Interest Limitation and CFC rules in the Anti Tax Avoidance Directive

Andzej Trusevic (656967)
Prof. Dr. S.A. Stevens

2017
Interest Limitation and CFC rules in the Anti Tax Avoidance Directive

Master thesis International Business Taxation/ track: International Business Tax Law

Tilburg School of Law

Tilburg University

Name: Andzej Trusevic
ANR: 656967
Supervisor: Prof. Dr. S.A. Stevens
Second reader: Dr. A.W. Hofman
Date: 19 June 2017
Abstract

This research looks into the interest limitation and the CFC rules as adopted in the Anti Tax Avoidance Directive that Member States have to implement before 2019. The selected tax laws are tested against their efficiency to tackle BEPS, issue that has been in the center of the OECD debates for many years. This research evaluates the possibility of the interest limitation and the CFC rule to effectively limit BEPS and be fair to the taxpayers. On the other hand, in order for the selected tax laws to be legitimate they must satisfy the fundamental freedoms and general principles embedded in the EU primary law. This thesis shows that adopted tax laws are not efficiently limiting BEPS as envisioned by the OECD Action Plans and due to the available differences in implementation by the Member States create unfair taxation system in the internal market of the EU. Furthermore, the underlying rationale of the adopted tax laws is not in line with the primary EU law. Interest limitation disturbs the principle of proportionality as it is seen as unable to achieve its primary aim, while CFC rules are artificially applied to domestic situations in order not to infringe upon the freedom of establishment. In addition, both legal and economic issues presented in the paper result in unnecessary administrative burden for the taxpayer.
Table of Contents:

Abstract ........................................................................................................................................3

1. Introduction ...............................................................................................................................7
    1.1 Introduction .........................................................................................................................7
    1.2 Motivation of the research question ......................................................................................8
    1.3 Research method ...................................................................................................................9
    1.4 Limitation and benchmark ....................................................................................................9

2. Interest limitation .....................................................................................................................10
    2.1 Interest limitation under the ATAD .....................................................................................11
        2.1.2 Comparison with the German interest barrier rule .......................................................12
    2.2 Economic efficiency of interest limitation based on the German interest barrier rule ...........14
        2.2.1 Main objective – limitation of BEPS ..........................................................................15
            2.2.1.1. Empirical analysis – the situation before the reform of 2009 ...............................15
            2.2.1.2. Empirical analysis – the situation after the reform of 2009 .................................16
            2.2.1.3. Financing Alternatives .........................................................................................17
            2.2.1.4. Preliminary Conclusion ........................................................................................17
        2.2.2 Economic issues stemming from the interest limitation rule in the ATAD ......................18
            2.2.2.1. Mismatches as a result of “may” clauses .................................................................18
            2.2.2.2. The EUR 3 000 000 exemption ...........................................................................18
            2.2.2.3. Standalone and group escape exemptions ..............................................................19
            2.2.2.4. Pro-cyclical problem ............................................................................................21
            2.2.2.5. Preliminary Conclusion ........................................................................................23
    2.3 Legal compatibility with primary EU law ............................................................................24
        2.3.1 Interest limitation does not satisfy the principle of proportionality ...............................24
            2.3.1.1. Reasons to abandon the Arm’s length principle are not sound .............................25
            2.3.1.2. Requirement of the counterevidence rule ...............................................................27
            2.3.1.3. Interest limitation measure is manifestly disproportionate to attain its aim ..........28
            2.3.1.4. Preliminary Conclusion ........................................................................................29
        2.4 Interest limitation rule infringe the ability to pay principle .............................................29

3. Controlled Foreign Company ..................................................................................................31
    3.1 CFC under the ATAD ...........................................................................................................32
    3.2 Economic efficiency of CFC ...............................................................................................34
        3.2.1 Empirical analysis of base erosion and profit shifting ..................................................34
            3.2.1.1. German CFC rules .................................................................................................35
            3.2.1.2. CFC and thin capitalization rules .........................................................................36
            3.2.1.3. CFC and the impact of the Cadbury-Schweppes case ...........................................37
            3.2.1.4. Preliminary Conclusion ........................................................................................38
        3.2.2 Capital flight and lack of fairness ....................................................................................39
3.2.2.1 Preliminary Conclusion
3.2.3 Economic double taxation
3.3. Legal compatibility with primary EU law
  3.3.1. Domestic and cross border application of CFC
  3.3.2. Substantial economic activity
  3.3.3. Preliminary conclusion
3.4. Non-legal issues
  3.4.1. Control
  3.4.2. Political issues
4. Conclusion
List of Abbreviations:

AG – Aktiengesellschaft (public limited company)
ATAD – Anti Tax Avoidance Directive
BEPS – Base Erosion and Profit Shifting
CFC – Controlled Foreign Company
EBITDA – Earnings Before Interest Taxes Depreciation and Amortization
ECJ – European Court of Justice
EEA – European Economic Area
EU – European Union
EUR - Euro
FDI – Foreign Direct Investment
G20 – Group of Twenty (international forum)
GmbH - Gesellschaft mit beschränkter Haftung (company with limited liability)
Mil – Million
MNE – Multinational Enterprise
MS – Member State of the EU
OECD - Organisation for Economic Co-operation and Development
SME – Small and Medium Enterprise
1. Introduction

1.1. Introduction

On the 12th of July 2016, the Council of the European Union adopted the Draft Directive combating tax avoidance practices commonly used by multinational companies.\(^1\) This initiative was a response to the Commission’s proposal of January 2016 to strengthen rules against tax avoidance, which build on the 2015 OECD recommendations to focus on the base erosion and profit shifting practices (BEPS).\(^2\) OECD recommendations themselves followed from the initial debate of 2013 by the G20 countries which concluded that “The current tax rules have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting (BEPS), thus requiring a bold move by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.”\(^3\) In other words, the outdated tax systems gave an opportunity for aggressive tax planning by the multinational enterprises (MNEs), while other taxable subjects were able to make use of the differences in tax systems that resulted in no taxation at all. Further, the lack of transparency and mutual exchange of information weakened the possibility to hold tax evasion practices accountable. This has lead to the worldwide Corporate Income Tax loss of between 100 to 240 USD billions annually.\(^4\) Hence, as a response the OECD issued the BEPS recommendations, which consisted out of 15 Action Plans, that countries could follow in order to decrease harmful tax practices.

The Commission implemented the recommendations of the OECD BEPS Action Plans in its Anti-Tax Avoidance package\(^5\). One of the elements of the Anti-Tax Avoidance package initially included the draft of the Anti-Tax Avoidance Directive (ATAD) that would tackle harmful tax practices in 6 areas.\(^6\) After lengthy discussions on the Draft ATAD the Economic and Financial Affair Council reached an agreement on the 17th of June 2016 and the ATAD was officially adopted on the 12th of June 2016 by the Council of the European Union.\(^7\) The Directive specifies 5 key tax laws that the Member States should implement by 2019. These laws include: Interest limitation rule that builds upon Action 4 of the OECD BEPS, Controlled Foreign Company rules that are in line with Action 3 OECD BEPS, Exit taxation rule that codifies the previous ECJ judgments\(^8\) and follows some parts of BEPS Action Plan 6,

---

\(^1\) COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.


\(^8\) Daily Mail Case 81/87 (1988); Überseering Case-208/00 ; Cartesio C-210/06; 2012, C-371/10, National Grid Indus.
General Anti Abuse rule that aims to fix harmful tax arrangements when other specific tax laws do not cover them and Rules on Hybrid Mismatches that follow the BEPS Action Plan 2.¹⁹

1.2. Motivation of the research question

As stipulated above, the ATAD will be in force as of 2019. The desired result of the new tax laws should be the limitation of BEPS. However, the ATAD does not follow the Action Plans proposed by the OECD directly. In order to maintain the Member States’ sovereignty in their tax laws, the Directive incorporates many “may” clauses that leave it open for the Member States whether to implement them to their national tax law or not. Disparities result from different tax rates in all Member States. This, in turn, causes the possibility of tax system mismatches between Member States, something that OECD BEPS Action Plans aim to preclude from happening in the first place. As a result, the different implementation may lead to different tax results and could amount to “Member State shopping” and competition between Member States in order to attract investments. This is important as MNE’s could make use of these mismatches in their business decision making processes to their advantage even after the ATAD is implemented. Furthermore, since tax laws in the ATAD do not follow strictly the OECD recommendations due to the political discrepancies and compromises reached on the political level, the economic rationale of some of the tax laws implemented is exposed. Additionally, some tax laws raise concerns as to their compatibility with the EU principles. In order to examine the impact of the selected tax laws in the ATAD this thesis will focus on the main research question and two sub-questions.

The main research question of this thesis can be defined as: Are the selected tax laws in the ATAD efficient enough to tackle the problem of BEPS?

Further the efficiency itself is examined by the research sub-questions, which divide the efficiency criterion to two categories. First sub-question deals with the economic rationale of the adopted tax laws. The research sub-question can be formulated as follows: Does the tax law achieve the desired economic effect of limiting base erosion and profit shifting while being fair to the taxpayer?

However, even if the adopted tax law is economically sound, it is necessary to test the selected tax laws against the fundamental principles and freedoms of the EU, in order for the tax laws to be legitimate under the European law.

Therefore, the second sub-question can be formulated as follows: Are the selected tax laws of the ATAD in conformity with the general principles and fundamental freedoms of the EU?

The results of these two sub-questions will also illustrate what administrative problems may arise. The issues of administrative burden flowing from the economic and legal constraints will be incorporated through this thesis.

Overall, the thesis subjects two tax laws of the Directive to a high level of scrutiny and joins the side of the vast majority of academics that state that the adopted tax laws do not eliminate BEPS as MNEs are still capable to optimize their tax structures attractively. Alternatively, the thesis evaluates different possible substitutes to the enacted tax laws that may restrict BEPS in a wider scope. As a result, this work will fruitfully contribute to the existing criticism of the ATAD on the academic level.

1.3. Research method

In order to produce sound analysis of the adopted European tax laws the thesis will examine relevant literature on this topic and will scrutinize the tax legislation as such. Both legal and economic principles will serve as a benchmark for the analysis. In order to present a credible economic justification for the conclusions made in the thesis, the research method will incorporate quantitative data in order to illustrate the economic productivity of the selected tax law. On the other hand, the research methodology will incorporate the qualitative data gathered by scholars on this topic in order to strengthen economic arguments made in the thesis as well as to display the legal compliance of the tax laws with the primary legal principles and to address administrative consequences resulting from it.

1.4. Limitation and Benchmark

In order to extensively examine the effect of the specific ATAD tax rules, this thesis will exclusively focus on the interest limitation rule (Article 4) and controlled foreign company rules (Article 7). In this way, an extensive analysis can be done against two benchmarks for each tax rule.

First, the economic efficiency will be examined. In other words, how a particular tax rule reaches the desired economic effect of reducing base erosion and profit shifting. However, the desired economic effect must be examined together with the notion of fairness. This is due to the fact that economically a tax measure can be effective but it would be highly unfair for the taxpayer. The principle of tax fairness is constructed of horizontal tax equity which stipulates that “like situated taxpayers should be taxed the same” and vertical tax equity specifying that “differently situated taxpayers should be taxed differently”. Therefore, tax law that is fair does not favor one segment of equivalent taxpayers over the other. In the light of the European internal market, taxpayers should be treated equivalently in order to ensure a fair taxation system. This thesis will examine compliance of the two tax laws with the

---

principle of fairness especially in the context of investments and capital shifting opportunities by
different taxpayers in the same position but in different Member States.

The second benchmark of the thesis that two tax laws will be tested against is the EU fundamental
freedoms and principles. In the area of the interest limitation, the principle of proportionality is at stake.
Therefore, the interest limitation rule will be tested against the principle of proportionality, which
stipulates that “Union action shall not exceed what is necessary to achieve the objectives of the
Treaties”. 11 In order to illustrate recent developments in the area of the interest limitation rule, the tax
law rule will be tested against the principle of the ability to pay. Although the principle of the ability to
pay is not a general principle of European legal order, it is interesting to see how interest limitation is
interpreted by the national court, in this case the German Federal Tax court and what implications it
can have for the interest limitation rule of the ATAD. On the other hand, in the area of the controlled
foreign company rules freedom of establishment may be compromised. Hence, CFC rules will be tested
against the freedom of establishment, which states that an undertaking can establish itself and pursue
economic activities in any Member State without any restrictions or impediments created by a Member
State. 12 This will illustrate the conformity of the selected tax laws with the primary EU law that
overrides secondary EU law. This examination can show whether the adopted tax laws are in line with
the primary ideals and principles of the European Union.

Finally, when two tax laws are tested against the benchmarks stipulated above, this thesis will show
how legal and economic consequences influence the administrative burden of both the Member States
and the individual taxpayers. This will illustrate whether the implementation of the ATAD is
excessively burdensome upon Member States and individual taxpayers and whether future amendments
are needed in order to combat excessive compliance requirements.

2. Interest Limitation

The Interest limitation rule presented in the ATAD highly resembles the national German interest
barrier rule implemented in 2008. 13 This is because OECD BEPS Action Plan 4 itself decided to follow
the existing national interest barrier rules, as the thin capitalization rules were depicted as unable to
counter BEPS. As a consequence, the OECD introduced the interest barrier rule, which was later
transposed to the ATAD. Hence, in order to establish the economic efficiency of the proposed interest
limitation rule in the ATAD, it is logical to examine the economic aspects of the similar interest barrier
rule in the national law, which the OECD followed itself. Since Germany had the thin capitalization
rules before the interest barrier rule was established, it is interesting to examine what economic changes

13 German income tax act, section 4b(1).
this amendment has brought. Therefore, first the ATAD interest limitation rule will be described in detail. Secondly, similarities and differences will be outlined with the German interest barrier rule, followed by the underlying economic considerations of distortion and fairness. Thirdly, the correlation between interest limitation rule and the EU primary law will be examined. Throughout, administrative mismatches resulting from the implementation of the tax law will be scrutinized.

2.1.1. Interest limitation under the ATAD

The objective of the interest limitation rule in the ATAD is to “limit deductibility of taxpayers’ exceeding borrowing costs” due to the fact that companies tend to engage in the base erosion and profit shifting, in order to reduce their global tax liability, through excessive interest payments.\textsuperscript{14}

Article 1 stipulates that the provisions of the Directive are applicable to “all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.” However, for the purpose of interest limitation rule, Member States may also include in the notion of taxpayer “an entity which is permitted or required to apply the rules on behalf of a group, as defined according to national tax law” as well as “an entity in a group, as defined according to national tax law, which does not consolidate the results of its members for tax purposes.”

Article 4 lays down the main and only mandatory mechanism of interest limitation that the EU Member States have to transpose into their national law. As stated in the Art 4. (1): “Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 percent of the taxpayer’s earnings before interest, tax, depreciation and amortization (EBITDA).” In other words, this means that when taxpayer's interest payment exceeds 30% of his EBITDA he cannot deduct the excessive part of the interest payment and in this manner he should pay corporate income tax on the excess. The Directive includes the method of EBITDA calculation which constitutes the following: “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 amortisation. Tax exempt income shall be excluded from the EBITDA of a taxpayer.”

However, in order not to overburden SME’s and standalone entities, Member States are given an option to allow deduction of all exceeding borrowing costs up to EUR 3 000 000 and to fully deduct exceeding borrowing costs if the taxpayer is a standalone entity.\textsuperscript{15} It is important to note that EUR 3 000 000 is

\textsuperscript{14} COUNCIL DIRECTIVE (EU) 2016/1164, Preamble, considerations 6-9, and Articles 3 and 4.
\textsuperscript{15} COUNCIL DIRECTIVE (EU) 2016/1164, Art 4. 3 (a) (b).
considered to be a limit for the whole group and not the individual taxpayer within the group. The standalone entity is defined as: “a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment.”, which causes uncertainty problems as will be addressed below. Additionally, the Directive incorporates a “may” clause as Member States may exclude the loans concluded before the 17th of June 2016 or loans used for the long term public infrastructure projects within the EU. 16

Member States are given even more freedom to exercise exceptions to the interest limitation rule in paragraph 5 of the article 4. Group exception is available which entails that when a taxpayer is a member of a consolidated group for financial accounting purposes, he may fully deduct exceeding borrowing costs if he can demonstrate that the ratio of his equity over total assets is at least 98% of the equivalent ratio of the group and all assets and liabilities are valued using the same method as in the consolidated financial statements. 17 Another exception to the main rule that the Member States may implement is stipulated in point (b) of paragraph 5, which entails that some deduction of the exceeding borrowing costs is acceptable within the group. First, the group ratio is calculated by dividing the exceeding borrowing costs of the group vis-à-vis third parties over the EBITDA of the group and then this ratio is multiplied by the EBITDA of the taxpayer. Hence, the taxpayer, who is a part of the group, is allowed to deduct more depending on the ratio of the group as a whole. As a last point of the extensive article 4, the Member State may provide “rules stipulating the setting off of exceeding borrowing costs against unused interest capacity in prior years or capacity in future years.” 18

Therefore, the interest limitation mechanism incorporated in the ATAD is virtually limited to the deductibility up to the 30% of the company’s EBITDA rule. All of the other exceptions are laid down as a “may” clause, which means that MS may incorporate them into their national tax law but they are not obliged to do so.

2.1.2. Comparison with the German interest barrier rule

As presented before, the EU Commission published the first draft of the Directive on the 28th of January 2016 that followed the OECD BEPS Action Plan. 19 Accordingly, limitation on the deductible interest was a central issue discussed in the Plan. The Commission decided to base the interest limitation on the German interest barrier rule that has been adopted in 2007 and came into force on January 1st 2008. 20

---

16 COUNCIL DIRECTIVE (EU) 2016/1164, Art 4.4 (a) (b).
Therefore, the interest barrier rule serves as a blueprint for the Art 4. of the Directive. It is important to note that initially the German interest barrier rule was subject to thin capitalization rules regarding the deductibility of interest payments. The Economic Growth Acceleration Act implemented changes into the interest barrier rule in 2009 and was a response of the government to the aftermath of financial crisis of 2007-2008. In this way, rules were changed in order not to overburden the companies that were struggling to resuscitate from the crisis.

Unsurprisingly, the majority of the rules regarding the interest limitation remained unchanged in the Art.4 of ATAD. Deductibility of the interest is allowed only up to the 30% of EBITDA. Difference is visible with the carry forward mechanism as it is applied not only to the non-deductible interest but also to the unused EBITDA amounts that can be carried forward over a period of five years in the German legislation. The unused EBITDA amounts arise when net interest expense does not amount to 30% of the company’s EBITDA. Thus the difference between the 30% of EBITDA and the interest expense actually paid can be carried forward. In this way the taxpayer can increase the deductible net interest expenses in the future. However, initially in the 2007 version of the German legislation this clause was not included and was only added in 2008 as a response to the financial crisis of 2008. The response to the financial crisis in the form of EBITDA carry forward allowance is actually part of the bigger procyclical issue that will be illustrated in the economic considerations. Next to the EBITDA carry forward, as already mentioned, the taxpayer can carry forward non-deductible interest expense indefinitely to subsequent financial years. This option is also available to the Member States in their transposition of the ATAD into their national law.

Similarly to the interest limitation rule in ATAD, German interest barrier rule has three statutory exemptions but it incorporates counter-exemptions that are missing in ATAD. First exemption is the threshold of EUR 3 000 000, which applies in the same manner as the one in the ATAD and is applicable to the group as a whole. As with the EBITDA carry forward the threshold was increased from EUR 1 000 000 to EUR 3 000 000 in 2008 due to the financial crisis. Second exemption is the “stand-alone clause” which exempts taxpayers from the interest barrier rule provided that they do not belong or partially belong to a corporate group. The third exemption is the “escape clause” which applies in the same manner as the group exception in Art.4 paragraph 5 ATAD, which means that the exemption

---

21 German income tax act, section 4h(1).
24 Section 4 (1) (2) GITA.
25 Section 4h(2) (1) (a) GITA.
26 Section 4h(2)(1)(b) GITA.
28 Section 4h(2)(1)(c) GITA.
is applied when groups equity to debt ratio does not exceed the equity to debt ratio of the taxpayer by more than 2%. Hence, the German interest barrier rule and the ATAD are virtually the same in these categories and mechanisms. It is important to note, however, that in the ATAD all of these exemption are merely options that the Member States may decide to implement in their national law, whereas in the German interest barrier rule these exemptions are embedded in the tax law.

Striking difference in the legislation between Germany and the EU is the counter-exemptions, adopted in the German rules, that apply to the stand-alone clause and the escape clause respectively. These counter-exemptions exclude the application of the exemptions in the case there is a harmful shareholder debt financing. Harmful shareholder debt financing consists of two parts. First, when taxpayer, who is a part of the group, pays interest to a shareholder, who is holding directly or indirectly more than 25% of the shares of the one company within the group. The indirect holding extends even to the parties related to such shareholders or even third parties with recourse to such shareholders. Second, such interest payment must exceed 10% of net interest expense for the counter-exemption rule to disallow the applicability of the escape clause. Additionally, the law places the burden of proof on the taxpayer itself, making the application of the escape clause extremely difficult for the big companies within the group. For instance, “a German head of group must demonstrate that its Hong Kong affiliate has not paid interest in excess of 10% of its net interest expense to some bank in Russia that has recourse to someone related to a substantial shareholder of the affiliate”.

2.2. Economic efficiency of interest limitation based on the German interest barrier rule

Since the ATAD will only be incorporated by the Member States in 2019, the economic aspects and effects cannot be stipulated precisely. Nonetheless, as seen from the previous section, the German interest barrier rule is comprised out of the similar elements as the interest limitation rule in the ATAD, except for the counter-exemptions. Therefore, it is reasonable to assess the economic efficiency of the tax rule in the German context in order to project the main issues that the interest limitation may face due to the striking similarity. First, the main objective of the interest limitation will be examined, which is limitation of base erosion and profit shifting. Second, the economic issues present in the interest limitation regime will be tested against the notion of tax fairness.

---

30 Section 8a (2) KStG & Section 8a (3) KSt.
2.2.1. Main objective – limitation of BEPS

It is important to bear in mind that the German interest barrier rule explicitly includes three exemptions in the form of the minimum EUR 3,000,000 threshold, stand-alone entity and the “group escape clause”, whereas in the ATAD these mechanisms are merely given as an option for the Member States to implement. Additionally, the two counter-exemptions that are applicable in the German interest barrier tax rule relating to the harmful shareholder debt financing are not found in the ATAD at all. Therefore, the yield of the economic analysis based on the German interest barrier rule should provide the similar result as for the Member State who chose to include the three exemptions in its national law after the transposition of the ATAD. However, due to the German practice most of the countries would follow the German practice and include three exemptions in order to stay competitive on the market and attract investments. However, when at least one of the three exemptions is not implemented this will lead to different economic results.

2.2.1.1. Empirical analysis – the situation before the reform of 2009

Building up on the extensive empirical research provided by various scholars it is interesting to note that the German interest barrier rule does indeed fulfill its goal of the reduction of the excessive debt financing but to a very limited extent.33 The empirical research done by the University of Cologne in 2008 reveals that 55.7% of the German companies, that were listed on the German stock indexes in 2008 (DAX, MDAX and SDAX) and German subsidiaries of companies listed in the EURO STOXX 50 or in the DOW JONES stock index did exceed 30% of their EBITDA on their interest payments.34 Out of 55.7% of the German companies only 12.8% were able to make use at least of one of the available exemptions as soon as the tax law was implemented. However, this study was conducted before the financial crisis hit Germany and before the escape clause of EUR 1,000,000 was changed to EUR 3,000,000, as well as before the possibility to carry forward unused EBITDA amounts. Therefore, the new studies that have been done after the amendment35 do conclude that the “economic relevance of this tax reform in Germany is rather small” mainly due to the threshold amendment and other re-structuring possibilities.36

34 Annex
35 Since the Citizens' Relief Act of 2009 and the Growth Acceleration Act in 2009 the exemption limit was raised to € 3 million.
2.2.1.2. Empirical analysis – the situation after the reform of 2009

The empirical research from 2015 done by the Centre for European Economic Research\(^37\) tested the hypothesis that more companies would have been affected by the interest barrier rule, had it been in place between 2005 and 2007 when Germany still had the debt to equity ratio of 1.5:1 for the related party debt.\(^38\) In this way, the research compared the difference in the scope of the thin capitalization rule and the interest barrier rule. This was done by adopting interest barrier rule applicable after the amendment due to crisis to the companies during 2005-2007 and comparing it with the sample of companies from 2005-2010. The study only examined in its sample the medium and large limited liability companies (AG and GmbH) that operated from 2005 to 2010.\(^39\)

Surprisingly, the results showed that had the post-crisis interest barrier rule been applied to the companies in 2005-2007 only 4.5% more companies would have been affected. Additionally, the multinational companies were not found to respond to the interest barrier particularly strongly as it affected mostly national firms. Hence, the study concluded that “the goal of the interest barrier to avoid excessive cross-border lending from low-tax countries by multinational companies does not seem to have been achieved”.\(^40\)

An alternative study from 2016 with different test sample tested the hypothesis that “Companies that met the subject-to-interest barrier criteria before the 2008 corporate tax reform to interest barrier rule reduced their debt ratio after the implementation of the reform to a greater extent than the companies that did not meet these criteria prior to the interest barrier reform”.\(^41\) The yield of the statistical model applied suggests that only 5% of the medium and large companies were affected by the interest barrier rules, which means that they could not make use of any applicable exemption or counter-exemption applicable. Again, the study included the citizen’s relief act of 2009 into its calculations.\(^42\) In fact, the study suggests that the companies that are affected by the interest barrier clause reduce their debt ratio by 4.7%\(^43\) more than the companies that are not affected. Despite the fact that reformed German interest barrier rule does induce companies to utilize more equity than debt in their financing structures, the


\(^38\) Alfons J. Weichenrieder and Helen Windischbauer, ‘Thin-Capitalization Rules and Company Responses Experience from German Legislation’ [29 April 2008].


scope of companies actually affected remains rather small due to the exemptions available.

2.2.1.3. Financing Alternatives

Even the companies that are still at risk that the interest barrier rule may apply to them when they are no longer protected by at least one of the exemptions, have several financing alternatives that they may use. First of all, company can simply shift interest expenses to other jurisdiction within certain limitations of national law. Secondly, “it is possible to include all subsidiaries in a tax consolidated group which is then treated as a single firm and therefore not captured by the interest barrier”, of course only if this is allowed under the national tax law. For instance, the ECJ case law stipulates that EU Member States are not forced to grant the offsetting of the results in the cross-border tax consolidation. However, if the national law sufficiently deals with the risk of double loss compensation, cross border relief may be seen obligatory as is the case in France and Italy. Conversely, firms could split up into subsidiaries and in this way utilize the group escape clause. All of this confirms the fact that interest barrier rule only slightly reduces the excessive debt financing in general and yet the non-deductible interest expense can be evaded by the restructuring of a company as long as interest payment is not made to the shareholder that holds more than 25% of the company and the payment does not amount to more than 10% of the interest expense due to the fact that then the counter exemptions may apply.

2.2.1.4. Preliminary conclusion

As seen from the empirical evidence provided above, German interest barrier rule does, in fact, limit the excessive debt financing. However, the impact of the interest barrier rule after the amendments of post crisis 2009 Citizens’ Relief Act on the companies is greater than the pre 2008 thin capitalization rule only by 4.5% – 5%. Nonetheless, as presented in the studies, the companies that did fall under the interest barrier rule were not Multinationals with debt from the low-tax jurisdictions. Therefore, the aim to limit the placement of debt in the low-tax jurisdictions by Multinationals was not achieved. Additionally, German interest barrier rule can be avoided with different financing possibilities. Therefore, analogous reasoning leads to the same or even worse economic efficiency results for the ATAD due to the fact that there are many possibilities for the mismatches and no availability of counter-exemptions. In the end it is reasonable to conclude that interest limitation rule as implemented in the

---

45 Case C-337/08. X Holding BV. v. Staatssecretaris van Financiën.
ATAD, which mirrors German interest barrier rule, will not decrease base erosion and profit shifting as envisioned.

2.2.2. Economic issues stemming from the interest limitation rule in the ATAD

2.2.2.1. Mismatches as a result of “may” clauses

As seen from the empirical evidence, the German interest barrier rule is economically efficient to a very limited degree. Hence, if a Member State chooses to implement Art.4 of the Directive with all of the available exemptions, the result will be the same as German interest barrier rule. However, it is possible that some Member States would not allow any exemptions or will implement only one or two out of the three available. Therefore, there are eight scenarios of possible implementation result by the MS, when MS implements one of the three exemptions (three possibilities), two out of three exemptions (three possibilities), all of the exemptions or none of the available exemptions. Each one of these scenarios will lead to different economic results. Based on the evidence provided above, one can reason by analogy that if all of the three exemptions are adopted the result would be similar to the German interest barrier outcome and it would not be the same due to the lack of counter-exemptions in the ATAD. At the other extreme is the situation when none of the three exemptions are adopted. This will probably yield excessive burden of taxation, especially on the SME’s as they would not be able to make use of the standalone entity escape or threshold of EUR 3 000 000 clause, which would negatively affect their cash flow, potentially leading the business to bankruptcy. Therefore, the mismatches that may occur due to the differences in implementation of “may” clauses may be unfair to the taxpayers that are in the comparable position but incorporated in different Member States.

2.2.2.2. The EUR 3 000 000 exemption

As presented in the empirical researches, the main reason for the drop of the percentage of companies affected by the interest barrier rule, was the increase of the threshold from EUR 1 000 000 to EUR 3 000 000. This means that as long as Member State will incorporate this threshold into their national law, the majority of SME’s will be excluded from the effect of the interest limitation rule. This is because their interest payable as a whole will simply not reach the stipulated threshold. However, when this exemption is not incorporated the taxpayers may face unfair and administratively burdensome taxation as SME’s themselves do not pose a great threat to the profit shifting and base erosion as

---

stipulated by the OECD in their Final Report.\textsuperscript{48} Hence, when a Member State does not include this provision in its law it will lead to unfair taxation followed by the compliance costs for the taxpayer compared to the SME that is located in the jurisdiction that includes such provision. Following this reasoning, SMEs would rather establish in the jurisdictions with the provision available. However, the nature of SMEs stipulates that they are not easily mobile. Hence, the interest limitation system in itself is unfair towards SMEs in various jurisdictions depending on the implementation of the provision by their Member States.

2.2.2.3. Standalone and group escape exemptions

When a Member State chooses to incorporate exclusively a standalone clause all of the intra-group debt allocation and deduction will be subject to the 30\% EBITDA limitation. This will highly overburden SME’s as well as MNE’s due to the fact that different sectors require different indebtedness levels based on their business model.

The ATAD proposes two alternatives to the group relief. One exemption that the Member States may incorporate into their national law is virtually the same as equity escape clause in the German interest barrier rule. This means that when a company’s debt to equity ratio does not exceed 2\% of the group debt to equity ratio the company may still deduct the excessive interest payable. Another alternative is the group escape as proposed in the OECD BEPS Action Plan 4. The OECD Report proposed the Group ratio on the basis of the group’s net third party interest/EBITDA ratio\textsuperscript{49} This method is calculated by dividing the net third party interest expense of the Group with Group EBITDA and multiplying the result with the Entity’s EBITDA. In such way, the aim was to “align individual entities’ interest expenses with overall group’s interest expenses”.\textsuperscript{50}

The method of net third party interest/EBITDA, however, is proposed by the OECD to be used cumulatively with the group ratio based on the debt to equity criterion. Therefore, under the OECD BEPS Action Plan 4 approach, the taxpayer has three options for the limitation of the non-deduction of the interest payment. First, the taxpayer can make use of the “equity escape”. If the result is negative, the taxpayer can use the net third party interest/EBITDA ratio which would limit his non-deductible 3rd party interest payments as long as individual taxpayer’s 3rd party indebtedness ratio correlates with the 3rd party interest payments to EBITDA ratio of the group. If taxpayer’s net third party interest/EBITDA

\textsuperscript{48} OECD, OECD/G20 Base Erosion and Profit Shifting Project Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Final Report) p. 35.

\textsuperscript{49} OECD, OECD/G20 Base Erosion and Profit Shifting Project Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Final Report).

\textsuperscript{50} Christiana HJI Panayi, Advanced Issues in International and European Tax Law p. 74.
does not match the group’s 3rd party indebtedness he could still deduct all interest expenses up to 30% of his EBITDA.\textsuperscript{51}

The problem with the ATAD is that two group reliefs are offered for the Member States not cumulatively but alternatively.\textsuperscript{52} Therefore, Member States that implement the debt to equity group ratio will be favored by businesses more than the Member States that opt for the second option of net third party interest/EBITDA. Additionally, this is due to the fact that within the group it is rather uncomplicated to align individual taxpayer’s debt to equity ratio to the group’s ratio which would make it possible to deduct all interest expenses.\textsuperscript{53} This can be done by intragroup loans and capital contributions in order to align individual taxpayer’s debt to equity ratio to the group debt to equity ratio. On the other hand, the net third party interest/EBITDA has stricter consequences for the interest deductibility. This can be illustrated by the following example.

The Group as a whole has three companies. A Co has EBITDA of 15Mil and interest payable of 30Mil to the Bank. B Co has EBITDA of 50Mil and interest payable to A Co of 29Mil. C Co has EBITDA of 50Mil and interest payable to B Co of 23Mil. The whole structure is visualized in the Annex. If one applies the net third party interest/EBITDA calculation, it is seen that A Co and B Co can fully deduct interest payable as in the case of A Co the deduction of 2,8 Million is allowed, while interest payable is only 1Million. In the case of B Co the deduction allowed is 9,56 Million, while interest payable is only 6 Million. However, in the case of C Co the deduction allowed is 9,56 Million but the interest payable is 15 Million, which means that C Co cannot deduct 5,44 Million of the aggregate of the interest that it has to pay to 3rd party and as an intragroup payment.

One of the reasons why OECD proposed the third party net/EBITDA approach was because of the manipulation of the equity escape clause by the MNE’s, since they could issue capital contributions in for the group members raising their equity. Alternatively, it is possible to gather more loans as a part of the group which would lead to the higher debt. Depending on the need, MNE’s are able to manipulate this structure which leads to a situation where all interest payable is deductible up to the specified debt to equity ratio.

\begin{footnotesize}
51 OECD, OECD/G20 Base Erosion and Profit Shifting Project Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Final Report) p. 93.
52 Article 4(5) of ATAD reads: Where the taxpayer is a member of a consolidated group for financial accounting purposes, the taxpayer may be given the right to either: (a) fully deduct its exceeding borrowing costs if it can demonstrate that the ration of its equity over its total assets is equal to or higher than the equivalent ratio of the group…(b) deduct exceeding borrowing costs at an amount in excess of what it would be entitled to deduct under paragraph 1. This higher limit to the deductibility of exceeding borrowing costs shall refer to the consolidated group for financial accounting purposes in which the taxpayer is a member and be calculated in two steps: (i) 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 (ii) econd, the group ratio is multiplied by the EBITDA of the taxpayer calculated pursuant to paragraph 2.
\end{footnotesize}
The OECD discusses in its drafts that there is a potential risk where group takes excessive third party debt to increase its net third party interest to EBITDA ratio, which would lead to higher deductibility of interest payments. In order to preclude that from happening, the OECD proposes the term “related parties”. The term “related parties” includes a situation when an entity has an investment or interest in other person or an entity and that person exercises effective control of the latter. Additionally, more than 25% investment in the entity does classify as a “related party”. Once such creditor is identified as a “related party”, the interest payment to him is excluded from the definition of the net third party interest. Hence, MNE’s cannot artificially take loans with the “related parties”. Similarly, German counter exemptions function in the Group Escape clause. Interest payment made to the shareholder that holds more than 25% of the company and when such payment exceeds 10% of the interest expense is considered to be subject to primary 30% earning stripping rule and no group exemption applies. The limitation in German earning stripping rule prevents companies to receive loans from affiliated parties with unreasonable interest payable when equity becomes higher so the taxpayer’s debt to equity ratio can be equivalent to the group leverage ratio.

The ATAD presents no definitions of what constitutes a third party in the context of net third party interest/EBITDA rule. Additionally, no explanation is given in regards to the possibility of enlarging third party interest expense by the utilization of “related parties” and high interest paid to them. Finally, net third party interest/EBITDA rule and the Group escape rule are presented as alternatives for the Member States to implement, which could potentially lead to the mismatches of the group escape clause laws in the European Union. Therefore, if one compares two MNEs with the same amount of indebtedness but in the different Member State that implemented different alternative rules, tax treatment of the comparable MNEs will be unfair. For instance, when MNE is located in the jurisdiction that implemented net third party interest/EBITDA it can deduct less interest payable in contrast to the MNE that is located in the jurisdiction that does not have such rule due to the fact that group escape rule is easier to circumvent than the net third party interest/EBITDA rule as presented in the OECD Report.  

2.2.2.4. Pro-cyclical problem

One of the biggest issues concerning the interest barrier rule is that it generates pro-cyclical effects in the time of a financial crisis. The effect of the interest limitation or interest barrier rule is that a

---

54 ECD, OECD/G20 Base Erosion and Profit Shifting Project Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Final Report) p. 93.
company may pay tax even when it is making a loss. This is because in the economic downturn situation the cash flow in the company is low which may lead to smaller or even negative EBITDA. The core of the procyclical problem is that when the company is making a financial loss, the interest payable remains the same as it has been legally fixed before. Again, the interest barrier rule stipulates that the interest expense can be only deducted up to the 30% of positive EBITDA. Therefore, when EBITDA is relatively smaller compared to the other financial years, the taxpayer can deduct only a fraction of the interest expense compared to what he is used to deduct. This is due to the fact that 30% of the new positive EBITDA constitutes a very small amount and taxpayer is allowed only to deduct this amount from the interest expense.

This can be simplified with a basic numerical example: before the financial crisis company’s X EBITDA amounts to 100 mil EUR and the same company has 4mil EUR interest expense. Therefore, it is entitled to deduct interest expenses that do not exceed 30% of its EBITDA. In this case, the company X would be able to deduct 30mil and since it has only one interest payable of 4mil it can deduct it fully. However, let us assume that the next year there is an economic downturn, or the company X has lost its business profitability due to the internal factors and its EBITDA amounts to 10mil. Now it is only allowed to deduct the interest expense up to the 30% of 10 mil which amounts to 3mil. However, the interest payable remains the same at 4mil. This will result in a deductibility of 3mil and taxation on exceeding 1mil, which according to the German corporate income tax can amount to 30%, which would result in the 300,000 EU tax. This example perfectly depicts the frightening effect of the interest barrier rule in the case of dramatic EBITDA downfall in combination with the same interest payable. In the case of the negative EBITDA situation, the taxpayer cannot deduct any interest expense at all and has to pay tax on it virtually from the money he does not accumulate due to the economic downturn or inefficient business ventures.

As a result, this may lead investments out of the country, since companies with the high EBITDA fluctuations can incur even more costs due to the tax system applied. This issue has been acknowledged by the German policymakers as in 2008 when the financial crisis struck the whole world and some adjustments were made. First of all, before the financial crisis there was no possibility to carry-forward the unused EBITDA amounts. However, as a response to the worldwide economic downfall the carry forward of unused EBITDA amounts was allowed up to five years. Additionally, this applied retrospectively, which meant that companies struggling to deduct interest expenses due to

---

57 30% of 100 mil = 30 Mil
58 Wamser, Essays on Behavioral Responses of Multinational Enterprises to International Taxation (Munich: University of Munich, Department of Economics, 2008), 95.
the lower than usual EBITDA, could use the unused amounts from the previous years. The interest carry-forward plays another important role as a company may indefinitely carry forward the interest expense and in such way defer taxation. As a last measure to fix the aftermath of the pro-cyclicality of the interest barrier rule the the threshold of initially EUR 1 000 000 was raised to EUR 3 000 000 in the hope to exclude even more SME’s that may be hit with the interest barrier rule due to their high EBITDA volatility.\textsuperscript{60}

In this light, by the virtue of the analogy, ATAD interest limitation rule will face the same problem of pro-cyclical nature. Nonetheless, what makes matters even worse is that the carry-forward mechanism that to the certain extent neutralizes the procyclical effect is left as an optional clause for the Member States to implement. Provided that some Member States choose not to incorporate such clause in their national legislation, companies with high EBITDA volatility have no way to escape unfair taxation that explicitly violates the ability to pay principle. Additionally, when Member States choose not to incorporate the paragraph 3 of Article 4 (3 mil EUR limitation and exclusion of standalone entity) virtually all companies that have interest payable will risk to be taxed when they generate less money in the first place. Such result can lead to the high level of distortion through the EU in the decisions of the investors, who are looking for the highest rate of return with the lowest risk possible.

2.2.2.5. Preliminary Conclusion

As seen above, the disparities resulting from the potential different implementation of the “may” clauses by the Member States can misbalance the whole system of internal market as taxpayer in different Member States will be treated differently. Different implementation of the tax law aimed at limiting BEPS will result in different economic consequences for the taxpayers. For instance, EUR 3 000 000 exemption seems vital to implement in order not to overburden SMEs with small turnover, as BEPS is only concerned with MNEs escaping taxation. Additionally, standalone clause seems logical in the light of the BEPS Action Plan as single companies are not able to shift their profits to the extent that MNEs can. Furthermore, unfair taxation may result when comparable taxpayers can make use of either net third party interest/EBITDA or group escape clause. This is because group escape clause is easier to circumvent than net third party interest/EBITDA clause. However, since ATAD does not incorporate definition of what constitutes a third party, MNEs may attract more third party debt in such way increasing their overall group ratio, which would allow them to deduct more. Finally, the procyclical nature of interest limitation still remains. The carry forward rules that aim to limit such issue are also presented as “may” clauses. Overall, depending on the implementation of the “may” clauses by the Member States comparable taxpayers may be taxed completely differently while being in comparable

\textsuperscript{60} Scheunemann & Mueller-Duttin. (n. 51), 521.
2.3. Legal compatibility with primary EU law

From the economic assessment presented above it follows that the interest limitation rule is not really economically efficient and therefore is not proportionally adequate to achieve the objective of the limitation of tax avoidance. However, the interest limitation rule must also be examined against the EU law itself. The thesis will focus on the compatibility of interest limitation rule with the inherent general principle of EU law as specified by the ECJ – the proportionality principle. This principle is laid down in Art 5 (4) of the Treaty of European Union and is directed towards EU institutions: “Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality.”

However, the distinction must be drawn between purely domestic law that may infringe the EU freedoms and the law that has been enacted by the EU itself. In our case, the interest limitation rule applies both to the domestic and cross-border scenarios as stipulated in Art 1 of the Directive. This distinction is crucial because usually the ECJ tends not to rule that the secondary EU law that has been enacted by the EU legislative bodies does not satisfy the proportionality principle. Nonetheless, with the EU enacted measures the ECJ can, in fact, rule that the measure does not satisfy the proportionality principle when the measure itself is not fully harmonized. This follows from the ECJ’s settled case law where the EU Member State implementing not fully harmonized measures can infringe the principle of proportionality. Hence, the next sections will stipulate whether the interest limitation rule is harmonized or not and how it infringes the principle of proportionality.

2.3.1. Interest limitation does not satisfy the principle of proportionality

When one addresses the tax avoidance rules “under a settled case law concerning domestic interest limitation rules restricting a fundamental freedom for purposes of combating tax avoidance practices,
the European Court of Justice (ECJ) holds that such measures do not comply with the principle of proportionality if they, amongst others, either do not provide the taxpayer with an opportunity to substantiate the commercial reasons for not entering into an arm’s length loan arrangement, or restrict the deductibility of more interest than an arm’s length interest.” 67 Because ATAD follows directly the OECD BEPS Action Plan 4, the arm’s length principle is abandoned in the interest limitation clause of the directive due to the fact that OECD states that it cannot efficiently tackle base erosion and profit shifting. Hence, this directly negates the ECJ case law practice and overall domination of Arm’s length principle. Within the EU the Arm’s length principle is not only addressed in relation to anti-tax avoidance rules but is also included in the Member State’s transfer pricing guidelines as well as Art 4 of the EU Arbitration Convention. ATAD does stipulate that: the “Directive should not affect the taxpayers’ obligation to comply with the arm’s length principle or the Member State’s right to adjust a tax liability upwards in accordance with the arm’s length principle, where applicable.” 68 Therefore, only the upwards adjustment is allowed, which means that the arm’s length principle only serves as a tool to potentially increase the tax burden of the taxpayer and not to decrease it. What concerns the ability to present commercial reasons for entering the arrangement not according to arm’s length principle, the Directive gives no such option for the taxpayers, therefore restricting any commercially sound practice that may still not follow arm’s length. This means that the individual taxpayers have no other alternatives but to follow the 30% EBITDA interest deductibility without any possibility to argue that the interest payable does indeed make commercial sense.

2.3.1.1. Reasons to abandon the Arm’s length principle are not sound

The ECJ has granted numerous decisions that approve the use of the Arm’s Length principle in the context of domestic thin capitalization rules. For instance, in the Thin Cap case 69 ECJ Grand Chamber provided that arm’s length principle plays a pivotal role in determining whether the thin cap rule that directly restricts the freedom of establishment is nonetheless in line with the principle of proportionality. From the Thin Cap case it followed that when the loan does not comply with the Arm’s length principle, the taxpayer should be given the option to justify such non-commercially beneficial loan arrangement. However, even when the taxpayer cannot provide sufficient evidence, the deductibility based on the arm’s length principle applies as thin cap rule may not restrict it. This application of the Arm’s length principle to the thin cap rules has been approved in relation to the freedom of establishment and freedom of capital. 70 The Thin Cap case is seen as a landmark decision also because it acknowledged that Arm’s

---

67 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].

68 COUNCIL DIRECTIVE (EU) 2016/1164 paragraph 14.


The length principle applies not only to profit allocation but also to profit determination. In other words, not only to the place where the interest should be allocated is determined by the ARM’s Length principle but also “whether the allocated interest due by a resident corporate taxpayer would be, in whole or in part, tax deductible”. Nonetheless, the OECD in its Action Plan 4 disqualifies the application of the ARM’s Length principle to the interest limitation rule based on three main arguments.

First reason relates to practical difficulties surrounding the application of Arm’s length principle. However, OECD failed to acknowledge that profit allocation (i.e. what amount of interest expenses is allocable to the state in which such taxpayer resides) will always rely on Arm’s length principle. This is because loan arrangements inside the group must be according to Arm’s length principle. The interest limitation rules merely specify to what extent the interest can be deductible after it has been allocated to the specific jurisdictions. Therefore, the view that Arm’s length principle is inapplicable in the profit determination stage is illogical due to the fact that profit allocation, which operates based on the Arm’s length principle, serves as a prerequisite for the profit determination. Hence, the practical issues that may arise in regards to the Arm’s length principle, such as heavy documentation requirements and audit efforts, will continue to exist due to the allocation rights.

Secondly the Arm’s length principle is simply “incapable of limiting deduction of interest expenses that exceed third party interest expenses” because the arm’s length principle does not distinguish between third party debt or intra-group debt. In turn, the Action 4 Report OECD proposed the interest limitation rule with the aim to limit excessive third party debt financing. This was done due to the common perception that MNCs tend to allocate their third party debt to the high tax jurisdictions. Therefore, when net third party debt to group EBITDA ratio multiplied by the taxpayer’s EBITDA is higher than the taxpayer’s net interest payable, the excess will not be deductible according to the group ratio rule. However, as OECD presents in its own report in the table B.3, 47% of the Multinationals have a net third party interest to group EBITDA ratio of only 5%. However, as proposed by the OECD the 30% EBITDA deductibility rule should be combined with the Group ratio rule. This can result in a situation that the OECD intends to prevent in the first place. For example, when the net third party net interest to Group EBITDA amounts to 5%, the individual taxpayer within the group is nonetheless able to deduct interest expenses amounting up to 30% of its individual EBITDA and not 5% of its EBITDA. Therefore, the individual taxpayer of the group can deduct even six times more in order to reach 30%.

---

71 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].
72 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].
73 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].
75 Annex
In addition, almost half of the multinationals have the net third party interest to Group EBITDA even lower than 5%. Therefore, only when net third party interest to Group EBITDA is higher than 30% the individual group member will not be allowed to deduct the interest excess of 30% of its EBITDA. From the table presented in the OECD report, however, it is evident that 47% of multinational companies have third net interest to Group EBITDA of 5%, so they individual group members are inclined to deduct up to 25% more, when the third party interest to group EBITDA amounts to 10% individual group members can deduct 20% more due to the fixed 30% rule. The group as a whole will be inclined to deduct as much interest payable as it can. Therefore, individual taxpayers within the group can reach the maximum deduction of 30% of their EBITDA via intragroup debt and intragroup capital contributions as well as third party debt when it will benefit the group as a whole.

Thirdly, the ARM’s length principle is incapable of limiting deduction of interest expenses relating to tax exempt income as EBITDA explicitly excludes the tax exempt income from its calculation. However, as stipulated in academic literature there is an easy solution to the application of arm’s length to tax exempt income. For instance, if taxpayer’s arm’s length interest expenses amount to 200 EUR and his assets generate taxable income at 3000 EUR whereas the value of his assets generating tax exempt income are 2000 EUR the tax “deductibility of the arm’s length interest expenses could be limited to the portion relating to the value of the taxpayer’s assets generating taxable income as part of his total assets’ value”76: 3000/5000 x 200 = 120EUR. Therefore, this simple mathematical rule would be sufficient to still apply ARM’s length principle.

All of this, therefore, leads to the conclusion that the abandonment of the arm’s length principle is not justified. This is because the arguments that OECD put in front against the arm’s length principle can be easily rebutted as presented above.

2.3.1.2. Requirement of the counterevidence rule

As stipulated above, the settled ECJ case law requires that in order for the domestically implemented EU secondary anti-abuse law to satisfy the proportionality principle it must include the counterevidence rule, that would ensure case-by-case examination for any valid commercial reasons the taxpayer may have not to abide by the anti-abuse provision.77 This holds true for the “Member State implementing an anti abuse provision included in a direct tax directive, to the extent the interpretation of its terms

76 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].
77 Sept. 2006, C-196/04 (Cadbury Schweppes), ECR 2006, I-07995, paras 70 and 75, and Thin Cap, para. 82.
leaves discretionary power to the Member State (non-harmonized EU rule)." In the Leur-Bloem case the ECJ held that even though limited holding period may constitute evidence of tax evasion, there may be valid commercial reasons for the taxpayer to exceed the specified limit laid down in the Merger Directive and so the taxpayer must be able to demonstrate his commercial purpose. In contrast to the non-harmonized EU rule, in the case Denkavit ECJ did not require the case-by-case examination in relation to the Parent-Subsidiary Directive (harmonized EU law). Therefore, there seems to be a pattern where ECJ scrutinized non-harmonized EU laws more than the harmonized laws in relation to the ability to present valid commercial reasoning for the taxpayer who did not comply with the anti abuse laws. In the ATAD the ability to present valid commercial reasoning is not found at all. Nonetheless, even if ATAD’s interest limitation constitutes harmonized EU law, next section will illustrate that it should nonetheless be investigated by the ECJ because it does not satisfy the proportionality principle as it contradicts its own aim.

2.3.1.3. Interest limitation measure is manifestly disproportionate to attain its aim

Interest limitation rule presented in the ATAD incorporates harmonized laws as Member States may not change them and they can only implement them or not. Only 30 percent EBITDA deductibility is seen as a non-harmonized law due to the fact that Member States may choose percentage lower than 30. Generally, ECJ tends to scrutinize non-harmonized laws more than harmonized laws in its decisions. However, in the case of interest limitation, it seems that it is harmonized EU law. The abandonment of the ability to present counterevidence may be justified on the basis of the ECJ case law following the decisions on the harmonized EU laws. However, even if one considers the interest limitation law to be a harmonized EU law, it fails to achieve its own aim of “combating tax avoidance practices carried out by taxpayers that are part of a multinational group” and in such way is not in line with the general EU principle of proportionality. Economically, interest limitation rule is not more efficient than the existing thin capitalization rules, given the evident disadvantages it has. Moreover, different implementation by the Member States may lead to the Member State shopping which will further disharmonize the competition on the EU internal market. Arm’s length principle in itself is acknowledged by ECJ and EU instruments to be a valid tax avoidance measure and the reasons for its abandonment in the ATAD still remain highly challengeable. The option for the taxpayer to present its commercial reasoning is not even presented as an option in the ATAD which stems from the exclusion of arm’s length principle. When Member States choose not to implement any exemptions, the rule will

78 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].
81 Denkavit and Others C-292/94, ECR 1996, I-05063
82 Pieter van Os, Interest Limitation under the Adopted Anti-Tax Avoidance Directive and Proportionality [EC TAX REVIEW 2016/4].
target more SME’s than MNE’s, which is contradicting to the very aim the ATAD aims to achieve. The most striking phenomenon of the interest limitation rule, as presented above, is that it effectively allows the individual taxpayers of the MNE’s to deduct up to 30% EBITDA of their interest expenses, where the net third party interest to EBITDA of the whole group in 47% of the cases constitutes only 5%. Therefore, the individual taxpayers would be inclined to utilize more debt and deduct 25%. Therefore, where in the Denkavit case concerning harmonized EU law the question concerned the anti-abuse law which in principle was not able to induce abusive practices, in the interest limitation case the anti-abuse law explicitly allows such practices to occur. Therefore, taken all these points into consideration, interest limitation rule does not effectively ensure the limitation of base erosion with profit shifting, even in some cases induces it. This leads to the conclusion that the interest limitation rule is manifestly disproportionate to achieve its aim.

2.3.1.4. Preliminary Conclusion

As stipulated above the proportionality principle requires tax law directed at the interest limitation to be at Arm’s length with the possibility to provide counterevidence by the taxpayer. In the examination provided above, interest limitation rule as adopted by the ATAD does not incorporate any of the two requirements. However, following the settled case law of the ECJ, harmonized EU laws are rarely challenged by the EU on the grounds that there is no ability to present counter evidence rule. Arm’s length abandonment can be justified as a mere choice of the tax law design, which nonetheless contradicts the preamble and practice of the European tax system. The only possible ground on which ECJ can challenge harmonized interest limitation rule is by exemplifying that it is manifestly disproportionate to achieve its aim. In order to do this, ECJ needs to present arguments both legal and economic that would illustrate the the aim of limitation of base erosion and profit shifting cannot be achieved by current tax law design.

2.4. Interest limitation rule infringes the ability to pay principle

Due to the striking similarity of the interest limitation rule and the German interest barrier rule, it is important to discuss the pending appeal case in the German Constitutional court (Bundesverfassungsgericht) that concerns the German interest barrier rule being unconstitutional. On the 10th of February 2016 the German Federal Tax Court (Bundesfinanzhof) rendered a decision in which stipulated that the interest barrier rule infringes Art 3 of the German constitution which relates to the principle of equality.83 The principle of equality transposed to the tax law system means that the legislator has to design the legislation taking into account the ability to pay principle as well as

83 DE: German Constitution (Grundgesetz) 1949. Art 3(1).
In respect to the corporate taxpayers, the ability to pay is based on the objective net principle, which explicitly stipulates that the expenses of the taxpayer should not be taken into account when calculating the tax assessment. This means that the business costs must be deductible form the taxable basis.

According to the German Federal Tax court the German legislator violated the aforementioned objective net principle due to the fact that interest barrier rule limits the deduction of interest, which is qualified as a business cost. The court argued that the applicable carry-forward of the interest mechanism does not justify the infringement of the ability to pay because “in a system of yearly periodic taxation, costs must be deductible in the year that they are borne”\textsuperscript{85}. Additionally, taxpayer that is experiencing the economic downfall is still subject to the 30% EBITDA rule and so potentially could never make use of interest carry-forward. This phenomenon has been exemplified in the economic reasoning of the procyclical argument above. As an end result “The Federal Fiscal Court took the view that only in individual cases can the interest carry-forward alleviate the legal consequences of a (partial) prohibition against deduction.”\textsuperscript{86} Nonetheless, the court did in fact look at the possible justifications for the infringement of the ability to pay rule.

The first justification considered was that of the purpose of strengthening equity in German enterprises. However, this justification failed when examined against the aim of the interest barrier rule itself. Since interest barrier aimed at regulating the deduction of the interest expenses of the MNE’s the vast majority of taxpayers were excluded from the application of this rule either by the stand alone exemption or the EUR 3 000 000 threshold. In fact, in 2008 less than 1200 German enterprises were affected by this rule.\textsuperscript{87} The second justification revolved around the argument of safeguarding German national tax base. However, the Court rejected this argument due to the fact that interest barrier rule equivalently applied to the purely national situations where there was no need to share revenue with another state. Additionally, court gave priority to the ability to pay principle over the fair share principle. As a last justification the anti-tax avoidance argument was reviewed. The court stipulated that the interest barrier rule does not apply to “abusive structures that either lie below the exemption limit or that have a positive interest balance, but does apply to financing models that are common market practice, make sense and are not typically abusive.”\textsuperscript{88} In addition the court stipulated that since in the purely domestic situation the base cannot be eroded, the legislator should not have included the interest barrier rule to the national

\textsuperscript{84} Steffen Lampert, Till Meickmann and Maria Reinert, ‘Article 4 of the EU Anti Tax Avoidance Directive in Light of the Questionable Constitutionality of the German “Interest Barrier” Rule’ [August 2016] IBFD EUROPEAN TAXATION.
\textsuperscript{86} Steffen Lampert, Till Meickmann and Maria Reinert, ‘Article 4 of the EU Anti Tax Avoidance Directive in Light of the Questionable Constitutionality of the German “Interest Barrier” Rule’ [August 2016] IBFD EUROPEAN TAXATION.
\textsuperscript{88} T R 20/15 (14 Oct. 2015), para. 53 et seq.
situation. At first glance such suggestion of the court would imply breach of the discrimination principle of the EU. However, under the settled ECJ case law, Member States may exclusively enact laws that target cross-border tax avoidance situations but which enable taxpayer to prove that his transactions are in fact reasonable from the commercial point of view. Therefore, since the interest barrier rule applies in cross-border and domestic situations without any chance to prove commercial validity, the Court rejected such justification as well.

Therefore, the German Federal Tax Court raised valid points of the correlation of the ability to pay principle with the interest barrier rule. Since ATAD’s interest limitation is very similar to the German interest barrier rule, analogous reasoning can be applied. This means that the interest limitation rule does not only infringe the proportionality principle but the underlying principle of tax law – ability to pay.

3. Controlled Foreign Company

ATAD incorporates a controlled foreign company rule in Article 7. The objective of the CFC rule is to tax companies, which are controlled by EU resident taxpayers, but are located and are residents of low-tax jurisdictions. Article 7 of the ATAD follows the BEPS Action Plan 3 that deals exclusively with the CFC rules. Action Plan 3 itself stipulates that without the CFC rules MNEs can shift their profits to low-tax jurisdictions or defer taxation for the long term. States that advocate the exemption system or the credit system do not tax the active profit of foreign subsidiary. With the exemption system generally the participation exemption applies when capital is repatriated back to the high-tax parent state. The credit countries, usually allow to defer taxation until the repatriation of the foreign profit. However, when a foreign subsidiary located in the low-tax jurisdiction is merely engaged in passive income activities without the aim of repatriation and does not compete with other foreign business it raises concerns about profit shifting and CFC rules aim at preventing such economic behavior. Therefore, in order to prevent base erosion and profit shifting Action Plan 3 stipulates guidelines on how the CFC rules must be structured. In order to analyze Article 7, it is first reasonable to illustrate what the Article 7 actually stipulates. Secondly, it is logical to examine the CFC rules from an economic perspective and in particular whether adopted CFC rules do in fact counter base erosion and profit shifting and whether CFC rules are fair to taxpayers while not distorting competition and direct foreign investment strategies. Thirdly, CFC rules as incorporated under the ATAD may nonetheless not be in conformity with the fundamental EU principles. Hence the correlation between CFC rules and EU primary law will

---

89 Cases Test Claimants in the CFC and Dividend Group Litigation (C-201/05), Cadbury Schweppes (C-196/04) and Itelcar (C-282/12).
90 Paula Benéitez Régil, BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out? IBFD EUROPEAN TAXATION.
be examined. Finally, administrative difficulties that may arise due to the new CFC legislation will be illustrated in the economic and legal examination. Non-legal issues will also be presented.

3.1. CFC under the ATAD

Article 7 (1) provides the criteria according to which the Member State shall classify an entity or a permanent establishment as a controlled foreign company, provided that profits of such entity or a permanent establishment are not subject to tax or are exempt from tax in that Member State. The determination of controlled foreign company consists of two cumulative conditions.

First, in the case of the legal entity, a parent that is located in the Member State should himself or together with associated enterprises hold directly or indirectly the participation of more than 50 percent of the voting rights, or own directly or indirectly more than 50 percent of the capital or should be entitled to receive more than 50 percent of the profits of the entity. Associated enterprise is defined further in the Article 2 (4) of the ATAD, which stipulates the following: “ ‘associated enterprise’ means: (a) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25 percent or more of the profits of that entity; (b) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25 percent or more or is entitled to receive 25 percent or more of the profits of the taxpayer;”^{92}

The second condition entails that the actual corporate tax paid by the foreign entity or permanent establishment should be lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment if it was located in the Member State and the actual corporate tax paid by the entity or permanent establishment. For example, if the Member State has an effective tax rate of 25 percent and the entity or permanent establishment is subject to the effective tax rate of 10 percent in the foreign country, the difference of the tax rates is 15 percent. Since the effective tax rate in the foreign country is 10 percent the foreign entity or permanent establishment would classify as a CFC because the difference is greater than the effective foreign tax paid.

Once the entity is classified as a CFC, Article 7 (2) provides two options of what income of the foreign entity or the permanent establishment can be attributed to the Member State to tax. Point (a) of the Article 7 paragraph 2 advocates an entity based approach. Under this approach the Member State may tax the non-distributed income of the foreign entity or the income of the permanent establishment which

^{92} COUNCIL DIRECTIVE (EU) 2016/1164 Article 2 (4) ATAD.
is derived from the six specified categories: interest, royalties, dividends, income from leasing, income from insurance banking and other financial services and income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value. However, when the foreign entity or the permanent establishment carries on a “substantive economic activity supported by staff, equipment and premises” CFC rules will not apply provided that the substantive economic activity is evidenced by relevant facts and circumstances. This exception is optional if the foreign entity or permanent establishment is situated in a country that is not party to the EEA Agreement. Additionally, pursuant to paragraph 3 of Article 7, Member States may choose not to treat the foreign entity or the permanent establishment as a CFC if one third or less of the total income falls in the six specified categories.

The second approach presented in the Article 7 paragraph 2 point (b) is the transactional approach. This approach attributes the non-distributed income of the entity or permanent establishment to the Member State provided that such income arises from the “non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage”. The non-genuine arrangement is considered to be an arrangement or series of the arrangements “to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.” However, paragraph 4 of Article 7 stipulates that Member States may exclude from the scope of transactional approach an entity or permanent establishment with accounting profits of no more than EUR 750 000 and non-trading income of no more than EUR 75 000, or when accounting profits amount to no more than 10 percent of its operating costs for the tax period.

Further in Article 8 the computation of the controlled foreign company income is stipulated. If the Member State applies the entity approach the income should be calculated according to the national corporate tax law of the Member State. Losses of the foreign entity or permanent establishment may not be included but can be carried forward according to national laws. When the Member State chooses the transactional approach the income included to the tax base of the taxpayer of the Member State should be limited to the amount generated through assets and risks that are linked to significant people functions carried out by the controlling company.

Additionally, article 8 paragraphs 5 and 6 stipulate that the Member States should ensure that there is no juridical double taxation. This should be done by providing deduction from the tax base of the parent of the Member State, which has already paid the tax on the CFC income, when that income has already
been distributed to the parent or when the parent disposes of its participation in the CFC. Finally, Article 8, paragraph 7 stipulates that Member States should grant a deduction to the parent taxpayer for the tax already paid by the CFC.

As stipulated above countries may choose between transactional and entity based approach, which have their advantages and disadvantages. Entity based approach is less burdensome administratively because once tax administration has determined which income falls into which category, CFC rules automatically apply, provided that the classification criteria are met. No further analysis needs to be undertaken by the tax administration. The taxpayer, on the other hand, has legal certainty as he knows in advance what income will be subject to taxation. The disadvantage of the entity based approach is that it is possible to change income that would have been included as a CFC taxable income to the income that is excluded from the exhaustive list of income. Nonetheless, within EU substance requirement is still included in the entity based approach, in order for it to be in line with primary EU law. However, CFC’s located outside the EEA may not be subject to such requirement in the entity based approach. Transactional approach, on the other hand, is more burdensome administratively as tax administration has to check every stream of income based on the substance analysis. However, transactional approach is better equipped at attributing income as it determines every stream of income that may be put in place in order to avoid taxation. Hence, income that raises BEPS concerns is better attributed by transactional approach as it may include not only passive but also active income.

3.2. Economic efficiency of CFC

In order to examine the economic efficiency of the CFC rules adopted in the ATAD it is reasonable to examine whether the CFC rule reaches the desired effect of the limitation of base erosion and profit shifting. This examination will be done based on the empirical evidence of the CFC rule. In addition, the question of fairness must be analyzed. In other words, whether the system is created in such way that everyone pays taxes equivalently and no segment of comparable taxpayers is favored over the other. In the context of the European CFC rules, fairness would entail that no taxpayers of one MS are favored over the taxpayers of other MS, provided that they are in the comparable positions, in their foreign direct investment strategies. Another important economic consideration that will be analyzed is that of economic double taxation, which is addressed in the BEPS Action Plan 3 but it is left out in the ATAD CFC regime for speculative reasons.

---

3.2.1. Empirical analysis of base erosion and profit shifting

The data needed to empirically assess the economic implications of the CFC rules is not publicly available, which makes empirical research scope rather limited. Nonetheless, due to the fact that German Deutsche Bundesbank provides financial data, empirical research has been done on the German CFC. Therefore, the next section will illustrate the findings of such study. Furthermore, the most recent empirical study has explored the policy choices between the thin capitalization rules and the CFC rules by the governments in order to limit profit shifting by the MNEs. This study is highly relevant for the thesis as it shows which rule, CFC or interest limitation, affects the behavior of the MNEs to the greater extent and the findings of the study positively correlate with the empirical studies presented in the interest limitation section. Finally, the empirical study on the implications of the Cadbury-Schweppes case will be illustrated as it served as a precedent in the ATAD to include the transactional approach and heavily influenced the entity based approach of the CFC profit allocation.

3.2.1.1. German CFC rules

The empirical study conducted by Martin Ruf and Alfonso J. Weichenrieder\(^{96}\) examines the German CFC rules. Specifically, how the CFC rules restrict the use of foreign subsidiaries located in the low tax jurisdiction to protect passive income from the German taxation. German CFC rules require more than 50 percent of the ownership of ordinary shares or voting rights held directly or indirectly. CFC applies to passive income which is defined negatively, so it includes everything that is not active income. Finally, German CFC rules apply when the passive income in the low-tax jurisdiction is effectively taxed with less than 25 percent CIT.

The empirical study gathered the data of the MiDi database of the Deutsche Bundesbank. The data is available because German investors that have ownership in subsidiaries with total asset value exceeding 3 Million EUR must report their affiliation. The data compiled period from 1996 to 2006. The empirical analysis consisted of portfolio investments and loans granted to other affiliates. The results of the research stipulated that generally offshore tax-heaven countries are not able to attract major amounts of passive investments because of the applicable CFC rule. Additionally, the study concludes that “One piece of empirical evidence for the effectiveness of the CFC rules is that, while a lower local tax rate in general attracts German passive investment, this effect is lower for countries for which the rules are applicable, since their local rate is below the safe-haven rate.” This means that lower tax rate in the foreign countries can attract German passive investment but when the tax rate of the foreign country

falls below the safe-heaven rate of 25 percent, MNEs are no longer attracted to shift their passive income in such country due to the effect of the CFC rules.

3.2.1.2. CFC and thin capitalization rules

The most recent study\(^97\) on the CFC rules examines the correlation between the CFC rules and thin-capitalization rules and how they affect the foreign direct investments (FDI). The empirical study ventures into examination of the conditions under which governments would like to utilize CFC rules together with the thin-capitalization rules in order to reach optimal tax mix. Secondly, the research analyzes how this optimal tax mix utilized by the governments changes in the case of increased mobility of the FDI.

The results of the empirical study stipulate that in the best scenario each government will implement thin-capitalization rules in order to allow MNEs operating at home to deduct some internal debt of the group. However, in order to attract FDI government would want to implement less strict thin capitalization rules for the foreign MNEs incorporating in the country. Nonetheless, thin-capitalization rules should be equally used by domestic MNEs and foreign MNEs. This means that deduction should be equal when home MNE is making use of the foreign direct investment and when foreign MNE is incorporating in the home state. The study stipulates that “due to the existence of trade costs that create a “home market bias” the elasticity with which investment by home-based multinationals responds to tax incentives is generally lower than that of foreign-based multinational companies.” \(^98\) This means that home MNEs tend to respond less to tax incentives due to the “home bias” as they would rather stay home and do not invest abroad. Foreign MNEs, on the other hand, utilize incentives in a bigger manner. So government is even more tempted to implement stricter thin capitalization rules for the home MNEs in order to gather more tax revenue and less strict thin-capitalization rules for the foreign MNEs in order to attract FDI as it makes economic sense. However, this is not possible with the thin-capitalization rules at least in EU due to the settled case law of non-discrimination. \(^99\) One way that governments are able to make such distinction is by implementing the CFC rules that would directly tax passive income of the home MNEs’ subsidiaries, in such way accumulating the most tax revenue, while leaving relatively lenient thin-capitalization rules as they apply both to home MNEs and foreign MNEs. Thus, foreign MNEs, would still be incentivized to invest in the government.

---

\(^{97}\) Dirk Schindler, Andreas Haufler, Mohammed Mardan, , ‘Double tax discrimination to attract FDI and fight profit shifting: The role of CFC rules’ [January 06, 2017] Norwegian School of Economics.

\(^{98}\) Dirk Schindler, Andreas Haufler, Mohammed Mardan, , ‘Double tax discrimination to attract FDI and fight profit shifting: The role of CFC rules’ [January 06, 2017] Norwegian School of Economics.

\(^{99}\) Lankhorst-Hohorst, C-324/00, 12 December 2002, ECJ.
The study finds that when there is a reduction of the transaction costs for the FDI the thin-capitalization rules are tightened and CFC rules are relaxed. In fact, it is cheaper to increase thin capitalization rule in order to disallow internal debt to be deducted from the domestic tax base rather than enjoy the benefits that FDI brings. On the other hand, since the cost of capital is increased for the MNEs they are compensated by laxer CFC rules. However, when costs of debt shifting to tax heavens are reduced both thin-capitalization and CFC rules are strengthened. This is because “Both of these measures increase the corporate tax base and prevent multinationals from taking advantage of the lower costs of debt shifting to the tax heaven”. Therefore, the study correlates with other empirical evidence presented for the interest limitation in the way that generally thin-capitalization rules are lenient and do not overburden MNEs due to the fact that government cannot discriminate between home and foreign MNEs. In order to prevent base erosion and profit shifting and at the same time to ensure FDI flowing into the government, CFC rules are used. Only in the cases of extreme reduction of the transaction costs for the FDI the thin capitalization rules are tightened and CFC rules are relaxed. When there is a decrease of costs for debt shifting to tax heaven both rules are strengthened.

3.2.1.3. CFC and the impact of the Cadbury-Schweppes case

The next empirical research examines the impact of the Cadbury-Schweppes case from 2006 on the development of the CFC rules thorough EU. The Cadbury-Schweppes concerned the British MNE that had established two subsidiaries in Ireland. Since British CFC rules applied to the subsidiaries established in the Ireland due to the low effective tax rate in Ireland, Parent MNE in the Britain had to pay 8.6 million GBP and no exemption applied. ECJ in its decision stipulated that such restriction cannot be justified by the Irish subsidiary taking advantage of the lower tax rate. Restriction can only be justified when it is aimed at preventing wholly artificial arrangement, which does not reflect economic reality and has a sole tax avoidance purpose. Unless such motive of the arrangement can be proven, restriction constitutes an infringement of establishment.

The research focuses on the fact that freedom of establishment applies only to entities and individuals with the EEA. Therefore, CFC rules may still discriminate against non-European affiliates. The study utilizes data of the German MiDi database of the Deutsche Bundesbank used in the first research presented in this chapter. The research focuses on the passive and active investment change from 1999 to 2010, in which case the implication of the Cadbury-Schweppes decision of 2006 would be highly visible. As a result, the study concludes that the passive investments by the German MNEs decreased in the low-tax non-EEA countries and significantly increased in the low-tax EEA countries. In fact,

---

100 Martin Ruf, Alfons J. Weichenrieder, 'CFC legislation, passive assets and the impact of the ECJ’s Cadbury- Schweppes decision' [November 2013] Oxford University, Centre of Business Taxation.
German MNEs’ passive investment in Ireland has doubled from 2005 to 2008. Additionally, vast amount of passive income has systematically increased in the low-tax countries within the EEA like Ireland, Estonia, Latvia and Poland compared to the low-taxed countries outside the EEA.

The implication of this study is highly relevant for the Article 7 of the ATAD. This is because during the negotiations of the ATAD the ECJ decision in Cadbury-Schweppes was explicitly mentioned. The transactional approach envisioned in the Article 7 paragraph 2 point b specifically addresses what ECJ had in mind in the Cadbury-Schweppes case. Nonetheless, entity based approach still had to be preserved with the exception that it would not apply when CFC “carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances”. However, the most important is the second exception which states that “Where the controlled foreign company is resident or situated in a third country that is not party to the EEA Agreement, Member States may decide to refrain from applying the preceding subparagraph.” This means that the substantive economic analysis has to be done only in respect of the companies resident in the EEA and not towards foreign companies. This implication of the Cadbury-Schweppes is highly relevant as it sets up a system where capital flight may be directed by the MNEs towards low-taxed EEA countries.

3.2.1.4. Preliminary conclusion

Empirical research presented above shows that CFC rules do limit base erosion and profit shifting. In the case of German companies, once the jurisdiction has tax rate that is under the safe haven rate of 25 percent, companies are reluctant to incorporate CFCs there due to the fact that German CFC regime will tax passive income located in such jurisdiction. In such way base erosion and profit shifting to low-tax jurisdictions is limited. Second empirical study suggested that CFC is seen as an effective tool to preclude home MNEs to venture into FDI in the low-tax jurisdictions. Thin capitalization rules are then relaxed in order to attract foreign FDI, while CFC rules make it unattractive for the home MNE to invest into low-tax jurisdictions. Such mix of tax laws results in the optimal revenue gathering solution for the government. Finally, last study suggested that in order to introduce EU level CFC regime it is necessary to ensure that there would be no infringement of freedom of establishment. The CFC rule is structured having the outcome of the Cadbury-Schweppes case in mind, which allows CFC rule not to be discriminatory. However, while CFC rule does limit base erosion and profit shifting the requirement of substance within the EU and lack of such requirement in relation to jurisdictions outside the EU makes the system unfair.

3.2.2. Capital Flight and lack of fairness

Based on the empirical research provided above an assumption can be made that CFC legislation incorporated in the ATAD will in fact make it possible for the MNEs located in the high-tax jurisdictions to shift profits to the low-tax jurisdictions. First of all, based on the Cadbury-Schweppes decision, Member States cannot discriminate based on the low tax rate, the restriction on the tax benefits is only allowed when the arrangement is artificial with the aim to get tax advantage. Since the freedom of establishment can only be invoked by the residents of the EEA, this has several implications for the future application of the CFC regime. First of all, taxpayers from the high-tax jurisdictions within the EEA can shift their profits via FDI to the low-tax EEA jurisdictions such as Bulgaria, Cyprus, Malta, Hungary or Liechtenstein where statutory tax rate is not higher than 15 percent. When a subsidiary has active income and substantial economic activity in the low-tax EEA jurisdictions, parent jurisdiction cannot invoke CFC rules in order to tax passive income that is located within the subsidiaries, unless such arrangement is made solely for tax advantage. This implies, that there are opportunities for tax-planning after the implementation of the ATAD within the EU itself. Hence, it is reasonable to expect that more passive income with the substantial economic activity will be located in the low-tax EEA countries as a result of the CFC legislation.

The application of the CFC rules outside the EEA does not require the substantial economic activity analysis for the entity based approach. This means that the Member State can tax passive income of the foreign subsidiary that falls into the category specified in Article 7 paragraph 2 point a. However, in order for the subsidiary to be qualified as a CFC there is the requirement of the effective tax paid in the foreign country. The requirement specifies that subsidiary or permanent establishment is considered to be a CFC when the difference between effective tax paid in the parent state and effective tax paid in the foreign state is higher than the effective tax paid in the foreign state. Mathematically, this amounts to more than 50 percent of the parent effective tax rate. Nonetheless, MNEs may make use of the effective tax rate disparities within the EU in order to facilitate capital flight to the low-tax offshore jurisdictions. Member States may implement the entity based approach as it does not require the substantial economic analysis for the foreign subsidiary and all passive income can be taxed in the jurisdiction of the parent. Therefore, if MNE is located in the Netherlands and the entity based approach is applied without need to analyze substantial economic activity, the subsidiary located in Qatar will be subject to Dutch CFC. This is because if it is assumed that even statutory rate is the same as effective tax rate, corporate income tax in the Netherlands is 25 percent while in Qatar it is 10 percent. This means that for the Netherlands Qatar will qualify as CFC jurisdiction. In such case MNE can simply incorporate in low-tax EU jurisdiction such as Bulgaria where statutory corporate income tax rate is 10 percent. Hence, in this example Qatar will not be qualified as a CFC by the Bulgarian tax authorities and accordingly there will be no excessive taxation of the passive income located in Qatar. Due to the discrepancies in the tax
rates of the Member States this scheme can be highly utilized, which can lead to “the race to the bottom” of tax rates by the Member States themselves in order to attract MNEs.

3.2.2.1. Preliminary Conclusion

Overall assessment shows that principle of tax fairness is not complied with in the European CFC system. According to the notion of horizontal equity of the fairness principle “like situated taxpayers should be taxed the same”\(^\text{103}\). In the case presented above, MNE in the Netherlands and MNE in Bulgaria may be equally economically active and holding the same share of the European market with comparable financial statements. However, when MNE in the Netherlands wants to invest into Qatar it is captured by the Dutch CFC, which results in extra costs for the enterprise as well as extra administrative compliance costs. On the other hand, Bulgarian MNE that is equivalent to the Dutch MNE is not captured by the Bulgarian CFC regime, which means it does not have additional costs as an enterprise and additional administrative burden. Bulgarian MNE is clearly favored by the CFC regime over the Dutch MNE. Hence, such result of the European CFC regime is clearly unfair for the MNEs located in the high-tax jurisdictions within the EU. Logical consequence of such CFC regime is that it will distort investment decisions of the MNEs as EU Member States will lower their effective tax rates in order to attract capital.

3.2.3. Economic double taxation

Article 8 in paragraphs 5 and 6 specifies that deduction should be given from the tax base for the taxes already paid by the company on the CFC profits when an actual distribution of those profits takes place or when the parent company disposes of the shares in the CFC. The first point concerns the situation when the distribution of the CFC income takes place in the form of dividends and since usually the participation exemption would apply for the dividend distribution relief is necessary.\(^\text{104}\) In regards to second scenario when parent disposes shares he realizes capital gains but since the taxpayer has been previously taxed on the undistributed income Member State should refrain from taxing “subsequent gains realised by a taxpayer in respect of the shares of a CFC to the extent that the same amounts have previously been taxed under CFC rules operating in the taxpayer’s jurisdiction.”\(^\text{105}\)

---


However, the rule presented in the paragraph 7 of Article 8 is of general nature. It obliges Member State of the parent company “to grant relief for the taxes already paid by the CFC by means of deduction.” However, it is not specified whether Member State should grant relief only for the taxes paid in the jurisdiction of the CFC by the CFC or it also includes the situation when CFC income is attributed to other Member State by virtue of indirect control. Such situation may occur when UK company directly holds shares in the Dutch company that has more than 50 percent voting rights in the CFC jurisdiction. In this way, both UK and the Netherlands classify the company as a CFC. The UK by the means of indirect control and the Netherlands by the means of direct control. Such structure is visualized in the Annex. Since both Member States see the low-tax jurisdiction as a CFC they can tax undistributed passive income of that CFC which leads to double economic taxation since the same passive income is taxed in the hands of two different taxpayers.

This specific economic double taxation issue is explicitly addressed in BEPS Action Plan 3. OECD suggests to implement a hierarchy structure in which first the CFC income will be attributed to the company holding directly the participation in the CFC. Afterwards, the Member State of the company holding indirect participation in the CFC should grant a credit for the taxes paid in the first Member State and tax the remaining available sum. In the example presented above, the Netherlands would be entitled to tax passive income first and then UK could grant a credit for the taxes paid in the Netherlands and tax the remaining income. However, since effective tax rate is higher in the Netherlands, all passive income from the CFC will be taxed in the Netherlands and UK should refrain from taxing.

Therefore, it seems unreasonable that such prevention mechanism was not included in the CFC rules laid down in the ATAD. Some scholars suggest that such implicit allowance of the double economic taxation is linked with the discouragement of the MNEs to structure their system with the intermediary. Nonetheless, the preamble of the Directive stipulates that “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.” Hence, such double economic taxation seems to be countering the aim and purpose of the ATAD itself.

108 Annex
3.3. Legal compatibility with primary EU Law

In the BEPS Action Plan 3 OECD makes specific remarks relating to the compatibility of the CFC laws with the EU fundamental freedoms. In order to eliminate the potential infringement of the fundamental freedoms of movement and establishment, OECD proposes to extend the applicability of the CFC laws to purely domestic situations as well. OECD stipulates that since CFC rules apply equally to both domestic subsidiaries and cross-border subsidiaries there is no discrimination against non-residents and so no justification is needed. Another point made by the OECD is that CFC rules will be in line with the fundamental freedoms of the EU provided that there is a requirement to carry on analysis whether CFC is engaged in the genuine economic activities. Therefore, first the question of the applicability of the CFC rules to the purely domestic situations will be addressed. Secondly, the question of substantial economic activity will be analyzed.

3.3.1. Domestic and cross border application of CFC

When the CFC regime applies to both domestic and foreign situations this rules out the possibility of discrimination. However, the legal paradox of the domestic CFC is that there will almost never be a domestic CFC. This is because when there is a parent with the domestic subsidiary, the domestic subsidiary will never qualify as a CFC to begin with because it will be subject to the similar effective tax rate as the parent. Therefore, only in the cross-border situation parent will encounter CFC and additional taxation. As a result, there is a difference in taxation of the parents with purely domestic subsidiaries and parents with subsidiaries established in the low-tax jurisdictions. However, the difference is visible only under closer analysis but by the virtue of including the same laws for purely domestic situations and cross-border situations there is no discrimination under the freedom of establishment. This tendency to include anti-avoidance rules to domestic situations merely to escape possible finding of discrimination was mentioned by the Advocate General Geelhoed in the Thin Cap case.

The Advocate General noted that: “I find it extremely regrettable that the lack of clarity as to the scope of the Article 43 EC justification on abuse grounds has led to a situation where Member States, unclear of the extent to which they may enact prima facie ‘discriminatory’ anti-abuse laws, have felt obliged to ‘play safe’ by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists.” Even European Commission stated in its Communication to the Council that such measures should be “prohibited as they are counter-productive in terms of economic efficiency

---

113 Paula Benéitez Régil, BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out? IBFD EUROPEAN TAXATION.
114 UK: Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue, para. 68, ECJ Case Law IBFD.
and run contrary to the interest of the internal market”.\footnote{Commission Communication of 10 December 2007 to the Council, the European Parliament and the European Economic and Social Committee entitled The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM(2007) 785 final (10 Dec. 2007).}

Hence, not only do such practices make no legal sense of protection of the fundamental freedoms but they are also causing unnecessary administrative burden for the Member States, which makes them counter-efficient to the interest of the internal market, just so the measure could not be challenged under the discriminatory infringement of the fundamental rights. Nonetheless, currently mere application of the anti-abuse laws directed towards cross border avoidance to domestic situations makes them unchallengeable under the notion of discrimination.

3.3.2. Substantial economic activity

OECD acknowledges that there should be analysis of the substantial economic activity in order for the CFC to be in line with the fundamental freedoms. Some scholars argue that there may be grounds on which the CFC regime as adopted in the ATAD can be challenged by the ECJ due to the horizontal discrimination, provided that there is an analysis of the genuine economic activities. This is because in the Cadbury-Schweppes case ECJ explicitly acknowledged the comparison between domestic and foreign subsidiary (vertical) and the comparison between two subsidiaries established in different Member States (horizontal). Firstly, the court specified that the restriction would be made if resident company is taxed on the profits of the subsidiary located abroad and is not additionally taxed if the subsidiary is located in the parent state. Secondly, the court specified that the restriction would be made if the subsidiary of the parent is located in a Member State with the high level of taxation with no additional tax due and a subsidiary located in the Member State of the low level of taxation with additional tax due. Hence, some scholars\footnote{Błażej Kuźniacki, PhD Candidate, Department of Public and International Law, University of Oslo, ‘Comments received on Public Discussion draft BEPS ACTION 3: STRENGTHENING CFC RULES’ [27th of April, 2015, Vienna].} have acknowledged that since the court has made such horizontal distinctions there can be grounds to challenge the application of the CFC regime adopted in the ATAD. The discrimination may result when “the treatment in the home state different in respect of an investment in Member State A versus an investment in Member State B.”\footnote{N. Bammens, The Principle of Non-Discrimination in International and European Tax Law p. 597 (IBFD 2013), Online Books IBFD.} However, it seems highly unlikely that horizontal discrimination will be challenged by the ECJ, since settled case law in respect of the direct taxation stipulates that there is no horizontal comparability available.\footnote{horizontal comparison was rejected by the CJEU in cases: Columbus Container case C-298/05, ECR 2007, p. I-10451, paragraphs 39-40 and the D case C-376/03, ECR 2005, p. I-05821, paragraphs 61 63.}

Additionally, some scholars advocate that ECJ did not make a distinction between vertical and horizontal comparability in the Cadbury-Schweppes case in the first place.\footnote{Kemmeren, E. C. C. M., The Internal Market Approach Should Prevail over the Single Country Approach, in: Luc Hinnekkens and Philippe Hinnekkens, A Vision on Taxes Within and Beyond European Borders, Festschrift in Honor of Prof. Dr. Frans Vanistendael, Kluwer Law International, The Hague, The Netherlands 2008; O’Shea, T., The UK’s CFC rules and} Therefore, since the
substantial economic analysis is included in the ATAD at least for the EEA members there seems to be no discrimination based on the pure tax rate. Article 7 paragraph 2 specifically states that within the EEA analysis on the substantive economic activity should be carried out. Hence, this is in line with the Cadbury-Schweppes case that stipulated that generally discrimination based on the tax rate is not allowed unless the arrangement is wholly artificial and does not reflect economic reality. ATAD also allows to exercise the option of adopting the analysis of the substantial economic activity towards the third countries. This is highly important as recent case law\textsuperscript{120} has shown that CFC can be interpreted in the light of the free movement of capital, which is the only freedom that can be relied on by the non-EEA countries. \textsuperscript{121}

3.3.3. Preliminary Conclusion

Therefore, it can be concluded that CFC regime is non-discriminatory based on the two criteria proposed by the OECD. First, even if it makes no legal sense to introduce CFC laws in pure domestic situation, this will preclude the CFC laws of being challenged based on the discrimination. Secondly, the mandatory substantial economic test for the EEA members and optional substantial economic analysis in respect of 3\textsuperscript{rd} states ensures that there is no breach of the freedom of establishment and even freedom of capital. Whether such test is applied by the Member States in relation to the third countries does not matter from the EU discrimination on the basis of establishment perspective.

3.4. Non-legal issues

3.4.1. Control

The CFC rules stipulated in the ATAD require that the taxpayer together with the associated enterprises would hold directly or indirectly participation of more than 50 percent. This is in line with the BEPS Action Plan 3 as direct and indirect control covers both economic and legal control. However, the issue of the de facto control is addressed in the BEPS Action Plan 3 which is missing in the ATAD CFC rules. \textsuperscript{122} De facto control entails that countries should look not only at the legal and economic control by the parent but also at the factors such as who has the ability to direct or influence day-to-day activities or who takes the top-level decisions regarding the affairs of the foreign company. Hence, de facto control should be an additional anti-avoidance rule that ensures that legal and economic requirements are not bypassed by the parent. However, such control may be difficult to monitor by the tax

\textsuperscript{120} Commission v. UK (C-112/14), paras 16–29, supra n. 13.
administration and when it tries to examine the de facto control it would lead to added costs and possibly compliance complexity for taxpayers. Nonetheless, it must be acknowledged that such requirement can be implemented as a separate supplementing test or targeted provision.

3.4.2 Political issues

In the course of the creation of the CFC rules in the ATAD, countries faced various political difficulties that lead to the adoption of different rules than proposed by the BEPS Action Plan 3. First of all, countries disagreed on the switch-over clause that had to be implemented in the ATAD. The switch-over clause as such was not mentioned in the BEPS Action Plan 3. The switch-over clause meant that the national participation exemption will not be applicable for profits derived from the low-tax jurisdiction subsidiaries or permanent establishments even if there was an active business.\(^{123}\) The switch-over clause predominantly was challenged by the Dutch representatives as it would render Dutch participation exemption useless for offshore transactions. Also when the subsidiary has active business income. Additionally, BEPS Action Plan 3 specifically states that the qualification of the CFC depends on the percentage of the tax rate paid by the CFC. However, due to the objections of the Irish Finance Minister the threshold was changed as to the difference between the effective tax rate of the Member State and the effective tax rate paid by the foreign entity or permanent establishment. If the difference is lower than the effective tax rate of the Member State, the entity or the permanent establishment is considered as a CFC, provided that the control test is also fulfilled. This decision was clearly of political nature as Irish Finance Minister, Michael Noonan stated that setting of the tax rates was exclusively national right.\(^ {124}\) The result, however, mathematically remains the same.

4. Conclusion

The G20 suggested that BEPS is the main issue of the international business taxation nowadays. The Anti Tax Avoidance Directive was implemented with the sole purpose to tackle the problem of BEPS. However, in the course of the design of the tax legislation, the lawmakers focused also on the sovereignty of the Member States’ tax systems. Therefore, the Directive incorporates many “may” clauses that individual Member States may choose to follow or opt out of the implementation of such clause. Disparities also result due to the different tax systems and tax rates in every Member State. The possibility to implement different variations of tax laws aimed at the limitation of the BEPS in a different manner by every Member State leads to the overall misbalance in the system. Hence, this

---


thesis has exemplified on the basis of interest limitation rule and CFC rule incorporated in the ATAD, that the discrepancies present in the laws due to the need to preserve Member States' taxing sovereignty highly compromised both legal and economic principles that the tax laws should follow.

In the case of interest limitation both legal and economic principles are exposed. The only legal requirement that the Directive imposes on the Member States is that a taxpayer can only deduct his interest payable only up to 30 percent of his EBITDA. Other laws presented in the legislation are “may” clauses that Member States may choose to implement or not. Based on the empirical evidence of the German interest barrier rule, the economic significance of the interest barrier rule is rather small, as only 5 more percent of the companies are affected by the interest barrier rule in contrast if the thin capitalization rule would apply. Additionally, only small fraction of MNEs fell into the new post-crisis German interest barrier rules adopted in 2009. Therefore, economic efficiency of the limitation of the base erosion and profit shifting by the MNEs is achieved only on the small scale by the interest barrier rule, which is almost identical to the interest limitation rule presented in the ATAD. On the other hand, if a Member State chooses not to adopt at least one of the “may” clauses the economic effect is even more unfortunate. If a Member State chooses not to implement the EUR 3 000 000 exemption, the vast majority of the SMEs will be affected by such choice as the would not be able to deduct interest exceeding 30 percent of their EBITDA. Since SMEs have different level of indebtedness the procyclical issue may arise where due to the economic downfall the company’s EBITDA is lower than usual but interest payable remains the same. This would be contrary to the aims of the BEPS Action Plan presented by the OECD as it only targets big MNEs. The absence of the standalone clause would result in the excessive taxation of singular companies that do not even have the possibility to shift their profit by interest, since they do not have any affiliated companies. The group escape exemptions allow Member States to choose between group escape clause and net third party interest/EBITDA ratio. Economically, group escape rule is easier to circumvent than the net third party interest/EBITDA rule because MNEs may issue capital contributions within the group in order to align individual taxpayer’s debt to equity ratio to the overall group’s debt to equity ratio. Such manipulation is not possible in the net third party interest/EBITDA rule. Precisely this disparity of the ATAD will lead to the unfair taxation of the taxpayers in the comparable positions but in the jurisdictions with different adopted tax laws.

From the legal point of view, the proportionality principle is not satisfied in the interest limitation rule. The settled ECJ case law dealing with interest limitation rules provides that principle of proportionality is infringed when tax law does not allow taxpayer to prove that he may have commercial reasons for different interest payable or when deductibility is not based on the Arm’s length basis. There is no option in the interest limitation rule for the taxpayer to present his arguments on why there is different interest payable. Additionally, Arm’s length principle is abandoned altogether in the interest limitation
rule based on the OECD BEPS Action Plan 4. As presented in this thesis, the arguments made by the
OECD on why Arm’s length should be abandoned are unsound. Furthermore, the case pending in the
German Constitutional court challenges the German interest barrier rule on the basis of the ability to
pay principle. Nonetheless, interest limitation rule may be seen as harmonized tax law under the EU
because laws presented in the interest limitation do not give Member States discretion as to what extent
they want to implement them. Only non-harmonized law is the 30 percent EBITDA rule as Member
States may choose to lower such percentage. Other rules are harmonized as they are set at specific
thresholds and Member States may not change them. However, Member States may choose to
implement them or not. As seen from the thesis, the ECJ is highly unlikely to challenge harmonized tax
laws. The only possible way for the ECJ to challenge such law is on the grounds that it is manifestly
disproportionate to achieve its aim. In the view of the author, interest limitation rule does not achieve
the limitation of BEPS economically as it can distort competition on the market even further with the
“may” clauses. Additionally, the design of the legislation abandons the Arm’s length principle and the
possibility of counter evidence rule. All of this leads to the conclusion that interest limitation rule is in
fact manifestly disproportionate to achieve its aim and should be challenged by the ECJ on the
proportionality grounds.

CFC rules adopted in the ATAD also exemplify issues of economic and legal nature. The notion that
CFC rules limit BEPS is presented in the thesis based on the German empirical data. In fact, CFC rules
do tend to limit BEPS as jurisdictions that do not satisfy safe haven rate and considered to be CFC
jurisdictions are less favored by the MNEs for their FDIs. Additionally, CFC rules are seen as an
effective tool of control next to the thin capitalization rules. Deductibility of interest may be relaxed by
the states when CFC rules are in place, in such way making it unpleasant for the domestic MNEs to
invest in the low-tax jurisdictions while attracting foreign FDIs due to the lax thin capitalization rules.
However, due to the fact that the CFC regime adopted in the ATAD classifies jurisdiction as a CFC
jurisdiction when the effective tax rate is less than a half of the effective tax rate that would have been
applied had the company stayed in the home jurisdiction, disparities arise within the EU itself. Due to
the Cadbury-Schweppes decision, Member States are obliged to test the substance test and cannot
merely classify another Member State as a CFC jurisdiction based on the rate. In such case capital flight
seems to be inevitable. MNEs can shift their capital to the low-taxed Member States such as Bulgaria,
Cyprus or Malta with enough economic substance and from there they can venture into the FDIs to the
low-tax jurisdictions that are not considered to be CFC due to the low rate in those Member States but
would have been considered CFC had the MNE stayed in the high-tax EU Member State. This results
in the taxation unfairness as for the comparable taxpayers application of tax law differs based on the
place of establishment within the EU. Additionally, the CFC regime adopted in the ATAD does not
deal with the economic double taxation, the matter that is explicitly dealt with in the BEPS Action Plan
3. The rule stipulated in the ATAD obliges Member State of the parent company to grant relief for the
taxes already paid by the CFC by the means of deduction. However, it is not specified whether Member State should grant deduction due to the indirect control that the company may have in the CFC or also grant deduction for the taxes paid by the CFC in other Member State where company has direct control in the CFC. Therefore, when a Holding company is established in one Member State with participation in the company of the other Member State that in turn has shares in the CFC, double economic taxation will occur. This is because Member State of the Holding will only deduct taxes paid by the CFC in the CFC jurisdiction and not taxes paid in the Member State of direct holding.

From the legal point of view CFC satisfies the principle of freedom of establishment. This is due to the fact that CFC rule does comply with the Cadbury Schweppes decision by establishing mandatory economic substance test in order for the company to classify as a CFC. In this way, it is not possible to determine whether the company located in the specific Member State classifies as a CFC purely based on the tax rate as substantial economic activity test is essential. On the other hand, CFC rules adopted in the ATAD apply both domestically and cross-border. As presented in this thesis, there are no reasons why the CFC regime should apply in the domestic situation as effective tax rates in the same Member State will be always similar. Therefore, the only explanation why CFC applies both domestically and cross-border is that it makes it impossible for ECJ to challenge based on the discrimination of the place of establishment freedom. This issue is addressed by the AD General Geelhoed in Thin Cap, who specified that it is unfortunate that such inclusion of tax law for domestic situations is made solely on the basis to escape possibility of the abuse of the law. Nonetheless, as long as the scope of the tax law is the same for the domestic and cross-border situations it is in line with the EU fundamental freedom of establishment.

Based on the facts presented above it is reasonable to conclude that interest limitation and CFC rules adopted in the ATAD are not efficient enough to tackle the problem of BEPS. From the economic perspective, CFC rule does in fact limit BEPS, however, the CFC rule implemented in the ATAD results in the economic double taxation. Overall, the CFC regime will lead to capital flight to the low-taxed EU Member States in order to venture into FDIs without being covered by the CFC rule. Such treatment is unfair to the comparable taxpayers located in different Member States as it distorts internal market. Interest limitation only slightly increases limitation of BEPS and can result in different levels of BEPS limitation based on how Member States implement the “may” clauses which can misbalance the system. Comparable taxpayers will be treated differently on the internal market based on how their Member State implemented the interest limitation clauses. Additionally, interest limitation rule seems to target more SMEs than MNEs.

From the legal point of view, interest limitation rule abandons Arm’s length principle and ability to provide counter evidence which is contrary to the established ECJ case law. Since its economic
rationale is disproportionate to achieve BEPS limitation and its legal design is contrary to the established precedents, the ECJ could challenge the interest limitation clause based on the grounds that it is manifestly disproportionate to achieve its aim. CFC rule, on the other hand, is in conformity with the freedom of establishment, as required by Cadbury-Schweppes decision, although this is created artificially in order to escape possible infringement of the fundamental freedom of establishment.
Annex

<table>
<thead>
<tr>
<th></th>
<th>Affected Companies</th>
<th>Unaffected Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>55.7%</td>
<td>44.3%</td>
</tr>
<tr>
<td>Turnover ≥ 5 Billion €</td>
<td>67.5%</td>
<td>32.5%</td>
</tr>
<tr>
<td>EURO STOXX 50</td>
<td>57.1%</td>
<td>42.9%</td>
</tr>
<tr>
<td>DOW JINDUS</td>
<td>48.0%</td>
<td>52.0%</td>
</tr>
<tr>
<td>SDAX</td>
<td>66.7%</td>
<td>33.3%</td>
</tr>
<tr>
<td>MDAX</td>
<td>59.3%</td>
<td>40.7%</td>
</tr>
<tr>
<td>DAX</td>
<td>14.3%</td>
<td>85.6%</td>
</tr>
</tbody>
</table>

Interest expense exceeds 30% of EBITDA\textsuperscript{125}

**Table B.3 Tabulations for multinational and non-multinational companies, excluding companies with negative EBITDA, average for 2009-2013**

Percentage of companies that would in principle be able to deduct an amount equivalent to their net third party interest expense

<table>
<thead>
<tr>
<th>Percent of EBITDA limit on net interest deductibility</th>
<th>Average 2009-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Non-MNC</td>
</tr>
<tr>
<td>5%</td>
<td>43%</td>
</tr>
<tr>
<td>10%</td>
<td>55%</td>
</tr>
<tr>
<td>15%</td>
<td>65%</td>
</tr>
<tr>
<td>20%</td>
<td>72%</td>
</tr>
<tr>
<td>25%</td>
<td>77%</td>
</tr>
<tr>
<td>30%</td>
<td>81%</td>
</tr>
<tr>
<td>35%</td>
<td>84%</td>
</tr>
<tr>
<td>40%</td>
<td>87%</td>
</tr>
<tr>
<td>45%</td>
<td>89%</td>
</tr>
<tr>
<td>50%</td>
<td>91%</td>
</tr>
<tr>
<td>55%</td>
<td>92%</td>
</tr>
<tr>
<td>60%</td>
<td>93%</td>
</tr>
<tr>
<td>65%</td>
<td>94%</td>
</tr>
<tr>
<td>70%</td>
<td>94%</td>
</tr>
<tr>
<td>75%</td>
<td>95%</td>
</tr>
<tr>
<td>80%</td>
<td>95%</td>
</tr>
<tr>
<td>85%</td>
<td>96%</td>
</tr>
<tr>
<td>90%</td>
<td>96%</td>
</tr>
<tr>
<td>95%</td>
<td>96%</td>
</tr>
<tr>
<td>100%</td>
<td>97%</td>
</tr>
</tbody>
</table>

Source: OECD Secretariat calculations based on data in Table B.1.

\textsuperscript{125} Prof. Dr Norbert Herzig, Dr Uwe Lochmann and Dipl.-Kfm. Bernhard Liekenbrock, ‘Impact Study of the New German Interest Capping Rule’ [2008] INTERTAX, Volume 36, Issue 12.
### Earnings (EBITDA)

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings (EBITDA)</td>
<td>15 Million</td>
<td>50 Million</td>
<td>50 Million</td>
<td>115 Million</td>
</tr>
</tbody>
</table>

### Net third party interest income/(expense)

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>(30 Million)</td>
<td>-</td>
<td>8 Million</td>
<td>(22 Million)</td>
<td></td>
</tr>
</tbody>
</table>

### Calculation of the Group Ratio: (Group Net third party interest/ Group EBITDA)

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>22 Million/115 Million = 0.19</td>
</tr>
</tbody>
</table>

### Group Ratio x Entity EBITDA

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.19 x 15 Million = 2.8 Million</td>
<td>0.19 x 50 Million = 9.56</td>
<td>0.19 x 50 Million = 9.56</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Net interest income/(expense)

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>29-30 = (1 Million)</td>
<td>23-29 = (6 Million)</td>
<td>23 - 8 = (15 Million)</td>
<td>(22 Million)</td>
<td></td>
</tr>
</tbody>
</table>

### Interest cap

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2.8 Million)</td>
<td>(9.56 Million)</td>
<td>(9.56 Million)</td>
<td></td>
</tr>
</tbody>
</table>

### Non Deductible interest expense

<table>
<thead>
<tr>
<th></th>
<th>A Co</th>
<th>B Co</th>
<th>C Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(5.44 Million)</td>
</tr>
</tbody>
</table>

---

**Diagram:**

- **A Co**: Earnings: €15 million
- **B Co**: Earnings: €50 million
- **C Co**: Earnings: €50 million
- **Group**: Earnings: €115 million

**Loan and Interest:**
- **Loan** from Bank to A Co: €30 million interest
- **Loan** from Bank to B Co: €29 million interest
- **Loan** from Bank to C Co: €8 million interest
Effective tax rate: 20%

UK Ltd.

55%

Effective tax rate: 25%

Netherlands BV

55%

Effective tax rate: 7%

3rd country X Co.
Reference list

Literature:


Christiana HJI Panayi, Advanced Issues in International and European Tax Law pp. 74

Claus-Peter Knöller, 'The Efficacy of Thin Capitalization Rules and Their Barriers: An Analysis from the UK and German Perspective' [2011] INTERTAX, Volume 39, Issue 6/7


Dirk Schindler, Andreas Haufler, Mohammed Mardan, , 'Double tax discrimination to attract FDI and fight profit shifting: The role of CFC rules' [January 06, 2017] Norwegian School of Economics


Martin Ruf, Alfonso J. Weichenrieder, 'CFC legislation, passive assets and the impact of the ECJ’s Cadbury- Schweppes decision' [November 2013] Oxford University, Centre of Business Taxation


P. Craig and G. de Búrca, EU Law, Text, Cases and Materials (3rd edn., 2003)

Paula Benéitez Régil, BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out? IBFD EUROPEAN TAXATION

Prof. Dr Norbert Herzig, Dr Uwe Lochmann and Dipl.-Kfm. Bernhard Liekenbrock, 'Impact Study of the New German Interest Capping Rule' [2008] INTERTAX, Volume 36, Issue 12


Stefan Homburg, 'Fiscal Policy in Action Germany’s Company Tax Reform Act of 2008' [15 November 2007]

Steffen Lampert, Till Meickmann and Maria Reinert, 'Article 4 of the EU Anti Tax Avoidance Directive in Light of the Questionable Constitutionality of the German “Interest Barrier” Rule' [August 2016] IBFD EUROPEAN TAXATION


Wamser, Essays on Behavioral Responses of Multinational Enterprises to International Taxation Munich: University of Munich, Department of Economics (2008)

Case law:

Case C-201/05 Test Claimants in the CFC and Dividend Group Litigation [2008] I-02875

Case C-105/07 Lammers & Van Cleeff ECR [2008] I-00173

Case C-168/01 Bosal Holding BV v. Staatssecretaris van Financiën [2003] ECR I-9409

Case C-196/04 Cadbury Schweppes [2006] I-07995

Case C-292/94 Denkavit and Others, ECR 1996, I-05063

Case C-282/12 Itelcar [2012] ECLI:EU:C:2013:629

Case C-324/00 Lankhorst-Hohorst [2002] I-11779

Case C-337/08 X Holding BV. v. Staatssecretaris van Financiën [2010] I-01215


Case C-524/04 Thin Cap [2007] ECR I-02107

Case Case C-28/95 Leur-Bloem, [1997] ECR I-4161

Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue, para. 68, ECJ Case Law IBFD.
Other sources:

Allenover, 'Interest deductions and other financial payments' [31 October 2015] TaxJournal


COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.


German Constitution (Grundgesetz) 1949. Art 3(1)

German income tax act, section 4h(1)


OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report,


OECD, Action Plan on Base Erosion and Profit Shifting (2013), International Organizations’ Documentation IBFD.

OECD, OECD/G20 Base Erosion and Profit Shifting Project Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Final Report)

OECD/G20 Base Erosion and Profit Shifting Project

Since the Citizens' Relief Act of 2009 and the Growth Acceleration

Treaty on European Union

Wachstumsbeschleunigungsgesetz (‘Economic Growth Acceleration Act’), BGBl I 2009, 3950