Anti-Tax Avoidance Directive and Its Implications

On 12 July, 2016 the European Council (EC) adopted the Anti-Tax Avoidance Directive (ATA). The aim of this directive is to strengthen the protection against aggressive tax planning, combat the erosion of tax bases (BEPS) in the internal market and the shifting of profits out of the internal market. By adopting ATA directive, the EC is attempting to ensure that the OECD anti-BEPS measures are implemented in a coordinated manner in the EU.

The ATA Directive contains such measures as limitation of interest deduction, exit taxation, a general anti-abuse rule (GAAR), a controlled foreign company (CFC) rule and hybrid mismatches.

Member States will have to transpose the directive into their national laws by 31 December 2018, except for the exit taxation rules which are to be transposed until 31 December 2019.

The issue at hand

Although many agree that tax competition is a healthy and natural economic process that drives economies, the EC now sees tax harmonization as an essential factor for the functioning of the single market. Together with the CCCTB initiative, the ATA Directive could be seen as a first step toward this harmonisation. The directive covers all taxpayers that are subject to corporate tax in one or more Member States, including subsidiaries of companies based in third countries. It lays down the EC's stance on corporate taxation and establishes anti-tax-avoidance rules in five specific fields:

- **Interest limitation** rules. Although for some entities lending from a subsidiary may be the only available source of finance and the interest rate of such transaction could be identical as borrowing from any other entity, the EC disapproves of such practices. According to the EC's view, multinational groups may finance group entities in high-tax jurisdictions through debt and arrange that they pay back inflated interest to subsidiaries residing in low-tax jurisdictions. The outcome is a reduced tax liability for the group as a whole. The EC aims to discourage this practice by limiting the amount of interest that a taxpayer may deduct in a given tax year, up to 30 percent of the taxpayer's EBITDA or €3 million.
- **Exit taxation** rules. Corporate taxpayers may try to reduce their tax bill by moving their tax residence and/or assets to a low-tax jurisdiction. The EC has established exit taxation rules aiming at preventing tax base erosion in the state of origin.
- General **anti-abuse** rule (GAAR). This rule is intended to cover gaps that may exist in country-specific anti-abuse rules. A general anti-abuse rule therefore enables tax authorities to deny the tax benefits of transactions or arrangements which do not have any commercial substance.
- **Controlled foreign company** (CFC) rules. In order to reduce their overall tax liability, corporate groups can shift large amounts of profits by transferring ownership of intangible assets such as intellectual property to the controlled subsidiaries in low-tax jurisdictions and then shifting royalty payments. CFC rules reattribute the income of a low-taxed controlled foreign subsidiary to its parent company usually subject to higher taxation.

- Rules on **hybrid mismatches**. The EC critically assesses corporate taxpayers practice of taking advantage of disparities between national tax systems in order to reduce their overall tax liability. Such mismatches may lead to double deductions (i.e. tax deductions in both countries) or a deduction of the income in one country without its inclusion in the other.[1]

The ATA Directive contains rules closely resembling the German tax system. Some Member States (Ireland, Slovenia and Estonia) which have largely competitive corporate tax systems have already expressed their concerns on some of the provisions of the directive at the time of its preparation.[2]

This paper will briefly look at the issues addressed in the ATA Directive (for example, CFC provision and its scope), the consequences of its implementation in the economies of Member States and the issues that have to be borne in mind during its transposition into national law.

There are reasons to claim that the ATA Directive is not the best tool to address tax avoidance practices used by MNEs.

Tax competition is not unfair, does not hinder the internal market and fundamentally does not differ from other types of competition that Member States engage in.

The diversity of tax systems is not a roadblock for the internal market. Quite the opposite, differences in tax systems might serve as a stimulus to trade. Taxes constitute a significant share of costs and a large share of the price of factors of production, labour in particular. It is tax diversity (which is usually determined by the necessity to accommodate to local conditions and traditions) that provides serious incentives to produce cheaper goods and services and to offer them on the internal market. The absence of centralised tax harmonisation is promoting trade rather than undermining it.

Countries have always competed using their exogenous factors (e.g. the amount of land, population, proximity to waterways, etc.) as well as endogenous ones (e.g. the level of corruption, political stability, low bureaucracy and the level of taxation). If the European Union accepts competition based on endogenous factors, it should not discriminate against competition based on other factors that depend on the government (e.g. taxation).

In other words, favorable tax regimes should not be perceived as “unfair” or “unnatural.” Tax competition is no different from the competition for investment that is reflected in policies designed to cut red tape and bureaucracy and other factors that are decided by national governments. What is perceived by the EC as a tax avoidance is in most of the cases an exploitation of differences in tax systems. Tax system harmonization would deprive companies of this normal business practice.

Tax system harmonization will have unintended consequences on the competitiveness of different Member States.

The ATA Directive together with the relaunched Common Consolidated Corporate Tax Base (CCCTB) initiative will definitely lead to the harmonization of tax bases as one of its aims is to regulate 'transfer pricing'. Although many countries (for example, Germany and the UK)

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[1] http://www.consilium.europa.eu/en/press/press-releases/2016/06/21-corporate-tax-avoidance/

[2] http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/583804/EPRS_BRI(2016)583804_EN.pdf

already have their deductible EBITDA percentage set at 30%, others limit interest deduction by the rule of thin-capitalization. For example, in Lithuania the debt-to-equity ratio of 4:1 applies and any interest attributable to the debt in excess of this ratio is non-deductible (if the paying entity cannot demonstrate that the same loan would have been granted under the same circumstances by an unrelated party). After the transposition of the ATA Directive, all countries will have to apply the same interest limitation rule, only the percentage of deductible interest may vary up to the stated threshold. As mentioned above, unified tax rules can hardly contribute to more extensive international trade. On the contrary, as in Lithuania's case, they will only hamper the competitiveness of national tax systems.

The ATA Directive enacts stricter anti abuse provisions than OECD's anti-BEPS measures.

The ATA Directive itself is based on the OECD recommendations on BEPS. Many argue that in certain areas ATA (and the whole Anti-Tax Avoidance Package presented by the EC) goes beyond OECD's recommendations. For example, in the case of hybrid mismatches OECD recommends rules that would neutralize the tax advantage of hybrid mismatches.[3] Yet another concern is that by raising effective corporate tax rates and deviating from international agreements the ATA Directive will put the EU at a competitive disadvantage in attracting global investment.[4]

There is a risk that the transposition of the ATA Directive into national law would establish stricter rules.

Although the ATA Directive establishes minimum requirements, Member States may still impose stricter rules when transposing the directive into national legislation. In case of interest limitation rules, countries may set a lower threshold of deductible interests and this will deteriorate business conditions.

The ATA Directive raises concerns about the principle of subsidiarity and compatibility with EU fundamental freedoms.

Even national parliaments expressing their support for setting-up common rules to fight tax-avoidance have emphasized the principle of subsidiarity, the fact that regulation of direct taxes falls within the competence of each individual Member State.[5]

The ATA Directive not only affects Member States' tax sovereignty and takes a step backwards on balancing Member States' abilities to stimulate their economies through tax policies and incentives.[6] It also poses a threat on the guaranteed fundamental freedoms, such as the free movement of capital (for example, in the case of the exit taxation rules). For example, according to the provisions, the recipient Member State shall accept as an entry value the value used by the exit Member State with respect to the exit taxation, unless this value does not reflect the market value. Unfortunately, the provision does not contain any safeguards against double taxation. In theory, the exit Member State may impose an exit tax at a higher value than

[3] http://www.thetaxadviser.com/issues/2016/jun/adopting-beps-in-eu.html
[4] https://www.businesseurope.eu/publications/businesseurope-position-anti-tax-avoidance-package
[5] http://www.twobirds.com/en/news/articles/2016/netherlands/the-final-european-antitax-avoidance-directive
[6] https://www.taxjournal.com/articles/ec-anti-tax-avoidance-directive-usurps-eu-member-state-sovereignty-23062016

the market value since the directive stipulates minimum requirements. Consequently, the recipient Member State is not obliged to use this higher value as entry value.[7]

Restriction on the free movement of capital also affects other freedoms such as the freedom of establishment, having direct influence on how many businesses (and jobs) are created in the internal market. Exit taxation means that Member States may impose tax on the value of an asset before it is transferred outside the EU or even within the EU, thus impeding the freedom of establishment.[8]

ATA has potential unintended consequences of increased tax administration costs and uncertainty of the business environment.

Tax advisers note that the anti-tax avoidance clause is vague and may grant tax authorities excessive rights to interpret taxpayers' business intentions.[9] Due to the GAAR, it can be expected that local tax authorities should be challenging structures that in their view lack business rationale. This might create legal uncertainty and lead to political interference and even corruption.

Legal entities with little physical presence and minimal staff may no longer produce the desired effects and need to be revisited, despite playing a genuine and critical role in society.[10] Companies may have to devote more resources and recruit more employees in order to justify themselves as genuine business units that are set-up to achieve business goals, not only to obtain tax advantages. This will result in losses in terms of productivity or, in extreme cases, closing down of certain businesses.

Large MNEs may be subject to separate, multiple and uncoordinated audits from various authorities at any time. Extensive cooperation between revenue authorities will be needed to ensure this does not happen.[11] International investigative processes will be costly not only for the businesses, but Member States as well. This may require an additional layer of bureaucracy and create regulatory uncertainty.

Tax revenues may also diminish as evidence exists that implementation of rules such as established in the ATA Directive may have unintended consequences on investments. For example, the CFC rule treatment significantly changes the taxation of all profits of a foreign subsidiary due to a sharp increase in the general cost of capital. Therefore, it may lead to substantial adjustments in general investment behavior, not only investments in passive assets.[12]

All these unintended consequences are even less justifiable having in mind the fact that the impact assessment was limited to generalized estimates of effective multinational corporate income tax rates and did not include estimates on the future tax burden on business or expected tax revenues after the implementation of the directive. Businesses and governments will have to

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[7] http://kluwertaxblog.com/2016/10/17/uncertainties-following-final-eu-anti-tax-avoidance-directive/

[8] http://www.jonesday.com/eu-update-the-anti-tax-avoidance-package-02-18-2016/

[9] http://www.twobirds.com/en/news/articles/2016/netherlands/the-final-european-antitax-avoidance-directive

[10] http://www.loyensloeff.com/en-us/news-events/news/qa-what-is-the-impact-of-the-eu-anti-tax-avoidance-directive-on-investment-funds

[11] http://economia.icaew.com/opinion/october-2014/beps-is-coming-but-raises-legitimate-concerns-for-business

[12] http://voxeu.org/article/anti-tax-avoidance-laws-unintended-consequences

comply with new legislation without substantial proof of the extent, quantum or even compelling financial rationale for it.[13]

Conclusion

The ATA Directive is an attempt to regulate 'transfer pricing' and the basis of it is double taxation rules and agreements between countries which have existed for decades. Therefore, the directive and its enforcement should be analysed together with these rules and agreements.

Firstly, in practise the directive sets out minimum requirements, meaning that national regulation will differ and 'transfer pricing' will be functioning further. This raises doubts about the possibilities of reaching the goals set out by the EU as the directive may end up creating extra administrative rules as well as posing additional legal and financial burdens.

Consequently, the EU risks to lose its competitiveness with regard to third countries; de-localisation is one of the transfer pricing rules and rather than moving within the EU, companies may choose Singapore, India or the UK after Brexit (the UK government is promising lower levels of taxation for companies).

Secondly, the directive will result in increased administrative burden and uncertainty with double taxation rules and agreements (how it will be implemented in terms of administration and tax rates from country to country).

Thirdly, the biggest threat is a potential of 'witch hunting.' Intrusive policies and investigations of tax inspectorates (which are already very aggressive in cross-border tax matters) may be very harmful (especially if the burden of proof will be put on companies, not on the state).

Recommendations

In the light of this EU harmonization initiative, the competitiveness of tax systems where Member States promote lower levels of taxation requires a simple taxation and tax administration system in order to avoid any possible adverse impact on growth, investment and entrepreneurship. Due to the minimum requirements set out in the directive, the final consequences of the directive will depend on the measures chosen by individual Member States. Therefore, it is important to choose a reasonable implementation. Given the abovementioned negative consequences that the ATA Directive may cause after its transposition into national laws, countries must ensure that:

- the scope of the ATA Directive is not extended to transparent entities, sole proprietors and SMEs;
- the maximum allowed threshold of interest that the taxpayer is entitled to deduct in a tax year is enshrined in the national law, thus ensuring the greatest possible degree of the competitiveness of the tax system; and
- the burden of proof is not transferred to business entities.

[13] http://www.unikone.co.za/wordpress/?p=236