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Client Alert

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European Commission Proposes Anti Tax Avoidance Directive

The proposed Council Directive is a further step towards tackling tax avoidance

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Background

The Commission has published a proposal for a Council Directive, the 'Anti Tax Avoidance Directive' (the "Proposed Directive"), confirming the Commission's intention to combat tax avoidance and to coordinate effectively Member States' efforts in this area. The Proposed Directive represents a significant move regarding direct taxation within the EU.

The Proposed Directive includes recommendations in six specific areas which will apply to all taxpayers subject to corporate tax in any Member State (including taxpayers which are permanent establishments of corporate taxpayers not resident within the European Union).

1. Interest Limitation Rules

The Proposed Directive provides that, as a general rule, taxpayers will be able to deduct interest expense:

- to the extent that the taxpayer receives taxable interest or income from 'financial assets';
- up to a yearly maximum of 30% of its EBITDA (or, if higher, €1 million per year), with any excess interest above the maximum being deductible in future years.

A taxpayer will be entitled to a greater interest deduction by Member States to the extent that the taxpayer can demonstrate that total leverage is lower than the leverage of the group to which the taxpayer belongs.

While the interest limitation rule does not currently apply to financial undertakings, as defined by the Proposed Directive, the Commission has stated that it ultimately intends to introduce rules to cover such taxpayers.

2. "Exit" Taxes

The Proposed Directive anticipates that cross-border transfers of assets will be treated as taxable disposals at fair market value. Relevant transfers would likely include those from:

- one permanent establishment to another permanent establishment located in a Member State or a third country; and
- a permanent establishment located in a Member State to a non-Member State.

The Proposed Directive would also likely apply to the change of residence of a taxpayer from one Member State to another location (whether or not a Member State), unless the assets of the taxpayer are allocated to a permanent establishment within the 'transferring' Member State.

3. "Switch-Over" Provisions

The Proposed Directive aims to ensure that Member States' 'participation exemption' regimes will only be available where a minimum tax rate is applied by the 'source' state (i.e. the country where the shares from which dividends or gains from disposal arise, or the country where the permanent establishment obtaining profits is located). The "Switch-Over" Clause would only apply to income sourced from non-Member States. It will be interesting to determine whether such a provision would result in issues regarding Treaty compatibility.

As regards the minimum tax rate, the Proposed Directive, as currently drafted, applies a minimum tax equal to 40% of the 'statutory' (i.e. not 'effective') tax rate. Where a Member State cannot grant the exemption on foreign income, the Proposed Directive would allow the mitigation of double taxation through the application of the 'credit' method. The Switch-Over Clause will not apply to losses incurred by a permanent establishment of a resident taxpayer situated in a third country, nor to losses incurred in the disposal of shares in an entity resident in a third country.

4. General Anti-Abuse Rules (GAAR)

Non-genuine arrangements are to be ignored and tax liability is to be calculated by reference to economic substance; this does though require an assessment of what represents a "non-genuine arrangement". Ultimately, it is probable that this will be translated differently by each Member State, with further interpretation by the EU Court of Justice.

5. "Controlled Foreign Company" (CFC) rules

The Proposed Directive applies where a taxpayer controls an entity located in a low or nil-tax jurisdiction, and that entity obtains mainly passive income. For this purpose, 'control' will be deemed as 50% or more of share capital, voting or economic rights of the participated entity (with attribution rules applicable to associated companies). A jurisdiction will be deemed as 'low-tax' if the effective tax rate is lower than 40% of the 'effective tax rate (not the statutory tax rate - note difference with the Switch-Over Clause) which would have been the rate under the applicable corporate tax regime in the taxpayer's Member State. An entity is deemed to obtain mainly passive income if more than 50% of the income accruing to that entity falls within any of the categories listed in the Proposed Directive. The Proposed Directive anticipates exceptions for financial undertakings and listed entities.

6. Hybrid Entities and Instruments

Where classification of entities or instruments, given by two Member States, produces situations of double non-taxation, the aim of the Proposed Directive is that legal characterisation followed by the Member State where a given payment is

made (or the expenses are incurred, or the loss suffered) shall be followed by the other Member State that is involved in any mismatch. The Proposed Directive only refers to mismatches occurring within Member States, and does not refer to third countries.

Conclusion

The Proposed Directive poses significant challenges and it is to anticipate that it will likely not become law for a considerable period of time.

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