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Anti-BEPS Directive / Anti-Tax Avoidance Directive (ATAD)

The ATAD was presented by the European Commission as part of the Anti-Tax Avoidance Package on 28 January 2016. It contains **six main elements**, three of which (**interest limitation rule, CFC rules[1], rules on hybrid mismatches**) draw directly on the outcome of the OECD BEPS project whereas the three other elements (**exit taxation, switch-over clause and general anti-abuse rule (GAAR)**) are additional proposals by the Commission.

In principle, those measures are useful defences against profit shifting by multinational corporations (MNCs). But they need significant upgrade in order to be effective against the current level and sophistication of aggressive tax planning. Importantly, while the Commission claims that Member States (MS) can go beyond the common standard level of protection, the fierce tax competition MS are engaged in will significantly discourage stronger national measures.

1. Interest limitation rule

What it means

MNCs frequently shift profits by means of oversized interest payments on intra-company loans provided, for instance, by entities in low-tax jurisdictions to entities in higher-tax jurisdictions where actual economic activity takes place. The proposed rule restricts the extent to which individual entities can reduce their profits by deducting interest cost[2].

The main threshold is set at 30% of an entity's earnings before interest, tax, depreciation and amortisation (EBITDA). Interest cost above this threshold can only be deducted if it offsets interest income or equivalent earnings from financial assets, if the overall deduction is below €1m[3] or if an entity's equity to total assets ratio is equal or higher than the equivalent ratio of the overall group (*group carve out*). This last exemption is based on the idea that for an entity to be the source of profit shifting, it will typically be disproportionally (compared to the rest of the group) loaded with debt and hence have a comparably low equity to total assets ratio. This group carve out is limited to groups where payments to associated entities do not exceed 10% of total net interest expenses.

There is indefinite carry-forward of the deductible allowance (i.e. if net interest cost is only 20% of EBITDA in year one, the difference to 30% can additionally be deducted in year two and following years) and of incurred net interest costs (i.e. if costs were 40% of EBITDA in year one, and a fourth of the costs could hence not be deducted, those can be deducted in subsequent years in as far as the 30% threshold is not breached) and the entire rule does not apply to the financial sector for which negotiations are on-going at the OECD level.

Where it needs improvement

The principal 30%-of-EBIDTA threshold is too generous[4]. For it to constitute an effective restriction on MNCs' ability to shift profits, it needs to be reduced to 10% (in line with the OECD recommendation proposing a value between 10-30%, where the lower bound seems justified because of the EU's comparably integrated market).

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[1] General guidelines and best practices on CFC rules are part of the BEPS package, but there was no agreement on exact provisions.
[2] A similar rule already exists in at least 5 MS (DE, ES, FI, IT, PT).
[3] The additional absolute threshold is meant to benefit SMEs as well as companies with a negative EBITDA.
[4] The Business and Industry Advisory Committee to the OECD (BIAC) provided evidence to the OECD consultation (Part 1, full report in annex, analysis on p. 136) based on a survey done by PwC using the S&P database with over 20,000 entries. More than 50% of companies had a net ratio below 10% and 80% were below 30%.

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The carve-out for financial and insurance undertakings should be limited in time (e.g. two years) after which they would be subject to the same rule. This would prevent political obstruction of specific rules for the financial sector from generating a permanent total exemption. Also, the carry-forward should be limited to maximum of two years and there need to be provisions for financing arrangements outside the group but with the same effect (for instance with the owners as private individuals).

In addition, the fixed-cap concept (10-30% of EBIDTDA) could be shelved in favour of an entirely group-based rule which puts an entity's position in relation to the rest of the group. The OECD BEPS project featured in its conclusion a mode whereby an entity would be eligible to deducting as much interest compared to its EBITDA-profits as the average of the group[5]. Another option was championed by civil society whereby a group's overall interest costs would be consolidated and the remaining net external interest cost would be apportioned to individual entities based on each respective entity's share of the group's total EBITDA.

Such rules would require a tax administration to dispose of information on profits and costs of the entire group in order to be applied with certainty. Moreover, they may be gamed if entities legally outside the group but practically under economic control of the group's owners are created and take part in the avoidance strategy. A sizable advantage, in addition to being probably stricter than a fixed cap, would be that they take the situation of each MNC group into account as thresholds depend on the rest of the business. This would prevent arbitrary discrimination among companies based on a one-size-fit-all approach.

In line with suggestions by some academics, the interest limitation rule could also be extended to cover royalty fees in addition to interest payments[6]. Here, group ratio based rules would be less suitable, but one could operate either with a limited fixed cap (x% of EBITDA eligible for deductibility) or with a provision conceptually similar to CFC rules whereby the deductibility depends on the level of effective taxation at the destination of the royalty (and interest) payments. Below a certain level of effective taxation, say 25%, deductibility could be fully or progressively (decreasing with the level of effective taxation) restricted. No DTAs would need to be amended for such an extension.

2. Exit taxation

What it means

MNCs often transfer assets or even the entire taxable presence of some entities to low-tax jurisdictions. In the case of intangible assets, such transfers can be the basis for later setting up profit shifting structures based on royalty and licence fee payments from high-tax jurisdictions with actual economic activity to low-tax jurisdictions.

[5] This takes up a weakness of the Commission's equity ratio approach which may be manipulable for entities within the same corporate group. The Commission however argues that backstops against abuse of equity ratios could be inserted in national laws based on the directive (like in Germany). In addition, a ratio based on profits would mean that in cases where the group makes losses, no deduction would be possible. Further, with the equity clause, **full** deduction is possible in the case the threshold applies. With the group ratio, only proportional additional deduction is possible, i.e. probably less than with the equity ratio.
[6] http://www.jarass.com/Steuer/B/Business%20Taxation,%20published.pdf

The provisions on exit taxation try to make such transfers less lucrative by taxing away any potential difference in actual (market) and book (tax) value[7] of the assets concerned. This does not make transfers impossible, but aims to ensure that assets are transferred at market value and that profits (of the transfer) accrue in the jurisdiction of origin.

Where it needs improvement

The proposal might make certain preparatory steps of aggressive tax planning practices more cumbersome and/or costly. It does however not tackle actual profit shifting regimes. In addition, it suffers from the same methodological flaw than the entire system of international corporate taxation, namely that MNCs are called to operate internal transactions with market prices (i.e. at arm's length), but that those are inherently difficult to establish for many (intangible) assets.

Hence, it will be difficult for tax administrations to challenge MNCs' calculations. With respect to the specific purpose of tackling asset shifting in early stages of intellectual property development, there is also an objective challenge of valuing such assets for which there is substantial business risk in terms of their later commercial exploitation. This uncertainty about the proposal's effectiveness notwithstanding, a surcharge on the calculated tax should be added in cases where the market value of the assets concerned increases disproportionately within a given time frame after the transfer. This would be a way to retrospectively detect undervalued transfers with the aim of saving tax.

3. Switch-over clause

What it means

At the moment, most MS generally apply the so-called *exemption method* for foreign profits flowing into their jurisdiction. This means that profits earned abroad and repatriated into the jurisdiction are not taxed under the assumption that they have already been subject to corporate tax abroad. The idea is to avoid double-taxation and the principle is enshrined in many bilateral tax agreements.

The Commission proposes, for transfers from third countries into the EU, to replace the exemption method with the so-called *credit method* (i.e. to *switch-over* from one method to the other) under the condition that the country where the profits originate has a statutory tax rate[8] of 40% or less than the rate prevailing in the MS of destination. This means that for profits coming from third countries with levels of taxation below the threshold (e.g. 12% if the MS itself applies a rate of 30%), those profits are fully subject to tax in the MS (at 30%), but all tax already paid in the third country would be credited against the tax due, so as to avoid any actual double-taxation[9].

Where it needs improvement

The threshold rate of 40% will provide incentives for corporations to move to low-tax MS within the EU as it is based on a relative comparison with the rate of MS of destination. For example, a company based in Bulgaria, which applies a

[7] [SoI] “the market value shall include a profit sharing element reflecting the extent of the functions and risks assumed by the transferee [or the entity to which the assets are transferred]” see para. 6.70 of the revised Transfer Pricing Guidelines (ch. VI on Intangibles), on p. 83-84 of the BEPS report on Actions 8-9-10.

[8] The clause is based on the statutory rate following the assumption that the effective tax rate of non-controlled sources of foreign income will not be naturally known to the parent (and can't hence be requested by the tax authority) ≠ CFC rules.

[9] According to the legal service of the Council, the switch-over clause would require a renegotiation of DTAs in case they prescribe the exemption method. EU law overrules in such cases national law including DTAs. MS may however opt, in their implementing laws, to limit the scope of application of the article to countries for which there are no DTAs yet.

10% corporate tax rate, would only see its foreign income be subjected to the switch-over clause if it originates in a jurisdiction with less than 4% statutory corporate tax rate.

The provisions also do not apply to intra-EU profit flows. The Commission argues that this would be unrealistic given the unanimity requirement in the Council (but it would not be legally impossible with current treaties according to the ECJ). A general extension to intra-EU transfers would reduce opportunities for immediate profit shifting, but would also tend to exacerbate intra-EU tax competition as it becomes more attractive to be headquartered in a low-tax jurisdiction. This problem could only be solved through sufficiently high minimum corporate tax rates across the EU.

4. General anti-abuse rule (GAAR)

What it means

This proposal introduces a common minimum standard for a general anti-abuse rule across all MS (most but not all MS already have one in their tax laws). This means that tax administrations can disregard a company's legal arrangements if those are carried out for the essential purpose of obtaining a tax advantage and are not put in place for valid commercial reasons which reflect economic reality.

Where it needs improvement

GAAR tend to have limited value in practice because of their (inherent) general nature. Tax administrations have to proof that a certain legal arrangement falls under the generic conditions stipulated by the clause. Such decisions are very often prone to legal challenge and therefore, given their limited resources compared to MNCs, administrations regularly refrain from taking them in the first place.

5. Controlled foreign company (CFC) legislation

What it means

MNCs often park profits in subsidiaries in low- or no-tax jurisdictions. Traditionally, such profits would not be subject to tax in the country where the subsidiary's parent is located. Under CFC rules, however, non-repatriated profits in foreign subsidiaries are added to the parent's tax base and thus subject to tax at the (higher) local rate.

For CFC rules to apply according to this proposal, subsidiaries need to be controlled (50% of voting rights or capital or rights to profits), situated in a low-tax regime (effective tax rate of 40% or less than the comparable rate in the respective MS) and generate at least 50% of their income from passive sources (interest, royalties, dividends, leasing, insurance, finance, intra-group services etc.). For financial undertakings, as additional condition, 50% of the passive income needs to be intra-group for the CFC rules to apply. If both subsidiary and parent are located inside the EU, existing national CFC rules are limited to wholly artificial establishments, as a consequence of ECJ jurisprudence. But the Commission included provisions in its proposal which would allow for artificial transactions to be covered even if they are conducted by entities which would not fall under the (restrictive) legal interpretation of *wholly artificial*.

Where it needs improvement

The proposed rules are most likely still hardly applicable between EU MS and this drastically limits their impact. In addition, the threshold tax rate of 40%, below which CFC rules kick in, is significantly lower than an earlier OECD recommendation of 75% (academics call for even higher values around 90%) and would mean that subsidiaries of

companies headquartered in low tax MS such as Ireland or Bulgaria won't be affected even at low single digit rates[10]. As alternative to a much higher relative threshold, consideration could be given to an absolute threshold between 10-25% of tax.

The income categories playing into the calculation of whether a foreign subsidiary is subject to CFC rules should include intra-group trade in goods as well as services as the transfer prices with which good are traded are also commonly used for profit shifting. It could be useful to decrease the threshold of income of passive nature required for CFC rules to apply from 50% to 25%.

A further important add-on would introduce a place-of-effective-management (POEM) test. This is meant to avoid holding structures which technically own subsidiaries (and hence profits are going upstream, not covered by the CFC proposal as it stands), but are in fact shell holdings in tax havens with any economic or managerial substance. Such a situation would typically be the result of inversions used for tax planning purposes whereby a company's ultimate parent is moved out of a high-tax country into a tax haven.

A more ambitious proposal would include actual full-inclusion CFC rules. This effectively means a systematic change to an approach that makes an entity tax-liable for its world income (including all foreign subsidiaries) with credit given for any foreign tax paid.

6. Hybrid mismatches

What it means

Differing legal characterisations of a financial transaction or a business entity between two jurisdictions are regularly exploited for profit shifting purposes. In order to limit the danger of such mismatches, the Commission proposes to introduce a general principle whereby the MS of destination of a transaction shall follow the characterisation applied by the source MS.

Where it needs improvement

The actual implementation of the proposed provision crucially depends on the destination MS' political will to close gaps opened through hybrid mismatches. As that MS is often benefitting from profit shifting, this may not happen in practice. Hence, the harmonisation could also start with the destination country and subject/empower the source country to follow the former's definition. This would require the source administration to have knowledge about the (later) treatment of a given instance in the country of destination, but this should not be problematic within the EU. In addition, hybrid mismatches should also be dismantled between EU MS and third countries and MS should hence implement above provisions also in all tax relations with states outside the EU.

7. Entirely missing elements

[10] The problem of tax competition and downward pressure on tax rates in the countries where parents are located will not be affected by any CFC rule, even with a very high threshold rate, as a the maximum result of any CFC rule is taxation at the rate of the parent company's location. CFC rules only help the home/source country. As part of the tax race-to-the-bottom, two major home countries of MNCs essentially abandoned their CFC regimes: the USA with check-the-box, and the UK when it moved to a 'territorial' system in 2012.

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- A clear definition of **permanent establishment (PE)** as the avoidance of PE status constitutes a major tax avoidance strategy. This was part of the December 2015 Council compromise proposal by the Luxembourg Presidency. In its January 2016 communication on the implementation of measures against tax treaty abuse, the Commission recommends that MS implement changes to the OECD's model convention in line with BEPS Action 7.
- A specific definition of **associated enterprise**, a term which is crucial for the application of CFC rules. Again, this was part of the Council text and should be re-inserted.[11]
- A clause aimed at containing the potentially restrictive effects of **double tax agreements (DTA)** for defensive measures against tax avoidance, e.g. with respect to withholding taxes or the definition of permanent establishment. In its communication on the implementation of measures against tax treaty abuse, the Commission merely recommends that MS implement changes to the OECD's model convention in line with BEPS Action 6, i.e. that they introduce a so-called principal purpose test in their bilateral conventions so as to avoid treaty shopping through entirely artificial constructions.
- Additional **punitive measures for tax havens**.
- A **rehabilitation of withholding taxes** (in combination with credit for foreign withholding taxes or triggered by an insufficiently high effective taxation in the destination country) as a means to curtailing profit shifting and ensuring profits are taxed at least once. This would probably require changes to existing DTAs which significantly limit the use of withholding taxes.

8. Germany vs. COM proposal

- **Interest limitation rule / *Zinsschranke***: Introduced in 2008, but weakened in 2009; 30% fixed-cap like COM, with safeguard clause of €3m (instead of €1m); carry-forward limited to 5 years; equity group carve out has backstop against cascade or nested legal constructions allowing groups to manipulate subsidiaries' equity; less than 1000 companies currently affected; may be repealed in its current form by constitutional court as it discriminates among nominally equal interest costs depending on the circumstances (may be rectified by making it more explicitly apply to cross-border transactions).
- **Exit taxation / *Wegzugsbesteuerung*:** Exists since 2008
- **Switch-over clause** / *Switch-over Klausel*: Have been introduced in recently signed DTAs, but only in the form of an additional option for the tax administration and not as an obligation like in the Commission's proposal
- **GAAR** ***/ Allgemeine anti-Missbrauchsvorschrift****:* Exists in similar form but is rarely used for reasons outlined above
- **CFC rule / *Hinzurechnungsbesteuerung***: Based on an absolute, fixed rate of 25% of tax below which CFC rules can be applied; set of included income however much more limited than in COM proposal; not applied in practice because of ECJ intra-EU and DTAs extra-EU
- **Hybrid mismatches / *hybride Qualifizierungskonflikte***: Has been repeatedly called for by the *Bundesrat* but so far been ignored by the *BMF*

[11] There defined as "a person 'associated' to a taxpayer means a situation where the first person holds a participation of more than [25]% in the second, or there is a third person that holds a participation of more than [25]% in both"

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