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The European Union Adopts the Anti-Tax Avoidance Directive

Earlier today, 12 July 2016, the European Union (EU) Economic and Financial Affairs Council (Ecofin) formally adopted the so-called Anti-Tax Avoidance Directive (ATAD).

The first step toward the ATAD was made on 28 January 2016, when the European Commission published its initial Anti-Tax Avoidance Package (the Package), inspired by the OECD's project on avoiding Base Erosion and Profit Shifting (BEPS). The Package forms part of the European Commission's agenda for fairer, simpler, and more effective corporate taxation in the EU. It contains measures to address aggressive tax planning, increase tax transparency, and create a level playing field in the EU.

The ATAD is considered to be one of the key elements of the Package and was initially tabled for approval by the Ecofin on 25 May 2016. However, following lengthy discussions and due to disagreements among several EU Member States' delegates on certain measures included in the ATAD proposal, the Ecofin reached political agreement on an amended ATAD and now formally adopted the directive. Compared to the initial ATAD proposal as published on 28 January 2016, substantial changes were made.

In this Alert we will briefly discuss the main aspects of the rules that the ATAD lays down in five specific fields:

- a general interest limitation rule;
- a provision on exit taxation;
- a general anti-abuse rule (GAAR);
- a provision on controlled foreign companies (CFC); and
- a framework against hybrid mismatches.

Main Aspects of the Approved ATAD

The Deductibility of Interest

The interest deductibility limitation provision in the ATAD aims at discouraging taxpayers to finance group entities in high-tax jurisdictions through debt, and arrange that they pay back inflated interest to subsidiaries resident in low-tax jurisdictions. The provision limits the deduction of exceeding borrowing costs[1] to the higher of:

(i) an amount of EUR 3 million; or

(ii) 30 percent of the taxpayer's taxable earnings before interest, taxes, depreciation, and amortization (EBITDA).

The rule does not distinguish between third party and related party interest, nor between EU or third country debt. Member States can choose to apply the fixed rule of 30 percent and the EUR 3 million threshold escape at the level of a local group as defined according to national tax law. In addition, Member States can choose to exclude standalone entities from the application of the interest deduction limitation.

Furthermore, if the taxpayer is a member of a consolidated group for financial accounting purposes, the ATAD provides for two alternative worldwide group ratio escapes. Member States are, however, not obliged to implement either one of these two escape rules. Member States may provide for carry forward and carry back rules, and may exclude financial undertakings from the application of the rule altogether. Lastly, Member States may exclude exceeding borrowing costs incurred on: (i) loans used to fund long-term public infrastructure projects within the internal market, and (ii) loans which were concluded before 17 June 2016 – albeit that that the exclusion shall not extend to any subsequent modification of such loans.

Exit Taxation

The exit tax provision determines that all Member States must apply an exit tax on assets moved from their tax jurisdiction in specific circumstances (including company migration, transfers from a head office to a PE, or a transfer of assets out of a PE). In such cases, the taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of the exit of the assets, less their book value for tax purposes. Provided certain requirements are met, Member States must give tax payers the right to defer the payment of the exit tax by paying it in installments over five years. The Member State to which the assets are transferred, must accept the market value of the transferred assets as the starting value for tax purposes (*i.e.*, allow a "step-up").

General Anti-Abuse Rule (GAAR)

Under the GAAR, an artificial tax arrangement should be tackled, if there is no other anti-avoidance rule that specifically covers such arrangement. Generally speaking, the GAAR should function as a safety net covering gaps in case other anti-abuse provisions cannot be applied. An arrangement (or series of arrangements) is considered to be artificial if the arrangement has not been put into place for valid commercial reasons.

Controlled Foreign Corporations (CFC)

The CFC provision intends to reattribute the income of a low-taxed controlled foreign subsidiary to its parent company. The CFC provision determines that the Member State of the parent company is required to treat an entity, or a permanent establishment (based in either another Member State or third country) of which the profits are not subject to tax or are exempt from tax in that Member State, as a CFC if:

(i) in case of an entity, the taxpayer holds a (direct or indirect) participation of more than 50 percent of the voting rights, more than 50 percent of the capital, or is entitled to receive more than 50 percent of the profits of that entity; <u>and</u>

[1] '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.

(ii) the actual corporate tax paid by the entity or PE in the CFC jurisdiction 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 the profits in the CFC jurisdiction.

In principle, the CFC provision prescribes that the parent company becomes subject to taxation for certain non-distributed income of the CFC. The Member State of the parent company may choose to either include in the tax base:

a) the non-distributed income of the entity or PE derived from certain categories of income; or

b) the non-distributed income of the entity or PE arising from non-genuine arrangements put in place for the predominant purpose of obtaining a tax advantage.

Member states can include a carve-out for the inclusion under (a) above for CFCs that carry on a substantive economic activity supported by staff, equipment, assets, and premises, but may also opt not to apply this exemption if the CFC is a resident or situated in a country that is not party to the European Economic Area agreement.

Under the inclusion mentioned under (b) above, Member States may include a carve-out for CFCs that either (a) have accounting profits of no more than EUR 750,000 and trading income of no more than EUR 75,000, or (b) that have accounting profits that do not exceed 10 of its operating costs.

Hybrid Mismatches

A hybrid mismatch is, under the ATAD, considered to be the consequence of differences in the legal characterization of payments (financial instruments) or entities that surface in the interaction between the legal systems of two jurisdictions, often leading to a double deduction or a deduction without inclusion.

The hybrid mismatch provision included in the ATAD states that where a hybrid mismatch results in a double deduction, the deduction should only be granted in the Member State where the payment has its source. Similarly, to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

The scope of the hybrid mismatch provision is limited to hybrid mismatches between Member States. In the Annex to the ATAD, the Ecofin requests the European Commission to also put forward a proposal for hybrid mismatches with third countries by October 2016.

Conclusion

Member States have to implement all measures as of 1 January 2019, except for the interest deduction limitation provision and the exit taxation provision. For those measures, different implementation dates apply.

As a firm, we will keep you updated on implementation steps taken by relevant EU Member States.

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