EU adopts linking rule for hybrid loans under Parent-Subsidiary Directive

Executive summary
On 20 June 2014, the European Union’s Economic and Financial Affairs Council (ECOFIN) reached political agreement on a proposed amendment to the Parent-Subsidiary Directive (PSD). This amendment is targeted at cross-border hybrid loans and aims at neutralizing international mismatches that may arise due to international qualification differences of such loans. It is anticipated that the Member States implement the amendments in their domestic tax laws by 31 December 2015 at the latest.

Detailed discussion
The PSD aims at removing double taxation in the case of profit distributions made by a subsidiary located in one Member State and received by its parent located in another Member State. To this end, the Member State where the parent company is located should provide relief for double taxation, either by exempting the received distribution from taxation, or by allowing a deduction of the foreign underlying profit tax from the parent’s own corporate tax liability.

The European Commission found that the exemption method provided for under the PSD could give rise to non-taxation in the case of hybrid loans where, based on a difference in the qualification of the loan, the remuneration is treated as a deductible expense in the subsidiary state whereas the remuneration is treated as a tax-exempt profit distribution in the parent state. To that end, the Commission released a stakeholders’ consultation on 27 March 2013. This consultation provided for two possible amendments of the PSD:

- Option A: payments of distributed profits which are deductible in the source Member State would be excluded from the benefits of the PSD; or
- Option B: payments of distributed profits which are deductible in the source Member State would be excluded from the benefits of the tax exemption in the Member State of the parent.
On 25 November 2013, the European Commission released its proposal to amend the PSD, in which the second option was followed. The essential elements of this proposal were the following:

- A linking rule that should deal with hybrid loan arrangements;
- A more detailed general anti-abuse rule (GAAR).

Under the proposed linking rule, the Member State where the parent company is located would no longer be allowed to exempt distributed profits to the extent that such profits are not deductible by the subsidiary of the parent company.

The proposal was supported by the European Economic and Social Committee on 25 March 2014 and by the European Parliament during a vote on the amendments to the PSD on 2 April 2014. However, since several Member States raised concerns about the proposed GAAR, it was subsequently decided to split the proposal.

Further, the Council agreed to split the agreement from the broader proposal of the introduction of a common anti-abuse rule in order to allow early adoption of the new rule on hybrid loans.

Implications

The amendment must be seen in the light of the Action Plan against tax evasion and tax fraud released by the European Commission in December 2012 and the OECD project on Base Erosion and Profit Shifting. While the Member States are required to apply the linking rule only to situations that fall under the scope of the PSD, they are free to decide to give the new rule broader application. It is anticipated that the Member State implement the amendments in their domestic tax laws by 31 December 2015 at the latest.

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