Comment

Examining the revised EC Anti-Tax Avoidance Directive

Speed read

The Economic and Financial Affairs Council (ECOFIN) of the European Union has now approved the draft Anti-Tax Avoidance Directive (ATAD) initially proposed by the European Commission that will soon be adopted by European Parliament. The EC claims ATAD seeks to ensure a consistent and uniform implementation of BEPS recommendations across the EU, with five key measures: general interest limitation rule; exit taxation; the GAAR; controlled foreign companies rules; and hybrid mismatch framework. The measures go beyond providing a mere framework, significantly restricting a member state's ability to set its own tax policy. This is supranational law and, unlike the BEPS project, has been forced on member states without any coherent, analytical or reasoned opposition. Whether the UK is included in ATAD depends on the terms of its exit from the EU.

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At midnight, on Monday 20 June, the Economic and Financial Affairs Council (ECOFIN) of the European Union approved the draft Anti-Tax Avoidance Directive (ATAD) for corporate taxpayers in the EU, but on 23 June, the UK voted to leave the EU. How it chooses to do so will determine whether its competiveness as a corporate tax jurisdiction is compromised or enhanced by Brexit.

If the UK adopts the 'Norway model' and joins the EEA, it would remain subject to EU law and so also to ATAD. If it chooses more substantial disengagement from Europe, ATAD may never apply to the UK, which, along with wider freedom to define its tax rules, could give UK corporate tax policy a considerable competitive advantage. However, that potential advantage is also under threat. On 21 June, the European Parliament's Special Committee on Tax Rulings II put forward wide-ranging recommendations to be voted on at the Parliament's July session that it believes would make corporate taxation in the EU 'fairer and clearer'. Along with a call for a European Commission (EC) proposal to bring forward proposals for a common consolidated corporate tax base (CCCTB) before the end of this year, they include a minimum withholding tax (WHT) on all profits leaving the EU. If these measures are approved, the EU would become a walled garden of harmonised corporate tax rules with minimum corporate tax rates for non-EU shareholders. So at first sight, the UK's potential post-Brexit competitive advantage would seem to be eroded: after it leaves the EU, its companies may then not be subject to ATAD or the CCCTB, but UK parent companies could suffer withholding tax from their EU subsidiaries. However, the UK's extensive double tax treaty (DTT) network should override the full effect of any such withholding tax. Many of the UK's DTTs with the remaining member states were concluded before the UK joined the EU in 1973. Of these, over half permit a nil rate of dividend withholding tax where certain minimum holding requirements are met, over a third permit a 5% rate and just two with a 10% rate. Such a low level of tax leakage that would be acceptable to many multinationals, especially given the competitive advantage they would then enjoy in continuing to be able to distribute dividends free of withholding tax out of the UK while their EU rivals were hobbled by the new rules.

> The UK's post-Brexit competitive advantage could erode if a proposal for a minimum dividend withholding tax on distributions to non-member states is adopted by the European Parliament in July

The question is therefore how far the attractiveness of the UK as a corporate jurisdiction would also be enhanced if it is not subject to ATAD. Intentionally or not, ATAD reduces the scope for corporate tax competition. The EC claims ATAD seeks to ensure a consistent and uniform implementation of the OECD's 2015 BEPS recommendations across the EU. However, it seems to go considerably further than this. Under the guise of 'restoring trust in the fairness of tax systems and allowing governments to effectively exercise their tax sovereignty', the EC is arguably pushing its own agenda of unified EU corporate tax policy, building on its 2011 proposal for a common consolidated corporate tax base (CCCTB). The EC, through ATAD, has unified anti-avoidance rules, rather than allowing member states to adapt these rules to their different national systems for tax policy implementation (as recommended by the OECD). If a common measure of accounting profit were to follow, a minimum corporate tax rate becomes a very real possibility.

Instead of empowering member states, ATAD does the exact opposite: removing their ability to implement BEPS in line with their own national tax and economic policies. For example, BEPS Action 3 on controlled foreign companies (CFCs) recognises that a state that exempts foreign profits for companies may prefer limited CFC rules, focusing on profit artificially diverted abroad from the parent company rather than 'foreign to foreign stripping'. This is what the UK has chosen to do.

The UK has spent almost ten years positioning itself as the go-to territory for multinational groups seeking to locate their European headquarters. Starting with the reform of the taxation of foreign profits and ending with a recast CFC regime, the UK has taken on Luxembourg and the Netherlands and won. That victory is under threat for the UK if the terms of its exit from the EU leave it subject

BEPS v ATAD

	BEPS recommendations	ATAD measure
Interest limitation rule	Recommendation by BEPS to cap interest deductions at 10–30%.	ATAD introduces the BEPS minimum standard as a binding measure. Member states are free to restrict this further under their domestic law. Cap interest deductions at the higher of 30% or €3m. Interest on any loans in existence at 17 June 2016 not subject to restriction – provided no modification.
Exit tax	Not recommended by BEPS.	ATAD goes beyond BEPS recommendations and arguably infringes fundamental freedoms of establishment and capital.
GAAR	More limited recommendation in BEPS Action 6 of 'principal purpose test' that applies only cross-border.	A general anti-abuse law to apply where domestic law cannot find against a taxpayer in a perceived abusive arrangement. This seems to apply not just to the cases of 'egregious' abuse targeted by the UK's GAAR.
Controlled foreign companies	Recommendations by BEPS to permit a territorial approach to implementing CFC rules or a wider approach.	ATAD forces member states to adopt CFC rules with a 'one size fits all' approach that extends to arrangements with third countries.
Hybrid mismatch	Recommendation by BEPS to remove the ability for groups to secure double non-taxation through mismatches in domestic tax systems.	Binding measure that tackles mismatches between member states broadly in line with the BEPS recommendations, but is not extended to third countries.
Switch over clause	Not recommended by BEPS except in relation to hybrids.	Thankfully dropped at the eleventh hour, this was a measure that would have forced member states to apply a credit method on the receipt of dividends or gains on disposal of shares where the income or gain is not taxable in the original company at a rate of at least 40% of the corporate tax rate of the recipient country.

to ATAD. ATAD would significantly curtail its ability to compete with other EU states on corporate tax policy. While ATAD ensures the BEPS recommendations are implemented by member states, this is at the cost of a 'one size fits all' policy.

The current 28 member states have vastly differing economic performance and priorities. A uniform implementation of the BEPS recommendations must be balanced with member states' ability to stimulate their economies through tax policy and incentives. For example, the UK has a comprehensive and effective CFC regime that includes an exemption for foreign group finance companies (where certain conditions are met). It is difficult to see how this would survive if the UK were obliged to implement ATAD. Meanwhile, Ireland, which does not currently have a CFC regime, will have a CFC regime forced upon it (as will Malta and Cyprus). Countries will respond because they need to remain competitive: Ireland may well move from a credit method for dividends to an exemption method.

Thankfully the pernicious 'switch over' clause has been dropped at the last minute; the same thing that happened when some states tried to have it included in the Parent-Subsidiary Directive in 2014. However, the ATAD is subject to review in four years' time when this could be revisited.

One wonders why member states haven't rejected the ATAD; perhaps they haven't yet woken up to how their ability to chart their own course has been taken away from them? The ATAD significantly overshoots the target of harmonisation with BEPS by including yet another GAAR and exit tax provisions (that appear to be contrary to EU law). This is supranational law and – unlike the BEPS project – has been forced on member states without any coherent, analytical or reasoned opposition.

Now that the UK has chosen to leave the EU, it could have a significant competitive advantage simply by having the ability to set its own tax policy.

When does ATAD apply?

Member states must implement all measures by 1 January 2019 with the exception of:

- the exit tax measure, which must be implemented by 1 January 2020; and
- the interest deduction limitation measure, which may not be implemented until 1 January 2024 where the member state has sufficient existing domestic rules that broadly achieve the same result.

The key measures in ATAD

We now take a closer look at ATAD's key provisions.

1. General interest limitation rule

Many groups will fund their overseas subsidiaries with a combination of debt and equity. It is common to fund primarily with debt, as it is cheaper and easier to extract than equity. Most importantly, interest charged on the debt may be deductible against income, thus reducing an entity's taxable profits (subject to the local territories' tax rules that may already exist to restrict interest deductions, such as transfer pricing and thin capitalisation).

The measure included within the ATAD is consistent with the recommendations and fixes a ratio for deductibility. Deduction of net interest expenses is restricted to 30% of the taxpayer's earnings before net interest, tax, depreciation and amortisation (EBITDA) or up to €3m, whichever is higher. The deductibility rate is set at the top end of the scale of 10–30% recommended by the OECD and member states may decide to restrict this to the lower end.

Where the taxpayer is part of a group that files statutory consolidated accounts, the indebtedness of the overall group at worldwide level may be considered.

After push-back from certain member states, a grandfathering provision means that loans concluded before 17 June 2016 will not be subject to this restriction, provided no amendments are made to the loan.

How will it affect member states?

States will need to repeal or restrict existing rules that are more generous than the proposed measures. As the ATAD introduces the minimum recommended OECD standard, member states may well already be prepared to make such changes. The UK announced in its 2016 Budget that it would introduce a 30% restriction and cap at €2m from 1 April 2017, albeit subject to a detailed consultation. The UK will effectively remove its similar worldwide debt cap legislation, but will still have transfer pricing, thin capitalisation and the unallowable purpose rules to further restrict interest deductibility. It is not clear why the consultation process will be necessary in light of the ATAD measures, as aside from increasing the cap to €3m, there is very little the UK can do differently.

2. Exit taxation

An area not considered by the OECD as part of the BEPS project, this measure seeks to tax any unrealised gains on assets, business of a permanent establishment or residence of a company transferred out of their member state of origin (an 'exit tax'). The unrealised gain is determined by reference to the market value at the date of transfer and the base cost in the asset.

The taxpayer may either immediately pay the exit tax or defer payment of the tax over five years, settling the tax liability through instalments. The deferral period ceases when the gain is realised and tax becomes recoverable, such as on a sale. Where the tax liability is deferred, interest may be charged by the member state; and where there is a demonstrable and actual risk of non-recovery, a guarantee may be required.

It is stated that this measure is in line with EU law, but it is highly questionable whether these rules are compatible with the Treaty on the Functioning of the European Union (TFEU), in particular the free movement of capital and freedom of establishment principles. It is clear from the CJEU case *N* (Case C-470/04) that to tax a person on unrealised gains when transferring an asset, company residence or business to another member state would be discriminatory. In the more recent case *National Grid* (Case C-371/10), it was held that exit tax provisions would be compatible with EU law where they granted the following options to the taxpayer:

- to pay the tax due at the time of emigration;
- to request a tax deferral until the moment that the capital gains on assets are realised; or
- to pay the tax in instalments.

Controversially, the CJEU said that where a business moves from one country to another, it would be acceptable for interest to be charged if the taxpayer chooses to defer the tax or pay in instalments. This was a change of position from its decision in the *N* case (which had merely involved an asset transfer and not a transfer of a whole business). It would seem the EC has leveraged off this interest requirement without restricting it to situations where a whole business is moved and also disregarded the court's requirement for the taxpayer to have the option to defer the tax until the gain is actually realised. It is very difficult to see how this can be compatible with EU law, since it imposes a tax liability merely by virtue of asset migration, even though no gain is realised.

How will it affect member states?

Key issues for member states to consider are: how to deal with losses arising on later realisations or currency gains or losses; whether the host state should give a credit for tax paid to the state of origin; and whether a claim can be brought by the taxpayer for a refund of tax from the state of origin when the asset is subsequently disposed of at a lower value. These issues were only partly dealt with in the *National Grid* case for situations where a taxpayer emigrates from one member state to another, but not where a mere asset transfer abroad occurs. In the absence of clear guidance or instruction within the ATAD, there is a risk of incompatible national rules and double taxation.

3. The EU general anti-abuse rule (EU GAAR)

Many countries have invested time to develop an appropriate general anti-abuse provision within their domestic law. No GAAR is easy to apply. In the UK, there is a 'GAAR advisory panel' to ensure it is used correctly by the tax administration. This was to reassure companies that the GAAR would not turn into open hunting season for HMRC. There is no such requirement in the EU GAAR.

The ATAD seeks to cover gaps not covered by a domestic GAAR (or where no domestic GAAR exists) and will apply to artificial arrangements or a series of arrangements that have been designed to obtain a tax advantage that defeats the main, or one of the main, objects or purposes of the relevant tax provision. Where the EU GAAR applies, the arrangement or arrangements must be ignored and reconstructed by reference to economic substance and in line with the member state's domestic law.

Almost all member states have targeted anti-avoidance rules (TAARs), such as CFC and interest expense restriction rules, and many now have GAARs. So why introduce a GAAR within ATAD, without proper consultation? The answer starts with the CJEU *Halifax* case (Case C-255/02). This case concluded that the particular tax avoidance arrangements in place were so extreme that they constituted an 'abuse' of rights granted by EU law; and, where this was the case, they should be reconstructed in the context of 'normal commercial operations'. The proposed EU GAAR follows the principles of the *Halifax* case, which now must form part of domestic law for corporate taxpayers.

How does it affect member states?

Whilst the GAAR provisions recognise and acknowledge the right of a taxpayer to choose the most efficient tax structure for its commercial affairs, it means that the taxpayer must consider TAARs, a domestic GAAR and an EU GAAR. If the UK finds itself having to adopt ATAD, it's possible the UK's GAAR will be found to be compliant with ATAD and no additional layer of complexity is introduced into UK domestic law.

However, when UK taxpayers are engaging in cross-border transactions, they are now at the mercy of potentially less scrupulous tax authorities in other member states, who may see the new EU GAAR as a useful tax raising measure and without the protection of the UK's GAAR panel. So not only is there an erosion of a member state's tax sovereignty, in that states are being forced to introduce a uniform GAAR when they have their own domestic mechanisms to deal with the issue (e.g. section 42 of the German tax code (Abgabenordnung or AO), and the concept of abus de droit in France), but the EU GAAR could also become a stick with which member states (such as Germany and France) can beat one another where they do not like the outcome of the application of domestic law TAARs and GAARs. It remains to be seen whether the EU GAAR will be a rarely invoked mechanism to restrain the most aggressive corporate tax planning, or whether it marks a further descent into discretionary taxation.

4. Controlled foreign company (CFC) rules

This measure is broadly consistent with the BEPS recommendations. It seeks to prevent companies in one member state from artificially diverting profits to a subsidiary or exempted permanent establishment (PE) in a low tax jurisdiction without proportionate economic substance in the subsidiary or PE.

Broadly, an entity or exempt PE will be treated as a CFC where:

- it is not subject to tax, or is exempt from tax in its territory of residence;
- the taxpayer and any associated entities hold directly or indirectly 50% of the voting rights, capital or profits of the subsidiary/exempted PE; and
- the actual corporate tax (if any) paid by the subsidiary or exempted PE is lower than that which would have been paid had the parent earned those profits.

The control test is in line with most CFC regimes, although an associated company for the purposes of ATAD means an entity in which the CFC's parent holds at least 25% of the voting power, equity or profits. By contrast, most countries' associated companies test requires a 50% control of voting power, equity or profits.

The lower level of tax test is very wide and means a controlled subsidiary will be subject to these rules just because it is subject to a lower corporate tax rate. There is no minimum threshold as to how much lower the corporate tax rate must be, meaning that more subsidiaries will by definition be CFCs and will need to consider whether there is an exemption or whether they have substantive economic activities supported by appropriate staff, equipment, assets and premises. Depending on how this is interpreted, it could easily become more restrictive than the test in the *Cadbury Schweppes* case (Case C-196/04), where the CJEU would only allow CFC rules between member states that 'specifically target wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage'.

> ATAD goes beyond providing a mere framework and significantly restricts a member state's ability to set its own tax policy

In its Action 3 report on CFCs, the OECD suggested permitting CFCs only where they engage in 'substantial activities', but was aware of the potential conflict with CJEU's more limited acceptance of CFC rules. So it suggested meeting the CJEU's requirements by interpreting substantial activities to mean companies that did not engage in 'genuine economic activities' or, more controversially, those that are 'only partly wholly artificial'.

However, the substantive economic activity test laid down in ATAD potentially goes further. The wording seems to be moving more in the direction of the BEPS Action 5 requirements for IP holding companies of appropriate levels of expertise, staff and activity commensurate with the level of profit in the subsidiary. Here, the EC seems to be pushing the boundaries further than the CJEU would allow or the OECD dared go in trying to overcome the CJEU's strictures.

The only permitted exemptions appear to be a low profit and low profit margin exemption. A CFC will be exempt where:

- accounting profits are less than or equal to €750,000 and non-trading income is less than or equal to €75,000; or
- accounting profits are less than or equal to 10% of operating costs.

How will it affect member states?

Member states with an existing CFC regime will most likely need to revise their basic definition of a CFC. Where there are exemptions from the CFC regime not included within ATAD, then these will need to be repealed.

The UK includes within its CFC regime a partial exemption from the CFC charge for foreign group finance or treasury companies. It is difficult to see how this can survive the introduction of ATAD should the UK become subject to it. The UK's CFC rules also exempts most companies in EU member states with the excluded territories exemption. This exemption would also have to be removed, so that a Maltese subsidiary of a UK parent would be subject to the new ATAD CFC test. Most of all, the UK's current CFC rules are territorial in focus, targeting only profits artificially diverted from the UK. In future, should the UK become subject to ATAD, a subsidiary of a UK parent that diverted profits from Germany to Malta would also be caught, something that BEPS Action 3 would not have required and which the UK in 2013 specifically aimed to avoid.

Interestingly, the ATAD permits member states when dealing with CFCs in third countries to choose between the 'substantive economic activity' test (as described above) or a 'purpose' test, whereby a CFC charge will not arise if the arrangement is genuine and not put in place for the essential purpose of obtaining a tax advantage. This is potentially more far reaching, in that substantive economic activity is no longer a grounds for exemption.

High-tax member states may therefore choose the 'purpose' test for third countries. However, the purpose test is also more subjective. Therefore, it is very likely that countries such as Malta, Cyprus, Ireland, etc. that do not currently have CFC regimes will either apply the 'substantive economic activity' test generously, or opt for the 'purpose' test for third countries and put their telescopes to their blind eye when it comes to judging the taxpayer's purpose. In either case, a group may establish an entity in a member state such as Malta or Cyprus, ensuring that it has substantive economic activity there, so as not to have a CFC charge from a higher-tax member state. The Maltese or Cypriot subsidiary entity in turn establishes subsidiary companies in third low-tax non-member state countries and successfully invokes the more subjective purpose test.

This measure is likely to create the most complexity, uncertainty and administrative burden for taxpayers.

5. Hybrid mismatch framework

This is broadly in line with the BEPS recommendations to counter taxpayers exploiting differences between domestic tax systems to achieve a double deduction for related party expenses or a deduction for the expense but no inclusion of the income in taxable income (i.e. double non-taxation).

In order for the BEPS recommendation on hybrid mismatches to have any effect, a solidarity of states is required. This is the one provision that is actually welcomed and is acknowledged as a necessity.

How does it affect member states?

Many member states will already be considering draft legislation to implement the BEPS recommendations and repeal any existing anti-arbitrage legislation. As such, this ATAD measure should not be a major unexpected impact to member states. However, ATAD only applies to transactions between member states, so domestic law will need to be extended to apply to third countries to ensure convoluted financing structures, such as the US Tower Structure, are closed down – unfortunately there is no relying on the US to implement the BEPS recommendations! The UK anti-hybrid changes, effective 1 January 2017, will apply to third country transactions.

Scope creep and the 'switch over' clause

Thankfully, the EC conceded to remove the proposed 'switch over' clause that would require a country to depart from its dividend exemption and apply a credit method where the income is taxed in the country of origin at less than 40% of the recipient country's corporate tax rate.

However, ATAD is set for a review after four years and this would present an opportunity to reconsider the switch over clause. Germany already includes such a clause in all of its new double tax treaties and is clearly championing this. The effect of such a clause is extra-territorial taxation and effectively produces an EU-wide minimum corporate tax rate through the back door, in much the same way that the European Parliamentary Committee's latest proposal for a withholding tax on profits leaving the EU would do for non-EU shareholders.

Final thoughts

The key objective of the ATAD is to improve the resilience of the internal market as a whole against cross-border tax avoidance practices which it is argued cannot sufficiently be achieved by the member states acting individually. As regards hybrid mismatches, we are in agreement.

However, ATAD is heralded as a method to implement the minimum standard recommended by the OECD, with a view to simply creating a framework within which a member state can still include its own tax legislation. This is just not true. The measures go beyond providing a mere framework and significantly restrict a member state's ability to set its own tax policy.

What is patently clear is that member states will have to make extensive changes to their corporate tax laws and that taxpayers will incur large costs of administration or require changes in behaviour that sacrifice growth. The EC talks of restoring trust in the fairness of the tax systems through the introduction of the ATAD, but consideration now needs to be given to repairing the taxpayers' trust in the administrators.

For the UK, given the lack of a clear plan on how Brexit is to be achieved, the outlook is much less certain. If it leaves the EU and adopts the 'Norway' solution of joining the EEA, it will still be subject to ATAD so that its currently generous CFC regime would become significantly less attractive. If instead the UK's departure from the EU also takes it further away from Europe's sphere of influence, it would avoid the impact of ATAD and the European Parliament's proposals to turn the EU into an increasingly harmonized zone of corporate tax rules. The UK's current corporate tax regime and its new-found freedom to amend it outside EU strictures such as state aid would then become an even greater competitive advantage than at present. But it is doubtful whether higher-tax countries such as Germany would allow the UK to become an effective tax competitor on the EU's doorstep. The proposed withholding tax on all profits leaving the EU may partially undermine the UK's ability to do this. Whatever happens, 'taking back control' will not be easy. ■

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