Tax and Legal Alert

PwC Romania

# Anti-Tax Avoidance Directive

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## In brief

On 21 June 2016, the Council of the European Union agreed a draft directive addressing tax avoidance practices commonly used by large companies.

The directive is part of a January 2016 package of Commission proposals to strengthen the rules against corporate tax avoidance. The package builds on 2015 OECD recommendations to address tax base erosion and profit shifting (BEPS).

The directive addresses situations where corporate groups take advantage of disparities between national tax systems in order to reduce their overall tax liability. Corporate taxpayers may benefit from low tax rates or double tax deductions. They can also ensure that categories of income remain untaxed by making them deductible in one jurisdiction and not included in the tax base in another. The outcome distorts business decisions and risks creating situations of unfair tax competition.

## In detail

The Anti-Tax Avoidance Directive (ATAD) sets out certain minimum standards that Member States need to adhere to in several areas covered by the OECD work on BEPS, including interest deductibility limitations, controlled foreign company (CFC) rules and rules for tackling hybrid mismatches. The ATAD goes further, however, and also sets out rules for exit taxation and a general anti-abuse rule. Though the ATAD stipulates minimum standards to be applied to all taxpayers subject to corporate tax in one or more Member States, it does not prohibit other anti-avoidance rules designed to give greater protection to the corporate tax base.

### *Key provisions in the ATAD:*

### *Deductibility of interest*

Net interest expenses will only be deductible up to a fixed ratio based on the taxpayer's gross operating profit. The rate for deductibility is likely to be set at the top of the scale (10% to 30%) recommended by the OECD. Member States may then introduce stricter rules. This rule will counter the practice of multinational groups which often finance group entities in high-tax jurisdictions through debt and arrange that these companies pay back 'inflated' interest to subsidiaries resident in low-tax jurisdictions. In this way, the tax base of the group decreases in the high-tax jurisdictions and increases in the low-tax State where the interest payment is received.

### *Exit taxation*

These new rules should ensure that if a taxpayer moves assets or its tax residence out of the tax jurisdiction of a State, that State will be able to tax the economic value of any capital gain created on its territory even if this gain has not yet been realised at the time of the exit.

### *Switch-over clause*

The rule changes the relief from double taxation set through the exemption method to the credit method. The exemption method has proven to encourage practices where untaxed or low-taxed income enters the Internal Market as exempt from taxation. Such practices are countered by a switch-over clause.

### *A general anti-abuse rule*

The general anti-abuse rule is designed to cover gaps that may exist in a country's

specific anti-abuse rules against tax avoidance. It would allow authorities the power to deny taxpayers the benefit of abusive tax arrangements. Based on the rule, arrangements are regarded as non-genuine to the extent they are not put into place for valid commercial reasons which reflect economic reality.

***Controlled Foreign Company (CFC) rules***

CFC rules re-attribute the income of a low-taxed controlled foreign subsidiary to its parent company. As a result of this, the parent company is charged tax on this income in its State of residence.
These rules are designed to counter the practices of taxpayers with controlled subsidiaries in low-tax jurisdictions which may engage in tax planning practices whereby they shift large amounts of profits out of the parent company towards subsidiaries which are subject to low taxation. The effect of such shifts is to reduce the overall tax liability of the group.

***A framework to tackle hybrid mismatches***

Hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities when two legal systems interact. Such mismatches may often lead to double deductions or a deduction of the income on one side of the border without its inclusion on the other side. The framework will lay down rules whereby one of the two jurisdictions in a mismatch should give a legal characterisation to the hybrid instrument or entity and the other jurisdiction should accept it.

The next step is for the ATAD to be submitted to a forthcoming Council meeting for adoption. The ATAD will enter into force on the twentieth day following its publication in the Official Journal of the EU. Member States are required to adopt and publish ATAD-compliant provisions by 31 December 2018 at the latest (exceptions are provided), with the provisions applying as of 1 January 2019. These deadlines will be extended by one year for the rules on exit taxation.

[*Source: Commission's proposal from 28 January 2016 COM/ 2016/0011*]

## The takeaway

The package contains concrete measures to prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the EU.

It will help Member States take strong and coordinated action against tax avoidance and ensure that companies pay tax wherever they make their profits in the EU.

As Romania is an EU Member State and adhered to ATAD, significant changes in the local tax legislation are expected to be implemented by the end of 2018.

## *Let's talk*

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