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Subject:	Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) - Explanatory notes

Preliminary comments

This document explains the background behind the Presidency consolidated text of a possible split from the CCCTB proposal related to the international anti-BEPS aspects (doc. 14544/15 FISC 171) and the changes inserted compared to previous versions of the articles discussed in past WPTQ meetings.

As foreseen in its EU-BEPS Roadmap (doc. 10649/15 FISC 93), the Luxembourg Presidency wrapped up in a consolidated text (see chapter 2) the seven international anti-BEPS elements of the current CCCTB proposal that had been identified under the Italian Presidency and submitted so far to the WPTQ for technical examination (in particular definition of permanent establishment, CFC rules, switch-over clause, general anti-abuse rule, exit taxation, interest limitation and possibly hybrid mismatches). The drafting of these anti-BEPS measures was adjusted to the context of a split of the CCCTB directive with a view to further work in the Council on these issues.

The Presidency also adjusted accordingly the scope and definitions (chapter 1), as well as the final provisions (chapter 3). It is worth noting that the consolidated text does however neither provide drafting suggestions for possible recitals nor does it contain any Annexes. These will have to be specified at a later stage.

This consolidated text does however not prejudge on the positions of the individual delegations with regard to both the scope and content of the various provisions.

Article 1 (scope)

Most delegations were supportive of the fact that the directive also addresses intra-EU situations, not just third countries. In light of this, the Presidency chose not to include any geographical limits into Article 1. Instead, the Presidency considers useful covering a broad range of practices by corporate entities that directly affect the functioning of the internal market, irrespective of whether they concern or not a cross-border situation. In this respect, a possible terminology would be 'base erosion and profit shifting' (BEPS). This terminology could be complemented with appropriate recitals at a later stage, for instance making amongst others reference to the necessary link between taxation and where economic activity takes place.

The title of the directive would also have to be adjusted to the scope of this directive. A potentially conceivable title (instead of CCCTB) could be: "*Proposal for a Council directive laying down rules against base erosion and profit shifting (BEPS)*" and could also be complemented with appropriate references to the OECD BEPS recommendations in the recitals.

Article 2 (de minimis application)

The legal drafting of this provision, which caters for a general 'de minimis' approach applicable to all of the provisions of this directive, has been inspired by the former paragraph 4 of Article 5 (general anti-abuse rule) which was supported in the framework of this provision by most delegations. It was clarified that this article sets out ‘minimum standards’. This means that the directive would provide for minimum common anti-BEPS rules aimed at preventing taxpayers’ practices on the basis of OECD recommendations, but, more importantly, that Member States would be able to go beyond the minimum standards set out therein in their transposition of EU anti-BEPS rules and/or to continue applying their existing national anti-BEPS rules if such rules go beyond that minimum.

Article 3 (eligible corporate entities)

The text is based on the Italian Presidency compromise with only minimal adjustments. The reference to ‘company’ was replaced by ‘corporate entity’ for the purpose of covering the broadest range of entities (i.e. entities other than companies). Former Articles 2 (eligible companies) and 3 (eligible third country company forms) were merged into this new article, for simplification sake. Annexes I and II have not yet been included in the consolidated text but will need to be updated at a later stage. Member States will have the possibility to specify in the Annexes to which entity forms the prospective anti-BEPS should apply.

Article 4 (definitions)

This article gathers amongst others definitions that were specifically discussed in the context of various articles.

The following may be noted:

- the 'permanent establishment' (PE) definition derives from the Parent-Subsidiary Directive and replaces paragraphs 1 and 2 of former Article 5 (Article 6 of the consolidated text). It was put into brackets for the reasons explained under Article 6 below;

- the 'EBITDA' definition is new and replaces that of 'gross operating profit';
- the definition of 'person' is also new and aims at covering a broad range of taxpayers other than the taxpayers covered by this directive;
- a definition was provided for the concept of 'market value' for the purposes of Article 10;
- the definitions of 'borrowing costs', 'financial institutions' and 'insurance undertakings' have been taken out of the former Article 14a (Article 7 of the consolidated text);
- the definition of 'associated' person is new and based on the OECD definition of 'related' enterprise;
- the definition of 'closely related' person is taken out of the former Article 5 on permanent establishment (Article 6 of the consolidated text). It was put into brackets for the reasons explained under Article 6 below;
- the series of definitions related to hybrid mismatches was copied from the Code of Conduct Group's guidance notes, with only very minimal adjustments.

In light of the 'de minimis' application of the Directive, the terms not specifically defined in this Article shall have the meaning granted in the Member States' national laws.

Article 5 (General anti-abuse rule)

The consequence of ignoring an arrangement or series of arrangements is now explained in paragraph 3 only. The reference to the tax 'base' in paragraph 3 was replaced by a reference to the tax 'liability'.

The reference to applicable 'corporate' tax law in paragraph 1 was removed and replaced by 'tax law' in general. The specification that this provision caters for a 'de minimis' application formerly included in paragraph 4 was removed due to the general 'de minimis' application of the Directive referred to in Article 2 and so was the reference to 'economic substance' in paragraph 3.

Article 6 (Artificial avoidance of PE status)

Paragraphs 1 and 2 of the former Article 5 were removed and replaced by the PSD definition of 'permanent establishment' in Article 4 (see above), whilst the anti-BEPS rules included in the final OECD report on Action 7 on the artificial avoidance of the PE definition were maintained. The title of the current Article 6 was adjusted accordingly ('artificial avoidance' of PE status).

All provisions related to the 'permanent establishment' status (definition of ‘permanent establishment’ and ‘closely related’ person in Article 4 and anti-avoidance rules in Article 6) were however put into brackets given the doubts expressed by many delegations about the interaction of these proposed provisions with the foreseen OECD multilateral instrument (OECD BEPS Action 15) and with respect to their impact on Member States' bilateral double taxation agreements.

The head sentence of paragraph 1 ("*the following shall not be deemed to give rise to a permanent establishment*") was revised compared to former paragraph 3 in line with requests from several delegations to closely rely on the OECD recommendations in Action 7.

The definition of 'closely related' person in paragraph 7 of the former Article 5 was moved to Article 4 and at this occasion streamlined to fit within this Article.

A general reference to the OECD Commentary on the Multilateral Tax Convention (MTC) could be envisaged in the Recitals so that Member States could take them into account when transposing the anti-BEPS directive into national legislation. As mentioned at an earlier meeting, a possible model in this respect could be recital 13 of Council Directive 2014/107/EU ("DAC2").

Article 7 (Interest limitation rule)

The threshold figures under paragraph 2 (30% and EUR 1 million) were put into brackets and would have to be discussed at a later stage, also in the light of the 'de minimis' application of the whole Directive. In this context one may indeed understand these figures as maxima, with the possibility for Member States to be more restrictive.

Paragraph 3 was put into brackets to reflect the opposition of several delegations to this provision. It is worth noting that this provision is an option proposed by the OECD and is therefore as such not mandatory. In the context of a general 'de minimis' application, Member States would remain free to opt for this aspect of the interest limitation rule in the framework on a domestic implementation of the BEPS recommendations. The carry-forward was limited to 5 years.

No 'carry-back' rule was inserted since the latter gathered even less support.

The ‘group carve-out’ rule was put into brackets for the same reason as the 'carry-forward' rule in paragraph 3. The principle of including this provision into the directive as well as the overall approach (net interest/EBITDA or asset/equity-based test) will need to be discussed further. Should the insertion of this rule be confirmed, a definition of what is to be considered as a 'group' would need to be included into Article 4.

Article 8 (Switch-over clause)

Several delegations have requested to be able to apply either the switch-over clause (Article 8) or CFC rules (Article 9). The request for optionality will need to be examined further.

Switch-over clauses and CFC rules share indeed similar objectives: that is, to fight against profit shifting towards low-tax jurisdictions and use low statutory or effective taxation at source as the main criterion for application - which explains the similar legal drafting. Yet, despite these common features, they remain substantially different. In the case of the switch-over clause, the state of tax residence taxes income of a foreign source but this is still income that flows into its territory and is earned by one or more tax residents. In contrast, CFC legislation is more far-reaching because the state of tax residence effectively extends its jurisdiction to tax revenues earned by non-resident (controlled) companies in other jurisdictions. In other words: for the switch-over rule to apply, there must be a distribution, whilst CFC legislation actually intervenes to capture non-distributed income. In addition, while a switch-over rule aims at changing the method for relieving possible double taxation (switch from the more favourable exemption method to the less advantageous credit method), the CFC rule is an objective test aimed at repatriating income earned by a non-resident entity controlled by a resident taxpayer.

Even though OECD does not recommend to include any such switch-over clause as a measure to prevent BEPS, the Presidency therefore believes that there is value in inserting such a clause in the anti-BEPS directive as it would to a certain extent function as a complement to CFC legislation, covering participations falling below the 50% ownership of voting rights or capital or profit entitlement which set the requirements for triggering CFC rules.

The scope of former Article 73 (limited to third countries) was maintained. In addition, the former paragraph 3 was included into paragraph 1 as a condition for denying the exemption method.

The reference to exchange of information was adjusted to the context of the Global Standard on automatic exchange of information. In order to avoid a very limited application of the clause in the context of a widespread adoption of the latter, a reference to Directive 2011/16/EC (the DAC) "*as amended and currently in force*" was inserted, which would mean in practice that this provision would include the automatic exchange of tax rulings, once the latter enters into force.

As in the case of the interest limitation rule, the threshold figure under paragraph 1 (40%) was put into brackets and will have to be discussed at a later stage, also in the light of the 'de minimis' application of the whole directive.

The word ‘passive’ to qualify the eligible income was also put in brackets since the concept of passive income is not defined and will therefore need to be further discussed.

Article 9 (Controlled foreign companies)

As agreed previously and in line with OECD recommendations on BEPS Action 3:

- the economic control test was extended to indirect control (paragraph 1.a);
- a rule concerning the calculation of the amount of income to be attributed to each shareholder or controlling person by reference to both their proportion of ownership and their actual period of ownership or influence was inserted (paragraph 4);
- a rule referring to the rules of the Member State where the taxpayer is resident for computing the income to be attributed (paragraph 5) as well as a rule specifying the tax year when income is to be include (paragraph 6) have been inserted;

- a rule obliging Member States to give a credit for foreign taxes actually paid and to exempt dividends and gains from taxation in case of sale of the shareholding in the CFC was inserted to avoid double taxation (paragraphs 7 and 8);
- a rule limiting the offset of CFC losses was inserted (paragraph 9).

As in the case of the interest limitation rule and switch-over clause, the threshold figure under paragraph 1.b (40%) was put into brackets as well as the method for calculating the effective tax rate and will have to be discussed at a later stage, also in the light of the 'de minimis' application of the whole Directive.

Considering that most Member States currently using CFC rules[1] prefer a comparison in relative terms, the Presidency proposes to maintain the approach proposed under the Italian Presidency compromise. Only two Member States currently use a threshold defined in absolute terms to define low taxation.

With respect to the scope of application of the CFC rules, several delegations argued that they should also apply to intra-EU situations. In case where this provision would be drafted in a manner to also include intra-EU situations, it would however need to be shaped so as to be in line with the EU Treaties as well as the CJEU case law. This means that in case an entity approach would be chosen, the scope of the CFC would need to be limited to wholly artificial entities; in case a transactional approach would be chosen, the rule would need to be confined to non-genuine arrangements. Given that the existing national CFC rules use either the one or the other approach and in light of a ‘de minimis’ application of the directive, the legal drafting of the CFC rules would become very complicated. Therefore, limiting this provision to third countries, as foreseen in the Italian presidency’s compromise text, seems to be the most suitable outcome in the framework of this directive. This approach would leave to the discretion of the Member States to extend the CFC rule to intra-EU situations by choosing the approach and the conditions they consider appropriate in domestic law.

[1] According to the IBFD (European Taxation Handbook 2014), the following 12 Member States currently have CFC rules: Denmark, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Portugal, Spain, Sweden, and the United Kingdom.

Regarding CFCs resident in EEA countries, a carve-out from the CFC rule was added that is subject to the condition of automatic exchange of information. The reference to the conclusion of an agreement "with the European Union" would de facto further limit this provision to those third countries where such agreements have been concluded or where negotiations are on-going (Switzerland, Liechtenstein, San Marino, Andorra, and Monaco). As regards the reference to Directive 2011/16/EC (the DAC) "*as amended and currently in force*", it follows the same logic as for the switch-over clause.

Article 10 (exit taxation)

The reference to 'market value' and the 'value for tax purposes' of paragraph 1 which refers to the capital gains was left unchanged and a definition of 'market value' was included in Article 4 (see above), so was the reference to the recognition of the value in paragraph 6. This is in line with commitment of the Member States in the Council resolution of 2 December 2008 on coordinating exit taxation[2].

A number of delegations have requested that some drafting be added on dispute resolution, but this will require further technical examination. The same applies to the request by some delegations to add a reference to the internationally agreed "arm’s length principle".

The wording of paragraph 1.d was slightly adjusted to clarify that it is the business carried out and not the 'permanent establishment' itself that may be transferred.

The expression 'suspension' of the effects of the transfer in paragraph 2 has been replaced by the expression 'deferred payment' of tax. This option was maintained on the basis of the case law of the CJEU. The time limit of 5 years on the other hand was not mentioned by the Court and is a compromise proposal between those delegations who want to delete the provision and those who want to maintain it. The Presidency also adjusted the drafting of the beginning of the paragraph to clarify that Member States should have the discretion to grant a deferred the payment of taxes or a payment by instalments, not the taxpayers.

[2] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32008G1218(01)&from=EN.

As requested by some delegations, the drafting of subparagraphs a) to d) under paragraph 2 was also revised in order to add the condition of an agreement on the mutual assistance for the recovery of tax claims (equivalent to Directive 2010/24/EU) in all four cases. This also allowed the text to be streamlined.

Article 11 (Rules for determining the treatment of hybrid mismatches for tax purposes between Member States)

The rules proposed in the three paragraphs have been inspired by the guidance devised in the Code of Conduct and have been adapted to a hard law drafting. To this purpose the drafting of the rules had to be slightly streamlined/adjusted (e.g. replacement of 'should' by 'shall'). It is worth noting in this context that the use of the 'to the extent' approach does not create a legal problem since it is for instance also used in the general anti-abuse rule.

With respect to the legal drafting inspired by the soft law approach, the following is worth noting:

- CoC Group guidance: "Where as a result of a mismatch situation for two Member States, in relation to a hybrid entity (…) a double deduction would otherwise arise, then, for the purpose of preventing that double deduction, *the two Member States concerned should treat that entity as not being transparent*, (…) notwithstanding the treatment of that entity that would otherwise apply. A hybrid entity should be treated as being transparent or not being transparent, in accordance with this guidance and contrary to the treatment that would otherwise apply, *only to the extent that is necessary for the purpose of preventing a double deduction* (…) that would otherwise arise, and not for any other purpose."
- Draft Rule: "To the extent that a hybrid mismatch situation results in double deduction, the relevant Member States shall treat the hybrid entity as not being transparent."

Article 12 (Rules for determining the treatment of hybrid mismatches for tax purposes in cases involving third countries)

The rules proposed in the three paragraphs are a hard law transposition of the guidance notes currently under elaboration in the context of the subgroup of the Code of Conduct Group.

So far only a draft on hybrid entity mismatches involving third countries has been agreed, but a similar approach can presumably be followed for hybrid PE mismatches involving third countries.

Chapter III (final provisions)

The text of this chapter was adjusted on the basis of the previous chapters.

The provisions related to delegated and implementing acts have links to Articles 3 and possibly 7 (depending on the group carve-out rule for the interest limitation provisions).