EU Member States Reached an Agreement on the EU Anti-Tax Avoidance Directive: What's the Impact on Luxembourg ?

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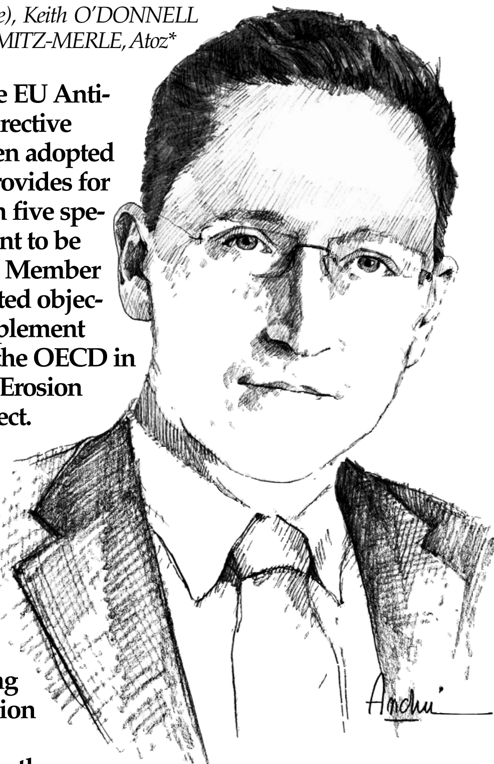

On 20 June 2016, the EU Anti-Tax Avoidance Directive ("ATAD") has been adopted at EU level. The ATAD provides for anti-tax avoidance rules in five specific fields which are meant to be implemented by each EU Member State ("MS"). The purported objective of the ATAD is to implement the recommendations of the OECD in regard to its BEPS ("Base Erosion and Profit Shifting") Project. However, the ATAD goes way beyond the BEPS recommendation and the minimum standards agreed between OECD countries. This Article provides an overview of the ATAD, outlines timing aspects and implementation options and analyses the impact of the Directive on the competiveness of Luxembourg as a location for doing business.

1. Introduction

The adoption of the ATAD is the result of a rather controversial political debate and process. The draft Directive has been discussed during two ECOFIN meetings (on 25 May 2016 and 17 June 2016) during which the EU Ministers did not manage to agree on any of the many compromise texts presented by the Dutch Presidency. In a final flourish, Cinderella-like, on the stroke of midnight of 20 June 2016, the final draft of the ATAD produced over the weekend was transformed. The draft was deemed to have received political agreement in the absence of objections which have not been submitted by MS.

The drama surrounding this Directive was indicative of the unease that a number of EU Member States felt about the ATAD. The reason for the unease is that the EU is proposing to go further than the commitments to minimum standards agreed by the Member States as OECD members. As a result, there is concern that the EU may be unilaterally reducing its competitiveness in the international sphere by forcing strict tax rules on its members that go beyond what the members committed to as part of the BEPS process.

2. Overview of the ATAD

The scope of the ATAD covers all taxpayers which are subject to corporate tax in an EU Member State as well as EU permanent establishments ("PEs") of taxpayers which are not in the scope of the directive. While the initial proposal entailed six anti-tax avoidance measures, only five thereof survived the political process. Notably, the switch-over-clause which was part of the initial proposal released on 28 January 2016 had finally to be removed following some pressure by several MS which would otherwise have refused to agree on the ATAD. In addition, since their first release on 28 January 2016, the measures had to be amended several times in order to take into account all objections raised over the past months and weeks by many EU Member States.

The final Directive provides for the following anti-tax avoidance rules:

- **Deductibility of interest**

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, subject to certain conditions and limitations, exceeding 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 3 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.

- **Exit taxation**

The second measure aims to discourage taxpayers to move their tax residence and/or assets to low-tax jurisdictions. Under the ATAD, 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); and
- A transfer of the business carried on through a PE from a MS to another MS or to a third 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.

- **General anti-abuse rule (GAAR)**

The ATAD further requires the introduction of a GAAR which would allow the tax authorities of a MS to deny taxpayers the benefit of arrangements considered as abusive. In this respect, the Directive states that non-genuine arrangements (i.e. arrangements not put in place for valid economic reasons which reflect economic reality) carried out for the main purpose or one of the main purposes of obtaining a tax advantage shall be disregarded. In case arrangements are disregarded in application of this rule, the tax liability shall be calculated in line with domestic tax law.

- **Controlled foreign companies (CFCs)**

The ATAD further 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 actual corporate tax paid on its profits by the entity or PE is lower than the difference between the corporate tax that would have been charged on the entity or PE under the applicable corporate tax system in the MS of the taxpayer and the actual corporate tax paid on its profits by the entity or PE; and
- The CFC rules shall not apply if the controlled foreign company carries on a substantive economic activity supported by staff, equipment, assets and premises. However, MS may opt to only apply this exemption to companies located in the EU.

- **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. In this regard, the ATAD determines that in case a hybrid mismatch results in a double deduction, deductions shall be given only in the MS where such payment has its source. Moreover, to the extent that a hybrid mismatch results in a deduction without inclusion, the MS of the payer shall deny the deduction of such payment. All five measures, except the one on hybrid mismatches, will apply to situations involving both EU and non EU jurisdictions. However, on hybrids, additional action (new proposal of the European Commission) is expected by October 2016 to cover situations involving third countries.

3. Timing aspects and implementation options

The objective of the ATAD is to implement BEPS recommendations in a coordinated manner in all MS of the EU. However, the Directive entails a number of implementation options and leaves MS the liberty to design rules which go beyond the rules provided in the ATAD.

The implementation options provided in the ATAD include, amongst others:
- A safe harbour of EUR 3m up to which exceeding borrowing costs may be deducted without restriction (interest limitation rule);
- Grandfathering of loans concluded before 17 June 2016 (interest limitation rule);
- Carve-out of loans used to fund long-term public infrastructure projects (interest limitation rule);
- Implementation of a group-wide rule as a carve out (interest limitation rule);
- Different carry-forward mechanisms for exceeding borrowing costs and unused interest capacity (interest limitation rule);
- Exclusion of financial undertakings from the scope of the interest limitation rule;
- Carve out for substantive business activities in case of CFCs resident in third countries (CFC rule);
- Carve out for CFCs with one third or less of passive income (CFC rule);
- Carve out for CFCs with an accounting profit of no more than EUR 750,000 (CFC rule).

As regards timing, the Directive determines that MS have to implement the measures no later than 1 January 2019. However, with respect to two of the measures, the ATAD allows the implementation at a later stage:
- The exit taxation rules may be implemented until 1 January 2020;
- The implementation of the interest limitation rule may be postponed until 1 January 2024, provided that MS have equally effective national targeted rules for preventing abuses. However, if the OECD countries were to agree on the interest limitation rule as a "minimum standard" before that date, this rule would have to be implemented before the end of the first tax year following the agreement at OECD level.

In light of the above, MS still have a significant amount of leeway when it comes to how and when the ATAD will be implemented into domestic tax law. With a view to safeguard Luxembourg`s competitiveness, it will be crucial for the Luxembourg Government to take the right decisions and to monitor how the Directive is implemented in the other MS.

4. Considerations regarding the contemplated corporate tax reform

The ATAD imposes a series of unfavourable tax law measures on the Luxembourg legislator. This also raises questions when it comes to the 2017 corporate tax reform that is supposed to enhance the competitiveness of Luxembourg in the post-BEPS era.

The main tax law changes that have been announced by the Luxembourg Government include:

- **Reduction of the CIT rate**

The corporate income tax rate is proposed to be reduced in two steps from 21% to 19% (in 2017) and from 19% to 18% (in 2018). The proposed measures do neither foresee a change of the 7% solidarity surcharge levied on the corporate income tax nor a change to the municipal business tax rate due by companies (6.75% in Luxembourg-City). Accordingly, the aggregate corporate tax rate applicable to companies established in Luxembourg-City would be decreased from currently 29.22% to 27.08% (in 2017) and 26.01% (in 2018).

- **Increase of minimum net wealth tax**

Since 1 January 2016, Luxembourg companies having their statutory seat or central administration in Luxembourg are subject to a minimum net wealth tax. Within the 2017 tax reform, it is planned to increase the amount of minimum tax for holding and finance companies ("SOPARFIs") from EUR 3,210 to EUR 4,815 (including solidarity surcharge).

- **Restriction to the use of tax losses**

According to the announcement of the Minister of Finance, it is further proposed to limit the use of tax losses generated as from 1 January 2017. The limitation on the use of tax losses is proposed to be two-fold:
- Firstly, such losses would only be available to offset 75% of the taxable income realized in subsequent periods;
- Secondly, such losses should only be carried forward for a period of maximum 17 years.

- **Setting the right priorities**

The ATAD will inevitably result in a harmonization of European corporate tax laws and a broader tax base for corporations. In this environment, the competitiveness of MS for international investments will largely depend on the applicable tax rate.

With an aggregate tax rate of currently 29.22% (in Luxembourg City, to be reduced to 26.01%), Luxembourg has currently rather a high tax rate. Other European countries which are competing with Luxembourg for foreign investments have significantly lower tax rates.

The most prominent examples include:

Malta:	5% (effective tax rate after tax refund to the shareholder)
Cyprus:	12.5%
Ireland:	12.5%
United Kingdom:	20% (to be decreased below 15%)
Switzerland:	between 12% and 20% (depending on the canton)
The Netherlands:	25%

In the authors' view, the Luxembourg Government needs to take a bold step and cut the corporate tax rate more significantly if the country should remain attractive for businesses. Even a reduction of the corporate income tax rate by 10% should be considered. This would be a clear signal to international investors that Luxembourg will remain attractive in the post-BEPS era. When considering such a measure, the question arises as to how a decrease of the corporate tax rate may impact the Luxembourg tax revenue. The impact of a decrease of tax rates on tax revenues has been analysed in various studies. All these studies come to the conclusion that a fall of corporate tax rates would not give rise to a decrease in corporate income tax revenues relative to GDP.

In other words, economic analysis shows that cuts in corporate income tax rates are expected to be self-funding in terms of overall tax receipt within a small number of years and this is an investment Luxembourg needs to make to secure its future. This should encourage the Luxembourg Government to take a step that is more courageous than the small decrease that is currently proposed.

5. Conclusions

The current international tax environment is characterized by an extreme legal uncertainty. The measures provided in the ATAD will have to be implemented by Luxembourg and need to be considered by the Luxembourg tax legislator when designing the planned corporate tax reform. Since tax competition will in the future mainly rely on tax rates, the Luxembourg Government should seriously consider a sharp decrease in the corporate tax rate that would allow the Grand-Duchy to compete with countries like Ireland (that attracts businesses with a 12.5%). However, it is now that international investors and multinationals have to decide on a (i) mid- and long-term strategy for the post-BEPS era and (ii) the locations for the structuring of business activities. In order to reinforce the competitive position of the Grand-Duchy, it is crucial for the Luxembourg Government to send out positive signals; for example, with the announcement of a reduced corporate tax rate.

It will further be important to monitor how other jurisdictions are implementing the ATAD. The ATAD provides for principle-based rules that leave MS a number of implementation options (also when it comes to timing). Luxembourg has to implement the ATAD in a smart fashion if it does not want to lose in terms of attractivity for international businesses. While the implementation date is still two and a half years away, businesses should start reviewing the impact of the Directive on their structures. Each of the measures will affect different businesses in different ways so there is no "one size fits all" approach. Our specialist BEPS team has been helping clients make sense of this all, starting from a high level BEPS scan through to a detailed implementation plan and project management of the execution.

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1) For the purposes of the minimum tax, a company is classified as a "holding and financing company" or SOPARFI if its fixed financial assets, transferable securities and cash at bank (as reported in the financial statements presented in the standard Luxembourg form) exceed 90% of its total gross assets. Since 2015, when 90% of the qualifying financial assets do not exceed EUR 350,000, holding and financing companies are subject to the general minimum tax rules and are liable to an annual minimum tax of either EUR 535 or EUR 1,605, depending on their total balance sheet (for the fiscal years 2013 and 2014, a SOPARFI was always subject to the minimum taxation of EUR 3,210, no matter of its total balance sheet).
2) The impact of a decrease in tax rates on the amount of tax revenue has, for example, been analysed in the following study:
http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_12_en.pdf.