LATHAM&WATKINS

Client Alert
Commentary

Latham & Watkins International Tax Practice February 5, 2016 | Number 1922

European Commission Proposes an Anti-Tax Avoidance Directive

The proposed Council Directive marks another, significant, though likely problematic, step towards tackling tax avoidance across Member States.

Background

The European Commission (the Commission) has been moving towards adopting tax measures that would protect the functioning of the internal market, since the European Council Conclusions in December 2014. The Commission's latest proposal for a Council Directive (the Proposal),[1] published 28 January 2016, comes only a few months after the OECD published recommendations in the Base Erosion and Profit Shifting (BEPS) Final Reports (5 October 2015). The Proposal confirms the European authorities' commitment to continue fighting tax avoidance and to ensure that Member States' efforts in this area are properly coordinated.[2]

Why would the Commission propose recommendations which are similar to those already included in the BEPS Final Reports? Possibly the need to avoid tax competition between Member States is driving the Commission, especially as public budgets are under the strain of the deepest economic crisis in a century, and the Luxembourg tax rulings scandal hinders the credibility of the single European market.[3] Or possibly, the Commission wants to ensure that the Member States properly coordinate any steps taken to tackle tax avoidance, to prevent Member States from generating any involuntary loophole or mismatch when implementing tax avoidance measures. Undoubtedly, this is a very significant move in the field of direct taxation within the EU.

Content

The Proposal includes recommendations in six specific fields, discussed below, which aim to capture 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.

Interest Limitation Rules

As a matter of general principle, the Proposal provides that taxpayers can deduct interest expense only to the extent that the taxpayer receives taxable interest or income from financial assets. Additionally, the Proposal confirms that interest accrued by a given taxpayer will only be deductible up to a yearly maximum of 30% of its EBITDA (or, if higher, €1 million per year), and any excess interest above the maximum may be deductible in future years. Also, if in a given tax year the interest accrued does not reach the EBITDA threshold, the unutilized EBITDA can be carried forward to use in future years. However, the Proposal also permits Members States to allow a greater interest deduction provided that

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. The Law Office of Salman M. Al-Sudairi is Latham & Watkins associated office in the Kingdom of Saudi Arabia. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2016 Latham & Watkins. All Rights Reserved.

the taxpayer can demonstrate that its total leverage is lower than the leverage of the group to which the taxpayer belongs. While this exception includes many detailed requirements, it certainly provides an alternative test not presently included in any legislation of Member States where interest deductibility is already subject to EBITDA limitations. Finally, this interest limitation rule does not capture financial undertakings, as defined by the Proposal, however the Commission has stated that it ultimately intends to introduce rules to cover such taxpayers.

Exit Taxes

Under the Proposal, the cross-border transfer of assets might be deemed as a taxable disposal at fair market value of the assets of the taxpayer. Eligible transfers could include transfers:

- From the head office to a permanent establishment (or vice versa, in both cases even if the beneficiary is located in a third country)
- From one permanent establishment to another permanent establishment located in a Member State or in a third country
- Of a permanent establishment out of a Member State
- Of residence of a taxpayer from one Member State to another country (Member State or third country), unless the assets of the taxpayer are allocated to a permanent establishment left in the Member State of departure

This section of the Proposal aims to remedy an inconsistency in the current rules caused by the Commission's concerns about potential discrimination. Changing the tax seat within a given Member State was not a taxable event, while moving the tax residency to another Member State might be subject to corporate taxes, arguably infringing on the freedom of establishment enshrined in the Treaty on the Functioning of the EU. Under the Proposal, Member States would be required to include provisions in their law to tax "exit strategies." This Proposal also allows a deferral of the tax payment, under some circumstances in exchange for guarantees, but only when the assets, or the residency itself, are transferred to another Member State or to a third country that is party to the Economic Area Agreement (EEA Agreement). Under these circumstances payment is required in instalments, over at least five years. The deferral may be discontinued under certain conditions mainly referable to the transfer of assets or residency to a third country. The development of this specific proposal bears watching, as it might potentially be deemed as running contrary to the principal of freedom of establishment, although justified as a proportionate measure against tax avoidance.

Switch-Over Clause

The Proposal aims to ensure that participation exemption regimes will only be granted provided that 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) applies a minimum tax rate. The Switch-Over Clause may prove controversial, as it only captures income sourced from third countries. Even if this is consistent with the proposal for a CCCTB, the potential introduction of this measure before the CCCTB is implemented might trigger questions about compatibility with the Treaty on the Functioning of the EU.

Leaving that discussion aside, though, the question arises about the quantity of this *de minimis* tax. The Proposal, as currently drafted, sets forth a minimum tax equal to 40% of the statutory (not effective) rate, applicable under the corporate tax system in the taxpayer's Member State. Questions remain about

whether this is consistent with the present tax system applicable in each of the different Member States. Likely the Switch-Over Clause will require some amendments if the Commission moves forward in this direction.[4] If a Member State cannot grant the exemption on foreign income, the Proposal eliminates double taxation through the application of the so-called 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.

General Anti-Abuse Rules (GAAR)

While the concept is simple, *i.e.*, non-genuine arrangements will be ignored and tax liability will be calculated by reference to economic substance, this is one of the most controversial principles existing under international and domestic tax law. Controversial, though, not because of its aim, but rather for the dubious notion of "non-genuine arrangement" (as opposed to an arrangement put into place for valid commercial reasons). Most likely, the translation of this measure into the legislation of the different Member States will not shed more light on the concept. As usual, it will be the practical application of the General Anti-Abuse Rules by each local authority, and the interpretation given by the Court of Justice of the European Union, that will render the application of this principle more or less effective. Hopefully, each of the Member States, with the support of the Court of Justice, will apply this principle in a uniform manner, to avoid unexpected conflicts derived from the practical approach taken by the different tax authorities within the EU. Yet another area that warrants following with care.

Controlled Foreign Company (CFC) rules

The Proposal captures situations where a taxpayer controls an entity located in a low or nil-tax jurisdiction, and the entity obtains mainly passive income. For this purpose, control is deemed as 50% or more of share capital, voting or economic rights of the participated entity (with important attribution rules applicable to associated companies), and a jurisdiction is deemed as low-tax if the effective tax rate of that entity is lower than 40% of the effective (not statutory, please note the difference with the Switch-Over Clause) tax rate which would have been charged under the applicable corporate tax system 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 Proposal. Also, the Proposal foresees some exceptions for financial undertakings and listed entities.

The complexity of this measure, though, lies in the proposed exception for entities located in a Member State or in an EEA jurisdiction. Effectively, CFC rules will not be applicable under the Proposal when the participated entity is located in a Member State, or in a third country member of the EEA Agreement, unless the establishment of the entity is deemed as wholly artificial, or to the extent that the entity engages in non-genuine arrangements which have been implemented mainly to obtain a tax advantage. The definition of a non-genuine arrangement is provided in the Proposal, and it is of paramount importance because when the entity is effectively engaged in those sorts of arrangements, the income to be included in the tax base of the controlling company is limited to assets and risks which are linked to "significant people's functions carried out by the controlling entity." We could affirm that the base rules of the CFC Proposal are not complex, but the income attribution rules of entities located in a Member State (or in a third country member of the EEA Agreement) engaged in "non-genuine arrangements" are complex, as they require a difficult assessment about the concept of "non-genuine arrangement," and then an equally challenging income attribution rule to the controlling entity based on arm's-length principles.

Hybrid Entities and Instruments

The underlying principle behind this draft measure is that different classification of entities or instruments, given by two Member States, should not produce situations of double non-taxation. In that respect, the

Proposal's approach is that the legal characterization 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. Notably, the Proposal only refers to mismatches occurring within Member States, and does not refer to third countries. As a matter of fact, the tax characterization of a given entity or instrument based on a third-country tax law would certainly be inappropriate, but most of the doctrine (BEPS included) recognizes that measures must be included by each of the different jurisdictions to tackle the use of hybrid structures. While this classification may lead to situations where Member States treat third countries differently, such an unusual discussion is beyond the scope of this paper.

Conclusion

As a final note, it is indeed remarkable that the Commission has reacted promptly to the need to tackle aggressive tax planning in order to protect the budget of the different Member States (and ultimately — albeit indirectly — the budgets of the EU Institutions). As the European Parliament and the Council of the Member States[5] review the Proposal, it will likely evolve. However, even at this stage, and on the basis of such a high-level analysis, the draft presents significant challenges.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Elisabetta Righini
elisabetta.righini@lw.com
+32.2.788.6238
+32.478.32.47.57
Brussels

Jordi Domínguez
jordi.dominguez@lw.com
+34.91.791.5043
Madrid

Sean Finn
sean.finn@lw.com
+44.20.7710.1000
London

Thomas Fox
thomas.fox@lw.com
+49.89.2080.3.8160
Munich

Tobias Klass
tobias.klass@lw.com
+49.40.4140.30
Hamburg

Karl Mah
karl.mah@lw.com
+44.20.7710.1179
London

Olivia Rauch-Ravisé
olivia.rauch-ravise@lw.com
+33.1.40.62.21.36
Paris

Xavier Renard
xavier.renard@lw.com
+33.1.40.62.21.71
Paris

Stefan Süss
stefan.suess@lw.com
+49.89.2080.3.8000
Munich

You Might Also Be Interested In

OECD Publishes Final BEPS Project Reports

UK Supreme Court Forces HMRC to Rethink its Tax Treatment of Delaware LLCs

The Devilish Details of the new Spanish Horizontal Tax Consolidation Regime

New Final Inversion Rules Maintain Tight Standard for Corporate Expatriations

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit http://events.lw.com/reaction/subscriptionpage.html to subscribe to the firm's global client mailings program.

Endnotes

[1] Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

[2] The Proposal was made public within the so-called Anti-Tax Avoidance Package, including also a Revision of the Administrative Cooperation Directive, a Recommendation on Tax Treaties, a Communication on an External Strategy for Effective Taxation and a Study on Aggressive Tax Planning.

[3] The Commission has decided that some countries have granted selective advantages in rulings addressed to specific taxpayers, which constitute illegal State aid. Additionally, a journalistic investigation made available to the public tax rulings for over 300 multinationals in Luxembourg, attracting international attention and comments about potential tax avoidance schemes put in place in that country.

[4] For instance, in Spain the exemption is allowed if the source state has signed a Double Tax Treaty with Spain, irrespective of its statutory rate.

[5] After adoption, a Commission's legislative proposal harmonizing the fiscal policy of the Member States is forwarded to the Council, which will have to approve it unanimously after hearing the opinion of the European Parliament (Art. 115 TFEU). Approval of legislative proposals in fiscal matters by the Council tends to be sensitive and time-consuming as such proposals touch upon one of the areas in which Member States wish to retain their national sovereignty. Once approved, a directive needs to be transposed into national legal acts of the Member States. It is not likely, therefore, that the rules proposed by the Commission with this package will become binding in the Member States for at least three to four years.