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EU Developments: Tackling Tax Avoidance

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European Commission releases proposed anti-tax avoidance package

On 28 January 2016, the European Commission released a draft anti-avoidance tax 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:

- **Revised Administrative Cooperative Directive** – to implement country-by-country (CbC) reporting between tax authorities
- **A draft Anti-Tax Avoidance Directive** – setting out proposals for legally binding anti-avoidance measures
- **Recommendations on Tax Treaties** – advising EU Member States on how to revise national tax treaties against abuse and
- **A Communication on External Strategy** – for measures to promote tax good governance internationally.

It is important to note that the above directives are **draft proposals** that have been put forward by the EU Commission. They have not yet been debated or considered by the 28 EU Member States. **Full unanimity** is required by all 28 EU Member States in relation to areas of direct tax policy. The release of the draft directives is very much the start of a process of engagement and debate among Member States on these important tax policy issues. In our view, the draft CbC directive should not be contentious and we would envisage this being adopted by the 28 EU Member States. However, it is hard to see how unanimity would be achieved on the draft Anti-Tax Avoidance ("ATA") directive in its current form and scope.

This alert focuses on the draft CbC and ATA directives, including our perspectives on what the proposals may mean for Ireland.

The European Commission did also release 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 OECD's base erosion and profit-shifting – i.e. "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.

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Our perspectives in an Irish context

The proposal for an EU ATA directive could be seen as a first step toward harmonisation in the context of the fight against base erosion and profit shifting. The European Commission continues to favour the adoption of the Common Consolidated Corporate Tax Base ("CCCTB"), despite its rejection by many Member States. The Commission intends to propose the adoption of a common corporate tax base, later in 2016, without consolidation, and the standardisation put forward in the draft ATA directive should be viewed in this context.

It is important to remember that the draft ATA directive does not affect country tax rates. Therefore, Ireland's 12.5 per cent tax regime is not affected by these proposals. It is also important to remember that the draft ATA directive is a proposal put forward by the European Commission, which has yet to be debated and considered by the 28 EU Member States. However, the anti-tax avoidance package released is instructive in terms of the ongoing significance of tax policy and tackling aggressive tax practices at EU level, which is likely to remain a key agenda item for the Commission in the near to medium term.

In our view, it is hard to see how unanimity among the 28 EU Member States will be achieved on all the proposals currently set out in the directive. The draft directive not only seeks to ensure the OECD's BEPS recommendations are legally binding across all EU Member States (something the OECD's BEPS process didn't achieve), but it seeks to further and go beyond that BEPS project. Given that the at the OECD, countries were unable to achieve agreement for minimum standards on interest, hybrids and CFCs, one would question what has changed to suggest that all 28 EU Member States will now accept these rules as legally binding in their countries as part of an EU directive process?

The draft ATA directive also seeks to introduce uniformity in certain other areas of tax policy that were not dealt with as part of the OECD's BEPS process, (a General Anti-Avoidance Rule, or "GAAR", a switch-over clause, and exit taxation) in the interests of tackling BEPS. These proposals have caught many countries off guard and were not well signalled or anticipated in advance of the directive's release. The switch-over clause and exit tax provisions, in particular, will be contentious in our view, and are unlikely to result in agreement among all 28 EU Member States.

The European Commission states that no impact assessment was carried out on the anti-tax avoidance directive proposal for a number of reasons, one of which is the *"strong link to the OECD BEPS work".* In our view, an important question is whether any adverse macro-economic impact of the Directive for the EU has been sufficiently considered – for example, if the EU moves ahead of the OECD's BEPS initiative, will that negatively affect inward investment into the EU compared to non-EU locations? Will certain industries, such as financial services, for example, be adversely affected if operating within more stringent tax rules in the EU compared to non-EU locations? These are important policy considerations that should feature in the future debate.

How individual EU Member States will respond with their objections, where relevant, to the draft proposals will be a sensitive issue, in particular given the commitment by the Member States to the OECD's BEPS project, combined with the level of focus and scrutiny by the public and media on acceptable tax practices and whether multinationals are paying their 'fair share' of taxes.

For Ireland, which has already adopted CbC reporting, overhauled its tax residence rules, and introduced the first OECD BEPS-compliant knowledge development box, the general focus on aligning taxing rights with where substance and real economic activities occur should be positive for Ireland, given our competitive corporate tax rate of 12.5 per cent. However, a number of the proposals in the draft ATA directive (e.g. CFC, exit charges, interest restrictions given Ireland's already complex and restrictive interest rules) would not, in our view, be desirable from an Irish tax perspective currently; in particular in a scenario where the EU is moving ahead of the general OECD BEPS process, and in the absence of a more-detailed economic impact assessment.

The timing of the EU's proposals would also have to be questioned; the ink on the final OECD BEPS papers is barely dry, with certain areas still a work in progress to achieve implementation of the minimum standards by the end of 2016. BEPS fatigue and ongoing uncertainty in relation to international tax are having a real impact on business. The EU proposals released last week now introduce additional complexity and uncertainty at a time when a preferred approach would have been to allow for the adoption of the OECD BEPS minimum standards, including CbC reporting, across both EU and non-EU countries that are party to the OECD's BEPS project, together with active use of the monitoring mechanisms.

In addition, the role of the Presidency of the EU cannot be underestimated. The Netherlands' government have indicated that it would not regard a harmonised approach as a priority during its Presidency of the EU and it cannot yet be determined how next presidencies will evaluate the proposed Directive, or what individual EU Member States would propose on a unilateral basis.

What is clear is that that there will be an ongoing focus by the European Commission on combating aggressive tax planning, and greater transparency on the tax policies and regimes applied within the 28 EU Member States. The Commission's staff working document, which was published as part of the EU anti-tax avoidance package last week, clearly highlights a range of tax-planning arrangements that may be viewed as aggressive in certain instances. It also highlights national tax rules within EU Member States, which may, in one way or another, assist multinationals in tax planning that the Commission views as aggressive. Although a number of these tax rules or practices are not specifically dealt with in the draft ATA directive, it will no doubt influence tax policy considerations and decisions to be made in Ireland and elsewhere in the EU in the years ahead.

Overview of process and background on draft directives

Direct taxation is the preserve of the EU's 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, harmonisation throughout the EU is generally possible only if there is unanimous agreement among the 28 Member States. Thus, the enactment of EU directives relating to tax 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). The area of direct taxation has always been contentious (one only has to look at how long the CCCTB proposals have been hanging around without progress) and the requirement of securing unanimity of all EU Member States suggests a long road ahead in relation to the draft ATA proposals.

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's BEPS papers. The draft directive 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 EUR 750 million. 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 language, which likely will recognise the EU's 23 official languages.

The directive will also 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 the freedom to legislate their own penalty regimes, which should be *"effective, proportionate and dissuasive".*

Anti-Tax Avoidance Directive

General background

The European Commission notes in the introduction to the draft ATA 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."*

This may point to the countries such as the UK, which unilaterally enacted a Diverted Profits Tax.

The Commission's staff working document1 accompanying the draft ATA directive refers to a study on the structures of Aggressive Tax Planning. The Commission noted that it sees a strong need to obtain increased knowledge of the tax laws and practices of EU Member States, which may expose particular countries to aggressive tax planning.

The study reviewed what it has identified as seven structures that are "*most commonly used by MNEs that engage in aggressive tax planning"*, including:

- The use of offshore loans
- Hybrid loans
- Hybrid entities
- Interest-free loans
- Two-tiered IP structures
- Patent Box structures
- IP and Cost Contribution agreements.

The study makes for interesting reading in that it sets out an overview of the aggressive tax-planning indicators for each Member State within the EU, including Ireland. It notes that Ireland has a number of tax avoidance indicators including, among others, the absences of deemed income from interest free loans and CFC rules.

Ultimately, the study and staff working document identify what they have determined are potential weaknesses of the national tax systems within the EU Member States and sets the ground for additional analysis and potentially new policy initiatives. With the exception of hybrids, the draft ATA directive released

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=SWD:2016:6:FIN&from=EN

last week does not deal specifically with the other structures or loans mentioned above.

Summary – draft ATA directive actions

The draft ATA directive proposes action in three areas already covered by the OECD's 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 ATA 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 directive 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 characterisation 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's 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 Member 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 per cent of tax-based EBITDA (earnings before interest, tax, depreciation and amortisation). 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 per cent 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.

It is critical to note that this restriction is wider than interest incurred by a company for trading purposes and can also include interest on borrowings incurred for investment purposes. In an Irish context, this would extend to s.247 financing, financing for property investment activities and so forth.

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 per cent 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 per cent of the tax rate in the country of the parent company and
- More than 50 per cent 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 or the broader European Economic Area (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. Therefore, this would be relevant for Irish-headquartered groups with subsidiaries in low-tax jurisdictions. In short, the CFC rules would not apply to subsidiaries whose shares are listed on a recognised stock exchange.

That said, the BEPS CFC paper notes that multinational groups that are based in jurisdictions that are not EU Member States could be at a competitive disadvantage compared to multinational groups that are based in the EU, since the latter would not be subject to equally robust CFC rules. This is because the fundamental freedoms in the EU treaty, as explained in the *Cadbury Schweppes* decision of the Court of Justice of the European Union (CJEU), would only allow such rules to be applied where wholly artificial arrangements are at issue.

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 that 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 instalments 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 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 longstanding 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.

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. The ability of Ireland, and indeed other EU Member States, to retain flexibility over their exit charge provisions, in line with their own national tax policy objectives, is likely to be an area of significant debate by the 28 EU Member States. This is likely to be a key proposal, which goes beyond the OECD BEPS recommendations, and which will trigger divergent views between Member States, particularly where a Member State has determined that it does not wish to levy an exit charge.

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 favourable 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 per cent of the tax rate in the relevant Member State. Clearly, countries that wish to adopt such a rule will need to include anti-conduit provisions to prevent income or gains from being routed via a third country.

In an Irish context, with the exception of dividends from portfolio holdings by a financial trader, Ireland operates a 'tax with credit' regime and subjects foreign branch profits to Irish tax, given our worldwide basis of taxation. Accordingly, the proposals in relation to the switch-over clause shouldn't significantly concern Irish taxpayers. However, Ireland's CGT Participation Exemption does exempt gains on qualifying disposals of shares, where certain conditions are met; therefore, qualifying disposals of shares in low-tax locations could be affected by this proposal if it were to be adopted on a unanimous basis by the EU Member States.

It is not obvious that it is necessary to introduce a switch-over rule across the EU, and a "one size fits all" approach clearly does not take into account the different dynamics at play within the individual 28 EU Member States. Again, this proposal goes beyond anything set out in the final BEPS papers, and is likely to be the subject of heated debate among the 28 EU Member States, many of whom, unlike Ireland, allow for dividend participation exemptions in qualifying situations, under their own national tax policies.

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 that 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 a country's 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. Furthermore, those countries with a GAAR will surely wish it to apply it more broadly than just to corporate tax and it would not be coherent to have different GAARs for different taxes.

Ireland has had such a GAAR rule since 1989 (the former s.811 TCA 1997) and our Irish GAAR provisions were completely overhauled by *Finance Act 2014*. Effectively, under the new s.811C TCA 1997 provisions in Ireland, there is now 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. Accordingly, Ireland should not have anything to fear with regard to the EU proposals on a GAAR. However, from a practical perspective, this could potentially create unnecessary complexity for taxpayers and tax authorities where differing standards are applied on transactions across borders.

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