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EU Developments: Anti-Tax Avoidance Directive

ECOFIN Council approves Anti-Tax Avoidance Directive

On 21 June, the EU's ministers of Finance and Economic Affairs, the so-called ECOFIN Council, unanimously approved the Anti-Tax Avoidance Directive ("ATAD"). This measure was originally proposed in January of this year and has been amended over the various meetings of the Council since then. In the public session of the ECOFIN Council on 17 June, Minister Noonan said that Ireland was committed to tackling tax avoidance and "remains committed to finding EU solutions to tackle this issue where possible".

He noted that the amended directive was a "finely balanced compromise" and one which Ireland could support subject to the removal of the switch-over rule, which was subsequently dropped. The rules in the ATAD have to fit within 28 separate corporate tax systems and the directive notes that they should be limited to general provisions leaving implementation to Member States as they "are better placed to shape the specific elements of those rules in a way that fits best their corporate tax systems".

Our perspectives in an Irish context

The ATAD could be seen as a first step toward harmonisation in the context of the fight against base erosion and profit shifting. Today was an important milestone in that journey in an EU context, given that unanimous agreement has been reached on a significant number of anti-tax avoidance measures that will have an impact on all 28 EU Member State tax regimes. For Ireland, measures such as the anti-hybrid rules or the General Anti-Avoidance Rule (GAAR) provisions will have less of an impact based on Ireland's current tax regime. However, the interest, exit tax and Controlled Foreign Company (CFC) changes, will have an impact for Ireland and the overall tax environment for businesses operating here (or indeed businesses seeking to invest in Ireland in the future) once the required directive changes are adopted and become effective.

It is important to remember that the ATAD does not affect country tax rates, and therefore, Ireland's 12.5 per cent corporate tax regime is not affected by these proposals.

The general focus of the OECD's BEPS and the EU's ATAD initiatives on aligning taxing rights with where substance and real economic activities occur is positive in the context of Ireland's 12.5 per cent corporate tax regime, which is substance based. However, the ATAD tax rules will bring about significant changes to our tax law, and introduce complexity to areas that would not have been priorities for Ireland. Against this rapidly changing international and EU tax landscape, which will affect Ireland's tax regime, it does mean that Ireland should assess its overall tax framework on a holistic basis, in particular from a corporate tax perspective. While ensuring that Ireland is BEPS and EU tax compliant, it would also be important to ensure that we continue to "play fair but play to win" as part of our international tax strategy.

Anti-Tax Avoidance Directive

Summary ATAD actions

The ATAD outlines action in three areas already covered by the BEPS actions:

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

However, the directive also outlines agreed actions in areas not reflected in the BEPS action plan:

- A GAAR and
- Exit taxation.

A switch-over rule denying tax exemptions on certain income and gains had been suggested as part of the January 2016 draft ATAD, but was dropped as part of the final version approved by ECOFIN. What follows is a brief overview of each of the above provisions in the directive.

Interest limitation rule (article 4):
In line with the initial proposal, exceeding (or net) borrowing costs, such as interest expenses, will only be deductible up to 30 per cent of a taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). Apart from that, a taxpayer may be given the right to fully deduct exceeding borrowing costs if it is, in short, not part of a group. Alternatively, a taxpayer may be given the right to deduct exceeding borrowing costs below a €3 million threshold, which should be considered for the entire group. In the earlier proposal, the threshold was set at €1 million.

Furthermore, the ATAD contains the option for Member States to choose between two different group exclusion provisions based on either an "equity/total assets"-ratio or a group EBITDA-test. The latter exclusion is a new addition when compared to the original proposal. The first exclusion originally included a limitation that payments to associated enterprises could not exceed 10 per cent of a group's total exceeding borrowing costs. This limitation, however, is no longer part of the ATAD. Other new elements include options for Member States to allow for: (i) grandfathering loans that were concluded before 17 June 2016 (and not modified thereafter); and (ii) an exclusion for third party loans used to fund a qualifying long-term public infrastructure project. Additional flexibility is provided to Member States to allow for the carry forward of non-deductible exceeding borrowing costs. Certain financial undertakings can also be excluded from the interest limitation rule.

In relation to the interest limitation rule, Member States that have national, targeted rules for preventing BEPS that are equally effective as article 4 in the ATAD are granted a transitional period. They can still apply those existing, targeted rules until the end of the first fiscal year following the date of publication of the agreement between the OECD Member States on a minimum standard with regard to BEPS Action 4, or, at the latest, until 1 January 2024.

Ireland already has significantly complex interest rules depending on the activity concerned (e.g. investment or trading activities) and in our view additional guidance would be welcome as to whether such rules would be considered to be "equally effective to the interest limitation rule" in this regard or otherwise. It would also be important for Ireland to assess its overall regime for the tax treatment of interest expenditure in light of the new interest limitations which will be introduced in the future, and whether other changes to our domestic interest relief rules are required.

Exit taxation (article 5):
Member States should introduce an exit tax for certain predefined situations, which include both transfers to other Member States and third countries. The "recipient" Member States shall accept the value determined by the "exit" states as the base of the assets for tax purposes unless this does not reflect market value. A new element is that, if a taxpayer fails to honour its obligation in relation to the payment of annual instalments of the exit tax, the deferral of exit tax payment is discontinued immediately and the tax becomes recoverable. Certain asset transfers, like the transfers related to the financing of securities and transfers that take place in order to meet prudential capital requirements that are set to return to the Member State of the transferor within a period of 12 months are not subject to exit tax.

Ireland has a longstanding exit charge provision that can apply a capital gains tax charge on companies moving their tax residence out of Ireland, subject to certain important exceptions. These exceptions have not been provided for as part of the ATAD such that significant change will be brought to our law as a result. This is likely to require consideration in terms of how the requirements are adopted into national law. There is a derogation in the ATAD allowing the application of the exit charge to commence on 1 January 2020 (rather than the generally applicable commencement date for the ATAD provisions of 1 January 2019).

General anti-abuse rule (article 6):
The wording of the GAAR, envisaged to cover gaps that may exist in a Member State's anti-abuse rules has been adjusted in order to align the wording of this GAAR with the wording of the GAAR in the recently amended EU Parent-Subsidiary Directive.

Ireland has had a GAAR since 1989 (the former s.811 TCA 1997) and our Irish GAAR provisions were completely overhauled by Finance Act 2014 with the introduction of a new s.811C TCA 1997. The new provisions now have a lower threshold applied in assessing whether a tax avoidance transaction is at issue – the test now being focused on whether, broadly, it would be "reasonable to consider" that a transaction's primary purpose was to give rise to a tax advantage. In our view, the current Irish GAAR provisions are in fact more stringent and broader in scope and application than that proposed under the draft directive.

Controlled foreign company rules (articles 7 and 8):
The CFC rules attribute to a taxpayer company predefined categories of non-distributed (passive) income ("Option A"), or non-distributed income from non-genuine arrangements ("Option B"), of a greater than 50 per cent controlled, low-taxed, direct or indirect foreign subsidiary of the taxpayer/parent company. Contrary to the original proposal, the revised ATAD also includes permanent establishments in scope of the CFC rules. While the original proposal referred to the effective corporate tax rate for determining whether a subsidiary/permanent establishment qualifies as "low taxed" under the CFC rules, the revised ATAD determines that a subsidiary/permanent establishment is a CFC if the actual corporate tax paid by that entity is lower than the difference between the tax that would have been paid on the

same profits in the Member State of the parent company and the actually paid corporate tax in the source state.

Option A: Should a Member State implement the CFC rules using Option A, it should not include CFC income in the taxpayer's tax base where a taxpayer can establish that a CFC carries on substantive economic activity. This needs to be sufficiently supported by staff, equipment, assets and premises. Member States may choose to exclude this "substantive economic activity" exclusion for CFCs in third countries. In addition, those Member States may opt not to treat a subsidiary/ permanent establishment as a CFC if one third or less of its income falls within predefined (passive) income categories or, in case of certain financial undertakings, if one third or less of the predefined (passive) income categories come from transactions with the taxpayer or its associated enterprises. The threshold for passive income is thus set at one third, whereby this originally was 50 per cent; in that sense the revised CFC rules are stricter.

Option B: Should a Member State implement the CFC rules using Option B, those Member States should not include CFC income in the taxpayer's tax base if such income arises from arrangements that have not been put in place for the essential purposes of obtaining a tax advantage. In order to determine the genuine (or otherwise) nature of an arrangement, or a series thereof, the significant people functions relevant for the income generating assets and risks owned/undertaken by the CFC should be considered. Member States implementing Option B may choose to exclude such income from a taxpayer's tax base if the CFC has accounting profits: (i) of no more than €750k and non-trading income of no more than €75k; or ii) amounting to no more than 10 per cent of its operating costs (excluding cost of goods sold) for the relevant tax period.

At the public session, Minister Noonan welcomed the fact that reference is no longer made to effective tax rates and that he could support an initiative based on the four substance based criteria noted at Option A above. Given that Irish legislation currently does not have CFC rules, there will be an obligation on Ireland to introduce such CFC rules into Irish tax legislation by 2018, to take effect from 1 January 2019.

Hybrid mismatches (article 9):
In line with the original proposal, the ATAD includes an anti-hybrid mismatch rule to tackle mismatches in the legal characterisation of a financial instrument or entity between Member States, if such a mismatch results in a double deduction or a deduction without inclusion. In case of a double deduction, a deduction shall only be given in the Member State where a payment has its source. In case of a deduction without inclusion, the Member State of the payer should deny the deduction of such payment. This approach, the disallowance of a deduction, is more in line with the OECD's BEPS project.
The original ATAD proposal did not aim at a disallowance of a deduction, but at mirroring the characterisation of the hybrid financial instrument or entity instead.
The Council added a statement to the ATAD in which the European Commission is requested to come up with a proposal by October 2016 in relation to hybrid mismatches with third countries that is consistent with and no less effective than the rules recommended by the OECD's BEPS report on hybrid mismatches, with a view to reaching agreement by the end of 2016.

Entry into force
It should be noted that the ATAD seeks to provide a minimum level of protection only. Consequently, Member States are still entitled to take actions that go beyond the wording of the ATAD. Today's Council agreement was an important step for the EU towards harmonisation in light of combatting base erosion and profit shifting. The procedure now is that the directive will be submitted to a forthcoming Council meeting for adoption.
The ATAD indicates that Member States

shall adopt and publish the laws and regulations necessary to comply with the rules by December 31, 2018 at the latest. Consequently, entry into force of the ATAD is required from January 1, 2019. In relation to exit taxes, Member States are granted a delay of one year. In relation to the interest limitation rule, Member States that have national, targeted rules for preventing BEPS that are equally effective as article 4 in the ATAD are granted a transitional period. They can still apply those existing, targeted rules until the end of the first fiscal year following the date of publication of the agreement between the OECD Member States on a minimum standard with regard to BEPS Action 4, or, at the latest, until 1 January 2024.

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