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Limitations on interest deductions: Does BEPS action 4 presume tax avoidance?

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Summary

Debt and equity are in most countries treated differently for taxing purposes. The asymmetry between the financing forms are being taken advantage of by MNEs, allowing them to plan their cross-border activities in a way that lowers the taxable burden for the whole group. To prevent the increasing problem of base erosion and profit shifting, Member States have implemented different rules limiting interest deductions, one of these sets of rules being thin cap rules. The existing ones are, according to BEPS action 4, not sufficient to counteract the harmful activities of MNEs. Hence, OECD and the G-20 countries have in action 4 developed the suggested best approach which contains the fixed ratio rule and the group ratio rule.

The aim of this paper is to find out if the best suggested approach assumes tax avoidance and hence is precluded by EU law. By applying the legal dogmatic method, the paper shows that interest limitation rules fall under the freedom of establishment and the free movement of capital. The application of the method also shows that the suggested best approach does not comply with EU law since the proposal does not provide for an objective measure which would allow the taxpayer to prove that a cross-border activity is genuine and commercially justified. The approach applies in a general manner, which is contrary to what is allowed according to CJEU case law, but does have a specific anti-abuse purpose. Applying a fixed ratio could also be precluded by EU law since CJEU case law show that a general limitation will lead to genuine cross-border transactions being affected.

The paper discusses whether thin cap rules are an effective measure to combat base erosion. The opinions of scholars are split but the paper agrees with the fact that base erosion and profit shifting does not address the underlying problem, which is the asymmetry between debt and equity. Without properly addressing this difference, problems with base erosion and profit shifting might always exist. Action 4 and the ATA Directive could, at least within the EU, mitigate the problem because of the coordinated rules.

Abbreviation list

AG	Advocate general
BEPS	Base Erosion and Profit Shifting
CJEU	Court of Justice of the European Union
CFC	Controlled Foreign Corporation
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes, depreciation and amortisation
EU	European Union
The European Commission	The Commission
GAAR(s)	General anti-abuse rule(s)
I&RD	Interest and Royalties Directive
MNEs	Multinational entities
OECD	Organisation for Economic Cooperation and Development
p.	Page
para.	Paragraph
PSD	Parent-Subsidiary Directive
TFEU	Treaty on the Functioning of the European Union
Thin cap	Thin capitalisation
v.	Versus

1 Introduction

1.1 Background

In September 2013, the Organisation for Economic Co-operation and Development (OECD) and the G20 countries, following the report *Addressing Base Erosion and Profit Shifting,* BEPS, adopted an Action Plan consisting of 15 different actions. The background of the adoption of BEPS is, inter alia, the weakness in the current system which creates opportunities for corporations to shift profits and tax base erosion. One way of shifting profits is by adjusting the debt within a group entity. This way is mainly used by multinational entities (MNEs) in order to achieve a lower tax burden for the whole group. The risk of Base Erosion and Profit Shifting can arise in several ways which all involve deductions of interest expenses. BEPS action 4 addresses this problem by suggesting several best practices which limit the deduction of interest expenses and other financial payments.[1]

Interest deduction limitation rules have already been implemented by some European Union (EU) Member States. Some countries apply a debt to equity ratio measure, which determines how much of the interest expense is tax deductible by allowing a deduction on interest payments on debt up to a certain threshold, for example, two times the amount of equity invested (2:1). Any excessive interest is not allowed to deduct.[2] Other countries apply the Arm's Length Principle, which compares inter-company debt and interest rates to the ones from a third party. These two approaches of limiting interest deductions are however not, according to the OECD, considered to be the best practices to tackle BEPS on their own. Together with the best practice approach, they may however be helpful.[3]

A few Member States have already introduced rules similar to the suggested best practice approach in action 4, one of them is Germany.[4] However, in February this year[5], the German Federal Court of Finance came to the conclusion in a case that the German interest limitation rules violate the fundamental right of equal treatment among taxpayers and the principle of taxation of net income. The Court did not find a justification for the

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[1] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4: 2015 Final Report, p. 3.

[2] OECD, Tax & Development, Thin Capitalisation Legislation, A Background Paper For Country Tax Administrations (Pilot version for comments), Initial draft- August 2012, p. 12.

[3] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4: 2015 Final Report, p. 20.

[4] Germany applies an earning stripping test, deductions on interest payments are allowed up to 30% of EBITDA, A. Perdelwitz, *Germany - Corporate Taxation* sec. 7., Country Surveys IBFD (accessed 11 May 2016).

[5] 2016.

application of the rules in the specific case. The matter is referred to the German Federal Constitutional Court.[6] Should the Federal Constitutional Court come to the same conclusion, the decision could have an impact on the implementation of BEPS action 4.

The field of direct taxation is not harmonised in the EU, and the Court of Justice of the European Union (CJEU) is the organ which mainly regulates how much a Member State is allowed to confine taxpayers right to deduct interest payments.[7] In January this year, the European Commission (the Commission) published a proposal for a council directive "*laying down rules against tax avoidance practices that directly affect the functioning of the internal market*", also called the ATA Directive.[8] In the directive the Commission proposes an interest limitation rule which is similar to both the German rules and the suggested best approach.[9] Due to the similarities between the three sets of rules, and due to the fact that both action 4 and the ATA Directive to date have not been implemented, it is necessary to put them in relation to one another. The implementation of both action 4 and the ATA Directive might be affected by the outcome of the German case and also by EU law.

According to EU law Member States may not presume that taxpayers engage in cross-border activities for the sake of escaping taxes.[10] It is therefore necessary to examine whether the suggested approach in action 4 complies with EU law

1.2 Aim

The aim of the thesis is to analyse if the suggested best approach to limit interest deductions in BEPS action 4 presumes tax avoidance and could hence be infringing EU law. The suggested best approach will be compared with the relevant fundamental freedoms of EU law. Doubts have arisen by scholars whether the rules, both in action 4 and the ATA Directive, comply with EU law since no element of objective measure is suggested in these proposals. In order to accomplish the aim, it is necessary to analyse to what extent limitations on interest deductions are acceptable under EU law.

The focus will be on the comparison between the relevant fundamental freedoms through case law from the CJEU determining when interest deduction limitation rules are precluded by the fundamental freedoms, and

[6] BFH, 14.10.2015, I R 20/15, DStR 2016, p. 301
[7] Court of Justice of the European Union, http://europa.eu/about-eu/institutions-bodies/court-justice/index_en.htm, downloaded 11.5.16.
[8] European Commission, *Proposal for a council directive laying down rules that directly affect the functioning of the internal market*, 28.1.2016.
[9] Ibid, article 4.
[10] C-196/04 Opinion of advocate general Léger, para. 53.

the suggested best approach. The analysis will determine if EU law could possibly affect an implementation of the suggested approach in BEPS action 4. The ATA Directive will also be discussed but it is not where the focus will lie.

1.3 Method and material

The method that will be used in the thesis to analyse the aim is the legal dogmatic method which is used to research the law as it stands.[11] Hence, the legal dogmatic method will be used in the paper to describe the existing rules on interest deduction limitations. The material that will describe the law as it stands will consist mainly of provisions in the Treaty on the Functioning of the European Union (TFEU) and case law. The material is chosen for the reason to give the most accurate view on the law as it stands. Direct taxes are not harmonised in the EU, which is why it is not possible to only use the TFEU as a legal dogmatic source. The TFEU will mainly be used as a source to describe the relevant fundamental freedoms. CJEU case law will describe the applicability of the fundamental freedoms.

The case law in the thesis is chosen for the reason to describe the limits of thin cap rules; when and how the rules are considered as either unjustified or disproportionate when applied to cross-border transactions. The cases are presented in a chronological order. When referring to Member States' domestic interest limitation rules, secondary sources of law are used, mainly IBFD, due to the language barrier. The purpose of explaining the current rules on interest deduction limitations is to give the reader an understanding of the different rules Member States have chosen to apply.

The ATA Directive will be described and analysed in the paper due to its relevancy and similarity with the suggested best approach. The focus will be on action 4 but a comparison will be made between the BEPS recommendations and the ATA Directive proposal. The ATA Directive is still in an early stage of development and will therefore not be used as a secondary source of EU law[12] but merely to describe the upcoming possible changes.

BEPS action 4 will be used in the thesis as a source of information to give the reader an explanation of the suggested best approach. An explanation of the suggested best approach is highly relevant since the thesis will analyse its conformity with EU law. It should be kept in mind that BEPS is a project and not a source of law. Action 4 will thus not be used in the paper as a legal source but merely for the purpose of describing and analysing the suggested best approach.

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[11] Sjoerd Douma, *Legal Research in International and EU Tax Law* (Kluwer 2014), p. 18.
[12] Secondary sources of law are i.e. directives, Access to European Union law, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3Al14534. Downloaded 12.5.16.

Doctrine will also be used in order to describe the current rules in a general manner used by Member States to limit interest deductions. It will also be used as a basis for discussion and analysis. Due to the fact that the BEPS project was only initiated in 2013, and because of the constant changes in this field of law, the articles in the thesis are time relevant.

1.4 Delimitation

This paper will be limited to only describe and analyse the suggested best approach in BEPS action 4 in a general manner. Consequently, rules such as targeted rules and the applicability of the best approach to banking and insurance groups will not be discussed. It is only necessary to give the reader a synoptic understanding of the suggested best approach since the focus of the analysis is on EU law. The fundamental freedoms will not be explained in depth since the CJEU case law will complement the explanation and make the provisions clearer.

As the CJEU has mainly been given rulings in cases regarding thin cap rules, these cases will be dominant in the discussion. Controlled Foreign Corporation rules (CFC-rules) will be mentioned in the paper but not analysed since they are not a part of action 4. Background information about the ATA Directive will be given but the focus will be on the provision regarding limitations on interest deductions.

1.5 Outline

The paper's second chapter starts with a general introduction of the content, and proceeds by describing the differences between debt and equity. After that, a short description of different ways of limiting interest deductions within the EU is presented. Following this, the best practice approach, the fixed ratio rule, the group ratio rule, interest and financially equivalent payments and the article 4 of the ATA Directive are presented.

In the third chapter of the paper the legal question will be answered. Also that chapter will start with a general introduction of the content. It proceeds by shortly describing the fundamental freedoms of the EU and then CJEU case law. The last parts of chapter three will be dedicated to analyse the material and the aim of the thesis will be answered. The paper ends with a conclusion chapter.

2 BEPS action 4 and the ATA Directive Proposal

2.1 Introduction

In this chapter, the suggested best approach in BEPS action 4 will be presented. The fixed ratio rule, group ratio rule and interest and financially equivalent payments will be described. After that, article 4 of the ATA Directive will shortly be described. It is most relevant to place the rules together because of the similarities they have and because the effect they might have on one another. The rules follow a general description of the difference between debt and equity and the interest deduction rules within the EU Member States.

2.1.1 Debt v. equity

Debt and equity are in most countries taxed differently. The reason why is that debt is typically regarded as a resource not belonging to the company. A company pays for the use of the resource by paying interest, and the interest should therefore be tax deductible, according to the underlying principle.[13] Accordingly, interest payments on debt are usually tax deductible for the paying company and taxed in the hands of the payee at ordinary rates. Equity returns, such as dividends, are however not tax deductible in the hands of the payer. These returns are usually subject to a tax relief, an exemption or credit for example, and are thus not taxed in the hands of the payee.[14] In a domestic situation, the financing forms can be considered as neutral since they are subject to comparable overall tax. The difference between the financing forms is being taken advantage of by MNEs, by setting up tax planning structures in order to reduce or lower the tax burden.[15]

When financing a subsidiary in another jurisdiction, the parent company generally choses the form of the financing. How much of the financing will constitute equity and how much will constitute debt, either from the parent or from outside the group, is decided by the parent. If the parent company choses to finance the subsidiary with equity alone, the allocation of taxable profits will not be affected, and the profits made by the subsidiary will be attributable to that jurisdiction. If the parent company, however, choses to finance the subsidiary with both equity and loan, the profit will be split

[13] Finnerty, Merks, Petriccione, Russo, *Fundamentals of International Tax Planning* (IBFD 2007), p. 107.
[14] Ibid, p. 108.
[15] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4: 2015 Final Report, p. 15.

between the two jurisdictions.[16] The split of profit ultimately affects the amount of tax the companies pay and results in a loss of revenue for the jurisdiction in which the subsidiary is situated. MNEs have an advantage relative to purely domestic businesses since the latter do not obtain the same tax advantage.[17]

2.1.2 Ways of limiting interest deductions in the EU

Direct tax law is not harmonised in the EU. It is within the competence of every Member State to legislate in that area. However, Member States must enact legislation in accordance with EU law.[18] Member States are tackling the issue of base erosion and profit shifting by implementing rules limiting the deductibility of interest where financing through loan between related parties is considered to be excessive. This can be achieved by applying a specific ratio rule to decide how much interest is allowed to be deducted. These rules, thin cap rules, have been implemented by some Member States. The rules aim at protecting a country's tax base by limiting the amount of interest that a company can deduct.

Countries which have implemented thin cap rules have done it in different ways, but generally they limit the interest deduction by applying a debt to equity ratio to decide how much interest is allowed to be deducted by the debtor. Any amount exceeding the threshold is considered as excessive for tax purposes.[19] For example, France applies a debt to equity ratio of 1.5:1 of the overall indebtedness of a group[20]. Denmark applies a ratio of 4:1 together with an asset test and EBIT test.[21]

According to BEPS action 4, thin cap rules as they are implemented by countries today, do not suffice to tackle base erosion and profit shifting. The report identifies the main advantages with the current thin cap rules as being the fact that tax administrations easily can obtain the required information, and that the rules provide legal certainty for groups in order for them to plan their finances. On the other hand, the disadvantages constitute of a significant flexibility for the company to set the interest rate. The debt-to-

[16] Finnerty, Merks, Petriccione, Russo, *Fundamentals of International Tax Planning* (IBFD 2007), p. 108.
[17] OECD, Tax & Development, Thin Capitalisation Legislation, A Background Paper For Country Tax Administrations (Pilot version for comments), Initial draft- August 2012, p. 7.
[18] C-319/02 *Manninen v. MDDP,* para. 19.
[19] Finnerty, Merks, Petriccione, Russo, *Fundamentals of International Tax Planning* (IBFD 2007), p. 221.
[20] P. Burg, *France - Corporate Taxation* sec. 7., Country Surveys IBFD (accessed 10 May 2016).
[21]L. Ambagtsheer-Pakarinen, *Denmark - Corporate Taxation* sec. 7., Country Surveys IBFD (accessed 10 May 2016).

equity test can easily be manipulated by the company in order increase the level of equity and thus the interest deductions.[22]

Other Member States do not apply a specific ratio rule but only the arm's length principle to transactions. This means that the interest rate set on a loan between related parties should be guided by rates that would have been set between non-related parties in a comparable situation.[23] A few Member States have already implemented rules similar to the suggested best approach in BEPS action 4,[24] which is the application of an earnings test. An entity is according to the test only allowed to deduct interest expenses up to a certain percent of the company's earnings before interest, taxes, depreciation and amortisation EBITDA.[25]

Another way for the source state to protect its tax base and hence counteract the base-shifting effect is to apply a withholding tax on interest payments abroad. The application of a withholding tax might however make a jurisdiction unattractive for the purpose of investments.[26]However, the Interest and Royalty Directive[27] obliges Member States to exempt interest and royalty payments from such taxes when the company or permanent establishment receiving the payment is situated in another Member State.[28] Hence, the application of a withholding tax on interest payments is not regarded as an effective way of combating BEPS.

2.2 The best practice approach

Shifting profit by using related party or third party interest could be one of the easiest existing profit-shifting techniques in international tax planning. The exercise of adjusting the debt and equity of a controlled entity is relatively easy due to the mobility of capital. This is one of the main reasons behind BEPS action 4 and the best practice approach, which is a recommendation of the best form to counteract excessive interest deductions and other financial payments.[29] By applying a consistent approach countries

[22] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4: 2015 Final Report, p. 21.

[23] Monsenego, Jérôme, *Introduction to Transfer Pricing,* (Studentlitteratur 2013), p. 26.

[24] Italy- G. Gallo, *Italy - Corporate Taxation* sec. 1., Country Surveys IBFD (accessed 16 May 2016). Spain- Á. de la Cueva González-Cotera & C. Morlán Burgasé, *Spain-Corporate Taxation* sec. 7., Country Surveys IBFD (accessed 16 May 2016).

[25] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4: 2015 Final Report, p. 25.

[26] Finnerty, Merks, Petriccione, Russo, *Fundamentals of International Tax Planning* (IBFD 2007), p. 109.

[27]Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157.

[28]Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, article 1(1).

[29] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4: 2015 Final Report, p. 15.

are, according to the action plan, more likely to succeed in the combating of base erosion and profit shifting. Distortions will be removed, the risk of unintended double taxation reduced, and the equality and fairness between groups will be improved.[30]

BEPS action 4 suggests an approach that is based on a fixed ratio rule. According to the rule, the deductions of an entity's net interest is limited to a fixed percentage of its profit, which is measured by using EBITDA. Countries are also allowed to use earnings before interest and taxes (EBIT), as a measure, and only in limited cases asset values instead of earnings.[31] An overview of the best practice approach as it is set up in action 4 can be found in the appendix *(Figure 1 in Appendix A).*

Action 4 encourages countries to apply a combined fixed ratio rule with a group ratio rule. Entities might in certain circumstances need to deduct more interest expenses since different sectors require different leverages, and by applying only a fixed ratio some groups might be subject to double taxation if the leverage is above the set level. A combination of a fixed and a group ratio is considered to be helpful of solving that problem.[32]

The action recommends that the rules mainly cover entities which are a part of a multinational group since those entities pose a higher risk of base erosion and profit shifting. Countries may however extend the application of the best practice approach to standalone entities and entities part of a domestic group.[33] Just as certain entities pose a higher risk of base erosion and profit shifting, other entities pose a low risk and should therefore be excluded from both the fixed ratio and group ratio rule under a *de minimis* threshold. By excluding low risk entities, compliance costs reduce for the entities and administrating costs for the tax authorities which can instead focus on the high risk entities. It is recommended that the minimum threshold is based on "*the total net interest expense of all entities in the local group*". The application of such a threshold should be relatively easy, and regardless of the company's size, an interest limitation rule is required for highly-leveraged entities only. If the threshold is based on the net interest expense of separate entities, the rules might be abused by groups trying to avoid the application of the rules by establishing several entities in order to fall below the threshold. Anti-fragmentation[34] rules should thus be considered as a complement to threshold based on the net interest expense of separate entities. Hence, the set level of a *de minimis* threshold should

[30] BEPS Action 4, p. 18.
[31] BEPS Action 4, p. 25-26.
[32] BEPS Action 4, p. 26.
[33] BEPS Action 4, p. 33.
[34] Anti-fragmentations rules are suggested in BEPS action 7 and are intended to prevent companies from abusing the permanent establishment rules by splitting activities between related entities.

reflect, inter alia, local economic environment, interest rate environment, relevant tax or legal considerations, which should be reviewed and updated periodically.[35]

2.2.1 Fixed ratio rule

According to the fixed ratio rule, an entity is allowed to deduct interest expenses up to a specific percentage of EBITDA, leaving a part of the profit for taxation. The fixed ratio benchmark is up to the government of each country to decide. The rule allows an entity do deduct interest payments up to the fixed ratio benchmark, and disallows any interest deduction above it. It applies irrespective of an entity's or a group's actual leverage and does not take into account the difference in the amount of leverage required by groups operating in different sectors.[36]

One of the advantages of the fixed ratio rule is that it is relatively simple for tax administrations to administer and for entities to apply. This advantage would cease and the rule would be more complex if it applied differently to groups in different sectors. The recommendation is hence that countries should apply the same fixed ratio rule to all groups in all sectors. Countries may however apply the rules more strictly to groups that generate higher levels of EBITDA which would under the approach generate high levels of interest deductions.[37]

The calculation of the allowed amount of deductible interest expense is made in three steps;

1. "*Calculating the appropriate measure of EBITDA"*

EBITDA is calculated by adding back net interest expense, net payments equivalent to interest payments *(see 2.2.3.),* depreciation and amortisation. Dividends, foreign earnings and other tax exempt income should not be included in the calculation of EBITDA.

2. *"Applying the statutory benchmark fixed ratio to an entity's EBITDA to determine the maximum deductible interest expense."*

The result of the application of the benchmark will determine the maximum amount of interest payments an entity can deduct.

3. *"Comparing this with the actual interest expense of the entity.*"

The amount determined under point 2 is in this last step compared with the actual interest expense an entity has generated. Any amount above the allowed maximum amount is therefore disallowed.[38]

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[35] BEPS Action 4, p. 35.
[36] BEPS Action 4, p. 47.
[37] BEPS Action 4, p. 47.
[38] BEPS Action 4, p. 47-48.

The benchmark fixed ratio should be set at an appropriate level to tackle base erosion and profit shifting between jurisdictions. Countries might want higher the level benchmark of the fixed ratio in order to attract foreign investment. The level should however not differ too much between countries since a high level benchmark fixed ratio would reduce the effectiveness of the tackling of base erosion and profit shifting. One of the recommendations for preventing a level set too high is for countries to set their benchmark within a "*corridor*". The corridor aims at identifying a range of benchmark fixed ratios which allows a deduction of an amount corresponding to their net third party interest expense, and limits the possibility for groups to use intragroup interest expense in order to claim total net interest deductions in excess of their net third party interest expense.[39]

Different factors affect the benchmark fixed ratio that a country sets, but data provided for by BIAC[40]/PwC show that a higher benchmark result in less and less groups being able to deduct all of their net third party interest expense. It is recommended that the benchmark fixed ratio is set within a corridor of 10-30%.[41]

2.2.2 Group ratio rule

The group ratio rule takes into account the fact that the leverage of groups in different sectors may vary. Some company groups are therefore affected by the rule more than others. Countries are thus recommended to combine the fixed ratio rule with the group ratio rule. An entity in a highly leveraged group is under the group ratio rule allowed to deduct net interest expense above the permitted amount under the fixed ratio rule. Countries could in that case apply a low benchmark fixed ratio which would be compensated by the group ratio rule.[42]

The group ratio rule allows an entity to deduct net interest expense up to the group's net third party interest/EBITDA ratio. If the ratio of an entity exceeds the EBITDA of the group, the group's ratio is the limit up to which the entity can claim deductions. Countries may choose to apply different group ratio rules than the suggested ones, or have no group ratio rule at all. The fixed ratio rule should then be applied with consistency to all entities regardless of the type of group, and with a benchmark fixed ratio within the corridor of 10-30%. The rules need to be relatively easy to apply both for the tax authorities and company groups, which is the reason why it is for the entity to obtain the necessary information and provide it to the local tax authority. If the necessary information for the application of the group ratio

[39] BEPS Action 4, p. 48-49.
[40] The Business and Industry Advisory Committee of the OECD.
[41] BEPS Action 4, p. 49-50.
[42] BEPS Action 4, p. 57-59.

rule cannot be obtained by the entity, the fixed ratio rule can still be applied.[43]

The amount up to which net interest expense is deductible is determined in the following way;

1. *"Determine the group's net third party interest/EBITDA ratio.*
   Net third party interest expense / Group EBITDA = Group ratio.
2. *Apply the group's ratio to an entity's EBITDA.*
   Group ratio x Entity EBITDA = Limit on net interest deductions."[44]

There are several ways of determining the group's net third party interest, but the proposed approach recommends that the calculation is based on figures from consolidated financial statements of a group. When calculating a group's EBITDA, it should be "*profit before tax plus net third party interest expense, depreciation and amortisation (including impairment charges)*".[45]

2.2.3 Interest and financially equivalent payments

There is no universal definition of interest, and many countries do not have a legal definition of the term. Each country decides themselves which expenses should be considered as interest and hence tax deductible. Easily explained, "*interest is the cost of borrowing money*".[46] In order to address base erosion and profit shifting in a sufficient manner, there are however benefits if countries use a consistent approach in identifying the items that should be covered by the rules. If the definition of interest is too strict, it would, according to action 4, raise three large issues;

- *"It would fail to address the range of base erosion and profit shifting risks that countries face in relation to interest deductions and similar payments.*
- *It would reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements.*
- *Its effect could be easily avoided by groups re-structuring loans into other forms of financing arrangement."*[47]

The rules should therefore be applicable to interest payments in all forms of debt and to financial payments equivalent to interest. For example, payments that are linked to an entity's financing and are determined by the application of a percentage to a notional or actual principal over time. The list of examples provided for in the action plan is non-exhaustive and it is up

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[43] BEPS Action 4, p. 57-59.
[44] BEPS Action 4, p. 60.
[45] BEPS Action 4, p. 62-63.
[46] BEPS Action 4, p. 29.
[47] BEPS Action 4, p. 29.

to every country to determine if a payment is economically equivalent to interest. The focus should be on the economic substance and not the legal form.[48]

2.3 Article 4 of the ATA Directive

In January this year, the Commission released a proposal for a Council Directive[49]. The directive is referred to as the Anti- Tax Avoidance Directive (ATA Directive) and is part of the Commission's Anti- Tax Avoidance Package for a fairer, simpler and more effective corporate tax rate in the EU.[50] The directive responds to the BEPS project and suggests anti-tax avoidance practices directly affecting the internal market. The directive aims at preventing unfair competition which can arise when taxpayers plan their activities in a manner to avoid paying taxes by exploiting disparities between tax systems.[51] Tackling cross-border tax avoidance is the target of the provisions in the directive which coordinates with the rules in BEPS. The most effective way of achieving this is by coordinating the rules at the EU level instead of each Member State implementing its own rules which would potentially lead to the existing fragmentation in the internal market being worsened.[52]

The reason behind the directive's interest limitation rule is similar to BEPS, which is to discourage MNEs from planning their economic activities in order to gain a reduced tax base for the whole group. It is also seen as way to create more equality between loan and equity.

Article 4 of the ATA Directive suggests similar interest limitation rule to BEPS action 4, with both a fixed ratio and a group ratio rule. The provision also proposes a benchmark ratio up to 30 % of the EBITDA and a *de minimis* threshold of one million euro.[53]

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[48] BEPS Action 4, p. 29.
[49] European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market,* 28.1.16
[50] Anti- Tax Avoidance Package, European Commission's website, http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_en.htm, January 2016. Downloaded 9.05.16.
[51] European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market,* 28.1.16, p. 3.
[52] ATA Directive, p. 4.
[53] ATA Directive, article 4.

3 Compatibility with EU law

3.1 Introduction

In this chapter the question whether the suggested best approach in BEPS action 4 presumes tax avoidance and if it could be infringing EU law will be asnwered. In order to find out the existence of such a presumption, the approach needs to be compared to the fundamental freedoms. The fundamental freedoms are legislated in the TFEU but the CJEU is the guardian of the freedoms as one of its roles are interpreting the law and ensuring that the Member States apply the law in the same way.[54] Therefore, relevant CJEU case law is presented under 3.4. The last parts of the chapter answer the legal question of the thesis and analyses the material.

3.2 Fundamental freedoms

Freedom of establishment is an EU constitutional right granted to taxpayers within the EU under article 49 TEFU. The article prohibits restrictions on the freedom of establishment regarding nationals of other Member States in the EU. Free movement of capital is guaranteed between Member States and between Member States and third countries, and all restrictions are prohibited under article 63 TFEU. The TFEU also prohibits restrictions on free movement of persons,[55] goods,[56] workers[57] and services[58]. Those freedoms are however not relevant in the case of rules limiting interest deductions which the CJEU case law will show. Freedom of establishment is the freedom applicable in most of the cases because of the objective of the rules on limitations on interest deductions, which is to prevent groups from shifting profit between entities through artificial arrangements. Free movement of capital is applicable in situations where the rules do not require a special relationship between the lender and the borrower, for example when financial ratios are called into question.[59]

Discrimination under the TFEU arises through the application of different rules to nationals of different Member States in a comparable situation, or through the application of the same rules to nationals of different Member states in a different situation with the result that the non-national is treated worse.[60] A national provision is directly discriminatory if it discriminates on

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[54]Court of Justice of the European Union, http://europa.eu/about-eu/institutions-bodies/court-justice/index_en.htm, downloaded 11.5.16.

[55] Article 21 TFEU.

[56] Article 34-35 TFEU.

[57] Article 45 TFEU.

[58] Article 56 TFEU.

[59] Paula Benéitez Régil, *BEPS Action 2, 3 and 4 and the Fundamental Freedoms: Is There A Way Out?* European Taxation (June 2016), p. 238.

[60] C-279/93 *Schumacker,* para. 30, C-391/97 *Gschwind*, para 21, C-311/97 *Royal Bank of Scotland*, para. 26, C-383/05 *Talotta,* para. 18.

the basis of nationality,[61] and indirectly discriminatory if it discriminates on other EU-nationals based on their residency, for example a provision stating that a tax benefit is dependent on the taxpayers residing in the state concerned for a whole year.[62] A national provision could instead of discriminatory be restrictive, which means that all measures that impede, prohibit or render less attractive the exercise of the fundamental freedoms are considered as restrictions.[63]

In CJEU case law, different justification grounds have been developed over the years in situations where domestic legislation has been found discriminatory or restrictive. These are mainly the territoriality principle, the prevention of double use of losses, anti-abuse/avoidance purpose, the safeguarding of balanced allocation of taxing rights, the need to ensure recovery of tax debt, the safeguarding of the effectiveness of fiscal supervision and the safeguarding of the fiscal cohesion of the national tax system.[64] Almost all cases below where the CJEU has ruled that a domestic law is infringing EU law have been justified by one or more of the justification grounds. However, the majority of them did not pass the proportionality test for reasons that will be explained.

3.3 CJEU case law

In the case law below, the CJEU has found that thin cap rules cannot be applied in every situation to every cross-border transaction. The CJEU has decided in a variety of cases when and how the rules may be applied. In order to describe the law as it stands today in the EU, it is necessary to describe cases the CJEU has ruled on and the impact they have had on the development of thin cap rules and other interest limitation rules in the EU.

3.3.1 Lankhorst-Hohorst GmbH

After the CJEU gave its judgement on this case, several Member States amended their thin cap rules.[65] In this particular case[66] the German thin cap rules were found incompatible with EU law.

Lankhorst-Hohorst, a German company, received a loan from its Dutch grandparent company Lankhorst Taselaar BV as a rescue attempt from high indebtedness in return of interest. The Finanzamt Steifurt reclassified the interest payments for some years as covert distribution of profit due to a deficit in the balance sheet of Lankhorst-Hohorst which was not covered by

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[61] C-175/88 *Biehl*, para. 13-14, C-155/09 *Commission v Greece*, C-279/93 *Schumacker*, para 26, C-383/05 *Talotta,* para 17.
[62] C-175/88 *Biehl.*
[63] C-55/94 *Gebhard,* para. 37, C-157/07 *Krankenheim*, para. 30.
[64] M. Helminen, *Chapter 2: Non-Discrimination and Basic Freedoms* in *EU Tax Law – Direct Taxation – 2015: 2015 edition*(IBFD 2015), Online Books IBFD, p. 44.
[65] Finnerty, Merks, Petriccione, Russo, *Fundamentals of International Tax Planning* (IBFD 2007), p. 227.
[66] C-324/00 *Lankhorst-Hohorst Gmbh v. Finanzamt Steinfurt*.

equity capital. The loan Lankhorst-Hohorst had obtained from its grandparent company could not, according to Finanzgericht, have been obtained by a third party lender under identical terms, and Lankhorst-Hohorst was unable to provide security for the loan. Accordingly, Lankhorst-Hohorst suffered a disadvantage for being a non-resident company since the national legislation only applied to companies with non-resident shareholders not entitled to corporate income tax credit in Germany.[67]

The CJEU held that the German legislation treated resident and non-resident companies differently since the national legislation was dependent on the location of the seat of the parent company. Thus, the legislation constituted an obstacle to the freedom of establishment. In the justification analysis, the Court observed that the legislation was applied in a general manner to any situation where the parent company was situated outside Germany, it did not have a specific purpose of preventing wholly artificial arrangements. Neither had any abuse been proven; the loan was genuine. Therefore, the Court did not find the rules justified and the German thin cap rules were found discriminatory.[68]

This judgement shows that thin cap rules must have specific purpose; to target wholly artificial arrangements and cannot be applied to any situation and transaction for the sole reason that the parent company is a non-resident. The same principle was established in *Cadbury Schweppes*[69] regarding the British CFC-legislation. In this case, the Court held that in order for CFC legislation to comply with EU law, the taxation the provision provides for must be excluded when an incorporation of a CFC reflects economic activity by carrying on genuine economic activities through an establishment in the host Member State. The resident company must be allowed to provide evidence of that fact.[70] Also, the judgements of *Lankhorst-Hohorst GmbH* and *Cadbury Schweppes* were both referred to by the Court in the Grand Chamber case *Thin Cap GLO*[71].

3.3.2 Thin Cap GLO

In the following case, the United Kingdom thin cap rules were brought into question in a group litigation as a result of the judgement in *Lankhorst-Hohorst GmbH*. The claims of restitution were brought by groups of companies. The national court selected test cases which all involved companies resident in the United Kingdom. All of them where at least 75%

[67] C-324/00 *Lankhorst-Hohorst*, para. 3, 6, 10-12.
[68] C-324/00 *Lankhorst-Hohorst*, para. 32, 37, 38, 45.
[69] C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Oversas Ltd v. Commissioners of Inland Revenue*.
[70] C-196/04 *Cadbury Schweppes*, para. 65, 66, 70.
[71] C-524/04 *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*.

owned by a non-resident parent company and had been granted a loan, either by their parent company or by another non-resident company of which the parent also owned at least 75%. Some of the test cases involved resident companies which had been granted a loan from a company established in the EU, and others from companies outside of the EU. The national legislation provided that interest payments in some circumstances were to be treated as distribution of profit and were thus non-deductible for the borrowing company. Some claimants in the proceedings had therefore converted part of the loans to equity to avoid a re-characterisation of the interest payments as distributions. Other claimants had concluded an agreement on the application of the legislation with the United Kingdom tax authorities. The national legislation did also include an additional corporation tax.[72]

The Court established that the applicable freedom in the case was the freedom of establishment since the national legislation only targeted group of companies.[73] The Court made a comparison between resident subsidiaries with a parent company in the same Member State, and a resident subsidiary with a parent company resident in another Member State and stated that the measure in question makes it less attractive for non-resident companies to exercise the freedom of establishment. Such a restriction is acceptable if it is justified by overriding reasons of public interest, and if the application of the measure is appropriate to ensure the attainment of the objective and does not go beyond what is necessary.[74]

The national legislation did not pass the proportionality test, and the Court ruled that the legislation was precluded by EU law unless it "*provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons only*".[75] This means that the taxpayer must be given the opportunity to provide evidence of a commercial justification, without any administrative constraints. It is also necessary that the national legislation, where a transaction is found to be purely artificial without a commercial justification, only re-characterises the part of the interest payments exceeding what would have been agreed at arm's length.[76]

3.3.3 NV Lammers & Van Cleeff

NV Lammers & Van Cleeff[77] was a Belgian subsidiary. The two shareholders of the subsidiary and the Dutch parent company BV Lammers & Van Cleeff were appointed directors of the subsidiary. The Dutch parent

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[72] C-524/04 *Thin Cap GLO*, para. 16-21.
[73] C-524/04 *Thin Cap GLO*, para. 33,35.
[74] C-524/04 *Thin Cap GLO*, para. 61, 64.
[75] C-524/04 *Thin Cap GLO*, para. 82.
[76] C-524/04 *Thin Cap GLO*, para. 83.
[77] C-105/07 *NV Lammers & Van Cleeff v. Belgische Staat*.

company held a claim against the subsidiary pursuant to which it paid interest for. The interest payments were considered and assessed partly as dividends by the Belgian tax authorities. The reason for the re-characterisation was the national legislation which reclassified interest payments exceeding a certain limit as dividends if the payments were made to a foreign company director. Only foreign company directors were subject to the legislation. The referring court sought to find out if the national provisions were precluded by EU law.[78]

The Court held that the national legislation constituted a restriction on the freedom of establishment. Also in this case, the national legislation did not pass the proportionality test. The Court referred to *Thin Cap GLO* and stated that the question was whether the loan would have been granted had there been a relationship at arm's length between the parties. The Court held that the limit above which interest payments are reclassified also affects situations where a transaction cannot be considered as a purely artificial arrangement. By reclassifying interest payments to foreign companies as dividends when they exceed such a limit, there is a risk that genuine loans set at arm's length will be reclassified as well.[79]

3.3.4 SGI

SGI, a Belgian holding company, granted an interest free loan to its French subsidiary Recydem, of which it held 65% in the year 2001. In 2001, the Belgian tax authority, in accordance with the national legislation, added to the profits of SGI the sum of the notional annual interest of 5% due to unusual or gratuitous advantages granted by SGI to a non-resident subsidiary. SGI was also paying director's remunerations per month to one of its shareholders, a Luxembourg company, Cobelpin. Those payments were considered as "*disproportionate and unrelated to the economic benefit of the services in question*" by the tax authorities which refused to allow the payments to be deductible as business expenses. The questions referred to the CJEU concerned added notional interest and its compatibility with EU law.[80]

The Court concluded that the applicable freedom was the freedom of establishment and that the national legislation constituted a restriction. In the proportionality analysis, the Court referred to *Thin Cap GLO* and repeated the conditions under which national legislation is considered to go beyond what is necessary in order to prevent tax avoidance and maintain the balanced allocation of the right to tax. According to the national legislation in question, the burden of proof lies with the tax authorities, and the taxpayer in given opportunity to provide proof for the tax authorities that the

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[78] C-105/07 *NV Lammers & Van Cleeff,* para. 7, 8, 10, 11.
[79] C-105/07 *NV Lammers & Van Cleeff*, para. 24, 30, 33, 34.
[80] C-311/08 *SIG v. État Blege*, para. 9-13, 18.

transaction is genuine. Only the part of the deduction which is considered as unusual or gratuitous is added back to the profit. Hence, the national legislation was found not to be precluded by EU law.[81]

3.3.5 Argenta Spaarbank NV

According to Belgian law, of which the objective was to reduce the difference in tax treatment between loan capital and equity (risk) capital, a company could deduct risk capital, so called 'notional interest', by deducting from the basis of assessment for corporation tax a percentage of the risk capital.[82] The Belgian company Argenta had a permanent establishment in the Netherlands. Under the Belgium-Netherlands Convention, the income of the permanent establishment was exempt in Belgium. In the assessment of Argenta's tax liability for the year 2008, the Belgian tax authority did not consider the net value of the assets in the Dutch permanent establishment for the determination of the risk capital which served as a basis for the deduction of risk capital, which Argenta sought to deduct. Had it been a domestic permanent establishment, the net value would have been taken into account. The referring court asked the CJEU whether such legislation was precluded by the freedom of establishment.[83]

The Court stated that the treatment of foreign permanent establishments was disadvantageous and stemmed solely from the fact that Belgian legislation did not allow assets from the permanent establishment to be taken into account. The Court dismissed the first ground of justification by the Belgian government that the rules were needed in order to safeguard the coherence of the tax system. There was no direct link between the advantage which arises by taking into account the assets, and the taxation of the generated return. The second justification ground, the preservation of the allocation of the power to tax between Member States, was also rejected by the Court. By granting the tax advantage to the permanent establishment in the case would neither jeopardise neither Belgium's nor Netherland's power to tax and would not result in a shifting of income.[84]

3.3.6 Itelcar

Itelcar, a Portuguese company, entered into a loan agreement with one of its shareholders; GE Capital. The loan agreement was for a period of 10 years with a line of credit Itelcar could use in return of interest payments at the Euribor rate plus a spread rate. At the time of the entering of the agreement in 2001, GE Capital did not own capital in Itelcar, but since 2005 GE Capital owns 0.02 percent. Despite the fact that Itelcar had approached the

[81] C-311/08 *SIG*, para. 37, 55, 71, 73, 76.
[82] C-350/11 *Argenta Spaarbank NV v. Belgische Staat,* para. 4-5.
[83] C-350/11 *Argenta Spaarbank NV,* para. 12-14, 16, 17.
[84] C-350/11 *Argenta Spaarbank NV,* para. 33, 46, 49, 55.

Director General of Taxes for the purpose of demonstrating that the level of credit obtained by GE Capital could have been obtained independently and that the spread interest rate was set at arm's length, adjustments were made to the company's basis of assessment. The final tax inspection report found that Itelcar had an overall excessive debt, which occurs, according to the national law, when the sum owed to an entity not resident in Portugal or the EU with which the resident company has special relations exceeds twice the amount of the entity's holding in the Portuguese resident's equity capital. The question referred by the national court sought to find out if the national legislation, which disallowed deductions of interest payments on the excessive part of an overall debt paid to a company resident in a non-Member State with which the resident company has special relations, is precluded by the free movement of capital.[85]

The CJEU found the treatment to be disadvantageous and liable to discourage a resident company from entering into such arrangements with a non-EU resident company with which the resident company has special relations as stated in the national legislation. The applicable treatment in this case was the free movement of capital due to the fact that the national rules did not relate to the access for non-Member States to the Portuguese market. The rules related to the tax treatment of interest on overall debts between a resident company and a company in a non-member country which was regarded as excessive.[86]

The Court found the rules to be justified in the sense that they were appropriate for combating tax evasion and tax avoidance. Regarding the proportionality test, the Court referred to *Thin Cap GLO* and *SIAT* as to when restrictive rules are proportionate. The term 'special relations' in the national legislation did encompass situations where the lending company in the third state did not necessarily hold shares in the borrowing company. The result of the legislation was that any credit arrangement between those companies would be regarded as excessive. Even if the rules were applied only in situations where the lending company had a direct or indirect shareholding, such application of the rules did not follow from the wording of the legislation. The rules did not meet the requirements of legal certainty since they did not determine the scope with sufficient precision. The Court stated that such rules can never meet the requirement of legal certainty.[87]

3.3.7 Masco Denmark and Damixa

The following case is a pending case in the CJEU concerning the Danish thin cap rules.

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[85] C-282/12 *Itelcar v. Fazenda Pública*, para. 3, 5, 6, 8, 9, 13.
[86] C-282/12 *Itelcar*, para. 31.
[87] C-282/12 *Itelcar v. Fazenda Pública*, para. 35, 37, 38, 41, 43, 44.

The Danish parent company Damixa ApS had lent money to its German subsidiary Damixa Armaturen GmbH. The interest payments from the subsidiary were treated as dividends for tax purposes according to the German thin cap rules. Due to the re-classification of the interest payments, Damixa ApS was not allowed a tax exemption on the interest income. According to the Danish thin cap rules, a resident company can enjoy a tax exemption on interest income from a resident subsidiary, regardless of the subsidiary being able to deduct the interest payments. The tax exemption is however denied if a non-resident subsidiary (debtor) is unable to deduct the interest payments due to domestic thin cap rules. The question that is referred to the CJEU concerns the rules' applicability with the freedom of establishment.[88]

In the opinion of advocate general (AG) Juliane Kokott, she starts by stating that the Danish rules are not infringing EU law due to the fact that the unfavourable treatment did not stem solely from the Danish domestic legislation, but also from the principle of autonomy. According to the principle, Member States are not infringing EU law by not taking into account another Member State's national legislation, which will ultimately lead to an unfavourable treatment of a cross-border situation. This has been repeated by the CJEU in several cases.[89] A Member State is never obliged under EU law to design its tax rules in accordance to the ones of other Member States for the reason to prevent disparities in the different tax systems.[90]

Kokott states further that there would have been no difference between a cross-border and a national situation without the German thin cap rules. It would have been a breach of the principle of autonomy if Denmark would be required to depend the exemption on whether the other Member State limits the interest deduction of the debtor.[91] Should the Court find the rules to be precluded by EU law, they could nevertheless be justified by the balanced allocation of taxing rights between Member States, and under the principle of the coherence of the tax system.[92]

By looking at the previous case law by the CJEU, it is evident that where Member States have applied restrictive rules only to cross-border situations, the rules have been infringing EU law.[93] By looking at the justification analysis in *Argenta Spaarbank*, in which the facts are similar to *Masco Denmark and Damixa,* one could speculate that Denmark might try to apply the same justification grounds. In order to justify a restriction under the need

[88] C-593/14 *Masco Denmark ApS and Damixa ApS v. Skatteministeriet.*
[89] C-157/07 *Krankenheim Ruhesitz am Wannsee-Senoirenheimstatt,* para. 49, C-322/11 *K,* para. 79.
[90] C-593/14 *Masco Denmark ApS,* opinion of AG Kokott, para. 18-20.
[91] C-593/14 *Masco Denmark ApS,* opinion of AG Kokott, para. 26-27.
[92] C-593/14 *Masco Denmark ApS,* opinion of AG Kokott, para. 37, 42
[93] See also Paula Benéitez Régil, p. 238.

to safeguard the coherence of the tax system, there must be a direct link between the tax advantage and the offsetting of it.[94] It could be argued that there is a lack of existence of a direct link since the tax advantage is granted to resident subsidiaries irrespective of the interest payments are deductible or not.

In *Argenta Spaarbank* the second justification ground, the preservation of the allocation of the power to tax between Member States, was also rejected because the granting of the advantage would not jeopardise the taxing rights of the Member States and would not result in a shifting of income.[95] The same reasoning could be applied in *Masco Denmark and Damixa*. Interest payments re-classified as dividends from a resident subsidiary are tax exempt, while from a non-resident the exemption does not apply. Also this argument could be rejected based on the fact that Denmark grants the exemption when the payment comes from a resident subsidiary, subject to thin cap rules or not. There is no shifting of income taking place that would normally be taxable in one or the other state.

3.4 Tax avoidance according to EU law and the OECD

Tax avoidance is one of the terms used in CJEU case law and doctrine to describe harmful practices. The term is often referred to together with tax evasion, although the terms are not synonyms. The line between the terms seems to have been blurred over the years, nevertheless it is important to distinguish between them. Within the EU, tax avoidance could be described as a "*more daring version of tax planning*"[96] which traditionally has been tolerated if practiced within the bounds of the laws of the Member States. Tax evasion is a criminal offence which could never be tolerated.[97]

Tax avoidance was not, at the outset, a justification ground the CJEU was keen on accepting. The reason was the difficulties for the national tax authorities to define the concept of tax avoidance and tax evasion with precision, apart from their own national concepts. To restrict the fundamental freedoms in a reliable way was therefore found deficient by the CJEU.[98] Many Member States had a wider scope of their national legislations than normally allowed, and even before *Lankhorst-Hohorst* and *Thin Cap GLO,* the CJEU stated in *ICI*[99] that national legislation must have

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[94] C-319/02 Manninen, para. 42, C-471/04 Keller Holding, para. 40, C-350/11 Argenta Spaarbank, para. 42.
[95] C-350/11 Argenta Spaarbank, para. 55.
[96] Stef van Weeghel, Frank Emmerink, *Global Developments and Trends in International Anti-Avoidance,* Bulleting for International Taxation (August 2013), page 431.
[97] Frans Vanistendael, *Is Tax Avoidance the Same Thing under the OECD BEPS Action Plan, National Tax Law and EU law?* Bulletin for International Taxation (March 2016), p. 163.
[98] C-270/83, *European Commission v. French Republic (Avoir Fiscal)*, para. 25, F. Vanistendael, p. 166.
[99] C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer.*

the specific purpose of preventing wholly artificial arrangements and cannot be applied in a general manner to every cross-border situation.[100]

The first time the Court identified the circumstances required for an artificial arrangement was in *Cadbury Schweppes.* These were the intention to achieve a tax advantage, and the need for obvious objective circumstances under which no genuine establishment could have been conducted in the other Member State, inter alia, the purpose of the freedom of establishment could not have been achieved.[101] As in *Thin Cap GLO,* the Court underlined the relation between the need to prevent tax avoidance and the need to maintain a balanced allocation of taxing rights between Member States. This shows that tax avoidance is unlikely to be the sole ground of justification of national rules preventing artificial arrangements.[102]

The differences in the concept and use of tax avoidance between EU law and the OECD are fundamental. While the CJEU has never accepted international double non-taxation as a justification ground[103], one of the purposes of BEPS, as well as the ATA Directive, is to counteract it.[104] Double non-taxation can arise from mismatches in tax rules; that is when neither the source state nor the resident state tax an income. The suggestion in BEPS is that, in a situation where neither of two contracting states tax an income, the state that according to the tax treaty has no taxing rights should be able to tax the income.[105] Ultimately, this means that an income must be taxed somewhere, which would be in accordance to the principle of single taxation to avoid both double taxation and double non-taxation.[106]

EU law leaves it for the Member States to legislate in the area of direct taxation. As long as taxpayers exercise their taxing power in accordance with EU law, it cannot be a case of tax avoidance. EU law does not consider mismatches in tax treaties and double non-taxation an issue, which BEPS does.[107] Hence, the OECD has created its own definition of tax avoidance which does not reconcile with the tax avoidance definition in EU law.

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[100] C-264/96, *ICI,* para. 26, F. Vanistendael, p. 166, Maria Hilling, *Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance*, Intertax vol. 41, issue 5 (Kluwer 2013), p. 296.

[101] C-196/04 *Cadbury Schweppes,* para. 64, Maria Hilling, p. 296-297.

[102] Maria Hilling, p. 297.

[103] C-303/07, *Aberdeen Property Fininvest Alpha Oy*, para. 50-51, M. Helminen, p. 44.

[104] OECD/G20 Base Erosion and Profit Shifting Project- Explanatory Statement, 2015 Final Reports, p. 4, F. Vanistendael, p. 170.

[105] OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arranagements*, Action 2: 2015 Final Report, F. Vanistendael, p. 170.

[106] Reuven S.Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015), p. 4.

[107] F. Vanistendael, p. 170.

3.5 Presumption of tax avoidance in the EU

By being a resident of the EU, a company has to be given the benefit of a doubt; restrictive national measures must have a specific purpose and cannot be applied in a general manner to every cross-border payment made between a resident and a non-resident company.[108] It has been established in many cases of the CJEU, not only those regarding thin cap rules, that taxpayers must be given an opportunity to provide evidence of a genuine, commercial activity to the tax authorities.[109] The burden of proof can however not be entirely put on the taxpayer. In the case *SIAT*[110] the Belgian national legislation disallowed the deduction of business expenses SIAT sought to deduct. The business expenses were related to a settlement payment to a former partner; a Luxembourg holding company which was not liable to pay corporate income tax in Luxembourg. The taxpayer was according to the national law allowed to provide proof that the transactions in question were in fact genuine and proper. The CJEU found the legislation disproportionate, one of the two reasons being the tax authority was not required to provide any evidence of tax evasion or tax avoidance.[111]

The case law show that whenever a Member State has presumed that a company engages in a transaction for the purpose of escaping taxes, the CJEU has found that the application of a restrictive measure to be discriminatory. A general presumption of tax avoidance is therefore not acceptable, even if a company sets up an establishment in a another Member State which has lower levels of taxation.[112] Setting a limit above which interest payments are disallowed to deduct could lead to real activities being negatively affected. The Court has also found that it is not sufficient that the goal of a restrictive measure is to combat abusive practices, it must also be reflected in the wording of provision.[113]

3.6 Does the suggested best approach presume tax avoidance?

The best practice approach suggests that the rules mainly cover groups part of a multinational group. It is voluntary for countries to extend the application to standalone entities and entities part of a domestic group. Issues may arise if Member States choose to apply the rules only to entities part of a multinational group. In *Lankhorst-Hohorst* the (former) German rules were found discriminatory and precluded by the freedom of establishment. The rules could not be justified because they applied in a

[108] C-324/00 *Lankhorst-Hohorst,* para. 37.
[109] C-194/04 *Cadbury Schweppes*, para. 70, C-524/04 *Thin Cap GLO*, para. 82, C-451/05 *ELISA*, para. 95.
[110] C-318/10 *SIAT v. État belge*.
[111] C-318/10 *SIAT*, para. 10, 12, 16, 56.
[112] C-196/04 *Cadbury Schweppes,* opinion of AG Léger, para. 53.
[113] C-282/12 *Itelcar,* para. 43.

general manner to any situation where the parent company was situated outside Germany, without there being any proven abuse of the law. In *Itelcar,* the CJEU found the Portuguese thin cap rules to be discriminatory partly because they only applied to foreign companies, which lead Portugal replacing the rules with new ones which also covers purely national situations.

If a Member State chooses to implement the suggested approach in this manner, by only making the rules applicable to multinational groups, the freedom of establishment could be violated. As established in *Lanhorst-Hohorst,* thin cap rules must have a specific purpose of preventing abusive practices, which action 4 although has. However, in *Thin Cap GLO* the CJEU established that the British thin cap rules were disproportionate because they did not allow the taxpayer to provide proof of commercial justifications.

Neither action 4 nor the article 4 of the ATA Directive provides for an objective measure to decide whether transactions are genuine or not. There is no provision in neither of the proposals allowing a taxpayer to provide proof for a genuine economic activity. Since it has already been established in case law that such legislation is precluded by EU law, one may wonder how the lack of such a provision can be justified in this case. Apart from base erosion and profit shifting, several other justifications grounds can back the provision; anti-abuse, sound public finance and neutrality (between debt and equity).[114] Even if those justification grounds could be accepted, the measures could still go beyond what is necessary by not considering CJEU case law such as *Lankhorst-Hohorst* and *Thin Cap GLO,* and thus be disproportionate to their aim.

According to the group ratio rule, an entity is allowed to deduct net interest expense up to the group's net third party interest/EBITDA ratio. If the ratio of an entity exceeds the EBITDA of the group, the group's ratio is the limit up to which the entity can claim deductions. This rule may not be corresponding to EU law since the CJEU tends to follow the per country approach when examining whether a national tax measure is compatible with EU law. The rule calls for Member States taking into consideration the rest of a group's net interest deductions. In CJEU case law, such as *Eurowings*[115] and *Danner*[116], it has been established that tax benefits arising in one Member State cannot trigger an unfavourable treatment in another

[114] Emilio Cencerrado Millán, María Teresa Soler Roch, *Limit Base Erosion via Interest Deduction and Others*, Intertax, Issue 1, pp.58-71 (2015).
[115] C-294/97, *Eurowings Luftverkehrs AG*, para. 42.
[116] C-136/00, *Danner*, para. 43.

Member State.[117] The principle of autonomy could also be infringed by forcing Member States to take into consideration another Member State's taxation schemes.

What is then the consequence of the application of thin cap rules? Do Member States achieve an effective base erosion prevention by applying them? And do the rules have an impact on MNEs? As stated in chapter 2, there are different kinds of systems of limiting interest deductions being used, not only in the EU but throughout the world. By looking at the case law from CJEU one can see that many issues have arisen with the different rules compatibility with EU law, tax treaties and with the constitution of the particular country.[118]

Thin cap rules have also been criticised for being too rigid due to their application to purely domestic situations and unrelated party borrowings where the risk and profit shifting is not high. The fact that many countries, both inside and outside of the EU, have implemented thin cap rules is an indication that the rules are considered by states to be successful in the combating excessive debt financing. For thin cap rules to work in the most effective way it is suggested that they do not operate alone. A combination between the rules and other rules such as general anti-abuse rules (GAARs) and CFC rules is preferable.[119] Although, applying different rules at ones may also increase the complexity of the application.[120]

Theoretically, thin cap rules can be divided into three different groups;

1. non-reclassification of the remuneration and the instrument (non-deductible interest expense),
2. reclassification of the instrument only,
3. and reclassification of both the instrument and remuneration.[121]

Depending on which group thin cap rules belong to, they can have different consequences. It has been argued that thin cap rules in group 1 result in the non-applicability of the Parent-Subsidiary Directive[122] (PSD) and the Interest and Royalties Directive (I&RD).[123] This argument is based on the

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[117] Christiana HJI Panayi, *The Compatibility of the OECD/G20 Base Erosion and Profit Shifting Proposals with EU Law*, Bulletin for International Taxation vol. 70, No. 1 (November 2015), p. 10.

[118] For example, BFH, 14.10.2015, I R 20/15, DStR 2016, p. 301. The case is not yet decided but nevertheless issues has arisen.

[119] René Offermanns and Boyke Baldewsing, Chapter 4, *Anti-Base-Erosion Measures for Intra-Group Debt Financing,* p. 107-108

[120] Johanna Hey, *Base Erosion and Profit Shifting and Interest Expenditure*, Bulletin For International Taxation, June/July 2014, p. 335.

[121] T.J.C. van Dongen, *Thin Capitalization Legislation and the EU Corporate Tax Directive,* European Taxation January 2012, p. 20.

[122] COUNCIL DIRECTIVE (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 21.

[123] PSD, p. 20.

CJEU decision in a case[124] and the wording of the I&RD, and argues that the I&RD is only applicable to income received by the creditor. Thin cap rules are only applicable at the level of the debtor.[125] Regarding the non-applicability of the PSD, "profit distributions" as used in the directive should not cover thin cap rules that does not reclassify interest payments since they are still legally regarded as such.[126]

Thin cap rules are usually characterised as anti-avoidance rules, but have been criticised for being merely "*structural changes intended to mitigate the effects of the deduction for interest on debt*".[127] It has also been argued that thin cap rules are merely the "symptom" of the cross-border debt bias "*disease*".[128] Empirical evidence to support the fact that thin cap rules impact the decisions of MNEs does exist,[129] which is why it could be argued that thin cap rules are effective in combating anti-avoidance. It has also been argued that thin cap rules only encourage levels of debt at the threshold ratio.[130]

Thin cap rules are also being considered as ad hoc, ineffective anti-avoidance rules. The fact that one ratio applies to all companies irrespective of sector, that interest limitation regimes are unstable in the sense that most of them have at least changed their rules ones, and the simplicity for MNEs to circumvent the rules are all arguments which could support the inefficiency argument.

It is suggested that the underlying "*disease*" of the debt bias is best tackled the tax treatment between debt and equity are aligned. This would eliminate the incentive for thin cap rules.[131] If the debt equity bias continues to exist, there will always be an incentive for thin cap rules. Lack of neutrality between the financing forms is the root to the problems of tax base erosion and profit shifting. Creating neutrality between debt and equity would mean going straight to the problem, instead of implementing measures circumventing it.

It can also be discussed whether thin cap rules assume tax avoidance. Thin cap rules are obviously allowed and encouraged by EU law for Member States to implement. However, applying a specific debt-to-equity ratio which disallows deductions above a specific limit suggests that there is a

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[124] C-397/09 *Scheuten Solar Technology.*
[125] C-397/09 *Scheuten Solar Technology*, p. 24.
[126] C-397/09 *Scheuten Solar Technology*, p. 28.
[127] Brown P, *General Report: The Debt-Equity Conundrum*, 97b Cahiers de Droit Fiscal International (2012), 40–41.
[128] Ann Kayis-Kumar, *Thin capitalisation rules: A second-best solution to the cross-border debt bias?* 30 Australian Tax Forum (2015).
[129] Buettner T and Wamser G, "Internal Debt and Multinationals' Profit Shifting: Empirical Evidence form Firm-level Panel Data" (Working Paper 0918, Oxford University Centre for Business Taxation, 2009).
[130] A. Kayis-Kumar, p. 310.
[131] A. Kayis-Kumar, p. 317.

presumption of abuse for activities falling above the ratio. The result is that companies with genuine activities are targeted by the rules, which is why thin cap rules are criticised for being not well targeted.[132] In order for thin cap rules to be better targeted they should have a narrow scope of application.[133] Such rules are however difficult to create due to the fact that EU law does not allow Member States to apply the rules in a too narrow manner as to only apply to companies controlled by non-residents.

The constant amendments of thin cap rules serve as evidence for the fact that there is no simple solution to the issue of base erosion and profit shifting.[134] Now there are two upcoming possible changes in the EU; BEPS and the ATA Directive. The main difference that comes with these two proposals lies in the coordination since both of them will get rid of distortions caused by different national legislations.[135] Although, as suggested above, thin cap rules can be regarded as merely the "symptoms" of the debt bias "disease". If implemented, BEPS and the ATA Directive could be successful because of the coordination of rules, at least in the EU.

3.7 Other possible threats to the implementation of BEPS and the ATA Directive

The German interest limitation rule is similar to both the suggested approach in action 4 and the provision in the ATA Directive. Under those rules, the *de minimis* threshold is set at three million euros and applies only to entities part of a group. [136] In the judgement of February 10th 2016, the German Federal Tax Court found the rules, in a purely domestic situation, to be violating the equal treatment principle in the German constitution. The matter is referred to the German Constitutional Court which will decide the case.[137]

The case is important for both the EU and action 4 since the rules are similar to one another. If the German Constitutional Court finds the rules to be violating the equal treatment principle it can have an impact on the implementation of both the ATA Directive and action 4. When implementing tax proposals in the EU, Member States have to agree on

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[132] Claus-Peter Knöller, *The Efficacy of Thin Capitalization Rules and Their Barriers: An Analysis from the UK and German Perspective*, Intertax, Volume 39, Issue 6/7 (Kluwer 2011), p. 318. C-105/07 *NV Lammers & Van Cleeff.*
[133] Ibid, p. 322.
[134] Kayis-Kumar, p. 332.
[135] J. Owens, *The Taxation of Multinational Enterprises: An Elusive Balance*, 67 Bull. Intl. Taxn. 8, sec. 5. (2013), Journals IBFD.
[136] A. Perdelwitz, *Germany - Corporate Taxation* sec. 7., Country Surveys IBFD (accessed 10 May 2016).
[137] BFH, 14.10.2015, I R 20/15, DStR 2016, p. 301.

them unanimously.[138] This means that if the German Constitutional Court finds the rules to breach the constitution and Germany does not implement the directive, no Member State will and the whole directive gets rejected.

Due to the similarities between the rules, a negative outcome of the German case can also have an impact on the implementation of action 4. The German Federal Tax Court found the interest limitation rule to be violating the principle of net income taxation.[139] Many Member States apply the principle, and if the German rule is found to be violating this principle, action 4 might be found to do so as well. At least it is unlikely that Germany in that scenario would implement action 4.

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[138] European Commission, Taxation and Qualified Majority Voting, The Intergovernmental Conference of 2003-2004, http://ec.europa.eu/taxation_customs/taxation/gen_info/conference/index_en.htm.

[139] BFH, 14.10.2015, I R 20/15, DStR 2016, p. 301

4 Conclusion

The aim of the thesis was to analyse if the suggested best approach in BEPS action 4 presumes tax avoidance and could hence be infringing EU law. In order to come to a conclusion, EU law needed to be analysed and the extent to which limitations on interest deductions are allowed. Interest deductions concerns companies and does therefore fall under the scope of the application of the freedom of establishment and free movement of capital.

The CJEU case law show that in order for thin cap rules be proportionate they must fulfil some requirements. Inter alia, they must have a specific anti-abuse purpose, be applicable to both residents and non-resident, taxpayers must be able to provide evidence of a commercial justification, only re-characterise the part of the interest payments exceeding what would have been agreed at the arm's length and finally disallow the setting of specific limit above which interest payments are re-classified as interest payments. There is a risk for BEPS action 4, and the ATA Directive, to be regarded as disproportionate because of the fact that neither of the suggestions provide for an objective measure to allow the taxpayer to provide proof of a genuine commercial justification. The application of a fixed ratio is also contradicting CJEU case law. Because of the rules non-conformity with EU law, it is argued that BEPS action 4 does presume tax avoidance.

It has been discussed in doctrine whether or not thin cap rules are effective as an anti-avoidance measure. Some argue that thin cap rules have an impact on the decisions of MNEs and thus are working. Others say that it is easy for MNEs to plan their activities around thin cap rules and that thin cap rules do not address the real underlying problem which is the lack of neutrality between the financing forms. This paper agrees with the latter opinion and the author believes that as long as the asymmetry between the financing forms exists, problems with base erosion and profit shifting will exist. Although, should the Member States implement action 4 and/or the ATA Directive, coordinated rules might be more effective on the tackling of base erosion and profit shifting within the EU.

Appendix A

Figure 1, overview of the best practice approach exactly as described in action 4.

De minimis monetary threshold to remove low risk entities
Optional, based on net interest expense of local group
+
Fixed ratio rule
Allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio Relevant factors help a country set its benchmark ratio within a corridor of 10%-30%
+
Group ratio rule
Allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio Option for a country to apply an uplift to a group's net third party interest expense of up to 10%
Option for a country to apply a different group ratio rule or no group ratio rule
+
Carry forward of disallowed interest /unused interest capacity and/or carry back of disallowed interest
Optional
+
Targeted rules to support general interest limitation rules and address specific risks
+
Specific rules to address issues raised by the banking and insurance sectors

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