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NEW ANTI-ABUSE CLAUSE TO THE EU PARENT-SUBSIDIARY DIRECTIVE

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1. Introduction

On 27 January 2015, the EU Council has formally adopted[i] the latest amendment to the Parent-Subsidiary Directive 2011/96/EU[ii] (hereinafter *PSD*) to prevent, on behalf of a new **anti-abuse clause**, tax avoidance and aggressive tax planning by corporate groups. It is aimed at helping governments tackle *non-genuine arrangements* that have been put into place to obtain tax advantages, without reflecting *economic reality*.

An earlier amendment was agreed at the Council's meeting on 20 June 2014 and adopted on 8 July, to prevent double non-taxation (and unintended tax benefits for corporate groups) of distributed profits deriving from *hybrid loan arrangements* by neutralizing the effects that may arise due to different qualifications of such loans between EU Member States.

Member States have until **31 December 2015** to introduce an *anti-abuse rule* into their national law, for the transposition of the July 2014 amendments tackling *hybrid loan mismatches*.

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2. The previous amendments to the Parent-Subsidiary Directive 2011/96/EU

The Parent-Subsidiary Directive has been established, since its draft in 1990 (Directive 90/434/ECC), to ensure the avoidance of double taxation on profit distribution made by a subsidiary located in one Member State and received by its parent located in another Member State. According to the *PSD*, four conditions must be cumulatively met: i) the parent company holds at least 10% in the subsidiary's capital, ii) both companies have one of the legal forms specified in the Annex to the Directive, iii) both companies are established in Member States, and iv) both companies are subject to Corporate Income Tax in a Member State.

The Directive has been amended several times, mainly following the accession of new Member States, with a progressive reduction of the shareholding percentage requirements (from 25% in Directive 90/435/ECC to 20% from 1 January 2005, 15% from 1 January 2007 and 10% from 1 January 2009) and the elimination of double taxation for subsidiaries of subsidiary companies.

In 2011 the "final" Directive 2011/96/EU was drafted, establishing that Member States are required to exempt from taxation profits received by parent companies from their subsidiaries in other Member States.

However, as specified by the statement of the EU Commissioner for Economic and Financial Affairs, Taxation and Customs[iii], even if the *PSD* "*was originally conceived to prevent same-group companies (…) from being taxed twice on the same income, (…) certain companies have exploited provisions in the directive and mismatches between national tax rules* ***to avoid being taxed at all in any Member State*** *(double non-taxation)*". In this regard and in light of the *Action plan to strengthen the fight against tax fraud and tax evasion*[iv] released by the European Commission on 2012 (as well as the *BEPS project* issued by the OECD on 2013), the Commission proposed amendments to the P*SD* to fill a loophole that allowed its misuse for the purposes of tax avoidance.

Two amendments were proposed:

1) provisions designed to prevent corporate groups from using hybrid loan arrangements to benefit from double non-taxation under the *PSD*, and
2) introduction of a general anti-abuse rule (GAAR).

The one adopted on July 2014[v] addressed the mismatches of *hybrid loans* originated from the interaction of different national tax systems, in the specific context of instruments where payments made by a subsidiary are classified as tax deductible while the profits received by the parent company are treated as tax-free distributions under the *PSD*'s rules. The Council of the European Union amended **Article 4(1)** of the "*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*" 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"*

Given those assumptions, 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.

Concerning the anti-abuse rule, the Directive 2011/96/EU in Article 1(2) allowed Member States to apply domestic or agreement-based provisions required for the prevention of fraud (as a form of deliberate evasion of tax which is generally punishable under criminal law) or abuse (as a set of illegal arrangements where liability to tax is hidden or ignored[vi]). In particular, this provision must be interpreted in light of the European Court of Justice (hereinafter *ECJ*) jurisprudence, where it is upheld the principle that the anti-abuse measures applied from Member States cannot go beyond the general Community Law principle when countering abusive behavior[vii].

3. The Anti-Abuse Clause and "de minimis" rule

"*With the Council's adoption of the anti-abuse clause of the Parent Subsidiary Directive today, the European Union is living up to its pledge of tackling tax evasion and aggressive tax planning. Today, we are building on the existing EU legislative framework to ensure a level-playing field for honest businesses in the EU's Single Market and we are closing down loopholes that could be exploited for aggressive tax planning. This achievement paves the way for other measures in this area. In particular, we are committed to extending the automatic exchange of information on tax rulings and we will present a legal proposal by Spring 2015*" said the EU Commissioner for Economic and Financial Affairs, Taxation and Customs[viii].

The *anti-abuse clause* will require Member States to withdraw the benefits of the *PSD* to those arrangements that are **not recognizably genuine** and that have been put into place to obtain an improper tax advantage **without reflecting economic reality**. The clause will prevent dividends and other profit distributions (within the scope of the Directive, as set in Article 1) paid by subsidiary companies to their parent companies from being misused for the purposes of tax avoidance, tackling an artificial arrangement or an artificial series of arrangements not justified by valid commercial reasons (other than the tax fraud or tax evasion).

Therefore, in light of the political agreement reached on 9 December 2014[ix] and formally adopted on 27 January 2015 by the EU Council, **Article 1(2)** of the "*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*" is replaced by the following:

> " *2. Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are* ***not genuine*** *having regard to all relevant facts and circumstances.*
>
> *An arrangement may comprise more than one step or part.*

3. *For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for* ***valid commercial reasons*** *which* ***reflect economic reality****.*
4. *This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse.*"

The spirit and the purpose of the new tax provision would require a clear definition of "artificial arrangements", considering how sometimes taxpayers may use those structures to relocate their tax base to other (low-tax) jurisdictions. According to the European Commission, **indicators** of an artificial arrangement or a series of artificial arrangements are:

- the legal characterization of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole;
- the arrangement is carried out in a manner which would not ordinarily be used in a reasonable business conduct;
- the arrangement includes elements which have the effect of offsetting or cancelling each other;
- the transactions concluded are circular in nature;
- the arrangement results in a significant tax benefit which is not reflected in the business risks undertaken by the taxpayer or its cash flows.

The *ECJ* also dealt with the **definition of "wholly artificial arrangements"** as a determining factor in the legitimacy of a national anti-abuse clause restricting fundamental freedoms. In *Cadbury Schweppes*[x] (Case 196/04) the Court considered that the presence of an artificial arrangement must be determined with reference to the *physical presence* (in terms of staff and equipment). Where physical presence does not exist, there would be enough elements to target the structure as a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State. Furthermore, the Advocate General (hereinafter *AG*) in *Cadbury Schweppes* found other relevant indicators in addition to physical

presence[xi]: i) *genuine nature of the activity provided by the subsidiary* and ii) *the economic value of that activity with regard to the parent company and the entire group*. Both conditions were not considered by the *ECJ* in the decision itself, but were mentioned by the *AG* as important circumstances that can contribute to identifying the nature of the arrangement.

In such a scenario, the agreement on the anti-abuse provision of the *PSD* will be helpful to prevent misuses of the Directive and to ensure a greater consistency in its application in different Member States, without prejudice to stricter national rules, which Member States may apply, as long as they meet minimum EU requirements.

The new GAAR will consist of two elements:

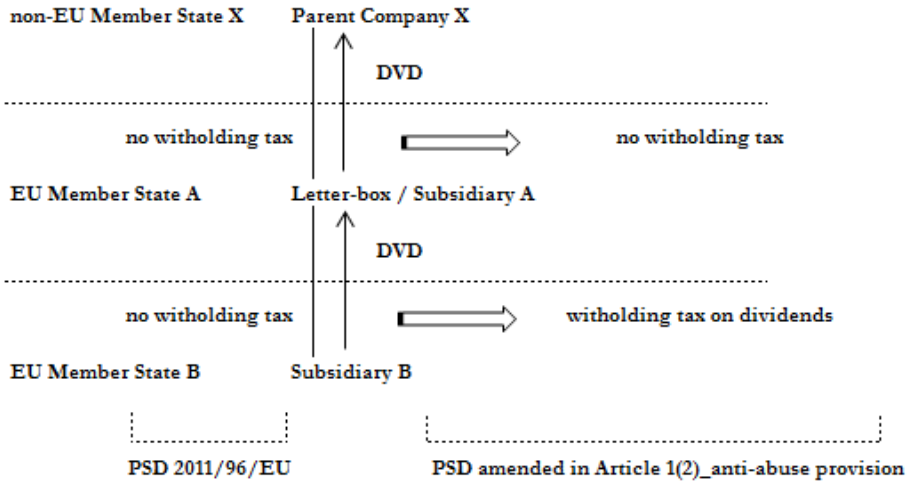
- a **subjective test** (whether an advantage is obtained by artificially creating the conditions[xii]) to evaluate if the arrangement is "*put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive*";
- an **objective test** (whether the actions are contrary to the objectives of EU Law) to check for lack of economic reality in the operation that is put in place with the selected arrangement.

It seems targeted primarily at arrangements where "letterbox" companies or "front" subsidiaries (generally both defined as a business established in a tax friendly country just for purposes of minimizing its tax liability) are used to benefit from the *PSD*'s advantages.

As an illustration. The Parent Company X, non-EU based, has an interest in Company A ("letter-box" or "front" subsidiary), resident in Member State A, which itself has an interest (meeting the minimum EU requirements) in Company B, resident in Member State B. Company B pays a dividends to Company A, which in turn pays its dividends to the Parent Company X. Further, assuming that Member State B imposes a withholding tax on dividends, while Member State A does not. Considering that Subsidiary A can benefit of the *PSD* in Member State B to eliminate the withholding tax, the real target of Subsidiary A in this scheme is clear. The

final result of such arrangement would be an improper non-taxation and a loss of revenues.

However, applying the new anti-abuse provision, Member State B can invoke the new Article 1(2) of the *PSD* to prevent an artificial misuse of the Directive, since the intermediate company ("letter-box" Subsidiary A) has no substance. Hence, the benefits of the Directive can be denied. In other words, the dividends paid to Subsidiary A would be subject-to-tax in Member State B (which would apply withholding tax on the payment as if made directly to a non-EU resident company, in absence of a Bilateral Tax Treaty for reduction of tax on dividends) and the artificial arrangements put in place by Parent X would be disregarded.



As already mentioned, the *PSD* was originally conceived to prevent profits made by cross-border groups from being taxed twice (avoidance of double taxation).

In this scenario, the new anti-abuse rule is formulated as a **"de minimis" rule** (minimum standards), meaning that Member States can apply stricter national rules, as long as they meet minimum EU requirements. However, this does not mean that Member States need to change the way they apply their domestic or agreement-based provisions

aimed at preventing tax evasion, tax fraud or abuse. But the inclusion of a common minimum anti-abuse rule helps preventing misuse of the Directive and ensures greater consistency in its application in different Member States.

To maximize the effectiveness of the anti-abuse clause, Member States will be able to use the anti-abuse clause to tackle cases where an arrangement or series of arrangements are not genuine but used solely or mainly for tax avoidance purposes.

4. Conclusions

Both amendments to the Parent-Subsidiary Directive 2011/97/EU, i.e. about the *hybrid mismatches* and the *anti-abuse rule,* are part of the EU's *Action Plan* to curb aggressive tax planning, which has been put in place in response to the OECD's *BEPS* Project, endorsed by the G20 Leaders. The issue of corporate tax avoidance is a high political priority and "*the Commission is at the forefront of these efforts to bolster the fight against tax fraud and tax evasion*", said Pierre Moscovici, the EU Commissioner for Economic and Financial Affairs, Taxation and Customs.

In this regard, the EU tax policy strategy for the years ahead is particularly focused on:

(i) setting out rules to address tax transparency and exchange of information across the EU in a more efficient manner;
(ii) stabilizing tax revenues of the Member States;
(iii) eliminating tax obstacles to all forms of cross-border economic activity between Member States; and
(iv) fighting harmful tax competition and tax fraud.

To achieve these goals, one of the priorities at EU level is to design a package of rules for a **fairer approach to taxation**. It means new measures to move to a system where profits are taxed in the same Member State where they are generated.

In this sense, both amendments to the *Parent-Subsidiary Directive,* as well the next amendments to the *Interest-Royalty Directive* (changing the scope of the Directive by extending the list of Companies to which it applies and reducing the shareholding requirements) are solid steps to ensure fair taxation and a level playing-field to legitimate businesses across the EU.

ELIO ANDREA PALMITESSA, *New Anti-Abuse Clause to the EU Parent-SubsidiaryDirective 2011/96/EU*, 7 Businessjus 65 - (2015)

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[i] *Council Directive 2015/121/EU of 27 January 2015 amending Directive 2011/97/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*

[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] EU Commission, *Commissioner Moscovici welcomes the adoption of measures against tax evasion and aggressive tax planning,* http://europa.eu/rapid/press-release_STATEMENT-15-3720_en.htm

[iv] 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*)

[v] Elio Palmitessa, *Amendment of the EU Parent-Subsidiary Directive 2011/96/EU*, http://www.businessjus.com/amendment-of-the-eu-parent-subsidiary-directive-201196eu/, Businessjus, October 2014

[vi] EU Commission, *Explanatory Memorandum - 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 MS,* http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2013)814_en.pdf

[vii] EU Commission, *Explanatory Memorandum - 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 MS* http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2013)814_en.pdf, paragraph 3

[viii] EU Commission , *Commissioner Moscovici welcomes the adoption of measures against tax evasion and aggressive tax planning,* http://europa.eu/rapid/press-release_STATEMENT-15-3720_en.htm

[ix] EU Commission, *Commissioner Moscovici welcomes Council agreement on measures against tax avoidance and unfair tax competition*, http://europa.eu/rapid/press-release_STATEMENT-14-2501_en.htm

[x] European Court of Justice, *Cadbury Schweppes plc - Cadbury Schweppes Overseas Ltd*, http://curia.europa.eu/juris/document/document.jsf?text=&docid=63874&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=46725

[xi] European Court of Justice, AG Opinion in *Cadburry Schweppes*, paragraph 111: "*The United Kingdom and the Commission cited in that regard three criteria which appear relevant. First, the degree of physical presence of the subsidiary in the host State, secondly, the genuine nature of the activity provided by the subsidiary and, finally, the economic value of that activity with regard to the parent company and the entire group*." Paragraph 112: "*The first of those criteria relates to whether the subsidiary is genuinely established in the host State. It means examining whether the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company which have resulted in the reduction of the tax due in the State of origin. If that is not the case, the subjection of those services to the tax sovereignty of the host State does appear to be a wholly artificial arrangement designed to avoid tax*". Paragraph 113: "*The second of those criteria relates to the genuine nature of the services provided by the subsidiary. In that connection, it is a question of looking at the competence of the subsidiary's staff in relation to the services provided and the level of decision-making in carrying out those services. If, for example, the subsidiary proves to be nothing but a mere tool of execution because the decisions necessary to carry out the services it is paid for are taken at another level, it is also right to consider that the subjection of those services to the tax sovereignty of the host State constitutes a wholly artificial arrangement*." Paragraph 114: "*The third criterion, relating to the value added by the subsidiary's activity, is no doubt trickier to apply where the services provided by it in fact reflect the exercise of genuine activities in the host State. This criterion seems to me to be relevant, however, in so far as it might make it possible to take account of an objective situation in which the services provided by the subsidiary have no economic substance in the light of the parent company's activity. If that were the case, I think it can be accepted that there is a wholly artificial arrangement because there appears, in effect, to be no consideration for the payment by the parent company for the services in question. Payment for such services could therefore be viewed quite simply as a transfer of profits from the parent company to the subsidiary*."

[xii] Dennis Weber, *Abuse of Law in European Tax Law: an overview and some recent trends in the direct and indirect tax case Law of the ECJ*, in European Taxation (IBFD), June 2013