EU Anti-Tax Avoidance Directive Took Effect January 1, 2019

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Background on the Anti-Tax Avoidance Directive

On January 1, 2019, the EU Anti-Tax Avoidance Directive (“ATAD”) went into effect for all 28 Member States. ATAD is the European Commission’s response to the relevant Action Plans of the base erosion profit shifting (“BEPS”) project of the Organization of Economic Cooperation and Development (“OECD”). There are 3 BEPS-related rules in ATAD plus an additional 2 rules which did not derive from BEPS, for a total of 5 substantive anti-tax avoidance rules. This alert provides an overview of these five areas. ATAD applies of course to the European operations of US groups and certain US-EU transactions within those groups. How ATAD impacts
specific group structures depends on the facts and circumstances of the particular structure and covered transactions.

**ATAD requires Significant Changes to National Tax Laws of the Member States**

It is important to note that ATAD is best described as a mandate for the 28 Member States to amend their national legislation to implement the 5 rules covered in time for the effective date. For many Member States, implementation of ATAD has been an enormous undertaking even though the ATAD text was finalized in 2016. Although the principles underlying the 5 areas covered belong to existing international tax norms, not all Member States had some version of the 5 rules in already existing under national law.

The European Union institutions have limited authority to legislate in the area of direct taxes. When the Member States are required to follow European legislation, the most common legal instrument is the European directive. A directive that concerns tax legislation requires a unanimous approval by the European Council of Finance Ministers (Ecofin) and then majority approval by the European Parliament. The directive is a mandate for the Member States to enact national legislation, by a certain deadline, to carry out the purposes of the particular directive. The mandate can be investment-friendly, such as the parent-subsidiary directive for cross border flows of dividends, or restrictive, such as the ATAD. Member States are not obliged to adapt into national law the exact text of ATAD. As a directive, the Member States have some flexibility to craft the text of the implementing legislation so long as it is consistent with the details contained in ATAD.

**The 5 Rules in ATAD**

**Interest Deduction Limitation**

ATAD includes the general rule that net borrowing costs will only be deductible up to 30% of the amount of the borrower’s EBITDA (earnings before interest, tax, depreciation, and amortization).

Specific exceptions to the 30% interest limitation may be allowed (i) up to EUR 3,000,000 or (ii) to the extent the issuer is not a member of a corporate group.

The ATAD contains the option for a Member State to choose between two different group exclusion provisions based on either (i) an equity-over-total-assets ratio or (ii) a group EBITDA test.

The ATAD includes options for the carryforward and carryback of disallowed interest expense arising for any taxable period.

There is a derogation from the entire ATAD interest deduction limitation rules for a transition period. The derogation applies if a Member State has national, targeted rules that are equally effective as the ATAD rules until the end of the first fiscal year following the date of the agreement between OECD Member States on a minimum standard with regard to Action Plan 4 (the output for the interest limitation) or, at
the latest, until January 1, 2024.

**WBD comment**: Cross-border debt financing is one of the most common ways to tax efficiently transfer earnings from the issuer jurisdiction to the creditor jurisdiction. The benefit of this interest deduction limitation is to have a uniform approach to interest stripping across the European Union. This rule represents for the European Commission significant movement to the goal of a comprehensive “common consolidated corporate tax base” which it has been pursuing for almost two decades.

**Business Exit Taxation**

The ATAD business exit taxation rule lists 4 transactions that are to be treated as a sale of assets, when assets located in one jurisdiction are transferred to another jurisdiction, but remain under the same ownership:

- Transfer of assets to a permanent establishment in another Member State or a third country
- Transfer of assets from its permanent establishment to its head office or other permanent establishment in another Member State or in a third country and the transferor Member State no longer has the right to tax the assets transferred.
- Transfer of taxpayer residence to another Member State or third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State
- Transfer of a business carried on by a permanent establishment from one Member State to another Member State to the extent the Member State of the permanent establishment no longer has the right to tax the transferred assets.

The gain recognized in the Member State of the transferring taxpayer will be the fair market value of the assets over their tax basis. The taxpayer may pay the tax due on the transfer on an installment basis over five years under certain circumstances. The Member State of the receiving party must set the tax basis of the assets at their fair market value.

**WBD comment**: ATAD codifies a uniform exit taxation rule across the European Union. The transactions covered by the ATAD rule had often been the subject of national tax audits by the jurisdiction from which assets were being transferred. The approaches to exit taxation by Member States varied across the European Union and in some cases did not exist prior to ATAD. This rule represents incremental progress.

**General Anti-Abuse Rule (GAAR)**

In computing corporate tax liability, the tax authority of a Member State may ignore an arrangement or series of arrangements which are not genuine under the relevant facts and circumstances if it determines that the main purpose or one of the main purposes of the arrangement is to obtain a tax advantage that defeats the purpose of the applicable tax law. A non-genuine arrangement is an arrangement that was not put into place “for valid business reasons which reflect economic reality.” The GAAR supplements specific anti-abuse rules under national legislation and in that sense is
intended to cover gaps in those specific rules.

**WBD comment**: GAAR rules have gained favor internationally as a result of the BEPS project. The test under the ATAD GAAR relies heavily on the facts and circumstances of a transaction, as many GAAR statutes do. National tax practice in this area evolved around rare national case law. Taxpayers operating in Europe over the years could, in effect, “cherry pick” transactions in those jurisdictions that did not have the type of standard under national law that GAAR now provides in the absence of specific anti-abuse rules in a particular jurisdiction. It is questionable what the impact of the GAAR legislation across the European Union will be and whether there will be different applications of the ATAD standard depending on the jurisdiction. Challenges to the application of GAAR by the tax authorities in the EU can now, in theory at least, go before the European Court of Justice.

**Controlled Foreign Company Rules**

Many, but not all, jurisdictions have regimes referred to as controlled foreign company (“CFC”) rules intended to deter the use of artificial arrangements within a controlled group to mitigate or eliminate the overall tax burden on group profits. ATAD contains a two part definition of CFC. Under Part 1, a CFC is given when more than 50% of (i) the voting rights, (ii) the value, or an interest in the profits of the tested entity is held directly or indirectly by a shareholder alone or together with associated enterprises.

Under Part 2, a CFC is given if the actual corporate tax paid on the tested entity’s profits is lower than the difference between (i) the corporate tax that would have been paid in the parent country and (ii) the actual corporate tax paid (in other words, 50% or less of the rate applicable in the home country).

If an entity meets the definition of CFC, there are two situations in which income of the CFC is included in the tax base in the parent country. The first situation concerns non-distributed income of the CFC that essentially consists of passive income items. There is an exception to this income inclusion if the CFC carries on a substantive activity (business substance standard). The existence of business substance is a facts and circumstances determination. The exception must not apply to a CFC resident in a third country that is not a party to the EEA Agreement.

The second situation is when the non-distributed income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. This will be the case if the CFC would not have undertaken the capital and risks generating the income but for the parent company controlling it carries out significant people functions that are instrumental to generating the CFC’s income.

Member States may apply two exceptions to the second situation. The exceptions apply (i) if the CFC has no more than EUR 750,000 accounting profits and non-trading income of no more than EUR 75,000 and (ii) if the operating profits amount to no more than 10 percent of operating costs.

**WB Content**: The US and most of its major trading partners have had some kind of CFC regime in place for decades. That is not the case with some of the smaller EU
Member States which are adding the ATAD CFC regime to national law. ATAD may introduce an additional layer of complexity to cross border group structures, also in the case of existing CFC regimes.

**Anti-Hybrid Mismatches**

Certain EU jurisdictions developed financial instruments decades ago to facilitate so-called “hybrid mismatches” cross border. Under a hybrid mismatch, a financial or “hybrid” instrument takes advantage of different characterizations of the instrument, for tax purposes between the issuer jurisdiction and the holder jurisdiction. The fact of these different characterizations was not challenged by the issuer or the holder jurisdiction and the practice of using hybrid mismatches for cross-border financing was generally accepted for certain jurisdictions.

The BEPS project specifically identified these arrangements as planning opportunities that were no longer acceptable, and action needed to be taken to broadly eliminate the tax benefits of such arrangements. The hybrid instrument intended to be covered in ATAD is one that can generate a deduction in the jurisdiction of the holder and a deduction in the jurisdiction of the issuer, or a deduction in the issuer jurisdiction and a non-inclusion in income in the holder jurisdiction.

ATAD provides that in the case of a hybrid instrument that results in a double deduction, the deduction can be taken only in the Member State where the payment is sourced, i.e., the jurisdiction of the issuer. In the case of a deduction and a non-inclusion, the payment is to be non-deductible in the Member State of the issuer.

ATAD mandated that the European Commission develop a directive to cover hybrid mismatches with third countries pursuant to the OECD BEPS report on hybrid mismatches. That directive has since been approved and will take effect in 2020.

**Implementation into National Law**

The ATAD was implemented not without the consternation of some Member States that had to make significant changes to their national law to comply with the directive. The ATAD has already been criticized in the tax community for the lack of sufficient guidance on some of the subjective rules found in the GAAR and CFC articles. ATAD represents movement towards the CCCTB project that has been high on the European Commission agenda for almost two decades and, in more recent years, has been championed by the French and German governments. ATAD moves the EU a bit closer to the reality of the CCCTB.

**WB comment** : From the US group perspective, there is some benefit to having consistency across the EU with these 5 ATAD rules. All multinational groups with ATAD covered subsidiaries in the EU will have to conduct a country by country analysis of the impact of the ATAD changes at the national level where these subsidiaries are established. To the extent some Member States did not timely implement ATAD into national law January 1, taxpayers are urged to proceed nevertheless in complying by that date to any changes imposed by ATAD.
ATAD is just one of the significant tax developments in the first half of 2019. To see our Top Ten list of significant developments, read here.

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