Bloomberg BNA

# TAX PLANNING INTERNATIONAL REVIEW

International Information for International Business

JULY 2017

www.bna.com

# What is Europe Doing About Tax Avoidance?

**Fabrizio Alimandi and Daniel Gutmann**
CMS Italy and CMS France

This article is the first in a four-part series looking at global tax avoidance practices and the measures being adopted to combat them. The Anti-Tax Avoidance Directive of the European Union is considered here.

**Fabrizio Alimandi is Senior Associate, CMS Italy and Daniel Gutmann is Partner, CMS France**

## Importance of the Anti-Tax Avoidance Directive

The Anti-Tax Avoidance Directive (2016/1164) (the "ATAD" or "Directive") (Council Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market, (OJ L 193/1 (2016), EU Law IBFD) represents a turning point in the history of European Union ("EU") tax legislation. This directive, which is strongly influenced by the OECD Action Plan on Base Erosion and Profit Shifting ("BEPS"), establishes a minimum framework that EU Member States have to implement in order to address tax avoidance practices that, according to its title, "directly affect the functioning of the internal market".

Member States are, therefore, faced with an obligation to transpose the ATAD into their domestic legislation and, in doing so, make structural policy choices that are likely to affect their tax systems in the long run. (According to article 11 of the ATAD, Member States must transpose the Directive before December 31, 2018 and apply its provisions from January 1, 2019. This principle contains, however, a few exceptions: as far as exit taxation is concerned, the deadline is one year later (with a sub-exception for Estonia, which benefits from a specific treatment regarding exit taxation because of the unique features of its tax system). Also, article 11.6 stipulates that "by way of derogation from Article 4, Member States which have national target rules for preventing BEPS risks at 8 August 2016, which are equally effective to the interest limitation rule set out in this Directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.")

The historical importance of the ATAD is not only attributable to the fact that it lays down rules of substantive law that go far beyond the reach of existing directives in the field of direct taxation (which, in short, are mainly aimed at eliminating tax surcharges


07/17 Copyright © 2017 by The Bureau of National Affairs, Inc. TPIR ISSN 0309-7900

that adversely affect the functioning of the internal market). The ATAD's importance is also due to its very broad scope, which is defined in Article 1. The ATAD indeed "applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country." Although Recital 4 of the ATAD clarifies that this scope does not extend to entities that are considered to be transparent for tax purposes, one understands that the ATAD constitutes a first step towards a more general harmonization of tax bases for groups of companies operating within the EU—a more general trend that is now gaining headway as a result of the publication by the European Commission of two proposals on the common (consolidated) corporate tax base ("C(C)CTB") (these two proposals are part of the package released by the Commission on October 25, 2016: Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 final and Proposal for a Council Directive on a Common Consolidated CorporateTax Base (CCCTB), COM (2016) 683 final).

It is evident, in particular, that even purely domestic situations might fall within the scope of the ATAD. Although some provisions of the Directive (such as rules on controlled foreign corporations, exit taxes and hybrid arrangements) might only affect cross-border situations, others may well apply regardless of any international element: interest limitation rules have a general scope and, therefore, their application is not limited to cross-border financing structures; the anti-abuse mechanism enshrined in article 6 is of a general nature as well. While article 115 of the Treaty on the Functioning of the European Union (2007), which is the legal basis for the adoption of the ATAD, makes a connection between the approximation of laws and rules that "directly affect the establishment or functioning of the internal market," it is noteworthy that the Member States have chosen to agree on a means of harmonization that might, in specific situations, have a rather remote connection to the internal market.

## Interest Limitation Rule

The interest limitation rule is aimed at restricting the base erosion and profit shifting pursued by multinational groups which place higher levels of third party debt in high tax countries or use intra-group loans to generate interest deductions exceeding the group's actual third party interest expenses.

Article 4 of the ATAD combats the above phenomenon by stating that corporate taxpayers are only entitled to deduct exceeding borrowing costs ("exceeding borrowing costs" means 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) incurred up to 30 percent of their tax EBITDA. The latter is calculated by adding back to the taxable income the tax-adjusted amounts of interest and depreciation and amortization expenses.

In line with recommendations of BEPS Action 4, article 4 contains a number of derogations granting some flexibility to Member States for the implementation of the new rule. It appears that such flexibility may create competition among Member States; the various derogations may indeed drive a situation where different tax systems, though all compliant with the Directive, may differ significantly from each other in terms of overall burden suffered by resident taxpayers and, to some extent, may increase transnational tax planning for multinational groups (unless the draft directive on a CCTB, which contains fewer options for Member States, actually limits their flexibility in practice).

In particular, paragraph 3 provides that Member States may allow taxpayers to fully deduct exceeding borrowing costs in case of standalone entities not affiliated to any group, as well as giving them the right to introduce a *de minimis* threshold up to three million euros. For entities part of a group the threshold shall be calculated at group level.The facilitations are clearly both aimed at reducing the administrative costs associated with the limitation rule, excluding entities associated with a low risk profile of base erosion and profit shifting and allowing the tax authority to focus on the entities with a higher risk.

Notwithstanding the above, the impact of the Directive will be less important for economies characterized by a high number of small and medium-sized entities (e.g., Italy, Greece): in those cases, the introduction of a *de minimis* threshold may dramatically reduce the scope of the restriction.

Member States are also given the opportunity to enact a grandfathering clause for loans concluded before June 17, 2016, but not for their subsequent amendments, and to exclude from the exceeding borrowing costs those interests related to long-term public infrastructure projects. In such cases the income associated with the projects must be excluded from the EBITDA.

In addition to the above, paragraph 5 lays down the possibility under certain conditions to grant the interest deductibility in full to taxpayers which are part of a consolidated group for financial purposes, to the extent that the entity's equity over its total assets is equal to or higher than the equivalent ratio calculated for the group.

Alternatively, in line with BEPS Action 4, the ATAD also allows a taxpayer to deduct net interest applying the group ratio rule instead of the fixed ratio up to 30 percent mentioned above. The group ratio rule looks after those companies whose leverage is a consequence of the specific sector in which they operate, rather than the result of a non-genuine tax planning strategy (based on this, the taxpayer may be allowed to deduct the exceeding borrowing costs up to the amount calculated by multiplying its EBITDA by the higher of the fixed rate (up to 30 percent) or the group rate (group net third party interest/group EBITDA)).

Lastly, Member States have the option to introduce a carry-forward mechanism, alone or combined with the carry back of exceeding borrowing costs for three years or the carry forward of unused EBITDA capacity for five years.

## Exit Taxation

The exit taxation rule is provided for by article 5 of the ATAD.

The goal of this measure is to establish a common framework which allows Member States to tax the economic value of any capital gain created in their territory, even though that gain has not been realized at the time of the exit.

Article 5 (1) of the ATAD identifies the following scenarios:

(a) transfer of assets from the head office ("HO") to a permanent estabishment ("PE") of another Member State/country;

(b) transfer of assets from a PE in a Member State to an HO or PE of another Member State/country;

(c) transfer of the tax residence to another Member State/country; or

(d) transfer of the business of a PE from a Member State to another Member State/country.

In all the above cases, tax shall apply only if assets and/or businesses are actually moving thus resulting in the risk for the country of origin to lose its right to tax. Taxation shall not apply to the extent that assets and/or businesses are linked to a PE maintained in the state of origin.

Article 5 of the ATAD introduces the right to defer the payment of exit tax over five years (see CJEU National Grid Indus (Case C-371/10) concluding that an immediate payment of exit tax results in the breach of the freedom of establishment, as well as cases DMC (Case C-164/12) and VerderLabTec (Case C-657/13)).

The provision applies also to transfers to third countries that are party to the European Economic Area agreement if they have concluded an agreement with the Member State of the taxpayer or with the EU on the mutual assistance for the recovery of tax claims.

The deferral of the payment is subject to some limitations if there is a demonstrable and actual risk of non-recovery: in such case, the taxpayer may be required to provide guarantees to defer the payment.

In addition, the deferred payment will be immediately revoked where:

- the transferred assets or the business carried on by the PE are sold or otherwise disposed of;
- the transferred assets are subsequently transferred to a third country;
- the tax residence of the taxpayer or the business carried on by its PE is subsequently transferred to a third country;
- the taxpayer goes bankrupt or is wound up;
- the taxpayer fails to honor its payment obligations in relation to the instalments and does not spontaneously settle the situation within a reasonable period of time.

Some considerations are relevant to the computation of the taxable base on which the tax must be calculated.

According to article 5, the taxable base is equal to the difference between the value of the assets (i.e., the market value—the amount for which an asset can be exchanged or mutual obligation can be settled between willing unrelated buyers and sellers in a direct transaction) and their value for tax purposes.

In this last regard, complexity may arise for companies which hold intangible assets (patents or trademarks) and for holding companies owning financial assets.

In addition, a potential conflict may derive from article 5 (5), which lays down that the exit value taxed by the Member State of origin should be recognized as starting tax value by the host s tate, unless it does not reflect the market value. It goes without saying that both countries may have an interest in maximizing their respective rights to tax. Considering the risk of double taxation which this provision entails, one should welcome the agreement reached by the Council on May 23, 2017 on a draft directive to resolve double taxation disputes within the EU.

Finally, article 5 (7) provides that exit tax is not due where assets are set to revert in the Member State of the transferor within a period of 12 months as of the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements of purpose of liquidity management.

## General Anti-Abuse Rule

Article 6 of the ATAD contains a broad general anti-abuse rule ("GAAR") which is designed to challenge abusive tax practices which are not supported by economic substance.

Paragraph 1 provides that Member States shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

The preamble to the ATAD clarifies that the GAAR applies in domestic situations within the EU and *vis-à-vis* third countries in a uniform manner so that its scope and result of application in domestic and cross-border situation does not differ. This intention may however be difficult to realize, as, similarly to the principal purpose test provided for by Action 6 of the BEPS Action Plan, such a general clause has a certain degree of unpredictability, and it is likely that each administration will apply it pursuant to its past domestic experience and to the general attitude of local tax administrations *vis-à-vis* abuse of law and aggressive tax planning in general.

## Controlled Foreign Company Rules

The Controlled Foreign Company ("CFC") rules introduced by articles 7 and 8 address base erosion and profit shifting by reattributing the income of a low-taxed CFC to its parent company, making them taxable in the "home jurisdiction."

The rule represents an important milestone in the European harmonization process considering that, although many Member States are familiar with CFC rules, more than half of the current Member States do not have CFC rules in place.

The CFC rules will apply only where the following conditions are both satisfied:



TPIR ISSN 0309-7900

(a) the taxpayer by itself, or together with its associated enterprises, owns a direct or an indirect participation of more than 50 percent of the voting rights or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of the entity; and
(b) the actual corporate tax paid on its profit by the entity or by the PE is lower than the difference between the corporate tax that would have been charged on the entity or PE under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profit by the entity or PE.

Member States have been given the choice of two different ways to determine the taxable base. The first option (article 7(2)(a)) provides that the taxable base is equal to the non-distributed income of the CFC deriving from certain categories of income: interest, royalties, dividends and income from the disposal of shares, income from financial leasing and others. The second option instead looks after the non-distributed income arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

As far as the first option is concerned, Member States which adopt the above regime may opt not to treat an entity or PE as a CFC if no more than one-third of the income accruing to the entity or PE falls within the categories of non-distributed income under article 7(2)(a).

In addition, Member States can also override the CFC rules for financial entities where no more than one-third of their income coming from the categories listed by article 7(2)(a) refers to transactions with the taxpayer or its associated enterprises.

As far as the second option is concerned, the business is deemed non-genuine where the entity or PE would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

Where Member States opt for the above approach the income to be included in the tax base of the taxpayer shall be limited to the amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company applying the arm's length principle.

The Directive states some additional exclusions giving Member States the faculty of not considering as CFCs entities with accounting profits of no more than 750,000 euros, and non-trading income of no more than 75,000 euros, or whose accounting profits amount to lower than 10 percent of the operating costs for the tax period.

As a general rule, under this regime the tax base shall be calculated according to the rules of the corporate tax law of the Member State where the controlling company is resident for tax purposes or situated. A specific regime is also stated for losses suffered by the CFC which shall not be included in the tax base but may be carried forward, according to national law, and deducted in the following tax periods.

Income will be included into the tax base of the controlling company of the fiscal year in which the tax year of the entity ends.

Furthermore, income already included in the tax base shall be deducted from the tax base when calculating the amount of tax due on the non-distributed profits, in order to avoid double taxation.

## Hybrid Mismatches

The purpose of the provision on hybrid mismatches (article 9 of the ATAD) is to neutralize the tax effects of hybrid mismatch arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more Member States to achieve a deduction in both states or a deduction of the income in one state without inclusion in the tax base of the other.

The rule contained in article 9 is in line with the recommendations contained in the final report on Action 2 of the OECD BEPS Action Plan. However, it is much more modest in scope, being brief and applicable only to intra-EU situations. It considers hybrid mismatches which result in a double deduction, to be tackled by allowing the deduction only in the Member State where such payment has its source, or mismatches which result in a deduction in the Member State without inclusion in the taxable base in the other state, to be tackled by the first state by denying the deduction of such payment.

Because of the limited scope of the hybrid rule in the ATAD, the European Commission issued another proposal in October 2016 in order to extend the scope of article 9 to third countries and to other forms of hybrid mismatches.

After a first meeting on February 21, 2017, the European Parliament gave its opinion on April 27, 2017 and, finally, on May 29, 2017, the Council of the European Union adopted the Council Directive amending Directive (EU) 2016/1164 and introducing new provisions regarding hybrid mismatches with third countries (ATAD 2).

## Conclusion

The ATAD is likely to have a huge impact on domestic tax systems. While all systems are not affected to the same extent (as some systems clearly served as sources of inspiration for some articles), all of them will have to be reformed in a rather significant way.

**Fabrizio Alimandi is Senior Associate, CMS Italy and Daniel Gutmann is Partner, CMS France.**

**The authors may be contacted at: fabrizio.alimandi@cms-aacs.com; daniel.gutmann@cms-bfl.com**