Tackling Tax Avoidance in the EU – Impact on Corporate Treasury

Introduction

Many corporate treasurers are likely to have become more aware of the OECD's Base Erosion and Profit Shifting (BEPS) project, given the worldwide publicity it has received and the focus it has placed on limiting tax benefits of intragroup financing arrangements as a source of aggressive tax planning.

Following on from the BEPS project, the European Commission released its own draft anti-avoidance tax package on 28 January 2016 which contains measures to prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the EU.

Below is a brief overview of some of the key proposed changes suggested by the EU and how they are relevant to corporate treasurers.

Overview of EU Anti-Tax Avoidance ("ATA") Package and relevance for Corporate Treasurers

The draft anti-tax avoidance package introduced by the European Commission contains a number of documents including:

1. A draft anti-tax avoidance Directive – setting out proposals for legally binding anti-avoidance;
2. Revised Administrative Cooperative Directive – to implement country by country reporting ("CBCR") between tax authorities;
3. Recommendations on tax treaties - advising EU Members States on how to revise national tax treaties against abuse;
4. A communication on external strategy – for measures to promote tax good governance internationally;
5. A Study on Aggressive Tax Planning

It is important to note that the directives published are draft proposals that have been put forward by the European Commission. They have not yet been fully debated or considered by the 28 EU Member States. Full unanimity is required by all 28 EU Member States in relation to areas of direct tax policy. The release of the draft directives is very much the start of a process of engagement and debate among Member States on these important tax policy issues.

The draft ATA directive proposes action in three areas already covered by the OECD BEPS actions:

- Interest deductibility restrictions (Action 4);
- Hybrid mismatches (Action 2); and
- Controlled Foreign Companies (Action 3)

Whereas the OECD released its final reports on the above actions in October 2015 (and endorsed by G20 leaders in November 2015), none of these actions were agreed as "minimum standards" for implementation in the near term amongst the participating countries. With the release of the draft directives the European Commission has therefore signalled an intent to go further than the outcome of the BEPS process and to secure implementation of tax law reform in the EU in the above areas in the near term.

The ATA directive also proposes actions in three areas not reflected in the BEPS action plan:

- A General Anti-Avoidance Rule ("GAAR");
- "Switch-over" clauses that treat some income/gains as taxable instead of granting an exemption; and
- Exit taxation

The aspects of the ATA package that should be taken note of by corporate treasurers are:

1. Interest deductibility restrictions;
2. Hybrid mismatches rules;
3. The "Switch-over" clause (which may be relevant to certain types of intergroup financing structures); and
4. The specific focus in the Study on Aggressive Tax Planning on a commonly used intergroup financing structure involving Ireland, namely the interest-free loan structure

1. Interest deductibility

The draft directive contains proposals on restricting interest deductibility which is broadly in line with the OECD BEPS Action 4 paper. The proposed rules starts off with the principle that borrowing costs are always deductible to the extent interest and other taxable revenues are generated from financial assets. The directive then proposes that where interest costs exceed interest income, the deduction of financing costs should be restricted to the higher of 30 per cent of a taxpayer's EBITDA or €1 million. This limitation applies without regard to the origin of the debt. For example, it is not relevant whether the lender is a connected party, a third party, in the EU or in a third country. In an Irish context, the restriction, if implemented, would be wider than interest incurred by a company for trading purposes and can also include interest on borrowings incurred for investment purposes (for example section 247 financing).

Member States may (but are not obliged to) implement an exception to this restriction where a taxpayer can demonstrate that its equity to total assets ratio is in line with or higher than the equivalent ratio of the group**,** where a group is defined as all entities that are included in audited consolidated accounts prepared under IFRS, US GAAP or GAAP of a Member State. In other words, where the group as a whole is highly leveraged a greater amount of interest deductibility could be allowed.

Importantly, however, the EBITDA of a tax year that is not fully reduced by the allowable interest expense in that tax year can be carried forward indefinitely and will increase the relevant EBITDA of the following year for the purposes of calculating the restriction. Also, excess interest which cannot be deducted because of the EBITDA restriction may be carried forward indefinitely to subsequent taxable periods.

There are some differences with respect to the interest deductibility restrictions being proposed by the European Commission compared with those originally put forward by the OECD in BEPS Action 4. For example, the Commission's ATA opts for an equity-based group test rather than a group interest to EBITDA ratio test, as per BEPS Action 4. Furthermore, as mentioned above, Action 4 was issued as a "Best Practice" recommendation by the OECD, meaning that countries would be free to assess and pick from the elements of the BEPS Action that best suited their current tax policy and strategy. By comparison, the uniform application of a set ceiling of 30% which Member States must apply differs from the OECD recommendations although Member States may also introduce stricter rules if they wish.

2. Hybrid mismatches

In respect of hybrid mismatches, the draft directive proposes an anti-hybrid rule for situations where there are essentially differences in the legal characterisation of payments (e.g. payments treated as interest in one jurisdiction but as a dividend in another) or entities between EU Member States. The rules would require that when an entity or instrument is classified differently in two Member States, the tax treatment in the Member State in which a deduction is claimed should be followed by the second Member State where the income is received.

It should be noted that this is essentially the opposite of the OECD's BEPS proposals which states that the deduction (e.g. for interest) should be disallowed in the paying country with a secondary rule requiring that income be taxed where the primary rule is not adopted. There is no obvious justification for adopting a different rule for payments within the EU compared with payments between EU Member States and third countries. In practice, this could raise a number of potential issues depending on whether the local jurisdiction of a lender (or borrower) outside of the EU has adopted the OECD's recommendations. It is possible that the divergent treatment suggested by the OECD and the European Commission could mean there is in effect a two tier approach to dealing with hybrid mismatches depending on whether they are intra-EU or with a non-EU country. As such, the use of hybrid financial instruments for cross-border intergroup financing (for example debt with equity characteristics such as profit-participating loans or preference shares) could become highly complex and prohibitively inefficient from a tax perspective.

3. Switch-over clause

The switch-over clause was not included in the OECD BEPS recommendations. It proposes that all Member States should adopt a rule whereby foreign dividend income, gains on the disposal of shares in a non-EU entity, or income from a permanent establishment situated outside the EU from low-taxed companies (or low taxed permanent establishments) should be taxable, with a tax credit given for any overseas tax actually paid. The proposal sets the definition of low tax as a statutory tax rate that is lower than 40% of the tax rate in the relevant member state. Broadly, this could result in the elimination of a participation exemption for foreign dividends and disposal of shareholdings as well as the foreign branch exemption that may exist in certain Member States.

In the context of intergroup financing, the potential elimination of the foreign branch exemption in certain instances represents a potentially significant change, given the prevalence of certain intergroup financing structures where a form of foreign branch exemption is relied on to exempt interest income on intercompany loans from tax.

4. Ireland and interest-free loan structures

The ATA package also includes a "Study on Aggressive Tax Planning", a document that, it is stated, "provides a useful basis for identifying areas for action in the fight against tax avoidance". The study focuses on aggressive tax planning (as defined in the Commission Recommendation) and essentially identifies factors or indicators in certain countries that facilitate aggressive tax planning.

A specific structure focused on is referred to as "Interest-free loan aggressive tax planning structure", and described as a structure that takes advantage of a situation where a deemed deduction of interest is afforded on an interest-free loan in one jurisdiction, but where there is no deemed interest taxation in the country of the lender.

A non-trading Irish tax resident company that has advanced an interest-free loan does not currently fall within the ambit of the Irish transfer pricing rules, i.e. there is no taxation in Ireland where a non-trading company has advanced an interest-free loan. The result of this is that tax efficiency can be achieved where such an interest-free loan is advanced to a company tax resident in a jurisdiction where a deemed deduction for interest is allowed. Such structures are known in multi-nationals and several treasurers may be aware of such structures within their own groups. The Study specifically highlights this structure in the section of the report dealing with Ireland and an “Active Indicator 7” was awarded to Ireland for not providing for the taxation of any deemed income on an interest-free loan granted to a group member company. In light of this, it remains to be seen for how much longer the Irish tax rules will allow for interest-free loans to not attract taxation in Ireland where a deemed deduction for interest has been claimed in the jurisdiction of a connected party debtor.

Conclusion

Multinational groups that have historically enjoyed low effective rates of tax as a result of efficient intragroup financing structures in particular will be impacted by the changes proposed by the Commission. However, the extent of any possible impact will depend on a number of factors, such as the extent to which unanimity is reach amongst all 28 EU Member States (or whether a smaller number of Member States agree to the proposals through enhanced cooperation), the type of financing structures employed by a multinational group, how the treasury operations are structured and in which jurisdictions. In its current draft form, it is hard to see how unanimity would be achieved on the current full draft ATA directive. Whereas the impact of the EU draft directive (and wider BEPS Actions) will no doubt be felt by many groups, there should continue to be a number of tax efficient options for the structuring of global treasury operations and intercompany lending. In this regard, there should be opportunity for groups to restructure their group treasury affairs in a manner that limits any adverse impact.

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