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# Luxembourg Tax Alert

## Compromise reached by all Member States on anti-tax avoidance directive

**22 June 2016**

On 28 January 2016, the European Commission presented an anti-avoidance package to implement certain BEPS measures (please refer to the previous tax alert).

**On 21 June 2016, further to the meeting of 17 June 2016 and subsequent silence procedure, a political agreement was reached between all EU Member States after numerous discussions and changes to the original proposal** (please refer to the Council of the EU press release). **The final compromise covers five out of the six initial provisions: interest limitation rule; exit taxation; general anti-abuse rule; controlled foreign company (CFC) rule; hybrid mismatches (exclusion of the switch over clause).** The final compromise, subject to verification by lawyer-linguists, should be formally approved at a later EU Council meeting.

The general deadline for Member States to transpose the text into national law would be 31 December 2018 with provisions applying as from 1 January 2019, apart from the provision on exit taxation which would be transposed by 31 December 2019 and applicable as from 1 January 2020.

On the basis of the text of the final compromise of the directive dated 17 June 2016 (), the provisions of the anti-avoidance directive are briefly presented below. Three of the five provisions introduced consist in the implementation of BEPS measures whereas two - the general anti-abuse rule and exit taxations rules - represent the EU's aims of addressing tax avoidance practices.

- **Interest limitation rule under conditions (articles 2, 4 and 11)**.
  Where deductible borrowing costs exceed taxable interest revenues and other economically equivalent taxable revenues, a deduction limitation would apply. In the tax period in which they are incurred, the interest would be deductible up to 30% of the taxpayer's earnings before interest, tax, depreciation and amortization (EBITA) or up to an amount of EUR 3 million, whichever is higher (with exceptions such as a group-wide test), or in full if the taxpayer is a standalone entity.
  A possibility may be included by each Member State for any exceeding interest costs to be carried forward or back. Financial undertakings may be excluded from the scope of this provision.
  Interest on loans concluded before 17 June 2016 and not subsequently modified as well as loans used to fund a long-term public infrastructure project in the European Union may be excluded by Member States from the calculation of exceeding interest costs.

Member States which already have national rules which are as equally effective as the proposed interest limitation rule (to be evaluated by the EU Commission – article 10 (3)) may apply such rules until 1 January 2024.

- **General Anti-Abuse Rule (article 6)**. The wording of this General Anti-Abuse Rule (GAAR) is similar to that which is included recently in the parent-subsidiaries Directive.
  Non-genuine arrangements or a series thereof carried out for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the applicable tax law would be ignored for the purposes of calculating the corporate tax liability. The general anti-abuse rule would serve to tackle an arrangement or a series of arrangements that are not put into place for valid commercial reasons which reflect economic reality. Where arrangements or a series thereof would be ignored, the tax liability would be calculated in accordance with national law.
- **Controlled foreign company income rules (articles 7 and 8).** This is an anti-deferral tax measure whereby the tax base of a taxpayer would include the non-distributed income of an entity provided certain conditions are met. The Controlled Foreign Company (CFC) income rules would apply to situations where the taxpayer directly / indirectly holds more than 50% of the voting rights or shares in an entity or permanent establishment for which the profits are not subject to tax or are tax exempt in the Member State of the taxpayer. This CFC legislation would apply, notably, if the actual corporate tax paid by the concerned permanent establishment or entity *"is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment".*
  A rough example of the CFC rules in action: A parent company is resident in an EU Member State and is subject to corporate tax at a rate of 40%. The EU parent company holds a CFC subject to corporate tax at a rate of 25% and has profits of 1000. The tax paid in the CFC State is 250 (25% of 1000). For the purposes of this example it is assumed that the computation of the taxable base in both jurisidictions is similar. If the profits had been subject to tax in the EU Member State in which the parent company is based, the total tax due would have been 400 (40% of 1000). There is thus a difference of 150 (400-250=150). In this case, the CFC rules would not apply, as the difference (150) is lower than the total tax paid in the CFC jurisdiction (250).
  Where an entity is considered to be a CFC under the compromise, such CFC income would not be included in the taxpayer's tax base provided it can proof sufficient economic substance (staff, office equipment, premises etc.).
  Member States may exclude from the scope of this rule the income of entities/permanent establishments with accounting profits of no more than EUR 750,000 and non-trading income of no more than EUR 75,000 (or of which the accounting profits amount to no more than 10 percent of its operating costs for the tax period).

**Hybrid mismatches rules (articles 2 (9) and 9)** whereby two European Member States give a different legal characterization to the same taxpayer / instrument in one or more European Member State(s) leading to a double deduction or a deduction without inclusion.

- In case of a double deduction, the deduction shall only occur in the Member State of the source of the payment.
- Where there is deduction without inclusion of the payment, the deduction would not be allowed.

The Commission has been requested to put forward a proposal by October 2016, in view of reaching an agreement before year-end, on hybrid mismatches involving third countries in order to provide for rules consistent with and no less effective than the rules recommended by the OECD BEPS report on Action 2.

- **Exit taxation for cross-border transfer of assets, residence or business carried on by permanent establishment (articles 2 (6,7,8) and 5)** whereby a taxpayer would be subject to tax for an amount equal to the fair market value of the transferred assets, at the time of exit, less their value for tax purposes subject to four circumstances. The text also provides for the deferral of payment of the above mentioned exit tax by paying in instalments over a 5 year period provided the assets / residence of a taxpayer's head office / permanent establishment are transferred to another European Member State or a third country that is party to the EEA Agreement. Under certain conditions, transfers of a temporary nature (within a period of 12 months), where the assets are intended to revert to the Member State of the transferor, would be excluded from the scope of this measure.

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