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Article

Evaluation of the Earnings Stripping Rules

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Member States had to have implemented the anti-earnings stripping rules by 1 January 2019. In this article these rules are evaluated from an economic and EU law perspective. The author concludes that the rules are probably not in breach of EU law because they are implemented without distinction between domestic and cross border situations. In addition there is little room to assess rules which are the result of (full) harmonization. Nevertheless some risks exist in particular with regard to the interaction between the group regimes and the earning stripping rules and the design of the standalone exception. An important drawback of the earnings stripping rules is the risk of double taxation. This could have been avoided by the EU legislator.

Keywords: Earnings stripping rules, EBITDA, interest, thin capitalization rules, manifest error, ATAD-Directive, Equity escape, BEPS, Minimum standard

1 Introduction

Member States had to have implemented the Anti Tax Avoidance Directive (ATAD Directive) by 1 January 2019.[1] An important measure in the ATAD Directive is the introduction of anti-earnings stripping rules.[2] This article evaluates these rules, in particular in the light of EU law. The author will examine whether the earnings stripping rules are consistent with the purposes of the ATAD Directive, principles of EU law, the TFEU and other EU tax policy initiatives. Since most Member States have implemented the rules, section 3 briefly considers the way the ATAD Directive is being transposed into national law by the Member States.

By adopting the ATAD Directive, the EU followed the OECD's recommendations in its (Base Erosion and Profit Shifting Report (BEPS report)[3] to introduce earnings stripping rules. The BEPS Action 4 Final Report identified the following BEPS risks in the area of interest deduction:

– groups place higher levels of third-party debt in high-tax countries;
– groups use intercompany loans to generate interest deductions in excess of their actual third-party interest expense; and
– groups use third-party or intragroup financing to finance the generation of tax-exempt income.

The introduction of the earnings stripping rules follows a trend which is basically a shift away from the historically more widely used specific targeted interest limitation rules towards more general interest limitation rules[4] which now also cover debt vis-à-vis third parties.
According to the ATAD Directive:

> *It is essential for the good functioning of the internal market that, as a minimum, Member States implement their commitments under BEPS and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion. In a market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the internal market and maximize the positive effects of the initiative against BEPS.*

An important reason for the EU initiative was that uncoordinated implementation of the OECD BEPS proposal could lead to a fragmentation of the internal market and that national implementation of measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union law.[5]

The purpose of these earnings stripping rules is to create a 'minimum level of protection for national corporate tax systems against tax avoidance practices across the Union'. The rules have to be flexible so that Member States can choose those that best fit their needs and they

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1 Council Directive 2016/1164/EU of July 2016, OJ L 193 (hereinafter: ATAD Directive).

2 The author will use the shorter term 'earnings stripping rules' but of course the intention of the rules is to limit interest deduction and thus reduction of the profit before tax (earnings).

3 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, Action 4 Final: 2015 OECD/G20 Base Erosion and Profit Shifting Report project OECD Publishing 5 Oct. 2015 (OECD Action 4 Final 2015).

4 Michael Tell, *Interest Limitation Rules in the Post-BEPS Era*, 45(11) Intertax, 750–763, at 752 (2017).

5 Council Directive 2016/1164/EU of July 2016, OJ L 193, recital 2.

should not give rise to any form of double taxation since that would hinder the efficiency of the internal market.[6]

The ATAD Directive can be seen as a second-best response. The EU policy goal was not to create a more equal treatment of debt and equity (although some Member States have adopted this rationale to defend the rules) and/or to establish a fair division of taxing rights with regard to mobile income such as interest. The Directive only tries to increase fairness in the tax system by curbing BEPS, and the allocation of external debt to a country when it does not have the right to tax foreign dividends remains a particular issue given inter-nation equity considerations.[7] The ATAD Directive notes in recital 6 that tax-exempt revenues should not be set off against deductible borrowing costs.

Policy initiatives that try to establish a fairer allocation of taxing rights are politically more controversial.[8] As examples of this, the author would suggest the Common Consolidated Corporate Tax BaseC(C)CTB initiative and the current debate on the taxation of digital companies. The OECD Pillar One initiative aims to change allocation rights and shift them more to market jurisdictions but remains more or less within the boundaries of the BEPS approach. The Pillar Two initiative tries to guarantee that companies pay a minimum amount of corporate tax in all jurisdictions.

In order to make it politically acceptable (the recital points out that Member States are better placed to shape the specific elements of the rules in a way that fits best their corporate tax system), the ATAD Directive includes many options from which Member States can choose, creating a tension with the policy goal to create a uniform and coordinated system and leaving room for tax competition between Member States.[9]

The ATAD Directive prescribes minimum standards. Under Article 3, Member States are allowed to maintain or enact stricter rules in regard to the areas covered by it. They are obliged to implement the rules but only to the extent that they do not already (or will in the future) provide for a *'higher level of protection'*.

The purpose of the interest limitation rule is to discourage BEPS by limiting the deductibility of taxpayers' exceeding borrowing costs.[10] This is achieved by limiting deduction of borrowing costs to 30% of earnings before interest, tax, depreciation and amortization (EBITDA):

> *Member States could reduce this percentage or place time limits and/or restrict the amount of unrelieved borrowing costs that can be carried forward or back to ensure a higher level of protection. Given that the aim is to lay down minimum standards, it could be possible for Member States to adopt an alternative measure referring to a taxpayer's earnings before interest and tax (EBIT) in a way that it is equivalent to the EBITDA-based ratio. Member States could in addition to the interest limitation rule provided by this Directive also use targeted rules against intra-group debt financing, in particular thin capitalization rules. Tax-exempt revenues should not be set off against deductible borrowing costs. This is because only taxable income should be taken into account in determining how much interest may be deducted.*

The interest limitation rules should apply in relation to a taxpayer's exceeding borrowing costs without distinction of whether the costs originate in debt taken out nationally, cross-border within the Union or with a third country, or whether they originate from third parties, associated enterprises or intra-group.[11]

Member States can postpone implementation of the earnings stripping rules until 1 January 2024 provided that they have adequate domestic rules in place that are equally effective to the interest limitation rules set out in the Directive. This option, too, increases the number of possible departures from the Directive.

2 A BRIEF DISCUSSION OF THE SUBSTANCE OF THE EARNINGS STRIPPING RULES

2.1 General

The main rule is that exceeding borrowing costs are only deductible up to 30% of the taxpayer's EBITDA or to a maximum of EUR 3 million if this is higher.[12] Member States are allowed to apply stricter limits and may apply the earnings stripping rules at group level according to national law if the rules are applied on behalf of a group.[13] In such circumstances, exceeding borrowing costs and EBITDA may be calculated at the level of the group and comprise the results of all its members. It is also allowed to treat a member of a group as a separate taxpayer if, according to national law, that entity (an entity in a group) does not consolidate the results for tax purposes.[14]

'Exceeding borrowing costs' means the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law. The term 'borrowing costs' is defined separately in a broad way and encompasses

6 ATAD Directive, recitals 4–5.

7 Johanna Hey, *OECD-Base Erosion and Profit Shifting and Interest Expenditure*, 68(6/7) Bull. Int'l Tax'n (2014).

8 Ana Paula Dourado, *The EU Anti Tax Avoidance Package: Moving Ahead of BEPS?*, 44(6&7) Intertax 440–446, at 442 (2016) states that the ATAD Directive is a means to circumvent the delay of more fundamental solutions such as the CCCTB Directive.

9 Dourado, *supra* n. 8, Guglielmo Ginevra, *The EU Anti-Tax Avoidance Directive and the Base Erosion and Profit Shifting (BEPS) Action Plan: Necessity and Adequacy of the Measures at EU Level*, 45 (2) Intertax 120–137, at 121 (2017) and João Carmona Lobita, *The ATAD's Interest Limitation Rule – A Step Backwards?*, 57(2/3) Eur. Tax'n (2019).

10 ATAD Directive, recital 6.

11 ATAD Directive, recital 8.

12 Article 4(1) ATAD Directive. The OECD recommended a range between 10 and 30%. OECD Action 4: 2016 Update at 49 and 52.

13 Article 4(1a) ATAD Directive.

14 Article 4(1b) ATAD Directive.

general interest, expenses and all other costs economically equivalent to interest in connection with the raising of finance.[15]

EBITDA is defined in Article 4(2) of the ATAD Directive: '*The EBITDA shall be calculated by adding back to the income subject to corporate tax in the Member State of the taxpayer the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and amortization*'.[16] Tax-exempt income is excluded from a taxpayer's EBITDA since the EBITDA rule refers to '*income subject to corporate income tax*'. The Member States have no discretion in this respect.

The principal items of income that are generally tax-exempt are income from associated enterprises and permanent establishments. A consequence of this approach is that any special regime or investment or other allowance which is designed as a tax base reduction will diminish the scope for interest deduction. On the other hand, tax incentives which apply a lower tax rate to certain income items will not have that effect. The ATAD Directive is therefore not neutral with regard to the design of tax incentives. Other common tax base reducers are investment allowances, Intellectual Property box regimes and regimes which determine tax profit on a notional basis, e.g. the tax regime for shipping companies. There also seems to be an important difference with regard to the rules to prevent double taxation. Foreign income for which the parent receives a tax credit or tax exemption may be included in EBITDA because it is not tax-exempt, while foreign income may not be taken into consideration under a base exemption system.

2.2 Exceptions to the Earnings Stripping Rules

2.2.1 General

The ATAD Directive allows Member States not to apply the 30% rule in certain circumstances:

(1) if the taxpayer is a standalone entity, which means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment[17];
(2) for loans which were concluded before 17 June 2016;
(3) for loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union[18];
(4) for the equity exception: if the debt to equity ratio is not excessive or the interest/EBITDA ratio of the taxpayer is not higher than the interest paid to third parties/EBITDA ratio of the group[19];
(5) if the taxpayer is a financial undertaking[20];
(6) when the Member State has equivalent effective rules in place.

These exceptions are discussed below in this section.

2.2.2 The Standalone Exception

A standalone entity means a taxpayer which is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment. The standalone exception is logical from the perspective that the risk of base erosion via debt financing exists in particular within groups. However, this exception opens the door to excessive financing via affiliated entities which, while they do not control the taxpayer, work to a certain extent in concert e.g. independent investment funds that make a joint investment or separate investors under the control of the same investment manager. A similar risk applies to the equity exception, which is discussed below. These exceptions require Member States to maintain other interest limitation rules to prevent base erosion.

2.2.3 Grandfathering Rule for Existing Rules

This exception is acceptable from the perspective of legal certainty and the fact that financing arrangements are in general entered into for several years and investors count on a certain tax treatment when they make an investment. A disadvantage is that it creates unequal treatment between existing and new situations and base erosion remains possible. The ATAD Directive stipulates that the exception no longer applies if a loan is subsequently modified. It is not clear which amendments of the terms and conditions are allowed.

2.2.4 Loans Used to Fund a Long-Term Infrastructure Project

This exception is probably motivated by political concerns and the fact that these projects are typically characterized by high capital expenditure and financing costs and agreements with long-term, predetermined compensation (in particular the contribution by the government) between the government and private operator for the entire period. The business case could substantially change if not all interest is deductible. From that perspective, while the limitation for public infrastructure projects is understandable, the argument should apply

15 *See* the definition of borrowing costs in Art. 2(1) ATAD Directive.
16 Article 4(2) ATAD Directive.
17 Article 4(3) ATAD Directive.
18 A long-term public infrastructure project means a project to provide, upgrade, operate and/or maintain a large-scale asset that is considered in the general public interest by a Member State. If this exemption applies, any income arising from a long-term public infrastructure project shall be excluded from the EBITDA of the taxpayer, and any excluded exceeding borrowing cost shall not be included in the exceeding borrowing costs of the group vis-à-vis third parties.
19 In Article 4(8) ATAD Directive the term group has been defined.
20 A 'financial undertaking' is defined in Article 2(5) ATAD Directive.

to all long term projects. It is not clear why only public *infrastructure* projects are tax-exempt; other public projects could be equally important and adversely affected by the earnings stripping rules. However, the definition of public infrastructure projects includes all large scale assets. Therefore the scope could be wider. A too wide exemption would conflict with state aid rules, which also apply to public entities if they conduct an economic activity.[21] Public entities could also engage in financing transactions which cause base erosion. Both the standalone exception and equity exception should provide sufficient relief for legitimate cases but some Member States have chosen not implement one or both of them.[22]

2.2.5 Equity Exception

An equity exception has been included because BEPS risks exist primarily within groups. This is in line with the OECD recommendations.[23] The equity exception has two alternatives: a debt to equity ratio and a third-party interest ratio.

2.2.5.1 Debt to Equity Ratio

The interest limitation does not apply when the taxpayer can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group and subject to the following conditions: (1) the ratio of the taxpayer's equity over its total assets is considered to be equal to the equivalent ratio of the group if the ratio of the taxpayer's equity over its total assets is lower by up to two percentage points; and (2) all assets and liabilities are valued using the same method as in the consolidated financial statements.

2.2.5.2 Third-Party Interest Ratio

There is an exception in Article 4(6)b which refers to the exceeding borrowing costs paid to third-parties by the group. This ratio is calculated as follows: (1) first, the group ratio is determined by dividing the exceeding borrowing costs of the group vis-à-vis third-parties over the EBITDA of the group; and (2) second, the group ratio is multiplied by the EBITDA of the taxpayer. The interest limitation therefore does not apply if the taxpayer's ratio is not higher than the group ratio.

The text of the two exemptions differs slightly. It appears that if the debt to equity ratio test is not passed, all interest which is more than 30% of the EBITDA is not deductible. For the third-party interest ratio, however, it seems that only the excess interest is not deductible.

2.2.6 Exception for Financial Undertakings

Financial undertakings[24] are excluded from the ATAD Directive since earnings stripping rules are not effective for these entities because of their special features. Most countries have excluded financial undertakings from the earnings stripping rules.[25] Separate thin capitalization rules targeting banking and insurance companies have been implemented in the Netherlands from 1 January 2020. Under these rules, banks and insurance companies must have a minimum leverage ratio of 8%, calculated in accordance with the specific supervision rules that apply to them. In essence, the leverage ratio is a risk-adjusted debt to asset ratio. A leverage ratio of 8% implies that a minimum of 8% equity is required to finance the risk-adjusted assets. This leverage ratio is stricter that the one adopted in the supervision rules (Basel II and Solvency II).

2.2.7 Equivalence Rule Exception

By way of derogation from Article 4 of the ATAD Directive, Member States which had targeted national rules for preventing BEPS risks at 8 August 2016 that are equally effective to the interest limitation rule set out in this Directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.

In a Notice of 7 December 2018, the European Commission considered the rules of France, Greece, Slovakia, Slovenia and Spain to be 'equally effective' to the interest limitation of Article 4 of the ATAD Directive, having regard to (1) the legal similarity and (2) the economic equivalence of the measures notified by the Member States.

Only rules which limit the deduction of exceeding borrowing costs in relation to the taxpayer's profitability were regarded as legally similar. Economic equivalence involves two criteria: (1) the notified measure should not produce significantly less revenue than the interest limitation rule of Article 4 of the ATAD Directive and (2) the measure is deemed to be equivalent when it leads to a similar or higher tax liability for a majority of large undertakings.

[21] S. A. Stevens, *Tax Aid to Public and Social Enterprises: A Collision Between Competition and Public Policy*, 23(3) EC Tax Rev. 149–170 (2014).

[22] In the Netherlands public housing associations complained that they were hit excessively hard by the earnings stripping rules because the Netherlands has chosen not to implement the standalone exception and the equity exception. Public housing associations are heavily leveraged but there is no risk of base erosion. The legislature feared that housing associations would not fall within the scope of public infrastructure projects. This position has been challenged in literature. *See* J.J.A.M. Korving en A.J.W. de Ruiter, Wie kan dat betalen? Onze huur! De algemene renteaftrekbeperking bij woningcorporaties, WFR 2020/80.

[23] OECD Action 4: 2016 Update at 116.

[24] Defined in Article 2(5) of the ATAD Directive.

[25] Hein Vermeulen & Vassilis Daomilis, *The (Draft) Laws Implementing ATAD I – An Overview of Implementation for Financial Undertakings in Different Member States, Especially as Regards the EBITDA Rule*, 20 (6) Derivates & Fin. Instruments (2018).

2.3 Carry Forward of Excessive Borrowing Costs and Unused EBITDA

The 30% rule could lead to a limitation of the interest deduction. This effect can be mitigated by allowing a carry forward of the exceeding borrowing costs and/or the unused interest capacity. This reduces uncertainty for groups concerning their future business planning and the risk of double taxation because interest expenses are permanently non-deductible. This rule is reasonable because borrowing costs and EBITDA are not always incurred in the same year. Article 4(6) stipulates the following options for Member States:

(1) to carry forward, without time limitation, exceeding borrowing costs which cannot be deducted in the current tax period;
(2) to carry forward, without time limitation, and back, for a maximum of three years, exceeding borrowing costs which cannot be deducted in the current tax period; or
(3) to carry forward, without time limitation, exceeding borrowing costs and, for a maximum of five years, unused interest capacity which cannot be deducted in the current tax period.

3 A first overview of the implementation choices

The Member States had to implement Article 4 of the ATAD Directive by 1 January 2019. A high level comparison of the Member States' implementation choices can be made using information in the country reports of the IBFD.[26] Some countries have not transposed the rules. For example Austria[27] and Ireland. Most Member States have opted for a lenient approach with regard to the limitation of maximum deduction of borrowing costs, choosing a maximum percentage of 30 and a safe harbour of EUR 3 million. A striking exception is the Netherlands with a maximum of EUR 1 million,[28] which is also used by Poland, Portugal, Romania and Spain. Sweden has the lowest safe harbour of EUR 450,000.[29] Most Member States have also included an exception for financial undertakings.[30] Exceptions are France, Finland, Romania, Poland and the Netherlands.[31]

Most Member States allow indefinite carry forward of exceeding borrowing costs. A few restrict this to five years (e.g. Poland and Portugal), six years (Sweden) or three years (Italy). The option to carry back unused borrowing costs does not seem to have been implemented by Member States. A number of countries have made it possible to carry forward unused interest capacity for five years (Cyprus, France, Germany, Hungary, Italy, Luxemburg, Malta and Portugal).

The effectiveness of the rules is largely determined by the application of the standalone and equity exceptions. A number of countries have implemented a standalone exception, including Belgium, Croatia, Cyprus, Finland, France, Germany, Malta, and Romania.

An equity exception has been implemented by Cyprus, Denmark, Estonia, Finland, France, Germany and Malta among others. Striking examples of countries which have not implemented the equity exception are Belgium and the Netherlands.

Belgium excludes loans between Belgium companies that are part of the same group.

Most countries use the definition of EBITDA as defined in Article 4 to limit interest capacity and the definition of interest income and interest costs. When assessing the implementation of the ATAD Directive, the EC should investigate whether deviations in the national implementation leads to material differences. A detail which could be relevant in this respect is that in some countries borrowing costs incurred during the period of construction must be accrued to the cost of an asset. The interest costs are deducted later on through depreciation. Article 4 of the ATAD Directive does not give specific rules on how these accrued costs should be treated under the earnings stripping rules. In the Netherlands, for example, excessive borrowing costs may not be accrued but must be carried forward, which under certain conditions is more beneficial for the taxpayer.

The ATAD Directive offers the opportunity to apply the earnings stripping rules at a group level if according to national law companies may be treated as a group for tax purposes. The author recommends examining the exact interaction between the earnings stripping rules and these group regimes in each Member State. The effects could differ among Member States because the group regimes differ. Known regimes are: a tax unity, a tax consolidation regime, contribution of losses and contribution of profits. The EU should investigate the effect of the group regimes on the effectiveness of the earnings stripping rules.

Finally, some Member States (e.g. the Netherlands) have introduced anti-abuse rules to prevent the trade in companies with interest capacity or excessive borrowing costs tax credits. In this respect, the same risks exist as with the trade in loss-making companies.

4 Economic aspects of the earnings stripping rule

4.1 General

The different treatment of debt and equity causes economic distortions. The debt bias distorts companies'

[26] Additional information has been obtained from the PwC report Comparative Analysis on Taxation of Multinationals (Jan. 2020).
[27] An infringement procedure against Austria has been started by the European Commission.
[28] Or an amount close or equivalent to EUR 1 million.
[29] Approximately SEK 5 million.
[30] *See* the overview provided by Vermeulen & Daomilis, *supra* n. 25.
[31] Also the United Kingdom is mentioned.

financing decisions.[32] Excessive debt results in social costs as it may increase macroeconomic instability which then creates welfare losses and negative effects on economic growth.[33]

There is significant evidence that Muli National Entities (MNEs) react to tax rate differentials through financing structures. However, the importance of debt shifting by means of financial arrangements and the impact of interest limitation rules remains largely unclear. Hey[34] refers to a number of economic studies on this which indicate that the location of external debt seems to be much less sensitive to tax rate differentials than intra-group lending. The reason is that there must be enough tax capacity to offset interest expense and intra-group financing seems to be compared with other instruments (e.g. transfer pricing) a less important instrument for profit shifting. This finding throws some doubt on the decision in the ATAD Directive to extend earnings stripping rules to loans vis-à-vis third parties.

The importance of debt shifting as a source of BEPS must not be exaggerated since, according to some studies, only 28% of the profit shifting consists of intra group financing.[35] A much larger part is explained by transfer pricing.[36]

The OECD BEPS Action 4 report contains an extended discussion of the advantages and disadvantages of earnings stripping rules, including a comparison with asset-based thin capitalization rules. The key advantages and disadvantages in the author's opinion are discussed in the following two sections.

4.2 Advantages of Earnings Stripping Rules

An advantage of earnings stripping rules is that they are a very effective measure to combat base erosion. The effectiveness depends on the percentage that is used to set the amount of excessive borrowing costs. The lower the percentage, the more effective the rule. Most Member States have opted for the maximum of 30%. A higher percentage creates more scope for tax avoidance but could also be seen as a moral signal to taxpayers that the higher borrowing costs are acceptable from a tax point of view. The OECD[37] has researched the impact of earnings striping rules and concluded that with a 30% EBITDA barrier, 22% of non-multinational companies and 18% of multinational companies are affected by the interest limitation.[38] With a barrier of 10%, these figures are 43% and 38% respectively.

Since tax avoidance by means of excessive financing could take place via internal or external debt, it is, from this perspective, not effective to draw a distinction between the sources of the debt.[39]

It is argued in economic literature[40] that earnings stripping rules can also be seen as a second-best solution[41] because the introduction of an Allowance for Corporate Equity (ACE) in a non-harmonized tax system (which is regarded by economists as a more optimal solution) will have either distortive or budgetary consequences. The distortive effect will be increased if the negative budgetary effect of an ACE is offset by an increase in the marginal corporate income tax rate. Such an increase could have an adverse effect on investment, especially Foreign Domestic Investment (FDI). Since excessive returns are fully taxed, an increase in the marginal rate in particular is expected to distort the allocation of activities that are possible to achieve an additional return because of the existence of economic rents. This can be prevented by increasing other taxes but that has distributive consequences.

Earnings stripping rules could also limit other tax avoidance strategies, such as manipulation of the transfer prices, because these strategies reduce taxable income (EBITDA) and therefore the scope for interest deduction.[42]

4.3 Disadvantages of Earnings Stripping Rules

An argument which is often raised against earnings stripping rules is that they have a pro-cyclical effect. Its magnitude depends, however, on the percentage that is used to limit the interest deduction. No empirical evidence has been found that during the financial crisis companies in Germany were confronted with extra limitations as a consequence of local earnings stripping rules.[43]

Earnings stripping rules could also jeopardize the ability to pay (or net) principle meaning that only profits (income minus costs) should be taxable income. From the perspective of net income taxation, interest should be

[32] R. A. de Mooij, *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations*, IMF Working Paper (2011).

[33] Christoph Spengel et al., *European Union/International – Addressing the Debt-Equity Bias Within a Common Consolidated Corporate Tax Base (CCCTB) – Possibilities, Impact on Effective Tax Rates and Revenue Neutrality*, 10(2) World Tax J. (2018).

[34] Hey, *supra* n. 7.

[35] However, if the base erosion is very large, it can still be important to reduce this 28%.

[36] *See* J. H. Heckemeyer & M. Overesch, *Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels*, ZEW Discussion Paper No. 13-045 (2013).

[37] BEPS Action 4 Report 2015, Annex B.

[38] These percentages are based on the 2013 consolidated financial statement information in Standard & Poor's GlobalVantage database.

[39] Richard Collier et al., *Dissecting the EU's Recent Anti-Tax Avoidance Measures: Merits and Problems*, 2 EconPol Policy Report 08/2018, at 6 (Sept. 2018).

[40] Dirk Schindler & Hendrik Vrijburg, *Hervorm de vpb door beperking van de renteaftrek*, ESB 118–134 (2019).

[41] It is outside the scope of this article to discuss fundamental policy reforms to deal with the different tax treatment of debt and equity. Another good solution would be to tax the interest via a withholding tax. *See* e.g. E. C. C. M. Kemmeren, *BEPS en renteaftrek en andere financiële betalingen: de verkeerde route*, WFR, 2015/7113, at 1107–1116 and Hey, *supra* n. 7.

[42] Schindler & Vrijburg, *supra* n. 40, 118–134, at 130.

[43] *Ibid.*

deductible in the country of the foreign subsidiary.[44] The net principle could – as in Germany – be part of the constitution.[45] If interest is paid to third-parties and is not deductible, too much total income is taxed. This effect is increased by the fact that, in principle, non-deductible interest remains taxed and this will lead to economic double taxation if taxpayers are not able to change their financing structure.[46] Double taxation of intra-group interest could be prevented by introducing a requalification rule under which interest which is not deductible is requalified as dividend. The double taxation would then be eliminated insofar as the Parent-subsidiary Directive applies. It is remarkable that despite the fact that recital 5 of the ATAD Directive explicitly states that taxpayers should receive relief for double taxation, the Directive does not contain provisions to this effect.

The argument that earnings stripping rules reduce the difference in treatment between debt and equity is not valid because they only reduce the incentive to use debt. A more equal treatment requires more fundamental reforms, all of which come with distributive effects.[47]

The earnings stripping rules ignore differences between firms if Member States do not implement equity exception rules.[48] To the extent that Member States have implemented equity exception rules, they do not deal with the issue that a group could have different activities which justify different debt to equity ratios.[49] If the earnings stripping rules are implemented without an equity exception, domestic companies which do not engage in excessive debt financing could also be affected.

Although the earnings stripping rules are rather general, they could still be difficult to apply in practice especially in connection with the group exception. Hey[50] notes with respect to the German interest barrier that *'it is so complex in its application that it cannot be enforced in a sufficiently equal manner'*. She also addresses the issue that not all tax authorities are equally resourced to enforce the rules and that both taxpayers and tax authorities benefit from stability of tax rules. In general there is a trade-off between introducing more effective rules with a substantial increase of compliance costs and borrowing costs for domestic firms and a less effective rule with only minor collateral damage.[51]

The OECD recommends including targeted interest limitation rules which limit interest deductions on payments made under specific transactions or arrangements, particularly in relation to risks posed in the banking and insurance sector.[52] Various BEPS risks remain with regard to interest even after introducing earnings stripping rules, e.g. loans from affiliated entities which are not part of the group or a group divided by using non-incorporated holding companies and artificial loans and/or structured arrangements.[53] Germany already had targeted rules in place in addition to the earnings stripping rules, specifically to prevent abuse of the group exception rule and the standalone exception[54] and the Netherlands has also upheld specific interest limitation rules. Some BEPS risks are targeted by other measures such as the introduction of the CFC rules. Finally, from a global perspective, the introduction of earnings stripping rules could discourage investments in Europe.

4.4 Interim Conclusion

The economic literature is not unanimously positive about earnings stripping rules. Important disadvantages have been identified but the need and political imperative to curb BEPS and the fact that significant Member States had already introduced general earnings stripping rules seem to have been decisive for political support and the course taken. However, the risk of double taxation in particular is clearly contrary to the purposes of the ATAD Directive.

5 Compatibility of the Earnings Stripping Rules with Primary EU Law

5.1 General

This section examines whether the earnings stripping rules are consistent with primary EU law, the Parent-subsidiary Directive and EU tax policy (CCTB). The freedom of capital and the freedom to provide services come into play because the earnings stripping rules apply irrespective of whether a loan is granted by a resident or non-resident or by an affiliated entity or vis-à-vis third parties. The freedom of establishment could also be relevant if an affiliated company which grants the loan has a holding in the debtor that gives him a definite influence over the company's decisions and allows him to determine its activities.[55] The freedom of establishment will in particular be relevant if a Member State has introduced an equity exception or if the effects of the earnings stripping rules are mitigated as a consequence of the application of a national tax group regime (a tax unity regime or group contribution regime, which in general can only be applied if the parent company exercises control). Tax measures can restrict the freedom of establishment even if, from a tax

[44] Hey, *supra* n. 7.
[45] Press notice of German Supreme Tax Court of 11 Feb. 2016.
[46] Lobita, *supra* n. 9.
[47] *See* e.g. the overview provided by Hey, *supra* n. 7.
[48] This was the reason the OECD recommended introducing a group exception. *See* OECD Action 4 Final 2015, at 47.
[49] Collier et al., *supra* n. 39, at 6.
[50] Hey, *supra* n. 7, § 6.
[51] Collier et al., *supra* n. 39, at 8.
[52] OECD Action 4 Final 2015, para. 169.
[53] G. F. Boulogne, *Debt Push Downs in Time of BEPS Action 4 and the ATAD*, 47(5) Intertax 450 (2019).
[54] Tell, *supra* n. 4, at 757.
[55] ECJ 13 Apr. 2000, Case C-251/98 (*Baars*), para. 22.

perspective, the position of a multinational group of companies is not comparable to that of a group of companies all of which are resident in the same Member State and taking into consideration that the financing of a subsidiary can structured in such a way that profits are transferred to a State where they are taxed at a lower rate.[56]

In order to establish a breach of EU law, a measure must directly or indirectly discriminate between cross-border and comparable domestic situation (nationality or place of establishment). There must then be a review of whether there is an objective difference between cross-border and internal cases which explains the different treatment of the cross-border case and whether the two positions are still comparable when viewed in the light of the object and purpose of the impugned tax measure.[57] If cases are not comparable, no justification is needed, but the CJEU has not always been very clear in this respect and has sometimes justified certain aspects of a measure which, on closer inspection, seemed to make the situations not comparable. An important aspect that makes situations comparable is that a Member State exercises taxing power. For example, in the OyAA[58] case on a Finnish group's contribution system, the CJEU saw a difference in treatment because Finnish law did not allow contribution of profit to a UK partner while contribution to a Finnish parent was possible. However, these situations were not comparable since the UK parent is not subject to tax in Finland while a Finnish parent, of course, is.[59] In addition it is possible that a measure, however at the outset the conditions are neutral, de facto discriminates cross-border situations.[60] The conditions of a measure do not discriminate between cross-border and domestic situation, but for a non-resident it is more difficult to comply with these conditions for example because the domestic rules in the country of the non-resident or commercial practice and/or organization are different. This extension of the discrimination doctrine brings EU direct tax case law in the direction of the mutual recognition approach which is elsewhere in EU law applied, but it is difficult to apply because EU law does not say which jurisdiction should recognize which other jurisdiction's taxing power.[61]

In the above evaluation, the specific question of how much discretion the CJEU has to apply primary EU law becomes relevant when the national rules are the result of the implementation of secondary EU legislation such as the ATAD Directive. In case law,[62] the CJEU seems to draw a distinction between situations where secondary EU law requires Member States to fully harmonize national law with a Directive and where Member States have discretion, for example under the de minimis rule, or can choose between options. To a certain extent, the ATAD Directive contains options between which Member State can choose. This means that the CJEU could, in theory, be entitled to scrutinize the comparability of the interest limitation rules as implemented by the Member States and the fundamental freedoms.[63]

In the Bosal case,[64] the CJEU affirmed that when a directive gives Member States options, such choices cannot violate fundamental freedoms. However, in the Argenta case,[65] the legitimacy of a rule which was a result of an option included in the Parent-subsidiary Directive was challenged. The CJEU applied primary EU law to this rule.[66] When EU secondary law does not leave space for discretion in implementation, a Member State cannot at the same time infringe EU primary law.[67]

The CJEU ruled:

> *In that respect, it is understood that, when the EU legislature adopts a tax measure, it is called upon to make political, economic and social choices, and to rank divergent interests or to undertake complex assessments. Consequently, it should, in that context, be accorded a broad discretion, so that judicial review of compliance with the conditions set out in the previous paragraph of this judgment must be limited to review as to manifest error.*[68]

If the CJEU is going to assess the compatibility of the earnings stripping rules with primary EU law, the following justifications could be put forward.

5.2 The Earnings Stripping Rules and the Freedom of Establishment and Capital

On several occasions in the past, the CJEU has ruled that thin capitalization rules, which have the same purpose as

56 ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), paras 59–60.
57 P. J. Wattel, Otto Marres & Hein Vermeulen, *European Tax Law* 322 (Kluwer 2018).
58 ECJ 18 July 2007, Case C-231/05 (*OyAA*).
59 Wattel, Marres & Vermeulen, *supra* n. 57.
60 ECJ 29 Nov. 2001, Case C-17/00 (*De Coster*), ECJ 8 June 2017, Case C-580/15 (*Van der Weegen Pot*), ECJ 6 June 2013, Case C-383/1 (*Commission v. Belgium*), ECJ 30 Jan. 2020, Case C-156/17 (*Deka*), ECJ 3 Mar. 2020, C-323/18 (*Tesco Global*) and ECJ 3 Mar. 2020, Case C-482/18 (*Google Ireland Ltd.*).
61 Wattel, Marres & Vermeulen, *supra* n. 57, at 333.
62 ECJ 5 Oct. 1977, Case 5/77 (*Carlo Tedeschi v. Denkavit Commerciale s.r.l.*), ECJ 9 June 1992, Case C-47/90 (*Etablissements Delhaize frères and Compagnie Le Lion SA v. Promalvin SA and AGE Bodegas Unidas SA*), paras 25–26, ECJ 5 Oct. 2004, Case C-475/01 (*Commission v. Greece (Ouzo)*), para. 24.
63 In the same vein Paula Benéitiz Régil, *BEPS Actions 2, 3, and 4 and the Fundamental Freedoms: Is There a Way Out?*, 56(6) Eur. Tax'n 230–245, at 239 (2016).
64 ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*).
65 ECJ 4 July 2013, Case C-350/11 (*Argenta Spaarbank I*).
66 *See also* ECJ 7 Sept. 2017, Case C-6/16 (*Eqiom Enka*), paras 15–17.
67 ECJ 5 Oct. 2004, Case C-475/01 (*Commission v. Greece Ouzo*), para. 24. *See* Ginevra, *supra* n. 9, at 123.
68 ECJ 7 Mar. 2017, Case C-390/15 (*RPO*), para. 54, ECJ 14 Dec. 2004, Case C-210/03 (*Swedish Match*), para. 48 and ECJ 12 July 2005, Case C-154/04 (*Alliance for Natural Health*), para. 52, ECJ 10 Dec. 2002, C-491/01 (*British American Tobacco*), para. 123, and ECJ 17 Oct. 2013, C-203/12 (*Billerud Karlsborg and Billerud Skärblacka*), para. 35.

earnings stripping rules, namely protecting the tax base against excessive (intra-group) debt financing, were in breach of the TFEU.[69] In all these cases, the rules contained a distinction between domestic and cross-border situations which was not justified or the applicable rules were not proportionate. After Iceltar, in which the CJEU decided that thin capitalization rules did breach the freedom of capital (and consequently were unacceptable in relation to third countries), Member States moved towards general restrictions on interest deductibility that also apply domestically because rules which apply cross-border and at home are prima facie compatible with EU law.[70] Later case law, however, shows that it is not always necessary to apply tax base protective measures indiscriminately.[71]

In principle, Article 4 of the ATAD Directive is equally applicable to cross-border and domestic groups of companies. The rules do not discriminate between the nationality or place of residence of the taxpayer or the creditor and are not in breach of EU law. It is settled case law that Member States are at liberty to determine the conditions and level of taxation for different types of establishments chosen by national companies or partnerships for operations abroad, on condition that those companies or partnerships are not treated in a manner that is discriminatory in comparison with comparable national establishments.[72]

Having said that, any direct discrimination with respect to nationality or place of residence, and whether the conditions of the earnings stripping rules could lead to de facto discrimination must also be assessed. The literature notes that application of the EUR 3 million exception could be covert discrimination if it effectively excludes domestic groups from the application of the earnings stripping rules (see § 5.4).[73] The exclusion of exempt income and the standalone exception, which is not applicable if the taxpayer has a permanent establishment, will also be reviewed (§ 5.5–§ 5.6).

The option to apply the earnings stripping rules on a group level under national law could offer the taxpayer further scope for interest deduction. Since, in general, only companies which are resident can be a member of a group for tax purposes, this rule could potentially (de facto) discriminate against multinational groups compared to domestic groups. This will be discussed in § 5.7.

Paragraph 5.3 will start with a discussion of CJEU case law which could be relevant when assessing the consistency of the earnings stripping rules with EU law. Although the earnings stripping rules do not discriminate directly it is still valuable to see whether they comply with the principles developed under EU law.

5.3 Justifications of the Earnings Stripping Rules

In its BEPS reports, the OECD noted that the proposed measures could restrict the fundamental freedoms but they mention the need to preserve the balanced allocation between EU Member States of the power to impose taxes and the need to prevent tax avoidance and combat artificial arrangements as examples of justifications for these restrictions.[74] These justifications will be examined separately in the following sections but it must be remembered that recently the CJEU has more often taken these justifications together and the distinction between the need to safeguard the coherence of the tax system and the balanced allocation of taxing rights is sometimes blurred. Moreover, if these justifications apply together, there would seem to be no need for a separate case-by-case anti-abuse analysis to establish 'wholly-artificial arrangements' nor should the taxpayer given the opportunity to provide counter-evidence.[75]

5.3.1 Safeguarding the Coherence of the Tax System

According to this justification, denial of interest should be acceptable when it is used to finance activities whose income cannot be taxed by the Member State of the parent. The CJEU applies the justification of coherence rather strictly. There has to be a direct link between the advantage that is granted and the restrictive measure which corrects it. According the CJEU, such a direct link existed in the Bachman case,[76] where the limitation of the deduction of insurance premiums was justified by the impossibility to tax the future allowance. The coherence argument was accepted in respect of the German claw-back rule on the deduction of losses of permanent establishments.[77] Germany accepted deduction of the losses but denied exemption of future profits until those losses were recovered. The CJEU seemed to relax the condition of a direct link. The coherence argument was accepted in the Papillion[78] and Timac Agro[79] cases without reference to a direct link.[80] However, this direct link was available, in particular in the case of Timac

69 ECJ 12 Dec. 2002, Case C-324/00 (*Lankhorst Hohorst*) and ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*).

70 Régil, *supra* n. 63, § 2.4.

71 Wattel, Marres & Vermeulen, *supra* n. 57, at 384. *See* ECJ 21 Jan. 2010, Case C-311/08 (SGI) and ECJ 31 May 2018, Case C-382 (Hornbach-Baumarkt).

72 ECJ 6 Dec. 2007, Case C- 298/05 (Columbus Container Services), para. 53.

73 Ginevra, *supra* n. 9, 120–137, at 124.

74 OECD Action 4: 2016 Update at 89.

75 Wattel, Marres & Vermeulen, *supra* n. 57, at 349.

76 ECJ 28 Jan. 1992, Case C-204/90 (*Bachmann*).

77 ECJ 23 Oct. 2008, Case C-157/07 (*Krankenheim Ruhesitz am Wannsee*).

78 ECJ 27 Nov. 2008, Case C-418/07 (Papillon).

79 ECJ 17 Dec. 2015, Case C-388/14 (*Timac Agro*).

80 Wattel, Marres & Vermeulen, *supra* n. 57, at 355.

Agro, because previously deducted losses were recaptured.

The argument of coherence was, however, rejected in the Bosal case. In principle, the Parent-subsidiary Directive allows Member States to restrict limitation of interest on loans with subsidiaries but Dutch rules denied only interest on loans which were entered into for the acquisition of foreign participating interests, which income was not taxed in the Netherlands.[81] The argument of coherence was rejected because, according to the CJEU, there was no direct link between the limitation of the interest deduction and a corresponding advantage at the level of the same taxpayer.[82] Reference can also be made to the Argenta Spaarbank 1 case,[83] which dealt with the Belgian notional interest deduction. The CJEU considered that the exclusion of equity allocated to foreign assets was not justified because there was no direct Belgian levy which recaptured the deduction. Since a direct link is missing the coherence argument will therefore probably also not be acceptable for the earnings stripping rules.[84] The link between the advantage of interest deduction and the possibility to tax the income generated by assets financed by loans is probably no direct enough. The justification safeguarding the balanced allocation of taxing powers resemblances the coherence justification but seems to be applies less strict by the CJEU (see below).

5.3.2 Safeguarding Tax Revenues

The earnings stripping rules must prevent base erosion via excessive interest deduction. It is settled case law that a reduction in tax revenue does not, as such, constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom.[85]

5.3.3 Safeguarding the Balanced Allocation of the Power to Tax

The need to maintain the balanced allocation of the power to tax between Member States may be capable of justifying a difference in treatment where the system in question is designed to prevent conduct liable to jeopardize the right of a Member State to exercise its power to tax in relation to activities carried out in its territory.[86] This justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardizing the right of a Member State to exercise its jurisdiction in relation to activities carried out in its territory but also if the rule is not specifically designed to exclude purely artificial arrangements devoid of economic reality from the tax advantage.[87] In that situation, the taxpayer must be given the opportunity to rebut the legal presumption of profit shifting.

In the Bosal case, the Netherlands and the Commission argued that the limitation of interest was justified by the aim of preventing an erosion of the tax base going beyond mere diminution of tax revenue. The CJEU dismissed this because such a justification does not differ in substance from that concerning the risk of a diminution in tax revenue.[88]

Profit shifting has been explicitly mentioned by the CJEU as part of what the balanced allocation justification tries to achieve. A suitable justification is a rule which tries to prevent '*the shifting of income normally taxable in one of those Member States to the other*'.[89] The Court has held that when companies are allowed to transfer profits in the form of unusual or gratuitous advantages, this may undermine the balanced allocation of the power to tax between Member States.[90]

The CJEU also accepted this justification in relation to the transfer of losses.[91] In the OyAA[92] case, the CJEU explicitly considered a measure to safeguard the allocation of taxing powers between Member States but not specifically designed to exclude from the tax advantage it confers purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory; taken as a whole, such legislation may nevertheless be regarded as proportionate to the objectives pursued as long as the taxpayer can rebut the presumption of abuse. If no possibility of rebuttal is provided, the measure must be restricted to wholly-artificial arrangements.

The CJEU has also accepted that anti base erosion rules may be restricted to cross-border situations only, provided that they are proportionate.[93]

Financing arrangements could influence the allocation of profits within a group. This is true with regard to intragroup loans and third-party loans but the

[81] ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*), paras 22–25.
[82] *Ibid.*, paras 27–34.
[83] ECJ 4 July 2013, Case C-350/11 (*Argenta Spaarbank I*).
[84] *See* S. P. van Mierlo en F. M. van der Zeijden, *Het EU-rechtelijke risico van de earningsstrippingmaatregel*, MBB februari 74–84, at 80 (2019).
[85] ECJ 12 Dec. 2002, Case C-324/00 (*Lankhorst Hohorst*), para. 36.
[86] It may be allowed to tax a presumed amount of the remuneration for the advantage granted gratuitously to a company established in another Member State with which it has a relationship of interdependence in order to take account of the amount which the parent company would have had to declare in respect of those profits if the transaction had been concluded in accordance with market conditions. ECJ 31 May 2018, Case C-382 (*Hornbach-Baumarkt*), para. 46.
[87] ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), paras 68–69.
[88] ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*), para. 42.
[89] ECJ 4 July 2013, Case C-350/11 (*Argenta Spaarbank*), para. 55.
[90] ECJ 31 May 2018, Case C-382 (*Hornbach-Baumarkt*), paras 43–44.
[91] ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), paras 62–63, ECJ 3 Dec. 2005, Case C-446/03 (*Marks & Spencer*), para. 46. ECJ 25 Feb. 2010, Case C-337/08 (*X Holding*), paras 28–30.
[92] ECJ 18 July 2007, Case C-231/05 (*Oy AA*), paras 56–63.
[93] ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), ECJ 5 July 2012, Case C-318/10 (*SIAT*) and ECJ 31 May 2018, Case C-382 (*Hornbach-Baumarkt*).

reallocation of profits is a consequence of the fundamental difference in treatment between debt and equity, which most countries have. Where debt reduces the tax base in the source country and increases it in the creditor country, equity financing increases the tax base of the source country. In the author's opinion therefore, the choice of the debt to equity ratio as such cannot distort the balanced allocation of profits and losses between Member States. A loan which is used to finance business activities can be expected to generate taxable income corresponding to or exceeding the company's interest expense and is therefore not in itself abusive.[94] The tax treatment follows the qualification of the instrument and there is no benchmark which stipulates the *normal* allocation of profits and losses. Moreover, Member States retain the power to define, by treaty or unilaterally, the criteria for allocation of their powers of taxation.[95]

In relation to normal financing transactions, the justification of the balanced allocation of power to tax in fact implies a budgetary justification and this is not accepted by the CJEU.[96] In the author's opinion therefore, introduction of the earnings stripping rules cannot in general be justified by the need to safeguard the balanced allocation power to tax. This is only the case if a financing arrangement qualifies as an artificial arrangement. In that situation, the balanced allocation of taxing rights could be distorted but this should than be assessed together with the justification of preventing abuse and the specific conditions which the CJEU has formulated to accept that justification must be met. As we will see, the most important difference is that the justification of abuse requires that abuse is assessed on a case-by-case basis and the taxpayer is given the opportunity to rebut the presumption of abuse. This is not necessary when a measure is justified by the need to preserve the balanced allocation of taxing rights[97] or the justifications of abuse and balanced allocation of taxing rights are taken together.[98]

5.3.4 *Prevention of Abuse*

Earnings stripping rules are also implemented to combat abusive debt financing and interest deduction.[99] In the past, the CJEU has decided that thin capitalization rules can in principle be an appropriate measure to prevent practices which have the sole purpose of avoiding tax that would normally be payable on profits generated by activities undertaken on national territory.[100]

The prevention of tax abuse qualifies as an adequate justification but it is also settled case law that this justification is only accepted if the national rules have the specific purpose of preventing wholly-artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on national territory.[101,102]

The CJEU has decided that a financial arrangement which does not comply with internationally accepted criteria such as the arm's length principle entails a wholly-artificial arrangement. In order to establish the artificial nature of the arrangement, the question is whether or not, had there been an arm's length relationship between the companies concerned, the loan would have been granted or granted for a different amount or at a different rate of interest.[103] Therefore a suspicion of abuse could exist if a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions.[104] In the Hornbach Baumarkt case, the CJEU nuanced this reasoning to the extent that there may be commercial reasons for a parent company (a shareholder) to agree to provide capital on non-arm's-length terms.[105] There are also situations in which it is insufficient or even irrelevant to consider whether the restriction is targeted solely at artificial arrangements, because the arrangement which is being scrutinized is by nature not a commercial transaction in the normal sense.[106,107] Group financing arrangements are, however, by definition made for commercial reasons, so this exception seems not to apply to the earnings stripping rules.

The purpose of the earnings stripping rules is to prevent excessive interest deduction, but they contain a general presumption that abuse exists if the exceeding borrowing costs are more than 30% of the EBITDA. Such a general presumption is difficult to reconcile with

[94] EFTA Authority Case No: 76153 (25 Oct. 2016).
[95] ECJ 13 Mar. 2007, Case C-524/04 (Test Claimants in the Thin Cap Group Litigation), para. 49.
[96] ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*).
[97] R. Bagci, P. Ruige & H. Vermeulen, *De earnings-strippingbepaling en de per-elementbenadering. Een Europeesrechtelijke analyse, noodzaak of anathema voor de interne markt?*, WFR 2018/153. Conclusion A-G Wattel HR 8 June 2018 X BV, para. 1.22 and para. 1.18 additional conclusion.
[98] ECJ 18 July 2007, Case C-231/05 (*OyAA*), paras 56–63.
[99] Recitals 5 and 6, ATAD Directive.
[100] ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 77.
[101] ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), para. 34, ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 74 and ECJ 12 Sept. 2006, Case C-196/04 (*Cadbury Schweppes and Cadbury Schweppes Overseas*), para. 55.
[102] The mere fact that a resident company has received a loan from a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty. *See* ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 73.
[103] ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 81 and ECJ 17 Jan. 2008, Case C-105/107 (*Lammers & Van Cleeff*). In the Lankhorst-Hohorst case, the ECJ had dismissed the arm's length test.
[104] ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), paras 71–72.
[105] ECJ 31 May 2018, Case C-382 (*Hornbach-Baumarkt*), paras 52–56.
[106] ECJ 18 July 2007, Case C-321/05 (*OyAA*).
[107] EFTA Authority Case No: 76153, 25 Oct. 2016.

CJEU case law, which stipulates that abuse must be assessed on a case-by-case basis. The CJEU has decided that rules may be regarded as not going beyond what is necessary to prevent tax evasion and avoidance, if, on each occasion when the existence of such an arrangement cannot be ruled out, those rules give the taxpayer an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction.[108,109] In the Lankhorst-Hohorst case, the CJEU dismissed the tax abuse justification because the thin capitalization rules in question were of a too general nature[110] as they applied to abusive and non-abusive situations.[111],[112] The aim of the Directive is to target tax planning schemes regardless of their 'abusive' nature. Loans with third-parties which prima facie are concluded on an arm's length basis could also fall within the scope of the earnings stripping rules. Implementation of the equity exception[113] makes the measure more proportionate because interest deduction is allowed as long as the taxpayer's financial ratios do not negatively deviate from those of the group. But even if the taxpayer uses more debt than the group, this does not necessarily mean than the level of debt is not at arm's length. On the other hand, the group rule exception does not exclude the possibility that a taxpayer is excessively borrowing funds from affiliated entities. Therefore, however the earnings stripping rules could be justified and are appropriate to prevent abuse by means of excessive interest deduction, they are, in the author's opinion, not proportionate.

A rule can also be disproportionate if it goes further than necessary to prevent abuse. A correction which denies full deduction of interest even when this interest would be deductible on an arm's length basis could be disproportionate.[114] The corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies did not have a relationship of interdependence.[115]

5.3.5 The Existence of Double Taxation

The earnings stripping rules could also lead to double taxation. In the Lankhorst-Hohorst case, the Commission argued that the principle of proportionality requires that the two Member States in question reach an agreement in order to prevent double taxation.[116] However, in the SGI-case, the CJEU accepted double taxation that existed as a restriction on the deduction of costs[117] and, in the Test Claimants in the Thin Cap Group Litigation Group case, the CJEU considered that a Member State cannot be obliged to ensure that the double taxation is prevented. In that case, an interest payment was recharacterized as a dividend distribution by the Member State of the borrower (the United Kingdom).[118] The United Kingdom was not responsible to avoid double taxation at the level of the Member State of the lender. The CJEU argued that in the absence of any unifying or harmonizing Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocation of their powers of taxation, particularly with a view of elimination of double taxation. In that context, it is for the Member States to take the measures necessary to prevent double taxation by applying, in particular, the apportionment criteria followed in international tax practice, including the model conventions drawn up by the OECD.[119] This may be different if in a domestic situation the Member State grants an exemption for the interest which is not deductible as a result of the application of the domestic thin capitalization rules. Than it would be disproportionate to deny that exemption in cross border situations.[120] However, the exemption may be restricted to the amount that in a domestic situation would have been exempted, also when according to the thin capitalization rules of the Member State of the subsidiary a larger amount of interest is not deductible and therefore to a certain extent double taxation remains.

There is no explicit rule of EU law prohibiting intra-EU double taxation.[121] However, it could be argued that abolition of double taxation is part of goals of European law.[122] According to current case law, the fact that the earnings stripping rules could lead to double taxation would not lead to the conclusion that they are disproportionate from an EU-law perspective.

Recital 5 of the ATAD Directive creates some doubt with regard to this conclusion since it explicitly states that when these rules (the rules of the ATAD Directive including the earnings stripping rules) give rise to double taxation, taxpayers should receive relief through a

108 ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), para. 37.
109 ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), ECJ 31 May 2018, Case C-382 (*Hornbach-Baumarkt*), para. 49.
110 ECJ 12 Dec. 2002, Case C-324/00 (*Lankhorst Hohorst*), para. 37.
111 Ginevra, *supra* n. 9, at 124.
112 *Ibid.*
113 In line with Art. 4(5) ATAD Directive.
114 ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), paras 38–39, ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 83.
115 ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), paras 71–72.
116 ECJ 12 Dec. 2002, Case C-324/00 (*Lankhorst Hohorst*), para. 35.
117 ECJ 21 Jan. 2010, Case C-311/08 (*SGI*) and ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), para. 75.
118 ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), paras 88–89 and ECJ 12 Dec. 2006, Case C-374/4 (*Test Claimants in Class IV of the ACT Group Litigation*), paras 59–60.
119 ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 49.
120 ECJ 21 Dec. 2016, Case C-593/14 (*Masco & Damixa*), paras 39–43.
121 ECJ 14 Nov. 2006, Case C-513/04 (*Kerckhaert and Morres*), ECJ 16 July 2009, Case C-128/08 (*Damseaux*) and ECJ 12 Feb. 2009, Case C-67/08 (*Block*).
122 E. C. C. M. Kemmeren, *After Repeal of Article 293 EC Treaty Under the Lisbon Treaty: The EU Objective of Elimination Double Taxation Can Be Applied More Widely*, 4 EC Tax Rev. 156–158 (2008).

deduction for the tax paid in another Member State or third country. The EU legislature probably had application of the CFC rules in mind when drafting this recital but the wording is not restricted to that situation. Recital 5 ends with the sentence '*Thus, the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation*'. Unfortunately, the ATAD Directive does not contain a provision in Article 4 to prevent double taxation. Double taxation is specifically prevented with regard to the application of the CFC rules via Article 8(7) and indirectly in the Exit Tax by the rule that the receiving Member State must, in principle, accept the value established by the other Member State as the starting value for tax purposes, see Article 5(5). Since a direct provision to prevent double taxation is absent from the substantive part of the ATAD Directive, the author concludes that it is not the purpose of the ATAD Directive to prevent double taxation in this specific situation and therefore the CJEU will not consider the earnings stripping rules to be disproportionate because double taxation could exist.

5.3.6 Other Relevant Elements

Rules which do not meet the requirements of the principle of legal certainty cannot be considered to be proportionate to the objectives pursued.[123] The principle of certainty requires rules to be clear, precise and predictable. João Camona Lobita points out that certain terms, such as a 'higher level of protection', are still vague.[124] In the author's opinion however, the earnings stripping rules appear generally consistent with this principle but this of course depends on national implementation.

5.4 The Threshold of EUR 3 Million Exception

In a number of cases,[125] the CJEU has decided that, in the absence of actual or covert discrimination, it must be assessed whether a measure contains elements which lead to de facto discrimination. If a Member State's economy is characterized by small and medium-sized domestic enterprises, a high threshold will effectively target foreign enterprises which are highly debt financed. This could constitute covert discrimination and would also not be in line with BEPS Action 4, which states that the de minimis threshold should reflect the domestic economic environment of the country implementing it.[126] However, in the Vodafone case the CJEU has accepted an important limitation to the scope of de facto discrimination. That case dealt with a Hungarian progressive tax levied from telecom companies. The levy was depended on the turnover. Since, foreign held companies realized a much higher turnover than the domestic companies the levy was de facto borne by foreign owned tax payers. According to Vodafone and the Commission this consisted indirect discrimination. In paragraphs 49–52 the CJEU recalls that Member State are free to establish the system of taxation that they deem the most appropriate. A progressive tax based on turnover falls within that discretion. The fact that due to the progressive nature of the greater part of the tax is born by persons of other Member States is not by itself discrimination. In particular not because the telecommunications market is dominated by such taxable persons, who achieve the highest turnover in that market. The same reasoning could be applied to the threshold of EUR 3 million. This threshold is based on a neutral criterion (EBITDA) and if it would de facto exempt domestic companies, because they are relatively small, that would be the result of the structure of the market, which seems to be acceptable.

5.5 The Exclusion of Exempt EBITDA and Interest

The exclusion of tax-exempt EBITDA and interest from the application of Article 4 of the ATAD Directive could be seen as discrimination against taxpayers with foreign income. In the author's opinion, there is no discrimination because taxpayers with domestic income and foreign income are not comparable since foreign income is not subject to tax in the country of residence. Consequently, the exclusion of the exempt EBITDA does not require a justification. This might be different if a Member State applies a tax credit or tax exemption system as a mode to prevent double taxation in connection with foreign income (dividends from a subsidiary or a permanent establishment). In that situation parents with domestic and foreign income are comparable because all income is subject to tax. The allocation of taxing rights is not distorted if foreign interest and EBITDA are included in the tax base. An exclusion should then be based on the need to prevent abuse, which may not hold (see below). Finally, the ATAD Directive does not explicitly allow exclusion of EBITDA and interest in this situation because that income is not exempt.

The exclusion of exempt EBITDA follows, without an option, from the application of the ATAD Directive. In § 5.1 we saw that according to CJEU case law, there is little scope to assess a breach of primary EU law when the contested national law is a result of harmonization. The exclusion of exempt income and interest is not an option but a minimum standard which must be implemented by the Member States. In the author's opinion, the CJEU cannot assess whether this rule breaches primary EU law, because it is not likely that the exclusion of tax exempt income is a manifest error exists given the

[123] ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), para. 44.
[124] Lobita, *supra* n. 9.
[125] ECJ 3 Mar. 2020, C-323/18 (*Tesco Global*), ECJ 3 Mar. 2020, Case C-482/18 (*Google Ireland Ltd.*) and ECJ 30 Jan. 2020, Case C-156/17 (*Deka*).
[126] Ginevra, *supra* n. 9, at 124.

purpose of the ATAD Directive to prevent base erosion.[127] The risk of base erosion is increased when exempt income has to be included in the EBITDA and exempt interest income reduces the balance of non-deductible interest. If the CJEU is going to assess the compatibility of the earnings stripping rules with primary EU law, the following justifications could be put forward.

5.5.1 *Safeguarding the Coherence of the Tax System*

It could be argued that the exclusion of foreign income is justified by the coherence of the tax system, namely that corporate income tax is levied according to the principle of territoriality in the place of the economic activities. According to this justification, denial of interest is acceptable when it is used to finance activities whose income cannot be taxed by the Member State of the parent. The CJEU applies the justification of coherence rather strictly. There must be a direct link between the advantage that is granted and the restrictive measure which corrects it (see § 5.3).

We saw that in the Bosal case[128] and the Argenta case[129] the CJEU did not accept this justification. In the author's opinion there is an important difference with these cases since the earnings stripping rules do not distinct between domestic and cross-border situations and all tax exempt income is excluded irrespective the allocation of the source of income.[130]

The balance of borrowing cost could be higher and, in extreme situations, the EBITDA could be lower. In addition, the EUR 3 million threshold must also be applied on a group level.

5.5.2 *Balanced Allocation of Taxing Rights*

The territoriality principle could also be put forward in connection with the need to safeguard the balanced allocation of taxing rights.[131] The host country of the parent company does not have taxing rights with regard to a foreign subsidiary or permanent establishment and so it does not have to include the EBITDA or the foreign interest income of that subsidiary or permanent establishment. However, the CJEU considered that the need to safeguard the balanced allocation of taxing rights cannot justify a Member State systematically refusing to grant a tax advantage to a resident subsidiary on the grounds that the income of the parent company, having its establishment in another Member State, is not capable of being taxed in the first Member State.[132]

Also the Parent-subsidiary Directive allows Member States to restrict limitation of interest in connection with loans for subsidiaries.[133] However, the principle of territoriality was not accepted in the Bosal case because the profits of resident and non-resident subsidiaries were not taxed at the level of the parent company because of the Dutch exemption system,[134] and so parents with Dutch and non-domestic subsidiaries were comparable. In addition, the Parent-subsidiary Directive does not provide for any exception concerning the territory where the profits of the subsidiaries might be taxed.[135] This argument was also rejected in the Argenta Spaarbank 1 case-[136] because the notional interest deduction did not jeopardize the right of the Member State in whose territory the company to which the permanent establishment belongs is established nor that of the Member State in whose territory the permanent establishment is situated to exercise the power to tax in relation to activities carried out in its territory and would not result in the shifting of income normally taxable in one of those Member States to the other.

Smit argues that according to CJEU case law, Member States are not obliged to take foreign losses into account in a system of tax contribution, and so it seems acceptable that foreign EBITDA is not taken into account. A difference may be that there is no risk that losses are allocated freely and taken into account twice.[137] In the author's opinion however, this risk is comparable because in this situation there is a risk that the same EBITDA is used in two Member States to calculate the scope for interest deduction.

In the author's opinion the need to preserve the balanced allocation of taxing rights is a suitable justification of a breach, if any, of primary EU law. This justification seems not to require the ability of the taxpayer to provide counter-evidence.

5.6 The Standalone Exception and EU Law

The standalone exception does not apply if a company has a permanent establishment. In the author's opinion, this is a discrimination between domestic and foreign branches which has to be justified. The ATAD Directive allows this distinction but, since application of this exception is an option, it may be scrutinized under EU law. Possible justifications would be the need to safeguard the balanced allocation of taxing rights between

[127] O. C. R. Marres, *Waarom de earningsstrippingmaatregel niet in strijd met het primaire Unierecht is*, NTFR 2019/3022.
[128] ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*).
[129] ECJ 4 July 2013, Case C-350/11 (*Argenta Spaarbank I*).
[130] R. Bagci, P. Ruige & H. Vermeulen, *De earnings-strippingbepaling en de per-elementbenadering. Een Europeesrechtelijke analyse, noodzaak of anathema voor de interne markt?*, WFR 2018/153.
[131] Bagci, Ruige & Vermeulen, De earnings-strippingbepaling en de per-elementbenadering. Een Europeesrechtelijke analyse, noodzaak of anathema voor de interne markt?, WFR 2018/153, § 5. D. S. Smit, *De Nederlandse implementatie van de earningsstrippingbepaling uit ATAD 1*, MBB 2018/11, 438–446 at 446.
[132] ECJ 18 July 2007, Case C-231/05 (*OyAA*), para. 53 and ECJ 16 Dec. 1976, Case C-33/76 (*Rewe Zentralfinanz),* para. 43.
[133] ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*), paras 22–25.
[134] ECJ 18 Sept. 2003, Case C-168/01 (*Bosal Holding*), para. 39.
[135] ECJ 18 Sept. 2003, Case C-168/01 (Bosal Holding), para. 41.
[136] ECJ 4 July 2013, Case C-350/11 (*Argenta Spaarbank I*), para. 55.
[137] *See* S. P. van Mierlo en F. M. van der Zeijden, *Het EU-rechtelijke risico van de earningsstrippingmaatregel*, MBB februari 2019, p. 74–84, p. 81.

Member States and the need to prevent abuse. In the author's opinion, neither is convincing since the ATAD Directive also stipulates that tax-exempt EBITDA and interest may not be included when determining the non-deductible borrowing costs. If the ATAD Directive is correctly implemented, there is no difference in the risk of base erosion between a company with only domestic branches and one with domestic and foreign branches. This might be different if the results of a branch are not tax-exempt but the Member State of the company prevents double taxation by means of a tax exemption or tax credit. In those situations, inclusion of the EBITDA and interest attributable to the permanent establishment could result in more scope for interest deduction in the company's Member State of residence.

5.7 Interaction Between the Earnings Stripping Rules and Tax Group Rules

5.7.1 Tax Treatment of Groups

A domestic group of companies can be part of a tax unity. Under national law, the earnings stripping rules can be applied at the level of the tax unity. This may be beneficial because (1) loans between members of the tax unity are disregarded for tax purposes or the effect of interest payments are effectively eliminated as a result of the group contribution rules, (2) the surplus of borrowing costs could be reduced because positive financial income of companies may be off set against the borrowing costs of other companies and (3) taxable income (EBITDA) of group companies could increase the scope for interest deduction.

However, many tax group regimes do not allow inclusion of non-resident entities. In Marks & Spencer and X Holding, the CJEU considered this restriction to be justified in the light of the need to preserve the allocation of taxing rights between Member States, the risk of double deduction of losses and the prevention of tax avoidance.[138] In X Holding too, the CJEU justified the breach of the freedom of establishment as a result of the restriction to deduction tax losses cross-border by reference to the need to preserve the allocation of taxing rights.

But as the Groupe Steria case showed,[139] each advantage of the tax unity must be assessed separately as to whether it is justifiable to withhold the advantage from non-resident entities. In Groupe Steria, the CJEU did not accept the difference in treatment of dividends received from an associated entity.[140] According to the CJEU, the justification of the balanced allocation of taxing rights did not apply because only one Member State was involved, and this is also true for the earnings stripping rules (paragraph 29). The coherence justification was rejected because there was no direct link between the advantage (a wider exemption) and the disadvantage which is the result of the group regime (paragraphs 31–37). The CJEU followed the same reasoning in the Finanzamt Linz case with regard to the amortization of goodwill.[141]

Finally, in the Dutch X BV and X NV case,[142] the CJEU decided that the Netherlands was not allowed to withhold the advantages of a tax unity for the application of a specific Dutch anti-abuse rule (section 10a Corporate Income Tax (CIT)).[143] The CJEU decided that the distinction between domestic groups and international groups was not justified.[144] According to the CJEU, the measure could not be justified by the need to safeguard the allocation of the power to tax:

> *because Netherlands law affords to deduct interest and restricts it only in the particular case and conditions laid down in Section 10a(2)(b) of the Corporate Income Tax Act. In avoiding that restriction, a parent company which together with its subsidiary forms a single tax entity <u>does not, therefore, obtain an advantage specifically linked to the tax scheme of the single tax entity.</u>*

Whether there is a direct link must be assessed in light of the purpose of the specific rule. In addition the CJEU argued that the application of section 10a(2)(b) CIT seemed not to depend on the place of taxation of the income comprising the interest paid and, therefore, on ascertaining which State benefits from that taxation, a factor which the Netherlands Government has not indeed addressed.[145] The CJEU also rejected the justification of abuse because the Netherlands did not raise that justification and according to the CJEU the difference in treatment did not stem from section 10a(2)(b) CIT but from that provision in conjunction with section 15 of the Act relating to the single tax entity, which has a different purpose. Finally, the CJEU argued that when a parent company finances the purchase of shares in a subsidiary by a loan taken out with another related

[138] ECJ 3 Dec. 2005, Case C-446/03 (*Marks & Spencer*), ECJ 25 Feb. 2010, Case C-337/08 (*X Holding*). *See also* ECJ 12 June 2018, Case C-650/16 (*Bevola and Trock*) and ECJ 4 July 2018, Case C-28/17 (*NN*).

[139] ECJ 2 Sept. 2015, Case C-386/14 (*Groupe Steria*).

[140] Under French national law, dividends from associated entities received a 95% exemption but when a subsidiary was included in a tax group the dividend was fully tax exempt. Only companies situated in France could be part of the tax group and therefore apply the 100% exemption.

[141] ECJ 6 Oct. 2015, Case C-66/14 (*Finanzamt Linz*).

[142] ECJ 22 Feb. 2018, Case C-398/16 and C-399/16 (*X BV and X NV*).

[143] Section 10a CIT restricts the deduction of interest with regard to loans from affiliated entities which are used to finance specific transactions (such as the distribution of dividend, a capital contribution and the acquisition of shares in an affiliated company). The application of s. 10a has now been extended to the acquisition of shares from third parties. s. 10a is not applicable if the interest is taxed according to an effective tax rate which is reasonable from a Dutch tax point of view unless the tax authorities can prove that despite the reasonable taxation no sound business reasons justify the transaction or the loan. If the interest is not reasonably taxed, the taxpayer has also the opportunity to prove that the loan and transaction are justified by sound business reasons.

[144] ECJ 22 Feb. 2018, Case C-398/16 and C-399/16 (*X BV and X NV*).

[145] *Ibid.*, paras 40–42.

company, the risk that that loan does not reflect a genuine economic transaction but is intended simply to create a deductible charge artificially is no less if the parent company and the subsidiary are both resident in the same Member State and together form a single tax entity than if the subsidiary is established in another Member State and is not, therefore, permitted to form a single tax entity with the parent company.[146]

This decision was heavily criticized[147] because the CJEU did not recognize that section 10a CIT is an anti-abuse rule and the abuse it intends to prevent (1) does not exist when a loan or transaction is eliminated on account of the tax unity and (2) there is an essential difference between internal domestic and cross-border situations because in domestic situations base erosion normally does not take place. The CJEU has accepted that anti base erosion rules may be restricted to cross-border situations provided that they are proportionate.-[148] Section 10a CIT is probably proportionate because it offers taxpayers the opportunity to offer counter-evidence.[149] In the case, a capital contribution to a domestic company would generate domestic taxable income and so no base erosion existed. Under Dutch domestic law, inclusion of the Italian holding company would lead to a transformation of the Italian company into a Italian branch of the Dutch shareholder. The loan which was received from the Swedish parent company would be allocated to the Italian branch and therefore not lead to any interest deduction in the Netherlands.

Despite the criticism in literature, the Dutch Supreme Court did not ask the CJEU follow-up questions and followed the reasoning of the CJEU. In its decision, the Dutch Supreme Court also considered how a comparison has to be made when assessing whether or not the tax unity confers an advantage. It considered that the consequences of a hypothetical situation in which a non-resident company is included in a tax unity with a domestic company must not be taken into account in that comparison. This means that the way in which double taxation of the profits of the non-resident company is prevented in such a hypothetical situation is not relevant to the comparison of the advantages of the group regime.[150] This is important because if this consequence is taken into consideration no interest deduction is possible in a situation of a cross-border tax unity. It is not entirely clear whether this effect may also not be taken into consideration when assessing the justification of the restriction. In this particular case, the Dutch Supreme Court did not do that and merely followed the CJEU's rejection of the justifications put forward by the Netherlands.

5.7.2 *Earnings Stripping Rules*

The above advantages of a tax unity in relation to the application of the earnings stripping rules are comparable with the advantages of section 10a and are also not directly linked to the tax unity but stem from the interaction between the tax unity and the earnings stripping rules. Therefore, there is a risk, as the CJEU decided in the X BV and X NV case, that the earnings stripping rules jeopardize the freedom of establishment. From a Dutch tax point of view, the inclusion of a foreign subsidiary in a tax unity would have the consequence, insofar as the non-resident entity has business activities or owns real estate, that these activities are treated as a permanent establishment. Under Dutch national law[151] and in many countries under tax treaties, the income attributable to that permanent establishment is tax-exempt. Under the earnings stripping rules, exempt income does not influence EBITDA and the balance of borrowing costs.[152] Article 4 and recital 6 of the ATAD Directive (and also Dutch national law)[153] explicitly state that only taxable income is taken into consideration. In addition Article 2 (2) stipulates that only taxable financial income and deductible financial costs may be offset. This provision seems to be a minimum standard and the Member States have no option to deviate from the Directive and include exempt income. If this rule qualifies as a restriction then it is a result of the Directive itself.[154]

Consequently, the above ability to offset taxable interest and taxable income in a tax unity would not result in a more favourable position, including with regard to the earnings stripping rules, due to the specific regulations within the earnings stripping rules.

The question is whether the fact that a non-resident entity which is included in a tax unity would be treated as a permanent establishment and thus the income would be tax-exempt may be taken into consideration when making the comparison. The Dutch Supreme Court seemed to reject this type of hypothetical situation.

However, if the effect of a tax unity is accepted and applied consistently, the conclusion must be that

146 *Ibid.*, paras 49–50.

147 Conclusion A-G-Wattel by HR 19 Oct. 2018, ECLI:NL:HR:2018:1968, BNB 2019/17.

148 ECJ 21 Jan. 2010, Case C-311/08 (*SGI*), ECJ 3 Oct. 2013, Case C-282/12 (*Itelcar*), ECJ 5 July 2012, Case 318/10 (*SIAT*), ECJ 31 May 2018, Case C-382 (*Hornbach-Baumarkt*).

149 The Dutch Supreme Court has ruled that the restriction of the freedom of capital which can be caused by s. 10a CIT is justified by the need to prevent tax abuse (HR 1 Mar. 2013, BNB 2013/137 and HR 8 juli 2016, BNB 2016/197).

150 HR 19 Oct. 2018, ECLI:NL:HR:2018:1968, BNB 2019/17, para. 2.4.2.

151 Provided that the Netherlands has concluded a tax treaty with the State of which the non-resident entity is a resident.

152 A. C. R. Marres, *Waarom de earningsstrippingmaatregel niet in strijd met het primaire Unierecht is*, NTFR 2019/3022.

153 Article 15b, ss 2 and 3 CIT.

154 R. Szudoczky, *The Sources of EU Law and Their Relationships: Lessons for the Field of Taxation*, 32 IBFD Doctoral Series, Amsterdam IBFD 211–217 and 385–387 (2014). C. Brokelind & P. J. Wattel, *European Tax Law* 343 (2018). ECJ 26 Oct. 2010, Case C-097/09 (*Schmelz*), para. 54 and conclusion A-G. Kokott, paras 42–44.

according to the ATAD Directive neither foreign EBITDA nor interest may be taken into consideration. In § 5.4 was showed that the exclusion of tax-exempt income and interest is not an option but a minimum standard which must be implemented by the Member States. In the author's opinion, the CJEU cannot assess whether this rule breaches primary EU law.

To the extent to which the CJEU would assess the compatibility of these rules with primary EU law e.g. because it considers that the restriction was created by the interaction of the tax unity and earnings stripping rules safeguarding the coherence of the tax system and the balanced allocation of taxing rights between Member States can be put forward as justifications. Reference is made to § 5.4 for an elaboration of these arguments which apply mutatis mutandis to this situation because the result of a tax unity is that the foreign EBITDA and interest is tax exempt. Therefore, this situation is comparable with the exclusion of the tax-exempt EBITDA in the first place. Safeguarding the balanced allocation of taxing rights and the prevention of abuse would in the author's opinion be adequate justifications. However, the rules are not proportionate which may not be an issue if these justifications are taken as a whole. Finally applying earnings stripping rules at a group level is not always favourable. The balance of borrowing costs could be higher and, in extreme situations, tyhe EBITDA could be lower. Further, the EUR 3 million treshold must also be applied on a group level.[155]

5.7.3 Comparison with the EFTA Surveillance Authority Case Regarding the Norwegian Earnings Stripping Rules

The EFTA Surveillance Authority has ruled that the Norwegian earnings stripping rules did jeopardize the freedom of establishment because multinational groups were de facto discriminated against compared with domestic groups because domestic groups could effectively mitigate the negative effects of the earnings stripping rules by applying the group contribution rules.[156] Cross-border groups did not have that opportunity because non-resident entities are not allowed to contribute results to domestic companies. The Norwegian rules deviated importantly from Article 4 of the ATAD Directive as they only applied to loans from affiliated entities. EU earnings stripping rules also apply to loans from non-affiliated entities.

The EFTA Surveillance Authority concluded that as a result, the group contribution rules:

> *(…) are in practice very unlikely to apply to wholly Norwegian groups of companies, and will never apply to groups that are entitled to grant each other contributions. (…) As a consequence, cross-border intra-group interest contributions will* de facto *be subject to the interest cap rules to a greater extent (since the exception provided under group contribution rules is not available to them).*[157]

The EFTA Surveillance Authority considered that a loan between domestic companies was comparable to a loan between a domestic company and a company situated in another EEA State. Companies from EEA (Euopean Economic Area) States that conduct cross-border activities were disadvantaged when compared to Norwegian-based companies when acquiring a Norwegian target company because Norwegian groups could effectively exempt themselves from the interest cap rules by applying the group contribution opportunity. This de facto discrimination is a restriction.[158]

The EFTA Surveillance Authority considered that this restriction could in principle be justified by the objective of the prevention of tax avoidance and abuse coupled with the balanced allocation of taxing rights but it considered that the Norwegian rules went beyond what was necessary to achieve their goal and contained an implicit presumption that loans to affiliated entities constituted an artificial arrangement which is not allowed. In addition, it considered that the rule was not proportionate because interest deductions were denied as a whole and were not limited to that part of the interest which exceeds what would have been agreed had the relationship been at arm's length.[159] The EFTA Surveillance Authority considered that the fact that both cross-border groups and groups which have only activities in Norway did not have the opportunity to provide counter-evidence was not relevant because domestic groups may still benefit from the group contribution rules which were not available for cross-border groups. The Norwegian authorities also justified the absence of an escape clause on the inadequacy of the arm's length principle as a measure to safeguard the balanced allocation of the power to tax between the EEA States and prevent tax avoidance through intra-group expenses.

5.7.4 Interim Conclusion

It is not certain that the earnings stripping rules are consistent with EU law when the interaction with group rules is taken into consideration. In the author's

155 Bagci, Ruige & Vermeulen, *supra* n. 130.

156 Case No: 76153, 25 Oct. 2016. Reasoned opinion delivered in accordance with Art. 31 of the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice concerning Norway's breach of Art. 31 of the EEE Agreement by maintaining in force interest deductibility restriction, such as the one laid down in s. 6-41 NTA, in particular s. 6-41 (3–4) NTA.

157 ECJ 5 Feb. 2014, C-385/12 (*Hervis*).

158 ECJ 12 Dec. 2002, Case C-324/00 (*Lankhorst Hohorst*), ECJ 5 Feb. 2014, C-385/12 (*Hervis*), ECJ 26 Oct. 1999, Case C-294/97 (*Eurowings*).

159 ECJ 13 Mar. 2007, Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), para. 83.

opinion the difference in treatment is justified and follows the aim of the Directive to exclude exempt EBITDA and interest. In the literature it is argued that the CJEU will take this aim of the ATAD Directive into consideration and so only exceptions which are manifestly disproportionate or discriminatory are in breach of the Treaty.[160] In light of the EU risks, Italy has made it possible for EU law considerations to include EBITDA of foreign subsidiaries and permanent establishments.[161]

5.8 Are the Earnings Stripping Rules in Breach of the Parent-Subsidiary Directive?

The question arises of whether the earnings stripping rules are in conflict with Article 4(2) of the Parent-subsidiary Directive[162] and the interpretation of this article by the CJEU in the Argenta case.[163] The CJEU considered the general limitation of interest deduction up to the amount of the exempt dividend but not restricted to loans entered into to finance the associated entity (the loans were not used to buy the participating interests) and this was not in line with Article 4(2) of the Parent-subsidiary Directive, which reads:

> *Each Member State shall retain the option of providing that any charges relating to the holding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5% of the profits distributed by the subsidiary.*

The purpose of the special rule in Article 4(2) is to prevent a parent company from benefitting from a double deduction (exemption of dividends and deduction of the interest). The CJEU did not accept the general Belgian interest deduction:

> *Second, it must be held that the rule established in Article 4(2) of Directive 90/435 would negate the effectiveness of the rule set out in Article 4(1) of that directive if that first rule had to be interpreted as allowing Member States to preclude the deduction, from the taxable profits of a parent company, <u>of all interest charged in respect of loans up to an amount equal to the amount of dividends</u>, which benefit from a tax exoneration, that the parent company receives from its holding in the capital of a subsidiary, <u>without that non-deductibility being limited to interest charges relating to the financing of that holding which pays out those dividends</u>. Such an interpretation would equate to allowing those Member States to increase indirectly the taxable profits of a parent company, thereby affecting the neutrality, from the tax point of view, of the distribution of dividends paid by a subsidiary located in one Member State to its parent company established another Member State.*[164]

In paragraph 56, the CJEU argues:

> *It follows that a domestic provision, such as Article 198(10) of the 1992 ITC, that excludes, generally and automatically, tax deductibility, as business expenses or charges, of interest relating to loans taken out by a parent company up to an amount equal to the amount of dividends paid out by a holding of that parent company in the capital of a subsidiary, that already benefit from tax deductibility, even if the payment of that interest does not relate to the financing of the acquisition of that holding, is not a compliant implementation of the derogating rule set out in Article 4(2) of Directive 90/435.*

The earnings stripping rules seem to go even further than the Belgian rules because they are a general rule and the limitation is not restricted to the dividend received. The missing link between the dividend and interest limitation could, however, also be an argument that the Parent-subsidiary Directive is not relevant in this situation. The purpose of the earnings stripping rules is not to undermine the effect of the Parent Subsidiary Directive (preventing double taxation of the dividends) but in general to set limitations on the deduction of interest and protect the tax base. The effect of the interest limitation is not that the exemption of the dividend is reversed. The scope for interest deduction is not influenced by the dividend distribution because exempt income must in general be eliminated from the EBITDA.

A difference between the Argenta case and the earnings stripping rule is that Member States must implement the earnings stripping rules. There is in principle no discretion for the Member States, while Article 4(2) of the Parent-subsidiary Directive contains an option for the Member States. The implementation of this option must be in line with the Treaty. A possible restriction must be blamed on the Member State, which is not the case with the earnings stripping rules. It was argued in section 5.1 that in a situation of no option, the CJEU cannot verify whether the national rule breaches primary EU law.

5.9 Compatibility of Article 4 of the ATAD Directive with CC(C)TB Proposal

The earnings stripping rule must also fit other important tax policy initiatives at an EU level, such as the C(C)CTB proposal. The CCTB proposal contains also earnings stripping rules (Article 13). These rules are generally comparable with those adopted in Article 4 of the ATAD Directive and the principal definitions are the same. The interest cap is 30% and the maximum safe harbour for exceeding borrowing costs is also EUR 3 million. The CCTB has also an exception for long-term

160 Ginevra, *supra* n. 9, at 124.

161 Gisueppe A. Galeano & Allan M. Rhode, *Italy Sets the Barrier to Deduction of Financing Costs at 30 Per Cent of EBITDA*, 36(6/7) Intertax 292–301, at 300 (2008).

162 Council Directive 2011/96/EU of 30 Nov. 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

163 ECJ 26 Oct. 2017, Case C-39/16 (*Argenta Spaarbank*).

164 *Ibid.*, para. 52.

public infrastructure projects, existing debt and financial undertakings. An important difference between the ATAD Directive and the current CCTB proposal is that the CCTB offers fewer implementation options. In addition, a group exemption is included in the ATAD Directive but is not proposed in the CCTB. Furthermore, the CCTB proposal only allows the carry forward of exceeding borrowing costs. The ATAD Directive is also more flexible with regard to the carry forward of excessive borrowing costs and interest capacity.

An Allowance for Growth and Investment (AGI) is included in Article 11 of the CCTB proposal. Under this, a deduction is allowed on the AGI equity base, which means the difference between the equity of a taxpayer and the tax value of its participation in the capital of associated enterprises as referred to in Article 56.

It is questionable whether, in the context of a CCTB, the AGI is an adequate measure to address the debt bias. Firstly, the AGI might contribute to higher financing neutrality but the CCTB will introduce new distortions with regard to the choice of legal form. Secondly, a budget-neutral introduction will increase marginal corporate income tax rates or other taxes must be increased. Thirdly it is doubtful whether higher tax rates are sustainable in an international arena of tax competition. Finally, the proposed AGI has a pro-cyclical effect because the deduction increases when a company realizes a profit as a result of which the equity increase. The reverse effect exits when the company is loss-making.[165]

5.10 Interim Conclusion

The earnings stripping rules do not as such seem to be in conflict with primary EU law because they do not discriminate. If there was a distinction, the CJEU would probably decide that the rules are not proportionate because (1) no opportunity exists to provide counter-evidence that the financing structure is based on arm's length conditions and therefore does not qualify as wholly-artificial and (2) the restriction of the interest deduction is not limited to the part of the interest which is not arm's length. The fact that the interest is double taxed does not cause a breach of primary EU law, but is not in line with the purpose of the ATAD Directive.

The exclusion of tax-exempt EBITDA and interest from the application of Article 4 of the ATAD Directive is not, in the author's opinion, in breach of EU law because domestic taxpayers with only domestic income and domestic taxpayers with foreign income are not comparable since foreign income is not taxed in the Member State of residence due to the exemption system. The exclusion of the exempt EBITDA therefore does not in the author's opinion require justification.

If these situations are seen as comparable, however, the need to safeguard a balanced allocation of taxing rights between Member States could be sufficient justification when foreign income is tax-exempt. The fact that the earnings stripping rules are sometimes disproportionate would not alter this conclusion. In addition, the exclusion of exempt EBITDA follows, without an option, from the application of the ATAD Directive. This reduces the room for the CJEU to assess the rule. It is not likely that this exclusion is a manifest error given that the purpose of the ATAD Directive is to prevent base erosion.[166] The risk of base erosion is increased when exempt income has to be included in the EBITDA and exempt interest income reduces the balance of non-deductible interest.

This might be different if a Member State applies a tax credit or tax-exemption system as a mode to prevent double taxation in connection with foreign income (dividends of a subsidiary or a permanent establishment). In that situation companies with domestic and foreign income are comparable, because all income is subject to tax. The allocation of taxing rights is not distorted if foreign interest and EBITDA is included in the tax base. An exclusion should than be based on the need to prevent abuse, which may not hold. Finally, the ATAD Directive does not explicitly allow exclusion of EBITDA and interest in this situation because that income is not exempt.

The EUR 3 million safe harbour could lead to de facto discrimination against foreign taxpayers if domestic taxpayers are all relatively small. The CJEU could assess the application of this exception because it is an option of the ATAD Directive. In practice it will be difficult to establish that the exception discriminates.

Under current case law, there is risk that earnings stripping rules in combination with tax group rules are in breach of EU law. However, the difference in treatment may be justified by the need to safeguard the balanced allocation of taxing rights between Member States. In addition, there is a difference from the perspective of base erosion between internal interest in a tax unity (which does not effectively lead to any interest deduction or base erosion) and cross-border interest which could in principle result in interest deduction in one Member State and no or lower interest income in another Member State. The need to prevent abuse could also be invoked but in the author's opinion the measure is not proportionate. Furthermore, it could be argued that the EU legislature has explicitly accepted the differentiation between cross-border and domestic groups by allowing the earnings stripping rules to be applied on a

[165] Christoph Spengel et al., *European Union/International – Addressing the Debt-Equity Bias Within a Common Consolidated Corporate Tax Base (CCCTB) – Possibilities, Impact on Effective Tax Rates and Revenue Neutrality*, 10(2) World Tax J. (2018).

[166] O. C. R. Marres, *Waarom de earningsstrippingmaatregel niet in strijd met het primaire Unierecht is*, NTFR 2019/3022.

group level and at the same time exclude tax-exempt EBITDA and interest.

The CJEU had decided that there is little scope to verify whether a Directive jeopardizes primary EU law. Therefore it is very unlikely that the CJEU would go against the intention and wording of the Directive itself. It is instead presumable that the CJEU will just adapt to the new legal background, with the only exception being the implementation of provisions that will be manifestly disproportionate or discriminatory.

6 Compatibility of Article 4 of the ATAD Directive with the OECD Model Treaty

The absence of the option to provide for the possibility that interest is at arm's length could be in breach of Article 9(1) of the OECD Model Convention.[167] Thin capitalization rules and earnings stripping rules could be consistent with Article 9(1) OECD Model Convention if they offer the option to demonstrate that the loan and interest are at arm's length.[168] Article 9(2) applies to loans between affiliated entities only, which would lead to the remarkable conclusion that the rules which limit interest deduction may be more strict for loans from non-affiliated entities while in that situation there is a lower risk of base erosion. That result is explained by the fact that these transactions do not fall within the personal scope of the OECD Model Convention. Other authors have argued that Article 9(1) is not applicable to thin capitalization rules (and earnings stripping rules) because they should be regarded as general (domestic) rules for the determination of taxable profit not covered by tax treaties.[169] In addition, the Commentary to Article 24(4)[170] explicitly states that it does not prohibit countries from applying domestic rules on thin capitalization insofar as they are compatible with Article 9(1) or Article 11(6).

A possible inconsistency with Article 9(1) could have been prevented by including a savings clause in the OECD Model Convention.

However, if the earnings stripping rules are seen as general rules for determining taxable profits and not as specific rules to determine profits at an arm's length level in a specific situation, they should not be in conflict with Article 9(1) of the OECD Model Convention. This is the most likely scenario because the earnings stripping rules of the ATAD Directive deny interest deduction of loans from affiliated and third parties.[171]

The deduction of interest could be limited to the effective tax rate that the lender must pay on the interest income.[172] Such a rule would cause significant administrative difficulties for lenders because they would need information from borrowers and for the same reason it will be difficult for the tax authorities to audit this rule. This limitation would not qualify as a withholding tax.[173]

7 Concluding Remarks

The earnings stripping rules are a second-best solution to deal with BEPS though financing arrangements and the different treatment of debt and equity. The general interest limitation will probably be effective in curbing BEPS but risks remain due to the high EBITDA percentage. Additional targeted rules have to be implemented to avoid artificial interest within the boundaries of the 30% rule and especially when a group exception is implemented. The weaknesses of the earnings stripping rules are that the net principle is not respected and that double taxation could exist. Double taxation is clearly in breach of the purpose of the ATAD Directive. Moreover debt and equity are not treated equally.

Because of their general nature and the fact that they are the result of secondary EU law, the earnings stripping rules will probably not be in breach of primary EU law. The CJEU will probably give primacy to the EU legislature which had to make economic, political and social choices. EU law does not give any guidance in that respect. The principle of proportionality plays an important role in EU law. However, the CJEU will not, in the author's opinion, come to assess a justification with regard to most issues because the earnings stripping rules are applied without distinction to domestic and cross-border cases. Nevertheless in the author's opinion the earnings stripping rules go further than necessary. It is disappointing to see that the EU legislature was not more prudent and avoided the risk of double taxation.

167 Natassia Burkhalter-Martinez, *BEPS Action 4 and Its Compatibility with the Principle of Non-Discrimination Under Article 24(4) of the OECD Model Convention*, 47(1) Intertax 55–65, at 59 (2019).

168 *OECD Report on Thin Capitalization* (OECD Publishing 1986), para. 79.

169 A. Fross, *Earnings Stripping and Thin Cap Rules: Maintaining an Arm's length Distance*, 53(10) Eur. Tax'n 515 (2013).

170 *OECD Model: Commentary on Article 24*, para. 74.

171 *See* Natassia Burkhalter-Martinez, *BEPS Action 4 and Its Compatibility with the Principle of Non-Discrimination Under Article 24(4) of the OECD Model Convention*, 47(1) Intertax 55–65, at 63 (2019) and her references to A. Fross, *Earnings Stripping and Thin Cap Rules: Maintaining an Arm's length Distance*, 53(10) Eur. Tax'n 515 (2013) and A. Linn, *IFA Cahiers 2010 – Volume 95A Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, Germany, at 333, 345 and other German literature in which this conclusion is disputed.

172 Tell, *supra* n. 4, at 761 and I. de Groot, *Interest Deduction and the CCCTB: A Walk in the Park for Tax Advisors*, 41(11) Intertax 571–580 (2013).

173 ECJ 21 July 2011, C-397/09 (*Scheuten Solar Technology*).