The EU Commission Releases Draft Directive on BEPS – A Critical Analysis

*By Oliver R. HOOR (left picture), Keith O'DONNELL (right picture) and Samantha SCHMITZ-MERLE, ATOZ **

On 28 January 2016, the European Commission presented its Anti-Tax Avoidance Package. One of the core pillars of this package is a Draft EU Anti-Tax Avoidance Directive (the "Draft Directive") which was already widely leaked in the press in the week before its official release. The Draft Directive proposes anti-tax avoidance rules in six specific fields which are meant to be implemented by each EU Member State ("MS"). This Article provides an overview of the proposed provisions and points out their most controversial aspects.

1. Introduction

The aim of the Draft Directive (also referred to as "BEPS Directive") is to implement at EU level the BEPS recommendations made by OECD and G20 in October 2015. The proposal follows the conclusions reached at the 8 December 2015 ECOFIN meeting, notably that EU directives should be, where appropriate, the preferred vehicle for implementing OECD BEPS conclusions at EU level. The content of the Draft Directive broadly follows a previous anti-BEPS Directive elaborated at EU Council level, which was made available to the public in December 2015 and which included many of the BEPS recommendations.

The Draft Directive covers all taxpayers which are subject to corporate tax in a EU Member State as well as EU Permanent Establishments ("PEs") of taxpayers which are not in the scope of the directive. The Draft Directive lays down anti-tax avoidance rules in the following fields:
- Deductibility of interest;
- Exit taxation;
- Switch over clause;
- General anti-abuse rule (GAAR);
- Controlled foreign companies (CFCs); and
- Hybrid mismatches.

These measures are presented as minimum standards, while certain of these are only recommendations or best practices in the BEPS framework, meaning that the proposals go way beyond the BEPS recommendations. Moreover, the proposals regarding exit taxation and the GAAR come in addition to the recommendations provided in the final BEPS Reports released in October 2015.

Although the concerns expressed by the European Commission to fight against tax avoidance in a coordinated manner are understandable, the proposals presented raise concerns in that they further dilute national sovereignty in tax matters, and by "goldplating" the BEPS recommendations, will make the EU a less attractive environment to do business.

2. Proposals in the Draft Directive

2.1. Limitation to the deductibility of interest expenses

The first measure aims to discourage multinational groups from reducing the overall tax base of the group by financing group entities in high-tax jurisdictions through debt. Here, the Draft Directive proposes a fixed ratio rule as the general rule and a group-wide rule as a carve-out from the general rule. More precisely, it is proposed to set a rate of interest deductibility at the top of the scale recommended by the OECD (i.e. 10% to 30%). Subject to certain conditions and limitations, borrowing costs shall be deductible only up to 30% of the tax payers' earnings before interest, tax and amortization ("EBITDA") (fixed ratio rule) or up to an amount of EUR 1 mio (safe harbour), whichever is higher.

Taxpayers who can demonstrate that the ratio of their equity over their total assets is equal to or higher than the equivalent ratio of the group (under certain conditions) can also fully deduct their excess borrowing costs (group-wide rule). Carry forward provisions are available in case the interest deduction or EBITDA is not fully used.

Under the current proposal, financial institutions and insurance undertakings are not subject to this limitation. Without further work, these exemptions raise questions from an EU State Aid perspective, which has a certain irony given that it is the EU Commission making this proposal.

With regard to financing activities, the proposal would allow interest expenses to be deducted without limitation, where interest income of a company is greater than its interest expense. Hence, Luxembourg companies performing financing activities may also under the proposed rules be taxable on an arm`s length margin.

When interest expenses are not deductible, double taxation will likely arise as the lender should be taxable on the corresponding income. Even the proposed carry-forward mechanism would not eliminate the problem of double taxation as companies may never be in a position to use the amounts carried forward. From experience of existing regimes in place with similar interest limitations, this can be a real problem for companies in financial difficulty as it may require them to pay corporate tax on non existent profits, adding to their financial difficulty.

Moreover, how a business finances its operations is an important business decision that depends on a range of factors. While the deductibility of interest expenses is one factor to be considered, the decision as to whether a company should be financed by equity or debt is generally not-tax driven and there are a number of good commercial reasons why intra-group loans can be preferable to a contribution of equity (legal requirements, regulatory constraints, foreign currency implications, business considerations, etc.).

The proposed rules could lead to significant disallowance of interest expense in case of Alternative Investments (for example real estate, private equity and infrastructure). These investments usually have relatively high levels of third party debt. Nonetheless, interest paid to third parties does not give rise to base erosion.

So far Luxembourg tax law does not provide for any thin capitalisation or earning stripping rules other than the 85:15 debt-to-equity ratio applicable to holding activities (which is based on administrative practice). The implementation of the proposed limitation to the deductibility of interest by Luxembourg might be harmful to the country`s position as a location of choice for the structuring of cross-border investments in and through Europe.

2.2. Exit taxation

The second measure aims to discourage taxpayers to move their tax residence and/or assets to low-tax jurisdictions. Under the proposal, a taxpayer shall be subject to tax at an amount equal to the market value of the transferred assets at the time of the exit, less their value for tax purposes in case of:
- A transfer of assets from the head office to a PE in another MS or to a third country;
- A transfer of assets from a PE to the head office or another PE in another MS or a third country;
- A transfer of tax residence to another MS or a third country (except for those which remain connected with a PE in the first country).

In case of transfers within the EEA, a taxpayer may defer the payment of exit tax by paying in instalments over at least 5 years. This is in line with the requirements determined in the jurisprudence of the European Court of Justice ("ECJ").

Under Luxembourg tax law, the aforementioned transfers are already taxable events (with the necessary possibility to postpone the payment of the exit tax when transfers occur within the EEA and, since 2016, extended to transfers involving tax treaty countries). Hence, no changes to Luxembourg tax law would be required in this respect.

2.3. Switch-over clause

The aim of the switch-over clause is to discourage companies from shifting profits out of high-tax jurisdictions towards low-tax jurisdictions, unless there is sufficient business justification for the transfer.

To achieve this, the proposed rule states that a MS shall not exempt a taxpayer from tax on:
- Third country income received in the form of a profit distribution;
- Capital gain on the sale of shares in a third country entity; or
- Income from a third country PE

if this third country taxes profits at a rate which is lower than 40% of the statutory tax rate that would have been levied in the MS. In these circumstances, the MS should apply the credit method (i.e. switch over from exemption to credit method) and grant a tax credit for the amount of tax paid in the foreign country on such income.

This rule would have a limited scope when implemented under Luxembourg tax law. This is because dividends and capital gains realised in relation to subsidiaries resident in third countries may only benefit from the Luxembourg participation exemption regime if they pass a comparable tax test. In this regard, a subsidiary has to be subject to an effective taxation of 10.5% on a comparable taxable basis. This translates into a tax corresponding to 50% the Luxembourg corporate income tax rate (i.e. above the 40% threshold proposed in the switch over clause).

Thus, with regard to dividend income and capital gains, this rule may only apply in the few cases in which Luxembourg has adopted the exemption method to avoid double taxation on dividend income in an tax treaty concluded with a third state. There may be a real issue here in relation to the directive imposing a unilateral treaty change (unless Luxembourg can renegotiate all the tax treaties concerned by the date for implementing the directive.

With regard to income derived through a PE in a tax treaty country, the host state of the PE has an unlimited primary taxing right and Luxembourg frequently adopts the exemption method for the avoidance of double taxation. The application of the exemption method is not conditional to the recognition of the PE by the other contracting state or the level of effective taxation. Hence, the proposed rule may apply where the income of a PE located in a third state is not taxed in its host state (or taxed at a low level).

However, even in the above mentioned cases the switch-over rule should not be applicable as it would represent an illegitimate treaty override which transgresses international law. Instead, individual tax treaties would need to be renegotiated in order to include the switch-over clause in the respective tax treaties. As this problem will be a recurrent one in European States, we would suggest that the EU Commission study carefully the number of DTT negotiations that would be required and at a minimum put in place grandfathering provisions pending renegotiations of DTTS.

2.4. General anti-abuse rule (GAAR)

The Draft Directive further proposes the introduction of a GAAR which would allow the tax authorities of a MS to deny taxpayers the benefit of arrangements considered as abusive. The explanatory memorandum to the proposal states expressly that the proposed GAAR is designed to reflect the artificiality test of the ECJ.

Under the proposal, non-genuine arrangements carried out for the essential purpose of obtaining a tax advantage shall be disregarded. The Draft Directive defines that arrangements are deemed to be non-genuine when they are not put into place for valid economic reasons which reflect economic reality. In case arrangements are disregarded in application of this rule, the tax liability shall be calculated by reference to economic substance in line with domestic tax law.

Accordingly, we now have a EU concept of "non-genuine arrangements" already seen in the GAAR included in the latest version of the EU parent subsidiary directive, but in a slightly different version, and overlaid with a new concept of "the essential purpose", while the EU parent subsidiary directive refers to "main purpose or one of the main purposes".

Given that these subjective concepts create already some legal uncertainty as they may give rise to a lot of different interpretations, it would be desirable that the EU Commission remains consistent with the concepts already defined in ECJ case law instead of proposing new concepts of vague character.

The proposed GAAR is fairly similar to the abuse of law provision provided under Luxembourg tax law[1] that enables the Luxembourg tax authorities to challenge transactions whose sole purpose is to evade taxes through abusive constructions. It follows that no tax law changes should be required in this respect. Nevertheless, the scope of the abuse of law provision (and the GAAR) should be limited to clearly abusive situations or wholly artificial arrangements (in accordance with relevant jurisprudence of the Luxembourg courts and the ECJ).

2.5. Controlled foreign company (CFC) rules

The Draft Directive also provides for CFC rules that would re-attribute the income of a low-taxed controlled company to its parent company even though it has not been distributed.

The CFC rules apply if the following conditions are fulfilled:
- The controlling taxpayer holds or holds together with its associated enterprises a direct or indirect shareholding of more than 50% in the controlled entity; and
- The controlled entity is subject on its profits to an effective tax rate which is lower than 40% of the effective tax rate that would have been charged in the MS of the controlling taxpayer; and
- More than 50% of the income accruing to the controlled entity is passive income (as defined in the proposal, i.e. interest, royalties, dividends, etc.); and
- The principal class of shares of the controlled entity are not regularly traded on a recognized stock exchange.

The CFC rules also apply to financial undertakings but only to the extent that more than 50% of their passive income, as defined in the proposal, comes from transactions with the controlling taxpayer or its associated enterprises. The CFC rules shall not apply if the controlled entity is located in an EU/EEA country, unless the establishment of the entity is wholly artificial or to the extent that the entity engages in the course of its activities in non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage.

Here, we have a concept of "non-genuine arrangement", overlaid with a concept of "essential purpose" and combined with a "transactional approach", meaning that the definition of "non-genuine arrangement" even differs from the one included in the GAAR. The draft Directive seems to be nervously skating around the "Cadbury Schweppes" standard of limiting any restrictions on intra-EU establishment to "wholly artificial" structures. Evidently, these subjective notions would result in significant legal uncertainty.

This concern has already been voiced in comments to the December draft directive which stated that: "limiting this (CFC) provision to third countries, as foreseen in the Italian presidency's compromise text, seems to be the most suitable outcome in the framework of this directive ...." as otherwise "...the legal drafting of the CFC rules would become very complicated". Indeed, CFC rules that apply in an EU context are hardly consistent with EU Law unless they consider the strict interpretation of the ECJ.

As of today, Luxembourg tax law does not provide for any CFC rules and the question might be asked why Luxembourg should implement such rules. Income from subsidiaries that come within the scope of the CFC rules would be taxable upon repatriation to the Luxembourg parent company so these CFC rules will impose an approach to timing of taxation of profits.

In our view, MS should be free to choose whether they want to implement CFC rules or not. CFC rules are not free from doubt in a DTT context with different views of whether they are contrary to the bilateral obligations assumed in a standard DTT. Here again, the proposal seems to dodge the point and fails to provide a mechanism to deal with the uncertainty in an international context

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2.6. Framework to tackle hybrid mismatches

The aim of the last measure is to eliminate the double non-taxation created by the use of certain hybrid instruments or entities.

As far as hybrid entities are concerned, the proposal provides that if two MS give a different legal qualification to the same taxpayer (including its PE) so that it leads to either a deduction of payments, expenses or losses at the level of the two MS or it leads to a deduction in one MS with no inclusion in the other MS, the legal qualification given by the country of source (country in which the payment has its source, or in which the expenses have been incurred or the losses have been suffered) has to be followed and is binding on the other MS.

As far as hybrid instruments are concerned, the proposal states that the legal qualification of the instrument in the jurisdiction of source of the payment made will be determinant and binding on the country of the other MS involved in the mismatch. It means that if the jurisdiction of source considers that the instrument is a debt instrument, the payment made under this instrument will qualify as interest both at source level and at residence state level. Hybrid mismatches in regard to financing instruments have already been largely dealt with through changes to the EU parent-subsidiary directive and the resulting changes to the Luxembourg participation exemption regime. It is interesting to note that these anti-hybrid rules should only apply in regard to hybrid mismatches between MS (not in regard to transactions with third states).

3. Conclusions and outlook

At this stage of the procedure, even though there is a clear political will to implement BEPS measures in a coherent and coordinated manner in order to, as the Commission says, avoid "national policy clashes, distortions and tax obstacles in the EU", one should keep in mind that EU countries will have to agree unanimously on all aspects of the proposal before it can become a final directive.

The Draft Directive could be seen by many MS as invasive in terms of national sovereignty, as it goes far beyond previous tax directives. Moreover, whereas previous directives sought to eliminate discriminations and tax barriers to cross border business within the EU, the Draft Directive seeks to impose a common tax system on all EU MS in the fields mentioned above, justifying this on the grounds that it is necessary for the functioning of the internal market.

This justification looks thin, frankly. If one applied the "essential purpose" test proposed in the Draft Directive, would a reasonable man conclude that the essential purpose of the package was a) tax harmonisation and revenue raising in the EU or b) improving the functioning of the internal market?

The proposals in the Draft Directive are clearly inspired by existing provisions generally seen in high-tax jurisdictions such as Germany, France and Italy. The risk of blunt "one size fits all" rules such as these is a drift in Europe towards a high-spending, high-taxing economy throughout reducing the tax competition within the EU that the Commission itself recognises as important. In addition, when taken with the aggressive stance of the EU Commission towards multinational businesses, the EU risks losing its competitive edge on the global stage.

The proposals would be especially detrimental for smaller countries with open economies such as Luxembourg. Therefore, it is imperative for the Luxembourg government to carefully analyse any BEPS recommendations before implementation into Luxembourg tax law and to defend the country`s and the EU`s interests where necessary. Once agreed by all MS, the Directive will have to be implemented into the national tax laws of all MS.

The proposal currently does not include any information on the timeline for such implementation although the Commission has indicated in its covering communication that it believes that it can achieve early agreement. Since the European Commission proposes principle-based rules in order to leave it to the MS to define their implementation details, it is questionable whether the objective of having a coherent implementation of BEPS measures at EU level will be met. It is evident that there is still a long way to run until these rules will become the new European standards.

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1) Section 6 of the Steueranpassungsgesetz

Call for evidence of the EU Commission : EU regulatory framework for financial services

Most probably in response to the excessive nature of the European Union's regulatory answer to the banking and tax crisis, the EU Commission launched a call for evidence on the EU regulatory framework for financial services in September 2015.

You will find below the preliminary and general observations which I found useful to submit to the EU Commission in addition to the answers to its (perhaps too detailed) questionnaire:

"At a time when nine out of ten of the largest banks in the World are American or Chinese and where the European Union is lagging behind as regards investment following the financial crisis, as a professor in EU banking and financial law and as a partner in a leading Luxembourg law firm, I commend the European Commission for launching the above-mentioned consultation.

I have answered the questionnaire as far as possible but would like to point out that I am disappointed by its format, which only touches upon the fundamental questions involved. Accordingly, I would like to raise in this cover letter some of the fundamental issues faced by the EU regulation of the financial services sector.

In my opinion, the approach of the EU as regards banking and financial regulation has several major defaults, which are presented below.

1) At the emotional level: sanction-based and guilt-inducing treatment of the financial sector, which is counterproductive for the European economy

Instead of encouraging cooperation between the authorities and the private sector in order to prevent another crisis (which it is worth reminding did not start in Europe) and to reinvigorate the European economy, the EU institutions have fallen into the trap of searching for a scapegoat and wanting to "punish" the financial sector for its perceived mistakes.

The perception of the financial sector as being at fault has of course been exacerbated by the media. The EU institutions have nonetheless contributed to the creation of a climate of tension and hostility, which has resulted in financial players and investments relocating outside Europe and in the general decline of the European financial sector.

2) At a methodological level : lack of rigour in the diagnosis of the problem and choice of remedy, lack of a coherent and considered vision and lack of a clear strategy; leading to merely following other powers at the international stage and a proliferation of legislative acts

The EU institutions have made a mistake in their approach. Rather than : (i) identifying and thoroughly attacking the actual causes of the European crisis provoked by the problems in the USA (excessive porosity of the European financial system) ; (ii) defining the financing needs of the European economy and the best ways of satisfying those needs by looking at the specific characteristics of the European financial system (major dominance of the banking sector) and international competition (reality-based approach) ; and (iii) outlining a clear and coordinated strategy; the EU can be criticised for simply following the G20 and being naïve in wanting to be a model pupil. In particular, the EU has not realised that its interests are not necessarily aligned with those of other powers and it has not paid enough attention to identifying what are its interests.

In deciding what policies to pursue, the EU has not shown the intellectual curiosity necessary to examine the reasons explaining why other countries escaped the consequences of the US crisis. It is noteworthy, for instance, that it has not looked at the example of Canada. Similarly, the EU has not reviewed critically its own policies in the banking and financial regulation since the launch of the 1999 financial sector action plan and therefore has not learnt any lessons from the past.

It is this lack of review and coherent and considered vision which has led to a proliferation of legislation. This legislation has been hastily drafted, often as a knee-jerk reaction to political, economic and financial developments and international pressure.

3) At the institutional and legislative level: too many regulatory acts and too many regulators

These strategy problems have been exacerbated by the implementation of legislation in a nervous political climate and by anxiety-provoking and risk adverse legislation. The legislation has been drafted by a number of EU organisations invested with different legislative and supervisory powers. The result has been a constant output of legislation of varying legislative value (Level I, II and III) coming from different authorities and often contradicting itself. It has become impossible for financial undertakings, and even EU banking and financial law specialists, to follow all of this legislation.

In addition, the transfer of supervisory powers to the EU level has been accompanied by significant delays in handling files by the authorities and a loss of understanding by the private sector of their policies. All this has occurred at an important time for the re-bolstering of the European economy. Given that finance involves, by definition, gambling on the future, it can only prosper in a reassuring, predictable and ultimate stable environment.

4) Systemic risk

Lastly, although the EU institutions have appeared to be concerned with systemic risk and moral hazard, the regulatory burden seems to work in the opposite direction. With so many obligations to respect and legislative acts with which to comply, only the bigger credit institutions are well-equipped to cope. The result will be a concentration of the financial sector and the increase in big players rather than a range of diverse operators in the market. Consequently, the European economy will be faced with credit institutions which are "too big to fail", which was exactly one of the problems in the financial crisis.

I sincerely hope that my comments in this letter and answers to the questionnaire will receive the same attention which the regulation of the European financial sector deserves".

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Closing of Accounts – The challenge to match timing and quality

By Laurent GATEAU, Associate Partner and Florent BAUDIN, Manager, KPMG Luxembourg

In the current economic world, the pressure on timing is always increasing. This statement is all the more true for CFOs and finance departments which need to be more and more reactive.

Financial information needs to be available quickly in order to ease decision making. Therefore the pressure on accounts closure routines is increasing. With the burden on cash flow and sudden changes in the economy, a company's management needs regular information in a timely manner to be able to act or react in the best interests of the company. The time when closing was mainly a statutory event and timing was not the highest priority is now over and the period for closure has started to be reduced to meet the information needs of stakeholders.

Finance departments are more and more required to become a business partner and a switch is required between running operations to enhancing the financial performance of companies. In a recent KPMG survey conducted worldwide*, a Finance department used to spend 50% of its time performing basic finance tasks, 30% focusing on reporting activities and 20% relating to finance performance. This recent evolution shows a shift from standard finance tasks towards business performance, where the percentages have now swapped. Therefore reduction of time used for low value added tasks to free up time for scarce finance resource is vital for a company.

Best in class firms are now able to close in three business days, but with those deadlines the possibility to correct any issue that might have occured during the close is very tight. At the same time, quality requirements are not a nice to have but a must which will be the cornerstone of reporting. Indeed, the information will not be used if incorrect and could lead to wrong decision making based on false facts.

Providing incorrect information might break the trust that the business and operations have in the Finance department, and lead them to produce their own dashboards instead of focusing on business which in the long run might be costly for the company. Therefore Finance departments need to perform a certain number of adjustments in their organization in order to make this change from mainly book-keepers to finance partner possible and to reduce the time spent on lower value added tasks. One of the first key elements is to anticipate any "what could go wrong" events in order to mitigate risks before close.

In an environment where the closing process is performed in less than a few days, a clear process needs to be in place to avoid that part of the information is missed during the close. Tasks need to be specified with owners including timing for their expected completion and can be monitored through the use of checklists. Doing this will allow one to know during the close where the process stands and to check if it is on track or if some actions are required to ensure that everything is in the books before the deadline.

Also one of the best practices is not to wait until after the period end to book everything. A large amount of information is available prior to close and can be booked through the month reducing the amount of work required during the closing period, thus allowing more time to review and analyse month end figures before releasing them, which will also bring more value and insight for management. Within groups, the standardisation of classification of the different cost and revenue elements under the required reporting captions is critical. In order to achieve this, communications to all parties and subsidiaries on how to classify them is essential to ensure comparability at group level and to help reduce the closing period.

With standardised templates and monitoring of accounts used, the information will be easier to analyse throughout a subsidiary and the identification of potential issues or risk in one of them will be facilitated. If communication is not efficient with a group's subsidiaries, and there are no guidelines regarding the allocation of costs, the comparability of data will be lost. Depending on the understanding of each counterpart, similar costs might be classified in different accounts leading to an inconsistency at group level and which may mislead the finance and operations departments when analysing figures.

To reduce closing time, the optimization of the IT system is an important feature. Excel is still largely used for compiling data (almost every company uses it at one stage of the closing and reporting process), and the risk of error in formulae needs to be monitored. The implementation of sanity checks as a safeguard is a must have and source data needs to be monitored. Also the automation of tasks will reduce the potential for manual mistakes and strengthen the reliability of final figures. On a worldwide level, 35% of respondents are expecting to invest significantly in their accounting system in the next two years*.

Closing is a critical activity for Finance departments and they can only be recognized as true business partners when they have mastered this activity in a sustainable fashion and thus create available time to provide value added information to internal stakeholders and also potential investors or analysts.

** KPMG International's global survey of CFOs*