**COUNCIL OF THE EUROPEAN UNION**

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**COVER NOTE**

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| From: | Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director |
| date of receipt: | 25 November 2013 |
| To: | Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union |
| No. Cion doc.: | SWD(2013) 474 final |
| Subject: | COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT Accompanying the document 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 |

Delegations will find attached document SWD(2013) 474 final.

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EUROPEAN
COMMISSION

Brussels, 25.11.2013
SWD(2013) 474 final

# COMMISSION STAFF WORKING DOCUMENT

## IMPACT ASSESSMENT

*Accompanying the document*

**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**

{COM(2013) 814 final}
{SWD(2013) 473 final}
{SWD(2013) 475 final}

# TABLE OF CONTENTS

## Executive Summary Sheet

Impact assessment on Proposal for a Directive on amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), as amended by Council Directive 2013/13/EU adapting certain directives in the field of taxation by reason of the accession of the Republic of Croatia

### A. Need for action

**Why? What is the problem being addressed?** Maximum 11 lines

The Commission adopted an Action Plan to strengthen the fight against tax fraud and tax evasion on 6th December 2012 (COM (2012 722). It identifies tackling mismatches between tax systems as one of the actions to be undertaken in 2013. In particular, the Action Plan envisages a legislative amendment of the Parent Subsidiary directive "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 makes reference to the discussions on the interaction between the Parent Subsidiary directive ("PSD") and the political guidance agreed within the Code of Conduct Group to avoid the distorting effects of mismatches resulting from differences in the tax treatment of hybrid loans between Member States. 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 ((C(2012)8806) where it is recommended that Member States should adopt a general anti-abuse rule (GAAR) to counteract aggressive tax planning practices.

**What is this initiative expected to achieve?** Maximum 8 lines

The initiative on hybrid loan mismatches aims at ensuring effective action against double non-taxation in this area. The application of the PSD should not inadvertently prevent such action. Avoiding double non-taxation is one of the key EU areas for urgent and coordinated action. It forms part of an on-going effort to improve the proper functioning of the Internal market by removing loopholes in tax legislation.

The initiative on an anti-abuse provision in the PSD aims at providing certainty and clarity. The current PSD lacks clarity and could potentially lead to abuse of the directive if some domestic anti-abuse provisions are less stringent or non-existing. The inclusion of the more comprehensive anti-abuse rule would remove these difficulties. It would also bring the wording of the anti-abuse provision in line with the jurisprudence of the ECJ.

**What is the value added of action at the EU level?** Maximum 7 lines

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. Additionally, the political agreement reached in the Code of Conduct Group can only be applied after an amendment to the PSD.

Member States' existing domestic anti-abuse provisions cover a wide variety of forms and targets. A common anti-abuse provision in line with ECJ jurisprudence would provide clarity and certainty, and would ensure the PSD against abuse.

### B. Solutions

**What legislative and non-legislative policy options have been considered? Is there a preferred choice or not? Why?** Maximum 14 lines

Options for hybrid loan mismatches

A0: No action.

A1: Profit distribution payments which are deductible in the source state would be excluded from the PSD.

A2: The tax exemption benefits in the PSD would be denied to profit distribution payments which are deductible in the source Member State. The MS of the receiving company shall tax the portion of the profit distribution payments which is deductible in the MS of the paying subsidiary. This is the preferred option. It is the most effective option as it ensures action against double non taxation by all MS.

Options for anti-abuse provision

B0: No action.

B1: Updating the current anti-abuse provisions of the PSD in light of the GAAR proposed in the Recommendation. Under this option, it would be an option for MS whether or not to adopt the anti-abuse rule.

B2: As B1, but under this option, it would be an obligation for MS to adopt the common anti-abuse rule. This is the preferred option. It is the most effective option in achieving a common standard for anti-abuse provisions

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| against abuse of the PSD. |
| **Who supports which option?** Maximum 7 lines |
| Options for hybrid loan mismatches: Option A2 is supported by a clear majority of the MS that have indicated a preference. Only one MS has indicated a preference for A1. Business representatives have indicated a preference for option A1, while representatives from academics and NGOs have indicated a preference for option A 2.<br>Options for anti-abuse provision: Most MS who have stated an opinion would prefer no action on this point. Most business representatives agree with this. One MS has indicated that it prefers option B2. NGOs seem to favour insertion of an anti-abuse provision, but have not indicated preference for B1 or B2. |
| **C. Impacts of the preferred option** |
| **What are the benefits of the preferred option (if any, otherwise main ones)?** Maximum 12 lines |
| Although hybrid mismatches may significantly reduce overall tax base revenues for taxpayers, it is not possible to quantify the benefits of the initiative. The international features and tax avoidance consequences make it difficult to calculate the revenue lost by the countries involved and, therefore, the tax revenue which would be rescued as a consequence of the amendment. As stated by the 2012 OECD Report on Hybrid Mismatch Arrangements, *"although there are no comprehensive data on the collective tax revenue loss caused by such arrangements, anecdotal evidence shows that the amounts at stake in a single transaction or series of transactions are substantial".* However, the figures involved are not crucial in the decision to fight hybrid financial arrangements; reasons of competition, economic efficiency, transparency and fairness - from which the internal market would greatly benefit - play a determinant role in this respect.<br>Similarly, it is It is not possible to quantify the benefits from countering tax avoidance.<br>Neither of the preferred options will have significant direct environmental impact or social impact. |
| **What are the costs of the preferred option (if any, otherwise main ones)?** Maximum 12 lines |
| Costs would be suffered by the taxpayers who are now taking unjustified advantages of the double non-taxation resulting from hybrid financial instruments mismatches or abuse of PSD. Loss of such unjustified benefits should however not be taking into consideration in weighing the costs and benefits of the initiative.<br>Neither of the preferred options will have significant direct negative environmental impact or social impact. |
| **How will businesses, SMEs and micro-enterprises be affected?** Maximum 8 lines |
| Large businesses making aggressive tax planning are affected. SMEs and micro-enterprises are not affected (or only to a limited extend) as aggressive tax planning requires cross-border operations, and expensive and sophisticated tax expertise. Today large businesses enjoy a competitive advantage over SMEs and micro-enterprises. The initiative will ensure a more level playing field. |
| **Will there be significant impacts on national budgets and administrations?** Maximum 4 lines |
| Counteracting double non-taxation deriving from hybrid financial arrangements and abuse of the PSD will have a positive impact on the tax revenue of Member States. The impacts can potentially be significant. There is however no comprehensive data on the collective tax revenue loss caused by mismatch arrangements or by abuse of the PSD. |
| **Will there be other significant impacts?** Max 6 lines |
| No, none of the other impacts will be significant. |
| **D. Follow up** |
| **When will the policy be reviewed?** Maximum 4 lines |
| The legal changes envisaged by this initiative are relatively straight forward. It is therefore not necessary to conduct a study of whether the objectives of the initiative are met. The Commission will continue to monitor the proper functioning of the PSD, including the proposed changes, through the Code of Conduct group and the Platform for Tax Good Governance. |

*This is a proportionate impact assessment given the technical nature of the problems addressed.*

## 1. Procedural issues and consultation of interested parties

***EU Context***

**<u>Hybrid loan mismatches</u>**

Since 2009 the distorting effects of mismatches resulting from differences in the tax treatment of hybrid loans between Member States have been discussed in the context of the Code of Conduct Group[1]. The Code of Conduct Group focused its analysis on a form of hybrid loans between associated companies, the profit participating loan (PPL), whose main characteristic is that interest payments are dependent on the profits of the debtor.

The Code of Conduct Group agreed that different tax qualifications given by Member States to cross-border PPLs - one Member State treating them as equivalent to simple loans, while another Member State regarding them as a form of equity capital - cause problems. The issue essentially is that payments under a cross-border PPL are treated as a tax deductible expense in the source Member State and as a tax exempt distribution of profits (dividend) in the recipient Member State, thus resulting in a double non-taxation[2]. Double non-taxation deprives Member States of significant revenues and creates unfair competition between businesses in the Single Market.

In its Report of 25 May 2010 to the ECOFIN Council (doc. 10033/10, FISC 47, par. 31), the Code of Conduct Group agreed upon a guidance according to which the recipient Member State should follow the tax qualification given to hybrid loan payments by the source Member State ("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"). This means that no tax exemption shall be granted for payments that are deductible in the Member State of the payor.

To facilitate the discussion about the proper form that the agreed guidance should take the Code of Conduct Group asked the Commission to examine more in detail the tax treatment of, and the approach to, hybrid loans in each Member State. A questionnaire was circulated to the Member States and the replies were presented at the Code of Conduct Group meeting of 17 February 2011.

The replies to the questionnaire:

- indicated that the legislation of six Member States might enable a situation in which a payment under a hybrid loan that was deductible abroad would nevertheless be exempted from taxation; for those Member States, therefore implementation of the Code of Conduct Group guidance might require national legislation;

- confirmed that for the three Member States earlier identified in an internal study of January 2009 (on a specific type of PPL), there was no doubt that they would need to

[1] The Code of Conduct on business taxation, set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997, is the EU's main tool for ensuring fair tax competition in the area of business taxation. The Code is not a legally binding instrument but it clearly does have political force. It sets out clear criteria for assessing whether or not a tax regime can be considered harmful. All Member States have committed to adhering to the principles of the Code. This means refraining from introducing tax measures deemed to be harmful and changing those that are found to be so. The Code of Conduct Group oversees the application of the Code, assesses regimes to determine whether or not they are harmful, and reports back to the ECOFIN on developments in this area at the end of each Presidency.

[2] The problem of double non-taxation does not arise if the Member State of the parent company applies the credit relief method. It only arises where the Member State applies the exemption relief method.

change their legislation in order to comply with the solution agreed by the Code of Conduct Group. One Member State indicated plans for such a legislative change, which in fact was made.

In October 2011, an analysis carried out by the Commission Services stated that the solution agreed by the Code of Conduct Group clashes with the Parent Subsidiary Directive[3] ("PSD"). Under the PSD, subject to various eligibility conditions, the Member State of the receiving parent company (or, under certain circumstance, of a permanent establishment of that parent company) is obliged to exempt profit distribution payments from subsidiaries of another Member State from taxation (or to grant a credit for the taxation levied abroad on the subsidiary level or lower tier levels). 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.[4]

The interaction between the Code of Conduct Group guidelines and the PSD was discussed in the Commission Working Party IV meeting on 11 January 2012. At the meeting the Commission suggested two alternative ways forward: (i) develop an alternative (different) solution in the Code of Conduct Group; or (ii) amend the PSD.

There was no support for an alternative (different) solution amongst Member States. On the need to amendment the PSD, some Member States expressed doubts – mainly on the grounds that they did not believe it was necessary to change the PSD in order to implement the guidance. Nevertheless, it seemed that most Member States would either support or not oppose a targeted amendment of the PSD to remove any possible barrier to the effective implementation of the Code of Conduct Group solution.

The fact-finding public consultation on double non-taxation launched by the Commission on 29 February 2012 showed that mismatches between countries' qualification of hybrid financial instruments and hybrid entities was found the least acceptable double non-taxation issue[5]. One contributor reported that "this is one of the most typical and most exploited forms of double non-taxation". These mismatches have harmful effects in terms of fairness of the tax systems and distortion of the Internal Market.

In a resolution adopted on 19 April 2012, the European Parliament called also for a review of the PSD in order to eliminate tax avoidance via hybrid financial instruments in the EU[6].

The Action Plan to strengthen the fight against tax fraud and tax evasion adopted by the Commission of 6 December 2012 (COM (2012)722) identifies 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 that *"Detailed discussions with Member States have shown that in a specific case an agreed solution cannot be achieved without a legislative amendment of the*

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[3] Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), as amended by Council Directive 2013/13/EU adapting certain directives in the fields of taxation by reason of the accession of the Republic of Croatia.

[4] The tax exemption obligation under Article 4(1)(a) in the PSD applies unconditionally when Member States have opted for relieving double taxation on subsidiaries' profit distributions through exemption (see C-138/07 Cobelfret).

[5] Http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/double_non_tax/summary_report.pdf

[6] European Parliament resolution of 19 April 2012 on the call for concrete ways to combat tax fraud and tax evasion (2012/2599(RSP)).

*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".*

An Impact Assessment was carried out for the Action Plan ( SWD(2012) 403&404).

As a follow-up to the Action Plan, the Commission started working on a proposal to amend the PSD and submitted two alternative options to Member States and stakeholders (experts from the private sectors, academics, business organisations, tax associations) to avoid that the PSD be an obstacle to the implementation of the Code of Conduct Group guidelines on hybrid loan mismatches. The consultation meetings were held on 11 and 12 April 2013, respectively, and two policy options (see also point 4. below) were discussed:

Option A1: Profit distribution payments which are deductible in the source Member State would be excluded from the PSD.

Option A2: The tax exemption benefits in the PSD would be denied to profit distribution payments which are deductible in the source Member State.

At the meeting with Member States, there was general support and positive feedback by the 15 Member States which took the floor. Their majority (eight Member States) strongly supported the option where Member States will be obliged to tax if the payment concerned is deductible in the source state (option A2). One Member State accepted to amend the PSD for clarity and expressed a slight preference for this option. Four Member States, even though they still believed that an amendment to the PSD is not necessary, said that they would accept to amend the PSD for clarification purposes. One Member State was in favour of an option to exclude hybrid financial payments from the scope of PSD (option A1). Another MS was open to both options and urged for a quick amendment. Four Member States chose not to attend.

At the Stakeholders meeting, the views expressed were different. Although responses to the 2012 public consultation had agreed in general that such mismatches were undesirable, some business representatives at the meeting now saw less damage in double non-taxation and in particular option A2, rather than option A1, was disliked as limiting the rights of the taxpayers and Member States. Basically double non-taxation was considered to be a possible deliberate choice on the part of Member States. Other business representatives supported option A1. Conversely, in general, NGOs and academics supported option A2.

On 21 May 2013, the European Parliament adopted a resolution[7] 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.

In its conclusions of 22 May 2013, the European Council called for rapid progress on certain tax issues; in particular, the European Council announced that "the Commission intends to

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

present a proposal before the end of the year for the revision of the 'parent/subsidiary' Directive"[8].

**Anti-abuse provision**

The Action Plan to strengthen the fight against tax fraud and tax evasion also includes the following future action to be undertaken in the short term (in 2013):

> "The Commission will also review the anti-abuse provisions of the Directives on Interest and Royalties, Mergers and Parent-Subsidiary, with a view to implement the principles underlying its Recommendation on aggressive tax planning."

In the Recommendation on aggressive tax planning it is recommended that Member States should adopt a General Anti-Abuse Rule ("GAAR") adapted to domestic and cross-border situations confined to the Union and situations involving third countries to counteract aggressive tax planning practices which fall outside the scope of their specific anti-avoidance rules. The recommended general anti-abuse rule reflects the limits imposed by Union law with regard to such rules.

So as to preserve the autonomous operation of tax directives the Recommendation does not apply within the scope of the corporate tax directives. The underlying principles cannot therefore be relied upon directly without implementation.

The analysis of the general anti-abuse rule was carried out in preparation of the Recommendation on aggressive tax planning, i.e. the Impact Assessment (SWD(2012)403), where it is stated that

> "In the case of aggressive tax planning the purpose and intention of Member States tax legislation can be undermined and issues of competition arise in relation to those taxpayers who do not choose or cannot afford to engage in such practices. Taxpayers may also be affected because of the additional compliance requirements that the fight against tax fraud, tax evasion and tax avoidance may lead the MS to adopt, and by the tax treatment that applies to the activities they perform in countries subject to anti-abuse measures.
>
> Relating to SME, there is no indication that they would be specifically affected, since such elaborated schemes based on international configurations are less likely to involve SME than large enterprises."

The underlying principles of the Recommendation were implemented in the proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT) of 14 February 2013 (COM(2013)71 final). This proposal includes an anti-abuse rule in Article 13 which was directly inspired by the rule in the December 2012 Recommendation.

The Commission has held consultations with Member States and stakeholders as part of the review of the anti-abuse provisions of the PSD, Interest and Royalties Directive and the Merger Directive.

The consultation with Member States was held on 11 April 2013.

[8] EUCO 75/1/13 REV 1.

Four of the five Member States who took the floor argued that a GAAR should not be inserted in the corporate tax directives. They would prefer domestic GAARs. Two of them also believed that the GAAR could be improved. The Member States did not specify why they prefer domestic anti-abuse provisions. An indication of the motivation can perhaps be deduced from the fact that they believe that the common GAAR should be broader than the GAAR recommended by the Commission if a common GAAR were to be adopted. They could have the opinion that the Commission's interpretation of the ECJ case law is too restrictive. A common anti-abuse provision could therefore in their view limit their ability to adopt/keep a broader domestic anti-abuse provision. However, the Commission believes that the recommended GAAR reflects the limits imposed by Union law with regard to such rules.

There are also some Member States that as a matter of principle are reluctant to adopt EU legislation in the direct tax area and believe that direct tax legislation should be the competence of Member States.

One Member State could support amending all three directives, although some work was needed on the drafting of the GAAR. In a written contribution this Member State has later reiterated its support for an amendment to the PSD where that amendment creates an obligation to have an anti-abuse rule.

The consultation with stakeholders was held on 12 April 2013. Stakeholders did not agree on whether to amend the directives with a GAAR or not. Business representatives were in general in favour of a domestic GAAR without implementing it into the directives. On the other hand NGOs and one business representative seem to favour the insertion of a GAAR clause in the directives.

In general, business representative could be of the opinion that the fewer restrictions, the greater the planning opportunities. Some other business representatives might therefore favour the current domestic anti-abuse provisions as some of these might be less stringent or non-existent.

In the fact-finding public consultation on double non-taxation launched in February 2012, several business contributors stated that double non-taxation should be handled at Member State level. One contributor (AmCham EU) stated in relation to double non-taxation in general that "If EU-wide restrictions were to go ahead, they would constrain normal commercial transactions and also reduce the attractiveness of Europe as a place of interest."

Stakeholders from small- and medium-sized enterprises (SMEs) did not contribute to the public consultation nor did they contribute during the stakeholder meeting.

***International Context***

The issue of corporate tax 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[9]. Also the

[9] 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.

OECD is currently undertaking work on base erosion and profit shifting ('BEPS') which is widely welcomed[10].

In March 2012 the OECD published a Report titled “Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues”. According to the Report, domestic law rules which link the treatment of an instrument (or entity) in the country concerned to the tax treatment in another country appear to hold significant potential as a tool to address hybrid mismatch arrangements, and the experience of the countries which have introduced these rules has overall been positive. The OECD recommends countries to consider introducing or revising specific and targeted rules denying benefits in the case of certain hybrid mismatch arrangements.

The Report on BEPS by the OECD stresses that there are various key pressure areas. One of these areas concerns international mismatches in entity and instruments characterisation, including hybrid mismatches arrangements and arbitrage. General anti-avoidance rules or doctrines which limit or deny the availability of undue tax benefits are seen as one of the most relevant rules against tax avoidance.

In order to address BEPS, the OECD has developed a comprehensive action plan that was agreed upon by the Committee on Fiscal Affairs at its meeting in June 2013. The action plan includes proposals to develop, among the others, instruments to put an end or neutralise the effect of hybrid mismatch arrangements and arbitrage.

While the Commission recognizes the importance of global solutions, there is a need for the EU to address mismatches and anti-abuse taking into account the existing EU legislation and the case law of the Court of Justice of the EU (CJEU). The Commission believes that the revision of the PSD can be an important contribution to the OECD BEPS work as it would represent a best practice in fighting base erosion.

*Procedural issues on the impact assessment (IA)*

Due to the technical nature of the problems addressed a formal impact assessment steering group was not established. The draft IA note and the executive summary sheet were instead in July 2013 send to the contact points in DG ECFIN, DG ENTR, DG COMP, DG MARKT, Legal Services (SJ) and DG SG inviting them for comments on the draft note.

Legal Services (SJ) provided a response with proposed changes to the text in track changes and comments which were incorporated by DG TAXUD in the draft for the IA Board.

Other comments received did not include any specific remarks on the technical aspects of the planned amendments for the PSD. However there are references to the absence of some usually included general aspects related in particular to the impact of COM initiatives on SMEs.

Although there was a suggestion to expand the IA to cover in more detail the specific implications for SMEs, the very specific character of the proposed changes to the PSD, namely not extending the scope of the Directive or changing the provisions/rules in a Directive, meant that this was finally not considered necessary. The very aim of the proposal is to close a loophole whereby mainly multi-national Enterprises (MNE) could unduly benefit

[10] OECD, Addressing Base Erosion and Profit Shifting, 2013.

from mismatches in national tax regimes. This loophole needs to be closed and one step to reach this target is the necessary amendment for the PSD. If in few cases also SMEs had benefited from unjustified tax advantages due to the mismatches in national tax regimes, the amendments will consequently also take away the tax benefits from these SMEs. But there are neither any compensating measures planned for these SMEs nor for the MNEs. The wished effect is that all economic operators (SMEs and MNEs) 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. Against this background it was also decided that a competitiveness analysis or the analysis of the costs and benefits of each option for SMEs was not necessary.

*Impact assessment Board*

A draft of the IA was submitted to the Impact Assessment Board on 19 July 2013. The overall opinion of the Board submitted on 6 September 2013 is positive.

Firstly, the Board recommended that the report should better indicate the extent of the problem, i.e. that some companies are currently not taxed on realised profits, because of the existence of loopholes related to hybrid financing in cross-border situations. It is difficult to provide a quantitative assessment of the extent of the problem. There is however a growing awareness of the problem among tax authorities and international organisations. As reported above, the objective of the initiative is that all companies are taxed on the realised profits in the EU Member State concerned and that companies cannot escape taxation by exploiting loopholes from hybrid financing in cross-border situations. A more specific quantification would therefore not be proportionate.

Furthermore the arguments surrounding the inclusion of a General Anti-Abuse Rule (GAAR) in this Directive have been strengthened by referring to input received from stakeholders and Member States. As regards the relevance of this initiative for SMEs; it is explicitly stated that although SME representatives were consulted, no objections were raised from their side.

Secondly, the Board recommended that the explanation of the proportionality of the options in solving the issue should be strengthened. It is now clearly explained why some of the options are not sufficiently effective.

Thirdly, the Board asked that the report should compare the options on the criteria of effectiveness, efficiency and coherence in achieving the objectives. This is now included in the report.

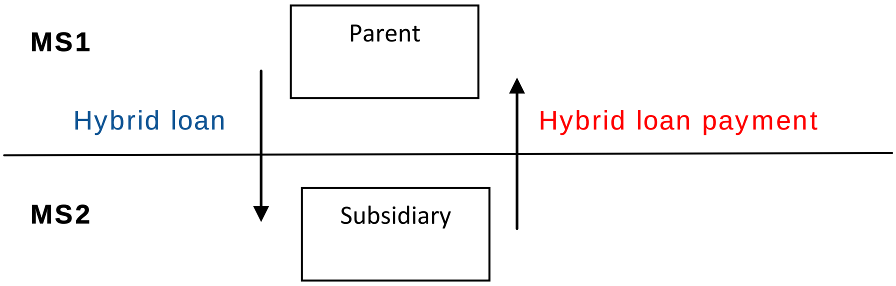
## 2. Problem definition

### ***Problem description***

<u>Hybrid loan mismatches</u>

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 payor) and as a tax exempt distribution of profits (dividend) in the other Member State (the Member State of the payee), thus resulting in an undesirable double non-taxation (from the perspective of the Member States).

Example: Member State MS1, where the parent company is resident, treats a hybrid loan as equity and received payments as exempt "dividend". Member State MS2, where the subsidiary is resident, treats the same hybrid loan as debt and payments on it as deductible "interest".




To solve the issue, the Code of Conduct Group agreed upon a guidance according to which no tax exemption shall be granted in the Member State of the recipient to hybrid loan payments that are deductible in the source Member State.

However, as mentioned in point 1 above, the solution agreed upon by the Code of Conduct Group cannot be safely implemented under the PSD without an explicit amendment of the text of the PSD.

The baseline scenario with no action would not address the double non-taxation issue nor would it allow Member States to implement in their national legislations the political agreed solution in the Code of Conduct Group. If Member States nevertheless implement the political agreed solution, they risk receiving complaints from businesses for infringement of EU law. The baseline scenario is therefore that the loophole will continue to exist. The consequences for the government finances will worsen as cross-border investments increase with the fulfilment of the Internal Market. More and more enterprises will be able to take unduly advantage from mismatches between different national tax treatments when they make or increase their cross-border investments. Purely national enterprises will on the other hand suffer a competitive disadvantage.

This scenario would also be in contrast with what is envisaged by the Action Plan as well as with the actions required in the international political context (G8 and G20 finance ministers' declarations).

Anti-abuse provision

The PSD already permits Member States to adopt domestic anti-abuse provisions. In its Article 1, paragraph 2, it provides for the following:

> "This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse."

According to the case law of the CJEU Member States, when countering abusive behaviour, cannot go beyond the general EU law principle that abuse of rights is prohibited. The anti-abuse provisions adopted by Member States must reflect this general EU law principle. Individuals and companies must not improperly or fraudulently take advantage of provisions of EU law. This has been stated by the CJEU in its case law on the anti-abuse rules in tax directives (see in particular on the Merger Directive C-352/08 Zwijnenburg, C-321/05 Kofoed and C-126/10 Foggia.

The Court has also stated that the principle of legal certainty precludes directives from being able by themselves to create obligations for individuals. Directives cannot therefore be relied upon per se by the Member State against individuals. Member States must therefore make a specific transposition provision transposing the anti-abuse principle into national law in order to apply the anti-abuse rule (C-321/05 Kofoed).

Some Member States, e.g. France and Germany, have their own versions of a general anti-abuse rule, which are applicable against abuse of the PSD. The German general anti-abuse rule is found in the Fiscal Code, Section 42 (Abgabenordnung (AO) § 42):

> "Section 42
> Abuse of tax planning schemes
>
> (1) It shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes. Where the element of an individual tax law's provision to prevent circumventions of tax has been fulfilled, the legal consequences shall be determined pursuant to that provision. Where this is not the case, the tax claim shall in the event of an abuse within the meaning of subsection (2) below arise in the same manner as it arises through the use of legal options appropriate to the economic transactions concerned.
>
> (2) An abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. This shall not apply where the taxpayer provides evidence of non-tax reasons for the selected option which is relevant when viewed from an overall perspective." [11]

Other Member States, such as Denmark, do not have a legislative general anti-abuse rule, but rely on other measures like domestic case law against abuse.

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 MS and features of their tax systems.[12] Some of the anti-abuse provisions adopted by Member States

[11] An unofficial translation from German:

**§ 42 Missbrauch von rechtlichen Gestaltungsmöglichkeiten**

(1) Durch Missbrauch von Gestaltungsmöglichkeiten des Rechts kann das Steuergesetz nicht umgangen werden. Ist der Tatbestand einer Regelung in einem Einzelsteuergesetz erfüllt, die der Verhinderung von Steuerumgehungen dient, so bestimmen sich die Rechtsfolgen nach jener Vorschrift. Anderenfalls entsteht der Steueranspruch beim Vorliegen eines Missbrauchs im Sinne des Absatzes 2 so, wie er bei einer den wirtschaftlichen Vorgängen angemessenen rechtlichen Gestaltung entsteht.

(2) Ein Missbrauch liegt vor, wenn eine unangemessene rechtliche Gestaltung gewählt wird, die beim Steuerpflichtigen oder einem Dritten im Vergleich zu einer angemessenen Gestaltung zu einem gesetzlich nicht vorgesehenen Steuervorteil führt. Dies gilt nicht, wenn der Steuerpflichtige für die gewählte Gestaltung außersteuerliche Gründe nachweist, die nach dem Gesamtbild der Verhältnisse beachtlich sind.

[12] Information on anti-abuse provisions in 14 Member States can be found in annex 1 which contains section 4.6.7. of annex 7 (Study including a data collection and comparative analysis of information available in the public domain on existing and proposed tax measures of the 14 Member States in relation to non-cooperative

may raise compliance issues with the PSD if they go beyond the general EU law principle on abuse of rights.

Taking all these factors into account it is clear that individual EU MS action would not be as effective as action on the EU level. This is why the Commission adopted its Recommendation on a GAAR in December 2012.

The current situation leads to a lack of clarity for taxpayers and for tax administrations and could potentially lead to improper use of the directive if the anti-abuse provisions in some Member States are less stringent or non-existent. The baseline scenario with no further action would therefore not ensure clarity and certainty and would not ensure against improper use of the PSD. In this case it will only be achieved if all Member States adopt the common General Anti-Abuse Rule as recommended by the Commission in December 2012. The General Anti-Abuse Rule, if adopted in domestic legislation by Member States, would be applicable for prevention of abuse of PSD as the directive permits Member States to adopt domestic provisions required for the prevention of fraud or abuse within the limits imposed by ECJ case law.

On 14 May 2013, the Council concluded[13] that it

> "16. CALLS upon Member States to consider where appropriate, to what extent their current national legal framework may include a General Anti Avoidance Rule which allows effective action, in compliance with the EU Treaties, against abusive tax arrangements.
>
> 17. INVITES Member States to consider the appropriateness of incorporating a General Anti Avoidance Rule, such as that suggested in the Recommendation (17617/12), in their national legislation. "

It would therefore seem as though implementation of the recommendation in some Member States could be relatively slow.

***Who is affected***

Hybrid financial instruments mismatches and tax avoidance have harmful effects in terms of tax revenue, economic efficiency, transparency, competition and fairness.

Member States are affected because of the budgetary impact deriving from the overall reduction of taxes paid by the parties involved and by the additional tax deductions represented by the costs incurred by the business for advice and set up of the arrangements.

Businesses are affected because certain large companies which operate cross-border and can afford to pay for sophisticated tax expertise enjoy a competitive advantage over small and medium-sized companies and over those large companies not using the hybrid financial mismatches.

Citizens are indirectly affected by the budget reduction for public services and social benefits.

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jurisdictions and aggressive tax planning) in the Impact Assessment accompanying the Commission's Recommendation on aggressive tax planning (SWD(2012)403).

[13] Council conclusions on tax evasion and tax fraud (doc. 95/49/13, Fisc 94).

Public confidence in the fairness and the transparency of the tax system may be affected by the possibility for some taxpayers to reduce their effective taxation by profiting from mismatch opportunities or tax avoidance.

***Subsidiarity and proportionality***

This initiative 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.

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 political 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 PSD which Member States cannot do without a proposal from the Commission.

As to the respect of the proportionality principle, the obligation to tax is limited to the portion of hybrid financial payments which is deductible in the source Member State.

Anti-abuse provision

The jurisprudence of the CJEU sets the principle that Member States cannot go beyond the general EU law principle when countering abusive behaviour which leads to undue benefits from the PSD. In addition, the application of anti-abuse measures must not lead to results incompatible with fundamental treaty freedoms.

However, 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.

Taking all these factors into account it is clear that individual EU Member States action would not be as effective as EU action.

**3. Objectives**

<u>Hybrid loan mismatches</u>

The objective of the initiative is that all companies are taxed on the realised profits in the EU Member State concerned and that companies cannot escape taxation by exploiting loopholes from hybrid financing in cross-border situations. The initiative aims at ensuring effective action against double non-taxation in the area of hybrid loan structures. The application of the PSD should not inadvertently prevent such action. The amendment will improve the functioning of the PSD and of the Internal Market.

The Action Plan initiative against hybrid loan mismatches is the result of previous consultations and politically agreed solutions on double non-taxation (see point 1. above) Double non-taxation is one of the key EU areas for urgent and coordinated action: it forms part of an on-going effort to improve the proper functioning of the Internal Market, by closing tax loopholes generated by exploiting the differences in national tax systems.

The Action Plan initiative is also in line with the fundamental purpose of the PSD that double taxation of distributed profits shall be avoided when profits have already been taxed in the source state where the subsidiary is resident. There is no taxation of the profits in the source state when the payment can be deducted therefore there is no double taxation to avoid.

<u>Anti-abuse provision</u>

The initiative aims at providing certainty and clarity for taxpayers and for tax administrations and at ensuring that companies do not improperly take advantage of the provisions of the PSD. The current PSD contains a clause allowing Member States to create and apply anti-avoidance provisions. However, Member States have adopted a wide variety of anti-abuse provisions in their current legislation. This could create lack of clarity and potentially creates confusion and could potentially lead to improper use of the directive. The inclusion of the more comprehensive anti-abuse rule could create a common standard and remove these difficulties.

It could also represent further clarification of the current principles underlying the anti-abuse provision as the anti-abuse provision must be in line with the jurisprudence of the CJEU.

## 4. Policy options

Hybrid loan mismatches

The following policy options are considered:

Option A0: No action (baseline scenario).

Option A1: Profit distribution payments which are deductible in the source Member State would be excluded from the PSD.

Option A2: The tax exemption benefits in the PSD would be denied 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.

Anti-abuse provision

For the purposes of clarity and certainty, the following alternative ways of improving the anti-abuse provision in the PSD are considered:

Option B0: No action (baseline scenario).

Option B1: Updating the current anti-abuse provisions of the PSD in light of the GAAR proposed in the December 2012 Recommendation on aggressive tax planning. The directive would be amended to include the recommended common anti-abuse rule. Under this option, Member States could choose whether or not to adopt the anti-abuse rule.

Option B2: The same as option B1 with the addition that under this option, it would be an obligation for Member States to adopt the common anti-abuse rule.

## 5. Analysis of impacts

Hybrid financial mismatches

- Option A0 would not address the double non-taxation issue nor would it allow Member States to implement in their national legislations the political agreed solution in the Code of Conduct Group. The baseline scenario is therefore that the loophole will continue to exist.

  The consequences for the government finances will worsen as cross-border investments increase with the fulfilment of the Internal Market. More and more enterprises will be able to take unduly advantage from mismatches between different national tax treatments when they make or increase their cross-border investments. Purely national enterprises will on the other hand suffer a competitive disadvantage.

- Option A1 would merely remove a legal obstacle which is preventing Member States from fully adopting the guidance agreed within the Code of Conduct Group; it is then up to Member States to decide whether to implement or not the agreed guidance.

  As to the effective benefits and costs, this will depend upon the actual implementation by the Member States of the agreed guidance. In case of implementation by all Member States, the costs and benefits will be as described under option A2.

- Option A2 would directly implement the guidance agreed within the Code of Conduct Group and tackle hybrid financial mismatches in the PSD. This option aims to solve the double non-taxation issue by providing for the taxation of payments deductible in the source Member State. This option is more effective in achieving the intended policy objectives, i.e. avoiding double non-taxation in the area of hybrid loan structures, as all Member States would be obliged to tax the profit distributions when the source state has allowed deductions for the payment. It will not depend upon the actual implementation by the Member States of the agreed Code of Conduct guidance.

  Counteracting double non-taxation deriving from hybrid financial arrangements 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. Indirectly, the positive budget impact will benefit the citizens in terms of more resources available for public services and social benefits. Domestic and small or medium-sized companies are not directly affected as tax planning in hybrid loan mismatches requires sophisticated tax expertise and cross-border operations. The amendment will however ensure a level playing field as large businesses will no longer be able to make aggressive tax planning in mismatches and enjoy an advantage. Public confidence in the fairness and the transparency of the tax system will also benefit from the amendment.

  As to the benefits quantification, even though hybrid mismatches may significantly reduce overall tax base revenues for taxpayers, their international features and tax avoidance consequences make it difficult to calculate the revenue lost by the countries involved and, therefore, the tax revenue which would be recovered as a consequence of the amendment.

  There is however an increased awareness of the problem with hybrid instruments in Member States' tax administrations and international organisations. The increased level of sophistication in the structuring of financial cross-border transactions poses important challenges to tax revenue authorities and tax policy makers.

  As stated by the 2012 OECD Report on Hybrid Mismatch Arrangements, "*although there are no comprehensive data on the collective tax revenue loss caused by such arrangements, anecdotal evidence shows that the amounts at stake in a single transaction or series of transactions are substantial. For example, New Zealand settled in 2009 cases involving 4 banks for a combined sum exceeding NZD 2.2 billion (EUR 1.3 billion). Italy recently reported that it has settled a number of cases involving hybrids for an amount of* *approximately EUR 1.5 billion. In the United States, the amount of tax at stake in 11 foreign tax credit generator transactions has been estimated at USD 3.5 billion*"[14].

Furthermore one contributor (the Hungarian branch of the International Fiscal Association (IFA)) to the Commission's public consultation on double non-taxation reported that *"This is one of the most typical and most exploited forms of double non-taxation, and it is impossible to list the many kinds and circumstances. However, most of them do seem to follow the basic pattern as described in the Commission's example. Mismatching is thus not precluded even in Hungary. Participating loan is always considered in Hungary as a loan. The Hungarian debtor can thus get access to interest deduction in the instance that the income the creditor receives may be qualified in the non-Hungarian situation as the dividends received, exempt from taxation there. Hungarian interest deduction cannot be denied for this reason. Such a scheme is proliferated, for example, in respect of the (quite obsolete) Netherlands – Hungary double tax convention."*

However, the figures involved are not crucial in the decision to fight hybrid financial arrangements; reasons of competition, economic efficiency, transparency and fairness - from which the Internal Market would greatly benefit - play a determinant role in this respect. 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, whether 10 or 100 or 1000 companies are making use of such tax planning. Further quantification would therefore not be proportionate.

Costs would be suffered by the taxpayers who are now taking unjustified advantages of the double non-taxation resulting from hybrid financial instruments mismatches. Loss of such unjustified benefits should not be taken into consideration in weighing the costs and benefits of the initiative.

Option A2 could have a simplification impact, on both taxpayers and tax administrations, as it will clarify the tax treatment, under the PSD, of financial hybrid payments.

Bringing Member States' legislation in line with the modified PSD could involve a burden on tax administrations for the related implementation aspects. However there would be corresponding benefits from increased tax revenue.

No significant impacts on relationships with other countries or transposition difficulties have been highlighted by Member States during the consultation meeting (cfr. point 1. above). Option A2 will have no environmental impact.

Both options A1 and A2 do not contain exclusion for SMEs, as the PSD applies to eligible companies, irrespective of their size. Conversely, as mentioned above, SME would benefit from measures which prevent hybrid financial mismatches.

The following table summarises the analysis of the impacts (ascending scale from --- to +++)

[14] OECD, Hybrid Mismatches Arrangements: Tax Policy and Compliance Issues, 2012, page 5.

| Expected impact | | | |
|---|---|---|---|
| | Option A0: No action | Option A1: exclude hybrid loans payments from the PSD* | Option A2: exclude hybrid loan payments from the tax exemption benefits of the PSD |
| Four freedoms | = | = | = |
| Economic impact | = | + | +++ |
| Social impact | = | + | ++ |
| Impact on taxpayers/tax administrations | = | + | +++ |
| Impact on EU budget | = | = | = |
| Impact on other parties | = | = | = |

* the expected impacts would be the same as in Option A2 if all MS were to implement the Code of Conduct Group guidance

Anti-abuse provision

- Option B0 would not ensure clarity and certainty vis-à-vis anti-abuse provisions. It would not ensure against improper use of the PSD either. In this case it will only be achieved if all Member States adopt the common General Anti-Abuse Rule as recommended by the Commission in December 2012. The Council conclusions from 14 May 2013 could indicate that progress could be slow for some Member States.

- Option B1 would provide the benefits of clarity as the provision would be brought in line with CJEU jurisprudence on abuse of rights. Furthermore, the anti-abuse rule is in compliance with Treaty Freedoms as interpreted by the Court. Under this option, it would be explicitly stated what Member States could adopt as an anti-abuse rule for the purpose of the PSD. This option would therefore ensure that the anti-abuse measures adopted and implemented by Member States on this basis would raise no EU law compliance issue. However, whether an anti-abuse provision is actually transposed into national legislation would be up to the individual Member State. This option would therefore not ensure against improper use of the PSD.

- Option B2 will ensure that the results mentioned under option B1 and the objectives of the initiative are achieved quicker and with more certainty as Member States will be obliged to adopt the anti-abuse provision. This option is therefore more effective than option B1.

  This option would also ensure 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 no such rule exist).

  Furthermore, the amendment will be in line with recent Commission proposals. Article 80 of the proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) of 16 March 2011 (COM(2011)121) includes a general anti-abuse rule and

Article 13 of the recent proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT) of 14 February 2013 (COM(2013)71 final) includes an anti-abuse rule which was directly inspired by the rule in the December 2012 Recommendation.

The analysis of a general anti-abuse rule in Member States' national legislation was carried out in preparation of the Recommendation on aggressive tax planning, i.e. the Impact Assessment (SWD(2012)403), p. 36-38. In the Recommendation itself it is furthermore stated that, *"As tax planning structures are ever more elaborate and national legislators are frequently left with insufficient time for reaction, specific anti-abuse measures often turn out to be inadequate for successfully catching up with novel aggressive tax planning structures. Such structures can be harmful to national tax revenues and to the functioning of the internal market."*

The impacts of updating the anti-abuse provision in the PSD would be similar, although it has to be taken into account that the rule would be limited to abuse within the scope of the directive.

Counteracting tax avoidance will have similar impacts as countering hybrid financial mismatches. As already indicated, countering tax avoidance will have a positive impact on the tax revenue of Member States. Domestic and small or medium-sized companies will not be directly affected as tax planning requires sophisticated tax expertise and cross-border operations. However, there will be a level playing field as no one will be able to abuse the directive. Public confidence in the fairness and the transparency of the tax system will also benefit from the amendment.

It is not possible to quantify the benefits from countering tax avoidance. However, as mentioned above, the figures involved are not crucial in the decision to fight tax avoidance; reasons of competition, economic efficiency, transparency and fairness - from which the Internal Market would greatly benefit - play a determinant role in this respect.

Costs would be suffered by the taxpayers who are now taking unjustified advantages of the tax avoidance. The loss of benefits that stem from avoiding legitimate taxation should however not be taken into consideration in weighing the costs and benefits of the initiative.

Both options B1 and B2 could have a simplification impact both on taxpayers and tax administrations, as it will clarify the tax treatment under the PSD. This will be more significant under option B2 as the anti-abuse provision must be transposed to Member States' legislation under this option.

No significant impacts on relationships with other countries or transposition difficulties have been highlighted by Member States during the consultation meeting.

The options will have no environmental impact or social impact.

Both options B1 and B2 do not contain exclusion for the SMEs, as the PSD applies to eligible companies, irrespective of their size. It should be noted that although SME representatives were consulted, no objections were raised from their side. Conversely, as mentioned above, SME would benefit from measures which prevent hybrid financial mismatches.

The following table summarises the analysis of the impacts (ascending scale from --- to +++)

| Expected impact | | | |
|---|---|---|---|
| | Option B0: No action* | Option B1: optional anti-abuse provision in the PSD* | Option B2: obligatory anti-abuse provision in the PSD |
| Four freedoms | = | + | + |
| Economic impact | = | = | + |
| Social impact | = | = | = |
| Impact on taxpayers/tax administrations | = | + | + |
| Impact on EU budget | = | = | = |
| Impact on other parties | = | = | = |

* the expected impacts would be the same as in Option B2 if all MS were to implement the recommended anti-abuse rule

## 6. Comparing the options

Hybrid financial mismatches

As explained in point 5, above, Option A0 would not address the double non-taxation issue. The baseline scenario is therefore that the loophole will continue to exist. Distributed profits that are deductible in the source state and not taxed in the receiving state would continue to be covered by the PSD. This is contrary to the fundamental purpose of the PSD.

Option A1 would be in line with the solution adopted in the Interest and Royalties Directive, where the source Member State is not obliged to ensure the benefits of that directive (i.e. the exemption from any tax, whether by deduction at source or by assessment, on interest or royalties payments in the Member State where they arise) to certain hybrid payments[15]. However, this option does not, per se, solve the possible double non-taxation generated by hybrid financial payments, leaving it to the Member States to adapt their internal legislation to the Code of Conduct Group guidance.

Option A2 would be more effective than option A1 in counteracting hybrid financial arrangements and would ensure consistency of treatment across the EU. No withholding tax on the distributed profits would be applied by the subsidiary since it would treat the payment as interest under the Interest and Royalties directive. As to the residual gap within the current 25% eligibility shareholding in the Interest and Royalties directive and the 10% shareholding in the PSD, there is a pending proposal in Council to align the shareholding threshold in the Interest and Royalties directive to the 10% of the PSD.[16] Moreover, typically hybrid financial

15 Article 4(1) of Council Directive 2003/49/EC. A recast of this directive (COM (2011) 714) is pending in Council.

16 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).

arrangements are set up in Members States having a zero withholding on interest payments under domestic or double tax conventions provisions.

Option A2 would 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 increase in cross-border investments has given cross-border 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 to a distortion of competition between cross-border and national groups within the EU, contrary to the purpose of the PSD.

Moreover, this option A2 would not only be in line with the OECD recommendation to introduce in national legislation targeted rules denying the exemption for certain hybrid mismatch arrangements, but also with the current EU and non-EU political approach against tax base erosion and aggressive tax planning (G8, G20 finance ministers' declarations and their strong support for the OECD work on BEPS).

Some business representatives prefer option A1 rather than option A2 as the latter in their view would be limiting the rights of taxpayers and Member States. It should, however, be noted that the effect of non-implementation of the Code of Conduct guidance in one Member State will affect the tax revenue in another Member State who allows the deductions for the interest payments. It is therefore important that all Member States introduce taxation of the profit distributions when the source state allows deductions for the payment. For these reasons it should not be left to Member States to decide whether or not they will implement the Code of Conduct guidance. These are also the reasons why it is in line with the subsidiarity principle and proportionate to choose option A2 rather than option A1. It is more effective in achieving the intended policy objectives, i.e. avoiding double non-taxation.

| **Comparing the options** | | | |
|---|---|---|---|
| | Option A0: No action | Option A1: exclude hybrid loans payments from the PSD | Option A2: exclude hybrid loan payments from the tax exemption benefits of the PSD |
| Effectiveness in achieving policy objective | = | + | +++ |
| Efficiency in achieving policy objective | = | + | +++ |
| Coherence with other tax policy | = | + | +++ |

Thus option A2 is the preferred Option.

<u>Anti-abuse provision</u>

Some Member States and some business representative have stated that they would prefer the current domestic anti-abuse provisions (i.e. option B0).

Some Member States seems to believe a common anti-abuse provision could limit their ability to counter abuse as they believe the Commissions interpretation of CJEU case law is too narrow. The Commission believes that the recommended GAAR reflects CJEU case law on abuse of rights.

Other Member States and some business representatives seem to believe that the drafting of anti-abuse provisions in direct tax legislation should be the competence of Member States. It must however be recalled that non-implementation by one Member State of an anti-abuse provision will affect the other Member States as investments could be channelled through the Member States with the weakest anti-abuse provisions.

Like one of the contributors to the public consultation, the Commission believes that restrictions should not constrain normal commercial transactions and that Europe should be an attractive place of interest. On the other hand, artificial arrangements targeted by the anti-abuse provision ought not to be protected or result in tax benefits.

Furthermore option B0 would not ensure clarity and certainty vis-à-vis anti-abuse provisions. The current situation with lack of clarity for taxpayers and for tax administrations would continue. The PSD would not be ensured against improper use either if the anti-abuse provisions are less stringent or non-existent in some Member States. In this case the objectives will only be achieved if all Member States adopt the common General Anti-Abuse Rule as recommended by the Commission in December 2012. The Council conclusions from 14 May 2013 could indicate that progress could be slow for some Member States.

As explained in point 5. Above, Option B1 would provide the benefits of clarity as it would be explicitly stated what Member States could adopt as an anti-abuse rule for the purpose of the PSD. This option would therefore ensure that the anti-abuse measures adopted and implemented by Member States on this basis would raise no EU law compliance issue. However, the decision to actually transpose the anti-abuse provision into national legislation would be up to the individual Member State. As such, this option would not ensure against improper use of the PSD.

Option B2 would on the other hand ensure against improper use of the PSD. It would also be more effective than option B0 and B1 in achieving a common standard for anti-abuse provisions tackling abuse of the PSD. A common anti-abuse provision in all Member States would establish clarity and certainty for all taxpayers and tax administrations. Option B2 would ensure that the anti-abuse measures adopted and implemented by EU Member States will raise no EU compliance issue.

B2 will be coherent with the recent policy line of the Commission as seen in the recent proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT) of 14 February 2013 (COM(2013)71 final).

B2 would also be a proportionate option and in line with the subsidiarity principle as it is the only way to ensure that all MS are placed under an obligation to refrain from recognizing the benefits of the PSD in the event of abuse. Otherwise, artificial arrangements such as conduit companies can benefit from less stringent or non-existing anti-abuse provisions in a Member State.

| Comparing the options | | | |
|---|---|---|---|
| | Option B0: No action | Option B1: optional anti-abuse provision in the PSD | Option B2: obligatory anti-abuse rule in the PSD |
| Effectiveness in achieving policy objective | = | + | +++ |
| Efficiency in achieving policy objective | = | + | +++ |
| Coherence with other tax policy | = | + | +++ |

Thus option B2 is the preferred option.

## 7. Monitoring and evaluation

It is established practice for the Commission to monitor the implementation of EU directives by Member States. The legal changes envisaged by the initiative are so straight forward that it is not necessary to conduct a study of whether the objectives of the initiative are met. No transposition issues have been identified and none are expected given the unanimity requirement for direct tax legislation. It is sufficient to monitor that Member States actually transpose the rules to national legislation.

The Commission will continue to monitor the proper functioning of the PSD, including the proposed changes, through the Code of Conduct group (together with Member States). It should be recalled that the distorting effects of mismatches resulting in different treatment of hybrid loans were discussed and analyses in the context of the Code of Conduct Group.

Furthermore, a new Platform for Tax Good Governance (where Member States and expert representatives from business, tax professional and civil society organisations participate) has been set up this year. The Platform shall assist the Commission in developing initiatives to promote good governance in tax matters in third countries, to tackle aggressive tax planning and to identify and address double taxation issues.

Additionally, OECD and G20 have initiated a comprehensive analysis of the international corporate tax system called Base Erosion and Profit Shifting (BEPS). A BEPS Action Plan was published on 19 July 2013. The actions outlined in the plan will be delivered in the coming 18 to 24 months by the joint OECD/G20 BEPS Project, which involves all OECD members and G20 countries on an equal footing. The Commission will participate in the work. The Commission will also endeavour to coordinate the position of the EU.

#### 4.6.7. General Anti-Abuse Rules

71. **Introduction: GAARs.** A general overview of all measures reported with respect to the selected MSs which can be qualified as general anti-abuse rules (below "GAARs") is provided at the end of this section. In a nutshell, GAARs can be summarised as rules applied generally that prevent taxpayers from entering into abusive transactions/planning, generally for the sole (or main) purpose of avoiding or reducing a tax charge.

72. **All the countries have reported one or more GAARs.** A total of 22 measures have been reported by 14 countries. Except Denmark, Cyprus, Germany and the Netherlands, all the reporting countries have two or more rules.

The measures are generally laid down in primary law. Of the 22 measures, only four are based on case law or derived from tax-administration practices (Denmark, France, the Netherlands and Sweden). In particular, the reported measures have generally been part of the legal system for a while. Only one reported measure has not yet been enacted (the United Kingdom) and another has been significantly amended very recently (Belgium).

73. **Types of GAARs.** In a nutshell, the reported measures can be categorised according to the following concepts/principles:

- abuse of law: the law is formally complied with but in a way that is not compatible with its spirit;
- the substance-over-form principle: the law is formally complied with but there is a lack of substance supporting the transaction/restructuring so that the tax authorities can disregard its form;
- the simulation/sham concept: a transaction is entered into by parties but not adhered to by them because another transaction, which is adhered to, alters or negates the first transaction.

The GAARs reported in the Study are briefly summarised in the following table.

**Table 13: General Anti-Abuse Rules**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| BELGIUM | | X | X | Art. 344, §1, BITC | The administration is not bound to recognise legal acts or series of legal acts effecting one and the same transaction if it establishes by means of presumptions or by other means of proof and on the basis of objective circumstances that tax abuse results. | Possibility of counter-evidence; the "Purposes" of some provisions could be unclear; "Other reasons" broader than legitimate economic or financial reasons<br><br>Related concept: Simulation ("sham") doctrine | Many decisions concerning the former provision led to its being reformulated<br><br>Provision too recent: no decision currently available |
| CYPRUS | X | | | Art. 33, ACTL L.4/78 | Where a Cypriot tax-resident company or individual enters into any transaction which the Director of Inland Revenue considers to be "artificial" or "fictitious", this may be disregarded and taxable income may be adjusted accordingly. | | |
| ESTONIA | | | X | Art. 83(4), ETA | Based on the Estonian "abuse of law" principle, fictitious transactions will not be taken into account for tax purposes (i.e. if a fictitious transaction is entered into in order to conceal another transaction) so that provisions concerning the concealed transaction apply to determine tax liability. | These two provisions are equally applicable to all taxpayers irrespective of the country of residence of the counterparty | One decision by the Supreme Court (3-3-1-42-11, 26 Sept. 2011) seems to have set a new trend in developments regarding these two provisions by attributing profits of a non-resident company to an Estonian resident, leading to taxation of these profits in the hands of the Estonian resident (hidden profit distributions) |
| | X | | | Art. 84, ETA | The Estonian "substance-over-form" principle means that, if it is evident from the terms of a transaction or act that it is performed for the purposes of tax evasion, conditions corresponding to the actual economic effect of the transaction or act apply for tax purposes. | | |

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| FRANCE | | | X | Art. L 64, French Proceedings Code | The abuse of law procedure enables the FTA to disregard transactions or acts carried out by a taxpayer if such transactions or acts are fictitious or if they have as their sole purpose the avoidance of French taxes that the taxpayer should have borne in the normal course of its activity and when the tax benefit of the transaction is contrary to the intent of the legislator. If the abuse of law is proved, the FTA are entitled to reassess avoided tax and to add a penalty of 40% to that tax (increased to 80% if the taxpayer is the principal investigator or beneficiary). | | The Supreme Administrative Tax Court fixed the limits of the abuse of law principle in its Janfin decision |
| FRANCE | | | ("Normal act of management") | (Case law concept) | According to French tax case law, a company engages in an abnormal act of management if it bears an expense or deprives itself of a profit without being able to show that it is in its own interests to do so. | Burden of the proof on the FTA | Many court cases but solutions generally depend on the facts<br><br>Interesting case by the Versailles Administrative Court of Appeal concerning a share buy-back deal |
| GERMANY | | | X | Art. 42, General Fiscal Code (Abgabenordnung (AO)) | The purpose of this measure is to avoid non-taxation or a reduced tax charge by "abuse of legal arrangements" contrary to the spirit (if not the wording) of the tax law. In such cases, the tax is due as if an arrangement considered appropriate had been chosen by the taxpayer. | Provision amended by the Legal Tax Act of 2008; now legally defining abusive transactions (a notion developed by the courts) and avoiding incompatibility issues between this general provision and the special anti-avoidance rules | |
| HUNGARY | X | | | Sec. 1 (7), Act on Rules of Taxation | This principle requires arrangements to be classified according to their commercial substance, though it does not specify any further detail. It gives the tax authority the right to recharacterise transactions if their substance differs from their declared legal classification. | Burden of proof on the taxpayer<br><br>Recharacterisation is not considered unconstitutional<br><br>Limited established court practice regarding interpretation | Two Resolutions of the Supreme Court have been reported (BH2002.509 and BH2002.702); it should be borne in mind that, in Hungary, Supreme Court decisions are not binding on the tax authority |
| HUNGARY | | | X | Sec. 2 (1), Act on Rules of Taxation | This provision gives the tax authority the right to recharacterise transactions if a taxpayer has not executed its rights within their meaning and intent | Recharacterisation not considered unconstitutional<br><br>Limited established court practice regarding interpretation | Two Resolutions of the Supreme Court have been reported (BH2005.332 and BH2011.327); it should be borne in mind that, in Hungary, Supreme Court decisions are not binding on the tax authority |

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| IRELAND | X | | X | Sec. 811, Taxes Consolidation Act 1997 | This measure is designed to counteract transactions which lack commercial reality and are put in place with a view to reducing or avoiding a charge to Irish tax, i.e. the so-called "tax avoidance transaction" or "tax avoidance scheme". If the transaction is found to be a "tax avoidance scheme", the Irish tax benefit arising from it will be denied and this will result in a tax liability together with interest and penalties owed on the underpayment of tax. | | Only one case (Revenue Commissioners v. O'Flynn Construction) confirming the Revenue's ability to look at the purpose for which tax relief was introduced in determining whether a transaction is a "tax avoidance scheme" |
| LUXEMBOURG | | X | | §5, Steueranpassungs-Gesetz ("StAnpG") | Where the agreement is found to be a "sham" (put in place to conceal another agreement), the tax authorities will tax the outcome of the "real" transaction that should have occurred without simulation. | | |
| | X | | X | §6, Steueranpassungs-Gesetz ("StAnpG") | This measure applies when the route chosen to carry out a transaction is one which would not usually be taken – and there is a lack of other (non-tax) reasons justifying this choice – leading to tax liability being circumvented. In that case, the fiscal consequences that the taxpayer wanted to circumvent are applied. | | In its decision no. 18971 (11 May 2005), the Administrative Court took a more "substance-over-form" approach to this measure in a case concerning tax residence |
| MALTA | X | | | Art. 51(1), ITA | Any scheme which reduces the amount of tax payable by any person is disregarded when it is artificial or fictitious or it is not, in fact, given effect to. The relevant person is assessable accordingly. | | A landmark decision (Enterprises' Limited v. Frank Bowers) specified that there is nothing wrong if a person legitimately makes use of the methods available in the law to reduce his ultimate tax liability, provided, naturally, that any planning falls within the parameters allowed by law |
| | | | X | Art. 51(2), ITA | This measure allows the Maltese tax authorities to nullify or modify schemes and connected advantages obtained as a direct or indirect result of any scheme whose sole or main purpose was to obtain any advantage which has the effect of avoiding, reducing or postponing liability to tax, or to obtain any refund or set-off of tax. | | |

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| | | | X | Art. 42, ITA | Arrangements including a series of transactions effected with the sole or main purpose of reducing the amount of tax payable by a person by reason of operation of the investment income provisions (which broadly allow for a lower tax rate of 15%) are disregarded. In such cases, the person is assessable as if the aforesaid provisions did not apply. | | |
| | | | X | Art. 51(4) and (5), ITA | Specific deductions are allowed on income resulting from a scheme or a change in the shareholding of a company only if it has not been put in place or performed solely or mainly for the purpose of obtaining the benefit of any loss or of any capital allowances so as to avoid liability to tax. | | Much case law, but on a case-by-case analysis so that it is difficult to provide a summary of the main case law. |
| NETHERLANDS | | | X | (Case law concept) | On the basis of the *fraus legis* concept, the tax authority has an instrument to challenge transactions (or sets of transactions) by taxpayers that are contrary to the purpose of the law. | If *fraus legis* is applied successfully, transactions are eliminated / substituted to arrive at an outcome that is in line with the object and purpose of the law. | Since this is a case law concept, the courts are decisive on applying this measure (e.g. HR, 26 May 1926 – first application of the concept – and HR, 21 Nov. 1984 – development of the main criteria of the concept) |
| SPAIN | | X | | Art. 16, SGTA | In the event of sham or simulation, the taxable event will be the transaction actually carried out by the parties. This can be a partial (another transaction is executed) or a full (no transaction is executed) simulation. | | |
| | | | X | Art. 15, SGTA | When a taxable event is wholly or partially avoided or when taxable income is reduced by acts or means where the following circumstances are met (i) the acts, whether individually or jointly, are contrived or unsuitable for the result attained; or (ii) as a result of the acts, there are no significant legal or economic consequences beyond tax savings. If a tax assessment is made under this rule, the tax is imposed on those acts or businesses that are avoided. | On an annual basis, the Spanish Tax Authorities publish a set of tax collection and audit objectives which are used as guidance and focused on in their tax audits. These guidelines explain which transactions are going to be challenged by the tax authorities. The guidelines specifically state that the fight against tax fraud is a priority. | |

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| SWEDEN | | | X | Tax Avoidance Act (Sw: Skatteflyktslagen (1995:575)) | A legal act undertaken by a taxpayer may be disregarded if it results in a significant tax benefit for the taxpayer and the tax benefit has been the main reason for it; the final, decisive criterion is that taxing the situation as presented would be contrary to the purpose of the legislation. | Measure only applied in court cases, i.e. the Tax Agency may not apply it in levying tax without a court ruling and, thus, it has to request the court to apply the law. | Many cases, but on a case-by-case analysis so that it is difficult to provide a summary of main case law. However, most recently (HFD 2012 ref 6), the Supreme Administrative Court refused to apply the GAAR in a case relating to interest deductions where it was clear that the interest-stripping rules were not applicable |
| | X | | | (Administrative practice/case law concept) | Where an agreement or transaction is incorrectly labelled, the Tax Agency or Administrative Court may tax the agreement or transaction according to its true meaning, by applying the ordinary interpretive methods of civil law. | The measure may not be used to recharacterise the agreement itself (e.g. characterising debt as equity); the legal form of an agreement is thus generally upheld for tax purposes. | In two cases (no. RÅ 2004 ref. 27 and RÅ 2008 not. 169), the Supreme Administrative Court rejected the "true meaning" approach taken by the Swedish Tax Agency |
| UK | | | "reasonable tax planning" | Consultation document released on 12 June 2012 | This future measure will target business and individuals that do not undertake "sensible and responsible tax planning", i.e. tax planning that *"can [not] reasonably be regarded as a reasonable exercise of choices afforded by the provisions of the Acts"*. | Could lead to additional corporation tax revenue of £2.1 bn a year | n/a (future measure) |
| | | | X | Interest: Sec 441 and 442, CTA 2009<br><br>Manufactured payments: Sec. 799 and 800, CTA 2010 | A company is not entitled to any relevant tax relief so far as this is in respect of interest or a manufactured payment where the payment is attributable to the unallowable purpose, i.e. one of the reasons why the company is party to them is not among the business/commercial purposes of the business. | | First Tier Tribunal - A.H. Field (Holdings) Limited vs. HMRC (March 2012) in favour of HMRC: FTT determined that tax avoidance was a main purpose of entering into the loan note and therefore that the borrowing costs were not deductible for tax purposes. |