The EU Anti-Tax Avoidance Directive – Impact on Corporate Treasury

Irish Association of Corporate Treasurers

Introduction

On 21 June 2016 the EU's ministers of Finance and Economic Affairs, the so-called ECOFIN Council, unanimously approved the Anti-Tax Avoidance Directive ("ATAD"). This measure was originally proposed in January 2016 as part of the wider Anti-Tax Avoidance Package and was amended a number of times since its initial release.

Below is a brief overview of some of the key changes agreed for implementation as part of the ATAD and in particular their relevance for corporate treasurers.

The ATAD outlines actions which build on three BEPS initiatives as follows;

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

In addition, the directive also outlines agreed actions in areas not reflected in the BEPS action plan:

- A General Anti-Avoidance Rule ("GAAR"); and
- Exit taxation

A switch-over rule denying tax exemptions on certain income and gains had been suggested as part of the initial January 2016 draft ATAD, but was dropped as part of the final version of the ATAD approved by ECOFIN.

It should be noted that the ATAD seeks to provide a minimum standard that each Member State must have in place. Consequently, Member States are still entitled to take actions that go beyond the wording of the ATAD. The ATAD indicates that all Member States shall adopt and publish the laws and regulations necessary to comply with the rules by 31 December 2018 at the latest, with entry into force of the ATAD from 1 January 2019 (subject to a few exceptions).

The aspects of the ATAD that should particularly be taken note of by corporate treasurers are:

1. Interest deductibility restrictions;
2. Hybrid mismatches rules; and
3. Controlled foreign company rules.

Interest deductibility restrictions

In line with the initial proposal in the ATAD, excess borrowing costs will only be deductible up to 30 per cent of a taxpayer's tax adjusted earnings before interest, tax, depreciation and amortisation (EBITDA). Alternatively, a taxpayer may be given the right to deduct excess borrowing costs below a €3 million threshold (which should be considered for an entire group) and to fully deduct interest if the taxpayer is a standalone entity (as defined). In the original draft of the ATAD, this limit was set at €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 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 either of two exceptions to this restriction, namely where a taxpayer can demonstrate that its equity to total assets ratio is in line with or higher than the equivalent ratio of the consolidated group for accounting purposes, or where the taxpayer's 3rd party net interest cost to EBITDA ratio is the same or lower than that of the overall consolidated group.

The introduction of the second exclusion (group wide interest/EBITDA test) is a new addition to the ATAD when compared with the original draft. Furthermore, the first exclusion originally included a limitation that payments to associated enterprises could not exceed 10 per cent of a group's total excess borrowing costs. This limitation is no longer part of the ATAD. A further significant change to the ATAD is the provision for the grandfathering of loans that were concluded before 17 June 2016 (and not modified thereafter). In other words, Member States are allowed to exclude loans concluded before 17 June 2016 from these new interest restriction rules. In such a case, only subsequent modifications (e.g. an increase in the loan amount) would be caught by the new rules. Also, Member States may exclude certain loans used to fund long-term public infrastructure projects in the EU.

Member States may allow for excess interest which cannot be deducted because of the EBITDA restriction in a year to be carried forward indefinitely to subsequent taxable periods, and also to carry such interest back for a maximum of 3 years. A further relieving option is also possible whereby unused interest capacity can be carried forward for 5 years together with excess disallowed interest.

It should be noted that Member States that have national targeted rules for preventing BEPS which are equally effective to the interest limitation rule in the ATAD are granted a transitional period from implementing the rules dealing with interest deductibility in the ATAD. Any such Member State may continue to apply those existing, targeted rules until the end of the first fiscal year following the publication of the agreement between the OECD Member States on a minimum standard with regards to BEPS Action 4 (which deals with interest deductibility) or at the latest, until 1 January 2024.

In this regard, the Department of Finance in a statement dated 22 June 2016 indicated that it views Ireland as a jurisdiction that already has strong targeted anti-avoidance rules and that the implementation of the interest restriction rules should therefore be deferred (in the Department's view) to 2024 in the case of Ireland.

Hybrid mismatch rules

In line with the original proposal, the ATAD includes an anti-hybrid mismatch rule to tackle mismatches in the legal characterisation of a financial instrument or entity between Member States, if such a mismatch results in a double deduction or a deduction without inclusion. In the case of a double deduction, a deduction shall only be given in the Member State where a payment has its source. In the case of a deduction without a corresponding income inclusion in another Member State, the Member State of the payer should deny the deduction of such payment. This approach, the disallowance of a deduction is more in line with the OECD's proposals in Action 2 of the BEPS Action Plan. The original draft of the ATAD did not aim at a disallowance of a deduction, but at mirroring the characterisation of the hybrid financial instrument or entity instead. The ECOFIN added a statement to the ATAD in which the European Commission is requested to come up with a proposal by October 2016 in relation to hybrid mismatches with third countries that is consistent with and no less effective than the rules recommended by Action 2, with a view to agreement by the end of 2016. The use of hybrid financial instruments, such as profit participating loans or preference shares, for cross-border intragroup financing may still be efficient from a tax perspective going forward, although this does very much depend on the final agreed wording of any proposals of the EU in dealing with hybrid mismatches with third countries.

Of further relevance is that the OECD released a Public Discussion Draft on 22 August 2016 as part of BEPS Action 2 with regard to so-called branch mismatch structures. The draft invites comments from the public by 19 September 2016 in connection with, *inter alia*, proposed measurers to eliminate tax efficiencies created by branch financing structures (e.g. interest-bearing loans allocated to branches in circumstances where no tax arises on the interest income in either the branch jurisdiction, or the jurisdiction of tax residence of the creditor). The outcome of this

consultation may have an impact on the proposals to be put forward by the European Commission on hybrid mismatches involving third countries targeted for October 2016.

Controlled foreign company rules

The finally agreed ATAD includes controlled foreign company (CFC) rules, which Member States have to apply from 1 January 2019 onwards. The CFC rules will have the effect, broadly, that EU holding companies would be subject to tax on certain types of profits earned by low-taxed subsidiaries in other countries, where the relevant CFC requirements are met. A CFC is essentially defined as an entity in which the taxpayer holds a greater than 50% shareholding (directly or indirectly) and where the actual corporate tax paid by that entity is lower than the difference between the tax that would have been paid on the same profits in the Member State of the taxpayer parent company and the actual corporate tax paid in the low tax country. A permanent establishment (i.e. a branch) the profits of which are not subject to tax or are exempt from tax in the Member State of the taxpayer is also deemed to be a CFC.

The consequences of having a CFC is that certain types of non-distributed passive income will be attributed to the holding company and taxed in that jurisdiction. Specifically included as a type of passive income is interest or any other income generated by financial assets. However, this will not apply where it can be shown that the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises. In other words, the profits of a financing company located in a low tax jurisdiction (relative to the parent company) would be at risk of taxation in the parent company jurisdiction unless it can be shown that substantive economic activities is carried on in that location supported as aforesaid. Alternatively, Member States will have the option of instead taxing all of the non-distributed income of a CFC arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.

Measures are also provided to limit the administrative burden such that Member States may exempt certain entities from the CFC rules if they have sufficiently low profits or a low profit margin.

In line with the objectives of the OECD BEPS process as a whole, the result of the below is essentially that organisations with treasury or financing companies in locations with a relatively low corporate tax rate (relative to the corporate tax rate in the parent company jurisdiction) should exercise care to ensure that substantive economic activities are undertaken in that jurisdiction.

Conclusion

The impact of international tax reform on intercompany financing and corporate treasurers has been closely followed by interested parties. A particular area of concern has been the proposed interest deductibility restriction rules and the concern that such provisions may unduly influence the manner in which intercompany financing is provided.

Whilst the agreed interest deductibility restrictions under the EU ATAD will no doubt impact some multinationals, any adverse effect should be minimised by a number of relieving options available to Member States on implementation. These can be summarised as:

- Provisions are effective only from January 2019 or in some cases (e.g. as put forward by the Irish Department of Finance), 1 January 2024;
- Grandfathering of existing loans concluded before 17 June 2016;
- Exclusion of stand-alone entities from the rules;
- A deduction for interest up to €3million (albeit calculated on a group basis);
- The possibility for an entity to still claim interest deductions where certain leverage ratios are in line with that of its consolidated group;
- A possible carry forward (and carry back) for excess interest to be available for deduction in future years.

What is potentially of greater importance for groups that utilise dedicated treasury or finance companies in favourable locations is the new CFC rules effective in the EU from 1 January 2019. This, together with the new OECD Transfer Pricing Guidelines (in particular BEPS Actions 8 to 10) will make it increasingly important to have the right level of substance and substantive economic

activity in such treasury location. This would be important not only to ensure the finance company is not a CFC, but also to justify that the level of interest and fees paid intergroup to the finance company are at arm's length.

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