Agreement on EU Anti-Tax Avoidance Directive

On 21 June 2016, the EU Council finally agreed on the draft EU Anti-Tax Avoidance Directive (ATAD). The agreement was reached following discussions by the Economic and Financial Affairs Council.

Details and impact on Dutch tax regime

The draft Directive lays down anti-tax avoidance rules in five specific fields: interest deduction limitation, exit taxation, general anti-abuse rule, controlled foreign company rules and rules on hybrid mismatches. Compared to the earlier proposals there are some substantial amendments made and the switch-over clause has been eliminated.

Member States need to implement these minimum rules in their legislation before 1 January 2019, with an exception for the rules on exit taxation (1 January 2020) and the rules on interest deduction (postponed to 1 January 2024 subject to certain conditions).

In this alert we will discuss the proposals in more detail, including the expected impact on the Dutch tax regime.

The deductibility of interest

To discourage cross-border groups that shift profits via debt in order to reduce their global tax liability, an earnings stripping rule is introduced. Exceeding borrowing costs (interest costs that exceed the interest revenue) shall be deductible only up to 30 percent of the EBITDA or up to an amount of EUR 3 million, whichever is higher.
Member States can choose to implement one of two alternative worldwide group escape ratios. Carry forward provision options are available to the Member States in case the interest deduction/EBITDA is not fully utilised.

Please note that financial institutions (such as banks) can be excluded by Member States.

The grandfathering of the rule provides that loans concluded before 17 June 2016 will not be affected. This grandfathering will however not apply to any modifications of such loans.

The implementation of the earnings stripping rule can be postponed by Member States until the end of the first full fiscal year following the publication of the agreement between the OECD members on the minimum standard on BEPS Action 4, but no later than 1 January 2024. The implementation can however only be postponed under the condition that the Member State has national rules to prevent base erosion and profit shifting that are equally effective as the introduced EBITDA rule.

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Impact on Dutch tax regime
Several complex limitations on interest deduction already apply in the Netherlands. However, the proposed measure is very general and could – together with the existing measures – result in overkill. We therefore hope that a number of rules will be deleted and merely the proposed earnings stripping rule will apply. We however do not expect that the leveraged acquisition holding regime will be deleted. In a recent letter, the Dutch Ministry of Finance stated this specific rule could be deleted, but only if earnings stripping regime without a group escape would be implemented. Since a group escape is included in the proposal we expect this rule will remain.

Taxand's Take
Implementation of the proposed Directive means that (in most cases) additional interest will be considered non-deductible. However there are a few exemptions in the proposal and we advise to carefully check if one of them applies. Double taxation will most likely be the result of this new rule, as interest will only be partially deductible but will remain fully taxed at the level of the company receiving the interest. Again, the details in the implementation by EU Member States will be key.

Exit taxation
In order to protect the possibility to tax capital gains and other reserves created at their territory, EU Member States should implement exit tax legislation following which a transfer of assets or tax residency results in a deemed capital gain. The 'receiving' EU Member State should accept the fair market value as starting value for tax purposes. The proposal furthermore includes conditions for an extension of payment (by paying the taxes due ultimately in five yearly instalments), provided that it concerns a transfer to another EU or EEA country (in case of EEA states only if there is an agreement between the Member State of origin and the EEA state on mutual assistance for the recovery of claims).

The exit tax should be levied upon: (i) a transfer of assets between the head office and a permanent establishment (or vice versa) or between permanents establishments in another EU country or third country, (ii) a transfer of the tax residency to another EU country or third country, and (iii) transfer of the permanent establishment itself. Taxation should not occur insofar the assets remain subject to tax in the 'transferring' Member State.

Impact on Dutch tax regime
Dutch tax legislation already includes rules on exit taxation that is levied upon a transfer of tax residency or a transfer of a permanent establishment away from the Netherlands. The conditions for payment will however have to be brought in line with the Directive. Following the implementation of the Directive, a transfer of assets between the head office and permanent establishment (which is currently not considered to result in a taxable event), should result in a levy of Dutch taxation.

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Taxand's Take
Implementation of the Directive means that a cross-border transfer of assets that include capital gains within one multinational entity will lead to Dutch tax payable. A risk to double taxation occurs if the third country to which the assets are transferred, does not accept the fair market value as starting point for tax purposes. Future internal reorganisations should therefore be structured carefully. This rule seems contrary to the objective of the EU to promote cross-border business within the EU.

General anti-abuse rule (GAAR)
The GAAR entails that non-genuine arrangements shall be ignored for corporate income tax purposes, if they are carried out for the essential purpose to obtain a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions. Arrangements shall be considered as "non-genuine" to the extent that they are not put in place for valid commercial reasons which do not reflect economic reality.

Impact on Dutch tax regime
Current Dutch legislative framework already has several anti-abuse rules that tackle artificial structures. In addition, following the implementation of the EU Parent Subsidiary Directive, which also includes a GAAR, the Netherlands has recently included specific new anti-abuse rules.

In addition to the specific anti-abuse rules, the Netherlands also has a general anti-abuse doctrine which has been developed in case law ("fraus legis"). The fraus legis doctrine has certain similarities to the newly proposes EU GAAR. Consequently, artificial arrangements that will fall into the scope of the GAAR, may already be tackled by the fraus legis doctrine.

Taxand's Take
The wording of the Directive indicates that arrangements will be ignored "to the extent that they are not reflecting economic reality". In addition, an "essential purpose" test seems to be included. In other recent anti-abuse rules, similar, but not necessary equal purpose tests were included. The question is how to deal with arrangements that have multiple purposes (both commercial and tax related) and are partially reflecting economic reality. In any case, the above shows that substance and commercial reasons for a structure is becoming more and more important.

Controlled foreign company (CFC) rules
The CFC rules aim to eradicate the incentive of shifting income to a low taxed jurisdiction. CFC rules have the effect of re-attributing the income of low taxed controlled subsidiaries or permanent establishments ("PE") to parent companies. The rules apply to shareholders that hold - or together with an associated party - direct or indirect 50% of the capital, voting rights or entitlements to the profit of an entity that is considered low taxed. An entity is considered to be low taxed if the actual tax paid by the entity or the PE is lower than the

difference between the corporate tax that would have been charged on the entity or PE under the applicable corporate tax system in the Member State of the shareholder and the actual tax paid on the profits in the CFC jurisdiction. In other words, CFC rules will be applicable if the entity is subject to an effective tax rate of less than 50% of the effective tax rate in the Member State of which the shareholder is a resident.

The non-distributed income of the CFC needs to be included in the taxable income of the shareholder. The Member States have the option for the CFC rules to target an entire low-taxed subsidiary or specific categories of income (with an exception where the CFC carries on substantive economic activity) or to be limited to income which has artificially been diverted to the subsidiary.

Impact on Dutch tax regime
Currently, the Netherlands does not have a CFC regime. A requirement however exists that shareholders with a 25% shareholding (or together with an associated party) in a low taxed subsidiary (with 90% or more free portfolio assets) should revalue their participation. We expect that this will be replaced by the proposed CFC rules. This will be an important change in the rules and mindset of Dutch taxation.

Taxand's Take
Operations in non-EU countries (for example Switzerland) may especially be impacted by these CFC rules. The link between the statutory rate and the effective rate at the subsidiaries will result in a different situation between EU Member States, as EU Members States with high corporate tax rates will more frequently apply these rules. Again, companies should carefully review their current structures.

Hybrid Mismatches
To tackle hybrid mismatches the Directive lays down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome. The earlier proposed full requalification of the hybrid entity has been replaced by a simple set of rules.

To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

The rules only apply between Member States, but a proposal has been put forward to also counter hybrid mismatches with non-EU countries.

Impact on Dutch tax regime
The Netherlands already has various rules which directly or indirectly target hybrid financing

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or hybrid entities. In addition, as of 1 January 2016 the participation exemption has been revised following the Parent-Subsidiary Directive amendments with regard to hybrid financing. It is the question whether the proposed rules will apply in addition or will replace the current rules, especially with the situations for third countries.

Taxand's Take

The rules on hybrid mismatches do not come as a surprise. What is notable is that the proposed rule does differ from the BEPS proposal on hybrid mismatches. This may have to do with the fact that currently the rule is proposed to be only applicable between Member States and not with third countries.

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