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Interest Deductibility and the BEPS Action Plan: *nihil novi sub sole*?

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Abstract

Interest payments between affiliated companies which aim at shifting profit from high to low tax countries are a well-known and frequently used tool in international tax planning. It is therefore not surprising that in the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) (Action Plan) considerable attention is given to the measures limiting the deductibility of (excessive) intra-group interest payments.¹ The Action Plan does not, however, provide any clear guidance as to which, among the domestic anti-abuse measures existing in OECD or non-OECD member countries, should be recommended. Moreover, the OECD, by sticking to the arm’s length standard, refuses to consider more radical corporate tax reforms that could put an end to tax arbitrage opportunities created by cross-borders intra-group interest payments. From the EU perspective one may observe some interesting convergences between the OECD initiatives and the new measures that are presently being discussed in the European Commission and the Council.

I. Excessive interest deduction in a globalised world, a serious concern for high-tax countries

Deduction of interest expenses lies at the core of (aggressive) international tax planning. It is, therefore, not surprising that the OECD Action Plan addresses this phenomenon both specifically and in connection with other BEPS issues, such as hybrid mismatch arrangements, controlled foreign company (CFC) rules and “treaty shopping”. The rules governing interest deductibility at the international (including European) and domestic levels are indeed frequently diverted from their original purpose of ensuring a taxation of the net profit and avoiding double economic taxation of the same income in the hands of the lender and the borrower, to be used in schemes resulting in double or multiple deduction or non-taxation.

International debt shifting is an issue which is well known to governments and has been broadly discussed in the academic literature for decades.² In this context the multinational enterprises (MNEs) tend to exploit those discrepancies which exist in the national tax systems


as regards general tax rates and the preferential tax rules which apply to interest. The MNEs, by comparison with purely domestic groups of companies, tend to finance those affiliates which are resident in high tax countries by using excessive external debt, while affiliates which are resident in low tax jurisdictions are usually financed with equity. As a consequence, deductible interest payments are used to reduce significantly the taxable profits in high-tax countries and the resulting tax savings then greatly exceed the increased tax liability in low-tax jurisdictions. This is one (if not the major) reason why multinational groups locate the internal banks or other financial companies of the group in tax havens and finance the operating affiliates through intra-company loans and other financial instruments from such havens.

II. The Action Plan in the light of past and recent OECD Initiatives as regards interest deduction

As a consequence of those tax-saving practices undertaken by the MNEs, the Action Plan places under the fourth action the need to “limit base erosion via interest deductions and other financial payments”. This is in line with the BEPS Report, Addressing Base Erosion and Profit Shifting (BEPS Report), which pointed out that “leveraging high-tax group companies with intra-group debt is a very simple and straightforward way to achieve tax savings at group level.”

It has been said that the Action Plan has the merit of putting all the issues related to (aggressive) international tax planning into one document. However, with regard to the specific issue of interest deductibility, the Action Plan does not introduce any new elements of significance apart from those already discussed in the OECD’s previous initiatives in this area. In the 1979 Report on Transfer Pricing and Multinational Enterprises (the 1979 Report) the OECD, albeit briefly, addressed the issue of domestic anti-abuse rules applicable to interest payments, warning against the adoption of a “hard and fast debt equity rule” or of rules applicable only to the residents. This was consistent with paragraph 6 of Article 11 of the OECD Model Tax Convention on Income and on Capital (the 1977 OECD Model Convention), which provides for a possibility for contracting states to refuse to apply Article 11 to excessive (non arm’s length) interests. In 1986 the OECD Council adopted the Committee’s Report on Thin Capitalisation (Thin Capitalisation Report) which focused on the excessive use of loan financing. By comparison

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3 Ruf and Schindler, above fn.2, 2.
8 See OECD, Transfer Pricing and Multinational Enterprises (1979), paras 183–191.
9 The 1979 Report, above fn.8, para.188.
with the BEPS Report, the Thin Capitalisation Report focuses on the compatibility of domestic anti-avoidance rules (thin capitalisation) with the tax treaties based on the 1977 OECD Model Convention. The Thin Capitalisation Report did not take any firm position on the way in which thin capitalisation problems should be addressed, but emphasised that the application of those domestic rules should occur in accordance with the arm’s length principle. Moreover, in the 1979 Report, the OECD’s major preoccupation seemed to be the risk of economic double taxation resulting from the application of domestic thin capitalisation rules and states were encouraged to grant relief in case of recharacterisation of those payments by the country of source or to resolve conflicts of qualification as to the nature of the payments by mutual agreement.

Moreover, profit shifting through interest payment is reinforced by the growing diversity of the financial instruments and vehicles used within multinational groups to channel investments between affiliates. Therefore, Action 4 is intimately linked with the problem of the characterisation of those instruments, the income derived therefrom and to the tax treatment of the borrower, that is, whether the borrower is to be treated as a transparent or non-transparent entity. Indeed, in some cases the tax savings are directly generated by the difference in characterisation of the income in source and residence states or by the fact that the borrowing entity is considered as non-transparent in one country, which allows the deduction of interest from the corporate tax base, and transparent in the other country, which allows the deduction of the interest expenses in the hands of the company holding the equity interest in the entity. Thus, interest deductibility is closely connected with the problems caused by hybrid arrangements (addressed by Action Number 2 in the Action Plan), which had been the object of a special OECD report in 2012.

Apart from the specific problem of hybrid arrangements, the issue of characterisation of an item of income as either interest or dividend has always caused a headache for tax administrators and practitioners. Quite recently, the tax distinction between debt and equity was even referred to as a “conundrum”. The reason is probably because, from a business perspective, the risks and rewards linked to an investment in a company are a matter of degree and do not fit in a bipolar distinction. Therefore, drawing the line between what is to be considered equity and what is to be considered debt is always arbitrary. Thus, each country, with the interpretational tools inherited from its legal tradition, has developed its own understanding of these concepts. Anyone who, at the supranational level, would defend the superiority of one national approach over another would be very ill-advised to do so. The difficulty inherent in defining interest precisely could explain why Action 4 is also extended to the “other financial payments that are economically equivalent to interest payments.”

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12 BEPS Report, above fn.6.
14 Such situations occur, where e.g. a source state treats certain income as interest, which is deductible from the corporate base, and a residence state treats the same income as dividends, which is exempt from corporate income tax.
16 Hybrid Mismatch Arrangements, above fn.15.
III. Existing domestic anti-avoidance measures limiting interest deductibility: does the OECD have preferences?

The first phase of Action 4 is concerned with developing recommendations on best practices in the design of anti-avoidance rules.\(^{19}\) It is to be noted that many states have already enacted various measures to limit profit shifting through payments of deductible interests to foreign companies, generally belonging to the same multinational group as the domestic borrowing company.\(^{20}\) Although these measures are generally broadly referred to as “thin capitalization rules”, they are very diverse as to their nature and their effects.\(^{21}\) Even though all these regimes have a common goal of limiting the amount of deductible interest and therefore protecting the taxable base of the borrower, the legal instruments used to achieve this result vary greatly among countries as do the consequences of these measures on the non-tax areas, such as civil and company law. Moreover, the territorial scope of these measures is not uniform. Whereas some countries limit the application of the thin capitalisation rules to the interest payments made to the creditors resident in low tax countries, others apply them only to the payments to non-resident companies in general. A third group of countries, as a consequence of domestic or supra-national non-discrimination obligations, apply thin capitalisation rules to the interest payments made in both the domestic and cross-border contexts. In the latter case, the underlying rationale of thin capitalisation rules—to counter international profit shifting—departs from its origins.\(^{22}\)

As to the legal consequences of dealing with the excessive interest, the thin capitalisation rules may be divided into the following three categories:

1. regimes limiting the amount of deductible interest without re-characterisation;
2. regimes reclassifying the payment in another category of income (generally dividends);
3. regimes reclassifying the debt instrument according to the economic substance.\(^{23}\)

In addition, a wide range of methods are used to calculate the threshold level at which interests are deemed to be excessive and, as a consequence, not deductible. Such a threshold may apply to the amount of principal on which interest payments may be made or directly to the amount of the interest payment itself by taking into account other variables, such as fixed amount threshold or in proportion to the company’s operating profit.

The allowable debt in intra-group situations may be determined by reference to the amount of loan which would be provided by the independent party in a comparable situation. Such an approach is referred to as the arm’s length approach. It does not necessarily require the enactment of specific provisions relating to interest payments since it falls most of the time within the scope of general transfer pricing rules. Transfer pricing rules are limited to intra-company dealings and necessitate appropriate benchmarks, which are not always easy to find, especially when it

\(^{19}\) Action Plan, above fn.1, 37.
\(^{20}\) Therefore, there is a close connection between anti-abuse rules concerning excessive interests and CFC rules. Action Plan, above fn.1, 17, 31.
\(^{21}\) For an overview see Arnold; Pilitz; and Dorado and de la Feria, above fn.2.
\(^{22}\) With the exception of the cases where domestic tax law provides for preferential regimes.
\(^{23}\) This classification has been borrowed from the following article: T. van Dongen, “Thin Capitalization Legislation and the EU Corporate Tax Directives” (2012) 52 European Taxation 20.
concerns financial instruments. Moreover, such an approach requires that tax auditors have significant expertise in company financing practices and grants them a wide margin in the exercise of their judgement, which may in turn undermine legal certainty for taxpayers.

Several countries have adopted a fixed ratio (generally the ratio of debt to equity) or a variable ratio, for example of the borrowing capacity of the concerned entity to the worldwide borrowing capacity of the group to which it belongs. The most common fixed ratio adopted worldwide seems to be 3:1. However, such a standard does not seem to be based on any economic rationale, notably because, being general, the standard does not take into consideration the differences in debt capacities between different types of companies. Sometimes, these ratios are used as “safe harbor” when an arm’s length approach is chosen.

Another approach to thin capitalisation consists of putting a cap on the total amount of deductible interest, for example in France, or more commonly allowing the deduction of interest up to a threshold which is determined as a proportion of the company’s income. Such a method is commonly known as either the “earnings stripping” or the “interest barrier” rule. The US was among the first to introduce this type of rule, although with a rather limited scope, in the late 1980s. More recently, as a consequence of the decisions of the Court of Justice of the European Union (CJEU), several European countries have adopted this system, first Germany (2008), followed by Italy (2008), Spain (2012), Portugal (2013) and Finland (2014). All these countries apply a limit to interest deductibility equal to 30 per cent of the company’s EBITDA. Any interest exceeding this threshold is not deductible from the tax base. It is possible to carry forward excess interest and deduct it in the following year, provided that the limit is not exceeded. Depending on the country, specific limitations are applicable, such as, for example, a de minimis threshold (€3 million in Germany, €1 million in Spain, €500 000 in Finland).

Lastly, some countries have introduced a limitation which applies to specific transactions only. This is, for example, the case with Spain, which does not allow the deductibility of interest on loans provided by a company belonging to the same group in order either to acquire, from a member of the same group, a participation in another entity, or to make a capital contribution.

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24 For a more detailed overview see “The Debt-Equity Conundrum”, above fn.17, Brown, General Reporter at the IFA Congress, 36. There are notable exceptions, such as, for example, France which applies a 1.5:1 ratio, or Belgium applying 5:1 ratio, which was previously 7:1 ratio.
26 Taxpayers with debt below the threshold have the legal certainty that interest will be deductible, but in the event of their exceeding the threshold, it would be possible to justify the debt ratio on the basis of the arm’s length character of the transaction and still be allowed full deductibility of the interest.
28 Some authors, however, do not share the view that the earnings stripping rules are thin capitalisation rules (see, e.g. Dourado and de la Feria, above fn.2).
29 EBITDA stands for earnings before interest, taxes, depreciations and amortization.
to a member of the group. Another example is France, which disallows the deductibility of financial expenses incurred for the acquisition of participations, when there is no autonomous decision making centre located in France.

Each of these types of domestic rules which limit interest deduction in the international context raises specific issues as to their compatibility with the existing double taxation conventions and, in particular, with the provisions contained in Articles 9, 10, 11, 23, 24 and 25 of the 1977 OECD Model Convention. This problem has been extensively discussed within the OECD and in the academic literature. Since the OECD has committed itself in its Action Plan to continue to follow the international standards it has contributed to setting up, it is unlikely that the Action Plan would result in changes in its position in favour of thin capitalisation rules, in particular as to the requirement that such rules be compatible with the arm’s-length principle.

Moreover, other mechanisms are also used both in domestic law and in double taxation treaties to counter such avoidance schemes. For example, the beneficial ownership doctrine may be relied upon to deny the exemption from withholding tax in the source country. Furthermore, the limitation on benefits clauses may be included in the double tax treaties. Other solutions include the general anti-avoidance rules (GAARs) or specific anti-abuse provisions, such as the denial of the deduction of any payments in cases where such payments are not subject to a minimum level of taxation in the country of the recipient.

The Action Plan does not provide any guidelines concerning the type of measures that the OECD would like to recommend to its members in order to avoid profit shifting through deduction of interest. On the one hand, this is consistent with the approach followed by the Action Plan which consists, first, in the gathering of information among OECD states about their domestic

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33 1977 OECD Model Convention, above fn.10.
34 The 1979 Report, above fn.8; OECD Model Convention, Commentary on Article 11, No.33.
36 Action Plan, above fn.1.
37 There is however an on going debate in the international tax community concerning the content of the concept of beneficial owner and its function as an anti-avoidance measure against conduit companies. See for example M. Lang, et al., *Beneficial Ownership: Recent Trends* (Amsterdam: IBFD, 2013). On the Danish experience, see T. Booker, “Beneficial Ownership, European Taxation” (2013) 53(4) European Taxation 164.
39 See for example Art.10a of the Netherlands Corporate Income Tax Act and Ch.24 ss.10 a-10e §§ of the Swedish Income Tax Law; Art.11(1)(4) of the Austrian Corporate Income Tax Act and Art.54 of the Belgium Income Tax Act. However, the general denial of the deductibility of the payments made to low tax countries has several drawbacks and, most importantly, such rules also catch genuine transactions. Therefore, it is important from a policy perspective to leave to the taxpayer the possibility of justifying the substance of such payments. Moreover such provisions may, if too broadly applied, raise issues of legal certainty as was shown in the SIAT case (Société d’investissement pour l’agriculture tropicale SA (SIAT) v État belge (C-318/10) [2011]) before the CJEU.
40 Action Plan, above fn.1.
experience. On the other hand, considering the great diversity of anti-avoidance rules in this area and the fact that this diversity is a well-known problem that does not need much additional enquiry as to its causes, the Action Plan can be considered as disappointing. There are, however, some indications as to OECD preferences, specifically, its willingness to treat this phenomenon within the more general issue of transfer pricing. The first indication is that in both the BEPS Report and the Action Plan, transfer pricing is presented as the most appropriate answer to most of the base erosion problems faced by the states. The second indication is that the expected output of the second and final phase of Action 4 is a change to the Transfer Pricing Guidelines concerning

“the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements”. 41

In the author’s view, it appears therefore unlikely that, at the end of process, the OECD would recommend the implementation of domestic measures which are too divergent from the arm’s-length principle, such as, for example, the earnings stripping method.

IV. Correcting the debt-equity bias: fundamental corporate tax reforms at the domestic and international level

In addition to the disparities created by the differences in tax rates and, more generally, the tax treatment of corporate income between countries, the main cause of excessive use of tax provisions allowing the deductibility of interest is the difference in tax treatment between returns on loan and equity capital in the hands of capital investors.

Although the economic literature has put in evidence the theoretical and practical (mostly negative) effects of treating debt and equity differently, very few countries have adopted measures to limit the existing bias towards debt financing. Examples of domestic corporate tax system reform in this direction are the introduction of an allowance for corporate equity (ACE), as is the case in Belgium, Italy and Brazil and the movement towards a comprehensive business income tax (CBIT). Although no country has ever implemented a tax based on the CBIT-model, some countries have adopted business taxes which include interest expenses in the tax base. Such countries include Italy (Imposta regionale sulle attività produttive), Michigan (Single Business Tax, abolished in 2008), New Hampshire (business enterprise tax), and, to a lesser extent, the Netherlands with the Interest Box regime (limited to intragroup transactions). 42

41 Action Plan, above fn.1, 17.
Moreover, at the international level, international organisations like the OECD do not seem to be keen on introducing radical reforms as regards the allocation of taxing rights between states organised by bilateral conventions. And in the Action Plan, the OECD expressly stated that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income”. This is confirmed in relation to interest deductibility since the OECD presents as an expected output of Action 4 only changes to the Transfer Pricing Guidelines (planned for December 2015).

It is, however, important to bear in mind that the problem of profit shifting will not be completely solved only by introducing additional anti-abuse rules, whether in domestic legislation or in international tax treaties. It is therefore useful to envisage other alternatives, even if the possibility of their ever becoming reality seems—at least in the present context—remote. This is due both to a lack of political consensus as regards the adoption of such fundamental reforms and to the fact that the reforms have several serious drawbacks that should not be ignored.

The more radical alternative to the present situation is certainly a system which would disregard intra-company dealings for the purpose of allocating the tax base between the countries where multinational groups of companies are active. This would imply consolidation of profits and losses on a supranational basis (regional, that is European, or worldwide) and the apportionment of the overall taxable profit according to predetermined criteria. This alternative is however explicitly rejected in the OECD Action Plan, on the grounds that

“… there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioral changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach.”

Regardless of the OECD position, other international organisations show more interest in formulary apportionment. The adoption at the EU level of a Common Consolidated Corporate Tax Base (CCCTB), as proposed by the European Commission in 2011, could put an end to arbitrage possibilities provided by the interest deductibility in intra-group situations, at least among the EU Member States. Under this proposal it would indeed not be possible to shift profits to affiliates located in low tax countries, because intra-company dealings would be disregarded for the computation of the consolidated taxable base, which would be apportioned among the companies of the group according to a three-factor formula based on assets, labour and sales figures. Interest deductibility would still be an issue for payments to non-EU countries.


43 Action Plan, above fn.1, 11.
44 Action Plan, above fn.1, 37.
45 Action Plan, above fn.1, 14.
Nevertheless, the CCCTB proposal, although extensively discussed at the EU level and strongly supported by the business community, is very unlikely to be adopted, at least in its present state, because of very strong opposition from some Member States, including the UK. An enhanced co-operation, following the precedent of the financial transaction tax, would appear to be the only option to enable this initiative to come into being. Moreover, even from the perspective of the Member States which do in principle agree with the concept proposed by the European Commission, there are still considerable technical issues to be resolved in relation to the determination of the common taxable base, consolidation, apportionment, international issues and anti-avoidance rules.  

V. The impact of the OECD Action Plan in the EU context

Apart from the CCCTB project, EU law already influences the issue of interest deductibility. The EU Member States are in principle free to determine the conditions under which interest is considered to be deductible for the purposes of income tax. The fact, however, that interest deductibility and taxation rules are not harmonised at the EU level, does not mean that Member States do not undergo constraints under primary and secondary EU Law.

The interaction between national and EU Law is most likely to be observed in the following four areas:

1. When designing rules limiting interest deductibility, Member States must test the compatibility of these rules with the fundamental freedoms laid down in the Treaty on the Functioning of the European Union.

2. Tax planning structures which exploit favourable domestic tax rules within Member States, especially provisions which relate to the characterisation of interest and dividends, could be scrutinised within the scope of work conducted by the Code of Conduct Group.

3. The Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (Interest—Royalties Directive) does contain a deductibility requirement for its application to permanent establishments.


4. The State Aid issue may come in to play, if the domestic provisions on interest deductibility are considered to be excessively generous and provide selective advantage to certain taxpayers.\(^{51}\)

At the political level, interest deduction in the framework of aggressive tax planning has so far been mostly treated as a component of harmful tax competition between Member States and has been dealt with within the framework of the 1997 Code of Conduct for Business Taxation and the subsequent Report issued by the Code of Conduct Group to ECOFIN in 1999.\(^{52}\) Abusive interest deduction has been regularly on the agenda of the Group of Representatives of the EU Member States, which was set up to supervise the implementation of the Code of Conduct, in particular, in relation to the hybrid loan arrangements between companies established in different Member States. The diverging characterisation of such instruments in two or more Member States has led often to a double non-taxation situation, in which the payment is considered as (deductible) interest in the country of residence of the payer and as (exempt) dividend in the country of residence of the beneficiary.

Paradoxically, this phenomenon has been accentuated by the CJEU in its case law on the fundamental freedoms, as well as by the Council of the European Union in the EU Interest-Royalties (2003/49/EC) and Parent-Subsidiary (2011/96/EU) Directives. The CJEU has dealt on several occasions with the compatibility of domestic anti-avoidance rules on interest deductibility, for example, thin capitalisation rules with the fundamental freedoms of the Treaty on the Functioning of the European Union (TFEU), in particular the freedom of establishment.

In *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (*Lankhorst-Hohorst*),\(^{53}\) concerning German thin capitalisation rules, the CJEU considered that:

“[The German thin capitalisation provision] applies only to repayments in respect of loan capital which a company limited by shares subject to unlimited taxation has obtained from a shareholder not entitled to corporation tax credit. As regards the taxation of interest paid by subsidiary companies to their parent companies in return for loan capital, such a restriction introduces a difference in treatment between resident subsidiary companies according to whether or not their parent company has its seat in Germany.”

Since the court did not accept any of the justifications put forward by the German Government, the German thin capitalisation regime was considered incompatible with primary EU Law. However, Germany reacted by simply extending the scope of application of this regime to payments made to resident companies\(^{54}\) and from 2008 it has applied the earnings stripping rules.\(^{55}\)

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\(^{51}\) Further analysis of the relationship between domestic interest deductibility rules with the State Aid is outside the scope of this article.


In Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue\textsuperscript{56} the court analysed the compatibility of the UK thin capitalisation regime and although it considered that this regime constituted a restriction to the freedom of establishment, it nevertheless admitted that it was justified on the ground of prevention of abusive practices.

According to the court,

“[The EU freedom of establishment] precludes legislation of a Member State which restricts the ability of a resident company to deduct, for tax purposes, interest on loan finance granted by a direct or indirect parent company which is resident in another Member State or by a company which is resident in another Member State and is controlled by such a parent company, without imposing that restriction on a resident company which has been granted loan finance by a company which is also resident, unless, first, that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question and, secondly, where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm’s length.”\textsuperscript{57}

Therefore, Member States are allowed to restrict the deductibility of interest between associated companies only provided that they set objective criteria which aim at determining whether those payments have, or are likely to have, a tax saving purpose only and that Member States exclude from such a limitation transactions which are concluded at arm’s length. The court further confirmed its position in a later decision concerning the Belgian thin capitalisation rules in an intra-EU context (\textit{NV Lammers & Van Cleeff v Belgische Staat}\textsuperscript{58}). However, in \textit{Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emendingen}\textsuperscript{59} the court excluded the possibility of thin capitalisation rules of the Member State frustrating the freedom of establishment in the situations involving third countries. Recently, the CJEU in \textit{Itelcar—Automóveis de Aluguer Lda v Fazenda Pública}\textsuperscript{60} nevertheless interpreted the free movement of capital (applicable in a third-country context) as precluding a Member State from denying the deduction of interest in the absence of a shareholding relationship between the lending and the borrowing company. As shown above, such case law has led to the repeal of thin capitalisation rules in several EU countries and the replacement of these rules by earnings stripping rules.

\textsuperscript{56} Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue (C-524/04) [2007] ECR I-2107; [2007] STC 906.


\textsuperscript{58} NV Lammers & Van Cleeff v Belgische Staat (C-105/07) [2008] ECR I-173 (European Court of Justice).

\textsuperscript{59} According to the CJEU, the potential restrictive effects of thin capitalisation rules do not affect the free movement of capital (applicable in a third-country context), but “must be seen as an unavoidable consequence of the restriction on freedom of establishment” (Lasertec Gesellschaft für Stanzformen mbH v Finanzamt Emendingen (C-492/04) [2007] ECR I-3775), which only applies between EU Member States.

\textsuperscript{60} Itelcar—Automóveis de Aluguer Lda v Fazenda Pública (C-282/12) [2013] BTC 681.
Double non-taxation of cross-border interests is also favoured by existing EU secondary legislation. Indeed, the Parent-Subsidiary Directive,\(^\text{(61)}\) which applies to the distribution of profits between associated companies located in different Member States, provides for a compulsory relief in the Member State of residence of the parent company, while the EU Interest-Royalty Directive, also applicable between the associated companies of different Member States, prohibits the Member State of the subsidiary from applying a withholding tax on outgoing interest.\(^\text{(62)}\)

The Interest-Royalty Directive is silent however as far as the specific issue of interest deductibility is concerned, except in the case of permanent establishments. According to the text of the Interest-Royalty Directive, it applies only to the payment made by a permanent establishment

“only insofar as those payments represent a tax-deductible expense for the permanent establishment in the Member State in which it is situated”.\(^\text{(63)}\)

In addition, in Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Süd\(^\text{(64)}\) the CJEU expressly rejected that interest deductibility could fall within the scope of the Directive on the ground of a teleological or contextual interpretation. According to the court:

“It follows that Article 1(1) of Directive 2003/49, read in the light of recitals 2 to 4 in the preamble to the directive, aims to avoid legal double taxation of cross-border payments of interest by prohibiting the taxation of interest in the source Member State to the detriment of the actual beneficial owner. That provision thus concerns solely the tax position of the interest creditor.”

Therefore, the Directive cannot be applied ultra vires to domestic rules governing the position of the interest debtor.

However, since deductibility of a payment is mainly connected with characterisation as an interest, it is important to point out that neither the Interest-Royalties Directive,\(^\text{(65)}\) nor the Parent-Subsidiary Directive contain\(^\text{(66)}\) a provision which could ensure that the same payment is treated in the concerned Member State either as distribution of profits or as an interest.\(^\text{(67)}\) The absence of connecting provisions between these two instruments creates a potential situation of

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\(^\text{(63)}\) This condition, contained in Art.1, para.3 of the Interest—Royalties Directive 2003/49/EC, above fn.50, is considered to be too restrictive, because it applies to all situations where the payment is considered not to be deductible under domestic law. The European Commission has suggested in its 2009 Report (Report from the Commission to the Council in accordance with Article 8 of Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. COM (2009) 179 final of April 17, 2009) a rather loose interpretation of this requirement, but this viewpoint is criticised in the academic literature and is not followed by most of the Member States who have implemented this provision. An amendment seems, therefore, necessary (on this see M. Fernandes, et al., “A Comprehensive Analysis of Proposals to amend the Interest and Royalties Directive, Part 1” (2011) European Taxation 408).

\(^\text{(64)}\) Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Süd (C-397/09) [2011] STC 1622 (European Court of Justice) at [28].


\(^\text{(66)}\) BEPS Report, above fn.6, 1.

\(^\text{(67)}\) This bridging provision between the two Directives was contained in 1998 European Commission Directive proposal, but was not included in the final text adopted in 2003 (on this see Fernandes, et al., above fn.63, 451).
double taxation, particularly where the source state would re-characterise excess interest as non-deductible profit distribution. Conversely, the absence of coordination does not always prevent abusive interest deductibility resulting in double non-taxation, especially when Member States do not make use of the possibility left open by the Directives to take anti-abuse measures.

Until recently, the EU Institutions, namely the Code of Conduct Group, seemed to favour a solution based on the recognition by the country of residence of the characterisation of the payment in the country of source. However, such a solution, as the Commission pointed out in a recent discussion paper, is likely to be incompatible with the obligations stemming from the Parent-Subsidiary Directive, which prohibits the Member State of the beneficiary to tax profit distributions irrespective of the characterisation of the payment in the source state. Therefore, the Commission will propose an amendment of the Directive, which would expressly allow/oblige Member States to disregard the qualification of the payments under domestic legislation and to deny the benefit of the exemption for the payments that would have been deductible in the source state. The questions remain open as to whether the amendment would consist simply of a possibility left to the Member States (as does the general anti-avoidance clause in the Parent-Subsidiary Directive for the other domestic anti-abuse measures) or whether the exclusion from the exemption would be mandatory.

The European Council has endorsed the Commission’s views and even called for an urgent action in this area. The Commission is expected to provide the amendment proposal by the end of 2013. This acceleration of the legislative iter of this anti-mismatch measure is, as the Council expressly stated, clearly connected with the OECD work on BEPS.

68 However, despite the absence of an express indication in the Directive, the Commission considers that “any amount reclassified as a profit distribution should be granted the benefits of the Parent-Subsidiary Directive” (Report from the Commission to the Council of April 17, 2009, COM (2009), 179).


71 On this issue see e.g. M. Nouwen, “The Gathering Momentum of International and Supranational Action against Aggressive Tax Planning and Harmful Tax Competition: The State of Play of Recent Work of the OECD and European Union” (October 2013) 53(1) European Taxation 503.


73 On this issue see e.g. Nouwen, above fn.71, 491–506.


75 European Council, above fn.74, 7.

66 Deductions; EU law; Interest; International taxation; OECD; Tax avoidance; Transfer pricing