International Tax

European Union Tax Alert

26 November 2013

Changes proposed to parent-subsidiary directive to tackle tax avoidance

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The European Commission published a draft amended parent-subsidiary directive on 25 November 2013 to tackle corporate tax avoidance in Europe.

The directive was originally conceived to prevent the double taxation of same-group companies based in different EU member states by providing a tax exemption for dividends and other profit distributions paid by qualifying subsidiary companies to their parent companies. However, some companies have exploited loopholes in the directive to avoid paying any tax. The Commission, therefore, has proposed two changes to tackle hybrid financial mismatches (due to the interaction of different national tax systems) within the scope of application of the directive and to introduce a general anti-abuse rule to protect the functioning of the parent-subsidiary directive.

First, changes would be made to the tax treatment of hybrid loan arrangements (such as profit participating loans). Specifically, a cross-border group of parent and subsidiary companies using hybrid loan arrangements would be denied a tax exemption in the member state in which the parent company is resident if the payments are deductible in the member state in which the subsidiary is resident. In other words, if a hybrid loan payment is deductible in the member state of the subsidiary, it would have to be taxed by the member state of the parent company.

Second, the anti-abuse rule would be updated. This proposal would require EU member states to adopt a common, more comprehensive anti-abuse provision allowing them to ignore artificial arrangements used for tax avoidance purposes, and to tax on the basis of real economic substance. This proposal is targeted at groups that interpose an intermediate holding company in the EU to act as a "letterbox" company to take advantage of lower withholding tax rates. The draft amendments specify five factors that can be used by member states in determining whether an arrangement or series of arrangements is artificial.

The European Commission acknowledged the OECD's BEPS initiative, but stated that there also is need to address mismatches and anti-abuse at the EU level, taking into account existing EU legislation, and that the revision of the parent-subsidiary directive can be an important contribution to the OECD BEPS project.

If the amended directive is adopted by the Council, it should be implemented by the member states by 31 December 2014.