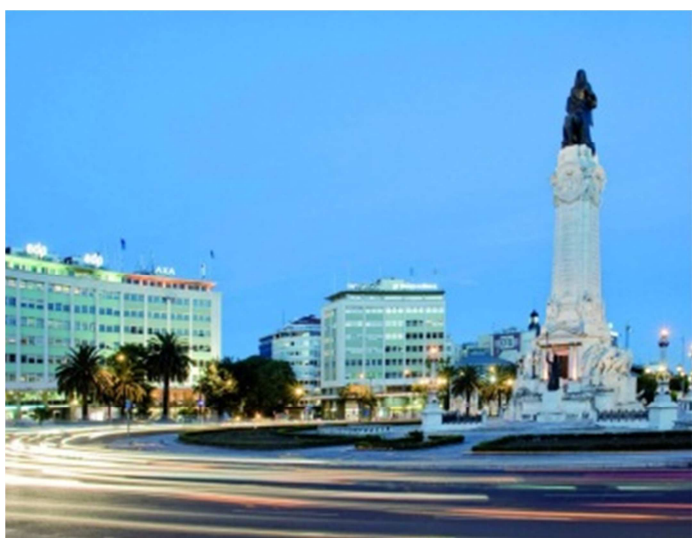


## ANTI TAX AVOIDANCE DIRECTIVE



## TAX &amp; BUSINESS



This Information is intended for general distribution to clients and colleagues and the information contained herein is provided as a general and abstract overview. It should not be used as a basis on which to make decisions and professional legal advice should be sought for specific cases. The contents of this Information may not be reproduced, in whole or in part, without the express consent of the author. If you should require further information on this topic, please contact [contact@rfflawyers.com](mailto:contact@rfflawyers.com).

\*\*\*

This Information is sent in compliance with articles 22 and 23 of Decree-Law no 7/2004, of 7 January, regarding unsolicited e-mails. If you wish to be removed from our mailing list and avoid similar future communications, please send an email with "Remove" to the email address [newsletter@rffadvogados.com](mailto:newsletter@rffadvogados.com).

## INTRODUCTION

The EU formally adopted a Council Directive, the so called Anti Tax Avoidance Directive, which lays down rules against tax avoidance practices that directly affect the functioning of the internal market. By transposing the OECD's recommendations made in the BEPS project into a legally binding instrument the EU goes further than the OECD approach. The Directive introduces legally binding provisions, without prejudice to provisions allowing for higher levels of protections for the domestic corporate tax base, addressing, in particular, five key areas of (international) direct taxation: interest limitation rules, exit taxation rules, general anti-abuse rule (GAAR), controlled foreign company (CFC) rules, rules on hybrid mismatches. These will have an impact on not only the domestic law, that will need, in part, to be accordingly amended, but also the international tax landscape.

## BACKGROUND

On July 12, the Economic and Financial Affairs Council (ECOFIN) formally adopted a Council Directive, the so called Anti Tax Avoidance (ATA) Directive, which lays down rules against tax avoidance practices that directly affect the functioning of the internal market. This Directive is part of a 'Anti Tax Avoidance Package' and was drafted in the context of both the BEPS project, headed by the G20/OECD, and the European Union's (EU) Action Plan on Corporate Taxation. However, by transposing the OECD's recommendations into a legally binding instrument the EU goes further than the OECD approach.

The Directive echoes concerns that were expressed and analyzed within the BEPS Actions. Within the EU these have been framed by the European Commission as ensuring that companies pay their fair share of tax, thus embodying a similar spirit to the OECD's proposals, namely of ensuring the effective taxation of companies, aligning the place of taxation with the place where the profits are

obtained, further tax transparency and addressing the risk of double taxation. It is seen as a stepping stone to the EU Common Consolidated Corporate Tax Base (CCCTB), on which work is underway with the goal of relaunching a proposal until the end of 2016.

The Directive introduces legally binding provisions, without prejudice to provisions allowing for higher levels of protections for the domestic corporate tax base, addressing, in particular, five key areas of (international) direct taxation:

- i) interest limitation rules;
- ii) exit taxation rules;
- iii) general anti-abuse rule (GAAR);
- iv) controlled foreign company (CFC) rules; and
- v) rules on hybrid mismatches.

## INTEREST LIMITATION RULES

This provision applies to entities that are not financial undertakings and allows for the deduction of borrowing costs when a taxpayer



receives interest or other taxable revenues from financial assets. However, it further introduces a limitation based on 30% of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). The Member States may allow the exceeding amount of the net interest expense to be carried forward without a time limitation, or up to five tax periods or yet to allow the carry forward and back for maximum of 3 years.

The taxpayer may yet fully deduct exceeding borrowing costs when the ratio of its equity over its total assets is equal or higher than the equivalent ratio of the group, where a ratio that is lower in less than 2% will be deemed equivalent to the ratio of the group, and all assets and liabilities are valued using the same method. Alternatively, the taxpayer may deduct exceeding borrowing costs, with the limit being based on i) the group ratio divided by the exceeding borrowing costs of the group vis-à-vis third parties over the group's EBITDA, and the multiplication of the group ratio by the EBITDA.

Thus, according to the Council of the EU, the directive sets out to discourage this particular kind of base erosion and profit shifting by limiting the amount of interest that the taxpayer is entitled to deduct in a tax year.

The Portuguese domestic law reflects, in part, some of the aspects of the Directive, namely the single entity ratio and the ability to carry forward the exceeding amount of the net interest expense for five years – but not the group ratio exception. There is detailed optional regime applicable to groups, but access to such group deduction regime will likely need to be amended to restrict access to the situations provided for in the Directive.

## 1. EXIT TAXATION RULES

The Directive gives, in part, body rulings from the Court of Justice of the European Union (CJEU), such as *National Grid Indus*, *N* and several *Commission* cases. At the same time, it seeks to harmonize exit taxation practices throughout the EU.

It provides that exit shall be assessed in the Member State of origin, having regard to the difference between the market value of the transferred assets, which shall be accepted by the transferor Member State, thus stepping up the value in the destination country, and their tax value.

Exit taxation shall happen, in particular, every time there is:

- i) a transfer of assets from a taxpayer's head office to its permanent establishment in another Member State or in a third country insofar as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer;
- ii) a transfer of assets from a taxpayer's permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country insofar as the Member State of the permanent establishment no longer

has the right to tax the transferred assets due to the transfer;

- iii) a transfer of tax residence by a taxpayer of a Member State to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State;
- iv) a transfer of business carried on by its permanent establishment from a Member State to another Member State or to a third country insofar as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer.

Furthermore, broadly in line with the latest CJEU rulings, taxpayers shall be allowed to defer the payment of an exit tax, by paying it in installments of over five years, without prejudice to guarantees against demonstrable and actual risk of non-recovery, when the transfers occurs to a Member State of the EU



or EEA. The deferral would, however, be interrupted in case the transferred assets are disposed of, transferred to a non-EU Member State, or in case the taxpayer goes bankrupt or is wound up.

The provision introduced by the Directive should have minimal effect to the current framework, as the optional taxation throughout five years is already in place, as is the trigger of taxation in scenarios provided for in the Directive.

The domestic law also demands that a guarantee is in case of *fundado receio* – *reasoned or grounded concern or fear*, loosely translate to English. That expression is different from Directive's expression, *risco demonstrável e real* – *demonstrable and actual risk*, in the English version. If the provision is not accordingly amended, we anticipate some legal discussion about this expression, which is an expression traditionally used throughout the Portuguese legal system.

## 2. GENERAL ANTI-ABUSE RULE

The Directive seeks to target non-genuine arrangements or series of arrangements that are carried out for the *main* purpose of obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions. A non-genuine arrangement is one that was not put in place for valid commercial reasons and, thus, deviates from the economic reality.

Portugal has had a general anti-abuse rule in its domestic law, in its current form, since 2001. In most cases, Portuguese courts, in a greater number rulings by the Tax Arbitration Courts, adopted the *fraus legis* theory, whereby they required the purpose of the legislator or the tax system to be defeated, in addition to the four requirements traditionally presented by the CJEU. That is, the result element, the means element, the intellectual element and the normative-systematic element.

It appears that there is not a significant difference between the Directive's provision and the Portuguese provision and, therefore, we do not expect any noticeable impact in this regard, with the exception that, from now on, some of the terms and expressions used in the Portuguese domestic tax law will become EU law, of which the CJEU is the ultimate interpreter.

The general anti-abuse rule introduced by the Directive is not expected to affect the various specific anti-abuse rules that exist in the domestic law (as some are derived from this or other Directives).

### 3. CONTROLLED FOREIGN COMPANY (CFC) RULES

The Directive requires Member States to introduce CFC regulations that are applicable to non-distributed income of an entity, or a permanent establishment of which the profits are not subject to tax or are exempt from tax in that Member State, when certain conditions are met, namely:

- i) the taxpayer, by itself or together with associated enterprises, directly or indirectly holds more than 50% of the capital or the voting rights, or is entitled to receive more than 50% of the profits of that entity; and
- ii) the income earned by the foreign entity is subject to an *actual* corporate tax lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.

When the CFC rule is triggered and an entity or permanent establishment encompassed by the rule, the taxpayer shall include in the tax base the non-distributed income of, namely, the following categories: interest, dividends and income from disposal of shares, royalties, income from financial leasing, income from banking and insurance activities and income from services rendered to the taxpayer or



associated enterprises, which add little or no economic value.

The Directive further provides, in a similar way to the CJEU's ruling in *Cadbury Schweppes* that the CFC provision shall only apply when non-genuine arrangements, which have been put in place for the *essential* purpose of obtaining a tax advantage, are at stake (a language and reasoning akin to the GAAR).

Furthermore, the Directive dictates that the attribution of controlled foreign company income shall be calculated in accordance with the arm's length principle.

Particularly, where the entity engages in non-genuine arrangements, the income to be included in the tax base of the controlling company shall be limited to amounts generated through assets and risks which are linked to significant people's functions, which is a concept from the Authorized OECD Approach for the attribution of profits to permanent establishments, carried out by the controlling company.

The Portuguese tax law already has in place a CFC regime. It coincides, in some aspects, with the text of the Directive, such as the amount of direct or indirect participation through capital ownership or voting rights. Moreover, the special term *effective* will need to be reflected in the domestic tax law, with a yet unclear implication, which will need to be addressed case by case.

However, the domestic law does not concern itself in such detail with income falling within certain types of categories, as the Directive does. It does have certain other – not entirely coinciding – activity related requirements. Therefore, we expect the need for some amendments to the domestic provision, in this regard.

The Portuguese domestic law on CFC does not pay particular attention to the special application of regulations concerning transfer pricing and attribution of profit to permanent establishments. However, these do exist. The

Directive clarifies that they must apply in these scenarios.

Because this intersects deeply with regulations (and guidelines) concerning transfer pricing and the attribution of profits to permanent establishments, we should highlight that the expression 'significant people's functions' is the center piece of the so called Authorized OECD Approach, which is not thoroughly applied in Portugal (and is sparingly applied even in other OECD countries).

As this language is being 'imported' to EU law, we expect that some legal discussion will arise and that the CJEU will eventually rule on what does that expression means, and, particularly, if it as the same meaning provided as in the OECD. If that is the case, that would mean a profound and burdensome change, for both the taxpayer and the tax authorities, in how such income computed.

#### 4. RULES ON HYBRID MISMATCHES

The relevant Directive provision addresses a long lasting issue that was also heavily targeted in the BEPS project. It refers to circumstances where a taxpayer would, essentially, legally take advantage of conflicts of qualification, either of an entity (e.g. one country characterizing an entity as transparent and another as opaque) or of a payment (e.g. one country characterizing as dividend and another as interest).

In short, the Directive dictates that, in case of a hybrid mismatch, only the Member State of source should provide a deduction, so as to prevent a double deduction; however, if the hybrid mismatch results in a deduction without inclusion (in the other Member State), then the Member State of the payer will deny the deduction,

The Portuguese domestic tax law will need to be amended to comply with this provision.



#### TIMELINE OF APPLICATION

The Anti Tax Avoidance Directive shall be transposed into the Member States' legal system until 31/12/2018, with the exception of the exit taxation rules, which shall be transposed until 31/12/2019

Lisbon, 20<sup>th</sup> of July, 2016

Rogério M. Fernandes Ferreira

Jorge Lopes de Sousa