EUROPEAN COMMISSION PRESENTS ANTI-TAX AVOIDANCE PACKAGE

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On January 28, 2016, the European Commission presented its Communication on the Anti-Tax Avoidance Package (ATA Package). The goal of the Package is to prevent aggressive tax planning, increase tax transparency and create a level playing field for businesses in the EU.

According to Commissioner Moscovici, tax evasion results in a €50 – 70 billion loss each year in the EU. Moscovici said that the ATA Package offers measures to prevent companies from transferring profits to tax havens and from taking advantage of differences in national legislation to reduce taxes. The measures will also strengthen rules against the misuse of bilateral tax agreements. Moscovici also touched on country-by-country (CbC) reports and the exchange of information across member states. Although the information in the reports should not be made public, the Commission is considering amending this rule going forward.

According to the ATA Package, certain corporations have not been paying their fair share of taxes and a coordinated approach to tackle tax avoidance is essential for a "well-functioning Single Market." The Commission discouraged unilateral and uncoordinated actions by member states to close the tax gap as this could potentially undermine the effectiveness of rules in other states. In some cases, the Commission said that legislation that the EU proposed is the appropriate course to ensure that a minimum standard is set across all states. In the case of tax treaties, however, a Commission Recommendation is viewed as a better option and would provide guidance on an EU-law compatible approach.

"Transparency is essential in ensuring fairer taxation among member states."

Three of the primary measures in the ATA Package are:

1. Amendments to the existing administrative cooperation directive to implement CbC reporting, as recommended in the OECD BEPS Action 13 final report
2. Draft anti-tax avoidance directive (ATA Directive) that incorporates the recommendations from OECD BEPS Actions 2-4
3. Recommendations to EU member states on how to reinforce tax treaties in an EU-law compliant manner

Within the EU, Directives are legally binding on all member states, requiring them to adopt legislation that is at minimum in line with the rules in the respective Directive. In order for the ATA Package to be adopted, unanimous consent of all member states is required. The current draft ATA Directive is the second draft, following an earlier version from December 2015. The Commission has an ambitious goal to have this draft approved in the next four to six months, which would allow the ATA Directive to become effective as early as January 1, 2017.

ADMINISTRATIVE COOPERATION DIRECTIVE TO IMPLEMENT CBC REPORTING (BEPS ACTION 13)

On January 28, 2016, the Commission proposed a Council Directive ("CbC Directive") that would amend Council Directive 2011/16/EU, addressing the political priority of combating tax avoidance and aggressive tax planning. The CbC Directive responds to demands of the European Parliament, imposing transparency requirements on multinational enterprises (MNEs), and is in line with the initiatives announced in the Commission's Action Plan on a Fairer Corporate Tax System (COM (2015) 302) to tackle tax avoidance.

In its Communication on the ATA Package, the Commission acknowledged that transparency is essential in ensuring fairer taxation among member states. As a result, these states need to have access to information on taxes paid in other jurisdictions. In March 2015, the Commission introduced a proposal aimed at achieving additional transparency through the automatic exchange of information on cross-border tax rulings, a topic discussed by the OECD BEPS Action 5 recommendations. The Council adopted the proposal in December 2015. Nevertheless, tax administrations continue to lack information necessary to identify companies that have artificially shifted substantial amounts of income into low- or no-tax jurisdictions through transfer pricing or other practices.

The CbC Directive requires MNEs to provide annually and for each tax jurisdiction in which they do business, certain information including the amount of revenue, profit before income tax, income tax paid and accrued, number of employees, stated capital, retained earnings and tangible assets. This information will enable tax authorities to react to harmful tax practices through changes in legislation or adequate risk assessments and tax audits. Increased transparency should also incentivize MNEs to pay their fair share of tax in the country where profits are made.

The new transparency requirements should ensure that the administrative burden imposed on businesses is minimized. EU MNEs should not be obligated to submit the information to each EU member state where they operate, but only to the tax authorities of their country of residence. The CbC Directive requires member states, on receipt of the CbC report, to share the information with other states in which companies are either resident for tax purposes or are subject to tax, with respect to the business carried out through a permanent establishment (PE).

To ensure an appropriate balancing of reporting burden and benefit to tax administrations, only MNEs with total consolidated group revenue of at least €750 million will be required to file the CbC report. According to OECD estimations, approximately 85% – 90% of MNEs will be excluded from the requirement, but the CbC report will nevertheless be filed by MNEs controlling approximately 90% of corporate revenues.

EU legislation provides for administrative cooperation between member states' tax authorities and sets out rules, including exchange of information, to assist them in collecting revenues. Council Directive 77/799/EEC 1 was the first response to member states' need for enhanced mutual assistance in taxation. The purpose of the present proposal is to ensure that Council Directive 2011/16/EU continues to provide for comprehensive and effective administrative cooperation between tax administrations through the mandatory automatic exchange of information regarding CbC reports.

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The CbC Directive is in line with international developments. On October 5, 2015, the OECD presented its BEPS final reports, which represented a major initiative for modifying existing international tax rules. On November 15 – 16, 2015, the G20 leaders endorsed the OECD package. The work on OECD BEPS Action 13 resulted in a set of standards for providing information on MNEs' transfer pricing positions, including the master file, local file and CbC report. Most member states, in their capacity as OECD members, have committed to implementing the BEPS final reports.

The goal of the CbC Directive is to achieve a certain degree of uniformity in implementing OECD BEPS Action 13 across the EU. The Directive also intends to foster fair competition between businesses and ultimately to protect the tax base of EU member states. It provides for the automatic information exchange of CbC reporting to build on the existing rules in Council Directive 2011/16/EU, including the use of standard forms.

The Commission is currently analyzing whether to make public, on an EU-wide level, the information submitted by MNEs on the CbC report. By making this information public, the Commission aims to ensure that profits are effectively taxed where generated and unfair differences in tax treatment between companies are reduced. However, the analysis should take into account the need to protect legitimate business secrets and promote a level playing field.

ANTI-TAX AVOIDANCE DIRECTIVE (BEPS ACTIONS 2 – 4)

On January 28, 2016, the Commission presented its ATA Directive, which is broadly inclusive and aims to capture all taxpayers that are subject to corporate tax in a member state. Its scope also includes PEs, located in the EU, of corporate taxpayers that are not subject to the Directive. The ATA Directive encourages member states to take a more coordinated stance against companies that seek to avoid paying their fair share of tax and to implement international standards against base erosion and profit shifting.

The schemes targeted include situations where taxpayers take advantage of disparities between national tax systems to reduce their taxes. Taxpayers may benefit from low tax rates, double deductions or having income deductible in one jurisdiction but not included in another jurisdiction. These situations distort business decisions and create unfair tax competition. This Directive "aims to achieve a balance between the need for a certain degree of uniformity in implementing the BEPS outputs across the EU and Member States' needs to accommodate the special features of their tax systems within these new rules." The ATA Directive lays down anti-tax avoidance rules in six specific fields, some of which were also discussed by the OECD BEPS Project:

1. Deductibility of interest — see also OECD BEPS Action 4 recommendations
2. Exit taxation
3. Switch-over clause
4. General anti-abuse rule (GAAR)
5. Controlled foreign company (CFC) rules — see also OECD BEPS Action 3 recommendations
6. Framework to tackle hybrid mismatches — see also OECD BEPS Action 2 recommendations

A coordinated EU approach with regard to these rules would strengthen the link between profit generation and taxation. Each of these topics is discussed on the next page.

DEDUCTIBILITY OF INTEREST

MNEs often finance group entities in high-tax jurisdictions through debt and arrange that these companies pay back interest to subsidiaries resident in low-tax jurisdictions. As a result, the MNE deducts interest at a higher tax rate, while including the amount in income at a lower rate. Overall, the outcome is a reduced tax base for the MNE as a whole.

The ATA Directive intends to discourage this practice by limiting the amount of interest that the taxpayer is entitled to deduct in a tax year. Net interest expenses will be deductible only up to a fixed ratio based on the taxpayer's gross operating profit. The OECD recommends that the rate for deductibility be 10% – 30%, and member states can introduce stricter rules.

Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations on interest deductibility , it is also acknowledged that these two sectors present special features that call for a more customized approach. Contrary to other sectors of the economy, financial undertakings are part of their core trade.

EXIT TAXATION

Taxpayers may try to reduce their tax bill by moving their tax residence or assets or both to a low-tax jurisdiction. Such practices distort the market because they erode the tax base of the state of departure and shift future profits to low-tax jurisdictions. If taxpayers move their tax residence out of a certain member state, that state will be deprived of its future right to tax revenues, which may have already been created but not yet realized. The same issue arises when taxpayers transfer assets (without disposing of them) out of a member state and those assets incorporate unrealized profits.

Editor's Note: The U.S. has attempted to address the same issue by tightening its rules regarding corporate inversions in Treasury Notices 2014-52, 2014-42 IRB 712 and 2015-79, 2015-49 IRB 775.

GAAR

Where current tax legislation does not protect sufficiently against tax-avoidance schemes, jurisdictions implement GAAR, which allows abusive tax practices to be captured despite the absence of a specific anti-tax avoidance rule. The proposed GAAR is designed to reflect the artificiality tests of the Court of Justice of the EU (CJEU) when this is applied within the EU.

CFC RULES

Taxpayers with controlled subsidiaries in low-tax jurisdictions may engage in tax planning to shift large amounts of profits out of the (higher-taxed) parent company toward lower-taxed subsidiaries. The effect is to reduce the group's overall tax liability.

The income shifted to the subsidiary is usually mobile passive income. A common scheme consists of first transferring, within a group, the ownership of intangible assets (e.g., IP) to the CFC and later shifting large amounts of income in the form of royalty payments in consideration for the right to use the assets owned and managed by the CFC. The functioning of the EU internal market is affected by these profit-shifting practices, primarily when the income is shifted out of the EU toward low-tax third countries.

CFC rules re-attribute the income of a low-taxed controlled foreign subsidiary to its parent company. As a result, the parent company is taxed on this income in its state of residence. CFC legislation, therefore, aims to eliminate the incentive of shifting income.

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FRAMEWORK TO TACKLE HYBRID MISMATCHES

Hybrid mismatches are the consequence of differences in the legal characterization of payments (financial instruments) or entities when two legal systems interact. Such mismatches often lead to double deductions (i.e., deduction on both sides of the border) or a deduction of the income on one side of the border without its inclusion on the other side. Taxpayers, especially those engaged in cross-border structures, often take advantage of such disparities among national tax systems to reduce their overall tax liability.

This problem has been explored by both the Group of the Code of Conduct on Business Taxation and the OECD. To ensure that member states introduce rules to effectively combat these mismatches, this Directive says that the legal characterization given to a hybrid instrument or entity by the member state where a payment, expense or loss originates will be followed by the other member state involved in the mismatch.

TREATY ABUSE

There are specific circumstances that would not be suited to a standalone Directive. In particular, issues relating to tax treaties have not been included in the ATA Directive. Nevertheless, a coordinated approach is necessary to prevent further tax evasion. The Commission, therefore, presented a recommendation on the implementation of measures relating to PEs, as well as to the G20/OECD report on tax treaty abuse. The recommendation says: "It is essential for the good functioning of the internal market that the Member States are able to operate efficient tax systems and prevent their tax bases from being unduly eroded because of inadvertent non-taxation and abuse and that the solutions to protect their tax bases create no undue mismatches and market distortions."

The OECD and EU support rules that make it more difficult for companies to artificially avoid having a taxable presence in a member state or to abuse tax treaty agreements. The ATA Package recommends that member states that conclude tax treaties with other states and with third parties apply the proposed new provisions to Article 5 of the OECD Model Tax Convention to address artificial avoidance of PE status addressed in the OECD BEPS Action 7 report.

Although the OECD BEPS Action 6 report includes limitation-of-benefits clauses as an option, the Commission acknowledged this may not be appropriate in all jurisdictions. These clauses limit the benefits of tax treaties to entities owned by residents of only one member state and, therefore, can be seen as detrimental to the Single Market by discouraging cross-border investment. Therefore, when member states include rules based on the G20/OECD option of a principal purpose test in their tax treaties, the Commission recommends that they should do so in an EU-law compliant manner and include additional specific language to further prevent tax treaty abuse.

CONCLUSION

The measures outlined in the ATA Package give the member states a single and coordinated approach to address tax avoidance. The Commission's goal is to create a level playing field for EU businesses, creating a common standard by which each jurisdiction can follow. It will be up to each member state to take advantage of this standard during implementation.

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