem. This was possible under the Belgian legislation applicable for the material time, as exceptional or gratuitous advantages granted to a related party were generally included in the tax base of a resident taxpayer which benefited. However if the benefactor was a non-resident related party the advantages were included in the tax base of the Belgian company which granted them. The CJEU got the task of determining whether this arrangement was compatible with the freedom of establishment.

The Court found the difference in treatment of advantages granted to resident and non-resident related parties to constitute a restriction on the freedom of

establishment, as the upward adjustment of the tax base of a Belgian company granting advantages to non-resident related parties could lead to double taxation of the advantages concerned. However this restriction was found to be justified by imperative requirements in the general interest, as it was intended to i) preserve the balanced allocation of taxing powers and ii) prevent tax avoidance.

Regarding the justification on balanced allocation of taxing powers the Court stated the Court found that the Belgian measures were necessary to prevent multinationals from shifting profits between jurisdictions at their own discretion (see para 61-64). The tax avoidance prevention argument was accepted as the contested measures were found suitable to counter the risk that income would be transferred to related parties by means of artificial arrangements (see para 65-68). Thus the arguments for both reasons of justification overlap to a large extent.

In the context the judgments in Lankhorst-Hohorst and Thin Cap it is even more interesting to revisit the arguments of the Court when it came to the analysis of the proportionality of the contested measures, to preserve balanced allocation of taxing powers and prevent tax avoidance, in para 71-72: “National legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction […] Second, where the consideration of such elements leads to the conclusion that the transaction in question goes beyond what the companies concerned would have agreed under fully competitive conditions, the corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence.”

In the SGI case the CJEU accepted an upwards adjustment of the tax base of a domestic company to the extent such adjustments were aligned with the arm’s length principle, i.e. “what the companies concerned would have agreed under fully competitive conditions”, as such adjustments were considered justified by the need to preserve the balanced allocation of taxing powers and combat tax avoidance.

Taken together and put simply it can be said that the line drawn by the CJEU in the cases above aligns with the arm’s length principle, i.e. that member states may restrict the freedom of establishment by discriminating between domestic and cross-border situations for the purpose of preventing tax avoidance and preserving the balanced allocation of taxing powers, but only insofar as payments are being made in excess of what would have been determined at arm’s length. It is also an important note that the CJEU emphasises that taxpayers should be allowed the full
opportunity to evidence the genuineness of their financing structure to the tax authorities before becoming subject to such difference in treatment.\textsuperscript{57}

6.2 Cross-border elements of Article 4 of the ATAD

Subparagraph 2 of Article 4(1) of the ATAD gives member states discretion to determine both EBC and EBITDA on a domestic group-basis for the purpose of applying the interest limitation rule, as discussed above in Chapter 4.3. This would have the effect that any domestic intra-group payments would not become subject to the interest limitation rule, as the interest expense of one group company would be netted out by the corresponding interest income of another group company. However cross-border intra-group interest payments would not be netted out in a similar manner, causing subsidiaries paying interest to associated companies cross-border to be at a disadvantage compared to subsidiaries paying interest to associated domestic companies.\textsuperscript{58} This is illustrated further in chapter 6.3 below. Prima facie it seems that if member states use this discretion under subparagraph 2 of Article 4 of the ATAD, they would be imposing a restriction on the freedom of establishment protected by Article 49 of the TFEU.\textsuperscript{59}

The interest limitation rules of Article 4 of the ATAD are not conventional thin cap rules, as they do not have the function of reclassifying interest payments as profit distributions. Rather they only limit the deductibility of such payments, for the payer, at a certain benchmark. This may however obviously lead to double taxation. The payer will be partially denied a deduction while the recipient will be taxed on the whole amount of the payment. Furthermore Article 4 of the ATAD makes no attempt at singling out abusive tax avoidance measures, but applies bluntly to any applicable situation, notwithstanding the real finance structure needs of the taxpayer.\textsuperscript{60} Furthermore the taxpayer gets no opportunity to evidence that the financing structure is actually at arm’s length. As such, the rule has even

\textsuperscript{57} See further a more comprehensive analysis of this CJEU case law in e.g. Moritz Glahe, “Transfer Pricing and EU Fundamental Freedoms” (2013) 22 EC Tax Review 222.

\textsuperscript{58} A similar conclusion is reached on the then applicable German interest limitation rule in Claus-Peter Knöller, ‘The Efficacy of Thin Capitalization Rules and Their Barriers: An Analysis from the UK and German Perspective’ (2011) 39 Intertax 317, 329.

\textsuperscript{59} See further discussion on the hierarchy of norms and implementation measures which may entail an infringement to the fundamental freedoms in chapters 2 and 3.

been criticised for going against the EU principle of proportionality.\textsuperscript{61} That discussion however falls outside the scope of this thesis.

Notwithstanding other possible shortcomings of the interest limitation rules of the ATAD, on the face of them they apply equally to domestic and cross-border situations and are as such not intended to allow for any restrictions on the freedom of establishment. This is emphasised in Recital 7 to the ATAD:

The interest limitation rule should apply in relation to a taxpayer’s exceeding borrowing costs without distinction of whether the costs originate in debt taken out nationally, cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group.

However, as was pointed out in chapter 4.3 above, subparagraph 2 of Article 4(1) of the ATAD prescribes that member states may choose to treat domestic groups as a single taxpayer to determine the EBIDTA and EBC for the purpose of limiting interest deductions. In Recital 7 the following paragraph was added, right after the one quoted above, to make this clear:

Where a group includes more than one entity in a Member State, the Member State may consider the overall position of all group entities in the same State, including a separate entity taxation system to allow the transfer of profits or interest capacity between entities within a group, when applying rules that limit the deductibility of interest.

The effect of this rule, if implemented into the domestic laws of a member state as is allowed for, would be that any domestic intra-group interest payments would be neutralised when determining this benchmark, as they would constitute as interest expense with one entity (the borrower) and a corresponding interest income with another group entity (the lender), and not contribute to EBC at the domestic group level.\textsuperscript{62} However, this would not apply in a similar manner to intra-group interest payments which are made cross-border. Such payments would contribute to the EBC of the payer, and their deductibility would be limited by the applicable interest limitation rules, while that same payment would be taxed in full at the level of the recipient. Accordingly subsidiaries which pay interest on loans to non-resident parent companies would be at a disadvantage compared to subsidiaries which pay interest on loans to resident parent companies. The rationale for this difference in treatment is quite obvious as interest payments which are made


\textsuperscript{62} C.f. chapter 4.2.1.
domestically cannot pose any significant BEPS risks, while cross-border payments obviously can. However, under the doctrine developed by the CJEU in *Lankhorst-Hohorst, Thin Cap* and *SGI* such rules are non-reconcilable with the freedom of establishment unless they apply solely to combat tax avoidance and to preserve the balanced allocation of taxing powers, and only to payments which are in excess of the arm’s length principle and thus to be considered wholly artificial. Article 4 of the ATAD makes no such distinction.

It is well perceivable that a cross-border interest payment to a related party, which would not be deductible under Article 4 of the ATAD, as implemented into the domestic legal system of a member state, should nevertheless be considered reasonable under the arm’s length principle. If that same member state chooses to use the authority prescribed in subparagraph 2 of Article 4(1) of the ATAD to take the overall situation of the domestic group into perspective when determining EBC and EBIDTA for the purpose of applying the interest limitation rule it is furthermore clear that a comparable interest payment to a related party in the same member state would not become subject to the interest limitation rule. In such a situation the relevant rules should be considered to discriminate between comparable domestic and cross-border situations and thus as a restriction on the freedom of establishment. Such a restriction might not by justifiable, at least not when looking at the precedence from *Lankhorst-Hohorst, Thin Cap* and *SGI*. The effect of this difference in treatment may yet be mitigated to some extent in cases where the group-ratio exemption applies; c.f. chapter 4.8. However, as is illustrated below, that may not suffice to eliminate any and all difference in treatment.

### 6.3 Illustration of a domestic vs cross-border situation

<table>
<thead>
<tr>
<th>Loan 100</th>
<th>Bank – external financing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Company A</td>
</tr>
<tr>
<td></td>
<td>EBIDTA 15</td>
</tr>
<tr>
<td>Loan 90</td>
<td>Interest 10</td>
</tr>
<tr>
<td></td>
<td>Interest 9</td>
</tr>
<tr>
<td></td>
<td>Company B</td>
</tr>
<tr>
<td></td>
<td>EBIDTA 5</td>
</tr>
</tbody>
</table>
The assumptions made for the purpose of this example are the following: i) Company A wholly owns Company B; ii) Company A borrows 100 from a third party entity (bank) and lends 90 onwards to Company B; iii) the bank charges 10% annual interest on the loan and Company A charges the same interest rate to Company B, at arm’s length; iv) the EBITDA of Company A is 15 and the EBITDA of Company B is 5; and v) each of the member states involved has implemented Article 4 of the ATAD using a 30 percent fixed ratio and allowing for consolidation of EBC and EBITDA for domestic groups.

In each of the examples we also assume that the equity escape rule does not apply, i.e. that Company B has an ‘equity over assets ratio’ lower than the group’s as a whole. Of course if the equity escape rule would apply Company B would in any case be allowed to deduct all of its EBC.

6.3.1 Each taxed individually

We assume that Company A and Company B are residents of different member states and neither the equity escape nor the group ratio exemptions apply.

The EBC of Company A is 1 (10-9). The interest deductibility benchmark applicable is 4.5 (30% of 15). No EBC is disallowed under the fixed ratio rule for Company A.

The EBC of Company B is 9 (9-0). The interest deductibility benchmark applicable is 1.5 (30% of 5). Company B will get 7.5 of its EBC disallowed under the fixed ratio rule.

6.3.2 Consolidated EBITDA and exceeding borrowing costs

We assume that Company A and Company B are both resident in the same member state.

The EBC of that domestic group is 10. The consolidated EBITDA of that domestic group is 20. The interest deductibility benchmark applicable is 6 (30% of 20).

Under the fixed ratio rule that domestic group will get 4 of its EBC disallowed.
6.3.3 Group ratio rule applies

We assume that Company A and Company B are residents of different member states and that the group ratio rule applies.

The net EBC of the group is 10. The group ratio is 50 percent (group’s exceeding borrowing costs over group’s EBITDA).

The EBC of Company A is still 1. The interest limitation benchmark for Company A is 7.5 (50% of 15). No EBC is thus disallowed for Company A.

The EBC of Company B is still 9. The interest limitation benchmark for Company B is 2.5 (50% of 5). Under the group ratio rule Company B will have 6.5 of its EBC disallowed.

6.3.4 Comparison

In the examples above it is clear that Company B is at a disadvantage if it is paying interest to an associated company resident in another member state, compared to if it was paying interest to an associated company resident in the same member state and consolidated for the purpose of determining EBC and EBITDA, as subparagraph 2 of Article 4(1) of the ATAD assumes member states may allow. This applies even in the case that the group ratio rule is applicable, although the situation is somewhat mitigated by it.

Obviously the effect of this difference in treatment would be exaggerated in a situation where the group has less or no third party debt.

It is also important to note that this difference in treatment would apply to genuine business situations where interest payments are at arm’s length, and the involved taxpayers would have no opportunity to evidence the genuineness of the financing structure.

7 Conclusions

Technically the interest limitation rule of Article 4 of the ATAD works to limit the deductibility of interest payments, whether interest is paid to associated or unrelated parties. However, the addition of subparagraph 2 of Article 4(1), which was made in a presidency compromise in the Council, allows member states to implement the rule in a way which would discriminate between comparable domestic and cross-border situations when interest is paid between group companies, even though the rule was originally drafted by the Commission to
have equal effect notwithstanding whether situations were domestic or cross-border or if interest payments were made intra-group or to unrelated parties. The difference in treatment allowed for by the current Article 4 of the ATAD, as is illustrated in the thesis, would be considered as a restriction on the freedom of establishment. Furthermore the restriction/difference in treatment would assumedly not be justified according to previous case law of the CJEU. This is the main critique in this thesis, i.e. that Article 4 of the ATAD allows member states to implement the rule in a manner which would unjustifiably restrict the freedom of establishment, even though it was one of the main objectives of the original Commission proposal to ensure that no such restrictions would be imposed.\textsuperscript{63}

\textsuperscript{63} Whether this infringement to the fundamental freedoms would be attributable to the EU or the respective member state was discussed briefly in chapter 3. However, it falls outside the scope of this thesis to answer that question conclusively. Reference is made to Szudoczy (n 5) 384–398.
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