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PROPOSAL

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Delegations will find attached a proposal from the Commission, submitted under a covering letter from Mr Jordi AYET PUIGARNAU, Director, to Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union.

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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

{SWD(2013) 473 final}
{SWD(2013) 474 final}
{SWD(2013) 475 final}

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

The issue of corporate base erosion is very high in the political agenda of many EU and non-EU countries and has been on the agenda of recent G20 and G8 meetings[1]; the OECD is currently undertaking work on base erosion and profit shifting ('BEPS') which is widely welcomed[2].

Double non-taxation is one of the key EU areas for urgent and coordinated action: it forms part of an on-going effort to improving the proper functioning of the Internal Market, by closing tax loopholes generated by exploiting the differences in national tax systems. Double non-taxation deprives Member States of significant revenues and creates unfair competition between businesses in the Single Market.

A specific example of double non-taxation was identified in 2009 in the Business Code of Conduct Group[3] concerning certain financial hybrid mismatches. Responses to the 2012 Commission public consultation on double non-taxation[4] had agreed in general such mismatches were undesirable.

Hybrid loans arrangements are financial instruments that have characteristics of both debt and equity. Due to different tax qualifications given by Member States to hybrid loans (debt or equity), payments under a cross border hybrid loan are treated as a tax deductible expense in one Member State (the Member State of the payer) and as a tax exempt distribution of profits in the other Member State (the Member State of the payee), thus resulting in an unintended double non-taxation.

To solve the issue, the Code of Conduct Group agreed guidance according to which the recipient Member State should follow the tax qualification given to hybrid loans payments by the source Member State (i.e. no tax exemption should be granted for hybrid loan payments that are deductible in the source Member State)[5].

However, the solution agreed by the Code of Conduct Group cannot be safely implemented under directive 2011/96[6], as amended by reason of the accession of the Republic of Croatia[7],

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1 Final declarations of the G20 leaders' meeting of 18-19 June 2012; Communiqué of G20 finance ministers and central bankers governors' meeting of 5-6 November 2012, of 15-16 February 2013 and of 18-19 April 2013; Joint Statement by UK's chancellor of exchequer and Germany's finance minister on the margin of the G20 meeting in November 2012; Communiqué of G8 leaders' summit of 17-18 June 2013.

2 OECD, Addressing Base Erosion and Profit Shifting, 2013

3 The Code of Conduct on business taxation was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997.

4 On 29 February 2012 the Commission launched a fact-finding consultation on double non-taxation and its potential impact on the Internal Market.

5 "In as far as payments under a hybrid loan arrangement are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption" (Report of the Code of Conduct Group of 25 May 2010 (doc. 10033/10, FISC 47), par. 31).

6 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 (recast) (OJ L 345, 29.12.2011, p. 8).

on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (Parent-Subsidiary Directive – 'PSD'). In the PSD, subject to various eligibility conditions, Member States are obliged to exempt from taxation (or to grant credit for the taxation occurred abroad) profit distributions received by parent companies from subsidiaries of another Member State. This is the case even if the profit distribution has been treated as a tax deductible payment in the Member State where the paying subsidiary is resident.

Both the European Council, in its March 2012 conclusions, and the European Parliament, in its resolution of 19 April 2012, have stressed the need to develop concrete ways to improve the fight against tax fraud and tax evasion. The European Parliament called for a review of the PSD in order to eliminate evasion via hybrid financial instruments in the EU.

The Action Plan to strengthen the fight against tax fraud and tax evasion adopted by the Commission on 6 December 2012[8] identifies tackling mismatches between tax systems as one of the actions to be undertaken in the short term (in 2013). In this respect, the Action Plan states *"Detailed discussion 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"*.

The Action Plan also announced a review of anti-abuse provisions in the corporate tax directives, including PSD, with a view to implement the principles underlying its Recommendation on aggressive tax planning[9]. In the Recommendation it is recommended that Member States adopt a general anti-abuse rule ('GAAR') to counteract aggressive tax planning practices.

Although the current PSD contains an anti-abuse clause, this lacks clarity and potentially creates confusion. The inclusion of the more comprehensive GAAR, adapted to the specifics of the Parent Subsidiary, along the principles indicated by the Recommendation on aggressive tax planning would remove these difficulties and would improve the efficiency of measures taken at national level to counter international tax avoidance, while enhancing coordinated actions by Member States and ensuring compliance with Treaty Freedoms, as interpreted by the Court of Justice of the European Union ('CJEU').

On 21 May 2013, the European Parliament adopted a resolution[10] whereby it urged the Member States to embrace the Commission's Action Plan and fully implement the Recommendation on aggressive tax planning. The European Parliament also called on the Commission to address specifically the problem of hybrid mismatches between the different tax systems used in the Member States, as well as to present in 2013 a proposal for the revision of the PSD with a view to revise the anti-abuse clause and to eliminate double non-taxation in the EU as facilitated by hybrid arrangements.

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7 Council Directive 2013/13/EU of 13 May 2013 adapting certain directives in the fields of taxation, by reason of the access of the Republic of Croatia (OJ L 141, 28.5.2013, p.30).

8 COM (2012)722.

9 C(2012)8806.

10 European Parliament resolution of 21 May 2013 on Fight against Tax Fraud, Tax Evasion and Tax Havens (2013/2060(INI)).

In its conclusions of 22 May 2013, the European Council noted the Commission's intention to present a proposal before the end of the year for the revision of the 'parent/subsidiary' Directive.

2. RESULTS OF CONSULTATIONS WITH THE INTERESTED PARTIES AND IMPACT ASSESSMENTS

In addition to the consultation work done within the context of the Code of Conduct Group and the public consultation launched by the Commission on double non-taxation in 2012 (see above under item 1), the Commission held technical meetings with Member States and with stakeholders in April 2013.

Impact Assessment

An Impact Assessment on amending the PSD has been prepared. The impact assessment looks at different options for amending the PSD which are compared with the 'no action' or 'status quo' scenario.

It was found that counteracting double non-taxation deriving from hybrid financial arrangements and aggressive tax planning will have a positive impact on the tax revenue of Member States otherwise affected from the overall reduction of taxes paid by the parties involved and by the additional tax deductions of the costs for tax planning and relevant arrangements. It was not possible in the impact assessment to quantify the benefits of the preferred amendments. However, the figures involved are not crucial in the decision to fight hybrid financial arrangements and tax abuse; reasons of competition, economic efficiency, transparency and fairness - from which the internal market would greatly benefit - play a determinant role in this respect.

Hybrid loan mismatches

In the impact assessment, it was found that the best option is to deny the tax exemption in the PSD to profit distribution payments which are deductible in the source Member State. Accordingly, the Member State of the receiving company (parent company or permanent establishment of the parent company) shall tax the portion of the profit distribution payments which is deductible in the Member State of the paying subsidiary.

It was found that this option was the most effective option in counteracting hybrid financial arrangements as it will ensure consistency of treatment across EU. This option will help achieving the fundamental purpose of the PSD, i.e. to create a level playing field between groups of parent companies and subsidiaries of different Member States and groups of parent companies and subsidiaries of the same Member State. The wished effect is that all enterprises are taxed on the realised profits in the EU Member State concerned and that not one company can escape taxation by loopholes from hybrid financing in cross-border situations. The aim is to close an unacceptable practice whereby companies escape proper taxation.

Anti-abuse provision

In the impact assessment it was found that the most effective option would be to update the current anti-abuse provisions of the PSD in light of the general anti-abuse rules proposed in

the Recommendation on aggressive tax planning from December 2012 and make it obligatory for Member States to adopt the common anti-abuse rule.

This option will be the most effective option in achieving a common standard for anti-abuse provisions against abuse of the PSD. A common anti-abuse provision in all Member States will ensure clarity and certainty for all taxpayers and tax administrations. The existing Member State anti-abuse measures cover a wide variety of forms and targets, having been designed in a national context to address the specific concerns of MS and features of their tax systems.

This option will provide the benefits of clarity as it will be explicitly stated what Member States shall adopt as an anti-abuse rule for the purpose of the PSD. It will therefore ensure that the anti-abuse measures adopted and implemented by EU Member States will raise no EU compliance issue. Furthermore, there will be an equal application of the EU directive without possibilities for "directive-shopping" (i.e. to avoid that companies invest through intermediaries in Member States where the anti-abuse provision is less stringent or where there is no rule).

3. LEGAL ELEMENTS OF THE PROPOSAL

The proposal seeks to tackle hybrid financial mismatches within the scope of application of the PSD and to introduce a general anti-abuse rule in order to protect the functioning of this directive.

These objectives require an amendment of the PSD, and therefore the only possible option is to present a Commission proposal for a directive. In direct tax matters, the relevant legal basis is Article 115 of the Treaty on the Functioning of the European Union (TFEU) under which the Commission may issue directives for the approximation of provisions of the Member States as directly affecting the functioning of the Internal Market.

The objectives of the initiative cannot be sufficiently achieved unilaterally by the Member States. It is exactly the differences in national legislation concerning the tax treatment of hybrid financing which allow taxpayers, in particular groups of companies, to employ cross-border tax planning strategies which lead to distortions of capital flows and of competition in the Internal Market. In addition, and in a more general sense, the considerable differences between the approaches of Member States against abusive behaviour lead to legal uncertainty and undermine the very aim of the PSD as such, namely the abolition of tax obstacles to the cross-border grouping of companies of different Member States. Action at EU level is required to better achieve the purpose of the initiative. Therefore the proposed amendments comply with the subsidiarity principle. The proposed amendments also comply with the proportionality principle as they do not go beyond what is needed to address the issues at stake and, thereby, to achieve the objectives of the Treaties, in particular the proper and effective functioning of the Internal Market.

Subsidiarity principle

Hybrid financial mismatches

Individual Member States' reaction to hybrid financial mismatches would not effectively solve the problem, as the issue originates from the interaction of different national tax systems. Indeed, single uncoordinated initiatives may result in additional mismatching or in the creation of new tax obstacles in the Internal Market.

Amending Double Tax Conventions between Member States would not be a suitable method for addressing the matter, as each country pair may arrive at a different solution. Other international initiatives, such as those undertaken by the OECD on corporate base erosion, would not be able to address the specific EU concerns as these require an amendment of the existing EU legislation.

Finally, the agreement reached in the Code of Conduct Group for Member States to take a coordinated approach can only be applied after an amendment to the Parent-Subsidiary directive which Member States cannot do without a proposal from the Commission.

Anti-abuse provision

The current Parent-Subsidiary directive allows Member States to apply domestic or agreement-based provisions required for the prevention of fraud or abuse. This provision must however be read as interpreted by the CJEU. The CJEU jurisprudence sets the principle that Member States cannot go beyond the general Community law principle when countering abusive behaviour. In addition, the application of anti-abuse measures must not lead to results incompatible with fundamental Treaty freedoms.

Furthermore, Member States' existing domestic anti-abuse measures cover a wide variety of forms and targets, having been designed in a national context to address the specific concerns of Member States and features of their tax systems. The current situation gives lack of clarity for taxpayers and for tax administrations.

Taking all these factors into account, individual Member States' action would not be as effective as action by the EU.

Proportionality principle

The obligation to tax is limited only the portion of hybrid financial payments which is deductible in the source Member State.

The proposed GAAR is in line with the proportionality limits envisaged by the CJEU case law.

Therefore, the proposed amendments comply with the proportionality principle as they do not go beyond what is needed to address the issues at stake.

Commentary on the Articles

The proposal aims at modifying the Recitals, Article 1, Article 4 and to update Annex I Part A of the current PSD. The modifications and update are contained in Article 1 of the proposal.

Recitals

Under the proposed amendment, the recitals explain that, in order to prevent that cross-border groups of parent companies and subsidiaries benefit from unintended advantages compared with national groups, the benefits of the tax exemption should be denied to distributions of profits that are deductible in the source Member State.

The fundamental purpose of the PSD is to create a level playing field between groups of parent companies and subsidiaries of different Member States and groups of parent companies and subsidiaries of the same Member State.

At the time the PSD was adopted, cross-border groups were generally at a disadvantage in comparison to domestic groups because of the double taxation to which profit distributions were subject; otherwise, bilateral double tax conventions were insufficient to create within the EU conditions analogous to those of an internal market.

To achieve the aimed neutrality, the PSD provided for the (i) abolition of withholding taxes on profit distributions and (ii) prevention of economic double taxation of the distributed profits through either tax exemption or tax credit in the Member States of the parent companies.

Since then, and in the last decade more and more rapidly, the situation has evolved.

The increase in cross-border investments has given cross-board groups the opportunity to use hybrid financial instruments taking unduly advantages from mismatches between different national tax treatments and from the international standard rules to relieve double taxation. This leads, within the EU, to a distortion in the competition between cross-border and national groups, contrary to the scope of the PSD.

Article 1

The proposed Directive would allow Member States to take measures in order to prevent fraud and evasion. In this respect, the Commission service has recalled that tax fraud is a form of deliberate evasion of tax which is generally punishable under criminal law, and tax evasion generally comprises illegal arrangements where liability to tax is hidden or ignored[11].

Furthermore, in order to address the risk of abuse, it is proposed to replace the current anti-abuse provision by inserting a common anti-abuse rule, based on the similar clause included in the Recommendation on aggressive tax planning.

Article 4

Under the proposed amendment, the Member State of the parent company and the Member State of its permanent establishment deny the benefits of the tax exemption to distributions of profits that are deductible by the subsidiary of the parent company.

Accordingly, in letter a) of the paragraph it is specified that the MS of the receiving company (parent company or its permanent establishment) shall refrain from taxing the received profits distribution only to the extent that those profits distributions are not deductible in the source Member State (i.e. in the Member State of the distributing subsidiary). The Member State of the receiving company shall therefore tax the portion of profits that is deductible in the source Member State.

No withholding tax would be imposed on the profits distributed by the subsidiary as the payment in the Member State of the subsidiary would be treated as an interest payment under the Interest and Royalties directive. There is a pending proposal in Council to align the current 25% eligibility shareholding threshold in the Interest and Royalties directive to the 10% of the PSD[12]. Moreover, typically hybrid financial arrangements are set up in Members States having a zero withholding on interest payments under domestic or double tax conventions provisions.

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11 SWD (2012) 403, p. 9.

12 Proposal for a Council Directive on a common system applicable to interest and royalty payments made between associated companies of different Member States (recast) (COM (2011) 714).

Annex I Part A)

The proposed amendments include eligible companies which have been introduced in the company laws of the Member States after the recast of the directive. The Commission has received an updating request from Romania.

To this purpose, in letter (w) the following two types of companies are added: ‘societăți în nume colectiv’, ‘societăți în comandită simplă’.

4. BUDGETARY IMPLICATION

This proposal does not have any budgetary implications for the EU.

2013/0400 (CNS)

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amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national Parliaments,

Having regard to the opinion of the European Parliament[13],

Having regard to the opinion of the European Economic and Social Committee[14],

Acting in accordance with a special legislative procedure,

Whereas:

(1) Council Directive 2011/96/EU exempts dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes and eliminates double taxation of such income at the level of the parent company.

(2) The benefits of Directive 2011/96/EU should not lead to situations of double non-taxation and, therefore, generate unintended tax benefits for groups of parent companies and subsidiaries of different Member States in comparison with groups of companies of the same Member State.

(3) For the purpose of avoiding situations of double non-taxation deriving from mismatches in the tax treatment of profit distributions between Member States, the Member State of the parent company and the Member State of its permanent establishment should not allow those companies to benefit from the tax exemption applied to received distributed profits, to the extent that such profits are deductible by the subsidiary of the parent company.

(4) In order to prevent tax avoidance and abuse through artificial arrangements, a common anti-abuse provision tailored to the purpose and objectives of Directive 2011/96/EU should be inserted.

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13 OJ C, , p. .

14 OJ C, , p. .

(5) It is necessary to ensure that this Directive does not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion.

(6) It is appropriate to update Annex I, Part A to that Directive to include other forms of companies which have been introduced in the company laws of Romania.

(7) Directive 2011/96/EU should therefore be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Directive 2011/96/EU is amended as follows:

1. In Article 1, paragraph 2, is replaced by the following:

"2. This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion."

2. The following Article 1a is inserted:

"Article 1a

1. Member States shall withdraw the benefit of this directive in the case of an artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of obtaining an improper tax advantage under this directive and which defeats the object, spirit and purpose of the tax provisions invoked.

2. A transaction, scheme, action, operation, agreement, understanding, promise, or undertaking is an artificial arrangement or a part of an artificial series of arrangements where it does not reflect economic reality.

In determining whether an arrangement or series of arrangements is artificial, Member States shall ascertain, in particular, whether they involve one or more of the following situations:

(a) the legal characterisation of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole;

(b) the arrangement is carried out in a manner which would not ordinarily be used in a reasonable business conduct;

(c) the arrangement includes elements which have the effect of offsetting or cancelling each other;

(d) the transactions concluded are circular in nature;

(e) the arrangement results in a significant tax benefit which is not reflected in the business risks undertaken by the taxpayer or its cash flows.

3. 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 of the parent company; or"

4. In Annex I, part A, point (w) is replaced by the following:

"(w) companies under Romanian law known as: ‘societăți pe acțiuni’, ‘societăți în comandită pe acțiuni’, ‘societăți cu răspundere limitată’, ‘societăți în nume colectiv’, ‘societăți în comandită simplă’;"

Article 2

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 31 December 2014 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.

Article 3

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union.*

Article 4

This Directive is addressed to the Member States.

Done at Brussels,

For the Council
The President