How to implement the EU Anti-Tax Avoidance Directive : Part I

*By Oliver R. HOOR and Keith O'DONNELL, Atoz**

On 20 June 2016, the EU Anti-Tax Avoidance Directive[1] ("ATAD") has been adopted at EU level. The ATAD provides for anti-tax avoidance rules in five specific fields which are meant to be implemented by each EU Member State ("MS"). On 29 May 2017, the EU Council formally adopted a compromise proposal for an EU Directive amending the ATAD (the so-called "ATAD 2").[2] While the ATAD included already measures dealing with hybrid mismatches in an EU context, ATAD 2 replaces the rules on hybrid mismatches and extends their scope to transactions involving third countries. This is the first of two articles which provide an overview of the main provisions of the Directive and consider how Luxembourg should implement the latter.

Introduction

The aim of the ATAD and ATAD 2 is to implement at EU level the recommendations regarding Base Erosion and Profit Shifting ("BEPS") made by the OECD and G20 in October 2015. Both Directives cover all taxpayers which are subject to corporate tax in an EU MS as well as EU Permanent Establishments ("PEs") of taxpayers which are not as such in the scope of the Directive.

The ATAD lays down anti-tax avoidance rules in the following fields:
- Deductibility of interest;
- Exit taxation;
- General anti-abuse rule (GAAR);
- Controlled foreign company (CFC) rules and
- Hybrid mismatches in an EU context.

In addition, ATAD 2 replaces the hybrid mismatch rules introduced by ATAD and extends their scope to transactions involving third countries. The measures provided in the Directives are presented as minimum standards whereas certain of these rules are mere recommendations or best practices in the BEPS framework. It follows that the proposed measures go way beyond the BEPS recommendations.

Although the concerns expressed by the European Commission to fight against tax avoidance in a coordinated manner are understandable, the ATAD and ATAD 2 raise serious concerns in that they further dilute national sovereignty in tax matters and, by "goldplating" the BEPS recommendations, will make the EU a less attractive environment to do business. However, given that MS have a certain leeway when implementing the ATAD, it is essential that Luxembourg makes the right choices so as to remain attractive to international businesses and investors.

Limitation to the deductibility of interest payments

The first measure follows recommendations on BEPS Action 4 (Interest deductions and other financial payments) and aims to discourage multinational groups to reduce the overall tax base of the group by financing group entities in high-tax jurisdictions through debt[3]. Here, ATAD provides for a fixed ratio rule as the general rule and a group-wide rule as a carve-out from the general rule.

More precisely, subject to certain conditions and limitations, exceeding borrowing costs[4] shall be deductible only up to 30% of the tax payers' earnings before interest, tax and amortization (EBITDA) (fixed ratio rule) or up to an amount of EUR 3 mio (safe harbour), whichever is higher.[5] However, the ATAD states that MS may also choose to introduce stricter rules. Financial institutions as well as insurance undertakings may be excluded from these limitations.[6] Standalone entities[7] are able to fully deduct their exceeding borrowing costs, meaning that they are also not subject to these limitations.

Taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group can (under certain conditions) fully deduct their excess borrowing costs (group-wide rule).[8] However, the application of a group-wide rule is an extremely complex exercise and entails many difficult measurement issues given the significant differences in tax and accounting principles applicable in different countries. Even the mere definition of interest may vary from one country to another. This would mean that MNEs will have to determine relevant figures for each group company and make adjustments to account for differences in the accounting and tax treatment.[9]

All this elevates the compliance burden and related costs to an unprecedented level when the group-wide rule should be applied. Furthermore, current year tax payments become more problematic and unpredictable due to groups not knowing their interest deductions until a considerable time after reporting their annual results to the market when their worldwide financial statements become available. Nevertheless, the group-wide rule does not only present an enormous administrative burden to taxpayers. Rather, taxpayers and tax authorities alike will have to bind substantial resources to administer such an intricate rule.

Carry forward provisions are available in case the interest deduction or EBITDA is not fully used.[10] However, the provisions provided in the ATAD provide for 3 alternative restrictions as to how MS may adopt carry forward (and carry back) mechanisms. Given that such measures merely avoid double taxation, it is not self-evident why such restrictions have been included in the Directive.

When interest expenses are not deductible, double taxation will likely arise as the lender should be taxable on the corresponding income. Even the proposed carry-forward mechanisms would not eliminate the problem of double taxation as companies may never be in a position to use the amounts carried forward. This can be a real problem for companies in financial difficulty as it may require them to pay corporate tax on non-existent profits, adding to their financial difficulty.

Moreover, how a business finances its operations is an important business decision that depends on a range of factors. While the deductibility of interest expenses is one factor to be considered, the decision as to whether a company should be financed by equity or debt is generally not tax driven and there are a number of good commercial reasons why intra-group loans can be preferable to a contribution of equity (legal requirements, regulatory constraints, foreign currency implications, business considerations, etc.).

As regards timing, the Directive provides that MS should implement the rule by 1 January 2019. Nevertheless, MS which have national targeted rules for preventing base erosion and profit shifting which are equally effective to the interest limitation rule set out in the ATAD may implement this provision at the latest until 1 January 2024.

Luxembourg tax law provides already for a number of targeted rules that limit the deductibility of interest payments. For example, the 85:15 debt-to-equity ratio applicable to holding activities and the financing of real estate situated in Luxembourg (which is based on administrative practice).

According to this rule, participations and Luxembourg real estate may be financed with a maximum of 85% of shareholder loans bearing interest at arm's length.[11] Furthermore, interest expenses incurred in relation to tax exempt income is not deductible.[12] Likewise, interest expenses that exceed the arm's length interest rate are not deductible.[13] As such, the existing limitations to the deductibility of interest expenses should suffice to avoid situations of abuses.

Luxembourg companies performing financing activities should, however, not be impacted by the limitation since it is only the part of the borrowing costs which exceeds interest or other taxable revenues from financial assets which will be subject to the limitation.[14] Therefore, these companies will still be taxable on an arm's length margin.

The fact that these rules are not minimum standards at global level means that many non-EU countries will decide not to implement them. This puts the EU, including Luxembourg, at a competitive disadvantage and does not contribute to the creation of a "level playing field".

The implementation of the proposed limitation to the deductibility of interest by Luxembourg might be harmful to the country's position as a location of choice for the structuring of cross-border investments in and through Europe. In this regard, it will also be important to monitor how other European MS will implement this rule.

It is interesting to note that on 14 October 2015, the German Federal Tax Court ("*Bundesfinanzhof*") decided on the German earning stripping rules which are fairly similar to the rule in the Directive.[15] In this case law, the German Federal Tax Court concludes that the German earning stripping rules are not in line with the German constitution as it violates fundamental tax principles, in particular, the principle that expenses incurred in relation to taxable income should be tax deductible ("*objektives Nettoprinzip*") and the ability to pay principle ("*Leistungsfähigkeitsprinzip*"). The German Federal Tax Court explicitly mentioned that these violations cannot be justified with the argument that a rule should avoid abuse.

Since the Luxembourg legal and tax system are based on the same fundamental principles as the German system, it is likely that the proposed earning stripping rule would raise similar concerns in Luxembourg. Nonetheless, one will need to wait for the final decision of the German Constitutional Court before being able to draw a conclusion for Luxembourg.

In order to remain competitive within the EU, Luxembourg should adopt all options provided by ATAD to not unnecessarily extent the scope of the interest limitation rule:
- Excluding financial undertakings, including among others credit institutions or investment firms, alternative investment funds within the meaning of the AIFM Directive, UCITS, insurance companies and reinsurance companies and clarify which Luxembourg vehicles (e.g. SICAR, RAIF) fall under these definitions and thus are not subject to the limitation;
- Excluding loans used to fund a long-term public infrastructure project where the project operator, borrowing costs, assets and income are all in the Union;
- Excluding loans which were concluded before 17 June 2016.

When defining what is to be considered as income equivalent to interest income, Luxembourg will have to make sure that the definition is not too restrictive, mirroring the broad definition of borrowing costs.

Luxembourg will further have to select a carry forward rule. Here, alternative 3 providing for a carry forward of exceeding borrowing costs (without limitation in time) and a carry forward of unused interest capacity (for a maximum of 5 years) should be most beneficial for Luxembourg taxpayers and the easier to manage than the other alternatives.

Finally, as regards timing, the Luxembourg legislator should investigate the possibility to implement this rule only as from 1 January 2024 given the number of targeted rules under Luxembourg tax law limiting the deductibility of interest expenses.

General Anti-Abuse Rule (GAAR)

The ATAD further introduces a GAAR which would allow the tax authorities of a MS to deny taxpayers the benefit of arrangements considered as abusive.[16] The explanatory memorandum to the provision states expressly that the proposed GAAR is designed to reflect the artificiality test of the ECJ. Under the Directive, non-genuine arrangements carried out for the essential purpose of obtaining a tax advantage shall be disregarded, non-genuine meaning that they are not put into place for valid economic reasons which reflect economic reality.[17] In case arrangements are disregarded in application of this rule, the tax liability shall be calculated in line with internal law.[18]

The GAAR provides for several subjective concepts which create some legal uncertainty as they may give rise to many different interpretations. It would have been desirable that the EU Commission remains consistent with the concepts already defined in ECJ case law instead of proposing new concepts of vague character which create additional legal uncertainty for taxpayers but also for tax administrations when they have to apply them in practice.

The GAAR is fairly similar to the abuse of law provision provided under Luxembourg tax law(19) that enables the Luxembourg tax authorities to challenge transactions whose purpose is to evade taxes through abusive constructions. However, the GAAR only applies to corporate taxpayers, not to individuals or other taxes such as Value Added Tax.

Hence, overall the scope of the existing Luxembourg rule is much broader than the GAAR under ATAD, providing the Luxembourg tax authorities with far reaching capabilities to challenge artificial arrangements. It follows that no tax law changes should be required in this respect. Moreover, it does not seem advisable to implement multiple layers of anti-abuse provisions that are meant to address the same topics.

In any case, the scope of both the domestic abuse of law provision and the GAAR should be limited to clearly abusive situations or wholly artificial arrangements (in accordance with relevant Luxembourg jurisprudence and ECJ case law).

Conclusion

The provisions provided in ATAD and ATAD 2 will have to be implemented into Luxembourg tax law. From a timing perspective, the first measures should come into force as early as 1 January 2019.

The implementation of the different provisions into the existing framework of Luxembourg tax law will be an intricate exercise in view of the interdependencies between different tax rules and concepts. For example, the design of the interest limitation rules needs to consider the rules on the carry-forward of tax losses and the recapture mechanism in relation to participations qualifying for the Luxembourg participation exemption regime in order to avoid collateral damages resulting from an inconsistent set of rules.

Ultimately, the Luxembourg legislator has to make the right choices where the Directive leaves EU MS some leeway and options so as to remain competitive in the post-BEPS environment.

** Oliver R. HOOR is a Tax Partner (Head of Transfer Pricing and the German Desk), Keith O'DONNELL is the Managing Partner with ATOZ Tax Advisers (Taxand Luxembourg).*

The authors wish to thank Samantha SCHMITZ-MERLE for her assistance.

The authors may be contacted at:
oliver.hoor@atoz.lu
keith.odonnell@atoz.lu

www.atoz.lu

1) Council Directive (EU) 2016/1164 of 12 July 2016.
2) Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries
3) See: http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm
4) That is the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law
5) Article 4 (3) of the Directive.
6) Article 4 (7) of the Directive.
7) That is a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment.
8) Article 4 (5) of the Directive.
9) Since 2007, German tax law provides for earning stripping rules that are broadly similar to the recommendations of the OECD. In practice, the escape clause can hardly ever be successfully applied.
10) Article 4 (6) of the Directive.
11) In accordance with administrative practice, however, Luxembourg companies are, depending on the financing instruments used, free to finance participations with higher portions of debt. For example, interest-free loans are treated as equity for the debt/equity ratio and may replace a large part of the 15% equity portion.
12) Article 45 (2) of the Luxembourg Income Tax Law (LITL), Article 166 (5) No. 2 of the LITL.
13) Article 164 (3) of the LITL.
14) Article 4 (1) of the Directive.
15) See Bundesfinanzhof (BFH), Decision of 14.10.2015, I R 20/15.
16) Article 6 (1) of the Directive.
17) Article 6 (2) of the Directive.
18) Article 6 (3) of the Directive.
19) Section 6 of the Steueranpassungsgesetz.