PROPOSAL FOR A COUNCIL DIRECTIVE LAYING DOWN RULES AGAINST TAX AVOIDANCE PRACTICES THAT DIRECTLY AFFECT THE FUNCTIONING OF THE INTERNAL MARKET (COM (2016) 26)

Implementing Ministry	Ministry for Finance (MFIN)	
Participating Ministries	N/A	
Originating Department / Entity	Office of the Commissioner for Revenue, MFIN	
Approvals	[Chairman, Inter-Ministerial Committee for European Union Affairs and Permanent Representative to the EU]	Permanent Secretary, Ministry for Finance (MFIN)
Copy	Director EU Affairs, Ministry for Finance (MFIN)	
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Signature	Minister for Finance	

1 Background

The European Council Conclusions of 18 December 2014 cite "an urgent need to advance efforts in the fight against tax avoidance and aggressive tax planning, both at the global and European Union (EU) levels". Since December 2014, the Commission has quickly launched the first steps towards an EU approach. Meanwhile, the Organisation for Economic Cooperation and Development (OECD) finalised its work on defining the global rules and standards to these ends.

This Directive, which is often referred to as the Anti- Tax Avoidance Directive, lays down rules against tax avoidance practices that directly affect the functioning of the internal market. It is one of the constituent parts of the Commission's Anti- Tax Avoidance Package, which addresses a number of important new developments and political priorities in corporate taxation that require quick reaction at EU level. In particular, it responds to the finalisation of the project against Base Erosion and Profit Shifting (BEPS) by the G20 and the OECD as well as to demands from the European Parliament, several Member States, businesses and civil society, and certain international partners for a stronger and more coherent EU approach against corporate tax abuse.

The schemes targeted by this Directive involve situations where taxpayers act against the actual purpose of the law, taking advantage of disparities between national tax systems to reduce their tax bill. Taxpayers may benefit from low tax rates or double deductions or ensure that their income remains untaxed by making it deductible in one jurisdiction whilst not being included in the tax base across the border either. The outcome of such situations distorts business decisions in the internal market and unless it is effectively tackled, could create an environment of unfair tax competition. Having the aim of combating tax avoidance practices which directly affect the functioning of the internal market, this Directive lays down anti-tax avoidance rules in six specific fields: deductibility of interest; exit taxation; a switch-over clause; a general anti-abuse rule (GAAR); controlled foreign company (CFC) rules; and a framework to tackle hybrid mismatches.

The Directive is broadly inclusive and aims to capture all taxpayers which are subject to corporate tax in a Member State. Its scope also embraces permanent establishments, situated in the Union, of corporate taxpayers which are not themselves subject to the Directive.

- The deductibility of interest

Multinational groups often finance group entities in high-tax jurisdictions through debt and arrange that these companies pay back 'inflated' interest to subsidiaries resident in low-tax jurisdictions. In this way, the tax base of the group (or more precisely, of the entities paying out 'inflated' interest) decreases in the high-tax jurisdictions whilst it increases in the low-tax State where the interest payment is received. Overall, the outcome is a reduced tax base for the multinational group as a whole.

The aim of the proposed rule is to discourage the above practice by limiting the amount of interest that the taxpayer is entitled to deduct in a tax year. In this way, it is also expected to

mitigate the bias against equity financing. For this purpose, net interest expenses will only be deductible up to a fixed ratio based on the taxpayer's gross operating profit. Given that this Directive fixes a minimum level of protection for the internal market, it is envisaged setting the rate for deductibility at the top of the scale (10 to 30%) recommended by the OECD. Member States may then introduce stricter rules.

Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. This is chiefly because, contrary to other sectors of the economy, financial costs and revenues are incurred by, or accrue to, financial undertakings as part of their core trade. Given that the discussions in this field are not yet sufficiently conclusive in the international and Union context, it has not yet been possible to provide for specific rules in the financial and insurance sectors. It is however necessary to clarify that despite the temporary exclusion of these financial undertakings, the intention is to ultimately conclude an interest limitation rule of broad scope which is not subject to exceptions.

- Exit taxation

Taxpayers may try to reduce their tax bill by moving their tax residence and/or assets to a low-tax jurisdiction. Such practices distort the market because they erode the tax base of the State of departure and shift future profits to be subject to tax in the low-tax jurisdiction of destination. If taxpayers move their tax residence out of a certain Member State, this State will be deprived of its future right to tax revenues of these taxpayers, which may have already been created but not yet realised. The same complication arises where taxpayers transfer assets (without disposing of them) out of a Member State and those assets incorporate unrealised profits.

Exit taxation serves the purpose of preventing tax base erosion in the State of origin when assets which incorporate unrealised underlying gains are transferred, without a change of ownership, out of the taxing jurisdiction of that State. As the application of exit taxation within the Union shall be in line with the fundamental freedoms and in line with the case law of the Court of Justice of the European Union (CJEU), this Directive also addresses the EU law angle of exit taxation by giving taxpayers the option for deferring the payment of the amount of tax over a certain number of years and settling through staggered payments.

- A switch-over clause

Given the inherent difficulties in giving credit relief for taxes paid abroad, States tend to increasingly exempt foreign income from taxation. The unintended negative effect of this approach is that it may encourage untaxed or low-taxed income to enter the internal market and then, circulate – in many cases, untaxed - within the Union, making use of available instruments within the Union law.

Switch-over clauses are commonly used against such practices. Namely, the taxpayer is subjected to taxation (instead of being exempt) and given a credit for tax paid abroad. In this

way, companies are discouraged from shifting profits out of high-tax jurisdictions towards low-tax territories, unless there is sufficient business justification for these transfers.

The threshold of low taxation

In its proposal for a Directive on a CCCTB[1], the Commission introduced a switch-over clause to capture situations where the income flowing into the internal market from a third country had been subject to a tax on profits in the third country at a statutory corporate tax rate lower than 40 percent of the average of statutory corporate tax rates in the Union. This rule would ensure that income of a third-country origin enters the Union after having been taxed at a level which at least equals the lowest level of taxation that this payment would have been subject to had it originated in a Member State. For this purpose, the proposal for a CCCTB refers, as a comparator, to the average of statutory corporate tax rates in the Union.

Considering that this Directive does not establish a standalone corporate tax system, neither does it include a mechanism for consolidating the tax bases of group companies across the Union in such a way as under the proposal for a CCCTB, it would be logical to use, as a reference, the statutory corporate tax rate in the Member State of the taxpayer receiving the foreign income – at least, until the plans to re-launch the CCCTB materialise, as announced by the Commission.

The proposed scheme takes into account the fact that there is no harmonisation of corporate tax rates in the Union. In order to target tax avoidance practices, the threshold should, in any event, be set to capture situations where taxation is at a level below 50 percent as compared to the State of the recipient taxpayer. Yet, neither should the threshold be fixed so low as to deprive the measure of any meaning by capturing only the most aggressive tax jurisdictions. In this light, a test whereby the statutory corporate tax rate in the entity's country of residence or the country in which the permanent establishment is situated is lower than 40 percent of the statutory corporate tax rate in the Member State of the taxpayer would strike a balance between recognising the scope for fair tax competition and the need to prevent tax avoidance practices.

Furthermore, by applying the switch-over clause, income of a third-country origin that flows into the Union would be taxed by the Member State of the taxpayer at the same level as income of a domestic origin, which would ensure equal treatment between Union and third-country origin payments. In this way, Member States would remain compliant with their undertaken obligations under both European and international law.

- A general anti-abuse rule (GAAR)

Tax planning schemes are very elaborate and tax legislation does not usually evolve fast enough in order to include all necessary specific defences to tackle such schemes. This is why a GAAR

[1] The Maltese Parliament submitted a Reasoned Opinion challenging this proposal for a Directive. The Maltese Parliament, together with many other national Parliaments, felt that the proposal went against the principle of subsidiarity enshrined in the EU Treaties.

is useful in a tax system; it thus allows abusive tax practices to be captured despite the absence of a specific anti- tax avoidance rule.

The GAAR is designed to cover gaps that may exist in a country's specific anti-abuse rules against tax avoidance. It would allow authorities the power to deny taxpayers the benefit of abusive tax arrangements. In compliance with the *acquis*, the proposed GAAR is designed to reflect the artificiality tests of the CJEU where this is applied within the Union.

- Controlled foreign company (CFC) rules

Taxpayers with controlled subsidiaries in low-tax jurisdictions may engage in tax planning practices whereby they shift large amounts of profits out of the (highly-taxed) parent company towards subsidiaries which are subject to low taxation. The effect is to reduce the overall tax liability of the group. The analysis above about the threshold of low taxation is also valid for CFC rules.

The income shifted to the subsidiary is usually mobile passive income. For example, a common scheme would consist of first transferring, within a group, the ownership of intangible assets (e.g. IP) to the CFC and as a second step, shifting large amounts of income in the form of royalty payments in consideration for the right to use the assets owned and managed by the CFC. The functioning of the internal market is clearly affected by such practices of profit shifting, primarily where the income is shifted out of the EU towards low-tax third countries.

CFC rules re-attribute the income of a low-taxed controlled foreign subsidiary to its parent company. As a result of this, the parent company is charged to tax on this income in its State of residence – usually, this is a high-tax State. CFC legislation, therefore, aims to eradicate the incentive of shifting income, so that this is taxed at a low rate in another jurisdiction.

- A framework to tackle hybrid mismatches

Hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities when two legal systems interact. Such mismatches may often lead to double deductions (i.e. deduction on both sides of the border) or a deduction of the income on one side of the border without its inclusion on the other side. Taxpayers, especially those engaged in cross-border structures, often take advantage of such disparities amongst national tax systems and reduce their overall tax liability in the Union.

This problem has been explored by both the Group of the Code of Conduct on Business Taxation and the OECD. In order to ensure that Member States introduce rules to effectively combat against these mismatches, this Directive prescribes that the legal characterisation given to a hybrid instrument or entity by the Member State where a payment, expense or loss, as the case may be, originates shall be followed by the other Member State which is involved in the mismatch.

2 Legal basis

2.1 Basic Treaties

Article 115 of the Treaty on the Functioning of the EU

2.2 European Parliament's involvement in decision-making procedure

2.2.1 Consultation procedure: The Council, acting unanimously on a Proposal from the Commission after consulting the European Parliament.

.2.3 Majority required in Council

2.3.1 Unanimity

3 Subsidiarity

3.1 In this context, Government proposes that Parliament submits a reasoned opinion to the Presidents of the European Parliament, the Council and the Commission, in line with the provisions of Article 6 of Protocol 2 on the Application of the Principles of Subsidiarity and Proportionality annexed to the Treaty of Lisbon. A draft reasoned opinion for the consideration of Parliament's Standing Committee on Foreign and European Affairs is attached.

4 Government's position

4.1 Government's position on the dossier in concrete terms

The following is the consolidated position of the Ministries concerned (Implementing: Ministry for Finance] with regard to the Proposal for a council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

4.1.1 The Government is still studying in detail this proposal, and whilst it is ready to engage in further discussions, there are certain areas which require a thorough analysis first.The Government expresses its disappointment that the proposal is not accompanied by an Impact Assessment. The Government feels that the reasons put forward by the Commission for not conducting an Impact Assessment, do not justify such approach. The Maltese authorities would like to recall the European Council Conclusions on Competitiveness of 19 February where it stated that: *The focus must be on: a strong commitment to regulatory simplification and burden reduction, including through withdrawal or repeal of legislation where appropriate,* ***and a better use of impact assessment and ex-post evaluation throughout the legislative cycle,*** *at the EU and national levels.*

Despite the European Council's clear statement in favour of using an impact assessment as well as ex-post evaluation of legislation, the Commission has decided to go against both these principles by (a) not preparing an impact assessment, and (b) not including any ex-post evaluation article in its proposal.

Furthermore, the Maltese authorities would like to emphasise the following points:

- The 2015 OECD 2015 deliverables were flexible and did not seek to lump everything into a one-size-fits-all minimum standard as the proposed Directive does (other elements are even beyond OECD work [e.g.; Switch-over clause; exit tax]
- Incongruities with national tax codes of Member States (especially non-OECD been considered) have not been considered;
- The pace of action in other leading global jurisdictions such as the US, Switzerland, Japan, Singapore and Hong Kong, has not been assessed when it is amply clear that the EU competes in a global environment;
- The proposal forces a common standard, despite the EU being a heterogenous block. The fact that we are a single market is no counterargument in this respect because economic realities of Member States differ, and this is purposely why the Treaties are framed the way they are (with no harmonising provisions for direct taxation);
- The OECD deliverables leave an element of latitude in their suggested implementation, and this should be retained;.
- The proposal is based on Art. 115 of the TFEU – on the approximation of laws for the functioning of the internal market. Within this context, it is therefore not clear why purely domestic scenarios should be covered (eg; Interest limitation rules). Evidently, there is no Base Erosion Profit Shifting (BEPS) risk there, nor risks for the functioning of the internal market. Those aspects are particularly in contempt of the subsidiarity principle enshrined in the Treaties;
- Finally, the Government considers it as particularly important that the provisions fully respect primary EU law as interpreted by the ECJ and not try to deviate from settled case law. (eg; on GAAR and CFC legislation intra-EU) .

Article 4 ***Interest Limitation Rule***

The Government understands that the aim of such limitation rules is that of solving the root cause explained in Para 7 of OECD Action 4 - the problem is caused because tax deductibility of interest in many tax systems is allowed even when it has no direct link to income and is independent from the income-producing activity it relates to. The tax benefit is given either to the item of interest itself or via the creation of trade losses which can then also be possibly shifted through group taxation or fiscal unity regimes. The Government is still analysing the impact of this proposal, but as it stands, the rule presents major problems for the Government. The Government sees a major inconsistency with our principle of deductibility, and this applies

across the board not only to interest. Article 4(1) of the proposed Directive starts with the wrong underlying assumption with our system. Under Maltese tax legislation, interest deduction may *only* be given where the interest cost is wholly and exclusively incurred in the production of the relevant income. The rule requires a *direct link* between the expense, and the income. If the expense is not generating income (e.g.; interest on loan to finance an idle business asset or say an investment which yields no or exempt income), the benefit of the deduction is automatically lost. One can't simply use this against "other income" as the Box 1 examples in OECD Action 4 (Page16) automatically assume.

This principle of deductibility applies across the board (all types of expenses, and not just interest). In the 7 ATP structures referred to in the CION SWD to the Corporate Tax package taken from the Ramboll Study, it can also be seen by reference to the first three structures with respect to interest for example. These three Holding Companies are incurring expenses in connection with their investment they made in the subsidiaries. Such expenses can only be deductible against income this investment generates (dividends), but not against any other income the Holding Companies may have.

Therefore, the deduction is already restricted and consequently, there is no reason to further restrict this.

The OECD Action 4 report assesses the desirable features of the suggested "best practice approach" in the light of the advantages and disadvantages of other different rules (See point 11 of the said Action 4 report), but we have not managed to find throughout the report an assessment of such "*in the production of income*" a rule. Having this proposed rule on top of what we have would be an overkill. We fail to see why we should unravel these rules when they have the same objective. After all, even the OECD Action 4 (Point 31) requires countries to take into account the specific features of the general tax system.

At this stage, therefore, the only way forward is of having a <u>conditional</u> carve out before the application of paragraphs 1-6 of Article 4 of the proposed Directive on the lines of: "*Where the tax deductibility of borrowing costs is not solely allowed to the extent that it is wholly and exclusively incurred in the production of income, the following provisions shall apply:*".

Article 5 Exit Taxation

The proposal constitutes an imposition to tax which the Maltese authorities find as inappropriate for inclusion in an international tax instrument. In particular:

- The Maltese authorities do not see why they should introduce such taxation if we do not need it and considers this to be another measure towards harmonisation without any respect for the principle of subsidiarity;

- The Maltese authorities is not convinced that this is an anti-abuse measure (the OECD BEPS Project did not include it) but more of a "budgetary" one and consequently we do not see why it should be included in an anti-abuse Directive;
- It is a rather blunt instrument that hits *bona fide* cases and abusive one alike;
- The Maltese authorities require assurances that this proposal is in line with EU legislation;
- Exit taxes will make the EU as a whole a less attractive economic bloc.

Article 6 Switch-Over Clause

This is another home grown element suggested by the Commission.

The Explanatory Memorandum refers to "sufficient business justification for the transfers", but there does not appear to be any substance test in the rule and the rule seems to target both passive as well as active income, especially considering its application to third country PE profits.

The Maltese authorities feels that a toolbox of options as worked upon in the Code of Conduct (CoC) group is preferable to the rigid approach proposed here, as this is also taking a different route to the 2010 CoC guidance. Participation Exemption systems would need to be switched-off in certain instances, but this does not necessary have to follow a single test.

The interrelation with the relevant provisions found in Malta's Double Taxation Agreements is not clear.

Considering that both this, and CFC rules (Arts. 8 & 9), are not OECD minimum standards, Malta considers it appropriate that the impact of these rules (including their cumulative effect) are carefully studied first, especially in connection with the need to safeguard the competitiveness of the EU and of its Member States.

Article 7 GAAR (General Anti-Abuse Rule)

The Government can generally support a GAAR to be inserted in the Directive on the lines proposed by the Commission.

In connection with para 1, however, the Maltese authorities call for a reference to "*having regard to all relevant facts and circumstances*".

The proportionality of anti-abuse measures, which is settled ECJ case law, ought to be characterised by their non-mechanical application and with the taxpayer being given the opportunity to provide evidence of any commercial justification. For this purpose, the Maltese authorities consider that such reference would strengthen the legality of this rule by highlighting its proportionate application.

In connection with paragraph 3 and in particular the reference to *"the tax liability shall be calculated by reference to economic substance in accordance with national law"*, the Maltse authorities hold that ignoring the arrangement and simply referring to the fact that the tax liability would then be determined in accordance with national law would simplify the practical application of this rule.

Articles 8 and 9** CFC legislation **(Controlled Foreign Company Legislation)

The OECD Action 3 is not devised as a minimum standard and this also purposely to "reflect different policy choices" of countries (e.g. para 5 pg 13 Action 3).

As also recognised by the ECOFIN Resolution of 2010 in this area (on CFC rules); *EMPHASISING, furthermore, that the guiding principles are a political commitment, whose implementation is left to the decision of each Member State, and therefore affect neither the rights or the obligations of the Member States nor the respective competencies of the Member States and of the Union under the Treaty and, in particular, do not require Member States who do not have the types of rules referred to in this Resolution to introduce such rules*. As aforementioned, the Maltese authorities remain to be convinced that the application of these rules would make sense for all Member States in the EU, considering their different economic realities. Considering the latter, it will be even more difficult to come to an agreement on a one-size-fits all standard. The Maltese authorities feel that the suggested standard is one which harms Malta's national interest..

The Maltese authorities would therefore suggest the following argument to be made:

The application of CFC legislation intra-EU is already possible today, and we recognise other Member States` fiscal sovereignty to apply such anti-deferral rules.

In the suggested Article 8(2), however, the Maltese authorities have not heard any compelling grounds why the application of these rules, in intra-EEA situations, should go beyond the consistently established line by the ECJ on CFC legislation. For rules to be lawful, they must be proportionate and serve the specific purpose of preventing "*wholly artificial arrangements*". The second part of Art 8(2) seems to be alluding to some concept of partial artificiality, which the Government cannot support. (These ideas seem to have creeped-in following the inclusion of the points made in Pg 18 of OECD Action 3 and reputable tax academics have already written on these points. The passing reference to "*or in part*" in Thin Capitalisation Group Litigation Order case needs to be read in context. Here the "part" referred to the re-characterisation (of the related party loan) of the amount in excess of the arms-length portion, and different types of CFC rules in existence (whether entity based, transaction based etc) has no bearing on whether the CFC is an artificial construct or not. Trying to exploit a new

interpretation of what is an established* "wholly artificial arrangements" test on CFC rules is only intended to erode the importance of this test

(eg; * ECJ Cases on CFC post Cadbury Schweppes; the Commission Communication of 2007 on anti-abuse; the ECOFIN Resolution on CFC of 2010, etc)

The Commission text in fact ends 8(2) with; "*The attribution of controlled foreign company income shall be calculated in accordance with the arm's length principle*". Therefore the attribution of non-arms length portion has nothing to do with the artificial construct of the CFC.

For this reason, the Government suggests;

- deletion of the remaining part of Art8(2) first para which reads; -."...*or to the extent that .....advantage*"

- deletion of the 3rd para of Art8(2), which would then leave it up to MSs to define, under their own national rules, what is "wholly artificial". Given the ATAD is a principles based instrument, such approach better respects proportionality and subsidiarity principles and leaves flexibility to MSs to operate different types of CFC rules, as long as they seek to prevent "wholly artificial arrangements"

- deletion of the first sentence first sentence of 4th para of Art8(2).

On the other hand, the Government would be amenable to the idea of the ATAD having; either in this context of income & expenses attributed to the CFC, or even as a standalone article with general application, the principle of arms-length test being applied between associated enterprises. Inspiration can also be taken from the IRD wording. Recitals motivating such article could refer to wording of Criterion 4 of the CoC, Art9 of OECD based DTAs and the work of the JTPF done in this area, also in view of Action8-10 of the OECD BEPS package. We consider that re-affirming such principle in the ATAD is important and strengthens the tax authorities hand in applying their different national rules on anti-abuse.

The concept of effective corporate tax rate is used here rather than that of the statutory tax rate as in the case of the switch-over clause. The wording 'general regime', 'effective corporate tax rate' and 'effective tax rate' renders the text very ambiguous.

Finally, the term 'recognised stock exchanges' in the proposal needs clarification.

Article 10 Hybrid Mismatches

At this stage, the Government is still studying the new approach put forward by the Commission with an open mind.

Alternatively, putting into legislation the Code of Conduct Sub-group's work (as per the LU PRES) could be an option. Whilst the proper guidance can be reflected in the legal text, the accompanying Explanatory Notes could be referred to in the recitals of the ATAD (by way of a reference to this CoC work) as a source of interpretation to those articles. We find some

difficulty understanding why that work should now be disregarded when Member States (OECD & non-OECD members) were expected to engage in that process for the last years.

It needs to be clear whether 'legal characterisation' refers to legal characterisation for tax purposes. There is also ambiguity in the term used 'same payment (hybrid instrument), whether it is qualifying the payment or the instrument?

4.2 *Economic and financial repercussions of the dossier*

4.2.1 Government will be making an impact assessment that will determine the economic and financial repercussions of this dossier.

5 National Context

5.1 *Internal Consultations*

5.1.1 The International Tax Unit Ministry of Finance.

5.2 *External Consultations*

5.2.1 N/A.

5.3 *Related national legislation*

5.3.1 Income Tax Act (Cap. 123)

5.4 *Changes required in national legislation*

5.4.1 Extensive amendments to the Income Tax Act (Cap 123) will be needed to implement the proposed Directive.