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EU Commission Releases Draft Directive on BEPS: A Critical Analysis from a Luxembourg Perspective

On 28 January 2016, the European Commission presented its Anti Tax Avoidance Package, one of the core pillars of which is a Draft EU Anti Tax Avoidance Directive or "Anti-BEPS" Directive. The Draft Directive proposes anti-tax avoidance rules in six specific areas, which are intended to be implemented by each EU Member State. This article provides an overview of the proposed provisions and analyses how they may impact Luxembourg tax law.

1. Introduction

The aim of the Draft EU Anti-Tax Avoidance Directive (the Draft Directive)[1] is to implement, at the EU level, the BEPS recommendations made by the OECD and G20 in October 2015. The proposal follows the conclusions reached at the 8 December 2015 ECOFIN meeting, notably that EU directives should, where appropriate, be the preferred vehicle for implementing OECD BEPS conclusions at the EU level. The content of the Draft Directive largely follows a previous anti-BEPS Directive elaborated on at the EU Council level, which was made available to the public in December 2015 and which included several BEPS recommendations.[2] The details of the Draft Directive, however, vary significantly from the previous draft of the anti-BEPS Directive.

The Draft Directive covers all taxpayers who are subject to corporate tax in an EU Member State, as well as EU Permanent Establishments (PEs) of taxpayers who do not fall within the scope of the Draft Directive. The Draft Directive lays down anti-tax avoidance rules in the following areas:
- the deductibility of interest;
- exit taxation;
- switch-over clauses;
- general anti-abuse rules (GAAR);
- controlled foreign company (CFC) rules; and
- hybrid mismatches.

The measures provided in the Draft Directive are presented as minimum standards but, in fact, certain of these rules are mere recommendations or best practices within the BEPS framework. It follows that the proposed measures go far beyond the BEPS recommendations.

Although the concern of the European Commission that tax avoidance should be fought in a coordinated manner is understandable, the proposals raise serious concerns in that they further erode national sovereignty in tax matters and, by "gold plating" the BEPS recommendations, are bound to make the European Union a less attractive environment to do business.

2. Limitation on the Deductibility of Interest Payments

2.1. Draft Directive proposals

The first measure follows the recommendations on BEPS Action 4 (on interest deductions and other financial payments) and aims to discourage multinational groups from reducing the overall tax base of the group by financing group entities in high-tax jurisdictions through debt.[3] Here, the Draft Directive proposes a fixed ratio rule as the general rule and a group-wide rule as a carve-out from the general rule.

More precisely, the proposal is to set a rate of interest deductibility at the top end of the scale recommended by the OECD (10% to 30%). Subject to certain conditions and limitations, borrowing costs will be deductible only up to 30% of the taxpayer's earnings before interest, tax and amortization (EBITDA) (fixed ratio rule) or up to an amount of EUR 1 million (safe harbour), whichever is higher.[4] The Draft Directive states, however, that Member States may also choose to introduce stricter rules. Under the current proposal, financial institutions and insurance undertakings are not subject to this limitation.[5]

Taxpayers who can demonstrate that the ratio of their equity relative to total assets is equal to or higher than the equivalent ratio of the group can (under certain conditions) fully deduct their excess borrowing costs (group-wide rule).[6] The application of a group-wide rule would, however, be an extremely complex exercise and entail

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1. Proposal for a Council Directive Laying Down the Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, COM (2016) 26 final (28 Jan. 2016), 2016/0011 (CNS) [hereinafter: Draft Directive].
2. OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports, available at http://www.oecd.org/tax/beps-2015-final-reports.htm.
3. Available at http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm.
4. Art. 4(2) Draft Directive.
5. Art. 4(6) Draft Directive.
6. Art. 4(3) Draft Directive.

many difficult measurement issues given the significant differences in tax and accounting principles applicable in different countries. Even the definition of interest may vary from one country to another. This means MNEs will have to determine relevant figures for each group company and make adjustments to account for differences in the accounting and tax treatment.[7]

All this would elevate the compliance burden and related costs to an unprecedented level. Furthermore, the current year tax payment would become more problematic and unpredictable due to groups not knowing what their interest deduction will be until some time after reporting their annual results to the market when their worldwide financial statements become available. The group-wide rule would not only present an enormous administrative burden to taxpayers, but taxpayers and tax authorities alike would have to consume substantial resources to administer such an intricate rule.

Carry-forward provisions are available in the event the interest deduction or EBITDA is not fully used.[8] When interest expenses are not deductible, however, double taxation will likely arise, as the lender should be taxable on the corresponding income. Even the proposed carry-forward mechanism would not eliminate the problem of double taxation, as companies may never be in a position to use the amounts carried forward. This can be a real problem for companies in financial difficulty, as it may require them to pay corporate tax on non-existent profits, at a time when they are likely to be cash-strapped, adding to their financial difficulties.

Moreover, how a business finances its operations is an important business decision that depends on a range of factors. While the deductibility of interest expenses is one factor to be considered, the decision as to whether a company should be financed by equity or debt is generally not tax driven and there are a number of commercial reasons why intra-group loans might be preferable to a contribution of equity (legal requirements, regulatory constraints, foreign currency implications, business considerations, etc.).

The proposed rules could lead to a significant disallowance of interest expenses in respect of alternative investments, such as real estate, private equity and infrastructure investments. These investments usually carry relatively high levels of third-party debt.

2.2. Potential impact on Luxembourg tax law

Luxembourg tax law currently does not provide for any thin capitalization or earnings stripping rules, other than the 85:15 debt-to-equity ratio applicable to holding activities (which is based on administrative practice). Accordingly, participations may be financed through a maximum of 85% shareholder loans bearing interest at arm's length.[9]

In general, interest expenses incurred by Luxembourg companies are deductible for Luxembourg tax purposes. There are, however, several exceptions to this rule. For example, interest expenses incurred in relation to tax-exempt income are not deductible.[10] Likewise, interest incurred on excess debt funding in relation to holding activities and interest expenses that exceed the arm's length interest rate are not deductible.[11] The existing limitations on the deductibility of interest expenses should suffice to avoid abuses.

Under the proposed rules, Luxembourg companies engaged in financing activities may still be taxable on an arm's length margin as the Draft Directive states that borrowing costs will always be deducted to the extent that the taxpayer receives interest or other taxable revenue from financial assets.[12]

The fact that these rules are not minimum standards at a global level means that many non-EU countries will decide not to implement them. This would put the European Union, including Luxembourg, at a competitive disadvantage with the result that there will not be a "level playing field". Implementation of the proposed limitation on the deductibility of interest by Luxembourg might be harmful to the country's position as a location of choice for the structuring of cross-border investments in and through Europe.

In the German Federal Tax Court's (*Bundesfinanzhof*) recent decision in I R 20/15 (14 October 2015), the Court decided on the German earnings stripping rules, which are fairly similar to the proposed rule in the Draft Directive.[13] The Court concluded that the German earnings stripping rules are likely not in line with the German constitution, as they violate fundamental tax principles, in particular, the principle that expenses incurred in relation to taxable income should be tax deductible (*objektives Nettoprinzip*), as well as the ability-to-pay principle (*Leistungsfähigkeitsprinzip*). The German Federal Tax Court explicitly mentioned that these violations cannot be justified by arguing that the rule is intended to avoid abuse. The Court referred the case to the German Constitutional Court for a final decision.

While this decision relates to a mere domestic fact pattern (i.e. it might be acceptable to limit such a rule to cross-border situations), in an EU context, it should not be possible to apply such a rule exclusively to non-resident lenders.[14] Hence, the earnings stripping rule might not, in a domes-

7. Since 2007, German tax law has provided for earnings stripping rules that are broadly similar to the recommendations of the OECD. In practice, the escape clause can hardly ever be successfully applied.
8. Art. 4(4) and (5) Draft Directive.
9. In accordance with administrative practice, however, Luxembourg companies are, depending on the financing instruments used, free to finance participations with a higher proportion of debt. For example, interest-free loans are treated as equity for the debt/equity ratio and may replace a large part of the 15% equity portion.
10. LU: Income Tax Act (LITA), arts. 45(2) and 166(5) No. 2, National Legislation IBFD.
11. Article 164(3) of the LITA.
12. Art. 4(1) Draft Directive.
13. *See* DE: BFH, 14 Oct. 2015, I R 20/15.
14. For example, *see* DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, ECJ Case Law IBFD.

tic situation, be consistent with the German constitution but, at the same time, cannot, under EU Law, be limited to cross-border cases (to the extent lenders are resident in another Member State).

Since the Luxembourg legal and tax systems are based on the same fundamental principles as the German system, it is likely that the proposed earnings stripping rule will raise similar concerns in Luxembourg, with the same limitation when it comes to applying the rule in an EU cross-border context.

3. Exit Taxation

3.1. Draft Directive proposals

The second measure is aimed at discouraging taxpayers from moving their tax residence and/or assets to low-tax jurisdictions. Under the proposal, a taxpayer will be subject to tax at an amount equal to the market value of any assets transferred at the time of the exit, less their value for tax purposes in the event of:

– a transfer of assets from a head office to a PE in another Member State or a third country;
– a transfer of assets from a PE to its head office or another PE in another Member State or third country; or
– a transfer of tax residence to another Member State or a third country (except for those that remain connected with a PE in the first country).[15]

With regard to transfers within the European Economic Area, a taxpayer may defer the payment of exit tax by paying in instalments over a period of at least five years.[16] This is in line with the requirements set out in the case law of the European Court of Justice (ECJ).

3.2. Potential impact on Luxembourg tax law

Under Luxembourg tax law, the aforementioned transfers are already taxable events (subject to the possibility to defer the payment of exit tax where the transfers occur within the European Economic Area, which, since 2016, has been extended to transfers involving tax treaty countries).[17]

Hence, even though the Luxembourg legislation is currently more favourable given that the payment of the tax can be deferred upon request until the effective realization of the gain, the rule included in the Draft Directive would not require any change to Luxembourg tax law. Indeed, in an EU/EAA context, the Draft Directive requires a deferral of the payment over a period of at least five years, which should mean that EU Member States will be able to implement more favourable measures in an EU/EAA context.

15. Art. 5(1) Draft Directive.
16. Art. 5(2) Draft Directive.
17. According to art. 172 LITA, the transfer of the seat and central administration of a Luxembourg company to a foreign jurisdiction is a taxable event. Transfers of assets between a head office and a PE (and between different PEs in different countries) are taxable events under Luxembourg tax law in accordance with the separate enterprise approach and OECD principles on the attribution of profits to a PE. LU: General Tax Law (*Abgabenordnung*, AO), sec. 127(2) and (3) provides that the payment of the tax may be postponed until the latent capital gains are realized and defines the conditions to be fulfilled by a taxpayer to benefit from this rule.

4. Switch-Over Clause

4.1. Draft Directive proposals

The aim of a switch-over clause is to discourage companies from shifting profits out of high-tax jurisdictions towards low-tax jurisdictions, unless there is a sufficient business justification for the transfer.

To achieve this, the proposed rule states that a Member State must not exempt a taxpayer from tax on third-country income received in the form of (1) a profit distribution, (2) a capital gain on the sale of shares in a third-country entity or (3) income from a third-country PE if this third country taxes profits at a rate that is lower than 40% of the statutory tax rate that would have been levied in the Member State. In such an instance, the Member State will grant a tax credit for the tax paid in the foreign country on such income.[18]

4.2. Potential impact on Luxembourg tax law

This rule would have an extremely limited scope once implemented under Luxembourg tax law. This is because dividends and capital gains realized in relation to subsidiaries resident in third countries may only benefit from the Luxembourg participation exemption regime if they pass a comparable tax test. Accordingly, the subsidiary has to be subject to income taxation at a rate of at least 10.5% on a comparable taxable basis. This translates into 50% of the Luxembourg corporate income tax rate (i.e. 10.5% minimum taxation equals 50% of the Luxembourg corporate income tax rate of 21%) and exceeds the suggested 40% threshold.

Thus, with regard to dividend income and capital gains, this rule might only apply in the few instances in which Luxembourg has adopted the exemption method in a tax treaty concluded with a third state to avoid double taxation. There may be a real issue here in relation to the Draft Directive imposing unilateral treaty changes that constitute illegitimate treaty override, as this would be contrary to international law. Instead, in order for the exemption to be no longer applicable, the relevant tax treaty would have to be renegotiated. Therefore, Member States should be given sufficient time to renegotiate their relevant tax treaties.

With regard to income derived through a PE in a tax treaty country, the host state of the PE has an unlimited primary taxing right and Luxembourg frequently adopts the exemption method for the avoidance of double taxation. The application of the exemption method is not conditional on recognition of the PE by the other contracting state or the level of effective taxation. Hence, the proposed rule may apply where the income of a PE located in a third state is not taxed in its host state (or taxed at a low level). Even in these instances, however, the switch-over rule should not automatically be applicable, as it would represent an illegitimate treaty override.

18. Art. 6(1) Draft Directive.

Although the switch-over clause would have a limited impact on the Luxembourg tax system, the EU Commission should study carefully the number of tax treaty renegotiations that would be required and, at a minimum, put in place grandfathering provisions pending renegotiation of such tax treaties.

Given the legal issue of a directive imposing a unilateral treaty change, a directive may not be the right legislative instrument for implementing a switch-over rule in the European Union. Rather, this rule should be part of a recommendation that EU Member States would have to take into account when negotiating or renegotiating tax treaties, similar to the recommendations made by the EU Commission regarding the principal purpose test (PPT). In this situation, EU Member States could choose whether or not they want to implement such rules.

5. General Anti-Abuse Rule (GAAR)

5.1. Draft Directive proposals

The Draft Directive further proposes the introduction of a GAAR that would allow the tax authorities of a Member State to deny taxpayers the benefit of arrangements considered to be abusive. The explanatory memorandum to the proposal expressly states that the proposed GAAR is designed to reflect the artificiality test of the ECJ.[19]

Under the proposal, non-genuine arrangements carried out for the essential purpose of obtaining a tax advantage shall be disregarded. Non-genuine means, in this respect, that they are not put into place for valid economic reasons that reflect economic reality.[20] If arrangements are disregarded in applying this rule, the tax liability is to be calculated by reference to economic substance in line with internal law.[21]

Accordingly, what is being proposed is an EU concept of "non-genuine arrangements". This is similar to the GAAR included in the latest version of the EU Parent-Subsidiary Directive (2011/96),[22] subject to some slight differences, i.e. it is overlaid with a new concept of "the essential purpose" (the Parent-Subsidiary Directive instead refers to "main purpose or one of the main purposes").

Given that these subjective concepts create a significant degree of legal uncertainty, as they may give rise to divergent interpretations, it would be desirable for the EU Commission to remain consistent with the concepts already defined in ECJ case law instead of proposing new concepts of a vague character that create additional legal uncertainty for taxpayers, as well as tax administrations, in terms of practical implementation of such rules.

5.2. Potential impact on Luxembourg tax law

The GAAR is fairly similar to the abuse of law provision provided for under Luxembourg tax law,[23] which enables the Luxembourg tax authorities to challenge transactions the sole purpose of which is to evade taxes through abusive constructions. It follows that no tax law changes should be required in this respect. Nevertheless, the scope of the abuse of law provision (and the GAAR) should be limited to clearly abusive situations or wholly artificial arrangements (in accordance with the relevant jurisprudence of the Luxembourg courts and the ECJ).

6. Controlled Foreign Company (CFC) Rule

6.1. Draft Directive proposals

The Draft Directive also provides for CFC rules that would re-attribute the income of a low-taxed controlled company to its parent company, even though it has not been distributed. In its final report on BEPS Action 3 (CFC rules),[24] the OECD provided recommendations on how to design CFC rules. These are, however, mere recommendations for countries that would like to implement such rules.

The CFC rules would apply provided:
- the controlling taxpayer hold or hold together with its associated enterprises a direct or indirect shareholding of more than 50% in the controlled entity;
- the controlled entity is subject, on its profits, to an effective tax rate that is lower than 40% of the effective tax rate that would have been charged in the Member State of the controlling taxpayer;
- more than 50% of the income accruing to the controlled entity is passive income (as defined in the proposal, i.e. interest, royalties, dividends, etc.); and
- the principal class of shares of the controlled entity is not regularly traded on a recognized stock exchange.[25]

The CFC rules also apply to financial undertakings, but only to the extent that more than 50% of their passive income, as defined in the proposal, comes from transactions with the controlling taxpayer or its associated enterprises.

The CFC rules will not apply if the controlled entity is located in an EU/EEA country, unless the establishment of the entity is wholly artificial or to the extent that the entity engages, in the course of its activities, in non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage.[26]

In this respect, the proposals provide for the concept of a "non-genuine arrangement", overlaid with an "essential purpose" concept, combined with a "transactional approach", meaning that the definition of a "non-genuine arrangement" differs even from that included in the GAAR. The Draft Directive seems to be nervously skating

19. Art. 7(1) Draft Directive.
20. Art. 7(2) Draft Directive.
21. Art. 7(3) Draft Directive.
22. Council Directive 2015/121 of 27 January 2015 Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 21/1 (28 Jan. 2015), EU Law IBFD.
23. LU: Law Concerning Fiscal Adaptation (*Steueranpassungsgesetz*), sec. 6.
24. Available at http://www.oecd.org/tax/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report-9789264241152-en.htm.
25. Art. 8(1) Draft Directive.
26. Art. 8(2) Draft Directive.

around the *Cadbury Schweppes* (Case C-196/04)[27] standard of limiting any restrictions on intra-EU establishment to "wholly artificial" structures.

The commentary on the December Draft Directive states that: "limiting this (CFC) provision to third countries, as foreseen in the Italian presidency's compromise text, seems to be the most suitable outcome in the framework of this directive […]" as otherwise "[…] the legal drafting of the CFC rules would become very complicated". Indeed, drafting CFC rules that would apply in an EU context is hardly consistent with EU law unless the strict interpretation of the ECJ is considered.

It is further troubling that the proposed CFC rule does not provide for any mechanism to avoid double taxation. Hence, in a chain of companies it is possible that the same income will be taxed two or more times. These issues and potential measures to provide relief to taxpayers have already been addressed in the 2015 BEPS Report on BEPS Action 3.

6.2. Potential impact on Luxembourg tax law

As of today, Luxembourg tax law does not provide for any CFC rules and it is questionable why Luxembourg should implement such rules. Income from subsidiaries that come within the scope of the CFC rules should be taxable upon receipt.

In the authors' view, Member States should be free to choose whether or not they want to implement CFC rules. This view seems to be shared by the OECD and G20 in that they decided not to establish minimum standards on CFC rules. Instead, the 2015 BEPS Report on BEPS Action 3 includes guidance that should be followed by participating countries, but only if they decide to implement CFC rules.

In a tax treaty context, CFC rules become problematic, as there are differing views as to whether they are contrary to the bilateral obligations assumed under a standard tax treaty. In addition, the administration of such a rule would be resource intensive at the level of the taxpayer, as well as the tax authorities. In light of the above, CFC rules should not be applicable in an EU context (given the restrictions imposed by EU law) and should be optional when it comes to investment in third states.

Both CFC rules and the switch-over rules broadly target the same situations. While the switch-over clause would apply in respect of dividends that are paid, the CFC rules would only be triggered the moment income is recognized for Luxembourg tax purposes. The adoption of both rules would require complicated provisions in order to avoid double taxation at the moment CFC income is distributed. In addition, the CFC rule and the switch-over clause may result in the shifting of business activities to those European Member States that feature the lowest corporate tax rates. This is because these rules would apply when income realized by a (direct or indirect) subsidiary is subject to tax at a rate that is lower than 40% of the tax rate that would have been levied in the Member State in which the parent company is resident.

7. Framework To Tackle Hybrid Mismatches

7.1. Draft Directive proposals

The aim of the last measure is to eliminate double non-taxation created through the use of certain hybrid instruments or entities. Hybrid mismatch arrangements are also addressed in the BEPS Action 2 Final Report.[28]

As far as hybrid entities are concerned, the proposal provides that if two Member States qualify the same taxpayer (including its PE) differently from a legal perspective, such that this qualification leads to either a deduction of payments, expenses or losses at the level of the two Member States or to a deduction in one Member State with no inclusion in the other Member State, the legal qualification given by the source country (the country in which the payment is sourced, the expenses incurred or the losses suffered) has to be followed and is binding on the other Member States.[29]

As far as hybrid instruments are concerned, the proposal states that the legal qualification of the instrument in the source jurisdiction of the payment made will be determinative and binding on the country of the other Member States involved in the mismatch. This means that if the source jurisdiction considers that the instrument is a debt instrument, the payment made under this instrument will qualify as interest both at the source level and at the resident state level as well.[30]

7.2. Potential impact on Luxembourg tax law

In accordance with the amended Parent-Subsidiary Directive (2014/86),[31] Luxembourg implemented a rule according to which dividend income is only tax exempt under the participation exemption regime to the extent that the payment was not deductible at the level of the distributing subsidiary. Hence, the rule targeting hybrid financing instruments should have no scope of application.

Moreover, as regards the classification of entities resident in other EU Member States, entities listed in the Appendix to article 2 of the Parent-Subsidiary Directive (2011/96) are treated as opaque for Luxembourg tax purposes. All other entities should be classified on a case-by-case basis as either a partnership[32] or a company[33] through the application of a corporate-resemblance test. In the EU context, however, the number of potential hybrid mismatches should be extremely limited.

27. UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, ECJ Case Law IBFD.
28. Available at http://www.oecd.org/tax/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm.
29. Art. 10 Draft Directive.
30. *Id*.
31. Parent-Subsidiary Directive (2014): Council Directive 2014/86/EU of 8 July 2014 Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 219 (2014), EU Law IBFD.
32. A partnership is treated as transparent for Luxembourg tax purposes.
33. A company is treated as opaque for Luxembourg tax purposes.

8. Conclusions

At this stage of the procedure, even though there is a clear political will to implement BEPS measures in a coherent and coordinated manner in order to, as the Commission says, avoid "national policy clashes, distortions and tax obstacles in the EU", one should keep in mind that the Member States will have to agree unanimously on all aspects of the proposal before it can become a final directive.

The Draft Directive could be seen by many Member States as invasive in terms of national sovereignty, as it goes far beyond previous tax directives. Moreover, whereas previous directives sought to reduce tax barriers to cross-border business within the European Union by eliminating barriers and discrimination, the Draft Directive seeks to impose a common tax system on all EU Member States in the areas mentioned herein, justifying this on the grounds that it is necessary for the functioning of the internal market.

This justification, frankly, looks thin. If one were to apply the "essential purpose" test proposed in the Draft Directive, would a reasonable man conclude that the essential purpose of the package was (1) tax harmonization and enhancing revenue in the European Union or (2) improving the functioning of the internal market?

The proposals in the Draft Directive are clearly inspired by existing provisions generally found in high-tax jurisdictions, such as Germany, France and Italy. These rules, however, would mean Europe drifting towards being a high-spending, high-taxing area through the mitigation of tax competition within the European Union, which the Commission itself recognizes as important. In addition, when you add to this the aggressive stance of the EU Commission towards multinational businesses, the EU risks losing its competitive edge on the global stage.

Once agreed by all Member States, the Draft Directive will have to be implemented into the national tax laws of all Member States. The proposal currently does not include any information on a timeline for such implementation, although the Commission has indicated in its covering communication that it believes that it can achieve early agreement.

Since the European Commission proposes principle-based rules, leaving it to the Member States to define the details of implementation, it is questionable whether the objective of having a coherent implementation of BEPS measures at the EU level will be met. Ultimately, there is still a long way to go before these rules will become the new European standard.