Q&A on the entry into force of the Anti-Tax Avoidance Directive

Some companies exploit the differences in Member States’ rules to minimise their tax bills by shifting profits within the EU. Aggressive tax planners also abuse weaknesses in one national system, or the absence of anti-avoidance measures in one Member State, to escape being taxed anywhere in the Single Market. Effective taxation is therefore heavily dependent on close coordination between Member States, to shut off opportunities for tax avoidance and prevent profit shifting in the Single Market.

The new rules will ensure that all Member States implement coordinated measures against tax avoidance, to boost their collective defences against aggressive tax planning. It also sets out a common approach to tackling external threats of tax avoidance and to help prevent companies from shifting untaxed profits out of the EU.

What anti-avoidance measures are contained in the new Directive and how will they help to prevent tax avoidance?

The Anti Tax Avoidance Directive sets out five key anti-avoidance measures, which all Member States should apply, to counter-act some of the most common types of aggressive tax planning, as identified in the discussions at the OECD, in Council discussions on tax avoidance and by the Commission itself. Three of the agreed measures come into force on 1 January 2019. These are:

a) Controlled Foreign Company (CFC) rule: To deter profit shifting to no or low tax countries

Multinational companies sometimes shift profits from their parent company in a high tax country to controlled subsidiaries in low or no tax countries, in order to reduce the Group’s tax liability. The proposed Controlled Foreign Company (CFC) rule should discourage them from doing this.

The CFC rule will ensure that the Member State where the parent company is located will tax certain profits that the company parks in a no or low tax country. The CFC rule will be triggered if the tax paid in the third country is less than half of that which would have been paid in the Member State in question. The company will be given a tax credit for any taxes that it did pay abroad. This will ensure that profits are effectively taxed, at the tax rate of the Member State in which they were generated.

Example*: A company has its headquarters in an EU Member State. It sets up a subsidiary in a non-EU country that does not apply corporate tax. This subsidiary does not carry out substantive activities relating to this income. The company makes inflated royalty payments to the offshore company, thereby reducing its taxable profits in the EU Member State. The payments the subsidiary receives are not taxed either, because of the zero rate in the non-EU country.*

With the proposed CFC rule, the EU Member State will tax the subsidiary's profits as though they had not been shifted to the no-tax country, thereby ensuring effective taxation at the tax rate of the Member State concerned.

b) Interest Limitation: To discourage companies from creating artificial debt arrangements designed to minimise taxes

Interest payments are generally tax deductible in the EU. Some companies arrange their inter-company loans so that their debt is based in one of the group's companies in a high-tax country where interest payments can be deducted. Meanwhile, the interest on the debt is paid to the group's "lender" company which is based in a low tax country where interest is taxed at a low rate (or not at all). In this way, the Group reduces its overall tax burden. Overall, the group has paid less tax by shifting its profits in loan arrangements between its companies.

The Directive proposes to limit the amount of net interest that a company can deduct from its taxable income, based on a fixed ratio of its earnings. This should make it less attractive for companies to artificially shift debt in order to minimise their taxes. Member States may choose to apply this rule only to companies which are part of a group, as standalone companies are not likely to use debt to shift profits.

The interest limitation rule includes an optional grandfathering rule, which means that Member States may exclude debt in place prior to 17 June 2016 from the scope of the rule, as they may for interest used to fund long-term public infrastructure projects. Member States which have equally efficient rules will be allowed to continue with those rules until the OECD recommends a minimum standard of interest limitation rules or at the latest by 1 January 2024.

Example: *A Group sets up a subsidiary in a no-tax third country, which then provides a high-interest loan to another company in the group, located in an EU Member State. The EU-based company must make high interest payments – which are tax deductible – to the subsidiary. In doing so, it reduces its taxable income in the Member State, while the corresponding interest income is not taxed in the third country either.*

Under the interest limitation rule, the Member State will put a fixed limit on the amount of interest that the company can deduct. This should discourage companies from shifting their debts purely to reduce their tax bills.

c) General Anti-Abuse Rule: To counter-act aggressive tax planning when other rules do not apply

Aggressive tax planning, by its nature, seeks ways around the rules in order to minimise the taxes a company has to pay. Aggressive tax planners continually try to find ways of by-passing anti avoidance provisions or new tax avoidance techniques that are not covered by specific rules.

The Directive sets out a General Anti-Abuse Rule, which will tackle abusive tax arrangements if there is no other anti-avoidance rule that specifically covers such an arrangement. The GAAR acts as a safety net in cases where other anti-abuse provisions cannot be applied. It will allow tax authorities to ignore abusive tax arrangements and tax on the basis of the real economic substance.

Further rules governing hybrid mismatches to prevent companies from exploiting mismatches in the tax laws of two different EU countries in order to avoid taxation, as well as measures to ensure that gains on assets such as intellectual property moved from a Member State’s territory become taxable in that country (exit taxation rules) will come into force as of 1 January 2020.