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AMENDMENT OF THE EU PARENT-SUBSIDIARY DIRECTIVE 2011/96/EU

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1. Introduction

On 20 June, 2014 the European Union's Economic and Financial Affairs Council (ECOFIN)[i] reached an agreement on amending the Parent-Subsidiary Directive 2011/96/EU[ii] (hereinafter *PSD*) to prevent the double non-taxation of distributed profits deriving from *hybrid loan arrangements*[iii].

The amendment is aimed at neutralizing the effects that may arise due to a different qualification of such loans between EU Member States, resulting in a double non-taxation and unintended tax benefits for corporate groups.

Member States will have until 31 December, 2015 to transpose this revised rule into their national tax systems.

2. The Parent-Subsidiary Directive 2011/96/EU

Since 1990[iv] the Parent-Subsidiary Directive was designed to eliminate any tax obstacle in the area of profit distributions among companies of the same group but located in different EU Member States by:

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- abolishing withholding taxes on profit distributions by a subsidiary to its parent company (article 5), and
- eliminating double taxation on the distributed profits. The State of the parent company must either exempt such profit distributions from tax or provide credit for tax paid by the subsidiary on the relevant underlying income (article 4).

In order to apply the provisions of the Parent-Subsidiary Directive 2011/96/EU, the following four conditions must be met:

1) the parent company must hold at least 10% in the capital of the subsidiary[v];
2) both companies have a legal form as one of those specified by the annex to the Directive;
3) both companies are established in a Member State;
4) both companies are subject to Corporate Income Tax in a Member State.

Over the last years the amendments to the Directive have gradually reduced the *minimum shareholding* by the parent company in the subsidiary (from 25% in Directive 90/435/ECC to 20% from 1 January 2005, 15% from 1 January 2007 and 10% from 1 January 2009), going so far as not considering any *holding period* in order to benefit from tax exemption on distributed profits[vi].

However, the benefits of the *PSD* should not lead to situations of double non-taxation and, therefore, generate unintended tax benefits within groups of companies in the EU when compared to groups of companies within the same Member State. In the specific context of hybrid loans arrangements, groups of companies would be able to exploit mismatches between different domestic tax rules so that the payments made by a subsidiary are classified as tax deductible payments while the profits received by the parent company are treated as a tax-free distributions under the *PSD*'s rules.

To illustrate this scenario, the following example can be helpful. Company X, resident in Member State A, has an interest of 100% in

Company Y, resident in Member State B. Company X grants a *hybrid loan* to Company Y, repayable in 10 years. Under the tax rules in Member State A, the *hybrid loan* is treated as equity and payments received are tax exempt. In Member State B, where subsidiary Y is resident, the *hybrid loan* is treated as debt and payments to Company X are treated as deductible expenses.

In this situation:

- each year Company Y would deduct an amount (interests) from the taxable profit, and
- according to the tax rules in Member State A, the amount annually received from the subsidiary Y would not be taxed at the level of the parent company X.

The final result of such arrangement would be a double non-taxation and a double loss of revenues for Member States.

3. Amendment to the Directive

At EU level, many efforts have been made to adopt a common and more comprehensive anti-abuse rule that would prevent artificial arrangements used for tax avoidance purposes, and allow the taxation of these arrangements on the basis of their real economic substance.

In respect of hybrid financial mismatches, on 6 December 2012 the European Commission released an *Action plan to strengthen the fight against tax fraud and tax evasion*[vii] which (i) encourage for a revision of the *PSD* ("… *issues such as hybrid loans and hybrid entities, and differences in the qualification of such structures between jurisdictions, is an area of particular importance. Detailed discussions with Member States have shown that in a specific case an agreed solution cannot be achieved without a legislative amendment of the Parent-Subsidiary Directive. The objective will be to ensure that the application of the directive does not inadvertently prevent effective action against double non-taxation in the area of hybrid loan structures*") and (ii) announce a review of anti-abuse provisions by adopting a common general anti-abuse rule in the EU Legislation.

On 21 May 2013, the European Parliament adopted a Resolution[viii] whereby "*calls on the Commission to present in 2013 a proposal for the revision of the*

Parent-Subsidiary Directive and the Interests and Royalties Directive, with a view to revise and align the anti/abuse clauses within both Directives and to eliminate double non-taxation as facilitated by hybrid entities and financial instruments in the EU".

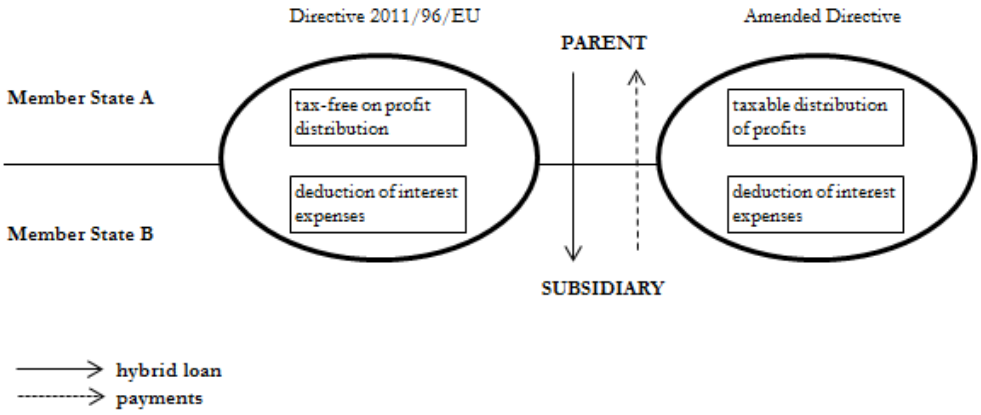
Considering that only a common and coordinated initiative would be able to solve discrepancies that originate from the interaction of different national tax systems, on 25 November 2013 the European Commission has proposed certain changes[ix] to the Parent-Subsidiary Directive in order to significantly reduce tax fraud, tax evasion and aggressive tax planning in the European Union. The main changes have been identified in (i) hybrid financial mismatches and (ii) the anti-abuse provision[x].

Last but not least, during the meeting held on 20 December 2013[xi] the European Council pushes again for "*fight against tax fraud and evasion, aggressive tax planning, base erosion and profit shifting (BEPS)*", with a specific focus on the amendments to the *PSD*.

In light of these developments, on 3 June 2014 the Council of the European Union in Article 1 of the "*Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States – Political Agreement*"[xii] (hereinafter *Agreement*) adopted the following amendment[xiii]:

> "*Directive 2011/96/EU is amended as follows:*
>
> 1. *In Article 4, paragraph 1, point (a) is replaced by the following:*
> *(a) refrain from taxing such profits* ***<u>to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary</u>***
> 2. *(…)*
> 3. *(…)*"

Hence, in a situation where a loan is treated as equity in the Member State of the parent company and as debt in the Member State of the subsidiary, the amended Directive ensures that the payments received would no longer be exempt in the former Member State, which would then tax the amount *pro-quota* of the payments which are deductible in the Member State of the subsidiary.



According to Article 2 of the *Agreement*, Member States are required to "***bring into force*** *the laws, regulations and administrative provisions necessary to comply with this Directive* ***by 31 December 2015 at the latest*** *(…). When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made*"[xiv].

The Council of the European Union during the semester of the Italian presidency, on behalf of Mr. Pier Carlo Padoan[xv], stated that: "*The adoption of this amendment to the parent-subsidiary directive is an important step change in the fight against aggressive tax planning. It represents a concrete achievement of the EU in this area, in line with international efforts to combat tax evasion and avoidance*"[xvi].

Concluding, the ECOFIN on its final conclusions[xvii] remarked the idea that the amended Directive is intended to ensure that:

- companies won't design their tax-planning in such a manner as to enjoy of an intended double-non taxation (due to differences in the tax treatment of profit distribution between Member States);
- the Member State of a parent company will refrain from taxing only distributed profits that are not tax deductible in the Member State of the subsidiary.

4. Conclusions

The amended Parent-Subsidiary Directive includes a limitation on the exemption of payments received from *hybrid loan arrangements*. Pursuant to this limitation, the Member State where the parent company is established shall tax profits distributed by its subsidiary located in another Member State, to the extent such profits are tax deductible in the latter. Therefore, the Member State where the parent company is established shall refrain from taxing such profits only to the extent such profits are not deductible by the subsidiary.

The proposal to amend the *PSD* should be seen as part of the efforts made at international level to fight aggressive tax planning, tax avoidance and tax evasion that enable base erosion and profit shifting. It addresses an aspect of hybrid instruments between intra-EU entities but not instruments between EU and non-EU companies.

The Directive closely follows the OECD initiatives in the field of base erosion and profit shifting. On 17 September 2014 the OECD has released the first set of deliverables for 7 of the 15-point Action Plan, including a focus on Action 2 "*Neutralizing the effects of hybrid mismatch arrangements*"[xviii].

However the work done by the OECD is going much further than the EU. Not only because the EU's action is limited to the European cross-border transactions but also for the issues covered. The amended Directive focuses on the *hybrid loans*, whereas Action 2 of BEPS focuses on mismatches that derive from the use of *hybrid entities*[xix] (where the same entity is treated differently under the laws of two or more jurisdictions) or *hybrid instruments*[xx] (where there is a conflict in the treatment of the same instrument under the laws of two or more jurisdictions).

Concluding, in author's view, even though at EU level all possible efforts have been made to improve the scope of the Directive, several doubts remain about its effectiveness to combat base erosion and profit shifting. The scope of the *PSD* is still limited to countering only *hybrid loans arrangements* (and in so doing, does not include any other types of mismatches) and it does not address how the income from such instruments must be taxed by the Member States.

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[i] Composed by the 28 Minister of Finance of the European Union.

[ii] *Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*.

[iii] Hybrid loans arrangements are financial instruments that have characteristics of both debt and equity.

[iv] Directive 90/435/ECC.

[v] In several sentences the European Court of Justice highlighted on the immediate applicability of the *PSD* once that the conditions set out (in term of minimum shareholding) are met.

[vi] Article 3 of the original PSD (Directive 90/435/ECC of 23 July 1990): "*By way of derogation from paragraph 1, Member States shall have the option of:*

> *(a) replacing, by means of bilateral agreement, the criterion of a holding in the capital by that of a holding of voting rights;*
>
> *(b) not applying this Directive to companies of that Member State, which do not maintain for an uninterrupted period of at least 2 years holdings qualifying them as parent companies, or to those of their companies in which a company of another Member State does not maintain such a holding for an uninterrupted period of at least 2 years*"

[vii] EU Commission, *An Action Plan to strengthen the fight against tax fraud and tax evasion*, http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf, paragraph 4 "Future initiatives and actions to be developed", section 14 (*A revision of the parent subsidiary directive (2011/96/EU)*) and 15 (*A review of anti-abuse provision in EU legislation*)

[viii] European Parliament, *Resolution on fight against tax fraud, tax evasion and tax havens*, http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2013-0205+0+DOC+XML+V0//EN

[ix] Council of the European Union, *Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* (doc. 16918/13), http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2016918%202013%20INIT

[x] The ECOFIN on its final conclusions proposed to replace the existing anti-abuse provision with a common general anti-abuse rule (GAAR), based on its *Action plan to strengthen the fight against tax fraud and tax evasion* delivered on 6 December 2012. The new provision will be discussed during the Italian six-monthly EU Council Presidency.

[xi] Council of the European Union, *Conclusions on Meeting held on 19/20 December 2013*, https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/140245.pdf

[xii] Council of the European Union, *Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* (doc. 10419/14), http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2010419%202014%20INIT

[xiii] "*Directive 2011/96/EU is amended as follows:*

1. *In Article 4, paragraph 1, point (a) is replaced by the following:*
   "(a) refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary; or "
2. *In Annex I, part A, point (w) is replaced by the following:*
   "(w) companies under Romanian law known as: 'societăţi pe acţiuni', 'societăţi în comandită pe acţiuni', 'societăţi cu răspundere limitată', 'societăţi în nume colectiv', 'societăţi în comandită simplă';"
3. *In Annex I, part A, point (u) is replaced by the following:*
   "(u) companies under Polish law known as: 'spółka akcyjna', 'spółka z ograniczoną odpowiedzialnością', spółka komandytowo-akcyjna".

[xiv] *"1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 31 December 2015 at the latest. They shall forthwith communicate to the Commission the text of those provisions.*
When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.
2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive".

[xv] Ministry of Economy and Finance of Italy

[xvi] Council of the European Union, *Council adopts amendment closing tax loophole for corporate groups*, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/143709.pdf

[xvii] Council of the European Union, *Council agrees to close tax loophole for corporate groups*, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/143274.pdf

[xviii] OECD, *Base Erosion and Profit Shifting Project - Neutralizing the effects of hybrid mismatch arrangements,* http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements_9789264218819-en

[xix] OECD, *Base Erosion and Profit Shifting Project - Neutralizing the effects of hybrid mismatch arrangements,* http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements_9789264218819-en, paragraph 47.

[xx] OECD, *Base Erosion and Profit Shifting Project - Neutralizing the effects of hybrid mismatch arrangements,* http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements_9789264218819-en, paragraph 47.