European Council reaches agreement on Anti-Tax Avoidance Directive

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On 21 June 2016, the European Council reached an agreement on the so-called Anti-Tax Avoidance Directive. This Directive introduces a common set of rules aimed at preventing tax avoidance practices in the European Union (EU).

This is a major step forward in the EU's implementation of the Organisation for Economic Co-operation and Development's (OECD's) Base Erosion and Profit Shifting (BEPS) Action Plan. The Directive introduces minimum standards in the EU with respect to three areas addressed by the OECD:

- interest limitation rules
- controlled foreign company (CFC) rules
- rules on hybrid mismatches.

In addition, the Directive addresses two areas which were not specifically considered by the OECD: exit taxation rules and a general anti-abuse rule (GAAR).

The Directive applies to all taxpayers that are subject to corporate tax in an EU Member State, including corporate taxpayers resident outside the EU with a permanent establishment in the EU.

Member States will have until 31 December 2018 to transpose the Directive into national law and regulation. With respect to exit taxation rules, Member States will have until 31 December 2019.

Interest limitation rules

The Directive limits the deduction of 'net' interest expenses to 30% of taxable earnings before interest, tax, depreciation and amortisation (EBITDA).

The EBITDA of a tax year that it is not fully absorbed by the borrowing costs incurred by the taxpayer in that tax year or previous years may be carried forward.

The Directive provides Member States with the discretion to include the following important exception in their respective national laws and regulations: taxpayers which are part of a consolidated group can fully deduct their net interest if they can demonstrate that the ratio of its equity over its total assets is no more than 2% points lower than the equivalent ratio of the group.

Exit taxation rules

The Directive requires Member States to apply an exit tax when a taxpayer moves its tax residence or assets out of the tax jurisdiction of a Member State. The Directive specifies four scenarios in which an exit tax should apply:

1. The transfer assets from a head office to a permanent establishment in another Member State or a third country.
2. The transfer of assets from a permanent establishment to the head office or a permanent establishment in another Member State.
3. The transfer of tax residence to another Member State or to a third country except for those assets which remain effectively connected with a permanent establishment in the original Member State.
4. The transfer of a permanent establishment out of a Member State to another Member State or to a third country.

The exit tax is to be applied to an amount equal to the market value of the transferred asset less their value for tax purposes (ie unrealised capital gains).

In order to avoid double taxation resulting from the application of different asset valuation methods, the Directive provides that the inbound Member State will be obliged to accept the value of the asset as established by the Member State of origin at the moment of transfer as the starting value of the asset. It should be noted, though, that this rule only covers intra-EU transfers – the Directive does not provide any solutions to EU-third country transfers, including transfers from countries party to the European Economic Area (EEA) agreement; double taxation could potentially arise under these scenarios.

Member States will need to amend their respective exit tax provisions in order to bring them in line with the Directive.

General Anti-Abuse Rules (GAAR)

The Directive introduces a GAAR which targets 'non-genuine' arrangements which have been set up for the main purpose of obtaining a tax advantage that defeats the object or purpose of the applicable tax law. The purpose of the GAAR is to target abusive tax practices not captured by a specific anti-avoidance rule.

The Directive specifies that an arrangement will be regarded as 'non-genuine' where it has not been put into place for valid commercial reasons which reflect economic reality. The term 'arrangement', however, is not defined in the Directive. Nonetheless, on the basis of the Commission's GAAR recommendation, it is expected that the term 'arrangement' will encompass any transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event.

A number of Member States already impose a GAAR, so this provision may not have a large impact on some taxpayers.

Controlled foreign company (CFC) rules

The Directive introduces CFC rules which oblige a taxpayer (ie the parent company) to include the non-distributed income of some related entities in its tax base. The related entities which are targeted by the CFC rules include low-taxed controlled entities and permanent establishments.

Initially, it had been proposed that the CFC rules would target undistributed profits that are subject to taxation at an effective corporate tax rate lower than 50% of the equivalent effective rate in the controlling Member State. The agreed Directive, however, provides Member States with the discretion to employ a higher threshold in comparing the actual corporate tax paid with the corporate tax that would have been charged in the Member State of the taxpayer.

Rules on hybrid mismatches

The Directive introduces new rules to counter so-called hybrid mismatches or arrangements that are the consequence of a different legal characterisation of payments or entities by two legal systems.

The Directive provides that where a hybrid mismatch results in a double deduction, it is only the source state that should grant the deduction. Furthermore, the Directive provides that where a hybrid mismatch results in a deduction without inclusion, the Member State of the taxpayer shall deny the deduction of such payment.

Contact

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