

The main measures contained in the Anti-Tax Avoidance Directive

Pilar Álvarez Barbeito

Reader (Associate Professor) of Tax and Public Finance Law, Universidad de La Coruña

Academic Counsel, Gómez-Acebo & Pombo

The Anti-Tax Avoidance Directive (ATAD), finally published in the Official Journal of the European Union on 19 July 2016, will impact five main areas: limits on interest deduction, the regulation of so-called exit taxation, the establishment of a general anti-abuse rule, a controlled foreign company rule and rules addressing hybrid mismatches.

1. Introduction

On 19 July 2016, Council Directive 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market was published in the Official Journal of the European Union (L193).

As we already know, this directive is the final outcome of a European Commission proposal published on 28 January 2016 as part of a package of anti-tax avoidance measures. The initial proposal has been modified a number of times, culminating in the definitive text whose main new features with respect to prior versions are described below.

2. Main measures contained in the directive

While the originally proposed text of the Directive contained tax-avoidance measures in six specific areas, the definitive text has reduced them to five, eliminating the measure originally included in article 6 of the proposal (the switchover rule). This rule limited the tax exemption of dividends and capital gains from holdings in entities resident

in third countries with a corporate income tax rate below 40% of the rate applicable in the parent's Member State of residence. Certain Member States' opposition to this measure, based on the fact that it exceeds the scope of the measures outlined in the BEPs project or that the intention of the Directive was not to set a minimum level of taxation, ultimately led to its removal.

The five main measures contained in the Directive are thus the following:

a) *Limits on interest deductions (article 4)*

This measure, in line with BEPS Action 4, limits the deduction of net interest costs, without distinction as to the origin of the debt, to 30% of the taxpayer's EBITDA, although it permits full deduction of net interest costs up to a threshold of 3 million euros.

As pointed out in article 4(2), the EBITDA shall be calculated by adding back to the income subject to corporate tax in the Member State of the taxpayer the tax-adjusted amounts for exceeding borrowing costs as well as the tax-adjusted amounts for depreciation and

amortisation. Tax exempt income shall be excluded from the EBITDA of a taxpayer.

The Directive also includes a number of clauses which allow the Member States to loosen the rule limiting interest deductions.

Firstly, they may exclude from the scope of the general rule exceeding borrowing costs incurred on loans which were concluded before 17 June 2016 or loans used to fund a long-term public infrastructure project, subject to certain requirements.

Secondly, where the taxpayer is a member of a consolidated group for financial accounting purposes, the taxpayer may be given the right to either fully deduct its exceeding borrowing costs if it can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group, subject to certain conditions, or deduct such costs at an amount in excess of what it would be entitled to deduct under the above. This higher limit shall refer to the consolidated group in which the taxpayer is a member and be calculated in two steps, taking into account the group's indebtedness with third parties and the taxpayer's indebtedness.

Thirdly, it states that Member States may provide for rules either to carry forward or carry back exceeding borrowing costs and exclude financial undertakings from the scope of this measure, including where they are part of a consolidated group. In this regard, Recital 9 of the Directive states that although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. However, as the discussions in this field are not yet sufficiently conclusive in the international and Union context, it points out that it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.

In accordance with the provisions of article 11 of the Directive, Member States have

until 1 January 2024 to adapt their national legislation regarding interest limitation rules, unless the OECD first agrees and publishes a minimum standard in this regard.

b) Exit taxation (article 5).

Article 5 of the Directive refers to exit taxation on assets transferred from the head office of a company to a permanent establishment in another Member State or in another third country, and vice versa, insofar as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer, in the first case, or insofar as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer, in the second case. Furthermore, it establishes the same rule for transfers of tax residence to another Member State or to a third country, as well as transfers of business carried on by a permanent establishment from a Member State to another Member State or to a third country, also because the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

Where the transfer of assets, tax residence or the business carried on by a permanent establishment is to another Member State, that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value.

This article also sets out that, provided that the assets are set to revert to the Member State of the transferor within a period of 12 months, this Article shall not apply to asset transfers related to the financing of securities, assets posted as collateral or where the asset transfer takes place in order to meet prudential capital requirements or for the purpose of liquidity management.

Moreover, it provides, as did the original proposal for this Directive, that taxpayers may defer payment of the exit tax, although interest may be charged and, if there is a demonstrable and actual risk of non-recovery, taxpayers may also be required to provide

a guarantee as a condition for deferring the payment.

c) General anti-abuse rule (article 6)

This measure, which has achieved broad consensus, is similar to the anti-abuse rule included in the Parent-Subsidiary Directive in 2015. In this regard, the Directive provides that a Member State shall ignore any commercial arrangement it suspects of having been put into place for the main purpose of obtaining a tax advantage and shall refuse to apply the intended tax benefits. Spain already has similar general anti-abuse rules, so the inclusion of this measure in the definitive text of the Directive should not lead to any significant changes in our country.

d) Controlled foreign company rule (articles 7 and 8)

The new controlled foreign company rule that must now be adopted by the Member States has been amended several times since the original proposal. The definitive text states that, provided a number of conditions are met, the Member State of a taxpayer shall treat an entity or a permanent establishment of which the profits are not subject to tax or are exempt from tax in that Member State, as a controlled foreign company.

In respect of the afore-mentioned conditions and apart from the condition regarding control percentages, which has not undergone any modifications, the definitive text of the Directive does modify the reference in the original text to an effective corporate tax rate of at least 50% of the effective rate that would have been charged in the member state of the head office. This percentage has been removed and, in its place, the Directive establishes a requirement that the corporate tax effectively paid by an entity or permanent establishment on its profits must be lower than the difference of tax that would have been charged in the Member State of the taxpayer and the actual tax paid by such entity or permanent establishment on its profits.

Member States have two alternative approaches for including non-distributed income in the tax base.

Firstly, article 7(2)(a) of the Directive indicates that the Member States may include in the tax base of an entity or permanent establishment treated as a controlled foreign company pursuant to the above the undistributed income included in the list of income categories in this article (interest, royalties, dividends, etc.). The above shall be possible only while the entity carries on no substantive economic activity (supported by staff, equipment, assets and premises), although Member States may decide to refrain from applying such exception if the controlled foreign company is resident or situated in a third country that is not a member of the European Economic Area. Irrespective of the above, Member States that choose this alternative may opt not to treat an entity or permanent establishment as a controlled foreign company if one third or less of the income accruing to the entity or permanent establishment falls within the categories under article 7(2)(a). Furthermore, Member States that choose this alternative may also opt not to treat an entity or permanent establishment as a controlled foreign company if one third or less of the entity's income from the categories under point (a) of paragraph 2 comes from transactions with the taxpayer or its associated enterprises.

Secondly, in the alternative, Member States may include in the tax base of an entity or permanent establishment treated as a controlled foreign company according to the above the non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. Article 7(2)(b) clarifies when an arrangement or a series thereof shall be regarded as non-genuine.

Member States that opt for the second alternative may exclude from the scope of article 7(2)(b) entities or permanent establishments with accounting profits of no more than EUR 750,000 and non-trading income of no more than EUR 75,000 or with accounting profits that amount to no more than 10 percent of its operating costs for the tax period. The Directive clarifies that the operating costs may not include the cost of goods sold outside the country

where the entity is resident, or the permanent establishment is situated, for tax purposes and payments to associated enterprises.

e) *Framework for addressing hybrid mismatches (article 9).*

As a final point, we should mention that the text of the Directive, compared to the original versions of the proposal, has greatly simplified the wording of article 9. This article provides, firstly, that 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 and secondly, that 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.

3. Transposition

Article 11 of the Directive establishes 31 December 2018 as the deadline for the Member States to transpose the Directive, with 1 January 2019 as the date provided for such measures to apply, without prejudice to the specific transitional provisions provided with in respect of certain measures.

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