The Commission Proposal for an Anti-BEPS Directive: Some Preliminary Comments

Kluwer International Tax Blog
February 5, 2016

Werner Haslehner (Luxembourg University)

Please refer to this post as: Werner Haslehner, 'The Commission Proposal for an Anti-BEPS Directive: Some Preliminary Comments', Kluwer International Tax Blog, February 5 2016, http://kluwertaxblog.com/2016/02/05/the-commission-proposal-for-an-anti-beps-directive-some-preliminary-comments/

On 28 January 2016, the European Commission issued its proposal for a Council Directive dealing with tax avoidance practices within the EU – the so-called Anti-BEPS Directive. The context of the proposal is well known: in a nutshell, the proposal results from the dual influences of the (thus far) failed 2011 CCCTB proposal and the OECD's BEPS project, and follows up on the Commission's announced Action Plan for Fair and Efficient Corporate Taxation, presented on 17 June 2015. This contribution aims to provide some preliminary thoughts and critical comments on the Commission's draft.

The proposed Anti-BEPS Directive

The proposed "Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market" consists of 6 different anti-avoidance measures. Briefly outlined, these are the following:

- An Interest Limitation Rule capping deductions at 30% of EBITDA (or € 1 m), with a carve-out for financial undertakings (Article 4)
- An Exit Tax on transfers of residence or transfer of assets outside the home country's tax jurisdiction, with the option for payment in instalments spread over at least 5 years (Article 5)
- A Switch-Over Clause (mandatory taxation) for foreign income taxed at

below 40% of the home jurisdiction's statutory tax rate (Article 6)

- A General Anti-Abuse Rule tackling "non-genuine arrangements" with the "essential purpose of obtaining a tax advantage" (Article 7)
- CFC Legislation requiring inclusion of non-distributed income earned by controlled passive subsidiaries taxed at below 40% of the home jurisdiction's effective tax rate. Within the EU/EEA, limited to "wholly-artificial" and "non-genuine" arrangements; carve-out for financial undertakings (Article 8-9)
- An Anti-Hybrid Rule ensuring congruent classification of entities and financial instruments within the EU in line with the Source State (Article 10)

In the following few paragraphs, I would like to comment briefly on these proposed measures, in light of the following four questions:

- Does the EU have the competence to harmonise Member States' BEPS responses?
- Is the proposal an efficient way of harmonising Member States' anti-avoidance legislation?
- How are tax treaties going to be affected by the proposed directive?
- Are the proposed rules substantively in line with primary EU law?

Competence and effectiveness of "minimum harmonisation" method

The objective of the directive is to "improve the resilience of the internal market as a whole against cross-border tax avoidance practices". To this end, it aims to target situations where "taxpayers act against the actual purpose of the law, taking advantage of disparities between national systems to reduce their tax bill". While it is true that the proposed measures all target at least indirectly the use of differences in Member States' tax laws – in particular with regard to their corporate tax rate – that connection may be somewhat tenuous, such as in the case of the proposed interest limitation or the exit tax. It is furthermore not clear that the directive is limited to counteracting situations "against the purpose of the law".

Irrespective of such petty criticism, it is an interesting question whether the EU is competent to harmonise Member States' direct tax law. The Commission relies on Article 115, the general rule for harmonisation measures affecting the functioning of the internal market. The justification for this is straightforward: If each Member State took unilateral and uncoordinated action to fight tax avoidance, especially by taking different approaches to implementing the BEPS recommendations, the internal market would be affected by even more fragmentation and obstacles to cross-border activity. The alignment of the six measures proposed by the Commission with BEPS Actions is thus no accident: the Commission explicitly aims to prevent a "fragmentation of the internal market, which would possibly result from uncoordinated unilateral actions by Member States" with respect to the BEPS project. From that perspective, a harmonised approach comes to the rescue of European businesses, which would otherwise face multiple regulations that would all but strangle multinational corporate structures. This perspective is perfectly reasonable and broadly in line with the justification for the existing company tax directives: the effective removal of obstacles. However, the Commission adds a second, quite different, dimension: the need to improve the internal market's "resilience against aggressive tax planning". This second perspective suggests that the "internal market" has itself a tax dimension, in the sense that it requires the prevention of tax avoidance. In fact, this is much less obvious than the first perspective: indeed, it is generally accepted that all taxation is liable to create an obstacle to free movement within the EU. However, it is not clear that there is an (internal) "market for taxation" that requires regulation at an EU level. Crucially, this latter reason could just as easily be employed to fully harmonise direct tax law within the EU and not only to justify anti-avoidance legislation.

One element of the Commission's proposal strikes me as inconsistent with the more convincing (first) argument for harmonising the Member States' responses: if the objective is to prevent fragmentation from uncoordinated approaches, then minimum harmonisation is certainly not the way forward. By leaving Member States the possibility to go beyond the proposed anti-BEPS rules, the danger for such fragmentation remains essentially unconstrained. The Commission seems to think that setting a minimum level is necessary to comply with the principle of proportionality. But proportionality also requires a proposal to be suitable to achieve its objectives. The Commission, however, does not appear to have fully made up its mind what these objectives are.

Relationship to Tax Treaties

The Commission maintains in its Communication COM(2016) 23 that "issues relating more to tax treaties have not been included in the Directive", but are instead tackled by a separate recommendation (C (2016) 271). Nevertheless, several of the proposed rules might require changes to tax treaties of EU Member

States, as they intend to limit access to exemptions (CFC, switch-over clause) or affect tax allocation rules (exit tax, anti-hybrid rule).

Within the EU, any potential conflict with tax treaties is resolved by the superiority of EU law. Thus, if such treaties were not changed by the deadline of implementation of the Directive, the respective limits imposed by them would simply be overridden by domestic legislation transposing the Directive. However, if the Directive is not properly implemented, the Member State remains bound by the tax treaty, as the Directive does not have direct effect to the detriment of the individual. A questionable case is where a Member State has transposed the Directive in domestic law, but has not changed a relevant tax treaty and, under its constitutional law, does not recognise the power of national law to affect a "treaty override". In relation to third countries, the Directive does not affect tax treaties entered into by Member States prior to their accession to the EU (Article 351 TFEU). Newer tax treaties are, by contrast equally affected by the Directive.

A further question will be to what extent the proposed harmonisation increases the likelihood of the Commission seizing competence to negotiate tax treaties with third countries on behalf of Member States. This appears unlikely considering its "recommendation"-approach to the issue of treaty abuse.

Concrete (preliminary) observations on the proposed measures

On the Interest Limitation Rule:

- It is interesting, though not very surprising, that the Directive provides a general carve-out for "financial undertakings". One may question the consistency of that decision with the general objective of the Directive: are financial undertakings a priori beyond suspicion of engaging in tax avoidance?
- Relatedly, one may question whether Member States remain free to deviate from the rule and not to exclude financial undertakings.
- With respect to the Member States' freedom to design their tax policies, one may wonder how Article 4 affects their right to create alternative – and from an efficiency perspective undeniably superior – corporate tax systems, such as the comprehensive business tax (CBT) and allowance for corporate equity based corporate tax (ACE). As Article 4(1) mandates the deductibility of borrowing costs matching taxable revenue from financial

assets, it could be argued that Member States are barred from denying interest deductibility generally as required by a CBT. On the other hand, a CBT might be conceived as "higher level of protection" and thus, in accordance with Article 3, be open to Member States. Notably, the ACE should also be unaffected, since notional interest deductions do not fall within the meaning of "borrowing costs" (defined as "costs that a taxpayer incurs in connection with the borrowing of funds") and thus are not limited by Article 4.

On Exit Taxation:

- The rule is structured to comply with the CJEU's case law in *DMC* and *Verder Labtec*, which is subject to serious criticism. Considering that case law, it is also really questionable whether such a mandatory exit tax is necessary; the need for coordination by forcing Member States to impose an exit tax appears rather limited, as the assumption that after exit taxation becomes impossible is not without doubt.
- It is questionable whether the proposal is really meant as a "minimum standard", considering the CJEU case law does not allow more restrictive legislation.
- Importantly, however, Article 5(5) requires Member States to accept the market value established by the State of origin of a taxpayer or asset. It is regrettable that this does not also apply where the State of origin is a third country (at least where the third country decides to impose an exit tax), while the obligation to impose an exit tax does apply to transfers to third countries.

On the Switch-Over Clause:

- One may wonder what a switchover from exemption to credit really has to do with profit shifting, considering that the only condition for its application is a comparably low tax rate in the other country. Effectively, such provision is liable to prevent Member States from implementing a system based on the ideal of capital import neutrality. It also defines the credit to be given – if any – but the credit limitation is not very precisely defined: "shall not exceed the amount of tax … which is attributable to the income that may be taxed".
- The Commission specifies that the rule takes aim at situations where low

or untaxed income from third countries would "enter the internal market and then, circulate – in many cases, untaxed – within the Union", but it does not explain why it would be harmful for the internal market if income earned in other markets and taxed at low rates there would become available to companies and individuals in the EU without additional tax charge. Is it not good for the internal market if its resident companies pay less tax in third countries?

On the GAAR:

- The proposed GAAR's wording is not in line with the Commission's GAAR recommendation of 2012, but aligns in substance with it, excluding arrangements put in place without commercial reasons purely to obtain a tax advantage and mandating treating such arrangements in line with economic substance "in accordance with national law". The reference to national law is interesting, since it essentially results in deferring to domestic legislation. It would appear to remain up to the Member States to define how taxation in line with economic substance is going to be put in place.

On required CFC Legislation:

- The proposal is clearly designed in order to comply with the CJEU's case law on CFC rules following *Cadbury Schweppes*, covering – within the EU – only wholly artificial entities and non-genuine arrangements with the essential purpose of obtaining a tax advantage. From the perspective of the freedom of establishment, this seems to be on fairly stable ground.
- The a priori exemption of "financial undertakings" from the CFC rules is again surprising, as it suggests that these are entirely unsuspicious of BEPS activity.
- A question may be raised concerning compatibility with state aid rules. This could only be an issue where a Member State deviates from the proposed provisions to have stricter rules. In that case, inconsistent rules would remain subject to scrutiny under Article 107. Consider the situation of a Member State that goes beyond the required standard by including some, but not all financial undertakings in a domestic CFC regime. In such case, excluding only certain undertakings would likely create a selective advantage.

- A final observation concerns the use of the terms “significant people’s functions” and “arm’s length principle”. It should be noted that the Proposal’s term deviates from that used by the OECD, which is “significant people functions”. This is probably only an oversight, but potentially dangerous: the OECD concept concerns “significant functions … performed by people”, whereas the term used by the Proposal implies that the “functions performed by significant people” should be decisive. The context of usage is also different, so maybe it is actually meant to be a different concept. The “arm’s length principle” is used, but not defined in the Proposal, which reopens concerns about whether there is an independent concept under EU law (see debate in my previous post).

On the Anti-Hybrid Rule:

- By giving priority to source State qualification, this rule can effectively and rather simply address mismatches. The practicality of it remains to be seen.
- Theoretically, one may wonder why the rule addresses only intra-EU situations and does not also extend that unilateral qualification rule towards third countries. While the Directive would not bind those to follow the same rule, a consistent policy implemented by all Member States would provide a strong incentive to create this as a global standard.

As a final remark, it is important to note that this proposal might well undergo significant changes over the upcoming months. Political momentum and much agreement on most points seem to be in place, so the Directive may well be approved before the end of the year, though the Proposal does not specify a date from which its provisions should apply. Considering the number of legislative changes that would be needed in many Member States as well as the necessity to give third countries the possibility to react to impending changes by way of renegotiating some treaties, one would expect a somewhat longer period of implementation than seen in recent changes affecting purely intra-EU situations.