The ATAD’s Interest Limitation Rule – A Step Backwards?

This article addresses the shortcomings of the interest limitation rule in the EU Anti-Tax Avoidance Directive (2016/1164).

1. Introduction

Following the OECD BEPS Final Reports, the European Union introduced the Anti-Tax Avoidance Package in order to, essentially: (i) prevent aggressive tax planning; (ii) increase transparency; and (iii) create a fairer environment for business in the European Union. The main legislative proposal, however, i.e. the EU Anti-Tax Avoidance Directive (2016/1164) addresses mainly the first pillar. The interest limitation rule, the main focus of this article, is one of the anti-abuse rules included therein. Having its roots in the Proposed CCCTB Directive, BEPS Action 4 and the German domestic interest limitation rule, this rule represents a novelty for most EU Member States. The purpose of this article is not to explain its main features, but rather to focus on its shortcomings in a way that might allow Member States and the European Union to revisit the rule in the future.

2. Shortcomings of the ATAD Interest Limitation Rule

2.1. Excessive number of options

The existence of an EU internal market entails progressive harmonization of the domestic legislation of Member States. This has been accomplished, to date, through a series of directives that are almost akin to regulations in the sense that they grant Member States minimal discretion with regard to implementation. In order to promote fairer and more efficient taxation, it is advisable to progressively harmonize tax rules. In this way, taxpayers face far fewer disparities when operating in cross-border scenarios. This goal, in the author’s view, was also one factor that triggered the adoption of the Anti-Tax Avoidance Directive (2016/1164) (ATAD). In fact, uncoordinated implementation of the BEPS recommendations and minimum standards would lead to more complexity for taxpayers operating in a cross-border setting and to additional inefficiency of the internal market.

The author believes that the interest barrier rule in the ATAD is not aligned with this aim. First, Member States have an enormous number of options that can be combined in multiple ways. The author has exhaustively mapped these rules, reaching the conclusion that, in total, one could build 288 rules based on the same provision of the ATAD. This development generates complex scenarios for taxpayers and tax authorities, since tax rules throughout the European Union are very inconsistent.

As a consequence, companies operating in different Member States will have to carefully check the specific standard in force in each state, instead of being able to rely on a “European standard” derived from the ATAD (as happens with most corporate tax directives). This diversity also offers opportunities for planning, which was certainly not the intended goal. In the author’s view, it would have been desirable to further negotiate in order to arrive at a less “optional” outcome.

Diagram 1 illustrates this diversity.

Second, Member States may use these alternatives as a sort of hidden incentive to attract foreign direct investment (FDI), introducing undesired competition. The current wording of article 4 provides Member States with the option to transpose less restrictive and more attractive rules, acting as favourable entry points for capital in the EU internal market that can later circulate freely due to the fundamental freedoms.

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In addition, the lack of harmonization creates obstacles and disparities within the internal market. The ATAD grants some discretion in the definition of the subjective scope of the rules. This may lead to discriminatory scenarios and to an infringement of fundamental freedoms (i.e. the freedom of establishment or the free movement of capital). For instance, assume Member State A has tax rules that include a specific status for tax groups that are composed only of resident companies, i.e. they are considered standalone entities. This may cause discrimination given that Member State A has opted to exclude standalone entities from the scope of the interest barrier rule (the limit would not be applicable to resident tax groups; however, it would apply to groups composed of both resident and non-resident companies since the latter would not be considered standalone entities). In this regard, the author believes that the Council must accelerate the process of harmonization of corporate taxation in the European Union, namely through a common consolidated corporate tax base (CCCTB) directive.

2.2. Undefined terms and legal certainty

In addition to the lack of harmonization that the ATAD ignites, it also raises some issues in terms of legal certainty, specifically the use of undefined legal terms and expressions. The ATAD establishes the de minimis threshold, meaning that it “shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases”, in observance of the sovereignty of Member States. It does not clarify, however, what “higher level of protection” refers to. On one extreme, every Member State could consider its own domestic rules as more effective in tackling tax avoidance, which would water down the utility of the ATAD. Moreover, it is crucial to acknowledge who the entity is that is competent to assess the validity of domestic laws introduced by Member States. The Court of Justice of the European Union (ECJ) holds the power to intervene in matters that fall under the de minimis threshold imposed by the ATAD. Nonetheless, whenever a Member State opts to introduce stricter rules in its domestic legislation, respecting the threshold, the ECJ’s actions are constrained. The ECJ can only intervene upon a Member State’s infringement of the ATAD, which means that if the threshold is respected, there is no infringement to be scrutinized by the ECJ. Therefore, given that the ATAD allows Member States to introduce a “higher level of protection”, as long as there is no restric-
tion of the fundamental freedoms, the ECJ cannot intervene in respect of such rules. In the author’s view, the best solution would be to establish minimum and compulsory standards.

2.3. Subjective scope of application

Article 4 of the ATAD states that it applies to all entities subject to corporate income tax (CIT) in their Member State of residence. It is applicable not only to companies, but also PEs located in the Member States, even if established by third-country residents. Taking into account the discrepancies between domestic CIT rules, uncertainty may arise in determining the real subjective scope of application of the rule. It may happen that an entity will be subject to the rule in one Member State but not in others, which, again, may lead to planning opportunities.

Moreover, some entities are liable to pay CIT but are objectively exempt. In the absence of a carve-out rule (and in the absence of an in claris non fit interpretation, i.e., whenever the rule is clear enough, there is no need for an interpretation of the rule), the rule will also apply to these entities, although it has no practical application due to the exemption. One can only wonder whether or not the application of the rule to objectively exempted entities is desirable (or even logical). In the author’s opinion, the rule should be revised to exclude these cases.

Regarding the subjective scope, it is possible for the EU Member States to exclude standalone entities. The rationale of this rule is simple: according to the drafters of the rule, base erosion would only occur in respect of interest payments between associated companies. The author believes, however, that this is not always the case. Erosion is less likely to arise in standalone entities given their size (small or medium-sized enterprises) and the absence of related parties. Nevertheless, and if one merely takes into account the OECD’s recommendations on this topic, some standalone structures may be larger and a lot more complex. This is true in respect of holding structures involving trusts or partnerships where there are several entities under the indirect control of the same investor. In these scenarios, the risk of erosion is quite similar to that of associated companies (despite the absence of a group relationship) and there may be advantages in transferring results among them, namely because they are under the indirect control of the same individual. For this reason, the author believes that Member States should opt for the application of the interest limitation rule to standalone entities and the ATAD’s rule could be revised to eliminate this option.

2.4. Double taxation

Interest payments are accounted for, for tax purposes, in the fiscal year in which they are recognized as deductible expenses. Such payments will likely be subject to withholding tax in the residence country of the borrower (as income of the non-resident lender) and subject to CIT in the residence country of the lender (as income of a resident). To avoid double taxation, and provided that the conditions of the Interest and Royalties Directive (2003/49) are met, no withholding tax will apply in the source state (the borrower’s residence state). Any interest paid will be exclusively taxed in the Member State of the lender. If the conditions are not met, then tax treaties may apply, reducing the applicable withholding tax rate and normally allowing for a credit for the amount paid at source in the residence state.

With the introduction of the ATAD, new double taxation issues may arise. The goal of the interest barrier rule is to limit the deduction of interest expenses, which will necessarily mean that, if applicable, the Member State of the borrower will tax a (fictitious) profit (an amount higher than the amount booked). This also means that the same income will be taxed in both jurisdictions. This situation cannot come as a surprise and was already identified in the ATAD; however, no mechanism has been provided regarding a profit adjustment in the country of the lender.

In the author’s view, when implementing the rule, Member States could also implement a mechanism pursuant to which the country of the lender will adjust its profits for tax purposes whenever an interest limitation rule is applied to the borrower. Double taxation could be avoided if the lender’s taxable profits were reduced in proportion to the “exceeding” interest deduction of the borrower. Such a measure would increase the administrative burden on tax authorities, as well as control measures required, and would certainly reduce the Member States’ revenue. Nevertheless, it may be imperative in addressing double taxation in the current tax scene of developed countries, with its range of instruments to eliminate double taxation. Given that this need was identified by the Council, it is hard to understand why such a mechanism has not been implemented. It seems that the Council’s first and foremost goal was to raise revenue, without any concern for bona fide taxpayers that do not engage in tax avoidance practices.
2.5. Debt versus equity

Article 4 has a significant impact on corporate financing methods. One of the underlying goals of the ATAD is to promote financing through equity rather than debt. This rule alone does not pursue its goal appropriately as, in its current configuration, it only establishes an arbitrary limit on the deduction of interest payments, as it is automatically applied. Rather than applying the said arbitrary limit, in the author's view, there should also be incentives to finance through equity.

For instance, the proposed CCCTB Directive introduces an interest deduction limitation that also takes into consideration equity financing methods. Whenever taxpayers opt for equity financing, such costs are deductible for tax purposes (i.e. expenses related to the issuance of shares or retaining profits). The proposed rule balances both financing methods such that taxpayers, in addition to incurring debt, are also motivated to open their doors to equity investment, improving their economic performance. This approach would ensure a lower predisposition for financing through debt and would also balance the interests of taxpayers and Member States better. Member States would be able to pursue the rule’s goal (decreasing debt) and still limit interest deduction and taxpayers would incur less debt, deduct more and improve their efficiency. In the author's view, automatically applicable rules and limits are not the best tools to regulate these cases.

2.6. Infringement of equality and proportionality

Article 4 of the ATAD does not per se act as an obstacle to the exercise of any fundamental freedoms since the rule applies irrespective of the taxpayers’ residence (and may also be applied to purely domestic situations). Even considering that the nationality test is not the only one to be taken into account, it is the author’s belief that two taxpayers in comparable scenarios will always be treated equally despite the fact that one operates solely in the domestic market and the other in a cross-border setting.

This prima facie compatibility with the fundamental freedoms does not mean that the rule is, as such, compatible with EU law. EU treaties enshrine many other rules and principles that must be observed by secondary law. In addition to the fundamental freedoms and the State aid prohibition – the two main hurdles of domestic direct tax rules – domestic rules must also abide by general principles of EU Law.

In this context, it is important to note the relatively recent decision of the German Federal Fiscal Court in IR 20/15 regarding the domestic interest barrier rule (which, as mentioned, has a similar modus operandi), in which the rule was struck down on the basis that it infringed the constitutionally protected equality and proportionality principles.

According to the Court, the domestic rule infringed the ability to pay (Leistungsfähigkeit) principle, a corollary of the equality principle. Applied to legal persons, this ability-to-pay principle requires that the tax base match the real and effective profit of the taxpayer. In this respect, whenever there is an interest barrier rule, the taxpayer will be taxed on a fictitious profit that does not correspond to his real one and, as a result, will not be taxed according to his ability to pay. Even considering the possibility of carrying forward the unused capacity of deduction or the exceeding expenses, the limitation of the deduction in a specific tax year generates an immediate cost to the taxpayer that cannot be eliminated or mitigated through the carry-forward option.

The German Federal Fiscal Court rejected the three justifications put forward to explain the restriction on the ability-to-pay corollary. Firstly, it was alleged that most German taxpayers were not affected by the interest limitation rule, meaning that restricting the equality principle could not be justified by the “incentive” to finance through equity. The limitation on debt financing is a means of control of economic policy. It motivates companies to opt for equity financing, for example, through the issuance of shares. Since the rule only applies to a reduced number of entities, there is no significant impact on the national economy.

Second, the Court ignored the financial needs of the state (the state of the lender) since the interest limitation rule only applies in a small number of cases and corresponds to a minimal gain in comparison to the limitation on the equality principle.

Finally, the Court rejected the justification regarding the need to tackle tax avoidance scenarios. Given that the rule is also applicable to purely domestic situations, in respect of which the risk of tax avoidance is low, the Court considered that the lawmaker went beyond what was necessary to tackle tax avoidance. The fact that the interest barrier rule does not allow the taxpayer to prove that his trans-
action does not constitute abuse implies that it is not proportionate. It should be noted that this decision is not final, since the decision of the German Constitutional Court has not yet been issued. It clearly indicates, however, the issues that might also be raised at the EU level. Of course, and due to the primacy of EU Law, the ultimate decision of the German Constitutional Court will not impact timely implementation of the ATAD before 31 December 2019 regardless of the similarity between the rules. It should be noted, however, that the ECJ has already considered both equality and proportionality as general principles of EU Law. In short, this means that the reasoning of the German Federal Fiscal Court (which likely will be followed by the Constitutional Court) may also be followed, at the EU level and regarding the ATAD rule, by the ECJ.

2.7. Fighting tax avoidance

The rule applies automatically, as it is supported by a numeric calculation independent of any abuse. Regardless of the conduct of the taxpayer in case, the rule is applicable whenever the established threshold is exceeded. The ECJ has already condemned anti-tax avoidance rules that are automatically applicable. The arguments it has made are valid and should also have been considered in this matter. The ATAD rules are based on the BEPS Project and should fulfill the aim of tackling tax avoidance situations. Bearing in mind that this is not the only purpose of the interest barrier rule, the author believes that the Council took a step back in terms of the ECJ’s path toward tackling tax avoidance situations. The European Union has significantly increased the scope of application of the interest limitation rule, favouring the ability of Member States to raise revenue and their taxation powers in general. Consequently, there is now an inconsistency between the rationale of the rule and its formal construction: initially thought to tackle abusive scenarios, it now covers a significant number of non-abusive cases, losing, in the author’s view, its legitimacy.

3. Implementation of the Interest Limitation Rule and Free Movement of Capital

Implementation of restrictive rules above the de minimis threshold imposed by the ATAD may originate restrictions on the free movement of capital. It is critical not to confuse the freedom of establishment with free movement of capital. The freedom of establishment is only applicable within the European Union while the free movement of capital can be applicable in relations with third countries. In determining which fundamental freedom is applicable, a normative criterion is applied. The ECJ has stated that the freedom of establishment applies exclusively where domestic law only covers scenarios in which the taxpayer holds a participation in share capital “which gives him definite influence over the company’s decisions and allows him to determine its activities”. When the provision being analysed does not exclusively tackle these scenarios, the ECJ has affirmed that the free movement of capital applies.

In general, the domestic rule could fall within the freedom of establishment. If, however, certain options are exercised, the domestic rule may trigger the application of the free movement of capital and, in certain scenarios, it may amount to a restriction of the said freedom. This will, namely, be the case where, for example, Member State A introduces an interest limitation rule (i) applicable to standalone entities (ii) with a more restrictive limit exclusively applicable to third-country residents (i.e. EUR 0.5...
million or 10% of EBITDA). Since the rule will also apply to standalone entities, the free movement of capital, which is also applicable to third countries, would be restricted and there would be discrimination.

Since the freedom of establishment only applies to Member States.

Even if the provision was not applicable to standalone entities, as long as the domestic group regime requires participation in the share capital that corresponds to "definite influence", this would fall within the scope of the freedom of establishment, and there would not be a restriction.\(^{57}\)

4. Conclusions

The ATAD requires a de minimis standard of protection of EU Member States’ tax systems against base erosion by way of interest deductibility. The subjective scope falls within the ambit of the Member States’ rules subjecting an entity to corporate income tax, which may lead to discrepancies and opportunities for planning. In the author’s view, the rule should be extended to cover standalone entities since they present similar concerns regarding base erosion.

Harmonization, or uniformity, is the underlying goal of any secondary EU law instrument. Due to the significant number of alternatives for implementation, however, the ATAD represents a missed opportunity to further promote this goal. Furthermore, the use of undefined terms and expressions increases the risk of litigation and potential restrictions on the fundamental freedoms in the Member States. It is, for now, very difficult for lawmakers to determine the reach of the de minimis threshold.

The ATAD does not meet its aim of stimulating financing through equity. In the author’s view, it would have been preferable to adopt a rule similar to that of the Proposed CCCTB Directive. Moreover, there are also double taxation issues that could be solved by introducing a profit adjustment mechanism in the Member State of the lender in order to balance the disadvantage caused by limiting the deduction of interest payments and taxing a fictitious profit that does not correspond to the real one reflected in the borrower’s accounting records.

The rule is compliant with the fundamental freedoms since it applies to residents and non-residents alike in both cross-border and purely domestic scenarios. The author believes, however, that it infringes primary EU law, namely the equality and proportionality principles, which are general principles of EU law. In addition, certain options may trigger the application of the free movement of capital. In this scenario, the imposition of a more stringent limit on third-country residents would not be permissible.

In the author’s view, and based on the “need to fight tax avoidance” justification, the European Commission ended up introducing an arbitrary limitation on interest deductibility that, under its current design, appears to be primarily aimed at increasing Member States’ tax revenues. With the introduction of this protectionist and conservative measure, it is feared that EU institutions will end up infringing some of the basic elements of the rule of law, which are likely to be taken into account by the ECJ if called upon to assess the compatibility of the rule with primary EU law.

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