CONFEDERATION FISCALE EUROPEENNE

Opinion Statement FC 3/2016

on the European Commission´s proposal for an Anti-Tax Avoidance Directive

of 28 January 2016

Prepared by the CFE Fiscal Committee
Submitted to the OECD and the EU institutions in March 2016

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries (18 EU and 16 OECD member states) with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.
The CFE is registered in the EU Transparency Register (no. 3543183647-05).

This Opinion Statement relates to the European Commission´s proposal for a Council Directive laying down rules against tax avoidance that directly affects the functioning of the internal market (COM(2016) 26 Final) of 28 January 2016[1] (in the following: *the proposal*, or *the draft Directive*).

We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.

1. Introduction

As explained in detail below, the draft Directive contains measures which, if implemented as they currently stand, will impose fundamental changes to the tax systems of each single member state. The CFE believes that any political decision to adopt the Directive should specifically include careful consideration of the correct approach to subsidiarity, separately from more practical political issues such as the consequences of introducing the Directive for the investment climate of the member states.

For the CFE, a key concern with the proposal is that its scope considerably exceeds the OECD agreement. By exceeding the OECD agreement in this way, the EU could end up at a considerable competitive disadvantage with respect to worldwide investments.

In addition, any change in the existing framework should ensure certainty and clarity and not add further complexity. As such, the proposal, as currently released, raises concerns.

Furthermore, CFE is concerned to ensure that anti-tax avoidance measures are implemented in a consistent and coordinated way across member states. Thus, the proposed measures should not be only a de minimis but a de maximis recommendation. Otherwise the purpose of the Directive –to implement anti-avoidance measures in a consistent way throughout the EU- will not be achieved.

2. Appraisal of the draft Directive as a whole

The CFE understands and is a supporter of converting OECD measures aimed at combating abuse in international structures into legislation (‘*hard law*’), provided that:

a) it does in fact combat the aforementioned abuse and the measures do not extend beyond what is necessary, to prevent unnecessary impacts on compliant businesses;
b) the measures provide for implementation in a manner that is as uniform (harmonised) as possible across the European Union[2], different implementation results in burdens for the business sector;
c) international double taxation is prevented (for example where one state considers something to be abuse but the other state does not, as a result of which a profit component is taxed in both states);

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1458819560592&uri=CELEX:52016PC0026.
[2] Two member organisations have pointed out that they do not support full harmonisation.

d) the hard law is adopted after careful consideration of all interests involved and their impact;
e) it is drafted in a manner that is legally tenable in the long term; and
f) there is a grandfathering clause or an adequate transition period to allow non-abusive structures that are inadvertently affected to be adapted to fall outside the scope of the new hard law.

However, the content of the draft Directive does not meet, in our opinion, some of the principles formulated above. In particular:

a) The European Commission (hereinafter "Commission") bases the draft Directive on the need to tackle tax avoidance practices that directly affect the functioning of the internal market. However, on a number of important points it goes much further than the primary goal of combating of tax avoidance practices. Examples of this are:
   - The proposed generic interest deduction measure, insofar as it concerns external interest for non-international groups or individual companies if there is no artificial over-allocation of external debt to corporations in member states;
   - The use of the switch-over clause.

   In addition, the CFC (Controlled Foreign Companies) measure on foreign activities that are not artificial, do not involve "mobile" income and that involve high "substance" (for example genuine operational activities) appears to address matters already adequately dealt with by transfer pricing rules.
b) The draft Directive goes far beyond the Final Reports of the OECD on BEPS.[3] Legislation is proposed for a number of points on which the OECD only makes non-binding recommendations. For example, the OECD recommendations for taxing CFCs can be summarised as only a recommendation ("guidance based on best practices").

   Also, with regard to the introduction of a generic interest deduction limit it applies that there is no question of a "minimum standard" to which the G20/OECD apparently would have committed. As explained already, going further than the OECD hard requirements has negative consequences for the competitive position of the European Union as a whole, and therefore indirectly for the competitive position of member states versus third (G20/OECD) states that will not do this. Hence, it hinders the business sector that does business both within and outside of the EU. The CFE understands that some member states consider it would be appropriate to limit the Directive to points mandated by the BEPS conclusions. The CFE sees the force in this view.
c) The draft Directive leaves wide policy choices to individual member states with regard to the GAAR measure and with regard to other measures that are designated as anti-abuse measures. Examples are the EBITDA percentage of the generic interest deduction limit, the question whether a group alternative is or is not be offered to taxpayers and the question of an offset within the framework of the switch-over and CFC clauses. The consequence of this is that no level playing field will be created in those areas, and a potential race to the least stringent tax regime is created, which is highly undesirable in the area of anti-abuse. The use of the tax rate of the taxpayer´s

[3] OECD BEPS 2015 Final Reports: http://www.oecd.org/ctp/beps-2015-final-reports.htm.

member state as a benchmark for a number of measures has the consequence that the race-to-the-bottom will be intensified with regard to rates.

d) If some states implement in a different way than others or, for example, apply the GAAR measure differently in practice, undesirable international double-taxation potentially arises. The draft Directive pays no attention to this. As a minimum, assuming the idea of an internal market, the removal of double taxation has to be considered, for example by providing for corresponding adjustments in the other member state, or by breathing new, and this time effective, life into the Arbitration Convention.
Minimum harmonisation, which is the approach (Art.3) of the Directive proposal, bears the risk of creating up to 28 different GAARs, with great legal uncertainty for the business sector as a result, as demonstrated by the recent inclusion of a GAAR measure in the EU Parent-Subsidiary Directive with effect from 1 January 2016. We expect a similar result from the proposed GAAR in the Anti-Tax Avoidance Directive.

e) The CFE notes that a public consultation on EU Anti-Tax Avoidance legislation has not taken place. The Commission refers to general discussions in an OECD context. However, many of the proposals now on the table were not discussed during that dialogue in specific terms. In addition, there is no impact analysis for the proposal. At least for some member states, the proposal has been published at a late stage, after there has been extensive consultation on design of domestic measures to address the OECD proposals. In the UK, this is particularly true in relation to interest deductibility and hybrid instruments, where proposals published on 16 March reflect extensive engagement between the UK and industry: how will the output of those discussions be taken into account?

f) The compatibility with European law and other higher -ranking law also appears not to have been tested, or at least the testing is not sufficiently evident from the published documents. For instance, measures whereby investments in third states are treated differently from a tax point of view than investments in other member states have to be tested for compatibility with the free movement of capital and proportionality (specifically relevant in the event of measures that are proposed for combating abuse but which do not apply only to wholly artificial situations). The CFE notes that on 14 October 2015, the German Federal Finance Court announced its decision to present the German *Interest Limit (Zinsschranke)* – to a large extent the model on which the general interest deduction limit is based – to the Federal Constitutional Court, because it is of the opinion that this measure, due to conflict with the principle of equality, is in conflict with the German Constitution[4]. It is clear from this that legal un-tenability is not a theoretical risk.

g) The draft Directive contains no grandfathering clause or transitional period for existing structures not covered by measures that primarily aim at combating abuse. We consider it to be a political choice whether existing structures, should, to a certain extent, be exempted from the proposed measures (grandfathering clause), or whether there will be a certain time period for them to be

[4] Reference: I R 20/15. The Federal Finance Court argues that by deviation from the principle of taxation on net income, taxpayers affected by the deduction limit are not taxed according to their financial ability to pay. Links (in German): Decision; Press release.

adjusted in an orderly fashion or phased out (transitional period), but it is not acceptable from the viewpoint of legal certainty and better legislation that the proposal includes neither of these.
By contrast, the OECD recommendations allow for the general interest deduction limit to be applicable on new external loan agreements that are entered into (such as bank loans) and to totally exclude existing external loans.

Moreover, in many cases the draft Directive raises the prospect of disputes between tax authorities affecting taxpayers. The Directive should be introduced only in conjuction with safeguards against those disputes. Existing consideration of those safeguards should be fast-tracked.
We note that the European Commission has launched a public consultation on improving double tax dispute resolution[5] and will provide our observations on that matter in due course.

3. Appraisal of each specific measure

The CFE provides its appraisal of each specific measure below, including also observations from the point of view of specific member states.

3.1. Generic interest deduction limitation (Article 4)

Over the years, many member states have implemented an imposing arsenal of legislative measures aimed at limiting interest deduction, primarily by only allowing interest costs to be deducted in genuine situations. Therefore, over the decades, these member states have sailed a different course than that which is now proposed in the draft Directive. By accepting the draft Directive, member states would set out in a completely different direction. The CFE is of the opinion that such a change of direction should only be accepted by member states after carefully considering the benefits and disadvantages of the measure now proposed. Should this proposal be accepted, the Directive should also provide for a consistent abolition of existing domestic measures to avoid inconsistencies.

The OECD/G20 BEPS recommendations suggest a '*common approach*' on interest deduction measures. By translating this into '*hard law*' the EU is going far beyond the OECD recommendation. Substantively, the measure also goes far beyond what is necessary for combating abuse. Consistently with the case-law of the CJEU, the abuse that the EU should be combating on this point concerns cross-border structures whereby artificial internal group interest flows are created, or whereby external interest is artificially allocated in an international group to the member states with the highest tax rates. However, the proposed measure affects all businesses, irrespective of whether they operate internationally or only locally, and also genuine external interest that is required to finance a local investment or operation and for which there is no artificial allocation to a member state.

[5] http://ec.europa.eu/taxation_customs/common/consultations/tax/double_tax_dispute_en.htm.

Examples of local businesses in the member states that will be disproportionately affected by this measure are: leasing companies, asset finance companies, large property and infrastructure projects (PPP projects and consortia that build roads, engineering structures, wind farms, etc.) that operate outside of a group relationship (as stand-alone operation). The UK's "Business Tax Road Map" published on 16 March 2016 envisages exemptions for suitable infrastructure projects. This approach should be followed. Relatively large acquisitions that are largely financed externally (using bank loans, debenture loans) without artificial over-allocation of debt to corporations in member states can, whether or not in a group relationship, be materially affected.

The SME tax-free allowance of (net) € 1 million helps affected companies but is not sufficiently high to prevent the unintended effects. The CFE notes that since 2008, Germany has had a tax-free allowance of € 3 million because of the identified impact on the genuine business sector in the recession and it does not apply the measure to companies that do not form part of a group (*'stand-alone-clause'*). Similarly, the UK's Business Tax Road Map proposes a *de minimis* threshold of GBP 2 million (ca. € 2.5 million). The CFE would therefore like to see the tax-free allowance increased to a level that is higher than the level currently proposed in the draft Directive.

In addition, the CFE notes that the proposed interest deduction limit has various "best practice" provisions that member states are not obliged to implement, but which they can opt to implement on a voluntary basis. This is in conflict with the minimum approach on which the draft Directive is based. As a result, the CFE worries that consistent implementation across the EU of the proposed interest deduction limit cannot be guaranteed. This may have serious negative consequences for the business sector. Fragmented European implementation of anti-abuse legislation thwarts in advance the adoption of financing structures in which the total financing burden is aligned with economic activities. Such a fragmented approach will lead to uncertainty for businesses and could stifle investment growth in the internal market. In addition, there is a potential risk that a group is unable to set off its total external financing burden and that (part) of the external interest costs are not deductible.

In this context the CFE argues for the following amendments to the draft Directive:

- Include a fixed EBITDA percentage of 30% (or up to an amount of € 3 million, whichever is higher), so that no downwards adjustment is permitted by the member states;
- Provide for an automatic deferment option for unutilised EBITDA margin to subsequent years (Article 4, paragraph 4). Under the proposed scheme, it appears that member states can opt to withhold this deferment option from a taxpayer, even though the option is of critical importance in order to cushion the impact of the uneven effect of the proposed interest deduction limit on any cyclical business; and
- A group test (Article 4, paragraph 3) should be implemented by each member state. On the basis of the group test a taxpayer can still deduct all interest costs if he is able to demonstrate that his relative debt financing is not greater than the debt financing of the group as a whole.

The final OECD BEPS report on the deduction of interest includes recommendations to make the scheme more acceptable to the business sector. The CFE regrets that those recommendations have not been adopted in the draft Directive. The CFE calls on the Commission and Council to specifically consider the following OECD recommendations:

- The OECD recommendation to only have the interest deduction limit apply in situations in which there is a group. The CFE is of the opinion that the interest deduction limit proposed in the draft Directive should not affect standalone companies. The CFE specifically notes that for this reason, Germany has included the *stand-alone clause* in its legislation.
- The OECD recommendation to base the group test – like the interest deduction limit – on EBITDA, whereby a taxpayer can deduct interest up to the amount that can be allocated to him in relation to the total external group financing burden on the basis of his share in the group's EBITDA. In contrast, the current draft Directive contains a group test design based on the individual balance sheet of the taxpayer. This balance test has an all-or-nothing approach on the basis of which a taxpayer is exempt from the fixed 30% rule if he is able to demonstrate that his financing burden is not heavier than that of the group. The EU should not choose this approach because it would result in a stricter outcome for many companies. Furthermore, it is worth recommending that the draft Directive should include the OECD recommendation to increase by 10% the external group financing to be apportioned in the framework of the EBITDA group test.[6] Implementing such a 10% increase reduces the risk of a group being unable to deduct its total external financing burden.

The CFE notes that the draft Directive does not provide for any transitional period, while the OECD has expressed that taxpayers should be granted a reasonable period for adapting their financing structure *before* the interest deduction limit enters into force.[7] Furthermore, part of the OECD recommendations include the possibility of excluding existing external monetary loans for a specific period, or even permanently. The CFE calls for a transitional period or grandfathering clause if a European interest deduction limitation is to be agreed upon. There will often be various (long-term) financing agreements with different parties and it takes time to align the financing structure with the new rules. In addition, many member states already have comprehensive domestic rules in place which govern interest deductibility and it is important that they are provided with adequate time to transition to any new rules. The CFE believes that not providing for a grandfathering or transitional clause can only be justified in situations in which there is evidence of clear abuse.

Allowing a taxpayer to claim deductions for "excessive" interest where it has evidence that the interest expense was incurred for a sound business reason would also create fairer conditions.

[6] See paragraph 138 of the final report regarding action point 4 (Limiting Base Erosion Involving Interest Deductions and Other Payments).

[7] See paragraph 194 of the final report regarding action point 4 (Limiting Base Erosion Involving Interest Deductions and Other Payments).

Finally, the precise meaning of the proposed Article 4, paragraph 3, sub e) is unclear. Does this provision address the question as to whether the group has borrowed from affiliated companies outside of the group or is it about the question whether the taxpayer has borrowed from affiliated companies (within or outside of the group)? The CFE asks the Commission to clarify this point.

3.2. Exit tax (Article 5)

The CFE has three comments.

It is not clear from the wording of the proposed Article 5 that it should only apply where the exit state will lose its taxing right (e.g., where assets are transferred to a non-treaty partner state or to a country with which the credit method is agreed). With respect to the transfer of assets from a head office based in a member state to a permanent establishment abroad, the CFE fails to see why an exit tax is necessary if the member state in which the head office is located retains the right to tax any subsequent disposal. In such situation there is no (risk of) abuse, and so the proposed measure would unduly limit the freedom of establishment and movement of capital. This might lead to conflict between the Directive and the fundamental freedoms, as interpreted by the CJEU in the case *DMC*[8], and unacceptable uncertainty. The CFE also believes that, specifically in the event of a transfer of an asset to a permanent establishment in a third country, there is no reason for not permitting a deferment of taxation. This is also the existing system in several member states.

Furthermore, from Article 5, paragraph 3, it seems to be possible to conclude that interest can be charged in the event of deferment of collection. The CFE believes that deferment of collection must be without interest being charged. Charging interest means that the deferment of collection of the exit tax results, in practice, in a dead letter because the interest charges have a hindering effect. The CFE therefore recommends that a specific ban on charging interest, from which the member states may not deviate, is included.

Finally, considering the Directive 2010/24/EU concerning mutual assistance for the recovery of claims relating to taxes, the CFE sees little reason to allow member states to demand security. Because of the possibility that member states have to demand assistance during collection, the EU Court of Justice finds this to be disproportional. The same reasoning would also apply with regard to third states, insofar as they are party to the Multilateral Assistance Treaty or otherwise have effective collaboration with regard to collection with the relevant exit member state.

3.3. Switch-over clause (Article 6)

The CFE has a number of specific concerns as to this clause.

[8] Judgment of 23 January 2014 in case C-164/12, *DMC*, paragraph 56 (link).

First, the CFE notes that no switch-over clause is included in the OECD's BEPS proposals. For this reason, it considers none should be part of the Directive.

Second, the Directive proposal combines a switch-over clause with CFC rules, without rules to address their interrelation, risking multiple taxation is a consequence. For instance, fiscal facilities given in the form of reduced tax bases are not affected by this measure (but depending on the type of activity it may be affected by the CFC measure). This indicates that the switch-over clause and the CFC measure are not logically aligned.

Third, many member states have for many years had a participation exemption, on the basis of which profits generated abroad by a foreign subsidiary are not taxed when distributed to, or realised in the form of a capital gain upon the disposal of the shares of the foreign subsidiary by, the parent company resident in that member state. Often, restrictions apply aimed at combating opportunities of abuse. This has resulted in many cases in a balanced participation exemption regime with a focussed anti-abuse measure, whereby subjection to a subject-to-tax requirement for the subsidiary is only relevant in the event of passive activities (investments and mobile capital), and that works well in practice. Active foreign holdings are therefore not affected by the aforementioned restrictions.
Consistently with that experience and the CJEU case-law, if the draft Directive is to impose a switch-over, it should do so only in cases of abuse. However, the measure proposed in the draft Directive contains no abuse threshold, and simply excludes the exemption from tax on foreign income where the entity or the permanent establishment is subject, in the entity's country of residence or the country in which the permanent establishment is situated, to a tax on profits at a statutory corporate tax rate lower than 40 percent of the statutory tax rate that would have been charged under the applicable corporate tax system in the member state of the taxpayer. The CFE recommends that member states should therefore not accept this aspect of the proposal.

Fourth, the proposal actively interferes with third countries' fiscal sovereignty. In the event that the jurisdiction in which the subsidiary is located grants a legitimate tax incentive in the form of a low tax rate, the benefit derived therefrom is taken back by denying the "participation exemption" in the shareholder's member state.
All forms of tax holidays and low or reduced statutory rates that a third country intentionally grants in order to attract foreign investments will be affected (both legitimate development zones in developing countries, as well as all fiscal facilities in the form of lower rates granted by developed countries).

Fifth, the switch-over does not provide for a credit-carry forward in loss situations, which may be contrary to the CJEU judgment in cases *Haribo* and *Österreichische Salinen*[9].

Sixth, with regard to unambiguously active companies, this measure is in conflict with the internationally accepted principle that tax on profits should be levied where the activities are undertaken. If the draft Directive is implemented, companies located in member states doing business in states with a low

[9] Judgment of 10 February 2011 in cases C-436 and 437/08, *Haribo* and *Österreichische Salinen*, para. 159 (link).

statutory rate will be disadvantaged in their competitive position compared to the local business sector and to competitors located in non-EU jurisdictions that have a participation exemption regime.

Seventh, ”*patent box*” regimes that apply in many member states that are shaped by a lower tax rate are regarded as abuse (while shaping them by means of a lower tax basis is apparently not abuse). This measure will therefore intensify the “race-to-the-bottom” with regard to rates. The lower the rate in the shareholder’s country of establishment, the higher the benefit that can be gained from lower rates outside of the EU. To repeat: the CFE points out that, because under the 40%-test there is a link to (40% of) the statutory rate of the member state in which the taxpayer is based, this results in a disadvantage for companies in member states in which the rate is relatively high. This therefore is likely to intensify the “race-to-the-bottom” effect if member states will react to this by lowering their statutory tax rates.

Eighth, the CFE considers it vitally important to clarify that the credit that should be given on the basis of the switch-over extends to the taxes levied at source that are owed by the taxpayer as well as - in holding situations - to the tax on profit levied from direct or indirect participation.

Ninth, the CFE recommends that the text of the Directive clearly state how, for example, a temporary tax holiday has to be handled in a country that ordinarily has a high corporation tax rate. Is this or is this not relevant to the question about whether the test based on the statutory rate is complied with? Furthermore, the CFE assumes that a local holding exemption, or the use of an offshore regime, has no effect on the test – which is important for the switch-over clause – based on the statutory rate. The text of the Directive or the explanatory notes should provide greater clarity. The CFE considers it incorrect that a low tax rate general regime triggers application of the switch-over rule where a base reduction under a high tax rate regime does not.

Tenth, the switch-over clause does not clearly spell out that the credit has to be calculated based on the foreign nominal tax rate, contrary to the CJEU´s judgment in the case “*FII 2*”[10].

Eleventh, given the evident objective of the switch-over clause, namely the prevention of low-taxed income entering the European Union ‘tax free’, it is in the CFE’s opinion incorrect that the foreign tax credit is (apparently) to be restricted to the tax at the level of the direct participation. After all, for the question about whether income is taxed at a low rate, it is necessary to look at the tax at all levels, not just the last link in the chain before the income enters the European Union.
The switch-over clause will even result in the levying of international double taxation if a low-taxed company´s direct subsidiary in turn has holdings in high-tax countries. The group that is liable via the direct holding will then be subjected to a high rate under the switch-over clause, but no credit will be given for the tax levied at the level of the lower-tier subsidiaries.

Twelveth, the CFE recommends that the switch-over clause not apply to foreign property and (other) non-mobile activities (therefore active operational activities with genuine substance). In that case, the choice

[10] Judgment of 13 November 2012 in case C-35/11, *Test Claimants in the FII Group Litigation*, paras. 62-64 (link).

about having assets/activities in the relevant foreign country would be based simply on economic grounds and in accordance with the internationally accepted principle profit should simply be taxed where the genuine activities are undertaken.

Finally, according to some countries´ legal systems[11], tax treaties are higher-ranking than national legislation, including national legislation that implements an EU Directive. As a consequence, national legislation implementing the switch-over clause could not override an existing tax treaty with a third country providing for a different outcome. The CFE would like to receive confirmation whether this issue has been considered by the Commission.

3.4. CFC measure (Articles 8 and 9)

Again the CFE has several concerns.

To the extent the CFC rules concern entities in third countries, these CFC rules deviate from the EU Commission's and the OECD's key proposal which maintains that income should be taxed based on transfer pricing rules where such value is realised.

Many member states already have CFC legislation in place, provided that the categories of activities proposed in this new measure are much broader and also include activities which, in the view of many member states, are sufficiently "active" in order to be covered by a participation exemption rather than by the CFC rules. Examples include genuine insurance and banking activities, genuine inter-group services as well as active group financing activities. The CFE is not aware that the CFC legislation of member states leads to abuse. Again, these CFC rules have been developed over time, often in consultation with industry, and have been amended so as to deal with practical problems arising. It is therefore unclear why a more extensive CFC measure would be required.

The CFE believes that dividend income and income resulting from the sale of shares is incorrectly deemed to be 'contaminated' income (Article 8, paragraph 1, section c, sub (iii)). This means that companies that carry out operational activities and that own shares in a majority-owned subsidiary are deemed to be a CFC company, even if such subsidiary only undertakes operational activities.

In the CFE's opinion, this CFC rule will involve major administrative burdens. It seems that the foreign tax basis would have to be recalculated to the tax basis of the relevant member state in order to compare the effective rates. But even this is not clear. The plain words of Article 8(1)(b) envisage a notional comparison of effective rates in the two systems, not by reference to specific profits, and excluding provisions which are not part of the "general regime". This uncertainty must be resolved.

Another undesirable consequence of including dividend income and income from the sale of shares as "contaminated" income is that a holding can be regarded as a CFC in one year but not in another year. Amongst other things, this will result in substantial administrative burdens, for example keeping records

[11] e.g. Ireland and the Netherlands

in years a dividend is subject to the switch-over clause (is that from a CFC year or from a non-CFC year?). This will result in classification and tracking issues (i.e. contaminated and non-contaminated income need to be distinguished). The draft Directive does not address this issue.

The CFE observes that Article 8 does not provide for a tax credit if and when foreign income needs to be reported as taxable income on the basis of this provision. Such a credit is available under certain conditions under the switch-over clause. However, income may need to be recognised at another time under the CFC rule – for example in the case of a capital gain – than under the switch-over clause (at the time of the distribution).

As stated above, the CFC rule and the switch-over clause do not properly interrelate. For example, the situation can arise whereby a holding is covered by the CFC clause but not under the switch-over clause. That is the case if the statutory rate in the country in which the holding is based is relatively high (higher than 40% of the rate in the member state in which the shareholder is established), while the effective rate is relatively low (due to basis deviations). In that case, no credit is granted under the switch-over clause and the CFC rule, as pointed out above, does not provide for a tax credit.

With respect to the definition of artificial establishment in a third country in Article 8, paragraph 2, first sentence and the definition of an artificial arrangement or a series thereof in the third sentence, the CFE raises the question how these provision relate to the GAAR of Article 7, according to which an arrangement or a series of arrangements shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality. Should not all provisions that address the same or similar issues be combined in one consistent set of rules? In this sentence it is unclear why a permanent establishment in the EEA of a third country entity is not protected.

With respect to the arm's length principle laid down in the fourth sentence of Article 8, subparagraph 2. the CFE questions the need and usefulness of this provision. It is not clear why this rule on arm's length amounts (in the context of "non-genuine" arrangements) has been included in the context of the CFC rule.

The CFE is of the opinion that the draft Directive should also clarify that CFC income can only be taxed in one member state under this provision. For example, if a UK company holds shares in a Dutch company which in turn holds shares in a low-taxed company in a third country, that low-taxed company is a CFC company for both the United Kingdom and the Netherlands. In the CFE's opinion, it should not be the intention that both the Netherlands and the United Kingdom will tax the undistributed income of the CFC company. The CFE believes that it should only be collected in the Netherlands. This can be clarified by including the word 'direct' in front of the word 'entitlement' in Article 9, paragraph 2.

The CFE wishes to make the observation that the CFC rules may lead to new forms of tax planning to mitigate its impact. For example, if a corporation located in a high tax member state that imposes corporate income tax at a rate of 25% owns shares in a CFC, the application of the CFC rules would result in the non-distributed income of the CFC entity to be taxed at an effective rate of 25%. By routing the investment through a jurisdiction that levies corporate income tax at an effective rate of at least 40% of the aforementioned (i.e. a rate of 10% or more), the effective tax rate would be reduced by up to 60%. Other examples include swamping of the tainted activity by "good" activities to ensure a CFC does not fail the 50% test in Article 8(1)(c), and moving significant people functions from a parent to a sister subsidiary (Article 8(2), paras 4 and 5).

Finally, article 8, paragraph 1, sub a, states that the 50% criterion is to be determined on the basis of 'the taxpayer by itself or together with its associated enterprises as defined under the applicable corporate tax system'. For example, the Italian CFC rules have been recently amended to exclude foreign companies in which an Italian entity does not hold a majority participation (i.e. it holds less than 50% of the share capital) from the scope of the CFC rules, and to eliminate the need for a mandatory advance tax ruling to obtain an exemption from CFC rules. The CFE wonders why the member states are being given so much opportunity of interpreting the 50% criterion themselves. The member states are given the choice about whether or not to interpret the 50% criterion 'by itself or together with its associated enterprises' and, furthermore, the member states may themselves define the 'associated enterprises'. This results in many different possibilities and applications of the CFC rule. The UK, for instance, has multiple definitions of "associated enterprises" and similar terms. Which one will apply? If the CFC rule is to be enforced the CFE recommends a clearer definition so that the CFC rules are applied consistently within the EU.

3.5. GAAR measure (Article 7)

The CFE regards the principle behind this measure as one "no-one can object to". However, there are genuine concerns regarding the measure itself.

The definition of abuse is extremely general and broad; terms such as "non-genuine", "essential purpose", "valid economic reasons" and "economic reality" are vague and multi-interpretable. This leads to uncertainty as to the scope of the GAAR and opens the possibility that member states will interpretate the terms differently.

In at least in the UK, this measure would also introduce a wholly new approach to statutory interpretation. UK legislation is interpreted in an textualist way. The concepts of "object" and "purpose" are not clearly identifiable, and have different meanings than might be expected in other jurisdictions. When the UK introduced its own GAAR in 2013 after extensive consultation it included wording specifically designed to address this problem. The uncertainty arising from this was acceptable when this GAAR wording was confined to EU legislation (eg the Parent-Subsidiary Directive (EU) 2015/121) but is not acceptable when applied to the full UK corporate tax code.

Further, this wording is clearly linked to the *Halifax* test applicable to VAT. But is it meant to be identical? What will happen if that test develops further in the case law?

In the CFE's view, there has to be an arrangement that prevents double taxation caused by applying the anti-abuse provision. On the basis of the anti-abuse provision, member states can attach different fiscal consequences to a particular fact pattern. The current text allows only a part of the transaction (in one

member state) to be ignored, while the fiscal consequences of the other part of the transaction remain unaffected in the other member state. International double taxation can arise as a result of this. Counterbalancing should take place either by an obligation of a corresponding correction in the other member state (both states apply the GAAR and both ignore the contested transaction, even if this means that a profit element is not therefore taxed in one state because it is already taxed in another state due to the application of the GAAR).
The measure should also provide for corresponding adjustments to personal tax where that is relevant.

Due to the use of vague terms and inadequate definition of abuse through examples and explanatory notes, there is also a risk that member states start using the GAAR for purposes other than hard abuse (for example to tax larger proportions of the profit of multinationals). A European solution should therefore have a truly European effect. This requires that the other member states involved are also convinced of the abuse character. Including a provision to this effect in the GAAR would raise the threshold against improper use of the GAAR by member states.

If there is double taxation because, e.g., no measure for corresponding adjustments is included in the Directive, or two or more member states have different views on whether there is an abuse situation, a procedure should be commenced in order to resolve that dispute between the tax authorities involved. This is the purpose of the Arbitration Convention, as far as double taxation arises from an adjustment in transfer pricing. However, the Arbitration Convention has proven to be not very effective in practice. Because the draft Directive would increase the possibility of double taxation in a range of areas, the CFE is of the opinion that the Commission, in support of the introduction of the draft Directive, should accelerare work on extending the Arbitration Convention and making it more effective.

3.6. Hybrid mismatches (Article 10)

The existence of hybrid mismatches between EU tax systems is an outstanding example of a matter that has to be resolved in an EU context. A member state is unable to do that alone. That is also the purport of the OECD recommendations in this area.[12] The CFE therefore welcomes that the Commission proposes measures in this area.
The CFE notes however that the approach proposed by the Commission deviates substantially from the OECD Recommendations, resulting in discoordination with third states that legislate in accordance with the OECD, with adverse consequences for European businesses that also operate outside of the EU.

Article 10 of the draft Directive provides, in brief, for an arrangement for the situation in which two member states give a different fiscal qualification to an entity with the result that a payment is deductible in two member states, or is deductible in one member state without a corresponding levy in another member state. Furthermore, Article 10 provides for an arrangement for the situation in which one member state regards an activity as a permanent establishment while the other member state does not. Finally, the proposed Article 10 addresses the situation in which two member states give a different legal

[12] Final report on BEPS Action 2, "Neutralising the Effects of Hybrid Mismatch Arrangements" (link)

characterisation to the same payment (hybrid instrument) and this leads to a situation where there is a deduction in the member state in which the payment has its source without a corresponding inclusion of the same payment in the other member state. The CFE notes that there is a need for definition of "inclusion" of a payment in the receiving member state. Does it simply mean that it would form part of the taxable income? What if that income is taxed at a low rate or is exempt?
The OECD recommendations boil down to what is known as “linking rules” which, in the case of a hybrid mismatch, cancel a deductible item or include a payment received in the levy.

The arrangement proposed by the Commission goes much further and results in complete mutual recognition of the fiscal qualification of an entity, permanent establishment or financial instrument. Under that arrangement the source state of the payment is always the guiding principle. It is unclear to the CFE why such a far-reaching intervention in the national corporation tax systems has been chosen. The sovereign right of a member state to determine which entities are independent taxpayers for the levying of corporation tax will consequently be affected to a great extent. The full requalification of hybrid entities proposed by the Commission undeniably also has indirect effects on the income tax systems of the member states. Even if the OECD methodology is vulnerable to challenge under the EU freedoms, very careful thought is needed before adopting such a wide-ranging measure instead of that methodology.

It should be noted that the UK continues to pursue new legislative proposals consistent with the OECD model; the same applies to draft German legislation.

The solution chosen by the European Commission results in other outcomes than the OECD Recommendations. The following example is derived from the final report on BEPS Action 2:[13]

Example
Company A, based in member state A, holds all of the shares in hybrid entity B, which is based in member state B. From member state A’s perspective, hybrid entity B is fiscally transparent and from member state B’s perspective it is fiscally non-transparent. If company A provides a financial loan to hybrid entity B, this will result in deduction of interest payment in member state B without any corresponding levy in member state A. The interest deduction at the level of hybrid entity B will then be used in member state B to offset the profit of a group company which is also established in member state B (for example via a consolidation regime or arrangement for loss carry-over within the group).

The primary solution of the OECD is that member state B should refuse the deduction of interest payment. This neutralisation seems logical. However, under the proposed Article 10 of the draft Directive, member state A must fully adopt the non-transparent qualification that member state B gives to the hybrid entity. The result of this is that the interest payment also becomes apparent in member state A so that member state A will proceed to levy on the interest received. An outcome therefore that is contrary to the OECD recommendations.

[13] This concerns example 3.1 relating to a so-called “disregarded hybrid payment”.

The CFE points out that under the laws of certain jurisdictions the application of the anti-hybrid interest rules can lead to unintended adverse consequences. For example, if one reads the Netherlands for member state A in the aforementioned example and (in addition to company A) a natural person also participates in the hybrid entity, this natural person could very well be regarded as having a so-called substantial interest in the hybrid entity which leads to the natural person being subjected to a fundamentally different tax regime. In the CFE's view it goes without saying that in practice unworkable situations will arise from this.

The CFE recommends that appropriate steps be taken to ensure that the "anti-hybrid mismatch rules" proposed by the Commission are properly thought through by the member states. The CFE suggests that in any event the scope of any European "anti-hybrid mismatch rules" be restricted in a manner that conforms to the OECD. In real terms, this means:

- Rules that aim to neutralise the fiscal mismatches in relation to *hybrid entities* should be restricted to mismatches in a *group context*. The OECD definition of a group is an interest of 50% or more.
- Rules that aim to neutralise the fiscal mismatches in relation to *financial instruments* should be restricted to mismatches in *associated relationships*. The OECD defines associated relationships as an interest of 25% or more.

4. Substantive conclusions

The following substantive conclusions can be formulated on the basis of the above:

a) The draft Directive lacks an even and balanced approach with regard to:
   - the relationship with third states;
   - a harmonised approach to abuse where there is a good reason;
   - the prevention of gold-plating and solutions for incorrect international double taxation caused by the proposed measures;
   - the adverse consequences for businesses that do not use aggressive tax structures;
   - the long-term legal tenability;
   - a grandfathering or transitional clause for existing and non-abusive situations.

b) The CFE concludes that in its current form, the draft Directive can negatively impact the EU competiveness and the envisaged clarity and consistency of the tax framework. If, despite this, member states decide to adopt the Directive, choices should be made during implementation to minimise damage to *bona fide* businesses.
c) In the event that the draft Directive is to be amended, member states must work actively on measures that tackle the essence of abuse, i.e. such action should be focussed on passive and mobile income and artificial structuring (for example using internal group interest and royalty structures) but should not impact on active, operational structures (including active group financing structures and *bona fide* holding activities) with substance abroad. The member states

should not accept a generic interest measure that also affects external paid interest of non-international group structures.

d) The CFE sees substantial issues with:
   - the generic interest deduction limit in its entirety and the lack of a stand-alone exception in particular, the lack of a much broader tax-free allowance and the lack of transitory law for non-abuse situations;
   - the entire switch-over clause;
   - the exit tax measure insofar as it concerns the transfer of assets to a permanent establishment from a head office and insofar as security has to be provided for tax in cases in which assistance for recovery is available for the exit member state;
   - the CFC measure insofar as the categories of activities also concern genuine active operational activities (including active group financing activities) and holding activities (everything that does not concern passive or mobile income);
   - the vagueness of the term abuse in the GAAR provisions and the lack of specific concrete measures against the levying of incorrect international double taxation; and
   - the hybrid mismatch measure insofar as it is not OECD compliant.