Articles

The Grandfathering Clause under Article 4 of the Anti-Tax Avoidance Directive ((EU) 2016/1164)

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Executive summary

Following the BEPS project and the European Union's efforts to tackle BEPS via Directive (EU) 2016/1064, an interest deductibility limitation rule has been implemented into the national legislations of the EU Member States. The authors will discuss the progressive evolution of such interest limitation rule and will particularly focus on the optional grandfathering clause which has found its way into the final directive, following negotiations.

Suite au projet BEPS et les efforts de l'Union européenne à combattre l'érosion des bases imposables par le biais de la directive (EU) 2016/1064, une règle de limitation de déductibilité d'intérêts a été implémentée dans le corps législatif des États membres de l'UE. Les auteurs traiteront de l'évolution progressive de cette règle de limitation de déductibilité d'intérêts, plus particulièrement l'optionnelle clause de grand-père qui a été implémentée dans la version finale de la directive, en tant que résultat de négociations.

I. Introduction

The aim of the Organisation for Economic Co-operation and Development ("OECD") was to tackle gaps and mismatches in international tax rules that have been giving multinational enterprises the opportunity to artificially shift profits to low or to no tax jurisdictions via its Base Erosion and Profit Shifting ("BEPS") project.

The BEPS project led to 15 actions, each tackling a specific issue that facilitated profit-shifting in international taxation.

The authors, in the context of the this article, will pay particular attention to Action 4: "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" and its implementation in 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 ("ATAD I"), as implemented into Luxembourg law, by the Law of 21 December 2018, following Bill of Law n° 7313 (the "ATAD Bill of Law").

II. Interest Limitation Rule pursuant to Article 4 of ATAD

The OECD in its Action 4 recommended a best practice approach based on "*a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) based on tax numbers*".[1] The OECD recommended a benchmark ratio in-between 10% and 30% of EBITDA.

The European Union ("EU") chose to incorporate this best practice rule in Article 4 of ATAD I on interest deductibility limitations, while opting for the upper limit of the recommended range of 30%. This does not however bar a Member State from applying a stricter approach.

In its proposal for ATAD I of 28 January 2016, the European Council (the "Council"), highlighted the fact that the goal of the interest limitation rule is to discourage the practice of profit shifting via excessive debt levels "*by limiting the amount of interest that the taxpayer is entitled to deduct in a tax year*".[2]

As such, the ATAD I interest limitation rule broadly defines "borrowing costs" as "*interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to, payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds.*"[3]

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1 OECD, *BEPS Action 4*, 2016 Update, p. 29.

2 European Council Proposal for a Council Directive, 2016/0011 (CNS); Brussels, 28 January 2016, p. 7.

3 ATAD I, Art. 2 (1).

The interest limitation rule is targeted at "*exceeding borrowing costs*", which are defined as "*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.*"[4]

The first draft of ATAD I already provided for a limitation on net interest deductibility of up to 30% of EBITDA. It also provided for a flat safe harbour amount of EUR 1.000.000.[5] Interestingly enough, neither the EUR 3.000.000 safe harbour of the final ATAD I, nor the grandfathering rule had made it into the first proposal for ATAD I.

However, taking into account the evolution of ATAD I, from its first published draft on 28 January 2016 to the final agreed version of 12 July 2016, it appears as if a grandfathering rule to the interest limitation rule to be implemented had proven to be a sticking point.

III. The implementation of an optional grandfathering rule into the interest limitation rule

III.a Proposal for ATAD I from 28 January 2016

As previously mentioned, the first proposal for the ATAD I, did not include a grandfathering rule in its Article 4 on interest deductibility limitation.

As such, it would have applied to all loans as of the application date of the ATAD I to Member States. This specific way of drafting Article 4, would have had a significant impact on corporate taxpayers.

Taking into account the particular characteristics of national investment fund industries, specifically securitisation vehicles, the first draft of the ATAD I would have engendered considerable risk for specific industry sectors. Indeed, small economies such as Luxembourg could have been disproportionally impacted by it.

III.b Proposal for ATAD I from 17 May 2016

Following the January proposal, the 17 May Presidency compromise proposal differed from it with respect to the interest deductibility limitation rule, by introducing a grandfathering rule for loans concluded before 28 January 2016. As the first draft proposal on ATAD I was published on that date, it is likely that this date had been chosen, to prevent taxpayers from potentially restructuring their loans in a way that would have allowed them to minimise the impact of the interest limitation rule on them.

The exact wording of the grandfathering rule was as follows:

"*Member States may exclude from the scope of paragraph 1 exceeding borrowing costs incurred on:*

(a) loans which were concluded before 28 January 2016 and have not been subsequently modified."[6]

As a result, the initial draft of the interest deductibility limitation rule allowed Member States to exclude loans concluded before the first draft proposal on ATAD I had been published, yet under the condition that they would not be subsequently modified.

However, some Member States' delegations were still insisting on additional waivers regarding the interest limitation rule, including a broader grandfathering rule. The General Secretariat of the Council in its Report 8899/16 even admits that "[*i*]*n order to find a final compromise the Presidency has extended the scope of the grandfathering clause substantially*". This indicates that reaching a consensus on the grandfathering rule was crucial for the timely adoption of ATAD I by the Member States.

III.c Proposal for ATAD I from 23 May 2016

As a consequence of the Presidency's concessions, the 17 May 2016 proposal was further amended, leading to the 23 May 2016 proposal. This 23 May 2016 proposal was published ahead of an Ecofin Meeting scheduled for 25 May 2016, in which the Council wanted to achieve substantial approval for the ATAD I.

The grandfathering rule had as a result been substantially modified and extended in its scope, indeed, it now provided for the following:

"*Member States may exclude from the scope of paragraph 1 exceeding borrowing costs incurred on:*

(a) loans which were concluded before 22 May 2016, but the exclusion shall not extend to any subsequent modification of such loans;"[7]

The application date of the interest deductibility limitation rule had been pushed back to 22 May 2016 and the grandfathering provision had been broadened in scope as the previous one had been perceived as too restrictive by some Member States.

Indeed, the previous wording of the grandfathering clause could have been interpreted in a way that would have meant that any given change in a loan agreement would then automatically make such loan drop out of the scope of the grandfathering provision, regardless of whether or not it constituted a material or non-material modification. A material modification in that respect

4 ATAD I, Art. 2 (2).
5 European Council Proposal for a Council Directive, 2016/0011 (CNS); Brussels, 28 January 2016, p. 16.
6 Proposal for ATAD I of 17 May 2016, Art. 4 4. (a).
7 Proposal for ATAD I of 23 May 2016, Art. 4 4. (a).

would, amongst others, includes changes to the term, frequency of payments, the amount or interest rate in the loan, whereas a non-material modification should be considered as being a purely formal modification.

The 23 May proposal, that has eventually found its way into the final ATAD I, took a more nuanced approach by allowing loans to be modified after the cut-off grandfathering applicability date, but limiting the grandfathering to the provisions of the loan as they existed at the cut-off date.

The Ecofin Council meeting held in Luxembourg on 17 June 2016 itself admitted that the final draft of the ATAD I constituted a "*final compromise text*" noting at the same time that now "*almost all*" Member States could agree to it.[8]

III.d Final ATAD I of 12 July 2016

The interest deductibility limitation rule in the agreed and final ATAD I version is the consensus approach from the 23 May 2016 Presidency compromise proposal with the minor adjustment of the cut-off date being modified to 17 June 2016.

However, in the preamble to the ATAD I, some further precisions were added in comparison to the 23 May proposal.

ATAD I in its preamble states that:

"[…] *Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified, i.e. in case of a subsequent modification, the grandfathering would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan.*"[9]

Taking this into consideration, one seems to be able to validly assume that, if a loan were to be modified after 17 June 2016 the grandfathering would still apply to it however, it would be limited to its initial terms and thus not allow the taxpayer to gain any further benefit from the grandfathering clause than he or she would have otherwise been entitled to before the cut-off date.

To illustrate this, take a EUR 10.000.000 loan with a 3% fixed interest rate and a maturity date in 2025.

If, after 17 June 2016, said loan would see its maturity date postponed to 2030, the grandfathering would only apply up until 2025, the years from 2025 to 2030 not being covered by the grandfathering rule anymore.

This nuance is quite important with respect to Luxembourg and its efforts of implementing ATAD I into national legislation by means of the ATAD Bill of Law.

IV. Luxembourg's implementation of the ATAD I

The ATAD Bill of Law

The grandfathering rule provided for in ATAD I is optional for Member States to opt into.

Out of the 28 EU Member States, 7[10], among them the Grand Duchy of Luxembourg, have opted to implement the grandfathering rule provided for in Article 4 (4) (a) of the ATAD I into their national legislation. On a side note, it should be noted that Lithuania has not transposed the grandfathering rule, but decided that its interest limitation rule shall only apply to loans concluded after 31 December 2018, (or to loans modified after that date) effectively opting for a different path that appears to be more straightforward. However, it remains to be seen if Lithuania's approach will lead to controversy, as it might effectively be considered as not properly implementing the ATAD I provisions.

The ATAD Bill of Law was introduced to the Luxembourg Parliament on 19 June 2018. As provided for in ATAD I, Luxembourg opted for the implementation of a grandfathering clause with respect to Article 4 of ATAD I on interest deductibility limitation.

However, interestingly Luxembourg in its first draft of the ATAD Bill of Law, did not opt for the exact wording of the grandfathering rule as provided for in ATAD I which had been established as a compromise in the 23 May 2016 ATAD I proposal. On the contrary, Luxembourg opted for the grandfathering wording that had been provided in the 17 May 2016 ATAD I proposal, and only amended the cut-off date to the final agreed one.

The difference being, as established earlier, that the 17 May 2016 grandfathering clause wording provided for a fixed cut-off date and allowed for no further modification of the loans at all, with any modification of the loans after the cut-off date leading to a future non-applicability of the grandfathering clause to that loan.

"*Are to be excluded from the scope of paragraph 2, exceeding borrowing costs incurred on:*

(a) loans which were concluded before 17 June 2016 and have not been subsequently modified."

"*Sont exclus du champ d'application de l'alinéa 2, les surcoûts d'emprunt afférents aux :*

a) emprunts qui ont été contractés avant le 17 juin 2016, à l'exclusion de toute modification ultérieure"[11]

8 Outcome of the Council Meeting, 17 June 2016 (10324/16, Presse 35 PR CO 34 EN), p. 4.

9 ATAD I, preamble, § (8), p. 3.

10 Countries that have opted for the implementation of the Grandfathering Rule are: Belgium, Cyprus, Finland, Hungary, Italy, Luxembourg and Malta.

11 ATAD Bill of Law, Art. 2 2° (7).

Now, the ATAD I's aim is to introduce minimum standards. As such, EU Member States may freely decide to take a more restrictive approach while implementing a directive into national law. And as such one could think that Luxembourg may have decided to do so.

However, this wording was conflicted with the legislator's commentary on the articles of the ATAD Bill of Law. In the comments specific to Article 2 2° (7) of the ATAD Bill of Law[12], the legislator makes reference to paragraph 8 of the preamble of the ATAD I and to the fact that the grandfathering clause shall apply to a loan, unless it has been modified, in which case the grandfathering *shall be limited to the initial loan conditions*.

The Luxembourg State Council (*Conseil d'État*) in its comments of 14 November 2018 on the ATAD Bill of Law did not fail to point out the aforementioned discrepancy, and suggested that the wording of the grandfathering clause should be adapted so that it is identical to the wording used in the ATAD I.

The legislator took the State Council's comments into account and adapted the wording of the grandfathering clause accordingly, for it to exactly take up the final wording of ATAD I.

The State Council, while commenting on the initially different wording of the grandfathering clause in the ATAD Bill of Law mentioned that:

"*[…] que la divergence textuelle mentionnée ne devrait pas produire de différence sur le fond*"

Which means, that the State Council did not expect the differing wording of the grandfathering clause to lead to a materially relevant difference in its application to loans.

However, this is probably not entirely correct. Given the step by step development of the grandfathering clause in the various ATAD I proposals and the gradually occurring concessions by the Presidency, it should be clear, that the final wording of the grandfathering clause of 23 May 2016 is, and was meant to be, effectively different in application from the one of 17 May 2016. The latter was drafted in a way that would have made a loan drop out of the scope of the grandfathering rule for any modification after the cut-off date, whereas the former ended up being drafted so that modifications were still possible without affecting the grandfathering of the initial loan terms.

This makes a significant difference and seems to be underlined by paragraph (8) of the ATAD I preamble.

Take for instance revolving credit facilities and take the example of a revolving credit facility concluded on 1st June 2016 for a total of EUR 100.000.000. As of the cut-off date of 17 June 2016, only EUR 10.000.000 has been drawn down.

The question which validly arises is whether or not subsequent drawdowns would fall within the grandfathering rule. As a subsequent drawdown would, in principle, not modify the terms of the initial revolving credit facility and given the aforementioned process that led to the final wording of the grandfathering rule, the revolving credit facility and subsequent drawdowns should, in principle, continue to benefit from the grandfathering clause, obviously under the condition that a subsequent drawdown does not modify the term or interest rate, overall amount etc. in the revolving credit facility.

It remains to be seen how, in practice, the grandfathering rule will be applied to various modifications of loans.

12 Equivalent to Art. 4 (4) (1) of the ATAD I.