TaxAlert

European Union Steps Forward in the Field of Direct Taxation

June 2016

KPMG's EU Tax Centre in Amsterdam has published it's latest news on EU direct tax matters. According to this, on its meeting of June 17, 2016 the Economic and Financial Affairs Council (ECOFIN) of the EU has reached political agreement on the proposal for an anti tax avoidance directive. The ECOFIN also approved Conclusions on the work of the Code of Conduct Group during the Netherlands Presidency and held a short discussion regarding the status of the proposal for a Directive on a Financial Transaction Tax.

There is no doubt that we live in turbulent EU tax times. As we informed you earlier this year, on January 28, 2016 the European Commission unveiled its new proposal for an anti-tax avoidance directive (ATAD), which had been a high priority for the Dutch Presidency. The ECOFIN of the EU held discussions with a view to reaching a political agreement on the ATAD. In the light of these discussions the Presidency put forward a final compromise text, to which almost all delegations could agree and announced a 'silence' procedure until Monday, 20 June 2016. As no objections were raised by that deadline, political agreement was reached and the text will be submitted to a later ECOFIN meeting for formal adoption. The ECOFIN also approved Conclusions on the work of the Code of Conduct Group during the Netherlands Presidency, and particularly welcomed the agreement reached on new guidance on hybrid permanent establishment mismatches involving third countries. Finally, a short discussion was held as regards the status of the proposal for a Directive on a Financial Transaction Tax (FTT).

Background of the ATAD

The anti-tax avoidance directive is one of the two legislative pillars of the European Commission's Anti-Tax Avoidance Package (ATAP). The directive is intended to provide a minimum level of protection for the internal market and strengthen the average level of protection against aggressive tax planning. Adoption of the ATAD has been one of the main goals of the Dutch Presidency, which ends in June 2016. Despite the Presidency's ambitions, an attempt to reach political agreement at the ECOFIN meeting of May 25, 2016 proved unsuccessful. The updated Presidency Compromise on the ATAD reflects work subsequently carried out including a meeting with the high-level working party on taxation on June 3 and a meeting of Fiscal Attachés on June 13.

Overview of the final ATAD compromise

The proposed rules lay down common minimum rules in the areas of interest limitation, exit taxation, general anti-abuse rules (GAAR), controlled foreign companies (CFC) and hybrid mismatches.

Interest limitation: The interest limitation rules take the form of an earnings stripping rule, whereby in principle no deduction would be given for interest exceeding 30% of EBITDA. The rules have been substantially amended to allow for flexibility and exemptions upon transposition, and include de minimis thresholds, escape clauses and a grandfathering provision. Member States which already have national targeted rules (e.g. thin capitalization rules) which are equally effective to the proposed interest limitation rule will have up to January 1, 2024 to implement this provision and phase out their domestic rules, unless an agreement is reached on interest limitation rules at OECD level

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prior to this date. This will be subject to notification prior to July 01, 2017 of all information necessary for evaluating the effectiveness of the national rules to the European Commission.

Exit taxation: The exit tax rules apply to certain cross-border transfers of assets or residence within the EU or to non-EU countries. The rules broadly reflect EU case law, including a tax deferral mechanism for transfers within the EU/EEA. Member States may defer the implementation of this provision to 31 December 2019 (instead of 2018 for the other provisions).

GAAR: The rule, which is intended to reflect EU case law, will require Member States to ignore arrangements that do not comply with the standard, which consists of both a motive test and a substance test.

Controlled foreign companies: Unlike the Council's initial proposal, the rules apply to both EU and non-EU CFCs and have been extended to permanent establishments. The CFC's income would become taxable in the 'home' jurisdiction if certain thresholds are met, especially as regards ownership (50%) and level of tax payable compared to what would have been due in the 'home' Member State (de facto effective tax rate of less than 50% of the home jurisdiction). A carve-out clause applies for CFCs that satisfy a substance test, which may be disapplied by Member States for non-EU CFCs.

Hybrid mismatches: Contrary to the Council's initial text, the ATAD covers only intra-EU situations involving hybrid entities and hybrid instruments. To the extent a hybrid mismatch results in a double deduction, a deduction shall only be provided in the source state of the payment. If a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied. In addition to the ATAD, the agreement covers a Council statement requesting the Commission to put forward a (legislative) proposal on hybrid mismatches involving third countries by October 2016. The statement is an integral part of the political agreement and intended to satisfy those Member States which were of the opinion that third-country mismatches should have been included in the ATAD. Finally some Member States' concerns as regards ensuring a level playing field at international level were addressed in a Council statement forming part of the agreement under which the Commission will closely monitor and engage with the OECD with regard to implementing the BEPS recommendations. The European Commission will also be required to provide an impact assessment 4 years after the directive comes into force, and especially of the interest deduction limitation rules.

Main changes from previous proposal

The main changes from the previous published version of the ATAD relate to the CFC rules. The previous wording which referred to an effective corporate tax rate of at least 50 percent of that of the parent's Member State has been replaced with a test based on the difference between actual corporate tax paid and the tax that would have been paid in the parent's Member State. However, the intention is that this would achieve effectively the same result as the original wording. In addition, the substance requirement, which applies in principle to EU and non-EU situations, with the option for Member States to limit such requirement to EU situations only, has been amended, to reflect current case law of the Court of Justice of the European Union in this respect. With respect to the interest stripping rules, a 5 year transition period (until 2024) was introduced for Member States wishing to keep their domestic targeted rules such as thin capitalization rules as a substitute for the interest stripping rules. Finally, the controversial switch-over clause has been deleted.

Conclusions on the Code of Conduct Group

The ECOFIN also approved Conclusions on the work of the Code of Conduct Group during the Netherlands Presidency, which is summarized in the Group's report issued on June 13, 2016. The Finance Ministers particularly welcomed the agreement reached on a new guidance on hybrid permanent establishment mismatches involving third countries. The guidance foresees that where (1) non-taxation without inclusion or (2) double deduction arise as a result of a mismatch situation in relation to a hybrid permanent establishment, the Member State concerned should align the treatment of the business activities concerned as being carried out (or not) through a PE to the treatment applied by the third state. If this is not sufficient and a double deduction still occurs, that Member State should in addition deny deductions to the company carrying on the business activities that give rise to the mismatch. Finally, the guidance - whose scope is limited to situations involving a Member State and a third country - clarifies that it is should only be applicable to the extent necessary for the purpose of preventing a double deduction or non-taxation without inclusion and not for any other purpose. It remains to be seen whether these guidelines will be reflected in the above-mentioned legislative proposal.

Financial Transaction Tax – State of play

Based on a report submitted to the ECOFIN the ECOFIN briefly discussed the way forward for this proposal. Austria underlined that there is a strong convergence on the core design of the tax, but that further work is needed on (1) the taxation of derivatives and its potential impact on borrowing costs, and (2) the appropriate mechanisms for an effective collection of the tax. These issues will be addressed by two dedicated task force groups, to be set-up.

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Next steps

Following this political agreement, the ATAD should be formally adopted without further discussion during the next ECOFIN meeting on July 12, 2016. Member States will then have until 31 December 2018 to implement the main provisions of the directive in their national legislation, which would then apply as from 1 January 2019. In accordance with the agreement reached with the Czech Republic delegation, the European Commission also committed to present, before the end of 2016, a legislative proposal allowing Member States to apply a generalised VAT reverse charge mechanism to certain domestic supplies.

EU Tax Centre comment

This is the second legislative proposal in the Commission's Anti-Tax Avoidance Package to reach political agreement, after the formal adoption of the proposal for automatic exchange of country-by-country reports at the last ECOFIN meeting in May 2016. Although the final text still needs to be formally adopted, this rapid consensus constitutes another indication of the EU's strong political will to effectively tackle tax avoidance.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your KPMG tax advisor in Hungary.

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