Kluwer International Tax Blog

How Should EU Member States Implement the Recommendations Following from the OECD BEPS Project? – A Comment to the Recently Published Discussion Draft on Action 3

Jakob Bundgaard (CORIT advisory) · Monday, April 13th, 2015

It is well known that case law from the European Court of Justice (ECJ) imposes limitations on the application of anti-avoidance rules by Member States. Accordingly, it is of vital importance that recommendations made under the OECD project on base erosion on profit shifting (the BEPS project), are adaptable, where necessary, to enable Member States to comply with EU law. If not, Member States simply cannot apply the recommendations, which may cause competitiveness concerns for multinational groups that are primarily based outside the EU Member State jurisdictions.

The BEPS deliverables made so far have been criticized for addressing EU law challenges very briefly. However, in the discussion draft on BEPS action 3 – Strengthening CFC Rules – a number of pages are dedicated to this issue. This is positive and should be welcomed.

In order to facilitate compliance with EU law the discussion draft suggests several alternatives for Member States to consider when implementing or strengthening CFC rules. The alternatives include:

- Introducing a substance analysis that only subjects taxpayers to CFC rules if the CFCs do not engage in genuine economic activities.
- Applying CFC rules to transactions that are "partly wholly artificial".
- Designing CFC rules to explicitly ensure a balanced allocation of taxing powers.
- Applying CFC rules equally to both domestic subsidiaries and cross-border subsidiaries.

The last suggestion, in particular, raises some concerns. The discussion draft states that a CFC rule will only be found inconsistent with the freedom of establishment if the rule itself discriminates against non-residents. Therefore, if a CFC rule treats domestic subsidiaries the same as cross-border subsidiaries, it arguably should not be treated as discriminatory under the case law of the ECJ, and no justification is needed.

In this regard the discussion draft mentions that Denmark already applies such an approach, and that the effect of Denmark's legislation is that there is no different treatment, no matter whether the parent company owns a subsidiary resident in Denmark, a foreign subsidiary resident in the EU/EEA or a foreign subsidiary resident outside the EU/EEA. Even though this statement is in line with the view of the Danish legislator, the correctness of this view can and has been questioned.

The widening of the scope of application of Denmark's CFC legislation to also cover purely domestic situations was a direct response to the ECJ's decision in case C-196/04 *Cadbury Schweppes*. At first glance, the amended Danish CFC rules do not appear to entail a difference in treatment, as the Danish parent company has to include the income of both Danish and foreign subsidiaries if the general conditions for CFC taxation are fulfilled. Accordingly, in that case, the Danish parent company is, in principle, taxed on profits of another legal person, regardless of where this other legal person is resident.

However, the actual Danish tax payable by the Danish parent company – seen in isolation – will be different depending on whether the subsidiary is resident in Denmark or in another Member State with a lower level of taxation. The main reason is that relief is granted for taxes paid by the subsidiary according to the ordinary credit method. Thus, if the CFC conditions are fulfilled with respect to a subsidiary resident in Denmark, relief is granted for the Danish tax paid by the Danish subsidiary. As the same corporate tax rate (currently 23.5%) applies to both the Danish subsidiary and the Danish parent company, the relief granted – for taxes paid by the Danish subsidiary – should normally fully absorb the parent company's additional tax on the income from the Danish subsidiary. In other words, if the CFC conditions are fulfilled with respect to a Danish subsidiary, there should not be a higher tax burden.

In contrast, if the subsidiary is resident in another Member State with a lower level of taxation, the relief granted for taxes paid by the subsidiary in the other Member State will normally not fully absorb the parent company's additional Danish tax on the income from the subsidiary. In other words, the tax advantage – i.e. the difference between the level of taxation in Denmark and in the other Member State – will be picked up at the level of the Danish parent company, if the CFC rules apply.

Accordingly, in my view, the Danish CFC rules probably still constitute a restriction on the freedom of establishment, as a difference in treatment, in reality, still exists because the application of the CFC rules only leads to an additional tax burden – i.e. a genuine tax disadvantage – for the Danish parent company, if the subsidiary is resident in another country in which the level of taxation is lower than the Danish level of taxation.

Moreover, it must be admitted that more recent ECJ case law has made it difficult to assess whether or not the Danish CFC rules can be justified, and if so, pass the proportionality test. Taking into consideration the very wide scope of the Danish CFC rules – including the fact that the rules may apply even in a situation in which a subsidiary resident in another Member State reflects economic reality in that Member State – it seems doubtful whether or not the Danish CFC rules, in general, should be considered justified and in line with the proportionality principle. At a minimum, therefore, it appears reasonable to conclude that the Danish reaction to *Cadbury Schweppes* has lead to uncertainty, as the current rules are not immune from criticism in the EU context. Accordingly, for this reason alone, it may not be expedient for other Member States to follow Denmark's approach.

Additionally, as stated by both the Commission and the general advocate at an earlier state, it would be regrettable for Member States, in order to avoid an accusation that they are treating comparable situations differently, to extend the application of anti-abuse measures designed to curb cross-border tax avoidance to purely domestic situations where no possible risk of abuse exists, as such unilateral solutions undermine the competitiveness of the Member States' economies, and are not in the interests of the internal market.

In this context, it should be noted that the extension of the Danish CFC rules' scope of application has resulted in a situation in which a Danish parent company – at least to some extent – has to assess possible CFC consequences/requirements with respect to all subsidiaries, regardless of whether the subsidiary is based in a low-tax jurisdiction, a high-tax jurisdiction or even in Denmark. This does not appear to be expedient if it is also a priority to keep taxpayer compliance costs at a fairly reasonable level, which the recent BEPS discussion draft mentions as an important policy consideration.

Thus, in in my view, the Danish approach should hardly serve as inspiration for other Member States. Hopefully, the OECD will take such considerations into account when finalizing its work on BEPS action 3.

Written by Peter Koerver Schmidt. Technical Advisor, CORIT Advisory P/S and Assistant Professor, Copenhagen Business School.

This entry was posted on Monday, April 13th, 2015 at 9:09 pm and is filed under BEPS, EU/EEA, Tax Avoidance, Tax Planning, Tax Policy
You can follow any responses to this entry through the Comments (RSS) feed. You can skip to the end and leave a response. Pinging is currently not allowed.