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Article

The Interest Limitation Rule in the Anti-Tax Avoidance Directive (ATAD) and the Net Taxation Principle

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This article discusses the rationale for limiting the income tax deduction of interest payments, taking into account the net taxation principle, as well as the compatibility of Article 4 of the Anti-Tax Avoidance Directive (ATAD) with the Treaty on the Functioning of the European Union (TFEU).

It also discusses the compatibility of a national provision that is similar to Article 4 of the ATAD, with a national constitution. Assuming that such national interest limitation rule is declared unconstitutional, but, in turn, Article 4 of the ATAD is not declared incompatible with the TFEU, a conflict with EU Law will arise. This is so, because European Union (EU) Law is to be given full effect by EU Member States.

1 Introduction

Thin capitalization is a practice of increasing debt capital disproportionally to its own equity capital, shifting debt to high-tax jurisdictions and profits to low-tax jurisdictions.[1] Base erosion and profit shifting (BEPS) caused by excessive deduction of interest has been described as follows:

> In the cross-border context, the main tax policy concerns surrounding interest deductions relate to the debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution. On the other hand, subsidiary entities may be heavily debt financed, using excessive deductions on intragroup loans to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market.[2]

The significant differences that apply in most countries to the tax treatment of debt on the one hand (deductible as expense), and equity on the other (economic double taxation of profits and dividends), have encouraged the use of thin capitalization as an instrument of international tax planning,[3] as well as legal answers to restore some tax neutrality between the treatment afforded to dividends and interest.[4]

The Action 4 Final Report of the OECD/G20 BEPS project calls for the best practices in the design of rules to prevent base erosion through the use of interest expenses:

> In constructing the best practice approach described in this report, a focus has been placed on the need for an approach that provides an effective solution to the risks countries face and which is robust against planning to avoid or reduce its application or effect. At the same time, this is balanced by the need for an approach to be reasonably straightforward for groups and tax authorities to apply.[5]

Interest limitation rules allegedly correspond to these best practices:

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1 A. P. Dourado & R. de la Feria, Thin Capitalization Rules in the Context of the CCCTB, WP 2008/04, Oxford Business Centre for Business Taxation, 1, http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_08/WP0804.pdf , also published as A. P. Dourado & R. de la Feria, Thin Capitalization and Outbound Investment: Thin Capitalization Rules in the Context of the CCCTB, in Common Consolidation Corporate Tax Base 381–382 (Michael Lang, Pasquale Pistone, Josef Schuch, & Claus Staringer eds, Wien: Linde Verlag 2008).

2 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, para. 3, 19 (OECD 22 Dec. 2016).

3 Dourado & de la Feria, *Thin Capitalization Rules*, *supra* n. 1, at 1–3; Dourado & de la Feria, *Thin Capitalization and Outbound*, *supra* n. 1, at 381. A.P. Dourado, *General Report, Tax Avoidance Revisited in the EU BEPS Context* 1.3.4 (A. P. Dourado ed., IBFD 2017), forthcoming; OECD, *supra* n. 2, para. 2, at 19.

4 E. Cencerrado Millán & M. T. Soler Roch, *Limit Base Erosion via Interest Deduction and Others*, 44(1) Intertax 60–61 (2015). S. Fatica, T. Hemmelgarn & G. Nicodeme, The Debt-Equity Bias: Consequences and Solutions, Taxation Papers, WP 2012/33; R. A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, 33 (4) Fiscal Studies, 489-512 (2012).

5 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project 29 (OECD 5 Oct. 2015); M. Mardan, *Why Countries Differ in Thin Capitalization Rules: The Role of Financial Development*, 91 Eur. Econ. Rev. 1 (2017).

> The best practice approach is based around a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) based on tax numbers. This is a straightforward rule to apply and ensures that an entity's interest deductions are directly linked to its economic activity. It also directly links these deductions to an entity's taxable income, which makes the rule reasonably robust against planning. As described in Chapter 5, although EBITDA is the recommended measure of earnings to be used, the best practice allows a country the flexibility to introduce rules based on earnings before interest and taxes (EBIT). In limited cases, a country may apply a fixed ratio rule based on asset values rather than earnings. Chapter 6 includes factors which a country should take into account in setting the benchmark ratio for a fixed ratio rule, within a corridor of 10% to 30%.[6]

Article 4 of the Anti-Tax Avoidance Directive (ATAD)[7] includes an interest limitation rule based on the recommendations set forth in the Action 4 Final Report. However, it is not clear whether Article 4 of the ATAD is compatible with the Treaty on the Functioning of the European Union (TFEU), as it challenges some of the principles settled by the jurisprudence of the European Court of Justice (ECJ), on the fundamental freedoms, as well as the principle of proportionality and the general principle of equal treatment.

Moreover, it is not clear whether a national interest limitation rule that may infringe national constitutional principles, such as the net taxation principle, can be disapplied taking into account the obligation of the national legislature to transpose Article 4 of the ATAD.

This article discusses the rationale for limiting the income tax deduction of interest payments, as well as the compatibility of Article 4 of the ATAD with the TFEU, and the compatibility of a national provision that is similar to Article 4 of the ATAD, with a national constitution. Finally, taking into account that EU Law is to be given full effect by EU Member States, a conflict with EU Law will arise if a national interest limitation rule which is similar to Article 4 of the ATAD, is declared unconstitutional.

2 Article 4 of the Anti-Tax Avoidance Directive

Under Article 4 of the EU ATAD,[8] a corporate taxpayer's excess borrowing expense is deductible in the tax year in which it is incurred up to (1) a maximum of 30% of the taxpayer's taxable EBIDTA (paragraph 1); or (2) a fixed maximum amount of EUR 3,000,000 for each entity or the group of which it is part.[9] Tax exempt income is excluded from EBIDTA, and therefore decreases the amount of deductible interest.[10]

A Member State may include a group exception where the taxpayer is part of a group filing statutory consolidated accounts. Taxpayers may be entitled to deduct higher amounts of excess borrowing expense, by considering the indebtedness of the overall group at the worldwide level; and an equity escape provision may be included where the interest limitation rule does not apply if the company can demonstrate that its ratio of equity over total assets is broadly greater than or equal the equivalent group ratio.[11]

Furthermore, a Member State may introduce rules providing for the setting off of the excess borrowing expense against unused interest deductions in prior years. A Member State may also provide for full deduction of excess borrowing expense if the taxpayer is a standalone entity[12]; and may exclude financial undertakings' loans concluded before 17 June 2016, and loans funding a 'long-term public infra-structure project' from the scope of the rule.[13]

Article 4 along with the other provisions in the ATAD is a *de minimis* rule and incorporates the main recommendations from Action 4.[14]

Article 4 of the ATAD is therefore the EU regional answer to Action 4. The ATAD presumably lays down rules against tax avoidance practices that directly affect the functioning of the internal market.[15]

3 Thin capitalization rules

Traditional thin capitalization rules consisted in implementing a safe harbour rule disallowing the tax deduction of interest payments to related parties if internal debt exceeded a specified debt-to-equity ratio.[16] Such rules were applicable only in a cross-border context and normally presumed an artificial shift of profits to low-tax jurisdictions. Under some countries' laws, the debt-to-equity ratio would not be applicable if the conditions under which the intragroup debt was assumed, respected the arm's length principle.[17]

Recently, some jurisdictions with thin capitalization rules relying on a debt-to-equity ratio and applicable on a cross-border (hence, discriminatory) basis, switched to a system of either (1) a pure earnings stripping rule (interest limitation rule), restricting tax deductibility if

6 OECD, *supra* n. 5, at 25-26.
7 EU Anti-Tax Avoidance Directive (ATAD): Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193/1 (19 July 2016).
8 *Ibid.*
9 *Ibid.*
10 *See* P. van Os, *Interest Limitation Under the Adopted Anti-Tax Avoidance Directive and Proportionality*, 4 EC Tax Rev. 190 (2016).
11 ATAD, *supra* n. 7, Preamble, at para. 7.
12 Under Art. 4 (3) (b), second paragraph, a standalone entity is a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment: ATAD, *supra* n. 7.
13 Van Os, *supra* n. 10, at 190.
14 *Ibid.*
15 ATAD, *supra* n. 7, Preamble, at para. 3.
16 Dourado & de la Feria, *supra* n. 1, at 3 et seq.
17 *Ibid.*

group interest payments exceed a certain fraction of the company's EBITDA (e.g. France,[18] Germany,[19] Finland,[20] Italy,[21] Norway,[22] Portugal,[23] South Africa,[24] Spain,[25] Sweden,[26] and the United Kingdom[27]), or (2) a mix of both (Denmark, Japan and the United States).[28] The interest limitation rule was first established in Germany, following the decision of the ECJ in the *Lankhorst-Hohorst* case,[29] which declared the German thin capitalization rule incompatible with the EU freedom of establishment. Austria introduced an interest limitation rule in 2014.[30] The Netherlands has diversified rules limiting interest deduction.[31]

All countries that switched to an interest limitation rule are developed countries.[32] Although Luxembourg does not have any of these rules in its law, administrative practice imposes a thin capitalization rule on the basis of an arm's length test.[33] Empirical evidence shows that as the financial development of a country improves, tax deductions for group interest payments become less generous, on average.[34]

4 Interest limitation rules, net income taxation and the symmetric condition

Net income taxation in each sovereign State is a manifestation of the ability-to-pay principle and was designed under a symmetric condition. This symmetric condition means that tax deduction of expenses and losses is allowed to the extent that the jurisdiction expects that an investment will be successful and that it will share the success by means of taxing revenue,[35] in an overall cost-benefit analysis.

Sovereign tax regimes do not allow for an unconditional and unlimited deduction of expenses and losses. Tax expenses and tax losses are normative expenses and losses. They imply an assessment by the law and do not entirely correspond to expenses and losses in accountancy, or to 'real' costs and losses. Identification of deductible costs and losses (deductible event and timing aspect), the amount of the deduction (unlimited or limited as a quantitative aspect), and the attachment to a taxpayer (qualitative aspect)[36] are the main criteria to identify a tax cost or loss.[37]

Again from a sovereign State perspective, deduction of expenses and losses presupposes the 'cohesion of the tax system', the 'symmetry' of the tax system, and its attachment to the 'principle of territoriality'. In a cross-border context, division of revenue also presupposes symmetry. This division of revenue presupposes that the agreement between the State and the taxpayer for the deduction of expenses and losses does not necessarily include cross-border expenses and losses, especially in a territoriality system. Worldwide taxation systems do not necessarily allow for unlimited deduction of cross-border expenses and losses, and may establish rules preventing avoidance and profit shifting.

In the above-mentioned national context, limits on the deduction of cross-border expenses and losses are based on the assumption of tax competition among jurisdictions, in contrast to tax coordination of tax bases and rates. Article 4 of the ATAD, providing for harmonization of the deductibility of interest, allocates taxing rights to the EU Member States, without harmonizing the Members States' corporate income tax bases.

Both thin capitalization rules relying on a debt-to-equity ratio and the pure earnings stripping rules (interest deductibility limitation) are a limit to the principle of net income taxation. But the debt-to-equity ratio only applies to associated companies, in cross-border scenarios, and therefore aims to guarantee the symmetry of sovereign tax systems (deduction of expenses should lead to taxation of income) where there is a risk of

18 E. Raingeard de la Blétière, *France*, in *Tax Avoidance Revisited*, *supra* n. 3, at 14.3.5.

19 E. Reimer, *Germany*, in *Tax Avoidance Revisited*, *supra* n. 3, at 15.4.2.

20 R. Immonen & J. Lindgren, *Finland*, in *Tax Avoidance Revisited*, *supra* n. 3, at 13.4.7.

21 *Ibid.*, at 13.4.8; G. Zizzo, *Italy*, in *Tax Avoidance Revisited*, *supra* n. 3, at 17.3.5.

22 B. Folkvord, *Norway*, in *Tax Avoidance Revisited*, *supra* n. 3, at 20.3.

23 Art. 67 of the Corporate Income Tax Code (Código de Imposto sobre as Pessoas Coletivas), introduced by Law n. 63-B/2012, 31 Dec.

24 C. West & J. Roeleveld, *South Africa*, in *Tax Avoidance Revisited*, *supra* n. 3, at 24.4.

25 Art. 16, Ley 27/2014, de 27 de noviembre, del *Impuesto sobre Sociedades*.

26 A. Hultqvist, *Sweden*, in *Tax Avoidance Revisited*, *supra* n. 3, at 26.8.4.

27 In force since 2017. *See* Sandra Eden, *United Kingdom*, in *Tax Avoidance Revisited*, *supra* n. 3, at 27.3.5.2.

28 Mardan, *supra* n. 5, at 1.

29 *Lankhorst-Hohorst GmbH* v. *Finanzamt Steinfurt*, Case C-324/00 (12 Dec. 2002), DE: ECJ, ECR 2002, I-11779.

30 S. Bergman, *Austria*, in *Tax Avoidance Revisited*, *supra* n. 3, at 7.3.1.

31 M. de Wilde & C. Wisman, *Netherlands*, in *Tax Avoidance Revisited*, *supra* n. 3, at 19.3.7.

32 Mardan, *supra* n. 5, at 2–3.

33 W. Hasslehner, *Luxembourg*, in *Tax Avoidance Revisited*, *supra* n. 3, at 18.3.6.

34 Mardan, *supra* n. 5, at 2: 'One reason why financially less developed countries implement more generous thin capitalization rules could be that the lack of access to external finance creates a need to use internal sources of funds to finance investment. Empirical evidence suggests that financing frictions also play an important role for multinational firms. Desai et al. (2004) find that MNEs shift scarce resources to affiliates in countries with a weak financial development and that internal debt substitutes three quarters of the reduced external loans induced by the weak development of the local capital market. Büttner et al. (2009) confirm these results using data on German multinationals. Egger et al. (2014) find higher tax-sensitivity of internal debt financing compared to previous research because they do not only take into account the tax incentive of internal debt usage but also non-tax incentives.'

35 35Y. Brauner, A.P. Dourado & E. Traversa, Ten Years of Marks & Spencer, 43(3) Intertax 312 (2015).

36 As criteria to identify a withholding tax, *see* PT: ECJ, 8 June 2000, Case C-375/98, *Ministério Público e Fazenda Pública v. Epson Europe BV*, ECR 2000, I-04243.

37 *See* Brauner, Dourado & Traversa, *supra* n. 35, at 312.

avoidance. Taking into account that tax revenues are still raised for the State budget, net taxation does not require the deduction of cross-border expenses and losses.

In contrast, rules limiting interest deductibility (such as that under Article 4 of the ATAD which applies to both domestic and cross-border situations), may be extended to stand-alone companies and, individually considered, work as a pure limitation on deductibility of expenses (on net taxation).

5 Tax symmetry and EU law

5.1 Generally

The facts under analysis in several direct tax cases involving EU fundamental freedoms and decided by the ECJ exemplify how domestic tax systems of EU Member States were designed.

In *Bachmann*, the deduction of insurance contributions was dependent upon taxation of subsequent premiums (cohesion)[38]; in *Marks & Spencer*, group losses were deductible in the United Kingdom, if incurred by an entity of the group in the United Kingdom (territoriality)[39]; In *Bosal*, payment of debts by a resident parent company were deductible if assumed to fund resident subsidiaries (territoriality, symmetry)[40]; in *Lankhorst-Hohorst*, full deductibility of interest was possible if paid to a resident (territoriality, symmetry), but was subject to a thin-capitalization rule when paid to a foreign related entity.[41]

Symmetry in a EU Member State national context, meant that the deduction of expenses presupposed taxation of the corresponding income in the same jurisdiction

In the social contract between the taxpayer and the state, under an economic allegiance and the 'administrative net output' perspective (corresponding to the difference between the benefit from public goods and revenue),[42] EU Member States allowed the deduction of expenses and losses in the expectation that there would be taxable income or business success in the long run.[43]

ECJ case-law, in building up the internal market, changed the above-mentioned sovereign approach, by concluding that limits on the deduction of interest applied only to cross-border payments within the EU and not also domestically were discriminatory. As domestic thin capitalization rules applied only to groups of companies (in case of definite influence), they were declared to be incompatible with the freedom of establishment.[44] The result of this case-law was that expenses incurred abroad and deductible in the EU residence Member State of the paying agent, implied overcoming the symmetry of the taxable base, especially if a Member State applied the territorial regime (de Groot,[45] Bosal[46]).[47]

More than that, ECJ case-law destroyed the symmetry or cohesion, by concluding that domestic funding and outbound funding were in comparable situations, and by denying the risk of avoidance as a relevant justification, even if in light of the arm's length principle.[48]

In respect of interest payments, in *Bosal* and *Lankhorst-Hohorst*, the ECJ applied the standard methodology in steps, considering:

(1) whether there is comparability in an outbound situation, i.e. between residents paying interest domestically and those paying interest to non-residents[49];

(2) in the face of comparability, the deduction of interest payments may not discriminate against payments to non-residents and therefore, deductibility in a domestic context implies deductibility in a cross-border context[50];and

(3) whether there are valid justifications for the discriminatory treatment (the risk of tax avoidance, because payment of interest abroad in a related-party context involving associated companies may imply profit shifting)[51].

Because, according to the ECJ, there was no valid justification for the restriction, the ECJ did not assess

38 BE: ECJ, 28 Jan. 1992, Case C-204/90, *Bachmann v. Belgian State*, ECR 1992, I-00249, para. 23: 'The cohesion of such a tax system, the formulation of which is a matter for each Member Sute, therefore presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers.'

39 UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, ECR 2005, I-10837, paras 14–16 and 23–24; *See also* para. 46: 'In effect, to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.'

40 NL: ECJ, 18 Sept. 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, 2003 I-09409, para. 8: 'In determining profit no account shall be taken of gains acquired from a holding or of the costs relating to a holding, unless it is evident that such costs are indirectly instrumental in making profit that is taxable in the Netherlands (exemption relating to holdings). In any event, the interest on and costs of loans taken up in the six months preceding the acquisition of the holding shall, except where it is likely that these loans have been taken up for a purpose other than the acquisition of the holding, be regarded as costs relating to a holding.'

41 *Lankhorst-Hohorst*, *supra* n. 29, para. 28.

42 K. Vogel, *Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments*, Part II, 16(10) Intertax 310, 314 (1988).

43 Brauner, Dourado & Traversa, *supra* n. 35, at 312.

44 *Lankhorst-Hohorst*, *supra* n. 29.

45 NL: ECJ, 12 Dec. 2002, Case C-385/00, *De Groot v. Staatssecretaris van Financien*, ECR 2002 I-11819, paras 17–25.

46 *Bosal*, *supra* n. 40, at paras 14, 18–19.

47 Brauner, Dourado & Traversa, *supra* n. 35, at 312.

48 *Lankhorst-Hohorst*, *supra* n. 29, paras 39–42.

49 *Ibid.*, paras 28–29; *Bosal*, *supra* n. 40, at para. 39.

50 *Lankhorst-Hohorst*, *supra* n. 29, para. 32; *Bosal*, *supra* n. 40, at para. 40.

51 *Lankhorst-Hohorst*, *supra* n. 29, paras 37–38; *Bosal*, *supra* n. 40, at paras 41–42.

whether the discrimination was proportionate to the aim to be achieved and did not go beyond what was necessary for that purpose (an irrebuttable presumption of abuse is not proportionate).

In tax law literature, deductibility of tax expenses and losses is often submitted to a similar analysis, as they both arise from business expenses.[52] However, the ECJ case-law on tax costs and losses and their compatibility with the TFEU has generally been based on different arguments.

5.2 The *Lankhorst-Hohorst* Case and Justifications to Restrictions on Interest Deductibility

In *Lankhorst-Hohorst*, no deduction was allowed for repayment of loan capital from a subsidiary to a parent company where 'the loan capital is more than three times the shareholder's proportional equity capital at any point in the financial year', unless (i) 'the company limited by shares could have obtained the loan capital from a third party under otherwise similar circumstances' or (ii) 'the loan capital constitute(d) borrowing to finance normal banking transactions'.[53]

Furthermore, interest paid by a resident subsidiary on loan capital provided by a non-resident parent company was taxed as covert dividend at a rate of 30%.[54] That provision applied mainly to non-resident parent lenders, as resident parent companies received tax credits in most cases whereas non-resident parent companies did not ('repayments in respect of loan capital which a company limited by shares subject to unlimited taxation has obtained from a shareholder not entitled to corporation tax credit which had a substantial holding in its share or nominal capital at any point in the financial year shall be regarded as a covert distribution of profits'[55]). This different treatment led to a restriction of the freedom of establishment.

In *Lankhorst-Hohorst*, the ECJ did not accept the risk of tax evasion or avoidance, as a valid justification to the aforementioned restriction, because the legislation was not specifically targeted at artificial arrangements.[56] Moreover, the arm's length principle, as part of the coherence of the domestic tax system, was overlooked by the Court as a valid justification to the restriction.[57] However, application of the arm's length principle in thin capitalization situations, was later accepted as a justification for a restrictive regime, in the *Thin Cap GLO*[58] and *SGI*[59] cases. In the former case, the arm's length rules applied to fix an artificial arrangement, whereas in the latter case, application of the arm's length rules was used as an instrument to prevent tax abuse.

As mentioned above, thin capitalization rules were exclusively aimed at cross-border loans because the symmetry did not occur. Ultimately, symmetry was destroyed when the ECJ denied the aim to obtain tax revenue in the source state as a condition to allowing the deduction of interest payments, and as an acceptable justification to restrict the fundamental freedoms.

In *Lankhorst-Hohorst* and in the subsequent *Thin Cap GLO* case, the ECJ did not follow the justifications put forward by that same court in *Marks & Spencer*, but could have done so. The allocation of taxing rights, double non-taxation and the risk of tax avoidance would be the adaptation of the *Marks & Spencer* justifications, to the thin capitalization cases. A limit on the deduction of expenses paid to a non-resident associated company could have been justified by 'the preservation of the allocation of the power to impose taxes between Member States', which entailed 'the symmetry between the right to tax profits and the right to deduct' expenses.

These justifications are now put forward in the Final Report Action 4, Annex A:

> 211. The scope of an interest limitation rule determines which freedom applies and there are a number of approaches that the countries involved in this work have discussed in order to avoid any restriction of EU treaty freedoms. In this respect, consideration should also be given to the circumstances in which EU Member States could justify a restriction of EU treaty freedoms, for example: the need to preserve the balanced allocation between EU Member States of the power to impose taxes the need to prevent tax avoidance and to combat artificial arrangements.[60]

It can be concluded that the ECJ case-law on the compatibility of national tax law and the fundamental freedoms does not promote coordination or cooperation but rather further competition.

6 Unconstitutionality of Interest Limitation Rules

Because interest limitation rules are an exception to the principle of net taxation, there may be issues of

52 Brauner, Dourado, & Traversa, *supra* n. 35, at 312.
53 *Lankhorst-Hohorst*, *supra* n. 29, para. 3.
54 *Ibid.*, para. 29.
55 *Ibid.*, paras 3 and 27.
56 *Ibid.*, paras 37–38.
57 *Ibid.*, paras 39–42.
58 UK, ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECR 2007 I-02107, para. 92.
59 BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. État belge*, ECR 2010 I-00487, paras 26, 58. *See also* para. 69: 'In the light of those two considerations, concerning the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance, taken together, it must be held that legislation such as that at issue in the main proceedings pursues legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that it is appropriate for ensuring the attainment of those objectives.'
60 OECD, Annex A, *supra* n. 5, at 85

unconstitutionality in some Member States. The German Federal Tax Court (*Bundesfinanzhof*, *BFH*) held that the German interest limitation rule was unconstitutional for violating the principle of net taxation[61] without due justification and for violating the proportionality principle: according to the *BFH*, German law does not take into account differentiations based on the sector of activity or on the financial situation of the borrower; it covers new companies and companies in a difficult financial situation; it covers situations that are not suspect of engaging in profit shifting; and it does not allow the taxpayer to demonstrate that there is no avoidance purpose in the concrete case.[62] The matter is now to be decided by the German Constitutional Court.

Net taxation is a sub-principle of the ability-to-pay principle in direct taxes, which in turn is the manifestation in tax law of the principle of equality. The declaration of the interest limitation rule as unconstitutional will have implications in light of EU Law, and some consequences that are foreseeable.

7 The ATAD as a Recognition of National Tax Sovereignty and Interstate Tax Competition

The ATAD acknowledges that national tax sovereignty and cross-border tax competition is still at the core of EU tax law. It does so in its preamble, by referring to the OECD/G20 BEPS project and its main priority, in ensuring that tax is paid where profits and value are generated.[63] The preamble also makes reference to the need for restoring trust in the fairness of tax systems and allowing governments to effectively exercise their tax sovereignty.[64]

In this context, EU harmonization is needed as a joint and coordinated response against aggressive tax planning and tax avoidance. It is necessary to 'lay down rules in order to strengthen the average level of protection against aggressive tax planning in the internal market'.[65] Those general provisions are aimed at 'creating a minimum level of protection for national corporate tax systems against tax avoidance practices across the Union'.[66]

By including the term 'aggressive tax planning' in its preamble, yet not defining it, the Directive identifies it with practices causing BEPS. It presumes to be the EU answer to BEPS, implementing the outputs of the fifteen Actions of the BEPS project. The Directive sets rules against the erosion of tax bases in the internal market and the shifting of profits out of the internal market.

The preamble makes further reference to the fact that the ATAD rules will have to be implemented in twenty-eight separate corporate tax systems and should therefore be limited to general provisions.[67] The areas identified as priorities are limitations on the deductibility of interest, exit taxation, a general anti-abuse rule, controlled foreign company rules and rules to tackle hybrid mismatches.[68] It is further mentioned that the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation.[69]

8 The ATAD Interest Limitation Rule as an Instrument to Allocate Taxing Rights against Aggressive Tax Planning

The interest limitation rule in the preamble of the ATAD is put forward as a means to discourage BEPS through excessive interest payments. As mentioned, groups of companies often engage in BEPS through excessive interest payments to reduce their global tax liability. This behaviour is not necessarily linked to avoidance or abuse in the strict terms put forward by the ECJ.[70]

The interest limitation rule is therefore an allocation of taxing rights rule, reinforcing the territoriality principle. Fixing a ratio for deductibility which refers to a taxpayer's taxable EBITDA, is put forward as the logical consequence for excessive interest payments. Member States may decrease the EBIDTA ratio; place time limits or restrict the amount of unrelieved borrowing expense that may be carried forward or back; and adopt an alternative measure, 'referring to a taxpayer's earnings before interest and tax (EBIT) and fixed in a way that it is equivalent to the EBITDA-based ratio'.[71]

Member States may also add to the interest limitation rule, creating targeted rules against intra-group financing, such as thin capitalization rules.[72]

However, there is no option not to introduce an interest limitation rule.[73]

61 DE: Bundesfinanzhof (BFH), 14 Oct. 2015, *I R 20/15 – Verfassungsmaessigkeit der sog. Zinsschranke – Billigkeitsmassnahme*, paras 15–27.

62 *Ibid.*, at para. 28 et seq. and 53–55. On the BFH decision and unconstitutionality of the German interest limitation rule, *see* e.g. Roland Ismer, *Verfassungsrechtliche Rechtfertigung der Zinsschranke*, Finanz-Rundschau 777–784 (2014).

63 ATAD, *supra* n. 7, Preamble, at para. 1.

64 *Ibid.*

65 *Ibid.*, at para. 3.

66 *Ibid.*

67 *Ibid.*

68 *Ibid.*, at para. 5.

69 *Ibid.*

70 *Lankhorst-Hohorst*, *supra* n. 29, paras 37–38; *Test Claimants*, *supra* n. 58, para. 92.

71 ATAD, *supra* n. 7, Preamble, at para. 6.

72 *Ibid.*

73 *Ibid.*: *a contrario sensu.*

9 The ATAD interest limitation rule and the fundamental freedoms

Formally, the interest limitation rule is not discriminatory and therefore would not be incompatible with the fundamental freedoms, as it should apply to expenses related to national or cross-border debt. Furthermore, it is irrelevant whether the debt originates from third parties, associated enterprises or within a group. However, it is recommended that standalone entities are out of the scope of the interest limitation rule given the limited risks of tax avoidance.

Member States are granted the option to exclude excess borrowing expenses incurred on loans used to fund long-term public infrastructure projects, considering that such financing arrangements present little or no BEPS risk. Because the EU is not yet in the position to provide specific rules in the financial and insurance sectors, Member States should therefore be able to exclude them from the scope of interest limitation rules.

10 The ATAD interest limitation rule as a rule with an anti-avoidance purpose and proportionality

From an EU Law perspective, Article 4 can be seen as a rule with an anti-avoidance purpose. This is so, because it replaces national thin capitalization rules, the main purpose of which was to combat abuse. Moreover, systematic interpretation would lead us to consider that it is a rule with an anti-avoidance purpose, since it is included in the ATAD.

As a rule with an anti-avoidance purpose, Article 4 does not contribute to positive harmonization of tax bases. On the other hand, Article 4 can also be seen as contributing to harmonize tax bases, since it goes beyond an avoidance purpose and interferes with the taxable base, by setting up limits on the deduction of costs. These limits may guide companies to find alternative mechanisms and Article 4 can therefore be also seen as a behaviour orientation rule (a steering rule).

Even if the interest limitation rule is not discriminatory (Article 4 does not provide for discriminatory treatment between domestic and cross-border cases), the above mentioned paragraph 211 of Action 4 Annex A, recognizes that a conflict with EU fundamental freedoms (the freedom of establishment, capital and services) may arise.[74]

The same kind of considerations were included in the OECD's public discussion draft on BEPS Action 4:

> 230. The Treaty freedoms that need to be considered in the context of interest limitation rules are the freedom of establishment, and the free movement of capital … .In addition, the freedom to provide services, which also has to be analysed from the perspective of the service recipient, may be restricted …
>
> 231 … In this respect, consideration should also be given to the circumstances in which EU Member States could justify a restriction of EU Treaty freedoms, for example:
>
> the need to preserve the balanced allocation between EU Member States of the power to impose taxes; or
>
> the need to prevent tax avoidance and to combat artificial arrangements.[75]

Thus, it was expected that the EU implementation of the OECD/G20 BEPS recommendations on interest deduction, followed the ECJ case-law: an interest limitation rule should enable taxpayers to prove that transactions respected the arm's length principle and had no tax avoidance motives.[76]

It can be questioned whether Article 4 goes beyond what is necessary to combat avoidance in the EU Member States. Necessity, adequacy and proportionality stricto sensu of a specific EU tax regime are required, also for the purposes of consistency.

For example, the necessity and adequacy of including domestic intra-group loans and stand-alone borrowing entities in Article 4, for the purpose of combating BEPS is more than disputable. Domestic intra-group loans are submitted to the principle of symmetry (deduction in the borrower's jurisdiction will correspond to taxation in the lender's jurisdiction) and stand-alone entities do not engage in thin capitalization with avoidance purposes.

Similarly to the *BFH* arguments in respect of the German interest limitation regime, it can be questioned whether Article 4 of the ATAD is proportionate to its purpose: in fact, it does not take into account differentiations based on the sector of activity or on the financial situation of the borrower; it covers new companies and companies in a difficult financial situation; it covers situations that are not suspect of engaging in profit shifting; and it does not allow the taxpayer to demonstrate there is no avoidance purpose in the concrete case.

Thus, the subjective and objective scopes of Article 4 are difficult to justify for other reasons than to formally comply with the EU non-discrimination principle.[77]

Moreover, since the Directive does not give alternatives to funding through loans, one could argue that it sets an arbitrary limit on the deduction of expenses, on

[74] OECD, Annex A, *supra* n. 5, at 85.

[75] OECD, *Interest Deductions and Other Financial Payments, Action 4, Public Discussion Draft*, OECD/G20 Base Erosion and Profit Shifting Project, para. 3 (OECD 18 Dec. 2014–6 Feb. 2015).

[76] Mentioning the respect of allocation of taxing rights in the bilateral treaties and the possibility granted to the taxpayer to prove that there were no tax avoidance motives: S. Douma, *Limitation on Interest Deduction: a EU Law Perspective*, 3 Brit. Tax Rev. 374 (2015).

[77] Mutatis mutandis, BFH, *supra* n. 61, at paras 13 et seq.

net taxation and therefore an obstacle to the freedom of establishment in the internal market.

Although comparability between residents and non-residents is the first test to assess discrimination, the inclusion of domestic situations in a rule with anti-avoidance purposes does not eliminate the cross-border obstacle to the exercise of a fundamental freedom.

Article 4 of the ATAD is applicable without discrimination on grounds of nationality or residence, but it is liable to hinder or to render less attractive the exercise by EU nationals, including those of the Member State which enacted the measure, of fundamental freedoms guaranteed by the Treaty. This is true, even if 'the EU measure concerned […] (does not impose) […] a specific disadvantage on operators desirous of moving or establishing themselves within the EU, in comparison to operators within the boundaries of one Member State. There is […] (no) […] discrimination against […] EU […] nationals wishing to assert their rights derived from the freedoms of movement'.[78]

The core of the fundamental freedoms is hit by a tax obstacle to funding.

As a rule against BEPS, the interest limitation rule aims to preserve the balanced allocation of EU Member States' taxing rights, prevent and combat avoidance, especially, the risk of avoidance.[79] It aims to discourage avoidance, even though it is not structurally designed as an anti-abuse rule based on rebuttable presumptions.

Even if it is considered that, in the absence of discrimination, there is no obstacle to the exercise of a fundamental freedom, Article 4 would be disproportionate, to its aim of combating BEPS. Article 4 creates a bias against loans, independently of the companies having alternative paths for funding and independently of the final tax result in the Member State.

Article 4 (6) allows the Member State of the taxpayer to provide for rules either (1) to carry forward, without time limitation, excess borrowing expense that cannot be deducted in the current tax period under paragraphs 1 to 5; (2) to carry forward, without time limitation, and back, for a maximum of three years, excess borrowing expense that cannot be deducted in the current tax period under paragraphs 1 to 5; or (3) to carry forward, without time limitation, excess borrowing expense and, for a maximum of five years, unused interest capacity, that cannot be deducted in the current tax period under paragraphs 1 to 5.7.

Although carry-forward of losses attenuates the restriction, it does not eliminate it, as it will not prevent companies with solvency problems from becoming insolvent.

Even though Article 4 is suitable to combat BEPS, it goes beyond what is necessary to combat tax avoidance and cross-border aggressive tax planning (BEPS): it does not specifically target wholly artificial arrangements designed to avoid paying taxes in the jurisdiction in which they conduct business and borrow funds; it denies full deduction of interest expense, even if the loan and the interest are at arm's length, or the tax advantage is not the essential aim of the loan transaction.[80]

The Swedish interest limitation rules are an example of a disproportionate regime, that is possibly incompatible with the freedom of establishment. It sets a limit on the deductions of intra-group loans if the interest is taxed at a rate less than 10%, under tax law in the residence state, unless there are good business reasons for the loans on which interest is paid. If the interest is taxed at a rate of 10% or more, but still results in a 'substantial tax benefit' for the company group, the deduction may be denied. On the other hand, a tax rate of less than 10% may not limit the deductibility, if there are good business reasons.[81] These rules will be assessed by the ECJ in light of the freedom of establishment, as a result of an infringement procedure.[82]

11 The ATAD interest limitation rule as a steering rule

The rule limiting the deduction of interest would play the role of a steering rule (*Lenkungsnorm*) if accompanied by rules on the deduction of expenses and other rules redressing the debt-bias. That is the case of the new common consolidated tax base (CCTB) proposal to harmonize the taxable base.[83] It provides for net taxation of income, by allowing the deduction of expenses as a rule, as long as 'they are incurred in the direct business interest of the taxpayer'[84] and 'are incurred with a view to obtaining or securing income … including costs incurred in raising equity or debt for the purposes of the business'.[85]

The CCTB proposal further includes a rule in Article 11 entitled 'The Allowance for Growth and Investment' which aims to redress this debt-bias, followed by a rule on non-deductible items (Article 12) and an interest limitation rule (Article 13).

The allowance for growth and investment will allow a tax deduction for companies that choose to increase equity

[78] Differently from UK: Opinion of Advocate General Poiares Maduro delivered, 7 Apr. 2005, Case C-446/03, *Marks & Spencer*, at para. 28.

[79] OECD, *supra* n. 2, Annex A, at 85.

[80] Douma, *supra* n. 76, at 365; European Commission, Letter of Formal Notice of 26 Nov. 2014, C 8699, paras 51 et seq. (2014).

[81] Hultqvist, *supra* n. 26, at Ch. 26.8.4. *Ibid.*

[82] *Ibid.*

[83] COM (2016) 685 final 2016/0337 (CNS) Proposal for a Council Directive on a Common Corporate Tax Base.

[84] *Ibid.*, Art. 9 (1).

[85] Art. 9 (2) of the CCTB. Those expenses 'shall include all costs of sales and all expenses, net of deductible value added tax, that the taxpayer incurred with a view to obtaining or securing income, including costs for research and development and costs incurred in raising equity or debt for the purposes of the business' (Art. 9 para. 2 of the CCTB): CCTB, *supra* n. 83.

for financing (e.g. by issuing new shares or retaining profits) rather than take on debt (e.g. a loan).[86] Companies will generally be allowed to continue these deductions for ten years. This should encourage companies to seek diversified sources of financing and to tap capital markets.

The allowance for growth and investment is particularly beneficial for smaller companies that often have difficulty in securing loans.

12 Equality as an EU principle

The general principle of equal treatment is an EU principle, requiring that comparable situations not be treated differently and that different situations not be treated in the same manner, unless such treatment is objectively justified.[87]

Article 4 of the ATAD could also be questioned in light of the principle of equal treatment, as it treats in the same manner avoidance and non-avoidance situations, domestic and cross-border situations, group companies and stand-alone companies, companies that need funding and those that could opt for other alternatives in the same manner.

Moreover, the ATAD does not provide for non-deductibility or limited deductibility of other comparable domestic and cross-border expenses. That is the case of profit distributions and repayments of equity or debt, entertainment expenses, bribes and expense incurred by a company for the purpose of deriving income that is exempt.[88]

And because there is no EU harmonized alternative to funding through loans, similar to the aforementioned allowance for growth and investment foreseen in the CCTB proposal, Article 4 of the ATAD cannot be justified as a steering rule. It is an arbitrary limitation on the deduction of expenses and thus on the net taxation principle and the principle of equality. Considered alone, interest limitation rules are not proportionate.

The ECJ should therefore assess whether taxpayers in need of loans, such as small companies and domestic groups are not in a disadvantageous situation as opposed to those taxpayers that could find alternatives to loans.[89] A disadvantageous situation in light of the principle of equality 'does not necessarily and systematically entail unfavourable economic consequences', as it will also occur if taxpayers in different situations would be treated equally by EU law.[90]

There may be a justification for including interest deduction limits and not other limits or exclusions in the ATAD, namely the fact that avoidance by means of thin capitalization in a cross-border setting is more difficult to control than avoidance by the above-mentioned deduction of entertainment expense, bribes or expense incurred by a company for the purpose of deriving income that is exempt.

But there is no objective justification for including in the interest deduction limits non-avoidance situations, domestic situations and stand-alone companies.

13 Unconstitutionality of domestic interest limitation rules and transposition of the directive

If Article 4 of the ATAD is seen as an anti-avoidance rule, compatible with the EU general principle of equality and the fundamental freedoms, there will still be an issue if a national constitutional court declares the national interest deductibility rule unconstitutional. Even if the ATAD contains *de minimis* rules, once a domestic rule is unconstitutional, there would be an obligation to transpose the corresponding rule in the Directive.

It is not clear whether the introduction of an arm's length test, in order to bring back the net income tax principle as required by national constitutional law, and combined with the interest limitation rule would be incompatible with Article 4.

The ECJ has already concluded that if an EU rule is allegedly unconstitutional (due to contradiction with the principle of legality and legal certainty in Criminal Law) but its disapplication would be in contradiction of EU Law, EU law would have to be granted full application.

This was the case in *Taricco*, where according to the ECJ, disapplication of EU Law would either (1) prevent the imposition of effective and dissuasive penalties in a significant number of cases of serious fraud affecting the financial interests of the EU, or (2) would provide for longer limitation periods in respect of cases of fraud affecting the financial interests of the Member State concerned than in respect of those affecting the financial interests of the EU. In such cases, the national court should give full effect to EU Law (Article 325 (1) and (2) of the TFEU).[91]

Mutatis Mutandis the non-transposition of a rule in a Directive is not only formally a violation of EU Law and its principle of primacy, but would also harm the financial interests of all Member States, and therefore of the EU, by changing the competition level playing-field, as some Member States would have an interest limitation rule and others would not.

It results from *Taricco* that a Constitutional Court, when verifying the constitutionality of the domestic

[86] The deduction will be calculated by multiplying the change in equity by a fixed rate, which is composed of a risk-free interest rate and a risk premium. Under current market conditions, the rate would be 2.7%: CCTB, *supra* n. 83, *see also* R. A. de Mooij & M.P. Devereux, *Alternative Systems of Business Tax in Europe: An Applied Analysis of CBIT and ACE Reforms*, Taxation Papers - European Commission Working Papers n. 17, 2009.

[87] FR: ECJ 16 Dec. 2008, C-127/07, *Société Arcelor Atlantique et Lorraine and Others v. Premier Minitre, Ministre de l' Écologie et du Développement Durable, Ministre de l'Économie, des finances et de l'Industrie*, ECR 2008 I-09895, paras 22–23.

[88] *See* CCTB Proposal, *supra* n. 83, Art. 12.

[89] *See* the question raised in ECJ: *Société Arcelor*, *supra* n. 87, at para. 39.

[90] *Mutatis mutandis*, *Société Arcelor*, *supra* n. 87, para. 44.

[91] IT: ECJ, 8 Sept. 2015, C-105/14, *Ivo Taricco et al.*, ECLI:EU:C:2015:555.

interest deduction rule, should also verify whether the national provision is itself required by EU Law. EU Law is to be given full effect and if the national rule is equivalent to Article 4, the national constitutional court would not have to request or await the prior approval of an article by way of legislation or any other constitutional procedure. The Italian Constitutional Court has recently referred a case to the ECJ, seeking the interpretation of the *Taricco* case. More specifically, it asks whether national law incompatible with EU Law is to be disapplied even when such non application would be unconstitutional.[92]

14 Concluding remarks

This article discussed the ATAD provision on interest limitation, namely Article 4. Traditional thin capitalization rules applicable exclusively to cross-border loans were based on the condition of sovereign state tax symmetry and this condition was jeopardized by the ECJ jurisprudence.

Article 4 of the ATAD allocates taxing rights against aggressive tax planning. It aims at preventing tax avoidance, but it is not drafted as an anti-avoidance rule in the terms laid down by the ECJ case-law. In the author's opinion, it restricts the fundamental freedoms even if it is not discriminatory. Furthermore, the EU principles of proportionality and equality of treatment are not observed by Article 4 of the ATAD.

Finally, if a national interest limitation rule infringes national constitutional principles, such as the net taxation principle, there will be a conflict with the obligation of the national legislature to transpose Article 4 of the ATAD.

92 IT: Corte costituzionale italiana, Sintesi dell'ordinanza n. 24 del 2017.