European Commission proposes amendments to Parent-Subsidiary Directive by introducing anti-hybrid clause and general anti-abuse provision

On 25 November 2013, the European Commission (the Commission) issued a proposal (the Proposal) for an amendment to the EU Parent-Subsidiary Directive (the Directive). The essential elements of the Proposal are (i) a “linking rule” that is supposed to deal with hybrid loan arrangements and (ii) a more detailed general anti-abuse rule (GAAR).

The proposed rule to deal with hybrid loans follows the 2012 Commission public consultation on double non-taxation that focused on hybrid mismatch arrangements. Such arrangements are also covered by the current OECD work on “Base Erosion and Profit Shifting” (BEPS) and similar initiatives of the EU Code of Conduct group. The OECD Action Plan on BEPS sets out two possible ways to deal with hybrid loans that would both link the tax treatment in one country to the tax treatment in another and can therefore be referred to as “linking rules.” Accordingly, the payor country could deny the deduction if the yield was not taxed in the recipient country or the recipient country could refuse to grant an exemption if the payor was able to obtain a tax deduction. The Commission proposes the second option. According to the Proposal, the Member State where the recipient is resident should “refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary of the parent company.”

Contrary to statements made in the explanatory memorandum to the Proposal, the wording of the proposed amendment does, in fact, not specifically require the recipient’s residence country to actually tax the payment. Therefore, it seems that
the proposed amendment would only allow Member States to not apply the exemption foreseen in the Directive where they chose to do so. Granting an exemption even though the payment was deductible for the subsidiary might in itself not be contrary to the Proposal. This is in line with other provisions of the Directive, such as the minimum shareholding threshold that is required for the exemption, where some Member States decided to apply a more favorable approach by granting the exemption to shareholdings even below the minimum threshold foreseen in the Directive. The suggestion for the introduction of a more detailed and harmonized GAAR follows the announcement in the 2012 “Action Plan to strengthen the fight against tax fraud and tax evasion.”

The current Directive contains a very brief anti-abuse clause that allows Member States to apply their own domestic or treaty-based anti-abuse provisions. This was felt to potentially lead to unclarity and confusion. The Commission hopes that a harmonized GAAR would lead to more efficiency of anti-abuse measures taken at national level. Under the amended anti-abuse rule, the benefits of the Directive would not apply in the case of “an artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of obtaining an improper tax advantage under this directive and which defeats the object, spirit and purpose of the tax provisions invoked.”

According to the Proposal, “a transaction, scheme, action, operation, agreement, understanding, promise, or undertaking is an artificial arrangement or a part of an artificial series of arrangements where it does not reflect economic reality.” Such arrangements would be considered artificial where they involve one or more of the following situations:

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

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

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

(d) the transactions concluded are circular in nature;

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

This amendment appears to merely codify the principles that were developed by the Court of Justice of the EU over time. Since currently Member States are authorized to apply their domestic anti-abuse rules, the proposed GAAR would be an improvement as it would hopefully result in more uniform application of anti-abuse rules within the EU.

If adopted in its current form, Member States would have time until 31 December 2014 to amend their laws. However, as mentioned above both amendments do not limit Member States in their taxation rights. Member States must implement limitations to their domestic tax laws, but may go beyond the requirements of the Directive. Therefore, it seems that a Member State could choose to not implement the GAAR and/or the linking rule, without this being considered a violation of the Directive. Nevertheless, in the current political situation most Member States will likely implement the GAAR and/or the linking rule if not yet foreseen in their current legislation. Furthermore, the question arises whether the European Commission could force the Member States to implement the amendments based on the concept of EU loyalty. However, even then taxpayers should be able to rely on their more generous local legislation until the amendments are actually implemented.
Endnotes

3. Hybrid loans are financial instruments that are treated as debt in one country and as equity in the other country, possibly resulting in the payor of the interest obtaining a tax deduction and the income being considered a tax-exempt dividend in the hands of the recipient.
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