



International Tax

European Union Tax Alert

28 January 2016

European Commission releases proposed anti-tax avoidance package

Contacts

Bill Dodwell
bdodwell@deloitte.co.uk

On 28 January 2016, the European Commission released an anti-tax avoidance package that contains proposed measures to prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the EU. The package contains the following:

- 1) Amendments to the administrative cooperation directive to implement country-by-country (CbC) reporting;
- 2) A draft anti-tax avoidance directive;
- 3) Recommendations to EU member states on how to reinforce their tax treaties in an EU-law compliant manner; and
- 4) A communication on an external strategy for effective taxation that presents a stronger and more coherent EU approach to working with third countries on tax good governance matters.

The draft CbC and anti-tax avoidance directives reflect some of the actions in the OECD's base erosion and profit shifting (BEPS) project. The CbC directive is intended to implement CbC reporting to the tax authorities in accordance with BEPS action 13. The anti-tax avoidance directive (sometimes called the "anti-BEPS" directive) is intended to establish a fixed framework for the 28 EU member states to implement certain other BEPS actions (and other tax measures) in a common form, although the draft directive is not entirely in accordance with the actions adopted by the G20 and OECD member countries. The draft anti-tax avoidance directive includes rules addressing hybrid mismatches, limits on the deductibility of interest and controlled foreign company (CFC) rules, as well as measures not in the BEPS action plan, i.e. a general anti-abuse rule (GAAR), a "switch-over" clause and an exit tax.

The European Commission also released a recommendation that member states should include a principal purpose test in their double tax treaties (although, oddly, the precise text put forward by the Commission differs in some small respects to that put forward in action 6 of the BEPS project).

The communication on an external strategy for effective taxation sets out a coordinated EU approach against third country risks of tax avoidance to promote international tax good governance.

This alert focuses on the two draft directives.

Overview of process and background on draft directives

Direct taxation is the preserve of the EU member states; in other words, individual member states retain sovereign legislative power in the area of direct taxation. Under EU law, in areas where the member states retain sovereignty, harmonization throughout the EU generally is possible only if there is unanimous agreement among the 28 member states. Thus, the enactment of EU directives relating to taxation requires full agreement (or if that is not possible, in some cases a subset of member states may choose to implement a measure under enhanced cooperation rules).

Once a draft proposal has been presented by the European Commission, a number of levels of discussions will take place at the Council of Finance Ministers (ECOFIN), including possible delegation to officials for technical analysis. Then, the president of the Council will facilitate a discussion where member states will raise concerns and possibly make recommendations for changes to the draft directive. In some cases, it may not be possible to find sufficient support at the Council for the directive to be approved (for example, as in the case of the previous draft directive for a common consolidated corporate tax base (CCCTB)).

The draft CbC reporting and anti-tax avoidance directives were expected. Taking into account the final reports issued by the OECD on the BEPS actions, the European Commission's 2015 announcement of an *Action Plan for Fair and Efficient Corporate Taxation*, a strategy to relaunch the CCCTB and the adoption of the changes to the EU parent-subsidiary directive, the directives appear to be the next step in the efforts to tackle what is perceived to be tax avoidance and the erosion of the tax bases of many countries.

CbC reporting to tax authorities

The draft CbC reporting directive operates by amending the existing administrative cooperation directive and largely follows the detailed material from the OECD. It would require EU member states to introduce by 31 December 2016 requirements for multinationals based in the relevant state to file the detailed information set out by the G20/OECD, where turnover exceeds the EUR 750 million benchmark set by the G20/OECD. The filing requirement would apply to fiscal years commencing on or after 1 January 2016 and the details follow the prescribed framework with two small exceptions. The first is that member states would be required to share information with each other within 15 months of the accounting period (action 13 allows 18 months for the first period). The second area concerns linguistics, which likely will recognize the EU's 23 official languages. The directive also will cover the exact sharing mechanism between member states, using existing communication networks, with more details to be released by the end of 2016. Member states would have freedom to legislate their own penalty regimes, which should be "effective, proportionate and dissuasive."

OECD and G20 countries also will need to exchange information with non-EU members, since the directive would only cover exchanges within the EU.

The draft CbC directive notes that the Commission may additionally propose some public reporting of tax information. In 2015, the Commission conducted a public consultation on corporate tax transparency in the EU, specifically on whether requiring companies to disclose more information about the taxes they pay could help tackle tax avoidance and aggressive tax practices. It is fair to note

that the businesses, professional firms and professional bodies responding did not favor public CbC reporting. However, equally unsurprisingly, nongovernment organizations (NGOs) responding did favor its introduction, as does the European Parliament, which has an equal role with the Council of Ministers in legislating in this accounting area.

Anti-tax avoidance directive

The European Commission notes in the introduction to the draft anti-tax avoidance directive that most member states (22 out of 28), in their capacity as OECD members, have committed to implementing the output contained in the final reports on the 15 BEPS actions. According to the Commission, it is “essential for the good functioning of the Internal Market that Member States transpose political commitments under BEPS into their national systems in a coherent and sufficiently coordinated fashion. This should be the way ahead in order to maximize the positive effects for the Internal Market as a whole. If not, unilateral implementation of BEPS would risk national policy clashes and new obstacles in the Internal Market, which would continue to be fragmented in 28 constituent parts and suffer from mismatches and other distortions.”

The draft anti-tax avoidance directive proposes action in three areas covered by the BEPS actions:

- Hybrid mismatches (Action 2);
- Interest restrictions (Action 4); and
- CFCs (Action 3).

However, the directive also proposes actions in three areas not reflected in the BEPS action plan:

- A GAAR;
- “Switch-over” clauses that treat some income/gains as taxable instead of granting an exemption; and
- Exit taxation.

The introduction notes that the draft directive is intended to set out principles, leaving the detailed enactment to the member states, taking account of their national legislation. However, it is clear that the principles set out in the draft do not simply reflect the BEPS actions.

Areas covered by BEPS

Hybrid mismatches: The draft directive proposes an anti-hybrid rule for situations where there are differences in the legal characterization of payments or entities between EU member states. The rules would require that when an entity or instrument is classified differently in different member states, the treatment in the state in which the first deduction is claimed should be followed by the second state where either income is received or a second deduction is claimed. This is the opposite of the G20/OECD proposals. The primary rule under BEPS action 2 is that the deduction should be disallowed, with a secondary rule requiring that income be taxed (or a second deduction disallowed) where the primary rule is not adopted.

There is no obvious justification for adopting a different rule for payments within the EU, compared to payments between EU states and third countries. In

practice, adopting two different rules for EU and non-EU hybrids could potentially lead to mismatches

Interest restrictions: The draft directive proposals for interest and other financing costs have their basis in the BEPS action 4 conclusions. The proposed rule starts with the principle that borrowing costs always are deductible to the extent interest or other taxable revenues are generated from financial assets. The directive then proposes that where interest costs exceed finance income, the deduction of financing costs should be restricted to 30% of tax-based EBITDA (earnings before interest, tax, depreciation and amortization). The directive proposes several reliefs:

- A de minimis exemption for interest not exceeding EUR 1 million;
- A fallback to a group-wide test, based on the accounting ratio of third-party debt to assets, less 2%; and
- The ability to carry forward excess EBITDA and disallowed interest.

Although the measures in the proposed directive are similar to the final report on BEPS action 4, the definition of the group-wide ratio is more restrictive. It also ignores the “public benefit exemption,” understood to have been proposed by the UK and agreed to by Germany. This exemption is designed to allow certain projects financed with third-party debt that provide wider public benefits, such as infrastructure, to be excluded from the wider group limitations.

Controlled foreign company rules: The G20/OECD agreed that CFC rules should be downgraded to a recommendation, the lower level of the BEPS proposals. BEPS action 3 noted that there are 36 CFC regimes globally and that many countries did not need them, given the nature of their economies. Most EU member states do not have CFC rules, although major countries such as France, Germany, Italy, Spain and the UK do have these provisions.

The draft directive proposes that all 28 member states introduce CFC rules. The proposed legislative text defines a CFC as a company where:

- More than 50% of the shares, profits or assets are controlled by the group;
- The company is based in a non-EU country with a statutory tax rate lower than 40% of the tax rate in the country of the parent company; and
- More than 50% of the income of the company comes from passive sources, such as dividends, interest, royalties, leasing, insurance, banking and other financial services and income from group services.

CFC rules would not be applied to subsidiaries in the EU/EEA, unless the establishment of the entity is wholly artificial or the entity engages in non-genuine arrangements that were put in place for the main purpose of obtaining a tax advantage. The CFC rules would not apply to subsidiaries whose shares are, in short, listed on a recognized stock exchange.

If the CFC rules applied, profits would be apportioned to the parent company only where the CFC does not have the necessary significant people functions to manage its business and then only to the extent those functions are in the shareholder company.

The draft directive has some similarities to the UK's CFC rules, presumably with the aim of attracting UK support. However, the justification for other countries,

such as Ireland, Malta or the Netherlands to adopt CFC rules is not clear, and some countries may lack the necessary resources to develop and manage such rules.

Areas not covered by BEPS

The next three areas are initiatives from the Commission, although each has support from some member states.

Exit taxation: The directive proposes an exit tax on specified transfers of assets or the transfer of residence, requiring the EU member state of origin to levy tax on the fair market value minus the tax book value. For transfers from an EU member state to another EU member state, tax could be paid in installments over a five-year period or until a third-party disposal, if that is earlier. Interest could be charged and, in case of the risk of non-recovery, guarantees could be required. The receiving member state should provide for a step-up to fair market value as established by the member state of origin as the starting value of the assets for tax purposes.

It has been a source of frustration to some member states that the Court of Justice of the European Union (CJEU) has ruled that states may not levy exit taxes when a company moves its tax residence to another EU or EEA country. The CJEU's rationale has been that payment of the tax should be deferred until ultimate disposal, although it has allowed the taxing state to levy interest.

However, the provisions go much wider than the cases on the transfer of residence and additionally provide that tax should be charged where assets are transferred from a head office to a branch. Many member states have long-standing exemptions or deferrals in this situation, and there is no clear reason why the European Commission considers that a new tax charge should be levied.

Switch-over clause: Most member states have tax exemptions for dividend income and for capital gains on the sale of qualifying shareholdings. A small number of states have expressed concern that this favorable exemption should not apply where the overseas company pays a low rate of tax. In response, the Commission has proposed that every member state should adopt a rule whereby dividends and capital gains from low-taxed companies should not be exempt, but instead should be taxable, with a tax credit granted for any overseas tax actually paid. The proposal sets the definition of low tax as a statutory tax rate that is lower than 40% of the tax rate in the relevant member state.

It is not obvious that it is necessary to introduce a switch-over rule across the EU. Clearly, countries that wish to adopt such a rule will need to include anti-conduit provisions to prevent income or gains being routed via a third country.

General anti-abuse rule: A GAAR is proposed to address gaps that may exist in a country's anti-abuse rules, and the European Commission proposes that all EU member states should adopt a GAAR to counter certain forms of tax avoidance. The draft provides that non-genuine arrangements to avoid corporate tax should be ignored and defines arrangements as non-genuine to the extent they are not put into place for valid commercial reasons that reflect economic reality.

Studies of the limited numbers of GAARs globally have found that, to be effective, a GAAR needs to be specifically designed to reflect national law. While there may well be sympathy with the overall aim of a GAAR, providing a fixed definition is unhelpful as it may be both broader in scope and narrower in its impact in

defeating highly artificial arrangements. Further, those countries with a GAAR will surely wish it to apply more broadly than to just corporate tax and it would not be coherent to have different GAARs for different taxes.

Comments

Given that many EU member states already have adopted legislation to require action 13 CbC reporting, it would be surprising if this directive were not adopted across the EU. Jurisdictions affiliated with member states, such as the UK's Crown Dependencies and Overseas Territories, are being encouraged to mandate action 13 CbC reporting for multinationals headquartered in the jurisdiction. In this regard, Jersey launched a consultation on 22 January 2016 on proposals to require that Jersey-regulated entities submit CbC reports.

The proposal for an EU anti-tax avoidance directive could be seen as a first step toward harmonization in the context of the fight against base erosion and profit shifting. The European Commission continues to favor the adoption of the CCCTB, despite its rejection by many member states. The Commission intends to propose the adoption of a common corporate tax base (without consolidation) later in 2016, without consolidation, and the standardization put forward in the anti-tax avoidance directive should be viewed in this context.

However, it remains unclear whether the unanimous agreement among the member states is achievable. Many member states do not favor a common tax base and the inclusion of options in the BEPS action plan clearly was designed to provide measures that a wide range of countries could support. Removing those options in the EU may well not be supported by member states. Unfortunately, the EU did not put forward measures in full accordance with the BEPS actions.

In addition, the role of the Presidency of the EU cannot be underestimated. The Netherlands has indicated that a harmonized approach will not be a priority during the Dutch presidency of the EU (until July 2016). It is unclear how future presidencies will approach the proposed directive.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see <http://www.deloitte.com/about> for a more detailed description of DTTL and its member firms.

Deloitte provides audit, consulting, financial advisory, risk management, tax and related services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's more than 225,000 professionals are committed to making an impact that matters.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.