21 June 2016
Global Tax Alert
News from EU Tax Services

ECOFIN reaches political agreement on Anti-Tax Avoidance Directive

Executive summary

On 21 June 2016, the Economic and Financial Affairs Council of the European Union (ECOFIN or the Council) reached final political agreement on the Anti-Tax-Avoidance Directive (ATAD).

At the ECOFIN meeting held on 17 June 2016 a final compromise text was put forward. Following the discussions, the President of the Council noted that almost all Member States could agree to it. The Presidency therefore announced a silence procedure giving Member States time to raise any objections they may have until 20 June 2016, midnight.[1] Since no objections were raised by that deadline, a unanimous agreement has been reached on the ATAD (formally titled *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market*).[2]

Detailed discussion

Background

The ATAD is intended to provide for a uniform legislative implementation of some of the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) recommendations. The agreed upon ATAD text establishes a minimum standard with respect to five areas: interest deductibility limitation, a General Anti-Abuse Rule (GAAR), Controlled Foreign Company (CFC) rules, hybrid mismatches and exit taxation.

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Interest deductibility

The ATAD limits the deduction of exceeding borrowing costs to 30% of taxable earnings before interest, taxes, depreciation and amortization (EBITDA). In addition to this fixed ratio, countries may give taxpayers who are part of a consolidated group the option to either (i) deduct their exceeding borrowing costs in full, if they can demonstrate that their equity to total assets ratio is no more than two percentage points lower than the equivalent group ratio (equity escape rule) or (ii) deduct exceeding borrowing costs based on a group ratio determined by dividing the third party exceeding borrowing costs of the group over group EBITDA (group ratio rule). Both the equity escape rule and the group ratio rule were recommended by the OECD under BEPS Action 4.

Furthermore, Member States are allowed to grant a deduction of the excess borrowing costs, if these do not exceed €3m or if the taxpayer in question is a stand-alone entity. Additionally, a grandfathering clause allows Member States to exclude exceeding borrowing costs arising from loans that have been concluded before 17 June 2016 and that have not been subsequently modified from the scope of the rule. Similarly, exceeding borrowing costs on loans used to fund long-term public infrastructure projects within the internal market may be excluded from the scope of this rule. Member States may also exclude financial undertakings from the application of the rule altogether.

The ATAD provides several possibilities with regard to the carry forward and back of unused exceeding borrowing costs or interest capacity.

By derogation from this rule, Member States that have equally effective national targeted rules preventing BEPS risks can continue applying these rules until the end of the first full fiscal year following the publication of an agreement between the OECD members on a minimum standard with regard to OECD BEPS Action 4, but not later than 1 January 2024.

Exit Taxes

The ATAD introduces an exit taxation rule whereby a taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets, at the time of exit, less their value for tax purposes in any of the four following circumstances:

- A taxpayer transfers assets from its head office to its permanent establishment (PE) in another Member State or in a third country, if the Member State of the head office no longer has the right to tax those assets due to the transfer
- A taxpayer transfers assets from its PE in a Member State to its head office or another PE in another Member State or in a third country, if the Member State of the PE no longer has the right to tax those assets due to the transfer
- A taxpayer transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a PE in the first Member State
- A taxpayer transfers the business carried out by a PE out of a Member State to another Member State or to a third country, if the Member State of the PE no longer has the right to tax those assets due to the transfer

The ATAD further sets out that a taxpayer may defer the payment of an exit tax by paying it in installments over at least five years if certain conditions are met.

If the payment is deferred, interest may be charged in accordance with the legislation of the Member State of the taxpayer or of the PE. It should also be noted that the five year installments of the tax debt might become immediately recoverable in five specific cases listed in the ATAD.

The exit tax provision needs to be transposed in Member States' national laws by 31 December 2019 and will apply as of 1 January 2020.

GAAR

The GAAR in the ATAD follows the GAAR already put in place in the EU Parent Subsidiary Directive. It applies to arrangements or a series of arrangements which having been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions, are non-genuine having regard to all relevant facts and circumstances. Arrangements are considered non-genuine if they have not been put in place for valid commercial reasons reflecting economic reality. The GAAR provision refers to the calculation of corporate tax liability and does not apply to withholding taxes.

CFC rule

The ATAD requires a Member State of a taxpayer to treat as CFC entities, and PEs resident in other Member States or in third countries, that are not subject to tax or are exempt from tax in that Member State if:

- In the case of an entity the taxpayer by itself or together with its associated enterprise holds directly or indirectly more than 50% of the voting rights, owns more than 50% of the capital or is entitled to receive more than 50% of the profits of that entity; and
- The corporate tax paid by the CFC is lower than the difference of tax that would have been charged in the Member State of the taxpayer and the actual tax paid under the applicable corporate tax system.

Member States may choose to apply CFC rules that target an entire low-taxed subsidiary, specific categories of income or income which has artificially been diverted to the subsidiary.

Where the entity or PE is treated as a CFC, the Member State of the taxpayer should include in the tax base the non-distributed income of an entity or PE derived from the following categories (categorical approach):

- Interest or any other income from financial assets
- Royalties or any income from intellectual property
- Dividends or any income from the disposal of shares
- Income from financial leasing
- Income from insurance, banking and other financial activities
- Income from "invoicing companies" that earn sales and services income from goods and services purchased from and sold to associated enterprises and add little or no economic value

This approach will not apply if it can be established that the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances. Member States may choose to not apply this carve-out if the CFC is resident or situated in a third country that is not party to the European Economic Area (EEA) Agreement.

Alternatively the Member State of the taxpayer could choose to include in its tax base the non-distributed income of the CFC arising from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage (substance approach).

If Member States choose to apply the substance approach, they will regard as non-genuine arrangements or a series thereof, to the extent that the CFC would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions relevant for those assets or risks are carried out and are instrumental in generating the CFC income.

Under the categorical approach, Member States may opt not to treat an entity or a PE as a CFC when the income from the "tainted" categories does not exceed one third of the CFC's income. Member States may also opt not to treat financial undertakings as a CFC when the income from the "tainted" categories coming from transactions with the taxpayer or its associated enterprises does not exceed one third of the entity's income.

Under the substance approach, Member States may exclude from the rules a CFC that either has accounting profits of no more than €750,000, and non-trading income of no more than €75,000, or that has accounting profits that do not exceed 10% of its operating costs.

Hybrid rules

According to the ATAD, a hybrid mismatch is a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States where a double deduction or a deduction without inclusion outcome is attributable to differences in the legal characterization of a financial instrument or entity.

The ATAD establishes that where a hybrid mismatch results in a double deduction, the deduction should be granted only in the Member State where the payment has its source. Similarly, where a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

The hybrid rules apply to hybrid mismatches within the EU only. Several Member States, however, expressed interest in having these provisions extended to third country hybrid mismatches. In this regard, a Council statement was tabled requesting the Commission to put forward a proposal on hybrid mismatches involving third countries at the latest in October 2016 with the aim to reach agreement by the end of 2016.

Next steps

The text of the ATAD will now be submitted through the Committee of Permanent Representatives to the Council, for formal adoption. The directive will enter into force on the twentieth day following its publication in the Official Journal of the European Union. It should be transposed in Member States' national laws not later than 31 December 2018 and should take effect as of 1 January 2019. Derogations apply to the interest deductibility limitation rule and the exit taxation rule. Member States that have national targeted rules preventing BEPS risks that are equally effective to the interest deduction limitation rule, can continue applying these rules until the OECD has reached an agreement on a minimum standard with regard to OECD BEPS Action 4, but not later than 1 January 2024. The exit taxation rule needs to be transposed in Member States' national laws not later than 31 December 2019 and should take effect by 1 January 2020.

Furthermore, the Council will request the EU Commission to put forward by October 2016 a proposal on hybrid mismatches involving third countries that provides for rules consistent with and no less effective than the OECD BEPS recommendations under Action 2. The Council would expect that an agreement is reached on such directive by the end of 2016.

Finally, the Council states that in order to avoid any unintended consequences and ensure that the EU is not placed under a competitive disadvantage relative to its trading parties, the Commission and Member States will closely monitor the implementation of the BEPS recommendations at the global level.

Implications

The ATAD is an unprecedented change in European direct taxation and it will have a significant effect on the taxation of multinational companies operating in the EU.

According to the Council's press release, the ATAD will ensure that the OECD anti-BEPS measures are implemented in a coordinated manner in the EU, including by seven member states that are not OECD members. Furthermore, pending a revised proposal from the Commission for a common consolidated corporate tax base (CCCTB), it takes account of discussions since 2011 on an existing CCCTB proposal within the Council. Three of the five areas covered by the directive implement OECD best practices, namely the interest limitation rules, the CFC rules and the rules on hybrid mismatches. The two others, i.e., the GAAR and the exit taxation rules, deal with BEPS-related aspects of the CCCTB proposal.

A broad range of structures may be impacted by the ATAD. Existing financing, holding, IP and supply chain structures may be impacted by higher effective tax rates e.g., due to a cap on interest deductions, restricted deductions in hybrid situations, CFC implementation and higher tax costs on transfers of assets and migrations within and out of the EU. More structures may come under the effect of the EU-wide GAAR. There is an imminent need for careful evaluation of existing arrangements in light of the expected legislative changes in the EU Member States.

Endnotes

1. See EY Global Tax Alert, *ECOFIN one step away from reaching political agreement on Anti-Tax Avoidance Directive*, 17 June 2016.
2. http://data.consilium.europa.eu/doc/document/ST-10426-2016-INIT/en/pdf.

For additional information with respect to this Alert, please contact the following:

Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft, Munich

- Klaus von Brocke +49 89 14331 12287 klaus.von.brocke@de.ey.com

Ernst & Young Belastingadviseurs LLP, International Tax Services, Rotterdam

- Ronald van den Brekel +31 88 407 9016 ronald.van.den.brekel@nl.ey.com

Ernst & Young Belastingadviseurs LLP, Amsterdam

- Angele Muscat +31 88 407 1095 angele.muscat@nl.ey.com

Ernst & Young LLP (UK), London

- Mat Mealey +44 20 7951 0739 mmealey@uk.ey.com

Ernst & Young LLP, Global Tax Desk Network, New York

- Gerrit Groen +1 212 773 8627 gerrit.groen@ey.com
- Jurjan Wouda Kuipers +1 212 773 6464 jurjan.woudakuipers@ey.com
- Jose A. (Jano) Bustos +1 212 773 9584 joseantonio.bustos@ey.com
- Joana Dermendjieva +1 212 773 3106 joana.dermendjieva@ey.com

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