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The Interest Limitation Rule In The EU Anti-Tax Avoidance Directive

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This article examines from a legal perspective the impact of the earnings stripping rule applicable to interest expenses in the recently adopted anti-tax avoidance directive. Said rule, comprising important tax policy options, is set to limit a taxpayer's deduction of net borrowing costs to 30 percent of its EBITDA.

1. Introduction

On June 17, 2015, the European Commission launched its Action Plan to reform corporate income tax in the EU. Subsequently, the ECOFIN meeting of December 8, 2015 concluded that EU directives would be the preferred legal instrument to implement the recommendations of the OECD/G20's base erosion and profit shifting (BEPS) project at the EU level, and later in the same month the EU Council presented general guidelines for an Anti-BEPS Directive.

The European Commission presented the first draft of the proposed Anti-Tax Avoidance Directive (ATAD) on January 28, 2016, also advancing anti-tax avoidance measures which are not part of the BEPS project. This draft underwent substantial changes in the following months, which were agreed upon by the EU Council on June 20, 2016.

The ATAD requires EU Member States to implement anti-tax avoidance measures as a minimum standard applicable to corporate taxpayers and permanent establishments (PEs) located in the EU by January 1, 2019.

The measures in the ATAD are summarized in the table below, with reference to corresponding BEPS Actions when applicable:

Table 1		
Measure	**Addressing BEPS**	**Aim**
Interest deductibility	Action 4	Limit the reduction of the tax base through leverage and interest deductions
Exit taxation	—	Discourage migration to low-tax jurisdictions
General anti-abuse rules (GAAR)	—	Target artificial practices
Controlled foreign company (CFC) rules	Action 3	Ensure at least sufficient single taxation of income of controlled subsidiaries located in low-tax jurisdictions
Hybrid mismatches	Action 2	Tackle classification mismatches resulting in non-taxation

2. General Rule Limiting The Deductibility Of Interest Expenses

The general interest limitation rule restricts the deductibility of interest expenses to 30 percent of the entity's EBITDA[1] or EUR1m (USD 1.1m), whichever is higher, in the tax year in which the interest expenses are incurred. The EU Member States may further restrict interest deductibility by decreasing the above percentage or by switching from EBITDA to EBIT.[2]

The calculation of the restricted interest amount involves three steps:

(1) *Determination of the actual amount of interest expenses* – the fixed ratio rule should be applied to the overall net borrowing costs. It is noteworthy that the meaning of "borrowing costs" is to be interpreted in a broad sense, including, for instance, expenses such as imputed interest or expenses incurred under non-traditional financial instruments.

(2) *Determination of the amount of deductible interest expenses (30 percent of EBITDA)* – the determination of the EBITDA should be made on the basis of: (i) the legislation of the jurisdiction where the entity is located, and (ii) the accounting data.

(3) *Comparing step 1 and step 2* – in case the actual amount of interest expenses, pursuant to step 1 above, exceeds the amount of deductible interest expenses, under step 2 above, the balance should be considered as non-deductible interest expenses for corporate income tax purposes.

3. Implementation Of The Interest Limitation Rule

Notwithstanding the above-mentioned deadline to implement the ATAD, EU Members States which have domestic provisions aimed at restricting the deductibility of interest expenses can postpone changes in respect to that measure until January 1, 2024.

The European Commission has introduced a definition of an associated enterprise based on limited participation in voting rights, capital ownership or profit entitlement, allowing for this type of entity to be treated as less exposed to base erosion and profit shifting.

EU Member States whose domestic law provides for a tax unity regime should take into account the position of all entities in the tax unity, based on the estimate of the net borrowing costs and EBITDA.

The European Commission has foreseen an optional exception for financial undertakings.[3]

EU Member States may (i) introduce a safe harbor rule (allowing the deduction of net borrowing costs up to EUR3m), (ii) apply a "grandfathering rule" to loans concluded before June 17, 2016 that have not been amended thereafter and to loans connected with public infrastructure projects, and (iii) grant two optional carve-outs (equity escape rule and group ratio rule).

4. Optional Carve-Out: Equity Escape Rule

EU Member States may grant a taxpayer the full deduction of net borrowing costs provided that the taxpayer can demonstrate that its stand-alone ratio of equity per total assets is not more than 2 percentage points lower than the equivalent ratio of the group (*e.g.,* if the ratio of equity per total assets of the group is 15 percent, then the stand-alone equivalent ratio of the taxpayer cannot be less than 13 percent).

For this purpose, an entity's stand-alone equity position should be adjusted as follows:

(i) Add goodwill included in the consolidated financial statements to the extent attributable to the business enterprise;
(ii) Adjust the valuation of assets and debts;
(iii) Deduct equity not carrying voting rights (with the exception of preference shares); and
(iv) Deduct equity investments in other group entities. Furthermore, financial claims which are not included in the consolidated financial statements but which are matched by liabilities of at least the same amount can be deducted from the total assets.

5. Optional Carve-Out: Group Ratio Rule

The taxpayer may opt to apply the ratio of its group whether higher or lower than 30 percent. The group ratio is computed as follows: net third party borrowing costs of the worldwide group divided by the accounting EBITDA of the worldwide group.

The group ratio will apply to the taxpayer's EBITDA in order to determine the interest deduction capacity of the taxpayer in case the group ratio is higher than the fixed ratio of the taxpayer on a stand-alone basis.

Unlike the equity escape rule, satisfying the group ratio rule does result in a full deduction of the net borrowing costs of the taxpayer. The calculation of the worldwide group's net third party borrowing costs should be determined on the basis of the consolidated financial statements of the group without any further adjustment.

6. Options Regarding The Carry-Back And Carry-Forward Of Disallowed Interest Expenses

The ATAD gives EU Member States the following three options for carrying back and/or carrying forward disallowed interest expenses or unused interest capacity:

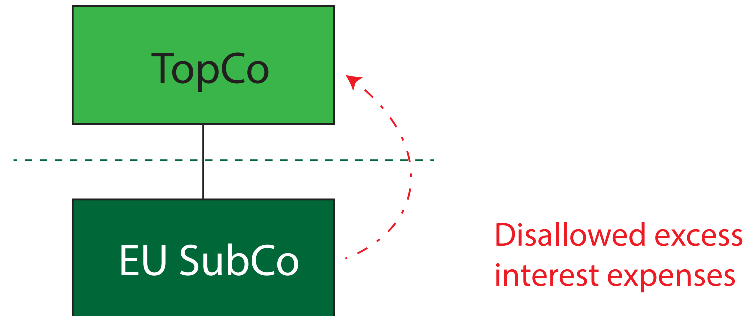
(i) Carry forward non-deductible interest expenses indefinitely; or
(ii) Carry forward non-deductible interest expenses indefinitely and carry back non-deductible interest expenses for a maximum of three years; or
(iii) Carry forward non-deductible interest expenses indefinitely and carry forward unused interest capacity for a maximum of five years.

7. Examples

Case 1

> "A group sets up a subsidiary in a no-tax third country [**TopCo**], which then provides a high-interest loan to another company in the group, located in an EU Member State [**EU SubCo**].
>
> The EU-based company must make high interest payments – which are tax deductible – to the subsidiary. In doing so, it reduces its taxable income in the Member State, while the corresponding interest income is not taxed in the third country either.

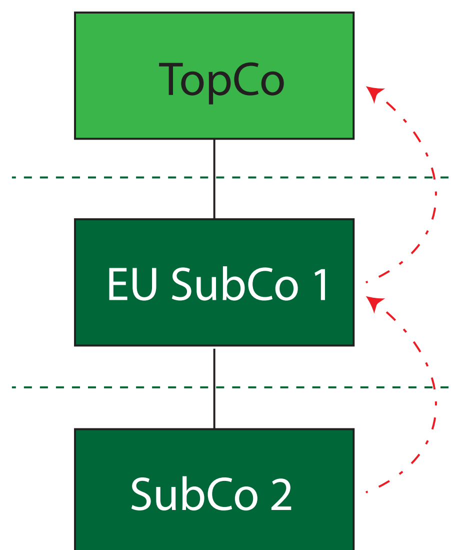
Under the interest limitation rule, the Member State will put a fixed limit on the amount of interest that the company can deduct and will tax the remainder of the payments. This should discourage companies from shifting their debts purely to reduce their tax bills." [4]



In this case, EU SubCo has 10 percent of business income (EBITDA), 5 percent of interest income, and 10 percent of interest expenses. The total amount of exceeding borrowing costs would be 5 percent (*i.e.,* 10 percent *minus* 5 percent), since no limitations apply to deductions up to the amount of interest income, and the maximum deductible interest would be approximately 3 percent (*i.e.,* 30 percent of 10 percent as the EBITDA). Therefore, of the 5 percent excess borrowing costs only 3 percent is deductible and 2 percent is non-deductible.

Case 2

In a setting where SubCo 2 pays 10 percent of interest to EU SubCo 1 and this pays 9 percent of interest to TopCo, retaining a taxable margin of 1 percent, the 9 percent of interest expenses is fully deductible for being less than 10 percent of interest income.



8. Final Remarks

The interest limitation rule as it stands has major architectural issues. However, the said rule may well be fine-tuned to account for these matters and fulfill an important role towards balancing the taxation of income earned by corporate bodies and PEs in the European Union.

Practicalities

The application of a group-wide rule might entail difficulties resulting from different tax and accounting principles applicable in different jurisdictions.

Income Taxation

Economic double taxation will likely arise as a consequence of interest expenses being non-deductible as the lender should be taxable on the corresponding income. The carry-forward options may not eliminate economic double taxation as the taxpayers may never be in a position to use non-deductible carried forward interest expenses, thus leading the taxpayer to be subject to corporate tax on the absence of net income.

The German Federal Tax Court (*Bundesfinanzhof*) in I.R. 20/15, October 14, 2015, decided on German earnings stripping rules. The Court concluded that these rules are not in line with the German constitution since they violate the principle that expenses incurred in relation to taxable income should be tax deductible (*Objektives Nettoprinzip*), as well as the ability-to-pay principle (*Leistungsfähigkeitsprinzip*), while these violations cannot be justified by the avoidance of abuse.

This matter was referred to the German Constitutional Court. According to this Court, the German earnings stripping rule might not, in a domestic situation, be consistent with the German constitution but should not however be limited to cross-border cases so to respect EU fundamental freedoms.

Transfer Pricing

The ATAD presumes that net interest deductions in an amount exceeding 30 percent of EBITDA necessarily represent tax avoidance, without allowing the taxpayer to demonstrate that comparable third parties would have similar levels of leverage and interest expenses. Hence, EU Member States not implementing the option for the group carve-out, described above, will create an un-rebuttable presumption of abuse resulting in discrimination, as the taxpayer is not allowed to demonstrate that a certain leverage and corresponding interest deductions are arm's length in a certain industry.

This would be the case if, for instance, associated enterprises are prevented from deducting interest while comparable stand-alone companies in the same situation are allowed higher leverage and higher interest deductions. Nevertheless, the group carve-out option does not eliminate this discrimination as there may be group entities with different functions and therefore different arm's length leverage ratios. Allowing the taxpayer to rebut the presumption through a transfer pricing analysis is a necessary step to avoid the discrimination. Lastly, it is unlikely that the ECJ would see the said discrimination as being justified.

Endnotes

1 EBITDA, *i.e.,* Earnings Before Interest, Taxes, Depreciation and Amortization.

2 EBIT, *i.e.,* Earnings Before Interest and Taxes.

3 *I.e.,* credit institutions or investment firms, insurance or reinsurance undertakings, alternative investment funds (AIFs), undertakings for collective investment in transferable securities (UCITS), central counterparties or central securities depositories.

4 Example retrieved from the European Commission's Fact Sheet on the Anti-Tax Avoidance Directive – Questions and Answers, Brussels, June 21, 2016.