European tax reform: agreement deferred

The Commission’s package of anti-tax avoidance measures needs unanimous agreement and Member States are still divided on it. The ECOFIN meeting on 25 May failed to produce an agreement, with controlled foreign company rules and the controversial switch-over clause being the main obstacles. EU Finance Ministers will reconvene on 17 June in a further bid for consensus.

Introduction

A major milestone was reached in October 2015 with the OECD publishing reports on all 15 Actions under its Base Erosion and Profit Shifting (BEPS) initiative. With countries already taking steps to implement some of the BEPS Actions, the European Commission is pursuing its own anti-tax avoidance agenda, in some cases going further than the OECD and leaving EU Member States now facing uncertain obligations.

The Anti-Tax Avoidance Directive (ATAD) needs unanimous agreement from all 28 Member States to become law and the Netherlands, which holds the rotating presidency of the EU until the end of June, has put forward several changes to the original draft that was published at the end of January.

What is the latest development?

The text that was on the table for the 25 May ECOFIN meeting (see Annex) was a compromise version that aimed to address potential objections from certain Member States. However agreement did not prove possible and several countries made objections. Only a few Member States backed the ATAD without reservation. A further attempt will be made to reach consensus at the next ECOFIN meeting on 17 June.

What has the Commission proposed?

BEPS-related matters:

Controlled Foreign Companies (CFCs): currently only some Member States have CFC rules. Under BEPS Action 3, the OECD proposed a series of “building blocks” based on best practices that countries could consider for an effective CFC regime, allowing flexibility and the ability to prioritise other aspects of tax reform. However under the ATAD, adoption of a CFC regime is mandatory. Some of the recommended design features could lead to inconsistency and complexity, particularly in multi-tier ownership structures. Points outstanding: (a) limiting the rules to artificially diverted income is not enough, some countries claim, and want the scope to be widened; (b) whether the rules can apply to non-EU based companies; and (c) the burden of proof that income has been diverted must be shifted to the national tax authorities.
Hybrid mismatches: the Directive simply proposes that where a hybrid mismatch gives rise to (a) a double deduction, the deduction is only given in the Member State of source; or (b) a deduction without inclusion (in the taxable base of the recipient), the Member State of the payer denies the deduction. A potential problem here is that BEPS Action 2 goes further and addresses imported mismatches, dual-residence rules and structured arrangements. Points outstanding: (a) possible extension of the scope to non-EU based companies; and (b) more detailed provisions for consistency with BEPS Action 2 and the rules in those Member States who have already taken steps to implement BEPS 2. One suggestion was that the Commission might come up with a new proposal in this area by October.

Interest limitation rule: this aspect is less controversial since the ATAD proposal is broadly consistent with BEPS Action 4, and proposes a limit (fixed ratio rule) of 30% of EBITDA, with the option of a group ratio rule to operate alongside the fixed ratio. The deduction of interest expense is only restricted to the extent that it exceeds taxable interest income, and countries have the option to allow all borrowing costs up to €3m to be deducted. In addition, carry-forward of borrowing costs that exceed the threshold is permitted, and Member States can opt to exclude from the rules loans concluded before May 22, 2016.

Non-BEPS-related matters
General anti-abuse rule (GAAR): The GAAR proposed in the ATAD is extremely broad, requiring Member States to ignore arrangements or series of arrangements which, having a main purpose of obtaining a tax advantage that defeats the purpose of the applicable tax law, are not genuine having regard to all the facts and circumstances. Currently only a few countries in the world have GAARs and what is proposed here is wider than most of these. The UK GAAR (the only existing GAAR in the EU) is targeted at a narrow range of abusive structures.

Exit taxation: the ATAD proposes a market-value based exit tax, of the type that some EU Member States already have, on transfer of assets from head office to permanent establishment in another Member State or third country, or vice versa, in so far as the transferor’s Member State of residence no longer has taxing rights over the assets transferred. Payment of exit tax can be deferred, by paying in instalments (with interest) over a 5 year period (some Member States currently allow for a longer period, typically 10 years), with payment becoming due immediately if any of the assets are sold.

"Switch-over" clause ensuring low-taxed foreign income is taxed, with a credit for tax paid, rather than exempted. The clause would be triggered where a distribution is received from an entity subject to an effective tax rate in its country of residence lower than 40% of the rate in the recipient's Member State. This would affect the exemptions that currently exist in many Member States for dividends and distributed gains. There was strong criticism that the effective tax rate criterion amounted to the EU itself imposing corporate tax rates. The Dutch Presidency proposed a statement to clarify that tax rates were strictly a matter for national governments, but this was rejected by some countries. Given the divisions on this clause, it now looks likely that it will be sacrificed if agreement can be reached on the rest of the package.

Will the ATAD become law?
Objections have been raised not only on the specific measures but also on process. For example, the chance for stakeholder input on the non-BEPS-derived matters has been minimal, and there appears to have been
no assessment of the potential impact not only on tax revenues but also on administrative costs, disputes, and double taxation for affected taxpayers, as well as the implications for the competitiveness of the EU as a place to invest and do business.

The Dutch Presidency is keen to reach a consensus on the general approach and its compromise package of measures by the end of June. If this is to be achieved, this might mean further changes and compromise. Depending on the outcome, the earliest date when the ATAD would come into effect would be 1 January 2019.