EU Tax Avoidance Package

The Proposals

By Fisconti Tax Consulting

In its strive to combat tax evasion by multinational companies, the European Commission seems to be more Catholic than the pope. The proposals by the European Commission that were released on 28 January 2016 go much further than necessary and can even create significant uncertainty for the business community. Hopefully, the final version provides a more balanced approach.

The main purpose of the proposals launched by the EC is to embed the results of the BEPS project started by the OECD in a set of rules that will be implemented in all EU Member States. The rules thus address tax evasion and artificial profit shifting by corporate taxpayers. The proposed new EU legislation may have a significant financial impact on how international active companies do business and are structured.

It is anticipated that the final version of the new legislation will be introduced as per January 1, 2017. First the EU parliament and the several EU member states needs to agree on the final wording of the legislation.

Please find below an overview of the proposed legislation:

Interest deduction limitation rule

The European Commission proposes to introduce a fixed limitation to the deduction of interest. The proposed rule is quite similar to the German interest deduction limitations. This means that interest expenses can be deducted up to 30% of EBITDA. There is an escape possibility if the taxpayer can show that its equity-to-asset ratio is higher than the same ratio of the entire multinational group of which the taxpayer is part. In practical terms this group ratio is probably quite complex to calculate since it also requires that all assets and liabilities of the local company are valued using the same method as in the consolidated financial statements. Non-deductible interest expenses can be carried forward to future years.

There is also relief for small and medium sized companies since annual interest expenses up to the amount of one million euro per year will not be subject to the new limitation rules.

Exit tax for cross border transfer of assets

A company that transfers business assets to its branch in another country may be required to pay exit tax. This means that the transferred assets will be subject to local corporate income for the difference between the market value and the book value. No exit tax will be due, however, if the transfer has a temporary nature and if it is intended that the asset reverts to the country of origin after use in the other country.

In other cases instant tax payments may be prevented, since there is an option to defer taxation in five annual instalments.

Most EU member countries already have quite detailed rules that are based upon common transfer pricing principles. The proposed legislation is not very detailed and will provide a lot of uncertainty. It will not be a reduction of the administrative burden in our view.

Amendment of participation exemption and tax exemption foreign branch income

Many countries, like the Netherlands, provide a tax exemption for income deriving from foreign branches or foreign subsidiaries. The driving principle here is that income may be taxed in the country where the profits are generated and there should be no double taxation if those profits are subsequently transferred to the country where the parent company or head office is located.

The new proposed rules create a threshold before the participation exemption or branch exemption can be applied. The proposal stipulates that no full exemption of that foreign income is available if the effective tax rate is lower than 40% of the tax rate of the parent company. For Dutch companies that would mean that the threshold for foreign taxation will be at least 10%. If the foreign taxation falls short of this percentage the full exemption cannot longer be applied. Instead a tax credit will be provided, which is less favourable.

The current proposal is in our view very broad and may also have an impact on genuine structures that cannot be regarded as tax avoidance. Local R&D branches or entities benefiting from local tax incentives for example, may be hit by this new regulation. In our view this measure is not proportional and is not achieving its objectives and hopefully these details will crystallise-out in time resting until implementation.

General anti-abuse regulation

A very broad and vague general anti-abuse principle will be introduced. Tax authorities may disregard so-called non-genuine arrangements, or a series thereof, if those are carried out for the essential purpose of obtaining a tax advantage. We fear that the imprecise rules will significantly increase the uncertainty for investors and companies.

Already in Dutch tax jurisprudence there is a lot of discussion and court cases regarding the explanation of anti-abuse provisions. The new EU rules will create an additional layer of complexity. Certainly if tax authorities are more cautious to provide advance certainty due to all the different 'state aid verdicts' provided by the European Commission regarding the provision of advance rulings to individual tax payers.

Controlled foreign company legislation

Some European countries, like the UK, already have tax rules that determine that certain income that is derived by foreign subsidiaries will be included immediately as taxable income of the parent company, regardless whether that profit is distributed or not. Such rules are know as Controlled foreign company income rules or simply CFC-rules.

The new proposals include the rule that foreign income will be included in the tax base of the parent company (or affiliated entity) if 50% of the income of the foreign entity falls in inter alia the following categories:

- Interest income
- Royalties
- Dividends and capital gains
- Real estate

The new EU-wide CFC-rules will be applied if the effective corporate tax of the foreign subsidiary is lower than 40% of the rate of the parent company. These CFC-rules may have a large impact, amongst others, on finance and (intermediary) holding companies. The CFC rules will not be applied to subsidiaries that are resident in the EU/EEA, unless the establishment of the foreign entity is artificial. We believe these CFC rules are discriminatory towards non-EU/EEA and certainly not contribute to an improvement of the EU investment climate.

Hybrid mismatches

Currently European countries apply their own rules to determine the nature of a legal entity or payments. This may result in a situation where one country considers a type of legal entity as a tax transparent partnership whereas the other country regards the same entity as a non-transparent corporation. Also payments can be classified as interest at one side and simultaneously as dividend at the other side.

A new hybrid mismatch rule will be introduced to prevent differences in classification of legal entities or payments between countries (source versus receiving country). The new rule proposes that the receiving country applies the same classification of the ‘source’ country. In other words the tax rules of the source country rules will determine the classification of an entity/payment and the ‘receiving’ country has to follow that classification.

In the Netherlands the so-called CV-BV structure is often implemented for US multinationals. This structure makes use of the mismatch between US and Dutch tax classification of legal entities (the US applies its own set of rules including the check-the-box options). Since the proposed directive only addresses EU member countries, the CV-BV can still be applied unless the US endorses and applies also the same approach as proposed by the European Commission.

Way forward

In the next couple of months we will see how successful the European Commission is to win support for this proposal. We anticipate a lot of debate and resistance regarding this ambitious project of the European Commission. Nevertheless, it is important that multinationals are aware of these developments. We have seen with previous projects that the actual implementation and acceptance was achieved much faster than the market initially anticipated.

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