Executive summary


What is clear is that the future implementation of all or parts of the ATA Directive in its current form, or as amended, will have a significant impact on the taxation of cross-border financial services businesses and could represent a step change in European corporate taxation. A broad range of structures involving reverse hybrids, EU holding and financing companies and branches, among others, might be affected by the proposals, but the precise impact will depend on the exact legal structure and jurisdictional footprint of a business. This Alert focuses on the core provisions included in the ATA Directive and two Commission recommendations on tax treaty abuse and looks at how they might affect businesses across the financial sector.
The ATA Directive has a stated aim of providing a common framework for implementing the Organisation for Economic Co-operation and Development’s (OECD’s) base erosion and profit shifting (BEPS) final recommendations and adopting solutions that work for the internal market as a whole. The Commission’s thinking in this regard is influenced by its June 2015 Action Plan on taxation and in particular, appears to draw on its proposal for a Common Consolidated Corporate Tax Base (CCCTB) and so differs in a number of respects from the OECD BEPS outputs.

It should be noted that, at this stage, the ATA Directive remains in draft form, and unanimous agreement of all EU Member States will be required before it can be implemented. Although there appears to be strong political pressure for an ATA Directive among Member States, it is quite possible that the form of the final ATA Directive will differ significantly from the current draft and the timetable set for agreement by July 2016 may not be met.

**Detailed discussion**

The proposed ATA Directive follows the 8 December 2015 conclusions of the Economic and Financial Affairs Council of the European Union (ECOFIN) regarding corporate taxation and BEPS.

In the 8 December conclusions, ECOFIN directed the Commission to present a legislative proposal regarding the EU-wide implementation of OECD BEPS Actions 2 (hybrid mismatches), 3 (Controlled Foreign Company [CFC] rules), 4 (interest limitation rules), 6 (treaty abuse — general anti-abuse rule) and 7 (permanent establishment [PE] status).

In the explanatory memorandum to the ATA Directive, the Commission explains that it aims to achieve a balance between the need for a certain degree of uniformity in implementing the BEPS outputs across the EU and Member States’ needs to accommodate the special features of their tax systems within the new rules. The text of the ATA Directive therefore sets out principle-based rules and leaves the details of their implementation to the Member States. In that regard, Member States may choose to implement measures that go above and beyond those set out in the Directive; in effect, it represents a set of minimum standards.

The ATA Directive is intended to be broadly inclusive by capturing all taxpayers that are subject to corporate tax in a Member State, which includes PEs situated in the EU of corporate taxpayers that are not themselves subject to the ATA Directive. As a general rule, the provisions, summarized below, are intended to apply to the financial services sector in the same manner as other EU groups.

**Interest deductibility**

The ATA Directive confirms that its aim is to provide a fixed level of minimum protection to Member States, and an entity-by-entity limit on borrowing costs of 30% of taxable earnings before interest, taxes, depreciation and amortization (EBITDA), or €1m, if higher, subject to countries being able to introduce an override if a taxpayer can demonstrate that its equity to total assets ratio is no more than two percentage points lower than the equivalent group ratio. The ATA Directive opts for an equity-based group test rather than a group interest to EBITDA ratio test, which is also permitted under the BEPS Action 4 recommendation. Moreover, the OECD report was issued as a “best practices” recommendation, meaning that countries are free to assess and pick from the elements of each of these BEPS Actions that are most suited to their current tax regime and tax competitiveness strategy. In this regard, a uniform application of a set rate (i.e., which Member States must apply, without choice) differs from the OECD recommendation.

The banking and insurance industry will be particularly concerned at conclusions that appear to have been drawn by the Commission regarding the need for specific interest deductibility restrictions for financial undertakings. The definition of financial undertakings, which encompasses regulated banking, insurance and asset management activities, specifically excludes captive insurance being insurance within a non-insurance group. Both the banking and insurance sectors have been making the case for some time that while they would generally be expected to be net recipients of interest and, therefore, not be within the scope of the general rule, this does not mean that there is any justification for any special rules to be applied to banks and insurers.

This is primarily on the basis that the banking and insurance sectors are subject to stringent regulation governing the format, composition and quantum of capital and funding. The mix of capital and funding for these businesses is subject to regulatory approval and consequently these sectors are restricted in comparison to other sectors as to their use of interest for tax planning purposes.
While the OECD and some Member States (such as the UK) appear still to be considering this point, the ATA Directive concludes that such special rules will definitely be required, although it observes that discussions in this field are not yet sufficiently conclusive in the international and EU context to agree the form of the final rules.

In its current form, the ATA Directive includes both UCITS funds (Undertakings for Collective Investment in Transferable Securities Directive) and alternative investment funds under the Alternative Investment Fund Managers Directive within the scope of the definition of financial undertakings and, as such, these funds are currently scoped out of the interest limitation rules.

This is welcome given that interest deductibility rules designed for corporate groups outside of the financial services area could result in unsatisfactory outcomes in the context of investment structures that utilize debt, such as infrastructure and real estate funds.

Exit taxation

The ATA Directive proposes an exit tax to be levied on assets in a range of specific circumstances (including company migration, transfers from a head office to a PE or on a transfer of assets out from a PE) subject to an ability to pay in installments over at least five years for transfers within the European Economic Area (EEA). The issue of exit taxation may be particularly relevant where financial services groups choose to move their assets and functions in light of their ongoing response to regulatory driven structural reform, the OECD BEPS outputs or the ATA Directive itself. Given the exempt status of major European fund vehicles, it is not expected that these provisions impact fund reorganizations or redomicilations.

“Switch-over” clause

A “switch-over” clause contained in the ATA Directive would have the effect that distributions, capital gains on shares and branch income derived from territories outside the EU, whose statutory tax rate is lower than 40% of the rate that would have been charged in the recipient Member State, would be required to be taxed in the recipient Member State (with a deduction for tax paid in the third country) rather than being exempt. This is a radical proposal given that many EU countries allow the repatriation of dividends and capital gains from a low tax or no tax subsidiary on an exempt basis, with many of these jurisdictions operating CFC rules that enable them to tax overseas profits indirectly, depending on the nature of the income.

Financial services businesses with operations in the EU will often hold subsidiaries and branches located in low tax jurisdictions via one or more EU-based operating or holding companies for a range of commercial and regulatory reasons.

Overall, the introduction of such a novel and significant change to the EU corporate taxation system could require financial services groups to reconsider whether some of their current corporate structures operate effectively.

There is potential for these rules to impact corporate investors in funds, for example a UK corporate taxpayer invested in a corporate fund established in a low tax jurisdiction may ordinarily benefit from an exemption from corporate tax on dividends received from the fund. The current drafting of the “switch-over” clause in the ATA Directive would appear not to allow for such an exemption.

CFCs

The CFC provisions contained in the ATA Directive would impose a charge on undistributed profits of controlled non-listed entities that are subject to taxation at an effective rate lower than 40% of the equivalent effective rate in the controlling Member State, where the entity principally receives financial income (e.g., interest), royalties, dividends, leasing income, certain real estate income, income from insurance, banking and other financial activities, and intragroup service income. Where triggered, such a CFC charge would be an “all-or-nothing” charge on all of the relevant entity’s non-distributed income, including income not within the above categories. The reference to non-distributed income defines the boundary with income taxed under the “switch-over” clause above.

A charge would not arise in relation to a CFC within the EEA unless the establishment of the entity in question was “wholly artificial” or the entity engages in non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage. Arrangements would be regarded as non-genuine to the extent that the entity would not own the assets or would not have undertaken the risks if it were not controlled by a company where the relevant significant people functions are carried out.
The financial services sector as a whole will welcome the inclusion of an exemption for CFCs which are financial undertakings located in the EU and EEA or EU PEs of those undertakings, although the drafting of the relevant provisions is not as clear as it could be. The notes to the ATA Directive provide that the scope for a legitimate application of CFC rules within the EU should be limited to artificial situations without economic substance that “would imply that the heavily regulated financial and insurance sectors would be unlikely to be captured by these rules.”

Where the CFC is a financial undertaking outside the EEA, the CFC rules would apply only if more than 50% of the entity’s income in the above categories comes from group transactions. This would appear to be the case even where the financial undertaking has commensurate substance and the arrangements are not “artificial” or “non-genuine.” The measurement of intragroup income is not clarified, but in the banking context the rules could, for example, impact on a non-EEA subsidiary such as an “offshore deposit taker” that raises deposits from third parties but lends the funds raised largely intragroup.

As outlined above, the definition of a “financial undertaking” includes an insurance undertaking and a reinsurance undertaking, both of which are defined in accordance with the EU Solvency II Directive. This may be seen as a positive outcome, as it ensures alignment with the regulatory position of EU insurers. However, the CFC provisions could benefit from greater clarity as to whether the meaning of financial undertaking includes all entities falling within Solvency II group supervision rules.

References to the specific definitions provided by the EU Solvency II Directive implicitly exclude captive insurers, being insurers within a non-insurance group, which are separately defined under the Solvency II Directive. Therefore, captive insurers would not fall within the definition of a financial undertaking and should therefore fall within the scope of the CFC provisions. Distinguishing between captive insurance in a non-insurance group vs. intragroup reinsurance in a regulated insurance group is consistent with the OECD BEPS Action 3 report and current domestic law of some EU countries, such as the UK.

A questions-and-answers document was also released on 28 January relating to the anti-tax avoidance package. This contains examples that seek to illustrate how the proposed anti-avoidance measures will help to prevent tax avoidance.

The example relating to the CFC provisions is an insurance company with headquarters in an EU Member State that sets up a reinsurance company as a subsidiary in a no tax third country, presumably outside the EU. The example states that the insurance company makes inflated premium payments to the offshore reinsurance company, which are taxed at the third country’s zero tax rate. The example concludes that, under the proposed CFC rule, the EU Member State can tax the insurance company’s profits as though they had not been shifted to the no-tax country.

It is not clear how this scenario could practically occur, given that the pricing of such an arrangement should be subject to the updated OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations that all EU Member States have agreed to implement. In addition, regulatory restrictions should prevent such inflated premium payments from being made by an insurance company to an offshore reinsurer outside of the EU. It is therefore not clear whether the inclusion of this example was an oversight or if the intention was to present the facts in a different manner.

**Hybrid mismatch provisions**

The ATA Directive includes hybrid mismatch provisions that would require the legal characterization of a hybrid instrument or entity in a Member State to follow its characterization in the Member State where the payment, expense or loss arises. This provision only applies to mismatches between Member States at this stage, with a brief note in the explanatory materials observing that mismatches between Member States and third countries still need to be further examined.

The rules differ significantly from the OECD proposals. While at a high level the two sets of rules both target double deduction and deduction/no inclusion outcomes, they diverge both in how they identify and how they counteract such an outcome. The Action 2 final recommendations do not focus on the legal characterization of entities or instruments. So, for example, while the Action 2 version of a hybrid financial instrument rule focuses on whether a payment under that instrument is expected to give rise to a mismatch in tax outcomes and whether that mismatch is attributable to differences in the way the instrument is taxed in the relevant jurisdictions, its ATA Directive equivalent looks only to the legal status of the payments made under the instrument.
The OECD Action 2 recommendations are that the “primary” response in a deduction/no inclusion scenario is that the source jurisdiction should deny the deduction. The ATA Directive suggests the opposite – that the recipient state should subject the payment to tax.

Banks and insurers will be concerned that the hybrid mismatch provisions do not, in their current form, include any form of regulatory capital carve out. The final report on Action 2 observes that countries remain free in their policy choices as to whether the hybrid mismatch rules should be applied to mismatches that arise under intragroup hybrid regulatory capital. The two sectors have argued that regulatory oversight provides an objective measure of how much (potentially deductible) additional tier one and tier two capital a bank or insurer might be expected to need. For this reason, they have argued that regulatory capital that conforms to the requirements of the relevant regulator should not be subject to the proposed hybrid mismatch rules.

Furthermore, the anti-hybrid rule in the ATA Directive does not contain any form of carve out for financial traders generally nor for capital market transactions, such as stock lending and repos. As such, hybrid mismatches arising in both scenarios described seem likely to be within the scope of the proposed hybrid mismatch rules. This is a specific area where the recommendations within the final Action 2 report were identified as provisional and potentially subject to refinement in September 2015. The OECD is continuing to explore with interested parties whether this inclusion raises questions about the operability of the rules and the impact on the capital market. Bank and insurers will be very concerned that the Commission’s proposals are capable of giving rise to a significant distortion in the EU capital markets.

**General Anti-Abuse Rule**

The ATA Directive proposes a general anti-abuse rule (GAAR) that would target non-genuine arrangements or a series thereof carried out for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions. This follows the embedding of a GAAR into the Parent-Subsidiary Directive, which Member States were required to have transposed into national legislation by 31 December 2015. The form of the GAAR might be familiar in many EU jurisdictions that have abuse of rights concepts applicable to tax law but may differ markedly if they do not. An example would be the UK’s GAAR (put in place after a detailed and lengthy consultation) that operates quite differently.

**Tax treaty abuse**

Separately, the Commission issued two recommendations to Member States that address the implementation of measures against tax treaty abuse. In the first recommendation, which concerns the PE definition, the Commission asks the Member States to adhere to the new proposed provisions to Article 5 of the OECD Model Tax Convention in their upcoming negotiations on tax treaties with other Member States or third countries. The second recommendation looks at anti-abuse rules and requests that Member States modify a treaty GAAR based on a principal purpose test (PPT) as follows (changes in bold).

“Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that it reflects a genuine economic activity or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.”

Given the volume of public comments on the granting of treaty benefits to investment funds, it is disappointing that the Commission did not take this opportunity to mandate a consistent and positive treatment of investment funds (in particular what the OECD refer to as Collective Investment Vehicles (CIVs)) under any Limitation on Benefits rules or PPTs Member States might adopt in response to OECD BEPS Action 6. Non-CIVs that employ holding company structures are more likely to be affected by the PPT, and there is no guidance in the recommendation on what is constituted by genuine economic activity. Understanding this will be key for non-CIVs that are considering their operating model going forward.

**Impact**

Financial services businesses may want to carefully monitor these developments and consider how the proposals might affect their particular sector and consider whether it would be worthwhile to engage with local policymakers to ensure their input is considered as the proposals move forward.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP (United Kingdom), London**
- Richard J Milnes +44 20 7951 7750 rmilnes@uk.ey.com
- Jenny Coletta +44 20 7951 5993 jcoletta@uk.ey.com
- Stuart Chalcraft +44 20 7951 1190 schalcraft@uk.ey.com
- Tom Passingham +44 20 7951 2846 tpassingham@uk.ey.com

**Ernst & Young AG, Zurich**
- Ralf Eckert +41 58 286 3559 ralf.eckert@ch.ey.com
- Thomas Brotzer +41 58 286 3412 thomas.brotzer@ch.ey.com

**Ernst & Young Tax Consultants SCCRL / BCVBA, Brussels**
- Stijn Vanoppen +32 2 774 9794 stijn.vanoppen@be.ey.com

**Ernst & Young Société d’Avocats, Paris**
- Loubna Lemaire +33 1 55 61 13 44 loubna lemaire@ey-avocats.com

**Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft, Frankfurt**
- Petar Groseta +49 6196 996 24509 petar.groseta@de.ey.com

**Ernst & Young (Ireland), Dublin**
- Donal O’Sullivan +353 1 2212 455 donal.osullivan@ie.ey.com

**Studio Legale Tributario in association with Ernst & Young, Milan**
- Marco Ragusa +39 02 851 4926 marco.ragusa@it.ey.com

**Ernst & Young TAX Sarl, Luxembourg City**
- Dietmar Klos +352 42 124 7282 dietmar.klos@lu.ey.com

**Ernst & Young Belastingadviseurs LLP, Amsterdam**
- Silvain Niekel +31 88 40 71675 silvain.niekel@nl.ey.com

**Ernst & Young, S.A., Lisbon**
- Nuno Bastos +351 21 791 2069 nuno.bastos@pt.ey.com

**Ernst & Young Abogados, Madrid**
- Adolfo Zunzunegui Ruano +34 91 572 7889 adolfo.zunzuneguiruano@es.ey.com

**Ernst & Young LLP, EMEIA FSO Desk, New York**
- Miles Humphrey +1 212 773 1425 miles.humphrey@ey.com
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